[* 1]

SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY

PRESENT: **MARCY S. FRIEDMAN** PART 57

Justice

Index Number : 103299/2011
COBBLE CREEK CONSULTING, INC.
vs.
SICHENZIA ROSS FRIEDMAN
SEQUENCE NUMBER : 001
DISM ACTION/INCONVENIENT FORUM

INDEX NO. _____

MOTION DATE _____

MOTION SEQ. NO. _____

The following papers, numbered 1 to _____, were read on this motion to/for _____

Notice of Motion/Order to Show Cause — Affidavits — Exhibits _____ | No(s). _____

Answering Affidavits — Exhibits _____ | No(s). _____

Replying Affidavits _____ | No(s). _____

Upon the foregoing papers, it is ordered that this motion is

DECIDED IN ACCORDANCE WITH ACCOMPANYING DECISION/ORDER.

FILED

JUN 26 2012

NEW YORK
COUNTY CLERK'S OFFICE

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

Dated: 6.19.12

J.S.C.
MARCY S. FRIEDMAN

1. CHECK ONE: ..... ☑ CASE DISPOSED ☐ NON-FINAL DISPOSITION
2. CHECK AS APPROPRIATE: .....MOTION IS: ☐ GRANTED ☐ DENIED ☐ GRANTED IN PART ☐ OTHER
3. CHECK IF APPROPRIATE: ..... ☐ SETTLE ORDER ☐ SUBMIT ORDER
☐ DO NOT POST ☐ FIDUCIARY APPOINTMENT ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK – PART 57

PRESENT: Hon. Marcy S. Friedman, JSC

COBBLE CREEK CONSULTING, INC., et al.,
Plaintiff(s),

Index No.: 103299/11

- against -

SICHENZIA ROSS FRIEDMAN FERENCE LLP,
Defendant(s).

DECISION/ORDER

In this action, plaintiffs sue defendant law firm for legal malpractice and breach of fiduciary duty. Defendant moves to dismiss the complaint, pursuant to CPLR 3211(a)(7) and (a)(1).

It is well settled that on a motion to dismiss pursuant to CPLR 3211(a)(7), "the pleading is to be afforded a liberal construction (see, CPLR 3026). [The court] accept[s] the facts as alleged in the complaint as true, accord[s] plaintiffs the benefit of every possible favorable inference, and determine[s] only whether the facts as alleged fit within any cognizable legal theory." (Leon v Martinez, 84 NY2d 83, 87-88 [1994]. See 511 W. 232nd Owners Corp. v Jennifer Realty Co., 98 NY2d 144 [2002].) However, "the court is not required to accept factual allegations that are plainly contradicted by the documentary evidence or legal conclusions that are unsupportable based upon the undisputed facts." (Robinson v Robinson, 303 AD2d 234, 235 [1st Dept 2003]. See also Water St. Leasehold LLC v Deloitte & Touche LLP, 19 AD3d 183 [1st Dept 2005], lv denied 6 NY3d 706 [2006].) When documentary evidence under CPLR

3211(a)(1) is considered, "a dismissal is warranted only if the documentary evidence submitted conclusively establishes a defense to the asserted claims as a matter of law." (Leon v Martinez, 84 NY2d at 88; Arnav Indus., Inc. Retirement Trust v Brown, Raysman, Millstein, Felder & Steiner, L.L.P., 96 NY2d 300 [2001].)

The complaint is based on the following allegations: Plaintiffs were holders of Series A Preferred Stock in KIT Digital, Inc. (KIT). In March 2005, when KIT issued the stock to them, plaintiffs were aware that defendant was representing KIT, but defendant "advised Plaintiffs that Defendant was also representing them." (Compl., ¶ 6.) Defendant agreed to include non-dilution provisions in the "Certificate of Designation, Powers, Preferences and Rights of Series A Preferred Stock," dated March 9, 2005 and filed with the Securities and Exchange Commission (Certificate), which set forth the terms and conditions on which plaintiffs relied in acquiring the stock. (Compl., ¶ 29.) The conversion rate set forth in the Certificate was two shares of common stock for each one share of Series A Preferred stock surrendered. (Certificate, ¶ 5.1[a], cited in Compl., ¶ 9.) Effective October 2005, KIT's common stock "was reverse split on a 1-for-50 basis." (Compl., ¶12.) According to plaintiffs, this reverse split did not affect their conversion rights pursuant to the Certificate, and each share of Preferred A continued to be convertible at any time into two shares of KIT's common stock. (Id., ¶13.)

In 2007, an investor group announced that it would take control of KIT, and acquired a minority of common shares. However, due to the number of Preferred A shares and the number of votes per share, the investor group would not be able to exercise control of KIT unless it acquired a significant amount of the Preferred A shares or "devise[d] a scheme to eliminate all shares of Preferred A." (Compl., ¶¶ 15-16.) In furtherance of the scheme, the principal of the

investor group and members of KIT's Board of Directors, who were the owners of a majority of the Preferred A shares, held a "secret meeting" on March 30, 2008, at which these owners voted to convert the Preferred A shares to common stock at a conversion rate substantially lower than that on which plaintiffs relied when acquiring their Preferred A shares. This vote eliminated plaintiffs' rights and virtually all of their shares, "all to the knowledge of the Defendant." (Id., ¶¶ 17-18, 20, 27.) Plaintiffs claim that the majority shareholders voted for this conversion against their own interests as owners of the Preferred A stock, because the investor group offered them restructured employment contracts and/or a severance payment. (Id., ¶ 26.)

According to plaintiffs, various subsequent filings with the SEC showed different conversion rates: The 14C Information Statement stated that 10,000,000 issued and outstanding shares of Preferred A would be converted into 400,000 shares of common stock – a conversion rate of 1 to .04. (Id., ¶ 20.)[1] Later SEC filings, which are not attached, allegedly stated that at the March 30 meeting, the holders of a majority of the Preferred A shares voted to convert them into 11,429 shares of common stock – a ratio of 1 to .0011429. (Id., ¶ 24; Ps.' Memo. Of Law In Opp. [Ps.' Memo.] at 9.)

Notwithstanding the reverse split of the common stock, plaintiffs claim that they continued to be entitled to conversion at the ratio of one to two, and that their 1,000,000 Preferred A shares should have been converted into 2,000,000 common shares. (P.'s Memo. at

[1]The complaint erroneously stated that the shares would be reduced to 40,000. The 14C Information Statement gave the number as 400,000. (This Information Statement also noted that 20,000,000 shares of outstanding Preferred A stock would be reduced to 10,000,000 prior to the conversion).

9.)[2]

In their first cause of action for legal malpractice, plaintiffs assert that defendant intentionally or negligently worked against the interests of plaintiffs "when it assisted KIT in creating the shares of the Preferred A on a basis inconsistent with the discussions with the representatives of the Plaintiffs and then eliminating the shares of Preferred A." (Id., ¶ 32.) In their second cause of action for breach of fiduciary duty, they allege that defendant intentionally or negligently worked against the interests of plaintiffs "when it assisted KIT in creating the shares of the Preferred A without the non-dilutive provisions which the representatives of Plaintiffs had discussed with Defendant and then eliminating the shares of Preferred A." (Id., ¶ 41.) The legal malpractice and fiduciary duty causes of action are thus based on the same underlying facts and alleged wrongs.

The complaint does not specify the discussions that plaintiffs had with defendant or the anti-dilution provisions that they claim should have been included in the Certificate of Designation. In opposition to the motion, plaintiffs submit the affidavit of Robert Rubin, "a representative of the Rubin Family Irrevocable Marital Trust (Rubin Aff., ¶ 1), in which he elaborates on his discussions with defendant regarding the Preferred stock, as follows: "It was agreed between the Parties (KIT, the Plaintiffs and Richard Friedman of SRFF [defendant law firm]) that any change in the common stock structure (e.g. a reverse-split) would not affect the conversion ratio of the Preferred Stock. I had numerous discussions with Richard Friedman with respect to the terms and conditions of the Preferred Stock." (Id., ¶ 16.) He also asserts: "I relied

[2]Plaintiffs do not allege the rate at which their shares were actually converted, but rely solely on the conversion rates allegedly set forth in the SEC documents. They also do not allege the price of their shares immediately before and after the conversion.

upon Richard Friedman's drafting of the documentation to reflect the agreed upon terms of the Series A Preferred Shares, specifically the anti-dilution provisions." (Id., ¶ 17.)

Affidavits may ordinarily be received in opposition to a CPLR 3211 motion to dismiss for the limited purpose of remedying defects in the complaint. (Rovello v Orofino Realty Co., Inc., 40 NY2d 633, 636 [1976].) The court rejects defendant's contention that such use of affidavits is barred here by the parties' November 16, 2011 stipulation of adjournment in which plaintiffs agreed that their opposition papers would "not include any cross-motions or any amendments to their verified complaint." That language is insufficient to evidence an intent on the parties' part to preclude any use of affidavits by plaintiff in opposing the motion to dismiss.

Giving the complaint, as amplified by the affidavits, the benefit of every favorable inference, the court finds that the complaint pleads that defendant represented plaintiffs in connection with their acquisition of the Preferred A shares, and that the "discussions" between plaintiffs and defendant were that anti-dilution provisions would be included to protect the Preferred A stock. The only term of an anti-dilution provision that plaintiffs specifically identify as having been agreed to, however, was that "any change in the common stock structure (e.g. a reverse-split) would not affect the conversion ratio of the Preferred Stock. " (Rubin Aff., ¶ 16.)

As a threshold matter, defendant argues that the allegations of the complaint do not plead sufficient facts to show that an attorney-client relationship existed between plaintiffs and defendant. "An attorney-client relationship is established where there is an explicit undertaking to perform a specific task. While the existence of the relationship is not dependent upon the payment of a fee or an explicit agreement, a party cannot create the relationship based on his or her own beliefs or actions." (Pellegrino v Oppenheimer & Co., Inc., 49 AD3d 94, 99 [1st Dept

2008] [internal quotation marks and citations omitted].) As defendant correctly points out, a corporation's attorney ordinarily represents the corporate entity, not its shareholders or employees. (Eurycleia Partners, LP v Seward & Kissel, LLP, 12 NY3d 553, 562 [2009].) Here, however, the complaint, as amplified by the Rubin affidavit, pleads an attorney-client relationship based not on plaintiffs' subjective belief or their status as shareholders of the corporation, but on the allegation that defendant affirmatively "advised Plaintiffs that Defendant was also representing them" (Compl., ¶ 6) in plaintiffs' business dealings with KIT, "including but not limited [to] the creation of the Series A Preferred Stock." (Rubin Aff., ¶¶ 13-14.) Mr. Rubin also details a longstanding relationship, dating to 1991, in which defendant has represented him individually, in connection with the corporations with which he is associated, and in his capacity as representative of the Rubin Trust. (Id., ¶¶ 8-9.) He offers a plausible explanation for the absence of a retainer or payment of fees for the subject representation, stating that due to the high volume of referrals plaintiffs have made to defendant and the high volume of representations of him and the Rubin Trust, engagement letters or retainers have not been executed in many transactions, and fees have not been charged for certain representations. (Id., ¶¶ 10-11.) The court notes plaintiffs' unusual locution in characterizing the subject representation – namely, that defendant "advised" plaintiffs that it was representing them, as opposed to "agreed to represent" them. However, liberally construing the allegations as to the attorney-client relationship, the court finds that they are sufficient – albeit, marginally so – to withstand this motion to dismiss.

The court accordingly turns to the pleading of the malpractice claim. "[A]n action for legal malpractice requires proof of three elements: the negligence of the attorney; that the

negligence was the proximate cause of the loss sustained; and actual damages. In order to establish proximate cause, plaintiff must demonstrate that but for the attorney's negligence, plaintiff would have prevailed in the matter in question or would not have sustained any ascertainable damages." (Reibman v Senie, 302 AD2d 290, 290 [1st Dept 2003]; Ulico Cas. Co. v Wilson, Elser, Moskowitz, Edelman & Dicker, 56 AD3d 1, 10 [1st Dept 2008]. See AmBase Corp. v Davis Polk & Wardwell, 8 NY3d 428, 434 [2007].)

As noted above, in acquiring their Preferred A stock, plaintiffs claim to have relied on the conversion rates stated in the Certificate of Designation setting forth the terms and conditions of the acquisition. (Compl., ¶ 29.) However, plaintiffs acknowledge that the Certificate also contained a provision that precluded the corporation from taking any action "which would adversely and materially affect" the rights of the Preferred A shareholders, except by a vote of the majority of such shareholders.[3]

Significantly, plaintiffs do not plead, and do not argue in opposition to defendant's motion, that defendant agreed to omit such a provision from the Certificate, or committed malpractice by including it. They also do not argue that this provision was atypical or that the

---

[3] This provision, as quoted in paragraph 9 of the complaint, stated:
"7. Restrictions and Limitations. Except as expressly provided herein or as required by law so long as any shares of Series A Preferred Stock remain outstanding, the Corporation shall not, without the vote or written consent of the holders of at least a majority of the then outstanding shares of the Series A Preferred Stock, take any action which would adversely and materially affect any of the preferences, limitations or relative rights of the Series A Preferred Stock, including without limitation:
(a) Reduce the amount payable to the holders of Series A Preferred Stock upon the voluntary or involuntary liquidation . . . ;
(b) Cancel or modify adversely and materially the voting rights as provided in Section 4 herein [10 votes for each share of Series A Preferred Stock]; or
(c) Take any action which would result in the change of control of fifty percent (50%) or more of the ownership of the Corporation."

percentage of preferred shareholders whose vote would be needed to alter the rights of the minority shareholders was not a matter for contractual negotiation. Nor could they do so, as it is well settled that "the relationship between a corporation and its preferred stockholders is primarily contractual in nature and primarily involves rights created in the certificate designating and defining the legal rights of the preferred stockholders. . . ." (Oppman v IRMC Holdings, Inc., 2007 NY Slip Op 50093U, 2007 NY Misc Lexis 117 at * 26-27 [Sup Ct, New York County 2007] [applying Delaware law and citing Jedwab v MGM Grand Hotels, Inc., 509 A2d 584 [Del Ch 1986];[4] 11 Fletcher Cyclopedia of the Law of Corporations, § 5295 [revised ed 2011].)

In the absence of any challenge by plaintiffs to the provision permitting alteration of the rights of Preferred A shareholders by majority vote, plaintiffs' malpractice claim cannot survive. Given the existence of that provision, the anti-dilution provision to which plaintiffs claim KIT and defendant agreed – i.e., one that preserved the conversion ratio for the preferred stock in the event of a restructuring of the common stock – would not have prevented the majority of the Preferred A shareholders from altering the conversion ratio for the Preferred A shares. Thus, even assuming for purposes of this motion that KIT and defendant did agree to include the claimed anti-dilution provision in the Certificate of Designation, its failure to do so was not a proximate cause of plaintiffs' damage. As plaintiffs cannot allege the necessary damage element of their malpractice claim, the claim is not stated.[5]

---

[4]While the parties have not addressed the issue, it appears clear that Delaware law applies because KIT is a Delaware corporation, and the law of the state of incorporation governs the internal affairs of the corporation. (See Oppman, 2007 NY Misc Lexis 117 at * 19, n 8.)

[5]The court notes parenthetically that an anti-dilution provision with the terms asserted by plaintiffs would have greatly advantaged plaintiffs upon conversion had the majority not voted to alter the conversion rate. Anti-dilution provisions typically adjust the conversion price upon a restructuring of

Finally, plaintiffs' breach of fiduciary cause of action as to defendant law firm must also be dismissed. As discussed above (supra at 4), this cause of action is based on defendant's failure to include anti-dilution provisions. As it alleges the same facts and seeks the same relief as the malpractice cause of action, it must be dismissed as duplicative of the malpractice cause of action. (See Weil, Gotshal & Manges, LLP v Fashion Boutique of Short Hills, Inc., 10 AD3d 267, 271 [1st Dept 2004].)

Plaintiffs arguably also seek to maintain the fiduciary duty cause of action based on defendant's conflict of interest in representing both plaintiffs and the corporation in the same transaction. It is well settled that a breach of fiduciary duty claim is not maintainable against an attorney based on a conflict of interest, without more, and that recovery requires not only a breach of a duty but "damages sustained as a result.". (Ulico, 56 AD3d at 10.) However, plaintiffs do not plead that the conflict of interest was implicated in the negotiation of the majority voting provision or that defendant breached a fiduciary duty in negotiating that provision. As in the case of the malpractice claim, they therefore fail to plead damages as a result of defendant's, as opposed to the majority Preferred A shareholders', conduct.[6]

---

the common stock, "so that the holder of convertible securities maintains the same percentage ownership both before and after the change." (Woronoff & Rosen, Understanding Anti-Dilution Provisions In Convertible Securities, 74 Fordham L Rev 129, 142 [2005].) The complaint does not plead any facts or circumstances showing why KIT would have agreed to an anti-dilution provision that preserved the preferred stock conversion ratio even in the event of a reverse split.

[6]A separate issue, which is not raised in this action, exists as to whether plaintiffs have a claim against the directors for breach of fiduciary duty in connection with their vote to eliminate the Preferred A shares. "[W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words [in, e.g., the Certificate of Designation] evidencing the contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards. (Jedwab, 509 A2d at 594.)

It is accordingly hereby ORDERED that defendant's motion is granted to the extent of dismissing the complaint with prejudice.

This constitutes the decision and order of the court.

Dated: New York, New York
June 19, 2012

MARCY FRIEDMAN, J.S.C.

Hence, the extensive case law that addresses whether a breach of fiduciary duty claim is maintainable by a shareholder who is claiming unfair allocation of consideration in connection with a conversion. (See id. at 593-594 [and cases cited therein].)