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SHORT FORM ORDER

INDEX NUMBER: 1959-2012

SUPREME COURT - STATE OF NEW YORK
COMMERCIAL DIVISION, PART 46, SUFFOLK COUNTY

***Present*: HON. EMILY PINES**
J. S. C.

Original Motion Date: 01-08-2013
Motion Submit Date: 01-08-2013
Motion Sequence Nos.: 003 MGCASEDISP
004 MOTDCASEDISP

[x] FINAL
[ ] NON FINAL

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PETER LISTER,

Plaintiff,

-against-

R & R MENSWEAR, LTD, RICHARD SCHWARTZ and RICHARD SCHNEIDER,

Defendant.

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In this consolidated action, Plaintiff, Peter Lister ("Plaintiff" or "Lister"), moves for partial summary judgment pursuant to CPLR 3212 (Mot. Seq. 003) in his action against corporate Defendant R&R Menswear Ltd., seeking judgement upon a secured promissory note, in the sum of $950,000, plus interest as set forth in that instrument. The corporate Defendant, R&R Menswear, Ltd. ("R&R" or "Corporate Defendant") does not oppose Plaintiff's motion to the extent that it seeks judgment on the note itself. However, it does oppose judgment on the Plaintiff's claimed right to foreclose on the corporate assets, asserting that Lister's instrument does not provide him with priority over the rights of the two other individual shareholders, Defendants Richard Schwartz ("Schwartz") and Richard Schneider ("Schneider"). Schwartz and Schneider cross-move for summary judgment pursuant to CPLR 3212 (Mot. Seq. 004),

dismissing the causes of action asserted by Lister directly against them for breach of contract, diversion of corporate assets, fraud, breach of fiduciary duty and declaratory judgment. Lister opposes the cross-motion.

This consolidated action began as two separate lawsuits. In the first case commenced in Nassau County, Lister sued Schwartz and Schneider (his co-shareholders in R&R) directly, seeking damages based upon the individual defendants' breach of contract (in awarding themselves excessive salaries and benefits); diversion of corporate assets; fraudulent concealment of corporate condition in order to induce the loan made by Plaintiff; breach of their fiduciary duties in both concealing financial information and diversion of corporate assets to different entities in which they had an interest; and judgment declaring that Lister was entitled to enter onto corporate premises to seize collateral for payment of his loan. In the second action commenced in Suffolk County, Lister sued R&R on the subject promissory note and also sought a declaratory judgment, permitting him, under the alleged terms of the note, to take possession of any collateral located on the corporate premises. Pursuant to this Court's order dated June 20, 2012, the Nassau County action was transferred to Suffolk County and the two cases were consolidated under Index No. 1959/12.

Entitlement to Secure Collateral

Lister asserts that he is entitled to priority over any loans provided to R&R by his co-shareholders, as his loan agreement granted him a security interest in all of R&R's assets via a separate Security Agreement dated February 11, 2011, the same date as the Secured Promissory Note. According to Lister, under the terms of the Secured Promissory Note (¶s 3 and 5), failure of R&R to make payment of principal together with accrued unpaid interest within ten days following written demand, constitutes a default under the Secured Promissory Note and invokes Lister's rights against R&R under the Security Agreement. The Security Agreement grants Lister a security interest in all of R&R's assets as security for the obligations incurred under the Secured promissory note. Schwartz and Schneider claim that

the parties' Shareholders Agreement dated June 14, 2000, evidences loans Schneider and Schwartz made to the company in the amount of $75,000, which have not been repaid and pre-date the Lister loan by eleven years. The Shareholders Agreement (which reflects that Lister also made a $75,000 initial loan to R&R) sets forth in Section 2B that: "Such loans to be subordinated to any secured financing the Corporation may obtain".

The Security Agreement, entered into in February, 2011 in conjunction with Lister's Promissory Note, sets forth in paragraph 2 that "(t)he Company hereby grants to the Secured Party a valid and binding security interest in the Collateral (defined as tangible and intangible assets of the Corporate Defendant) as security for the payment, performance, and observance by the Company of its obligations". It further sets forth in paragraph 7 that : " (u)pon the Company having an obligation to pay any amount to the Secured Party pursuant to any of the Obligations, the Secured party shall have the following rights and remedies . . . (a) . . .The Secured Party may at any time . . .enter upon any premises in which the Collateral or any part thereof may be located and, without the aid and assistance of others, enter upon any premises in which the Collateral. . . may be located and . . . . take possession of the Collateral. . . . ." The Security Agreement further provides that any proceeds form the sale of any Collateral received by R&R must be segregated and held in trust for the Secured Party. [Paragraph 7(b)]. Paragraph 4(b) of this the Security Agreement provides for subordination of the secured loan to "(a)ny lending institution set forth in Schedule 5 which provided or provides financing to the Debtor . . . .".

Breach of Contract Based on Overpayment of Salary and Benefits

In their cross-motion for summary judgment, the individual Defendants assert that Lister sets forth no basis for his claim they violated the parties' Shareholders Agreement in payment of excessive salaries and benefits as demonstrated by the documents all signed and agreed to by Lister. They annex the original Shareholders Agreement, which allows (at paragraph 3.3) Schneider and Schwartz an annual salary of $135,000 "(o)r such other amount

as the Shareholders may unanimously agree". On December 1, 2005, the shareholders, including Lister, unanimously agreed that:

> "The Compensation for the three (3) active partners, Schwartz, Schneider, and Lister is proposed to be calculated as follows: Schwartz and Schneider are to receive no less than the current (2005) compensation and be limited to no more than 5% of the volume. Lister is to receive no less than current compensation and be limited to no more that 3% of volume."

Defendants set forth that their aggregate compensation in 2005 was $437,417 and that a review of net sales and their joint salaries from 2006 through 2011 demonstrates that they never received over 5% of volume. According to the individual Defendants, Lister's hand picked accountants both prepared financial reports for each year so demonstrating and received a copy thereof, such being admitted at Lister's deposition. In addition, they assert that Lister has always had access, again through company financial statements, to information setting forth any and all benefits received by these parties and never once, as admitted in his deposition, complained about it until he brought this lawsuit years after the approved increases were set forth.

Lister argues in opposition to the cross-motion seeking to dismiss his breach of contract claim that he always read the parties' 2005 agreement as limiting the compensation of Schwartz and Schneider to 5% of volume in the aggregate as opposed to each one of them. He sets forth that this is supported by the fact that the yearly financial reports he received always reported their salaries in the aggregate. He also opines that compensation was always meant to include all economic benefits and not just salary. Accordingly, Lister asserts that numerous issues of fact remain to be determined prohibiting grant of summary judgment on the breach of contract issue.

In reply, the individual Defendants point out that Plaintiff's reading of the 2005 agreement makes no sense because the word "aggregate" is simply not there; and because it

also states that: "Schwartz and Schneider are to receive no less than current (2005) compensation". The record shows that in 2005, Schwarz and Schneider received $437,417, which was in the aggregate, well above 5% of the volume, thus contradicting Plaintiff's attempt to add nonsensical terms to the agreement. With regard to the issue that compensation was meant to include all forms of compensation other than salary, the individual Defendants demonstrate that utilizing Lister's own calculations and including all forms of compensation, the yearly income of each Schwartz and Schneider was always below the 5% level.

Diversion of Assets and Corporate Waste

With regard to Lister's claims of fraud, breach of fiduciary duty and corporate waste, the individual Defendants assert that all inventory was again disclosed in each financial statement provided to Lister and that until this lawsuit, he never complained about the same. With regard to the diversion of corporate business to a competitor, Plaintiff's statement at his deposition was solely: "It's a relatively small market, so one hears things". Since these allegations appear to be the bases for Plaintiffs' claims of waste, fraud and breach of fiduciary duty, the individual Defendants' assert they are devoid of any evidence and should be dismissed. They also argue that the breach of fiduciary duty, to the extent that it relates to the salaries of the individual Defendants, is duplicative of the breach of contract action; that the fraud claim lacks any specificity and that these claims, to the extent that they are based on allegation of corporate waste and diversion of corporate assets, are derivative in nature and cannot be asserted by Lister in a direct action, as they belong to the corporation.

Plaintiff argues that discovery will demonstrate that in addition to the excessive compensation claim, the individual Defendants gave their time and attention to other business endeavors, and they moved major clients to other companies with which they have associations or undisclosed dealings. With regard to the nature of the action, Lister claims

that Defendants have breached duties to him that are independent of those owned to the corporation.

Declaratory Judgment

Here, the individual Defendants remind the Court that this claim is against the corporation and is duplicative of the second cause of action, for which Plaintiff seeks Summary Judgment in the context of what was originally the second lawsuit.

Summary Judgment

The proponent of a motion for summary judgment must demonstrate to the court the absence of any material and triable issues of fact, thereby entitling such party to judgment as a matter of law. CPLR § 3212; **see, Morjan v Rais Const. Co.**, 7 NY2d 203, 818 NYS2d 792, 851 NE2d 1143 (2006); **Winegrad v New York University Medical Center,** 64 NY2d 851, 487 NYS2d 316, 476 NE2d 642 (1985). Upon such showing, the burden shifts to the party opposing the motion to demonstrate either that material issues of fact exist or that even the undisputed facts do not entitle the movant to judgment as a matter of law. **Winegrad, supra.** Where such material issues are set forth in the moving or opposition papers, the court must deny the motion and proceed to trial. **Fed. Ins. Co. v Automatic Burglar Alarm Corp.,** 208 AD2d 494, 617 NYS2d 53 (2d Dept 1994).

Breach of Contract/Breach of Fiduciary Duty/Fraud

The elements of a cause of action for breach of contract consist of: 1) formation of a contract between the plaintiff and defendants; 2) performance by the plaintiff; 3) defendants' failure to perform; and 4) resulting damage, **Furia v Furia,** 116 AD2d 694, 498 NYS2d 12 (2d Dept 1986); **see, Ascoli v Lynch**, 2 AD3d 553, 769 NYS2d 567 (2d Dept 2003). Where

there exists a dispute as to the meaning of the terms of the parties' contract, all parts thereof must be read in harmony to determine the intent, **Bombay Realty Corp v Magna Carta Inc.,** 100 NY2d 124, 760 NYS2d 734, 790 NE2d 1163 (2003). Primary attention must be given to the purpose of the parties in making their agreement, **Greenfield v Philes Records, Inc**., 98 NY2d 562, 750 NYS2d 565, 780 NE2d 166 (2002). However, in interpreting a contract, a court must not adopt an interpretation that would render a contract illusory when it is clear that the parties intended to be bound. **Zurakov v Register.Com, Inc.,** 304 AD2d 176, 760 NYS2d 13 (1st Dept 2003).

In order to establish a claim for breach of fiduciary duty, a plaintiff must prove the existence of a fiduciary relationship, misconduct by the defendants, and damages that were directly caused by such misconduct. **Kurzman v Bergstol**, 40 AD3d 588, 835 NYS2d 644 (2d Dept 2007). There exists no claim for breach of fiduciary duty when it is based on the same set of facts as a claim for breach of contract, **Brooks v Kay Trust Co. National Assoc.**, 26 AD3d 628, 809 NYS2d 270 (3d Dept 2006).

A shareholder in a closely held corporation owes a fiduciary duty to other shareholders in the corporate entity, **Littman v Magee**, 54 AD3d14, 860 NYS2d 24 (1st Dept 2008). The breach of such fiduciary duty may be the basis of an action if the alleged misconduct constitutes a wrong toward the plaintiff that is separate and distinct from any wrong to the corporation, **Burnett v Pourgol**, 83 AD3d 756, 921 NYS2d 280 (2d Dept 2011).

In an action to recover for fraud, the plaintiff must prove a misrepresentation or a material omission of fact which was false and known to be false by defendant for the purpose of inducing the other party to rely upon it, justifiable reliance by the other party on the misrepresentation or material omission, and injury, **Mandarin Trading Ltd. V. Wildenstein**, 16 NY3d 173, 919 NYS2d 465, 944 NE2d 1104 (2011).

Derivative vs Direct Claims

The Court of Appeals has stated repeatedly that claims are derivative in nature where: "[t]he remedy sought is for the wrong done to the corporation; the primary cause of action belongs to the corporation; recovery must inure to the benefit of the corporation" **Isaac v Marcus**, 258 NY 257, 179 NE2d 487 (1932); **Marx v. Ackers**, 88 NY2d 189, 644 NYS2d 121, 666 NE2d 1034 (1996). Where the remedy sought by plaintiff would inure to the benefit of the corporation before any benefit, such as monies owed, could be rendered to the plaintiff, the claim is considered derivative, not direct. **Longo v Butler Equities II, L.P.,** 278 AD2d 97, 718 NYS2d 30 (1st Dept 2000). A test recently described in **Yudell v Gilbert** (99 AD3d 108, 949 NYS2d 380 [1st Dept 2012][borrowing from Delaware law]), requires the court to look to the nature of the misconduct alleged and the party to which the requested relief should go, see **Tooley v Donaldson, Lufkin & Jerette, Inc.**, 845 A.2d 1031 (Del. 2004). Thus, allegations of mismanagement or diversion of corporate assets are considered to plead a wrong to the corporation, since it is only through the corporate loss that the individual shareholder suffers. **see, Yudell, supra.**

There is no question, based upon the papers submitted, that Plaintiff, Peter Lister, is entitled to summary judgment on his secured promissory note against Defendant R&R Menswear in the amount of $950,000, plus pre-judgment interest at the rate of $271.69 per day until the entry of Judgment, as set forth in Plaintiff's motion papers.

The parties dispute the meaning of the Security Agreement and the Shareholders Agreements concerning Plaintiff's second cause of action, which seeks a declaratory judgment that he is entitled to enter upon any premises upon which the collateral may be located and take possession or dispose of the same. As set forth above, this is based upon differing interpretations of these agreements and which of the parties have priority with regard to loans made to the corporation. Applying the law as set forth above, and reading the agreements together in light of the parties' intentions, it is clear that the Security Agreement,

entered into eleven years after the original Shareholders Agreement, and which sets forth that the $950,000 loan by Lister is subordinated to loans of institutional lender (and not other shareholder loans) is meant to take preference over any $75,000 loans originally made, including that of Lister himself. Reading the two instruments together, as required, it is clear that the original shareholder loans were specifically subordinated to any secured loans to the corporation. The Security Agreement would have been meaningless if it had subordinated Lister's large investment to any party other than loans by secured lending institutions. Accordingly, upon searching the record, the Court also grants Lister summary judgment upon his second cause of action for a declaratory judgment against the Corporate Defendant.

With regard to the cross-motion for summary judgment, the Court can make the same sort of analysis with regard to Plaintiff's breach of contract claim against his co-shareholders, based upon the allegation of overpayment of income not authorized under the corporate agreements. The agreements, when read together, set forth that Schwartz and Schneider were entitled to an annual salary of $135,000 or such other compensation as agreed to among the shareholders. As admitted, all three shareholders agreed on December 1, 2005, that Schwartz and Schneider were permitted to receive compensation amounting to no less than that received in 2005 and no more than 5% of the corporate volume. While Plaintiff asserts that an issue of fact exists as to whether such was aggregate or per shareholder, his argument makes no sense, Since, by adding income of the two shareholders in 2005, the year to view, such was already greater than 5% of corporate net profits. Thus, under Plaintiff's interpretation, the agreement could never have gone into effect as written. With regard to Plaintiff's argument that compensation was required to include benefits, the individual Defendants demonstrated financial statements showing that, even including benefits, their compensation never exceed 5% of corporate net profits. The fact that Plaintiff admitted at his deposition that he received this information each year in financial statements prepared by accountants he chose for the corporation and made no record of any objection or complaint until the 2011 lawsuit amounts to a waiver of this claim, even if the Court were to credit his interpretation. Accordingly, the individual Defendants are entitled to dismissal of the breach

of contract claim based upon alleged overpayment of compensation.

A careful view of the Plaintiffs' claims for breach of fiduciary duty, fraud and diversion of corporate assets demonstrates that the individual Defendants are entitled to dismissal of those claims as well. While the Court agrees that Plaintiff properly sets forth claims for breach of fiduciary duties by his co-shareholders in a closely held corporation, as well as fraud, based upon allegations of diversion of corporate assets and inventory as well as lack of loyalty to the corporation, these claims are properly those of the corporate entity under the law as set forth above. It is the corporation that is entitled to retain the benefits of diverted assets before any of the shareholders, including Peter Lister, can benefit therefrom. Thus, because those claims really intertwine requests for relief that would ultimately benefit both the corporation and himself individually and they were brought as direct causes of action, they must be dismissed. **see, Abrams v Donati**, 66 NY2d 951 (1985). In addition, with regard to Plaintiff's claim for fraud against the individual Defendants, such is simply not, as it relates to alleged overstatement of inventory in 2011, years after the making of the alleged loan.

As set forth above, since the Court has granted Plaintiff's motion for summary judgment against the Corporate Defendant for Declaratory Judgment, the second claim is duplicative and is dismissed as moot.

This constitutes the ***DECISION*** and ***ORDER*** of the Court.

Settle judgment on notice.

Dated: March 18, 2013
Riverhead, New York

Emily Pines

EMILY PINES
J. S. C.

[x] FINAL
[ ] NON FINAL