Sachs v Adeli
2006 NY Slip Op 30648(U)
August 21, 2006
Supreme Court, New York County
Docket Number: 603930/2003
Judge: Karla Moskowitz
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SCANNED ON 8/23/2006

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

PRESENT: Hon. KARLA MOSKOWITZ PART 03
Justice

---x

RICHARD B. SACHS,
Plaintiff,

- against -

KATAYONE ADELI, SEAN P. BARRON, KLOTHES, LLC, KLOTHES (NY), LLC, and JOHN DOES, 1-10,

Defendants.

---x

INDEX NO. 603930/2003

MOTION DATE ______

MOTION SEQ. NO. 006

MOTION CAL. NO. ______

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

	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 this motion is decided in accordance with the accompanying Decision and Order.

FILED
AUG 23 2006
COUNTY CLERK'S OFFICE
NEW YORK

Dated: August 21, 2006

KARLA MOSKOWITZ *J.S.C.*

Check one: ☐ FINAL DISPOSITION ☑ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☑ REFERENCE

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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK : IAS PART 3

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RICHARD B. SACHS,

Plaintiff,

Index No. 603930/2003

- against -

KATAYONE ADELI, SEAN P. BARRON, KLOTHES, LLC, KLOTHES (NY), LLC, and JOHN DOES, 1-10,

Defendants.

DECISION and ORDER

---x

Karla Moskowitz, J.:

Defendant Sean Barron moves for summary judgment dismissing the complaint against him. Plaintiff Richard Sachs cross-moves to amend his complaint to add three new claims, to compel defendants to produce documents or be precluded from presenting evidence opposing plaintiff's claims for fraud and to sanction defendants and their counsel pursuant to CPLR 3126 and 22 NYCRR Part 130-1.1.

FILED AUG 2006 COUNTY

Plaintiff, an investment banker and Managing Director at Bear Stearns, invested in a high-end fashion company, that defendant Katayone Adeli ("Adeli"), a fashion designer, created with defendant Barron, the sales manager and business officer for the fashion company. Plaintiff brings this action, claiming that the defendants fraudulently induced him to make the investment, a capital infusion of $925,000 into defendants Klothes, LLC and Klothes (NY), LLC. He claims that defendant Barron supplied him with certain financial projections and financial statements for the company before his investment, but that shortly after his investment and after defendant Barron departed from the company, the company issued a material modification to the financials, a negative prior period adjustment, that allegedly turned the financial picture of the company at the time of plaintiff's investment from one of financial promise to one of financial ruin. Plaintiff also contends that defendants committed other acts, including advising plaintiff that

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he was investing in a team, defendants Barron and Adeli, when the team was falling apart, with Barron being locked out of the company at the time of the investment; advising plaintiff they were looking for an investor to grow the company, when they were just looking for money to save the company, not grow it; failing to advise plaintiff of significant markdowns and chargebacks Barron gave to a customer without company authorization; failing to reveal to plaintiff that the company owed a significant sales tax liability, including interest and penalties; and providing plaintiff with a non-current Operating Agreement, that did not contain provisions restricting defendant Barron from working for a competitor. Plaintiff claims that he relied on these misrepresentations and omissions and would not have invested in the company had he known about them. Defendant Barron contends in his motion that plaintiff failed to perform the required due diligence before he invested and that he was aware of some of the matters that he claims defendants failed to tell him.

BACKGROUND

In October 1996, defendants Adeli and Barron formed a California limited liability company called Klothes LLC ("KCA"), that was in the business of the design, production and sale of women's clothing. (Defendant Barron's Rule 19-a Statement, ¶¶ 1-2; Plaintiff's Rule 19-a Statement, ¶¶ 1-2). Adeli has a 55% ownership interest and Barron has a 45% ownership interest in KCA. (Defendant Barron's Rule 19-a Statement, ¶ 3). Adeli was responsible for the design and production of the clothing. Barron was responsible for the marketing, sales and finances. (*Id.*, ¶ 4; Plaintiff's Rule 19-a Statement, ¶ 4). KCA sold its clothing to department stores. Its major clients were Saks Fifth Avenue, Bloomingdale's and Barney's. (Defendant Barron's Rule 19-a Statement, ¶ 5). In late 1998, Adeli and Barron formed 35 Bond Street, LLC ("35BS"), a California limited liability company, that established a retail store in downtown Manhattan to sell KCA clothing directly to the public. (*Id.*, ¶ 6). Defendant Klothes (NY), LLC, a Delaware

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limited liability company, formed to engage in the design, production and sale of the women's clothing Adeli designed. (First Amended Complaint, ¶ 4). In 2000, 35BS and the other related KCA entities merged with KCA, becoming the surviving limited liability company. (*Id.*, ¶ 9).

Plaintiff has been engaged in business, brokerage and investment banking since 1982. (Defendant Barron's Rule 19-a Statement, ¶ 16). In 1995, plaintiff worked for Salomon Brothers as Managing Director of the Private Investment department, and from 1995 to 2001, he was a Senior Managing Director of Bear Stearns. (*Id.*, ¶ 17; Plaintiff's Rule 19-a Statement, ¶ 17). Plaintiff's assets at the time of his investment in KCA include three homes, publicly traded securities and private business investments, including investments in non-publicly traded companies. (Defendant Barron's Rule 19-a Statement, ¶¶ 19-20).

The Transaction

In early 2000, KCA was encountering cash flow problems and began seeking investors and financing. (*Id.*, ¶ 9). A friend of plaintiff's, Lee Stein, made plaintiff aware of KCA's search for an investor. (*Id.*, ¶ 10; Plaintiff's Rule 19-a Statement, ¶ 10). In late May and early June 2000, plaintiff contacted KCA through defendant Barron to discuss investing in the company. (Defendant Barron's Rule 19-a Statement, ¶ 33-35). They had an in-person meeting at the KCA showroom that plaintiff, his wife, Barron and Adeli attended. (Deposition of Richard B. Sachs, Plaintiff's Exhibit 9, at 83-84). At that meeting, Adeli and Barron told plaintiff that they were looking to raise a million dollars to grow the business and plaintiff told them that he might be interested in investing. (Sachs Dep., at 85-87). Defendants Adeli and Barron also told him the history of the business and its operations. (*Id.* at 88). At that meeting, plaintiff requested "[a]ll financial information available that I could rely upon to make an investment decision." (*Id.* at 89, lines 14-16), but did not request any particular type of document. (*Id.*). Plaintiff attested, at his

deposition, that he received the "financial documentation" within a day or so. (*Id.* at 90, lines 14-15). This documentation included KCA's projections for 2000/2001, KCA's 1998 and 1999 Financial Statement and 35BS's 1999 Financial Statement, that KCA's accountant, Moss Adams LLP prepared and an earlier version (not the current one) of the KCA Operating Agreement, that did not contain any non-compete provisions, restricting Barron or Adeli from working elsewhere. (Exhibits H, I, J, K, and L to Defendant Barron's Motion).

With regard to the matters that plaintiff and defendant Barron discussed in various phone conversations, plaintiff attested that Barron discussed his and Adeli's different roles in the company– she was the designer and he was responsible for sales. (Sachs Dep., at 86, 941-42). Barron told plaintiff that they needed funds to grow the business. (*Id.* at 87-88). He said that he would be providing plaintiff with the financial information he needed. (*Id.* at 942). Barron also said that he and Adeli were a good team. (*Id.*). Plaintiff further attested that he requested from Barron all the financial information available that plaintiff could rely upon to make an investment decision, without any specifics. (*Id.* at 88, 118-19, 123). Plaintiff, however, could not recall anything Barron said to him about the "financials." (*Id.* at 950). Plaintiff further attested that he did not request any additional documents or information and did not have a discussion with Adeli or Barron, their accounting staff, accountants or factor about the company's finances. (*Id.* at 986-89).

Before the end of June 2000, Adeli and Barron were no longer working well together. Adeli sought to remove Barron from the transaction with plaintiff and out of the company. (Deposition of Katayone Adeli, Plaintiff's Exhibit 11 to Cross Motion, at 694-97). Adeli testified at her deposition that she informed Barron and plaintiff of this sometime in the last week of June 2000. (Adeli Dep., at 695-96, 698). On June 23, 2000, a term sheet plaintiff's counsel drafted

removed defendant Barron as an active participant in the company - - that is, he was no longer an employer (Exhibit Q to Defendant Barron's Motion, at A01963) and the transaction papers did not mention him. Thereafter, all of the transaction documents drafted and exchanged between Adeli and plaintiff from June 23, 2000 to July 27, 2000, the date the deal closed, do not mention Barron. (*See* Exhibits R, T-Z, AA-KK to Defendant Barron's Motion).

On June 27, 2000, plaintiff and Adeli, on behalf of herself, KCA and 35BS, executed a letter agreement containing the principal terms for their agreement in which plaintiff and his fellow investors (his wife, and Mr. Stein, as trustee of his children's trust fund) agreed to invest $1 million in KCA. This letter agreement provided that if KCA needed an infusion of cash before the parties agreed to and signed the definitive agreements, it could request so up to the amount of $250,000. (Exhibit R to Defendant Barron's Motion).

On July 6, 2000, plaintiff advanced KCA $250,000. (Exhibit U-V to Defendant Barron's Motion). On July 25, 2000, Adeli made a request for an additional $50,000 cash advance on plaintiff's investment. (Exhibit DD to Defendant Barron's Motion). On July 27, 2000, plaintiff, Adeli, and KCA executed the agreements, closing the transaction for plaintiff's investment in KCA. (Exhibits FF, GG to Defendant Barron's Motion).

Barron's Departure

In late June, early July 2000, Barron took a leave of absence, and upon his return found that KCA had physically locked him out and terminated his off-site internet access. (Deposition of Sean P. Barron, Exhibit E to Defendant Barron's Motion, at 229, 232-33). He then worked as a consultant for Theory, another clothing design and production company, in their men's division. (Deposition of Sean Barron, Exhibit 10 to Plaintiff's Cross Motion, at 84-86, 92-93). Sometime after 2001, he went to work for another clothing company, Joie. (*Id.* at 86). He remained a part

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owner of KCA.

Negative Prior Period Adjustment

On August 31, 2000, Moss Adams LLP ("Moss Adams"), KCA's accountant, issued an Accountant's Review Report and Balance Sheet dated July 1, 2000. (Exhibit MM to Defendant Barron's Motion). This balance sheet indicated a negative Member's Capital in the amount of $823,419. (*Id.* at 2, C00057). This was a decrease from the December 1999 Balance Sheet, that had indicated a positive Member's Capital in the amount of $286,882. (Exhibit K to Defendant Barron's Motion). Sometime after August 31, 2000, Moss Adams issued a "negative prior period adjustment" ("NPPA") in the amount of $499,437 on KCA's 1999 Financial Statement (Exhibits 5, 6, 20 to Plaintiff's Cross Motion), that then appeared on the Statement of Income and Member's Equity for the period ended June 30, 2000. (Exhibit 5 to Plaintiff's Cross Motion). The Members' Equity for the period ending June 30, 2000 now was a negative $1,140,962. (*Id.* at D04792).

The Saks Chargebacks and Markdowns

Barron, on behalf of KCA, had negotiated gross margin agreements with customers such as Saks Fifth Avenue ("Saks"). (Plaintiff's Rule 19-a Statement, ¶ 95). In the clothing industry, manufacturers often have gross margin agreements, a form of RADs (returns, allowances, and discounts) with customers, such as department stores, in which the manufacturer guarantees the store that the store will make a certain profit on the manufacturer's clothing. (Defendant Barron's Rule 19-a Statement, ¶¶ 93-94). If, at the end of the season, the store does not reach that profit, the manufacturer will negotiate to reimburse the store in some form, commonly by giving it markdown allowances or chargebacks. (*Id.*; Exhibit F to Defendant Barron's Motion, Adeli Dep., at 512; *see also* Sach's Dep., at 1034). The reimbursements can appear on the manufacturer's financials as RADs. (Defendant Barron's Rule 19-a Statement, ¶¶ 93-94, 97).

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In April 2000, Barron authorized chargebacks for Saks in the amount of $88,374. (Exhibit 3 to Plaintiff's Cross Motion, at 0148). As of September 2000, he had also authorized chargebacks in the amount of $164,340. (Exhibit 1 to Plaintiff's Cross Motion). In a letter dated July 13, 2000 to Barron, from KCA's counsel, Robert Ezra, Ezra told Barron that KCA was informed that he had given tens of thousands in markdown money to various customers of the company without the company's consent and that he was to make no more commitments to customers or enter into any agreements without the written consent of Adeli. (Exhibit 8 to Plaintiff's Cross Motion). After Barron left KCA, in about August or September 2000, KCA employed Emilia Fabricant, as President of Sales, who had a meeting with Saks, and discovered a chargeback liability from KCA to Saks of approximately $160,000. (Affidavit of Emilia Fabricant, dated April 22, 2005, ¶ 3). In September 2000, Saks reversed the chargebacks for July and August 2000 and agreed to allow KCA to pay the chargebacks in three monthly installments in September, October, and November 2000. (Exhibit 1 to Plaintiff's Cross Motion). In addition, Saks returned between $60,000 and $80,000 worth of KCA merchandise from the Spring 2000 clothing line. (*See* Plaintiff's Rule 19-a Statement, ¶¶ 101, 107).

The Sales Tax Liability

The 1999 Financial Statement for 35BS disclosed a sales tax liability, under the category "Current Liabilities," of $42,344 for the year 1999. (Exhibit L to Defendant Barron's Motion). Plaintiff received and reviewed this document and the sales tax figure, before investing in KCA. (Exhibit D to Defendant Barron's Motion, Sachs Dep., at 999-1000, 1022-1024). In the first quarter of 2000, 35BS incurred additional sales tax liability of $31,795.83 for taxes due for the quarter ending May 31, 2000 (Exhibit PP to Defendant Barron's Motion, at B00212) that was not due and payable until June 20, 2000. (Exhibit OO). KCA failed to pay this tax. For the tax period

ending August 31, 2000, 35BS owed and failed to pay sales tax in the amount of $16,773.69. (Exhibit PP to Defendant Barron's Motion; Exhibit 38 to Plaintiff's Cross Motion). As of July 3, 2002, 35BS owed over $128,000 in sales taxes, interest and penalties for tax periods in 2000 and 2001. (Exhibit 38 to Plaintiff's Cross Motion).

Adeli's Lawsuit Against Barron

In January 2001, Adeli commenced a lawsuit in California against Barron, seeking declaratory relief and damages for breach of contract, breach of fiduciary duty, and embezzlement. (Exhibit 13 to Plaintiff's Cross Motion). Adeli and Barron settled that lawsuit and Adeli dismissed the action on June 20, 2001. (Exhibit 18 to Plaintiff's Cross Motion, ¶ 6).

KCA's Collapse

In 2003, KCA continued to suffer financial difficulties, allegedly because of market conditions. (First Amended Complaint, ¶ 31). On April 15, 2003, KCA's factor sent a notice of default and KCA informed it that it was discontinuing its business. (*Id.*). Between June and August 2003, KCA's factor sold a portion of KCA's assets, including inventory, and collected some of its accounts receivable. (*Id.*, ¶ 36). Adeli has since filed for bankruptcy. (Transcript of Oral Argument, dated May 4, 2006, at 2).

The Pleadings

In its First Amended Complaint, plaintiff asserts eight causes of action, only one of which, a fraud claim (the second cause of action), it asserts against defendant Barron.[1] This fraud claim relies on the allegations that defendant Barron, with Adeli and KCA, fraudulently induced plaintiff

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[1]In the claims not asserted against defendant Barron, plaintiff seeks to recover from KCA more than $640,000 as the holder of the loans from KCA's factor, and for certain alleged fraudulent conveyances by KCA, which claims are not relevant to this motion and cross motion.

into making his investment in KCA. It alleges that the defendants omitted to tell plaintiff of the existence of chargebacks from Saks in the amount of $150,000 (First Amended Complaint, Exhibit A to Defendant Barron's Motion, ¶ 11) and of past-due sales tax charges in the amount of $100,000 that 35BS and KCA owed to the New York State Department of Taxation and Finance, at the time of plaintiff's initial investment. (*Id.*). Plaintiff further alleges that defendants failed to disclose the then-existing and proposed future financial condition of KCA. (*Id.*, ¶ 46).

Plaintiff's cross motion for leave to serve an amended complaint includes a Proposed Second Amended Complaint. (Exhibit 96 to Plaintiff's Cross Motion). This Proposed Second Amended Complaint contains three new causes of action against Barron, including aiding and abetting fraud, conspiracy to defraud, and negligent misrepresentation, as well as additional allegations amplifying the fraudulent inducement (second) cause of action. The fraudulent inducement claim now relies on allegations that Barron informed plaintiff that an investment in KCA and 35BS was an investment in a great team, i.e., Adeli and Barron, but that they failed to tell him that they were having differences. (Exhibit 96, ¶¶ 28, 30). It also alleges that in June 2000 a chargeback from Saks should have appeared on KCA's books in the amount of $250,000 and that Barron negotiated with Saks, without Adeli's knowledge, that KCA would accept returned merchandise from Saks of $60,000-$80,000 and that Saks would "hold" the remaining chargeback in the amount of $164,340 until after plaintiff's investment in KCA and after Barron's departure from KCA. (*Id.*, ¶ 29). In addition, it alleges that $100,000 was due in sales tax from 35BS and KCA to the New York State Department of Taxation and Finance, at the time of plaintiff's initial investment, but that defendants failed to tell plaintiff of these past-due taxes. (*Id.*). It further alleges that defendants omitted to tell plaintiff, prior to his investment, that Barron went to work for a competitor and that the version of the KCA Operating Agreement plaintiff received prior to

his investment was not current, did not contain a restrictive covenant and did not require that Barron and Adeli devote their full time to KCA, as contained in the current operating agreement. (*Id.*, ¶¶ 32-38).

Plaintiff also claims that, in July 2000, before his investment, Adeli accused Barron of giving unauthorized markdowns to customers, that led to the hostilities, Barron's departure and the California lawsuit in which Adeli accused Barron of embezzlement and Adeli's unsuccessful attempt to buy Barron out. (*Id.*, ¶¶ 39-46). The fraud claim then asserts that, almost immediately after plaintiff's investment, Moss Adams determined that the financial statements of KCA and 35BS needed a negative adjustment of $499,437 (the NPPA), eviscerating plaintiff's prospective equity interest, that he, through due diligence, could not have discovered the NPPA or the bases for it, prior to his investment and that defendants should have informed him of it. (*Id.*, ¶¶ 47-55).

The additional claim of aiding and abetting fraud alleges that Barron, as KCA's putative CEO, was involved in, knew, or should have known of, the alleged fraudulent acts and omissions, and that he, at the least, helped conceal the frauds. (*Id.*, ¶¶ 104-113). The conspiracy to defraud claim asserts that Adeli and Barron devised the scheme to defraud plaintiff and had a common purpose, to obtain plaintiff's money and create a way for Barron to leave KCA. (*Id.*, ¶¶ 114-20). Finally, the negligent misrepresentation claim alleges that Barron had unique knowledge of the operations of KCA and 35BS that placed him in a special relationship with plaintiff. It alleges that Barron knew KCA and 35BS needed an infusion of capital to pay past liabilities and not grow the business as they told plaintiff; that he knew that the financial documents they provided plaintiff deliberately understated KCA's liabilities by the amount of the NPPA; that he knew as of June 30, 2003, 35BS's tax liabilities were more than double what 35BS reported in the financial statement provided to plaintiff; that he knew he was engaged in divisive negotiations with Adeli to remove

him from the company and that he was working for a competitor. (*Id.*, ¶¶ 121-32). Thus, the Proposed Second Amended Complaint alleges that Barron is liable for negligently misrepresenting these facts and causing plaintiff damages.

The Motion and Cross Motion

In moving for summary judgment, Barron argues that plaintiff, a sophisticated and wealthy businessman, conducted a very cursory due diligence before making his $1 million investment, ignored a series of significant red flags on KCA's financial documents and blindly sought to go forward with his investment in KCA. He contends that plaintiff requested no further documents or information, other than what KCA had initially given him and, thus, may not claim that Barron fraudulently induced him. Barron asserts that the red flags on the financial documents include that, from 1998 to 1999, KCA's accounts payable more than doubled, while its accounts receivable decreased significantly, so that the payables exceeded the receivables by a multiple of more than 17. In addition, KCA's unsold inventory from 1998 to 1999 more than doubled. (Exhibits J-K to Defendant Barron's Motion). Further, its cash flow dramatically decreased from $795,618 in 1998 to $291,008 in 1999, while its liabilities nearly doubled from $821,584 in 1998 to $1,592,601 in 1999. (*Id.*). The net income decreased almost in half, from $1,186,476 in 1998 to $548,302 in 1999. (*Id.*). Barron also urges that Adeli's demand for immediate cash infusions before the deal closed on July 27, 2000, raised yet another red flag. (Exhibits U-V, DD to Defendant Barron's Motion). These red flags, along with plaintiff's business and investing sophistication, warrant a finding, according to Barron, that, as a matter of law, plaintiff did not reasonably rely on the financial statements submitted to him, and did not perform the required due diligence.

Barron also argues that the record is devoid of evidence that he made any false statements to plaintiff, or that he omitted to furnish plaintiff with any required material information. Barron

claims that he disclosed information underlying the purported omissions, relating to the company sales tax and allowances to Saks, to plaintiff in documents that plaintiff admits he received. He asserts that KCA disclosed figures for annual sales taxes and RADs (returns, allowances and discounts) in its financial statements that plaintiff received. He states that plaintiff never sought any additional information or documentation. He further urges that there is no evidence that he knowingly and intentionally made any false statement or omission. He contends that he simply provided documents to plaintiff that the company's accountants prepared. Barron contends that the undisputed evidence shows that he was literally locked out of KCA's business, removed from contact and the extensive negotiations of plaintiff's investment. Further, Barron asserts that the evidence shows that plaintiff was aware of this, and consented to it, through his negotiation of the entire transaction with Adeli and the resulting agreements, that entirely exclude Barron.

Barron also maintains that the purported omissions were not material. He argues that the assertions that he and Adeli were a team are too vague to base a fraud claim on; that the assertions that defendants sought the money to grow the business was just puffery; that his competitive activity was not material to plaintiff's claimed damages; that the undisclosed sales tax liability was, in fact, disclosed; that sales tax liability incurred after plaintiff invested was clearly not material to his decision to invest; that Adeli did not pursue the embezzlement claim against him and nevertheless that claim was immaterial to plaintiff's fraud claim.

In opposition, plaintiff argues that the parties' sharply conflicting deposition testimony on key issues, including whether plaintiff was or was not aware of certain key facts prior to investing, raises material issues of fact, precluding summary judgment. He urges that Barron, as KCA's and 35BS's co-founder and putative CEO, knew the facts underlying the NPPA and the resulting negative restatement of the member's equity, in the amount of $499,437. He asserts that he

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requested that Barron provide him with all the documents upon which to make an investment decision and that the documents provided (Exhibits I, J, K, and L) gave no indication of the impending NPPA. He contends that he has not had the opportunity to understand the basis of the NPPA, because both Barron and Adeli claim to have no knowledge or understanding of it. He contends, in connection with his cross motion, that they have not produced, and Moss Adams has not produced, all the documents with regard to the NPPA. Plaintiff maintains that, in response to his pre-investment inquiry for all documents upon which to make an investment decision, Barron had a duty to impart full and correct information with regard to KCA's finances, but that he, instead, provided false documents. (Exhibits I, J, K, and L).

Plaintiff further argues that the omissions and misstatements were material and that none of them are immaterial as a matter of law. He maintains that Barron's claim that he was not aware of the NPPA is incredible, particularly in light of his position as the financial person at KCA. Plaintiff presents evidence that Barron requested that Saks "hold" chargebacks in the amount of $164,000 at the time that plaintiff was considering investing in June and July of 2000 thereby rendering the financial documents false.

On the issue of reasonable reliance, plaintiff argues that he conducted sufficient due diligence, or, at the least, that there is an issue of fact as to this issue. He contends that he did not have a duty to audit KCA's and 35BS's books. He asserts that he justifiably relied on the positive financial picture that the financial statements and the KCA projections presented. In support, he submits an affidavit from a C. Herbert Leshkowitz, a Certified Public Accountant, who opines that the data in the financials provided to plaintiff before his investment show a growing business, with some expense increases commensurate with such growth. (*See* Affidavit of C. Herbert Leshkowitz, dated May 6, 2005, ¶¶ 6, 9-10). Mr. Leshkowitz opined that the purported "red flags"

Barron identified in his motion are either not red flags or that there are numerous potential alternative interpretations of that information. (*Id.*, ¶11). He stated with regard to the NPPA (Exhibit 6 to Plaintiff's Cross Motion, at D 4790-4792), that it was financially devastating because it demonstrates that the earnings of KCA or 35BS were artificially inflated for 1998 or 1999, completely destroying the members' equity of $286,882 at December 31, 1999 (Exhibit K to Defendant Barron's Motion, at B006998), converting it to a deficit of $212,555. (Leshkowitz Aff., ¶16). He asserts that there was nothing in the financial documents defendants gave to plaintiff that would or should have led him to understand that income for 1998 or 1999 would be written down or otherwise adjusted. (*Id.*, ¶¶ 17-20). Plaintiff maintains that this raises triable issues of fact as to reasonable reliance. Plaintiff also urges that the information underlying the fraud is peculiarly within the defendant's knowledge, and, therefore, that he may justifiably rely upon the representations or omissions.

On his cross motion, plaintiff asserts that his new claims for aiding and abetting, conspiracy and negligent misrepresentation all sufficiently state claims. In addition, he asserts that the court should deny defendant Barron's motion for summary judgment because discovery is still outstanding. He claims that documents from the defendants' former accountants and lawyers are in defendant Barron's possession, custody, and control. Thus, he seeks an order, pursuant to CPLR 3126, prohibiting defendants from presenting proof on the fraud claim, striking any defenses with respect to it, resolving the fraud issues in plaintiff's favor or striking defendants' answers. Finally, he seeks sanctions, pursuant to CPLR 3126 and 20 NYCRR Part 130-1.1, contending that defendants should pay counsel fees of $25,000 and sanctions of $10,000 for their spoliation of evidence, based on defendants' repeated failure to obtain necessary documents from their former counsel and accountants, Moss Adams.

DISCUSSION

The courts denies Barron's motion for summary judgment. The court grants the cross motion for leave to amend only to allow amendment of the second cause of action for fraud as set forth in the Proposed Second Amended Complaint. The court incorporates the fifth cause of action into the second cause of action. The court denies the cross motion for leave to amend as to the first, third and fourth through the eighth causes of action. The court refers the branch of the cross motion for discovery to a Special Referee to determine all open discovery disputes, with oral argument on all disputes on the record. The court denies the request for sanctions. First, the court will address the branch of the cross motion to amend, then the summary judgment motion and, finally, the discovery and sanctions portion of the cross motion.

Cross Motion to Amend

A court must grant leave to amend freely, absent a showing of prejudice the delay in seeking such amendment might engender (*Fahey v County of Ontario*, 44 NY2d 934 [1978]; CPLR 3025 [b]). However, where the proposed amendment is palpably insufficient as a matter of law or is totally devoid of merit, the court may deny leave to amend (*Thomas Crimmins Contr. Co. v City of New York*, 74 NY2d 166 [1989]). The first and third claims in the Proposed Second Amended Complaint are identical to those in the First Amended Complaint. The second cause of action in the Proposed Second Amended Complaint, the fraudulent inducement claim, contains additional allegations based on discovery. I will address the sufficiency of this claim with the additional allegations more fully addressed in the summary judgment analysis below. Defendant Barron fails to demonstrate prejudice from plaintiff's delay in amplifying it upon obtaining the facts from discovery.

The Proposed Second Amended Complaint contains three new causes of action against

defendant Barron, as well as two new claims against defendant Adeli, who has not appeared to oppose these motions and is in bankruptcy. Leave is denied as to the claim for aiding and abetting fraud (the proposed fourth cause of action), the claim for conspiracy (the fifth proposed cause of action) and the claim for negligent misrepresentation (the sixth proposed cause of action). Leave is also denied without prejudice as to all claims (the first, second, and fifth through eighth proposed causes of action) as against defendant Adeli, because all these claims are subject to a bankruptcy stay.

In the fourth cause of action in the Proposed Second Amended Complaint, plaintiff fails to state a claim for aiding and abetting fraud against defendant Barron. This claim is based on plaintiff's allegations that Barron, as KCA's "putative CEO," and financial or business person, was involved in, knew, or should have known of the fraud, or helped conceal the fraudulent acts. (Proposed Second Amended Complaint, ¶¶ 104-113). It alleges that he personally was involved in providing plaintiff with the financial documents, that were false and upon which plaintiff relied in investing. It also alleges that Barron knew or should have known of the NPPA, that Moss Adams issued shortly after plaintiff invested. It also alleges that Barron knew that he had asked Saks to "hold" a chargeback in the sum of $164,340 so that the chargeback would not appear on KCA's books and records until after plaintiff's investment and after Barron left KCA's employment. (*Id.*, ¶ 109; Fabricant Aff., ¶¶ 3-12).

To plead a claim for aiding and abetting fraud, the plaintiff must show a fraud by the principal party, the knowledge of this fraud by the aider and abettor and substantial assistance by the aider and abettor in the achievement of the fraud. (*See Kaufman v Cohen*, 307 AD2d 113 [1st Dept 2003]; *National Westminster Bank USA v Weksel*, 124 AD2d 144, 147 [1st Dept], *appeal denied* 70 NY2d 604 [1987]). The purpose of an aiding and abetting claim is to draw in defendants

who would not be liable on the main fraud claim, but who are alleged to have actual knowledge of the fraud and substantially assisted it. Here, the aiding and abetting claim is duplicative and unnecessary, because Barron is one of the two principal actors alleged in the fraudulent scheme. (*See Brackett v Griswold*, 112 NY 454 [1889] [promoters and directors of corporation are liable for false representations in reports issued by corporation with their sanction]). Thus, his liability is as a principal, not as an aider or abettor. Therefore, the court denies leave to add this claim.

The fifth claim in the Proposed Second Amended Complaint, that seeks to allege a claim for conspiracy to defraud, fails to state a separate claim. There is no substantive tort of conspiracy (*Alexander & Alexander of New York, Inc. v Fritzen*, 68 NY2d 968 [1986]; *Hickey v Travelers Ins. Co.*, 158 AD2d 112, 118 [2d Dept 1990]). Conspiracy allegations are permissible for the limited purpose of connecting the actions of separate defendants with an otherwise actionable tort (*id.*), and to show that those acts flowed from a common plan or scheme. (*See Buccieri v Franzreb*, 201 AD2d 356, 358 [1st Dept 1994]; *Cuker Indus. v William L. Crow Constr. Co.*, 6 AD2d 415, 417 [1st Dept 1958]). The purpose of the conspiracy claim here is to subject defendant Barron to liability to fraudulent inducement, even if Barron did not specifically make any misrepresentation to plaintiff, because he was engaged in a common action with Adeli to facilitate the fraud. (*See Dooley v Metropolitan Jewish Health Sys.*, 2003 WL 22171876 [ED NY 2003] [permitting conspiracy claim to subject individual defendants to liability who had not made specific misrepresentations to plaintiff]). Leave is denied to set forth a separate individual claim of conspiracy against Barron, but the conspiracy allegations are deemed part of the remaining fraudulent inducement (second) cause of action, to which they are relevant.

The sixth claim in the Proposed Second Amended Complaint fails to state a claim for negligent misrepresentation. In that claim, plaintiff alleges that Barron had unique knowledge of

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the operations of KCA and 35BS, simply based on his position as the sales and financial manager of KCA, that placed him in a special relationship with regard to plaintiff. A claim for negligent misrepresentation exists where a defendant owes a duty to the plaintiff to use reasonable care to impart correct information (*White v Guarente*, 43 NY2d 356 [1977]), that information was false and the plaintiff reasonably relied on the information. (*Saunders v AOL Time Warner, Inc.*, 18 AD3d 216 [1st Dept 2005]). The claim requires a special relationship of trust or confidence between the parties, that creates the duty to impart correct information. (*See id.*; *United Safety of Am., Inc. v Consolidated Edison Co. of New York*, 213 AD2d 283, 286 [1st Dept 1995]; *Delcor Labs., Inc. v Cosmair, Inc.*, 169 AD2d 639 [1st Dept 1991], *appeal dismissed* 78 NY2d 952 [1991]). A regular arm's-length business transaction will not create such a relationship (*see Sheridan v Trustees of Columbia Univ.*, 296 AD2d 314, 316 [1st Dept 2002], *lv denied* 99 NY2d 505, *cert denied* 539 US 904 [2003]; *Andres v LeRoy Adventures, Inc.*, 201 AD2d 262 [1st Dept 1994]), unless the defendant has a unique or special expertise. (*Kimmell v Schaefer*, 89 NY2d 257, 263 [1996] [unique, special expertise]). Here, plaintiff had merely an arm's-length business relationship with Barron. That is insufficient to support the negligent misrepresentation claim. Barron's position as part owner and co-founder of KCA at the time of the alleged misrepresentations does not bestow on him any unique or special expertise. (*JP Morgan Chase Bank v Winnick*, 350 F Supp 2d 393, 402 [SD NY 2004] [knowledge of the particulars of company's business and of the true situation underlying the misrepresentations pertaining to that business does not constitute the type of specialized knowledge required]). His financial knowledge of the business is not sufficiently unique as to create a special duty. (*Id.*). Accordingly, this claim fails to state a claim for negligent misrepresentation and the court denies leave to amend to add this claim.

Summary Judgment

The defendant Barron's motion for summary judgment dismissing the complaint as against him is denied. Summary judgment is a drastic remedy that deprives the litigant of his day in court and the court should not grant it where a genuine triable issue of material fact exists. (*Andre v Pomeroy*, 35 NY2d 361 [1974]). If there is any doubt as to the existence of a triable issue, or if the issue is even arguable, then the court should deny summary judgment. (*Sillman v Twentieth Century-Fox Film Corp.*, 3 NY2d 395 [1957]). The movant on a summary judgment motion must show prima facie entitlement to judgment as a matter of law, tendering sufficient material evidence to eliminate any material issues of fact. (*Ayotte v Gervasio*, 81 NY2d 1062, 1063 [1993]; *Estate of Nevelson v Carro, Spanbock, Kaster & Cuiffo*, 259 AD2d 282 [1st Dept 1999]; *Stuart Silver Assocs., Inc. v Baco Dev. Corp.*, 245 AD2d 96 [1st Dept 1997]). To defeat the motion, the opposing party has the burden of presenting admissible evidence showing that a triable issue of fact exists. (*Rinaldi v Holt, Rinehart & Winston, Inc.*, 42 NY2d 369, *cert denied* 434 US 969 [1977]; *Zuckerman v City of New York*, 49 NY2d 557, 562 [1980]; *Indig v Finkelstein*, 23 NY2d 728 [1968]). As set forth below, there exists genuine issues of material facts as to plaintiff's second cause of action for fraudulent inducement, precluding summary judgment in defendant Barron's favor.

To sustain a claim for fraud, a plaintiff must show "a representation concerning a material fact, falsity of that representation, scienter, reliance and damages." (*Stuart Silver Assocs., Inc. v Baco Dev. Corp.*, 245 AD2d at 98 [citation omitted]). On the element of materiality, if the representation or omitted facts would have made a difference to a reasonable investor, they are material. (*See Ballan v Wilfred Am. Educ. Corp.*, 720 F Supp 241 [ED NY 1989], citing *Basic Inc. v Levinson*, 485 US 224 [1988]). The representations or omissions may be held immaterial as a

matter of law only where the court can find that the representations or omitted facts undisputedly would add nothing to the information available that reasonable minds would regard as significant. (*Id.* at 249). "If there is room for difference the issue of materiality is for the jury." (*Id.*; *see Brunetti v Musallam*, 11 AD3d 280 [1st Dept 2004] [issue of material misrepresentation is not subject to summary disposition]; *Texaco Inc. v Synergy Group Inc.*, 171 AD2d 788 [2d Dept 1991] [issue of materiality more properly left to jury to resolve]).

With respect to the element of reliance, it is well-settled that establishing reliance is "essential to a claim of fraud." (*Valassis Communications, Inc. v Weimer*, 304 AD2d 448, 449 [1st Dept 2003], *lv denied* 2 NY2d 794 [2004]). To show reliance sufficient to prevail on a claim for fraud, a plaintiff must show that he acted or refrained from acting based on the alleged misrepresentation or omission. (*Id.*). In order to recover for fraud or fraudulent inducement or concealment, the reliance must be "reasonable" or "justifiable." (*Stuart Silver Assocs., Inc. v Baco Dev. Corp.*, 245 AD2d 96, *supra*; *Matter of Jack Kent Cooke Inc. (Saatchi & Saatchi N. Am)*, 222 AD2d 334 [1st Dept 1995]). Where "a party has the means to discover the true nature of the transaction by the exercise of ordinary intelligence and fails to make use of those means, he cannot claim justifiable reliance on defendant's misrepresentations." (*Stuart Silver Assocs., Inc. v Baco Dev. Corp.*, 245 AD2d at 98-99). The reasonableness of the plaintiff's reliance, however, is not determinable on a summary judgment motion, absent extraordinary circumstances. (*See Brunetti v Musallam*, 11 AD3d at 281 [issue of "reasonable reliance, [an] essential element[] of a fraud claim, [is] not subject to summary disposition"] [citations omitted]; *Swersky v Dreyer and Traub*, 219 AD2d 321 [1st Dept 1996], *appeal withdrawn* 89 NY2d 983 [1997] [issue of fact whether plaintiff reasonably relied on alleged statements]; *accord 767 Third Ave., LLC v Orix Capital Mkts., LLC*, 10 Misc 3d 1063(A); 6 Misc 3d 1019(A) [Sup Ct, NY County 2005]; *Computech Intl. v Compaq*

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Computer Corp., 2004 WL 1126320 [SD NY 2004] [reasonable reliance is issue of fact]; *Crigger v Fahnestock and Co.*, 2003 WL 22170607 [SD NY 2003] [whether plaintiffs reasonably relied and engaged in enough due diligence is issue of fact for jury]; *Granite Partners, L.P. v Bear, Stearns & Co.*, 17 F Supp 2d 275, 290 [SD NY 1998] [reasonableness of reliance is question of fact]; *Stratford Group, Ltd. v Interstate Bakeries Corp.*, 590 F Supp 859, 865 [SD NY 1984] [reasonable reliance is ordinarily fact issue for jury]).

Plaintiff has presented sufficient proof to raise a triable issues of fact as to whether Barron made material misrepresentations and whether plaintiff reasonably relied. First, plaintiff has presented proof that shortly after his investment, Moss Adams issued the NPPA that adjusted the 1999 financial statements for KCA negatively in the amount of $499,437, significantly decreasing the Members' Equity. (Exhibits 5, 6 and 20 to Plaintiff's Cross Motion). While, as Barron asserts, this was made after he left KCA to work for a competitor, the NPPA was made to the financial statement issued when Barron was responsible for the finances of KCA. In addition, Barron supplied plaintiff with the financial statements and projections, that were later negatively adjusted, that plaintiff asserts are misleading. It is unclear from the documents and the deposition testimony at this point as to why Moss Adams made this negative adjustment, how it effected KCA's financial state and if it was something that plaintiff could have discovered. Barron's failure to explain the NPPA either in his deposition testimony, or in his motion papers, simply highlights that plaintiff has raised an issue of fact as to whether this was a material misrepresentation, and whether plaintiff could have discovered the basis for it prior to investing. Plaintiff has not had the opportunity to depose KCA's accountant, Moss Adams, and has had limited opportunity to obtain documents from Moss Adams, because third-party discovery has been stayed since October 2004 pending completion of party discovery. (*See* Exhibits 59, 81). Third-party discovery is necessary

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on this issue.

Second, plaintiff has also presented proof that a month after he invested, on August 31, 2000, Moss Adams issued a Balance Sheet for KCA as of July 1, 2000, that negatively adjusted the Members' Equity from a positive $286,882 as of December 31, 1999 to a negative $823,419, only six months later. (*Compare* Exhibits K to MM). In addition, this new Balance Sheet shows, under the Current Liabilities column, that accounts payable and accrued expenses increased from $1,121,905 in the end of December 1999, to $2,280,153 as of July 1, 2000, in a company with total assets of less than $2 million. (*Id.*). This is a significant increase within a short period of time. This document also raises factual issues as to whether the financial documents plaintiff received to induce him to invest in KCA contained material misrepresentations and whether he reasonably relied upon them in investing.

Plaintiff has submitted further proof that Barron asked Saks to "hold" certain chargebacks, in the amount of over $164,000, at the time when plaintiff was considering investing and reviewing the financial documents. He submits the affidavit of Emilia Fabricant, Barron's successor at KCA, who attests that she had a meeting at Saks, with Daphne Pappas, the Divisional Merchandise Manager of Saks' Buying Department, who told her that Barron requested that Saks "hold" the chargebacks, that were due in or about June or July 2000, that is, to refrain from demanding payment of them. (Affidavit of Emilia Fabricant, dated April 22, 2005, ¶¶ 3-12, and exhibits annexed thereto). Such proof not only raises factual issues as to plaintiff's claim that the financial documents were misleading in that they did not reflect these requests, but also raises issues as to Barron's intent to defraud.

Defendant Barron's contention that this is hearsay evidence that is insufficient on summary judgment is unavailing here. A party opposing summary judgment may proffer hearsay evidence,

so long as it is not the only evidence in opposition (*Candela v City of New York*, 8 AD3d 45 [1st Dept 2004]; *see also Sunfirst Fed. Credit Union v Empire Ins. Co.*, 239 AD2d 894 [4th Dept 1997]), or the party tenders an excuse for the failure to proffer admissible evidence. (*See Zuckerman v City of New York*, 49 NY2d at 560). Plaintiff not only offers Ms. Fabricant's affidavit, he also offers documents from Saks tending to support that there were unpaid chargebacks in September, October and November of 2000. (Exhibits annexed to Fabricant Aff.). Plaintiff tenders the affidavit of a Senior Vice President and Deputy General Counsel for Saks, Kenneth L. Metzner, to show that Saks does not retain documents, e-mails or correspondence for more than the particular season or until completion of the transaction and that Ms. Pappas, the person to whom Ms. Fabricant spoke Saks no longer employs. In addition to this evidence with regard to the Saks chargebacks, plaintiff also presents a letter from KCA's counsel to Barron, dated July 13, 2000, in which counsel states that Barron had been giving "several tens of thousands of dollars in markdown money of various customers," and that this markdown money was given without the consent of KCA. (Exhibit 8 to Plaintiff's Cross Motion). While defendant Barron argues that defendants disclosed these markdowns and allowances in the financial statements as RADs, this letter and Ms. Fabricant's affidavit raise issues as to whether Barron had authority to give these markdowns and allowances, whether the financial statements took into account these markdowns and allowances and whether the defendants ever disclosed them to plaintiff prior to investing. Accordingly, summary judgment to Barron on this portion of the fraud claim is inappropriate.

On the issue of KCA's sales tax liability of over $120,000, that was accruing during 2000, plaintiff has raised a triable issue as to whether defendants, including defendant Barron, were aware, prior to plaintiff's investment, that no one at KCA was paying the sales tax to the New York

State Department of Taxation and Finance (Adeli Dep., at 89-96; Deposition of Sean Barron, dated January 24, 2005, Exhibit 10, at 34-38), whether they were aware by July 26, 2000 that there was delinquent sales tax due for the time period prior thereto (Exhibit 42 to Plaintiff's Cross Motion) and whether any of this was disclosed to plaintiff.

Defendant Barron presents proof that the 1999 Financial Statement for 35BS disclosed $42,344 in sales tax liability for 1999. (Exhibit L to Defendant Barron's Motion). Defendant Barron also points to a Consolidated Statement of Tax Liabilities from the New York State Department of Taxation and Finance, dated April 21, 2003, that indicates that in the first quarter of 2000, before plaintiff invested, 35BS incurred additional sales tax liability of over $30,000. (Exhibit PP to Defendant Barron's Motion). Based on this proof, Barron urges that plaintiff was put on notice as to amounts for later periods that would result in a total of over $100,000 in taxes, interest and penalties and that, therefore, he is entitled to summary judgment in his favor on this claim. This argument is not persuasive. A notation of a tax liability at the end of the 1999 year and additional tax liability appearing in a statement dated several years after the investment, does not, as a matter of law, put an investor on notice that the company was not paying the sales taxes at all from that time on until the time of plaintiff's investment, or the amount of such liability.

Plaintiff, in turn, presents proof in the form of deposition testimony from both Adeli and Barron that they were not paying the sales tax and that, in fact, the responsibility for paying sales tax had "fallen through the cracks." (Adeli Dep., at 93-96, 141-42; Barron Dep., at 39-40, 44-45). Upon further discovery on this issue (*see Sachs v Adeli*, 26 AD3d 52 [1st Dept 2005]), plaintiff submits a tax warrant indicating that the tax liability for the first half of 2000 had grown to over $100,000 with penalties and interest. (Exhibit 38 to Plaintiff's Cross Motion; Exhibit 4 to Plaintiff's Accountant Expert Affidavit Re: Sales Tax in Further Support of Motion). The tax

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warrant, however, is dated July 3, 2002, and it is unclear from the papers when the defendants were aware of the extent of their sales tax liability. Accordingly, the court cannot resolve as a matter of law the issue of whether or not defendant Barron knew of the tax problems facing KCA and 35BS prior to soliciting plaintiff's investment.

Defendant Barron's argument that there were numerous red flags in the financial documents plaintiff received, warranting a conclusion that the plaintiff's reliance on the financials was unreasonable as a matter of law, also is unpersuasive. In support of his argument, defendant Barron submits an affidavit from Kenneth Steckler, a Certified Public Accountant, as an expert in accounting, with experience servicing entities and individuals in the apparel business. (Affidavit of Kenneth Steckler, dated August 1, 2004). Mr. Steckler opines that the financial statements disclosed to plaintiff contained certain red flags, such as a 55% increase in inventory, a decrease of 63% in its net cash flow from operating activities, a decrease of 53% in its net income, and a 93% increase in its current liabilities. (*Id.*, ¶ 15). He concludes that this presents a negative picture to a would-be investor. (*Id.*). Mr. Steckler states that there were additional red flags, including KCA's increased borrowing from its factor, a negative balance with its factor and a footnote in KCA's 1999 Financial Statement indicating that KCA was not in compliance with the financial ratio covenant under its factor agreement. (*Id.*, ¶ 18). Based on this, defendant Barron contends that these red flags imposed a heightened duty on plaintiff as an investor to perform additional due diligence. Further, defendant Barron asserts that plaintiff was a sophisticated investor, pointing to his position at Bear Stearns, his business and investing experience, his significant assets in the form of three homes and investments in securities, real estate and hedge funds. (Affirmation of Nikol A. Gruning, dated April 4, 2005, ¶¶ 8-10 and Exhibit D to Defendant Barron's Motion, Deposition of Richard B. Sachs, at 8-45, 62-63, 565-66). Thus, Barron urges that plaintiff had a

further duty of due diligence.

Plaintiff presents a conflicting affidavit from an accountant, C. Herbert Leshkowitz (Affidavit of C. Herbert Leshkowitz, dated May 6, 2005), who also is a Certified Public Accountant, and a managing partner of a mid-sized CPA firm, Leshkowitz & Co., and who states in his affidavit that he has qualified as an expert witness in various federal and state cases, testifying on subjects such as bankruptcy, financial fraud, financial statement analysis, and other financial subjects. (*Id.*, ¶¶ 1-2; *see also* Exhibit 4 to Plaintiff's Cross Motion). Mr. Leshkowitz states that he reviewed the financial documents plaintiff received before he invested (Exhibits I, J, K, and L), and that, in his opinion, the financials "present a well-reasoned basis for an optimistic and confident view of future operations based on actual numbers, as well as a profitable past for the years 1998 and 1999." (Leshkowitz Aff., ¶ 6). He supports his opinion by pointing out that, while the 1999 profit did decline, the sales volume increased to $9,389,000 from $7,885,000, or by 19% and that KCA was still earning $548,000 in net income for 1999. (*Id.*, ¶ 8). He asserts that it is not uncommon for growing businesses to invest substantial costs in new product development, new infrastructure and staffing, increasing production costs, that would result in lower profits during earlier years. (*Id.*, ¶ 9). Mr. Leshkowitz disputes that items on the financials defendant Barron identified are red flags, stating that they need to be understood in the context of the entire financial statement. (*Id.*, ¶ 11). Thus, Leshkowitz asserts that the greater accounts payable is not as great as defendant states and is only 1.6%. He attributes this increase, in part, to increases in the ending inventory and that increases in inventory on hand in preparation for future sales often correlate with increases in supplier payables. (*Id.*). He further states that there was actually an increase in customer accounts receivable from $681,000 at December 31, 1998 to $962,000 at December 31, 1999, and not an 83% decrease as defendant Barron stated. (*Id.*). With respect to

KCA's increasing inventories in 1999, Mr. Leshkowitz asserts that sales had also increased by 19% and he projected them to increase by more than 40% in 2000 as compared to 1998 and that inventories must increase at least in proportion to expected sales increases so that there is sufficient product to fulfill the increasing orders. (*Id.*). Mr. Leshkowitz further explains that while there was a decrease in cash flow from operations, the members withdrew as "member distributions" significant amounts in 1998 and again in 1999, and that, based on the documents plaintiff received as an investor, he could reasonably look forward to a substantial return on his investment, that investment would enhance KCA's cash flow, given the 2000 and 2001 projections submitted to him. (*Id.*). Mr. Leshkowitz explains that the pre-execution capital infusion of $300,000 plaintiff gave to KCA before the formal closing on July 27, 2000, also is not a red flag, because it is not unusual in a growing business for the need for capital to outpace its ability to fund growth through its own cash flow. (*Id.*).

In reply to Mr. Steckler's affidavit, Mr. Leshkowitz attests that the 2000 and 2001 Projections plaintiff received before he invested support the expectation that inventory build up could be because of the reasonable likelihood of increased future sales. (Plaintiff's Accountant Expert Reply Affidavit of C. Herbert Leshkowitz, dated August 25, 2005, ¶ 5). With regard to the increase in factor debt, Mr. Leshkowitz asserts that this also is not a red flag. (*Id.*, ¶ 12). He states that typically, in a growing business, the need for cash to fund operations and growth exceeds the internally generated cash flow. (*Id.*). Factors loan money based on accounts receivable and inventory balances as its collateral, and that an increase in factor debt can be viewed as a positive endorsement by the factor of the company's collateral position and future likelihood of generating profits. (*Id.*). Mr. Leshkowitz asserts that while KCA was not in compliance with its factor's financial covenant ratio, as factors typically do, KCA's factor waived the non-compliance (*id.*, ¶

13) and continued to provide factoring services to KCA until April 2003. (*Id.*, ¶ 16). Thus, he affirms that it was not a red flag. Finally, Mr. Leshkowitz opined that the NPPA was financially devastating in that it demonstrates that the earnings of KCA or 35BS were artificially inflated for 1999, destroying the members' equity, and that there was nothing in the financial documents disclosed to plaintiff that would or should have led him to believe that there would be such an NPPA. (Leshkowitz Aff., ¶¶ 16-20).

These conflicting expert accountant affidavits raise triable issues of fact warranting denial of summary judgment about whether plaintiff's reliance was reasonable. Generally, the issue of whether reliance was reasonable is only subject to summary disposition before trial in rare circumstances. (*See Brunetti v Musallam*, 11 AD3d at 281; *Swersky v Dreyer and Traub*, 219 AD2d 321, *supra* [whether plaintiff had the means discover the fraud not resolvable on the record]; *JP Morgan Chase Bank v Winnick*, 350 F Supp 2d 393, *supra* [where financial reports show healthy revenues, reports themselves would not, on their face, have alerted plaintiff to fraud as a matter of law and fact issues raised as to whether plaintiff had access to truth and, if it did, what it would have taken to discover it]; *Crigger v Fahnestock and Co.*, 2003 WL 22170607 at *8 ["[w]hether plaintiffs engaged in enough due diligence relative to their networths [*sic*] and the resources potentially at their disposal to satisfy their burden is a question of fact"]). This case does not present such circumstances. (*Cf. Permasteelisa, S.p.A. v Lincolnshire Mgt., Inc.*, 16 AD3d 352 [1st Dept 2005] [no reasonable reliance where contract contained provision acknowledging that plaintiff had all information necessary to make an informed decision regarding transaction]; *J.A.O. Acquisition Corp. v Stavitsky*, 18 AD3d 389 [1st Dept 2005] [plaintiff's principal witness testified that he was aware prior to transaction that there were no letters of credit, the alleged misrepresentation, and that he so advised the plaintiff's bank]; *Stuart Silver Assocs. v Baco Dev.*

Corp., 245 AD2d 96, *supra* [plaintiffs did no due diligence and did not even read prospectus, relying instead on oral representations]). The inquiry into what constitutes reasonable reliance is very fact intensive, and the plaintiff's duty to inquire is not triggered, as defendant Barron contends, as soon as plaintiff has hints of any possibility of falsity. (*JP Morgan Chase Bank v Winnick*, 350 F Supp 2d at 406-09). Rather, the duty to inquire further is triggered where the "plaintiff may be said to have been 'placed on guard or practically faced with the facts' of the complained of fraud." (*Id.* at 408, quoting *Mallis v Bankers Trust Co.*, 615 F2d 68, 81 [2d Cir 1980], *abrogated in part on other grounds by Peltz v SHB Commodities, Inc.*, 115 F3d 1082, 1090 [2d Cir 1997]). Thus, for instance, in *Abrahami v UPC Constr. Co.* (224 AD2d 231 [1st Dept 1996]), the plaintiffs, private investors, sued the company in which they invested based on fraudulent statements about the company's excellent future business prospects. (*Id.* at 231). Upon a bench trial, and applying the clear and convincing evidence standard for proving fraud at trial, the Court held that plaintiffs' reliance was unreasonable because they were put on notice of the company's precarious financial situation and the need to inquire further, based on the reporting of only $54 cash on hand and on plaintiffs' failure then to conduct any independent investigation. (*Id.* at 234). Thus, the financial report disclosed to plaintiff in *Abrahami* demonstrated clearly and directly the dire state of the company's cash flow. Accordingly, to demonstrate that plaintiff had a duty to inquire further, defendant Barron must show that plaintiff was clearly placed on guard and faced with the facts of the fraud.

Here, defendant Barron fails to make such a showing based on undisputed facts. Again, the financials did not hint at the NPPA. It is unclear from the present record how much of the information regarding the NPPA defendant Barron had, and how candid he would have been with any information he did have, considering his deteriorating relationship with Adeli and his desire

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that she and the plaintiff buy him out after the closing. Even if plaintiff had launched a further inquiry, it is not clear on the present facts that he could have discovered the alleged fraud. These issues require the trier of fact to resolve. (*See Swersky v Dreyer and Traub*, 219 AD2d at 327).

In addition, both Mr. Steckler and Mr. Leshkowitz present conflicting interpretations about the significance of the numbers in the financial statements and how to interpret them with respect to KCA's financial future. They dispute if KCA was financially healthy, was a typically growing business, or if it was clearly in trouble; if the due diligence required of plaintiff based on the financial documents disclosed required a full audit of KCA; and if that would have disclosed the existence of the fraud. Contrary to defendant Barron's contention, this proof does not present the type of special circumstances in which this court could find, as a matter of law, that plaintiff's reliance on the financial documents submitted to him was unreasonable, or that, as a matter of law, he was under a duty to inquire further, and that he failed to do so. A reasonable fact finder could conclude that the financial documents provided would not, on their face, have alerted plaintiff to potential fraud. Although defendant Barron claims that plaintiff did no due diligence, the undisputed facts are that plaintiff did engage in some investigation. He, among other things, asked questions of defendants and demanded the financial documents, and reviewed the financial statements for both KCA and 35BS for 1998 and 1999, and the projections for 2000 and 2001. Whether plaintiff engaged in enough due diligence relative to his net worth, and the resources potentially at his disposal at Bear Stearns, or through business associates, as to satisfy his burden, also is a question of fact for a jury to decide. (*See Crigger v Fahnestock and Co.*, 2003 WL 22170607, *supra; Granite Partners, L.P. v Bear, Stearns & Co.*, 17 F Supp 2d 275, *supra*). Therefore, defendant Barron's motion for summary judgment is denied.

Cross Motion for Discovery and Sanctions

The court grants that branch of plaintiff's cross motion to compel the production of documents only to the extent that all open discovery disputes are severed and referred to a Special Referee to determine, with oral argument on all discovery disputes to be placed on the record.

The court denies that branch of plaintiff's cross motion seeking sanctions for defendant Barron's purported discovery delays, alleged false statements and frivolous motion. Plaintiff fails to present proof of intentional dilatory conduct. Plaintiff admits that Barron produced over 6,500 pages of documents, some of which defendant Barron went through the effort of obtaining from his former counsel in order to produce them to plaintiff. In addition, plaintiff submits an affidavit from defendant Barron in which he clarifies his deposition testimony regarding his search for documents, attests that he has searched for and produced any and all documents he had involving and relating to the parties and to the subject matter of the litigation (Exhibit 63 to Plaintiff's Cross Motion) and that he conducted an additional search of his California home and office, and did not find any additional documents. (*Id.*). This proof does not warrant sanctions. Moreover, while this court finds disputed issues of material facts, the summary judgment motion is not frivolous. Plaintiff does not support his argument that there was spoliation of evidence.

Accordingly, it is

ORDERED that the motion for summary judgment is denied; and it is further

ORDERED that the branch of the cross motion for leave to amend is granted, in part, to the extent that leave is granted to amend the second cause of action for fraud and to this extent the Proposed Second Amended Complaint annexed to the cross motion papers shall be deemed served upon service of a copy of this order with notice of entry; and it is further

ORDERED that leave to amend the complaint is denied with respect to the first, third, and

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fourth through eighth causes of action and those causes of action are stricken from the Proposed Second Amended Complaint; and it is further

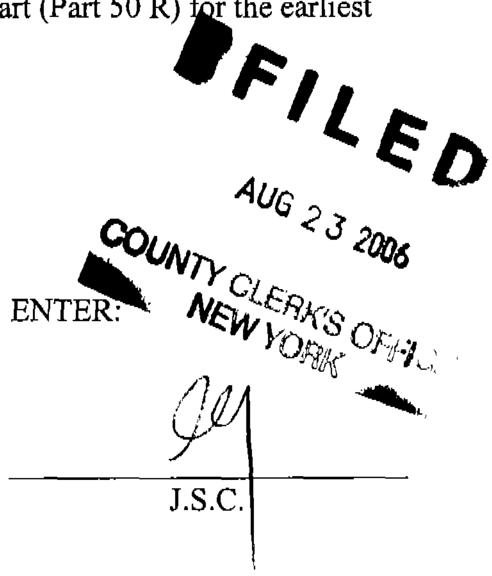
ORDERED that leave to amend the complaint as against defendant Katayone Adeli is denied without prejudice as to all claims against her (the first, second, and fifth through eight proposed causes of action), because these claims are subject to a bankruptcy stay; and it is further

ORDERED that defendant Barron shall answer the Second Amended Complaint within 20 days from the date of service of a copy of this order with notice of entry; and it is further

ORDERED that the branch of the cross motion for discovery and sanctions is granted, in part, to the extent that all discovery disputes are severed, and referred to a Special Referee to hear and determine; and it is further

ORDERED that counsel for the plaintiff shall, within 30 days from the date of this order, serve a copy of this order with notice of entry, together with a completed Information Sheet (copies are available in Room 119 at 60 Centre Street and on the Court's website), upon the Special Referee Clerk in the Motion Support Office in Room 119 at 60 Centre Street, who is directed to place this matter on the calendar of the Special Referee's Part (Part 50 R) for the earliest convenient date.

Dated: August 21, 2006



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J.S.C.