

Levy v Stein

2014 NY Slip Op 30839(U)

April 1, 2014

Supreme Court, New York County

Docket Number: 650798/13

Judge: Charles E. Ramos

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SUPREME COURT OF THE STATE OF NEW YORK
 COUNTY OF NEW YORK: IAS PART 53

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 DAVID M. LEVY, derivatively on behalf of
 MORSLY INCORPORATED,

Index No. 650798/13

Plaintiff,

-against-

HOWARD STEIN,

Defendant.
 -----x

Hon. Charles E. Ramos, J.S.C.:

Intervening-plaintiffs Stephen Levy and Morsly Inc.
 (together, Stephen), upon order to show cause, move to dismiss
 the complaint on the ground that this an improper derivative
 action pursuant to CPLR 3211 [a] [7] and 3211 [c] and, in the
 alternative, to stay this action pending the resolution of a
 related arbitration proceeding pursuant to CPLR 7503 [a] and
 2201.

Background¹

This is an action brought by David Levy, derivatively on
 behalf of Morsly Inc. (collectively, David), for alleged fraud,
 misrepresentation, breaches of fiduciary duties, and waste
 against defendant Howard Stein (Stein). Stephen moves to dismiss
 the action against Stein.

Morsly is a close corporation involved in the apparel
 industry and organized and operating under New York law. It is

¹ The facts set forth herein are taken from the pleadings, unless otherwise
 noted.

owned equally by two brothers, David and Stephen, each of whom are 50% shareholders of the company. Approximately 10 years ago, David ceased employment with Morsly, but remained a 50% shareholder and a director of the corporation, with Stephen holding the other 50% of the shares and continuing as a director and president of Morsly. Stein was employed as the chief financial officer (CFO) of Morsly and was responsible for maintaining the corporate books and records, and preparing the work papers for use by Morsly's outside accountants to generate Morsly's annual financial statements.

David alleges that from 2009 to 2011, Stein prepared two sets of work papers, one of which was accurate and the other of which was fraudulent. The accurate papers revealed that Morsly was steadily losing money since at least 2009, whereas the fraudulent papers indicated that Morsly was profitable.

Stein allegedly distributed the fraudulent work papers to Morsly's accountants, with the intent that the accountants would rely upon them in generating financial statements and tax returns. Those accountants relied on the fraudulent work papers to generate and distribute inaccurate financial statements, tax returns, and IRS Schedule K-1 reports (together, financial statements). The financial statements showed that Morsly was profitable and/or breaking even, and were distributed to the

Israel Discount Bank ("IDB"), Morsly's largest creditor, and to David and Stephen.

It is alleged that David and Stephen relied upon the inaccurate financial statements in making business decisions concerning Morsly. For instance, Stephen borrowed substantial monies from IDB, the company paid taxes on the fictitious earnings and the directors did not take actions to save Morsly such as liquidating or selling the business.

In creating the false work papers, Stein allegedly defrauded Morsly, the accountants and IDB, and breached fiduciary duties as an officer of Morsly. In addition, given the size of the company, annual net sales, and Stein's responsibilities, Stein allegedly received excessive compensation in the amount of \$464,999 from at least 2007.

In 2012, Morsly ceased operating with an alleged debt to IDB of approximately \$1,000,000. In 2013, pursuant to Morsly's shareholder agreement, Stephen commenced an arbitration proceeding against David with the American Arbitration Association ("AAA"). David answered and cross-claimed in the arbitration alleging fraud by Stephen.

Thereafter, David commenced this action against Stein claiming derivative causes of action for fraud, misrepresentation, breach of fiduciary duty, and waste. This Court dismissed the complaint for failure to adequately plead a

derivative suit, with leave to replead. David did file an amended complaint on behalf of Morsly, and Stephen moved to intervene as a plaintiff, which was granted.

Discussion

Stephen moves to dismiss the action on the ground that the pleading fails to state a cause of action and failure to plead a derivative action. Additionally, Stephen requests the Court treat the motion to dismiss as one for summary judgment, pursuant to CPLR 3211 (c).

In opposition, David contends that Stephen, an intervening-plaintiff, lacks standing to move to dismiss claims brought against Stein. "Upon a timely motion, any person may be permitted to intervene in any action when a statute of the state confers a right to intervene in the discretion of the court, or when the person's claim or defense and the main action have a common question of law or fact" (CPLR 1013). When a motion to intervene is granted and so ordered, the intervenor is granted all the rights as a party including the right to counterclaim, cross-claim, implead, appeal, etc (See *Brown v Waryas*, 45 Misc2d 77 [Sup Ct, Dutchess County 1965]; Siegel, NY Practice § 183 [5th ed 2011]). This Court granted Stephen's motion to intervene (Order, June 18, 2013). Accordingly, Stephen is afforded all the rights as a party to this action and has the requisite standing to bring the instant motion.

Alternatively, Stephen contends that this Court should dismiss the amended complaint since David has failed to allege derivative causes of action.

A plaintiff asserting a derivative claim seeks to recover for injury to the business entity (*Yudell v Gilbert*, 99 AD3d 108, 113 [1st Dept 2012]). A plaintiff asserting a direct claim seeks redress for injury to him or herself individually (*id.*). New York does not have a clearly articulated test, and courts previously approached the issue on a case-by-case basis depending on the nature of the allegations. Nonetheless, the First Department in *Yudell* adopted the following Delaware methodology: a court should consider "(1) who suffered the alleged harm (the corporation or the stockholders); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually)" (*id.* at 114, citing *Tooley v Donaldson, Lufkin & Jenrette, Inc.*, 845 A2d 1031, 1039, 1035 [Del 2004])).

Under the first prong of *Yudell* (*id.*), David sufficiently alleges that the company itself suffered harm. The allegations are that Morsly was financially hindered in that, by relying on Stein's false work papers, the directors made certain business decisions that contributed to Morsly's demise. David also alleges that Stein wasted company funds by taking an excessive salary during the time in which he committed the alleged fraud

and when the company was losing millions of dollars. Thus, David satisfied the second prong of *Yudell* (*id.*), in that David alleges that Stein's actions resulted in Morsly, and not the individual shareholders, suffering damages in the minimum amount of \$4,500,000. Furthermore, although both David and Stephen state that the company has ceased operations, there is no indication by any party that the company has been dissolved. As such, any recovery in the present action would be recovered by Morsly.

Stephen also contends that David has failed to state a cause of action. CPLR 3211(a)(7) states that "a party may move for judgment dismissing one or more causes of action asserted against him on the ground that the pleading fails to state a cause of action." On a motion to dismiss for failure to state a claim, "the court is concerned with whether the pleading states a cause of action rather than the ultimate determination of the facts" (*Stukuls v State*, 42 NY2d 272, 275 [1977]). Such motion will not be granted, unless the moving papers conclusively establish that no cause of action exists (*Ming v Hoi*, 163 AD2d 268 [1st Dept 1990]). The court should construe the pleadings in a liberal fashion by accepting the facts alleged in the complaint and interpreting them in a light most favorable to the plaintiff (*Leon v Martinez*, 84 NY2d 83, 87 [1994]).

Statements in a pleading shall be sufficiently particular to give the court and parties notice of transactions, occurrences or

series of transactions or occurrences, intended to be proved and the material elements of each cause of action (CPLR 3013). However, where a cause of action is based upon misrepresentation, fraud, mistake, breach of trust or undue influence, the circumstances constituting the wrong shall be stated in particularity or detail (CPLR 3016). CPLR 3016(b) is satisfied when the facts suffice to permit a "reasonable inference" of the alleged misconduct (*Pludeman v Northern Leasing Sys., Inc.*, 10 NY3d 486, 492 [2008]). The purpose underlying the statute is to inform a defendant of the complained-of incidents (*id.* at 486).

In pleading a claim of fraud, the plaintiff must allege representation of a material existing fact, falsity, scienter, deception, and resulting injury (*Sabo v Delman*, 3 NY2d 155 [1957]; *First Nationwide Bank v 965 Amsterdam. Inc.*, 212 AD2d 469 [1st Dept 1995]). Section 3016 (b) requirements are not "to be interpreted so strictly as to prevent an otherwise valid cause of action in situations where it may be 'impossible to state in detail the circumstances constituting a fraud'" (*Joel v Weber*, 166 AD2d 130, 133-34 (1st Dept 1991), quoting *Jered Contr. Corp. v New York City Transit Auth.*, 22 NY2d 187, 194 [1968]).

The amended complaint adequately sets forth specific factual references to an alleged fraud in the first cause of action. Stein knowingly produced false work papers on the financial status of Morsly, the work papers represented false information

that Morsly was financially stable, and Morsly's accountants relied on the work papers in preparing inaccurate financial statements and tax returns. Further, Morsly's directors detrimentally relied on the financial statements in making business decisions on the company, and as a result of these ill-informed decisions, Morsly suffered damages (Amended Complaint ¶¶ 22-33).

David also alleges a third cause of action for breach of fiduciary duty. To state a claim for breach of fiduciary duty, plaintiff must plead the existence of a fiduciary duty between the parties, breach of that duty, and damages suffered as a result of the breach (*Kurtzman v Bergstol*, 40 AD3d 588, 590 [2d Dept 2007]). "Plaintiff must go beyond merely alleging that these essential elements are present if its claim is to survive a motion to dismiss pursuant to CPLR § 3211(a)(7)" (*Gall v Summit, Rovins and Feldesman*, 222 AD2d 225, 226 [1st Dept 1995] [dismissing a claim for breach of fiduciary duty where the "verified complaint is devoid of factual allegations which sufficiently demonstrate a causal relationship between purported conduct on the part of defendants and damages suffered by plaintiff"]).

David alleges Stein owed a fiduciary duty to Morsly in his position as CFO. Stein repeatedly breached these fiduciary obligations by, among other things, producing and disseminating

the fraudulent work papers and wasting Morsly's assets. Morsly has been harmed by Stein's fiduciary breaches insofar as Stein deprived Morsly's directors of the ability to act in the best interests of the corporation by willfully withholding information concerning Morsly's finances and distributing fraudulent financial documents upon which they and others relied (Amended Complaint ¶¶ 1-2, 42-46). This Court finds that sufficient allegations have been set forth by David to state a cause of action for a breach of fiduciary duty.

The fifth cause of action is for alleged waste by Stein. To state a claim for waste, a plaintiff must set forth sufficient allegations under BCL § 720, which states:

"(a) An action may be brought against one or more directors or officers of a corporation to procure a judgment for the following relief: (1) Subject to any provision of the certificate of incorporation authorized pursuant to paragraph (b) of section 402, to compel the defendant to account for his official conduct in the following cases: (B) The acquisition by himself, transfer to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of his duties."

David alleges that Stein, as an officer of Morsly, had a duty not to waste Morsly's assets, Stein has wasted Morsly's assets by, among other things, causing Morsly to pay Stein an excessive salary of \$464,999 for at least one year during the period whereby Stein allegedly disseminated the fraudulent work papers when Morsly, with Stein's knowledge, was losing substantial sums of money. (Amended Complaint ¶¶ 2, 27, 52-56).

This Court finds that sufficient allegations have been set forth by David for waste.

The second and fourth causes of action are duplicative and should be dismissed. The second cause of action for alleged misrepresentation is duplicative of the first cause of action for fraud. Further, the fourth cause of action for breach of fiduciary duty is duplicative of the third cause of action for breach of fiduciary duty.

Stephen contends that this Court should also consider this motion as one for summary judgment under CPLR 3211 (c). This Court does not agree, as the parties have not been afforded the benefit of discovery.

Stephen also moves, in the alternative, to stay this action pending the resolution of the arbitration proceeding between David and Steven, citing to CPLR 7503 (a) and 2201. In opposition, David contends that a stay pending arbitration would be unwarranted and prejudicial since it does not relate to the alleged derivative claims against Stein, who is not a party to the arbitration proceeding.

"If an issue claimed to be arbitrable is involved in an action pending in a court having jurisdiction to hear a motion to compel arbitration, the application shall be made by motion in that action. If the application is granted, the order shall operate to stay a pending or subsequent action, or so much of it as is referable to arbitration" (CPLR 7503 [a]).

The express terms of CPLR 7503 (a) provide for a stay of the action only in conjunction with an order granting a motion to compel arbitration (*Heimlich v Charlton Lithographing, Inc.*, 103 Misc2d 74 [Sup Ct, NY County, 1979] [CPLR 7503 cannot be used to stay action and compel arbitration where an employee sued employer to recover wages since there was a contract between the employer and employee's union requiring arbitration of the claim and employee was not a party to the action]).

Nonetheless, this Court cannot invoke CPLR 7503 to stay the action because arbitration cannot be compelled against Stein, who is a non-party to the arbitration proceeding, and is not a signatory to the shareholder's agreement (*compare id.*).

However, under CPLR 2201, a court in which an action is pending may grant a stay of proceedings in a proper case, upon such terms as may be just, or except as otherwise prescribed by law. Several cases have expressly or impliedly recognized the right to obtain a stay without an order compelling arbitration (*id.* at 129, citing generally *King Records, Inc. v Brown*, 21 AD2d 593 [1st Dept 1964]).

Stephen argues that if the arbitration and this case are permitted to proceed simultaneously, it may result in inconsistent findings of fact. This Court agrees with Stephen's position. It is not disputed that David and Stephen have contracted to resolve issues relating to Morsly in arbitration

(See Shareholder Agreement, Exhibit A, p7 of Affirmation of Stephen in Support of OSC ["any controversy or claim arising out of or relating to this Agreement...shall be settled by arbitration..."]).

Furthermore, this Court is not in a position to stay the arbitration and proceed with this action where there is a clear agreement to arbitrate and there is evidence before the court that David and Stephen are already pursuing claims and counterclaims in arbitration (See David's Answer and Counterclaims in the Arbitration, Exhibit 4, Affidavit of Stephen Levy in Support of OSC). It is also in the interests of judicial efficiency that the present action be stayed in that certain claims relating to Stein may be resolved by agreement of David and Stephen in arbitration. A stay of this action is therefore appropriate until a disposition in the arbitration proceeding between David and Stephen is reached.

Stephen's remaining arguments are without merit.

Accordingly, it is

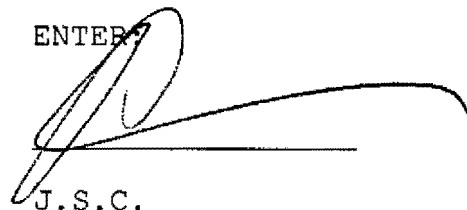
ORDERED that intervening-plaintiff's motion to dismiss is denied as to the first, third and fifth causes of action, and granted as to the second and fourth causes of action which are severed and dismissed; and it is further

ORDERED that this action is stayed pending disposition of the related arbitration proceedings between plaintiff and intervening-plaintiffs.

The parties are directed to contact the part clerk upon completion of the arbitration in order to restore this action to the calendar.

Dated: April 1, 2014

ENTERED

A handwritten signature in black ink, appearing to read 'C. Ramos', is written over a horizontal line. The signature is stylized and extends to the right.

J.S.C.

CHARLES E. RAMOS