SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: O. PETER SHERWOOD PART 49
Justice

CLUB ONE ACQUISITION CORP.,

Plaintiff,

-against-

GEORGE SARANTOS and ELAINE LONG,

Defendants.

KMGI, INC.,

Plaintiff-Intervenor.

INDEX NO. 650049/2012
MOTION DATE Sept. 19, 2013
MOTION SEQ. NO. 005
MOTION CAL. NO. ____

The following papers, numbered 1 to ____ were read on this motion for summary judgment.

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that the motion for summary judgment is decided in accordance with the accompanying decision and order.

Dated: September 30, 2013

O. PETER SHERWOOD, J.S.C.

Check one: ☐ FINAL DISPOSITION ☑ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

☐ SUBMIT ORDER/ JUDG. ☐ SETTLE ORDER/ JUDG.

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION PART 49

----------X

CLUB ONE ACQUISITION CORP.,

Plaintiff,

-against-

GEORGE SARANTOS and ELAINE LONG,

Defendants.

KMGI, INC.

Plaintiff-Intervenor.

----------X

DECISION AND ORDER

Index No. 650049/2012
Motion Seq. 005

O. PETER SHERWOOD, J.:

Plaintiff Club One Acquisition Corp. ("Club One") and Plaintiff-Intervenor KMGI, Inc. ("KMGI") move, pursuant to CPLR 3212, for summary judgment on parallel claims for a declaratory judgment declaring that a Final Arbitration Award in favor of defendants constitutes "Subordinated Indebtedness" under a Subordination Agreement entered into by Club One, defendants and the assignor of the Note now held by KMGI, and that the Subordination Agreement prohibits defendants from demanding payment of the Final Arbitration Award and that Club One is prohibited from making any payment to defendants.

I. Background

On February 24, 2007, Club One, owned by Dana Messina and Kyle Kirkland, and the defendants, George Sarantos and Elaine Long (the "Sellers" or "defendants") entered into an Agreement for Purchase and Sale of Stock ("Acquisition Agreement") pursuant to which defendants agreed to sell to Plaintiff the stock of Club One Casino, Inc., ("Club One Casino"). Under the terms of the Acquisition Agreement, Club One agreed to purchase Club One Casino for $27 million. As part of the transaction, Club One and the Sellers were obligated to calculate a Purchase Price Adjustment, reflecting certain adjustments related to changes in the balance sheet between the date of the agreement and the date of closing. Payment of the Purchase Price Adjustment was required "promptly after . . . resolution of any disagreements for which adjustments to the Purchase Price are permitted . . . ." Club One financed the acquisition with a loan from Fortress Value Recovery Fund

("Fortress"), as senior lender (the "Senior Indebtedness"), and pursuant to a Financing Agreement between Club One and Fortress, dated February 22, 2008 (the "Financing Agreement"). As will be discussed, Fortress assigned its interest in the loan to KMGI in April 2011.

Club One and Sellers also entered into a Seller Subordination Agreement, dated February 22, 2008 ("Subordination Agreement"), pursuant to which Sellers, as the Subordinated Creditors, agreed that certain of Club One's obligations arising out of or in connection with the Acquisition Agreement would be subordinated to the Senior Indebtedness and that, therefore, payment of such obligations could not be demanded by the Subordinated Creditors nor received from Club One unless and until the Senior Indebtedness was paid in full. Specifically, the Subordination Agreement provides in pertinent part that:

> [U]nless and until the Senior Indebtedness has been paid in full . . . (A) no Subordinated Creditor will take, demand or receive from Parent or any of its Subsidiaries [*i.e.*, Club One], and neither the Parent nor any of its Subsidiaries [*i.e.*, Club One] will make, give or permit . . . any payment of . . any part of the Subordinated Indebtedness . . . . (Subordination Agreement § 2(b)(2))

The Subordination Agreement further provides in pertinent part that:

> [U]nless and until the Senior Indebtedness has been paid in full . . . (B) no Subordinated Creditor will . . . exercise any of their rights or remedies with respect to the Subordinated Indebtedness, whether pursuant to any Subordinated Loan Document, at law or otherwise . . . . (Subordination Agreement § 2(b)(2))

In turn, the Subordination Agreement defines "Subordinated Indebtedness" as:

> [T]he . . . unpaid principal of and interest on the Subordinated Notes, and all other obligations and liabilities of the Parent or any of its Subsidiaries [*i.e.*, Club One] to the Subordinated Creditors . . . whether direct or indirect, absolute or contingent, due or to become due, or now existing or hereafter incurred, which may arise under, out of, or in connection with, this Agreement, the Subordinated Notes, or the Acquisition Agreement, in each case, whether on account of principal, interest, fees, indemnities, costs, expenses, or otherwise

> (including, without limitation, all fees and disbursements of counsel to the Subordinated Creditors that are required to be paid by the Parent or any of its Subsidiaries [*i.e.*, Club One] pursuant to the terms of the Subordinated Notes or any other Subordinated Loan Document).
> (Subordination Agreement § 1(b) [emphasis added]).

And lastly and most notably, Section 2(b)(2) of the Subordination Agreement provides:

> [s]o long as (x) no Default or Event of Default shall have occurred and be continuing and (y) the Parent and its Subsidiaries shall have Qualified Cash of not less than $500,000, in each case, both before and after giving effect to such payment, the Obligors may make and the Subordinated Creditors may accept (A) regularly scheduled payments of interest under the Subordinated Notes at a rate not to exceed 10% per annum (or such lesser rate as shall be the maximum rate allowable under applicable law) and (B) payments set forth in Section 3.5.1(a) and (f) of the Acquisition Agreement as and to the extent due and payable thereunder; and (ii) this Section 2(b)(2) shall not restrict the set off against or reduction in any amounts owing by the Obligors to the Subordinated Creditors under the Subordinated Notes against any indemnification or similar claims owing by the Subordinated Creditors to the Obligors under Section 11.1 of the Acquisition Agreement.

After Club One and the defendants were unable to agree on all issues relating to the sale and the Purchase Price Adjustment, the defendants submitted the dispute to binding arbitration in California pursuant to the terms of the Acquisition Agreement. On April 12, 2011, the defendants obtained an interim award against Club One ("Interim Award"). The arbitrator found that the Subordinated Creditors were entitled to receive a purchase price adjustment of $1,000,513 under the terms of the Acquisition Agreement. In his findings, the arbitrator called Kirkland and Messina's assertions regarding the Purchase Price Adjustment "simply not credible in light of [the] evidence"and found that they made "evasive and misleading statements . . . under oath" (Aaronson Affirm. Ex G p. 17). The arbitrator further criticized "questionable conduct in submitting a reengineered financial statement to [Fortress]" (*id.*). The arbitrator also held that the Subordinated Creditors were entitled to receive statutory pre-award interest, attorneys' fees, and costs and expenses. On April 22, 2011 Messina sent a letter to Fortress informing them of the result, but

stating that "we remain in good financial health despite this setback *and are current with all our obligations*." Aaronson Affirm. Ex. L [emphasis added].

In a subsequent interim award, dated June 27, 2011, the arbitrator specified that the Subordinated Creditors were entitled to approximately $300,000 in pre-award interest and approximately $650,000 for attorneys' fees, costs and expenses ("Subsequent Interim Award"). He also stated that the disputes that led to the arbitration "were the result of [Club One] asserting a counterclaim accusing [defendants] of fraudulent misrepresentation base upon which [Club One] demanded a reduction of the price they had paid for the casino" and not the amount due under the PSA (Aaronson Affirm., Ex. L, p. 3). In the April 12, 2011 interim award the arbitrator found that Sellers did not engage in any intentional misrepresentation and, in any event the Buyers could not have reasonably relied to its detriment upon any such misrepresentations

On June 27, 2011, counsel for Defendant Long informed Club One's counsel that absent timely payment of all sums due under the Final Award, Subordinated Creditor Long would file a "Petition to Confirm Arbitration" (*id.* Ex. O). On July 8, 2011, the arbitrator entered a final arbitration award awarding the $1,000,513 Purchase Price Adjustment as calculated by defendants as well as attorneys' fees, costs, and expenses (the "Arbitration Award").

On the day after the Final Arbitration Award was rendered, Messina sent an email to Fortress stating that "it is now imperative that our lenders issue a notice to us and the sellers enforcing the subordination language in our agreement" (Aaronson affirm. Ex. P). According to Fortress representative Kareem Benjamin, the letter was drafted by Messina and/or Kirkland, who "wanted [Fortress] to assert [their] rights under the Subordination Agreement" because they would be "precluded from making payments . . . on the seller financing" Perry affirm. Ex. 9 pgs. 41-45).

Fortress (as the senior secured lender) then advised the Subordinated Creditors that, pursuant to the Subordination Agreement, the Subordinated Creditors were barred from enforcing the Arbitration Award because the Award was subordinate to the Subordinated Indebtedness and the Senior Indebtedness had not yet been paid in full. In the letter dated, July 13, 2011, Fortress stated:

> Under the Subordination Agreement, "Subordinated Indebtedness" is expressly defined to include not just the principal and interest owing on the Subordinated Notes, but

> also all other obligations and liabilities of [Club One or its subsidiaries] to the Subordinated Creditors, including amounts that may arise under, out of, or in connection with the Acquisition Agreement. As a result, any Arbitration Award constitutes Subordinated Indebtedness.

Fortress further explained in its letter that "the commencement of any enforcement proceedings with respect to the Arbitration Award . . . will result in an immediate Event of Default" under the Financing Agreement. At this time, Club One ceased making interest payments under the Acquisition Agreement, although they had been making such payments prior to the Arbitration Award.

On September 26, 2011, defendants obtained from the Superior Court of the State of California, Fresno County, a judgment confirming the arbitration award (the "Judgment"). The Judgment, which reduced the Final Arbitration Award to a court-ordered judgment, awarded $994,816.50 to Defendant Long (plus statutory interest, at a rate of $272.55 per day) and $994,107.50 to Defendant Sarantos (plus statutory interest, at a rate of $277.35 per day [*i.e.*, 10%]). On January 4, 2012, counsel for Defendant Sarantos sent a letter to Club One's counsel indicating that the Subordinated Creditors had obtained from the court a "Writ of Execution" under California law and that they intended to execute on the Judgment in one week. Specifically, the letter states that the Subordinated Creditors intend to "have the Sheriff seize all money at the Club [*i.e.*, the Club One Casino] in an effort to collect the purchase price."

On January 10, 2012, Fortress declared an Event of Default, based on defendants' efforts to enforce the Arbitration Award, allegedly in contravention of the Subordination Agreement. On February 23, 2012, Fortress also declared a Maturity Event of Default because the loan was not paid in full as of February 22, 2012.

On April 11, 2012 Fortress sold its entire interest in the Senior Loan for full value to plaintiff-intervenor KMGI and assigned to KMGI all of its rights and obligations under the subordination agreement between Club One, Fortress, and the defendants. KMGI was formed by Club One principals Messina and Kirkland for the purpose of purchasing the Fortress loan. Messina and Kirkland are the only shareholders of KMGI and are eighty percent (80%) owners of Club One.

Concurrently with the purchase, KMGI discharged Messina and Kirkland from personal guarantees for the Senior Indebtedness.

II. Procedural Posture

On January 9, 2012, Club One sought a preliminary injunction in this Court seeking to enjoin defendants from enforcing the Arbitration Award. The Court issued a stay pending the defendants' response. Following briefing, the Court denied the motion on April 18, 2012 and vacated the stay.

Club One now moves for summary judgment seeking a declaration that (1) the Arbitration Award constitutes Subordinated Indebtedness under the Subordination Agreement, (2) the Subordination Agreement prohibits Subordinated Creditors from taking, demanding or receiving from Club One any payment of . . . any part of the Arbitration Award unless and until the Senior Indebtedness is paid in full, (3) the Subordination Agreement prohibits Club One from making, giving, or permitting any payment of any part of the Arbitration Award unless and until the Senior Indebtedness is paid in full, and (4) the Subordination Agreement prohibits the Subordinated Creditors from exercising any of their rights or remedies with respect to the Arbitration Award unless and until the Senior Indebtedness is paid in full.

III. Discussion

A. Summary Judgment Standard

The standards for summary judgment are well settled. Summary judgment is a drastic remedy which will be granted only when the party seeking summary judgment has established that there are no triable issues of fact (*see,* CPLR 3212 [b]; *Alvarez v Prospect Hosp.*, 68 NY2d 329 [1986]; *Sillman v Twentieth Century-Fox Film Corporation,* 3 NY2d 395 [1957]). To prevail, the party seeking summary judgment must make a prima facie showing of entitlement to judgment as a matter of law tendering evidentiary proof in admissible form, which may include deposition transcripts and other proof annexed to an attorney's affirmation (*see, Alvarez v Prospect Hosp., supra*; *Olan v Farrell Lines,* 64 NY2d 1092 [1985]; *Zuckerman v City of New York,* 49 NY2d 557 [1980]). Absent a sufficient showing, the court should deny the motion without regard to the strength of the opposing papers (*see Winegrad v New York Univ. Med. Ctr.*, 64 NY2d 851 [1985]).

Once the initial showing has been made, the burden shifts to the party opposing the motion for summary judgment to rebut the prima facie showing by producing evidentiary proof in admissible

form sufficient to require a trial of material issues of fact (*see, Kaufman v Silver,* 90 NY2d 204,208 [1997]). Although the court must carefully scrutinize the motion papers in a light most favorable to the party opposing the motion and must give that party the benefit of every favorable inference (*see, Negri v Stop & Shop, Inc.*, 65 NY2d 625 [1985]) and summary judgment should be denied where there is any doubt as to the existence of a triable issue of fact (*see, Rotuba Extruders, Inc. v Ceppos,* 46 NY2d 223, 231 [1978]), bald, conclusory assertions or speculation and "a shadowy semblance of an issue" are insufficient to defeat a summary judgment motion (*S.J. Capalin Assoc. v Globe Mfg. Corp.*, 34 NY2d 338 [1974]; *see, Zuckerman v City of New York, supra; Ehrlich v American Moninga Greenhouse Manufacturing Corp.,* 26 NY2d 255, 259 [1970]).

B. Contractual Interpretation

"The fundamental rule of contract interpretation is that agreements are construed in accord with the parties' intent . . . and [t]he best evidence of what parties to a written agreement intend is what they say in their writing. . . . Thus, a written agreement that is clear and unambiguous on its face must be enforced according to the plain terms, and extrinsic evidence of the parties' intent may be considered only if the agreement is ambiguous [internal citations omitted]" (*Riverside South Planning Corp. v CRP/Extell Riverside LP*, 60 AD3d 61, 66 [1st Dept 2008], *affd* 13 NY3d 398 [2009]). Whether a contract is ambiguous presents a question of law for resolution by the courts (id. at 67).

In accordance with these principles, a court should interpret a contract "so as to give full meaning and effect to the material provisions" (*Beal Savings Bank v. Sommer*, 8 NY3d 318, 324 [2007], quoting *Excess Ins. Co. Ltd. v Factory Mut. Ins. Co.*, 3 NY3d 577, 582 [2004]). "A reading of a contract should not render any portion meaningless ... Further, a contract should be read as a whole, and every part will be interpreted with reference to the whole; and if possible it will be so interpreted as to give effect to its general purpose'" (id. at 324–325, quoting *Matter of Westmoreland Coal Co. v Entech, Inc.*, 100 N.Y.2d 352, 358 [2003]). When a contract is negotiated between sophisticated business entities negotiating at arm's length, "courts should be extremely reluctant to interpret an agreement as impliedly stating something which the parties have neglected to specifically include" (*Vermont Teddy Bear Co. v 538 Madison Realty Co.*, 1 NY3d 470, 475 [2004] [internal quotation omitted]).

C. Prima Facie Case

In order to make out a prima facie case for a declaratory judgment, Club One relies on the terms of the Financing Agreement and Subordination Agreement. It does not dispute that the Purchase Price Adjustment and Interest on the Seller Notes are owed. Instead, Club One, maintains that under the terms of the Subordination Agreement the existence of Defaults and insufficient Qualifying Cash, precludes it from making these payments at this time.

Club One claims, and the defendant disputes, that Club One has been in default on certain covenants contained in the Financing Agreement beginning in 2009 and continuing without interruption to present. Specifically, Club One points to violations of the total leverage covenant (Financing Agreement § 7.03(b)), which was 3.33x in August 2011, exceeding the maximum allowed of 3.30x by .03x. However, the date defined in the Financing Agreement as the end of the fiscal quarter was June 30, 2011. On that date which is the relevant date due to the fact that the Final Arbitration Award is dated July 8, 2011 , the leverage ratio was 3.26, which was in compliance with the covenant.

Club One also points to the Minimum EBITDA test (Financing Agreement § 7.03(a)). Specifically, Club One was required to maintain a minimum Consolidated EBITDA of $5,000,000 for Fiscal Quarter ending March 31, 2008, and varying in amounts up to $5,600,000 for Fiscal Quarter ending December 31, 2011. A violation of the covenant occurs only if Consolidated EBITDA falls short of the target value for four (4) consecutive quarters. According to documents submitted by Club One, Fortress claimed that Club One violated this test every month since December 2009 (Perry affirm. Ex. 5 at FORT0002206). In every month between September 2010 and August 2011, Consolidated EBITDA was between $4,500,000 and $5,000,000. At the end of June 2011, this value was $4,874,208, short of the required $5,200,000 by $325,792.

Club One also claims that, since the July 8, 2011 entry of the Final Arbitration Award, it has not had sufficient cash to pay the approximately $2,000,000 Arbitration Award while maintaining the required reserve of $500,000 Qualifying Cash after giving effect to the payment. In support of this assertion, Club One points to unaudited financial statements for July 31, 2011, stating that Club One had $1,008,611 in unrestricted cash as of that date. (Messina aff Ex. H). This, amount was insufficient to pay the $1,000,513 Purchase Price Adjustment portion of the Final Arbitration Award and also satisfy the reserve requirement.

Club One has therefore made out a prima facie case as to a Default, thereby precluding it from making payments to the defendants. The burden then shifts to the defendants to rebut the prima facie case.

D. Defendants Rebuttal of Club One's Prima Facie Case

Defendants dispute that a default has occurred. Defendants further assert that the lender's actions after 2009, such as continuing to pay interest on the seller promissory notes, are contrary to any default and that a default, if any, was waived or deemed immaterial. Defendants point to three letters from Fortress to Club One which do not reference or allege a Default or Event of Default.

Defendant fails to address the specific documentary evidence that indicates that Club One was in Default in December 2009 and thereafter. Instead as discussed below, Defendant argues that Club One manipulated its cash to create bogus shortfalts. The alleged facts are insufficient rebut Plaintiff's *prima facie* showing.

The defendants dispute the Club One's claim that it had insufficient Qualifying Cash and further assert that to the extent that Club One did not have sufficient Qualifying Cash in a given month, it was due to Club One's pre-payments to its Senior Lender. In support of their position, Defendants point to emails from Dana Messina to Fortress dated September17, 2008, October 26, 2009, and December 11, 2009. The emails stated:

> "[W]e presently have a significant sum sitting with our local Fresno Bank. . . . [W]e thought the best alternative might be to pay down some of our loan with you." (Aaronson affirm., Ex. H, 9/17/08);
>
> "The balance sheet remains in good shape–we ended the month with $2.0 million in cash and made an accelerated principal payment on out loan of $500,000 . . . ." (Aaronson affirm., Ex. I, 10/26/09);
>
> "We wanted your approval to pay down the loan by $750,000 on December 15th and credit the amount against upcoming payments due early next year. We made the same request which was approved last year as well. *We believe it is important to reduce the amount of cash on our year end balance sheet as we head into arbitration proceedings.*" (Aaronson affirm., Ex. J, 12/11/09).

These letters do not speak to whether or not Club One had Qualifying Cash on the date of the Final Arbitration award. However they illustrate that Club One's had an ability to control the amount of Qualifying Cash on hand at any given time.

E. The Implied Covenant of Good Faith and Fair Dealing

"Implicit in all contracts is a covenant of good faith and fair dealing" (*Dalton v Educational Testing Serv.*, 87 NY2d 384, 389 [1995]). This covenant "embraces a pledge that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract. Where the contract contemplates the exercise of discretion, this pledge includes a promise not to act arbitrarily or irrationally in exercising that discretion. The duty of good faith and fair dealing, however, is not without limits, and no obligation can be implied that would be inconsistent with other terms of the contractual relationship" *id.* [citations omitted]. Whether a party's behavior was in bad faith is "an issue generally left to the trier of fact" *Richbell Info. Servs. v Jupiter Partners*, 309 AD2d 288, 303 [1st Dept 2003].

In this case, Club One has shown that it was in Default in December 2009 and has remained in Default ever since. The plain language of the Subordination Agreement precludes payment while Club One is in default. Defendants claim that the situation is one of Club One's own making. Specifically, defendant alleges that Club One wrongfully delayed payment of the Purchase Price Adjustment through frivolous counterclaims in a protracted arbitration proceeding, manipulated its finances to engineer a Default, unnecessarily paid down the principal balance of the Senior Indebtedness to ensure insufficient Qualifying Cash to satisfy its obligations to the Sellers, and has purchased the Senior Indebtedness to keep the loan in a permanent state of Maturity Default.

The record contains substantial credible proof of actions by Club One were taken after issuance of the Interim Award dated April 12, 2011 to inoculate itself from having to pay the anticipated Final Award dated July 8, 2011. However Club One was already in Default as of that date and thus was contractually barred from satisfying the Award.

There remains however, the question (as to which there are triable issues of fact) of whether or not Club One wrongfully delayed payment of the Purchase Price Adjustment when it became due in 2008 and instead forced defendants into a protracted arbitration proceeding in which Club One advanced counterclaims which the arbitrator held were baseless. The arbitrator also held that the Purchase Price Adjustment claimed by defendants was correct and rendered an award in the amount $1,000,513 which is the amount claimed in defendants demands for arbitration dated December 30, 2008. At that time, Club One was not in Default and could have paid the debt.

These facts are sufficient to raise triable issues of fact requiring a trial of the claim of breach of the implied covenant of good faith and fair dealing. A fact-finder could reasonably conclude that from the time of the initial calculation of the Purchase Price Adjustment, Club One has pursued multiple avenues to avoid payment of a legitimate obligation to the Sellers. The arbitrator's findings that Kirkland and Messina's defense as to the Purchase Price Adjustment had no factual basis raises addition questions of fact as to whether the entire arbitration proceeding served only to delay payment of a legitimate debt that could have been paid at the time it became due.

Accordingly, it is

ORDERED that the motion of Club One for summary judgment is DENIED.

DATED: September 30, 2013

ENTER,

O. P. Sherwood

O. PETER SHERWOOD
J.S.C.

O. PETER SHERWOOD