LNYC Loft, LLC v Hudson Opportunity Fund I, LLC
2017 NY Slip Op 31634(U)
August 3, 2017
Supreme Court, New York County
Docket Number: 650969/11
Judge: Carol R. Edmead
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 35

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LNYC LOFT, LLC individually and derivatively on behalf of HRC-NYC DEVELOPMENT LLC, and derivatively on behalf of ONE YORK STREET ASSOCIATES, LLC,

Plaintiffs,

-against-

HUDSON OPPORTUNITY FUND I, LLC, STANLEY PERELMAN, RICHARD ORTIZ, JANI DEVELOPMENT II, LLC, and ONE YORK STREET ASSOCIATES, LLC,

Defendants.

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Index Nº.: 650969/11
Motion Seq. Nos. 013

DECISION AND ORDER

CAROL R. EDMEAD, J.S.C.:

In a case involving a dispute over the distribution of proceeds of a real estate venture, defendants Jani Development II, LLC (Jani) and One York Street Associates, LLC (Associates) (together, the Perelman defendants) move to dismiss the derivative claims in plaintiff's third amended complaint: the third, fourth, fifth, seventh, and eighth causes of action.

BACKGROUND

This case arises from a luxury condominium located at 1 York Street in lower Manhattan. One York Property LLC (One York), which owns the property, is wholly owned by Associates. Associates, in turn, is comprised of, HRC-NYC Development, LLC (HRC), which has a 75% interest in Associates and Jani, the managing partner, which has a 25% interest. HRC is itself comprised of other entities: plaintiff LNYC Loft, LLC (LNYC), which owns 44% of HRC, and

defendant Hudson Opportunity Fund I, LLC (Hudson), which initially owned 56% of HRC, but subsequently sold that interest to nonparty One York Partners.[1]

The crux of this action, which the parties have been vigorously litigating for six years, is a dispute over how to distribute revenue from the condominium. The revenue structure is governed by Associate's operating agreement, which, initially, provided that HRC and Jani would receive revenue from the condominium at the same rate as their respective ownership interests -- that is, HRC would receive 75% of the revenue, while Jani would receive the remaining 25%. This structure was to last until HRC and Jani were paid back the amount of their investment and had achieved a 20% internal rate of return. Once this benchmark was hit, HRC and Jani were to split the revenue from the condominium 50/50. One thing the parties agree on now is that they will never achieve a 20% internal rate of return.[2]

Around the time that Hudson sold its interest in the project, in May 2010, Jani and HRC executed an amendment to the operating agreement (the first amendment) that, among other things, changed the revenue structure to a straight 50/50 split between Jani and HRC. LNYC claims that this amendment was improper because it did not consent to the change in writing, as required by HRC's operating agreement. This amendment changed LNYC's share in revenue from 33% to 22%.[3]

Various claims and defendants have been dismissed and LNYC's claims have evolved through three amended complaints. It filed its third amended complaint, alleging eight causes of

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[1] Both Jani and One York Partners are controlled by defendant Stanley Perelman and LNYC is controlled by nonparty Charles Darwish. Moving defendants describe this action as essentially a feud between these two men.
[2] The project ran into problems following the financial crisis of 2007-2008.
[3] Defendants contend that the purpose of this amendment was to incentivize Stanley Perelman to invest more of his time and money in saving the project.

action, on March 28, 2016. The first and sixth causes of action, for breach of contract against Hudson, and the second cause of action, for tortious interference against Jani and Stanley Perelman (Perelman), are not at issue in this motion. Instead, Jani and Associates seek only dismissal of LNYC's derivative claims.

As to the derivative claims, the third, fourth, and fifth causes of action seek damages on behalf of HRC for the allegedly improper change to the revenue distribution structure. The last two derivative causes of action involve claims that defendants' misappropriated funds. In the seventh cause of action, LNYC demands, on behalf of HRC, an accounting of One York Partners and Jani. In the eighth, LNYC brings a double derivative claim on behalf of associates to recover funds allegedly misappropriated by defendants. Thus, the derivative claims can be broadly grouped into distribution and misappropriation claims.

Special Litigation Committee

By retainer agreement dated March 14, 2016, HRC and Associates engaged Mark Zauderer (Zauderer), to evaluate, as special litigation committee (SLC), the claims LNYC is bringing on their behalf. More specifically, the retainer agreement provided that Zauderer

> "will conduct such factual and legal investigation as [he] deem[s] necessary and appropriate and [he] will have the sole, full and final responsibility, including powers of the members of the Companies, to determine the positions and actions that the Companies should take with respect to the Claims, considering, among other things, whether the claims have merit, whether they are likely to prevail, and whether it is in the Companies' best interest to pursue them."

(Retainer letter at 1).

On March 22, 2016 LNYC's counsel objected to Zauderer's appointment as special litigation committee, and Zauderer responded by suspending his work until the court clarified his role. The court, by decision dated September 1, 2016 (September 2016 decision), held, among

other things, that the appointment of the SLC was appropriate and granted HRC and Associates' application to designate Zauderer as SLC (September 2016 decision at 11, 15). The court also stayed the action pending the conclusion of Zauderer's investigation (*id.* at 15).

For his investigation, Zauderer interviewed the parties and their counsel and reviewed documents. While Zauderer did not undertake a comprehensive review of the thousands of documents exchanged in this litigation, he and his team reviewed the parties' memoranda setting out their positions, and 52 exhibits that the parties felt were the most crucial (SLC report at 15-16). The documents Zauderer reviewed included: pleadings, the relevant operating agreements, the disputed amendment, correspondence, email, financial records and statements, bills for legal services, deposition transcripts, affidavits, memoranda of law, decisions of the court, as well as statutes and caselaw (*id.* at 16).

As to the derivative distribution claims, the SLC found that LNYC invested $5,020,000 in the subject project, and has received, to the date of his report, $4,054,363.61 in distributions (*id.* at 17). If LNYC had been receiving distributions at the 33% it claims is its rightful due, the SLC found that it would have received $4,991,415, or $937,051.39 more than it actually received (*id.*).

The SLC summarized the factual issues relating to the distribution claim as: "(1) whether the First Amendment to the One York Operating Agreement was not authorized, and is therefore invalid, because LNYC did not provide written consent, and (2) whether a determination as to whether LNYC received back its capital contributions should be based on the use of invested or depreciated capital" (*id.* at 19). After reviewing the evidence submitted by the parties, Zauderer determined that LNYC "has the more persuasive arguments" (*id.* at 27).

"However," the SLC noted, "judicial resolution, which may be based in part on the credibility of the witnesses, is uncertain" (*id.*). The SLC then quantified that uncertainty:

> "Taking all of the arguments and factors into account, I have determined that LNYC has an approximate 67% chance of prevailing on the Distribution Claims. Therefore, I have determined that if the Companies could achieve a settlement by paying the plaintiff essentially two-thirds of the value of the Distribution Claims, without the expense and distraction of further litigation, it would be a desirable result"

(*id.* at 28).

As to the misappropriation claims, the SLC determined

> "that LNYC substantially benefited from Jani's management activities, that the claims alleging personal use of furniture and electronics are unproven, speculative and in some instances *de minimis*, and that Jani's explanations for the amounts spent using the Companies' credit card are not frivolous. However, it is possible that such claims could be proven through further discovery, and LNYC states that it intends to seek further discovery on these issues. We have reviewed legal bills of the Companies' lawyers and did not see any evidence that the Companies' funds were used to pay for legal services performed by its counsel on behalf of other entities or on behalf of Mr. Perelman. Also, we have not seen any evidence that Jani took preferential distributions to fund the purchase of Hudson's interest in HRC"

(*id.*).

With that in mind, the SLC concluded that:

> "LNYC has an approximately 50% chance of prevailing on the claims for the management fees and a 20% chance of prevailing on the other components of the Misappropriation Claims. In addition, because the Misappropriation Claims are fact and document intensive and are made up of hundreds of small, individual claims, the costs of pursuing the Misappropriation claims are likely to be disproportionately high in relation to their value, and the likelihood that further discovery would reveal claims of significant value is not high"

(*id.*).

The SLC determined that 9% statutory interest on the distribution claims should be calculated from April 1, 2011, and that interest on the misappropriation claims should be

calculated, at the same rate, from April 1, 2013 (*id.* at 29). As to legal fees, the SLC determined that "[t]here should be no component for reimbursement of legal fees," as, under the One York operating agreement, "[e]ither party could ultimately recover legal fees if the matter went to trial" (*id.* at 29). Even if LNYC were eventually to prevail on certain claims, entitling it to legal fees on those claims, the SLC determined that the amount of legal fees due would be significantly lower than the total amount expended by LNYC on its attorneys, as "much of the litigation cost incurred by plaintiff to date relate to non-derivative claims, many of which have been dismissed, and other matters on which defendants have prevailed" (*id.*).

Ultimately, the SLC determined that the claims should be settled by HRC and Associates paying LNYC $1,021,603.22 and agreeing to pay 29.37% on all future distributions (*id.* at 30-33). The cash payment consists of amounts for past distributions ($627,824.43), the misappropriation claim ($40,260) and prejudgment interest ($353,518.79) (*id.*). Zauderer calculated the payments on the distribution and misappropriation claims by multiplying the total amount of the claim by the percentage of likelihood each claim had to succeed (67% for the distribution claims, 50% for the misappropriation claims relating to management fees, 20% on the other components of the management fees) (*id.*).

Zauderer determined that the parties should settle on these terms rather than pursue the derivative claims not only because of the uncertainty of judicial determination, but also the cost:

> "Notwithstanding the substantial efforts and progress that the Court has made in narrowing the issues in the Action, the plaintiff's Claims appear to be constantly evolving, with no end in sight, and significant fact and expert discovery remain, additional motions and appeals are likely, and any trial of this matter will be expensive, especially when considered in light of the maximum possible recovery in this Action. The litigation costs incurred by the Companies have already exceeded more than $1 million dollars. It is easy to envision that prosecution of the Action through trial and appeal could cost the Companies another $1 million

> dollars more. The avoidance of such costs is a major factor in my determinations"

(*id.* at 29).

Thus, Zauderer concluded that, "[i]n consideration of the uncertainty that the plaintiffs will ultimately prevail on the Claims, the amounts at issue, and the potential litigation costs that will be incurred if the Action continues to be litigated, I have concluded that it is in the best interests of the Companies to settle this dispute on terms I have proposed" (*id.* at 30). Finally, Zauderer recommends that the court should approve the recommended settlement terms pursuant to Business Corporation Law (BCL) § 621 and that, if defendants approve of the terms in writing, they should move the court to dismiss the derivative claims (*id.* at 33).

By a letter to Zauderer dated May 18, 2017, Jani and Associates accepted the terms of the recommended settlement and agreed to pay $1,021,603.22 "promptly upon LNYC's acceptance of the settlement or upon entry of a final non-appealable Court Order giving effect to the settlement." Four days later, on May 22, 2017, Jani and Associates filed its notice of motion seeking summary judgment dismissing the derivative claims based on the special litigation committee's recommendation. LNYC opposes the motion, arguing that deference to the SLC is not warranted and that, even if it were, dismissal at this stage would be premature. Additionally, while the Perelman defendants contend that LNYC has waived any objection to the SLC process by participating in the investigation, LNYC argues that has not waived its objection.

DISCUSSION

It is well settled that where a defendant is the proponent of a motion for summary judgment, the defendant must establish that the "cause of action . . . has no merit" (CPLR §3212[b]) sufficient to warrant the court as a matter of law to direct judgment in its favor

(*Friedman v BHL Realty Corp.*, 83 AD3d 510, 922 NYS2d 293 [1st Dept 2011]; *Winegrad v New York Univ. Med. Ctr.*, 64 NY2d 851, 853, 487 NYS2d 316 [1985]). Thus, the proponent of a motion for summary judgment must make a prima facie showing of entitlement to judgment as a matter of law, by advancing sufficient "evidentiary proof in admissible form" to demonstrate the absence of any material issues of fact (*Madeline D'Anthony Enterprises, Inc. v Sokolowsky,* 101 AD3d 606, 957 NYS2d 88 [1st Dept 2012] *citing Alvarez v Prospect Hosp.*, 68 NY2d 320, 501 NE2d 572 [1986] *and Zuckerman v City of New York*, 49 NY2d 557, 562 [1980]).

Where the proponent of the motion makes a prima facie showing of entitlement to summary judgment, the burden shifts to the party opposing the motion to demonstrate by admissible evidence the existence of a factual issue requiring a trial of the action (CPLR §3212 [b]; *Madeline D'Anthony Enterprises, Inc. v Sokolowsky*, 101 AD3d 606, 957 NYS2d 88 [1st Dept 2012]). Mere conclusions, expressions of hope or unsubstantiated allegations or assertions are insufficient (*Alvord and Swift v Steward M. Muller Constr. Co.*, 46 NY2d 276, 281-82, 413 NYS2d 309 [1978]; *Carroll v Radoniqi,* 105 AD3d 493, 963 NYS2d 97 [1st Dept 2013]). The opponent "must assemble and lay bare [its] affirmative proof to demonstrate that genuine issues of fact exist," and the "issue must be shown to be real, not feigned since a sham or frivolous issue will not preclude summary relief" (*American Motorists Ins. Co. v Salvatore*, 102 AD2d 342, 476 NYS2d 897 [1st Dept 1984]; *see also, Armstrong v Sensormatic/ADT*, 100 AD3d 492, 954 NYS2d 53 [1st Dept 2012]).

I. The SLC's Recommendation and the Business Judgment Rule

The Court of Appeals held in *Tzolis v Wolff* that "LLCs may sue derivatively," even though they are not expressly authorized by the LLC Law, as "derivative suits should be recognized even though no statute provides for them" (10 NY3d 100, 109 [2008]). In a

derivative claim, of course, a shareholder or member brings a claim against a third-party seeking recovery "for injury to the business entity" (*Yudell v Gilbert*, 99 AD3d 108, 113 [1st Dept 2012]).

The Court Appeals held in *Auerbach v Bennett* that, in the context of a corporation, when a board of directors -- which would ordinarily decide whether to bring claims on behalf of a corporation -- is alleged to have a conflict of interest, boards can name a special litigation committee to make decisions about derivative claims (47 NY2d 619, 631 [1979]). Here, there is an alleged conflict of interest and the managers of HRC and Associates have decided to appoint an SLC to make decisions about these claims.

While LNYC argues that this mechanism is proper for corporations, but improper for an LLC, it fails to articulate a compelling reason why that should be the case. Indeed, LNYC's position goes against the reasoning of *Tzolis*, which put LLCs on equal footing with other business entities for purposes of derivative suits. Moreover, the Revised Uniform Limited Liability Company Act, which has not yet been adopted in New York, but which indicates general trends in this area of law, has recognized the principle that an LLC involved in derivative litigation may appoint an SLC composed of one or more disinterested outsiders. In any event, the court has already approved of the appointment of the SLC in the September 2016 order.[4]

Under *Auerbach*, once the business entity SLC is in place, it is entitled to deference offered by the business judgment rule, which bars judicial enquiry into the actions of corporate directors taken in good faith for the furtherance of corporate purposes (47 NY2d at 632-634). However, the application of the business judgment rule in the context of SLCs does not offer the

[4] LNYC has appealed this aspect of the September 2016 decision and oral argument was heard by the First Department on May 3, 2017,

committee a carte blanche to make decisions regarding derivative claims. Instead, "the court may inquire as to the disinterested independence of the members of that committee and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee" (*id.* at 623-624).

While LNYC argues that the scope of the SLC's powers were only to report as to whether the derivative claims are viable and whether they should be pursued, nothing in the *Auerbach* framework suggests that this is correct. In fact, in *Auerbach* the SLC decided to dismiss the claims and the court gave this decision deference and dismissed the derivative claims (*id.* at 624). LNYC argues that the SLC exceeded his power by acting as arbitrator, but that argument does not withstand scrutiny, as the power to decide not to bring a claim, as was exercised by the SLC in *Auerbach*, is no less than the power to impose a settlement.[5] Indeed, both are exercises of business judgment. Accordingly, the only inquiry the court may engage in is as to the SLC's disinterestedness and the sufficiency of its investigation.

Here, LNYC does not actually question the disinterestedness of Zauderer or the claims of independence he makes in the SLC report (SLC report at 10). Instead it acknowledges his independence and his stellar legal background. That leaves only the question of the sufficiency of the investigation. Here, LNYC argues that there has been no discovery with respect to the double derivative claims that allege misappropriation of funds by Jani and Perelman, as managers of Associates.

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[5] The Revised Uniform LLC Act, which, again, has not yet been adopted in New York, but which indicates general patterns in this area of law, provides, at section 805 (d) that "[a]fter appropriate investigation, a special litigation committee may determine that it is in the best interest of the limited liability company that the proceeding . . . be settled on terms approved by the committee."

In support of its contention that the SLC's investigation was insufficient with respect to these double derivative claims, LNYC cites to *Parkoff v General Tel. & Elecs. Corp.* (523 NY2d 412 [1981]). *Parkoff* followed *Auerbach*, and held that the doctrine of res judicata barred a derivative action by one shareholder for the same underlying conduct that had already been the subject of another derivative action, brought by a different shareholder, that was previously dismissed (*id.* at 415). The Court of Appeals, in analyzing the derivative claims, described the parameters of the business judgment rule in this context:

> "the business judgment rule does not foreclose judicial inquiry in cases such as this into the disinterested independence and good faith of the members of the special litigation committee and the adequacy and appropriateness of that committee's investigative procedures and methodologies . . . The business judgment doctrine should not be interpreted to stifle legitimate scrutiny by stockholders of decisions of management which, concededly, require investigation by outside directors and present ostensible situations of conflict of interest. Nor should the report of the outside directors be immune from scrutiny by an interpretation of the doctrine which compels the acceptance of the findings of the report on their face. In particular, summary judgment which ends a derivative action at the threshold, before the plaintiff has been afforded the opportunity of pretrial discovery and examination before trial, should not be the means of foreclosing a nonfrivolous action"

(*id.* at 417-418).

LNCY argues that, under *Parkoff*, it is entitled to limited discovery as to its double derivative claims, as well as into the SLC's investigation. As to the latter, LNYC contends that SLC conducted only minimal independent investigation and instead relied on the parties submissions. Accordingly, LNCY seeks discovery as to: the scope of the investigation, its basis for ascribing percentages to the various claims, and its decision not to conduct on-the-record interviews. In support of its application for discovery from the SLC, LNCY cites to a case from New York County in which such a discovery was allowed (*Weiser v Grace*, 179 Misc 2d 116 [Sup Ct, New York County 1998]). In *Weiser*, the court, in resolving a motion to compel

discovery, brought by the plaintiff in a derivative action, allowed for "the production of the notes, summaries, outlines regarding the committee's interviews of witnesses," reasoning that that "[t]he court, in the exercise of its discretion, may permit the parties to engage in limited discovery to assist the court in its inquiry regarding the good faith and independence of the committee as well as the bases supporting the committee's conclusions" (*id.* at 120-121).

The court's inquiry into the sufficiency of the SLC's investigation is confined to whether "'the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or halfhearted as to constitute a pretext or sham'" (*Ungerleider v One Fifth Ave. Apt. Corp.*, 164 Misc 2d 118, 121, quoting *Auerbach*, 47 NY2d at 634). Here, the SLC's report details the investigation, and that it reviewed the most important documents in this case and interviewed the parties, as well as their counsel (SLC report, at 15-17). Moreover, the SLC analyzed the double derivative claims and found that their worth would be exceeded by the cost of litigating them (*id.* at 25, 28).

The SLC's investigation, it is plain from the report, was neither shallow nor pro forma; instead, the report reflects a robust investigation through years of accumulated discovery, and through the SLC's own interviews. In these circumstances, no more discovery is warranted. Thus, as the SLC's investigation was independent and sufficiently thorough, the SLC's determinations, including that the derivative claims should be dismissed pursuant to the terms of its recommended settlement are entitled to deference. To rule otherwise, would be to subject these companies to further litigation when they have already decided, through the mechanism of an SLC, to settle the derivative claims on terms that are fair and sensible.

II. Waiver

The Perelman defendants argue that, in any event, LNYCs has waived any objections to the SLC process by participating in it for six months. In support, the Perelman defendants analogize to cases where courts have held that parties waived objections to an arbitration process by participating in that process (*see Matter of Commerce & Indus. Ins. Co. v Nester*, 90 NY2d 255, 262 [1997] [holding that "once a party participates in an arbitration proceeding, without availing itself of all its reasonable judicial remedies, it should not be allowed thereafter to upset the remedy emanating from that alternative dispute resolution form"]).

LNYC argues that it has not waived its objections, citing to *Gonder v. Dollar Tree Stores, Inc.*, 144 F Supp3d 522 (Dist Ct, SDNY 2015). In *Gonder*, the federal district court held, in a motion involving a motion to compel arbitration, that the defendant had not waived its right arbitrate by briefly participating in the judicial proceeding (*id.* at 529). In finding an absence of a waiver, the court in *Gonder* was swayed by the fact that defendant only waited one week to bring the motion to compel after removing to federal court and that "there had been very little litigation activity to date" (*id.*).

That is, of course, not the case here where the parties have been heavily litigating since 2011, although the derivative claims are comparatively recent. In any event, LNYC has appealed the September 2016 decision, which approved the SLC. However, LNYC waited six months to file an application to the Appellate Division to stay the SLC investigation pending the appeal. The First Department denied that application as moot by decision and order dated May 2, 2017.

Here, the court need not decide the question of waiver, as it has already decided that LNYC's objections are not sufficient to overcome the deference owed to the SLC's

determinations. Moreover, LNYC's informal application for a stay pending the First Department's decision regarding its appeal of the September 2016 decision is not only technically improper, it is also unwarranted. If the First Department did not see fit to stay the SLC's work pending its decision, neither does this court.

CONCLUSION

Accordingly, it is

ORDERED that defendants Jani Development II, LLC and One York Street Associates, LLC's motion for partial summary judgment dismissing the third, fourth, fifth, seventh and eighth causes of action of the third amended complaint is granted; it is further

ORDERED that the Clerk is to enter judgment accordingly; and it further

ORDERED that counsel for moving defendants shall serve a copy of this order with notice of entry within twenty (20) days of entry on counsel for plaintiff.

This constitutes the order and decision of the court.

Date: August 3, 2017

ENTER:

Hon. CAROL R. EDMEAD, J.S.C.