SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY

PRESENT: HON. ELLEN M. COIN Justice PART 63

Index Number : 651604/2011
MAGNETIC MEDIA HOLDINGS, INC.
vs.
ZAHAKOS, JAMES
SEQUENCE NUMBER : 001
DISMISS ACTION

INDEX NO. _____
MOTION DATE _____
MOTION SEQ. NO. _____

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

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

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

MOTION AND CROSS-MOTION(S) ARE DECIDED IN ACCORDANCE WITH ANNEXED DECISION AND ORDER.

This constitutes the decision and order of the Court.

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

Dated: 3/28/13

HON. ELLEN M. COIN, J.S.C.

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

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 63

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MAGNETIC MEDIA HOLDINGS, INC.,

Plaintiff, Index No. 651604/2011

-against- DECISION AND ORDER

JAMES ZAHAKOS and PETER ZAHAKOS,

Defendants,

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PETER ZAHAKOS and JAMES ZAHAKOS, suing individually, and as shareholders of Magnetic Media, Inc., suing in the right of Magnetic Media Holdings, Inc.,

Counterclaim-Plaintiffs,

-against-

MAGNETIC MEDIA HOLDINGS, INC., THOMAS ZEREGA, NORMAN JACOBS, DAVID A. SCHRADER, and SCHRADER & SCHOENBERG, LLP,

Counterclaim-Defendants.

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Hon. Ellen M. Coin:

Motion sequence nos. 001 and 002 are consolidated for disposition.

Counterclaim defendants David A. Schrader (Schrader) and Schrader & Schoenberg LLP (jointly, the Schrader counterclaim defendants) move for an order pursuant to CPLR 3211(a)(7)

dismissing the counterclaims asserted against them by Peter and James Zahakos (jointly, the Zahakoses), individually and derivatively on behalf of Magnetic Media Holdings, Inc. (Magnetic) (motion seq. no. 001). Counterclaim defendants Magnetic, Thomas Zerega (Zerega), and Norman Jacobs (Jacobs), support the Schrader counterclaim defendants' motion and move for an order pursuant to CPLR 3211(a)(7), dismissing any derivative claims asserted against Zerega and Jacobs in the first counterclaim (motion seq. no. 002). The Zahakoses cross-move for leave to amend their answer and several of their counterclaims.

Background

Magnetic, a Delaware entity with its principal place of business in Manhattan, manufactures and sells point-of-sale advertising displays. Zerega and James Zahakos founded Magnetic. Zerega was Magnetic's chief executive officer and a member of its board of directors, and James Zahakos was its president, chief operating officer, and a director.

Under its bylaws, Magnetic was to have three directors. While stockholders voted for the directors at the annual meeting, if a vacancy on the board arose, the majority of the board could fill it for the remainder of an unexpired term. At the time in issue, Magnetic was operating, at most, with only two directors.

Magnetic's officers were to be appointed by, and serve at the pleasure of, the board of directors.

Magnetic's amended certificate of incorporation recites that Magnetic was authorized to issue one million shares of common stock. Some of those authorized shares were issued, starting in 2007, and, at the relevant time, James Zahakos and his father, Peter, collectively owned almost 43% of the shares. Zerega owned 30.4895%, and Jacobs, who was neither a director nor an officer, owned 19.37078% of the shares. The balance of the shares was owned by nine other individuals, each of whom had fewer than two shares.

In about October 2010, James Zahakos ceased his employment with Magnetic, and the reasons why that occurred are in dispute. He was allegedly improperly removed as a director and officer. In November 2010, Peter Zahakos commenced an action (the recoupment action) (index no. 652050/2010) in this court against Magnetic to recoup sums totaling $200,000, which he allegedly lent it. On November 18, 2010, Schrader, on behalf of his law firm, wrote Zerega to confirm that Magnetic had retained the firm to represent it in the defense of that action, as well as in "disputes with James Zahakos in connection with the termination of his employment." (Kowlowitz Aff, Exh. B). After the

recoupment action was commenced, Jacobs offered to buy the Zahakoses's stock for $200,000, which would have given Jacobs a majority of Magnetic's shares, but that deal fell through in early January 2011. That month, Peter Zahakos commenced a derivative action (index no. 650063/2011) on behalf of Magnetic against Zerega for corporate waste.

The Instant Action

In June 2011, Magnetic, then represented by Schrader & Schoenberg LLP, commenced the instant action against the Zahakoses, charging them with corporate waste, conversion, breach of fiduciary duty, and/or aiding and abetting the breach of fiduciary duty. The complaint alleges that James Zahakos, having control over Magnetic as its president, and exclusive control of its financial records, stole from the company's bank account through fraudulent transfers; used company assets for personal expenses; repaid, at his father's request, a $50,000 loan through fraudulent means; and falsified the company's books to cover up his improper transactions, which were still in the process of being investigated by the firm's bookkeepers and accountants. The complaint further alleges that James Zahakos was removed as an officer and director and that he resigned from his employment. After his termination, it is claimed that he refused to turn

over, and destroyed, company records, including financial records. The complaint asserts that Peter Zahakos, who had allegedly served as Magnetic's attorney, assisted his son in covering up the thefts and fraud.

The Zahakoses answered, denying Magnetic's allegations and asserting six counterclaims. The answer alleges that, after the Zahakoses confronted Zerega about his squandering of corporate assets and failure to perform his duties, James Zahakos told Zerega that they could no longer work together. The Zahakoses claim that Zerega responded by purporting to accept James Zahakos's resignation as an officer and director, even though he never resigned from those positions, and that soon thereafter Schrader informed him that he was no longer an officer or a director. The Zahakoses further claim that the illegal decision to bar James Zahakos was, on "information and belief," directed by Jacobs, via his personal attorney, Schrader, in an effort to force the Zahakoses to sell their shares to Jacobs at an inadequate price. Answer, ¶ 61. The answer charges the counterclaim defendants with ignoring James Zahakos' protests as to his improper ouster and the Zahakoses' demands for Magnetic's financial information. Further, the answer contends that Jacobs, for his own gain and to the Zahakoses' detriment, acted as the de

facto head of the company after the freeze out, "making all important decisions." *Id.*, ¶ 67.

The answer recites that there was a corporate action letter containing defamatory statements about James Zahakos in his role as president, and that the letter was, either at a meeting or in person to person contact, shown to the shareholders other than the Zahakoses. The counterclaim defendants asked the other shareholders to sign that letter which purported to remove James Zahakos as an officer and director and install Zerega and Michael Egan (Egan), an alleged Magnetic employee, as directors and officers in violation of the bylaws, which require "a minimum of 3 directors." *Id.*, ¶ 73. The answer alleges that the letter was "apparently signed by some or all of the shareholders" *(id.*, ¶ 71), but that in violation of the corporate documents, the Zahakoses were not given notice of the meeting or the contents of the letter, and were not informed of what had transpired.

According to the answer, after the Zahakoses rejected Jacobs' offer to purchase their shares, the counterclaim defendants devised a retaliatory stock sale scheme to secure Jacobs's control of the company and to dilute the Zahakoses' interest in the company. This scheme's "sole purpose" was to "render[] the Zahakoses's stake in the company worthless." *Id.*,

¶ 95. It is claimed that to effectuate the scheme Egan was installed as a puppet director and officer.

In his affidavit Egan amplifies the answer's allegations. He asserts that he was a consultant[1] to Magnetic, and that in December 2010, after James Zahakos' ouster, Zerega asked him to become Magnetic's Secretary and a board member. However, he claims that he was never provided with any corporate records with which to effectively do his job. He contends that after the ouster Jacobs was a permanent fixture in Magnetic's offices, participated in its daily operations, and appeared to be running the company. Egan asserts that after the Zahakoses refused to sell their shares to Jacobs, Zerega sent him two corporate resolutions for his signature.

The first resolution, dated January 6, 2011, sought to remove James Zahakos as an officer and install Zerega as president, chief executive officer, and treasurer, and Egan as secretary. Egan signed that resolution.

The second resolution, dated January 8, 2011, recounted Magnetic's alleged financial woes and proposed to amend the amended certificate of incorporation, "subject to shareholder approval," increase the number of authorized shares, and raise

[1] It may be that the term "employee" was used loosely in connection with Egan.

$250,000 via a stock offering at a stated "fair valuation." (Egan Aff., Exh. B.) That resolution again provided that the board's authorization of the stock offering was "subject to Shareholder approval of the Amendment to the Company's Certificate of Incorporation." *Id.* Zerega signed that resolution on January 10, 2011, but Egan refused to do so. In a meeting that day with Zerega and Jacobs, arguments resulted, and Zerega informed Egan that he was fired. Egan alleges that after "calmer heads prevailed," he continued discussions that day with Zerega and Jacobs, who told him that if he did not sign the resolution, the company would be put out of business. *Id.*

Thereafter, Egan gave Zerega and Jacobs a letter of resignation from the board dated January 10, 2011. As the basis for his resignation, Egan listed the following: he had learned more of the company's financial troubles; there was an inaccurate allocation of company shares to shareholders; and because of "undo pressure" [sic] by Zerega and Jacobs to authorize the additional shares. (Egan Aff., Exh. C). Egan, who owned 1.987103% of Magnetic's shares, further stated in that letter that he would not be held responsible for any of the board's "misdoings" and hoped that his decision would not affect his employment status. *Id.*

Later that day, Schrader allegedly asked Egan to sign the resolution and to change his resignation letter to delete the references to Magnetic's financial condition and the pressure to sign the resolution. Egan alleges that he never rescinded his resignation, but signed the resolution because Zerega promised to pay him $3,000 of his past due commissions of $14,000 and because he was told that the company would be put out of business if he did not sign it. Egan then sent a sanitized version of his resignation letter, indicating that he was resigning from the board because his new position, as vice president at Channel Sales, would not permit him to effectively serve on the board, but that he hoped his decision would not affect his employment status with Magnetic.

The answer recites that thereafter all shareholders were sent two successive stock offering notices, the first dated January 10, 2011, and the second dated February 3, 2011, both of which provided that the board had authorized the sale of a total of 1,000,000 more shares of stock to the current shareholders on a pro rata basis. The first notice advised that while Magnetic had a promising product, it was facing a grave financial situation and the prospect of shutting down in a few days if capital were not raised and that Magnetic's attempts to raise

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money had been futile. The second notice, allegedly drafted by Schrader, advised that more than 400,000 of the new shares had been subscribed, extended the time to purchase the remaining additional shares, and indicated that an unaudited balance sheet was included because some shareholders had requested financial information so as to decide whether to subscribe.

The answer recites that all shareholders, other than the Zahakoses, were given financial information and/or more extensive information to evaluate the validity of both offers. Also, the Zahakoses allegedly protested, in writing, the stock offerings as violative of the certificate of incorporation, state law, and the bylaws. Moreover, the answer contends that since Magnetic's amended certificate of incorporation only provided for the issuance of one million shares, of which 668,863 had been issued before the first offering of an additional million shares, the offerings were improper in the absence of an amendment to the certificate of incorporation.

The answer asserts six counterclaims premised on the foregoing allegations. The first counterclaim purports to state breach of fiduciary duty claims on behalf of Magnetic and the Zahakoses against Zerega and Jacobs as alleged majority shareholders, officers, and directors. It is claimed that Zerega

and Jacobs were required to act with good faith, fairness, honestly, and loyalty, and without self-interest, "breached their fiduciary duty to the [c]ounterclaim [p]laintiffs as described above," caused injury to Magnetic and to "plaintiffs" [sic], and that, as a result, they are entitled to compensatory and punitive damages. Answer, ¶¶ 105-106.

The second counterclaim purports to assert aiding and abetting breach of fiduciary duty claims on behalf of Magnetic and the Zahakoses against the Schrader counterclaim defendants. This counterclaim alleges that: those defendants knew that Zerega and Jacobs owed fiduciary duties to Magnetic and the counterclaim plaintiffs; those defendants helped and knowingly induced Zerega and Jacobs to breach their fiduciary duties; and that therefore the counterclaim plaintiffs are entitled to compensatory damages.

The third counterclaim asserts a derivative claim against the Schrader counterclaim defendants for breach of their fiduciary duties to Magnetic as its counsel. It alleges that they owed Magnetic the duties of due care, undivided loyalty, honesty, and good faith. These counterclaim defendants allegedly breached their fiduciary duties to "[p]laintiffs" [sic]: by representing Jacobs's interests at Magnetic's expense; ignoring the bylaws in improperly altering the board of

directors; in orchestrating a plan to dilute the interests of the shareholders to benefit Jacobs; in pressuring employees to sign documents which purported to validate Jacobs's dilution plan; and in advising Magnetic that the illegal dilution plan was legal. *Id.*, ¶ 126. As a result, Magnetic was allegedly injured and is entitled to compensatory and punitive damages.

The fourth counterclaim, asserted only on behalf of the Zahakoses, is directed against all counterclaim defendants and seeks monetary damages for alleged breaches of the implied covenant of good faith and fair dealing in the bylaws and other corporate documents. Under the fifth counterclaim, the Zahakoses seek damages from all of the counterclaim defendants for shareholder oppression. The sixth counterclaim seeks a declaratory judgment invalidating the allegedly improper stock offerings and sales and restoring the Zahakoses to their positions on the Board.

The Instant Applications

The Schrader counterclaim defendants maintain that the second counterclaim for aiding and abetting breaches of fiduciary duty must be dismissed for failure to state a cause of action. In particular, they deny the Zahakoses' claim that Schrader represented Jacobs in his attempt to purchase the Zahakoses'

shares. They further assert that because they only acted as Magnetic's counsel and performed their services within the scope of their retention, they are afforded immunity, since no facts have been alleged to support any malice, bad faith, or fraud on their part. Additionally, the Schrader counterclaim defendants contend that the Zahakoses fail to allege facts supporting an inference that Schrader had actual knowledge of any improper acts committed by Magnetic. They maintain that to support an aiding and abetting claim, the counterclaim must allege that they committed an affirmative act. They also argue that because Magnetic, as a corporation, does not owe a fiduciary duty to the Zahakoses, the claim for aiding and abetting must fall, since that claim is predicated upon the breach of fiduciary duty claim.

The Schrader counterclaim defendants urge dismissal of the third counterclaim for breach of fiduciary duty on the ground that the Zahakoses' claim of dilution of their shares is an individual claim that does not belong to the corporation. They also contend that this counterclaim has not been pled with the requisite specificity mandated by CPLR 3016. Additionally, they urge that the counterclaim fails to indicate how Magnetic was harmed, and maintain that the infusion of capital obtained from the stock sale actually benefitted the company. Moreover,

because all of the shareholders were invited to participate in the stock offering and obtain a proportional share of the stock, and the offering had a legitimate purpose, the Schrader counterclaim defendants assert that the Zahakoses cannot demonstrate that the board's actions were improper or carried out in bad faith.

The Schrader counterclaim defendants maintain that the Zahakoses cannot simultaneously assert derivative and individual claims, because to do so would create a conflict of interest, a position echoed by the other counterclaim defendants. Finally, the Schrader counterclaim defendants contend that the fourth through sixth counterclaims must be dismissed because they were never Magnetic's shareholders, directors, or officers.

Magnetic, Jacobs, and Zerega move for an order dismissing only the derivative claims set forth in the first counterclaim on the ground that it fails to state any such claim. Specifically, these movants assert that this counterclaim fails to allege how Magnetic was harmed and that all of the harm alleged was direct.

The Zahakoses, while noting that it is inappropriate to combine derivative and individual claims under the same cause of action, urge that there is no prohibition against asserting derivative and individual claims in the same action. To rectify

the combined derivative and individual claims purportedly asserted under the first and second counterclaims, and evidently wishing to eliminate any individual claims asserted under those two counterclaims[2] or believing that all of their claims are derivative, the Zahakoses cross-move for leave to amend the answer and counterclaims as set forth in the proposed Amended Answer, Affirmative Defenses and Counterclaims.

The proposed amended answer is virtually identical to the original answer, but adds that the counterclaim defendants' attempt to sell nonexistent stock was for the sole purpose of rendering the stock of not only the Zahakoses, but also that of the other shareholders, worthless. The first counterclaim is essentially identical to the original, except that the caption deletes that it was brought individually, and the body of that counterclaim, instead of urging that the breaches of duty to the Zahakoses and Magnetic were the cause of injury to all of them, recites that the breaches injured Magnetic and that it is entitled to damages.

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[2] While it is not entirely clear, and the fifth counterclaim for shareholder oppression is not specifically pleaded as such, it may be that the Zahakoses will urge that the shareholder oppression counterclaim, which they assert individually, is based on Zerega and Jacobs' breaches of fiduciary duty. *See e.g. Barbour v Knecht*, 296 AD2d 218, 227 (1st Dept 2002).

The second counterclaim also deletes from the caption that the claim is brought individually and adds that Zerega and Jacobs intended to harm not only the Zahakoses, but also the other shareholders. This counterclaim continues to allege that the Schrader counterclaim defendants participated in Zerega and Jacobs's breach of fiduciary duties to the counterclaim plaintiffs, and substitutes Magnetic as the party entitled to damages.

The Zahakoses dispute the Schrader counterclaim defendants' assertion that they did not represent Jacobs in his attempt to purchase the Zahakoses' stock and offer Peter Zahakos' affidavit as well as various documents in support of that assertion. Peter Zahakos claims that after he commenced the recoupment action against Magnetic, Schrader and Jacobs approached him about whether he and his son wished to sell their shares to Jacobs and later met with Peter Zahakos and his attorney to discuss the matter. Zerega was allegedly not present. Peter Zahakos claims that it was clear to him that Schrader was representing Jacobs since Jacobs was going to buy the shares with his own money. Peter Zahakos maintains that they reached a preliminary agreement, subject to written agreements, and that Schrader drafted the various versions of the agreements.

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Peter Zahakos appends to his affidavit each of the December 31, 2010 versions of the draft agreements applicable, respectively, to himself and to his son. The drafts are each entitled "Stock Purchase Agreement, Settlement Agreement and Release", and the other parties to the agreements were to be Zerega, Magnetic, and Jacobs. Under the heading "Ambiguities," the drafts recited that the seller acknowledged "that it retained its own counsel and has not relied upon counsel for the Purchaser in connection with this agreement." (Peter Zahakos Aff., Exh. B). That provision does not mention counsel for Magnetic, and each draft defines the purchaser as Jacobs.

Peter Zahakos claims that after his son told Zerega that they could no longer work together, Jacobs, Zerega, and Schrader began a campaign to wrest control of Magnetic from all of the other shareholders, a plan made not to further Magnetic's interest, but only to profit Jacobs. Peter Zahakos maintains that the January 2011 stock offering notice was sent on the pretext that Magnetic needed cash to function.

Peter Zahakos alleges that the counterclaim defendants never effectively removed James Zahakos as director and that consequently, James' consent to the stock offering was required. In particular, Peter Zahakos asserts that the counterclaim

defendants violated bylaw section 2.10 (b), because the Zahakoses were not given prompt notice of James Zahakos's removal as a result of the corporate action letter signed by other shareholders. He claims that the Zahakoses were not given notice of a meeting. Further, he claims that Schrader was an experienced securities attorney and knew that Magnetic could not issue shares of stock in excess of those authorized in the absence of an amendment to its certificate of incorporation. (See Amended and Restated Certificate of Incorporation, Exh. F to Peter Zahakos Aff.).

Relying on Egan's affidavit, Peter Zahakos also claims that Schrader knew that Zerega, as a board member, could not act individually to put the dilution scheme into effect, and that Egan was no longer a director when he signed the resolution concerning the stock offering. Peter Zahakos argues that the resolution was therefore invalid, and that even if Egan were a director, "the vote of 2 shareholders was insufficient to authorize the sale of additional shares." (Peter Zahakos Aff, ¶ 26).

Peter Zahakos adds for the first time that the counterclaim defendants' scheme led to the near collapse of the company[3] and

[3] Although not raised by the parties, the Court notes that Peter Zahakos's complaint in his action against Zerega for

the departure of key employees, including Egan, whom he claims was responsible for 95% of Magnetic's sales. Egan asserts that the dilution plan "contributed" to his decision to leave Magnetic on February 4, 2011 to join his current company, Exceptional 3D, Inc., and that two other individuals "connected with" Magnetic also joined his new company. (Egan Aff. ¶ 11). One of those individuals was listed as the holder of about .5% of Magnetic's shares; the other was not a shareholder.

Aside from the alleged defection of key employees, Peter Zahakos, in response to the counterclaim defendants' assertion that the Zahakoses have failed to show that Magnetic suffered any financial harm, claims that the damages to Magnetic include: representing the interests of Jacobs at Magnetic's expense; ignoring the bylaws and state law, in improperly altering the board; pressuring employees to sign improper documents; advising Magnetic that the dilution plan was valid, when it was not; and orchestrating a plan to dilute all of the stockholders' shares to benefit Jacobs. The Zahakoses' memorandum of law (at 2, 13) adds that the price at which the shares were offered was likely too low, because in the past shares were offered at a higher price.

In reply, the Schrader counterclaim defendants argue that

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corporate waste alleges that it was such waste that led to Magnetic's near collapse.

the documentation makes it clear that they represented Magnetic, not Jacobs, in the proposed settlement. They contend that the draft agreements and related emails are inadmissible under CPLR 4547, which provides that evidence of an offer to give, or a promise to accept, consideration in an attempt to compromise a claim, "shall be inadmissible as proof of liability for or invalidity of the claim or the amount of damages. Evidence of any conduct or statement made during compromise negotiations shall also be inadmissible."

The Schrader counterclaim defendants assert that even if they simultaneously represented Jacobs with respect to the proposed purchase of the Zahakoses' stock, no injury resulted, since the transactions were never consummated. They also maintain that the Zahakoses' claims are individual, and that the proposed amended answer (1) is virtually identical to the original answer; (2) continues to allege that the Zahakoses were treated differently from the other shareholders; and (3) fails to set forth facts showing how all the shareholders have been harmed.

Discussion

Upon a motion to dismiss under CPLR 3211 (a) (7),

> "the pleading is to be afforded a liberal construction. We accept the facts as alleged in the [pleading] as true, accord [the proponent of the pleading] the benefit of every possible favorable inference, and determine only whether the facts as alleged fit within any cognizable legal theory. ... In assessing a motion under CPLR 3211 (a) (7), ... a court may freely consider affidavits submitted by the [pleading's proponent] to remedy any defects in the [pleading] ... and the criterion is whether the proponent of the pleading has a cause of action, not whether [the proponent] has stated one."

Leon v Martinez, 84 NY2d 83, 87-88 (1994) (internal quotation marks and citations omitted). Where a pleading's allegations consist of "bare legal conclusions, as well as factual claims either inherently incredible or flatly contradicted by documentary evidence," such allegations "are not presumed to be true and accorded every favorable inference." *Biondi v Beekman Hill House Apt. Corp.*, 257 AD2d 76, 81 (1st Dept 1999) (internal quotation marks and citation omitted), *affd* 94 NY2d 659 (2000). Also, "[t]here is no requirement that the measure of damages shall be correctly set forth in a [pleading], the test being merely whether or not the [pleading] sets forth allegations from which damages can properly be inferred." *Daukas v Shearson, Hammill & Co.*, 26 AD2d 526, 526 (1st Dept 1966). Further, a cause of action based on a breach of trust, including a breach of

fiduciary duty, is required to be pled with the particularity required under CPLR 3016 (b), which provides that "the circumstances constituting the wrong shall be stated in detail." *Palmetto Partners, L.P. v AJW Qualified Partners, LLC*, 83 AD3d 804, 808 (2d Dept 2011); *Block v Landegger*, 44 AD2d 671, 671 (1st Dept 1974).

Because Magnetic is a Delaware corporation, it is undisputed that its substantive law governs. Generally speaking, under both Delaware and New York law, the elements of a breach of fiduciary duty claim are the existence of a fiduciary duty, that the defendant breached such duty, and that damages were caused by the breach. *JFK Family Ltd. Partnership v Millbrae Natural Gas Dev. Fund 2005, L.P.*, 89 AD3d 684, 685 (2d Dept 2011) (applying Delaware law). To state a claim against a nonfiduciary for aiding and abetting a breach of fiduciary duty, the pleader is required to allege facts which meet the claim's four elements: "(1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, ... (3) knowing participation in that breach by the defendants, and (4) damages proximately caused by the breach." *Malpiede v Townson*, 780 A2d 1075, 1096 (Del Sup Ct 2001) (internal quotation marks and citations omitted).

Corporate board members (*Malone v Brincat*, 722 A2d 5, 10

[Del Sup Ct 1998]), as well as majority shareholders and minority shareholders in de facto control of a corporation *(Gatz v Ponsoldt*, 925 A2d 1265, 1276 [Del Sup Ct 2007]; *Kahn v Lynch Communication Sys., Inc.*, 638 A2d 1110, 1113 [Del Sup Ct 1994]), stand in a fiduciary relationship to the corporation and its shareholders, and usually owe them the duties of loyalty, good faith, and due care[4] (*Malone v Brincat*, 722 A2d at 10).

Additionally, directors and those in control of a corporation owe a fiduciary duty to shareholders to provide them with "accurate and complete information material to a transaction or other corporate event that is being presented to them for action." *Id.* In a lawsuit for breach of that duty, the "essential inquiry ... is whether the alleged omission or misrepresentation is material." *Id.* at 12. Moreover, the elements of such a claim do not include "reliance, causation and actual quantifiable monetary damages." *Id.* At least nominal damages must be awarded. *Id.*

An attorney also acts as his client's fiduciary. As such, the attorney has a duty of confidentiality, and is required to act honestly, competently, and with undivided loyalty. *Matter of*

[4] Magnetic's amended certificate of incorporation (at ¶ "EIGHTH") appears to exempt the directors and officers from liability to Magnetic and the shareholders for a breach of the duty of due care.

Cooperman, 83 NY2d 465, 471-472 (1994); *Matter of Kelly*, 23 NY2d 368, 375 (1968); *see generally General Video Corp. v Kertesz*, 2008 WL 5247120, *21, 2008 Del Ch LEXIS 181, *62-63 (Del Ch Dec. 17, 2008); *but see Rich Realty, Inc. v Potter Anderson & Corroon LLP*, 2011 WL 743400, *3, 2011 Del Super LEXIS 91, *7-9 (Del Super Ct Feb. 21, 2011) (breach of fiduciary duty claim does not lie unless lawyer does something other than just provide legal services; lawyer required to directly manage and control client's assets).

With respect to the sale of shares, a stockholder has "the right to maintain his proportionate equity in a corporation by purchasing additional shares ... ," but also has the right to decline to purchase more shares without having to confront dilution where there is no valid business reason for that dilution. *Katzowitz v Sidler*, 24 NY2d 512, 520 (1969); *see also Bennett v Breuil Petroleum Corp.*, 34 Del Ch 6, 12 (Del Ch 1953) ("action by majority stockholders having as its primary purpose the 'freezing out' of a minority interest is actionable without regard to the fairness of the price;" thus, motion to dismiss and for summary judgment denied where plaintiff conceded that corporation was not in good financial shape, but urged that motive for the sale of shares was to freeze him out).

A single transaction can give rise to a derivative claim, as well as to a separate and distinct direct claim. *Gatz v Ponsoldt*, 925 A2d at 1278. However, derivative and individual claims may not be combined under one cause of action. *Barbour v Knecht*, 296 AD2d at 227-228 (mingled derivative and individual claims in causes of action required dismissal of such causes of action; however, leave to replead may be granted). Contrary to the assertions of all of the counterclaim defendants, there is no impediment to joinder of individual and derivative causes of action in a pleading. *Young v Taber*, 284 App Div 829, 829 (4th Dept), *affd* 308 NY 687 (1954); *Bennett v Breuil Petroleum Corp.*, 34 Del Ch at 16.

Under Delaware law, in an approach adopted by New York's Appellate Division, First Department (*see Yudell v Gilbert*, 99 AD3d 108, 110 [1st Dept 2012]), in analyzing whether a claim is individual or derivative only the following questions are relevant: "'(1)[W]ho suffered the alleged harm (the corporation or the suing stockholder individually); and (2) who would receive the benefit of the recovery or other remedy ... ?'" *Id.* at 114, quoting *Tooley v Donaldson, Lufkin & Jenrette, Inc.*, 845 A2d 1031, 1033 (Del Super Ct 2004). In essence, the

> "court should look to the nature of the wrong and to whom the relief should go. The stockholder's claimed

> direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation."

Id. at 1039.

Zerega, Jacobs, and Magnetic seek dismissal only of the derivative claims asserted in the first counterclaim, on the ground that they fail to allege how Magnetic was harmed. Their motion is granted and those derivative claims are dismissed. The allegations in the answer fail to indicate how Magnetic was financially harmed as a result of the numerous acts alleged. The proposed amended answer does not remedy this deficiency. In particular, the original and proposed amended answers do not allege that the price at which the shares were offered was inadequate, nor do they allege that Magnetic was injured because key employees were lost as a result of the share offering.

Raised for the first time in his affidavit, Peter Zahakos' claim, regarding the alleged loss of key employees caused by the stock offering, fails to indicate that he has any first-hand knowledge as to whether Egan or anyone else was a key employee or why anyone left. Nor does Zahakos set forth any facts demonstrating that Magnetic was financially injured by Egan's departure, or how the Zahakoses, after their alleged freeze-out,

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gained knowledge of Magnetic's financial condition. Further, Egan does not claim that he would have stayed had the shares not been offered for sale. His claim that the share offering contributed to his leaving is dubious in light of the fact that as far as he was aware, he was responsible for its happening when he signed the resolution. In addition, after Egan signed the resolution authorizing the stock issuance, the sanitized version of his board resignation indicated that he was becoming the vice president of sales of another entity and hoped that his decision to resign from the board would not affect his "employment" status.

The claim (set forth for the first time and only in the Zahakoses' memorandum of law) that the price of shares was likely inadequate because shares had been sold for more in the past, is unavailing to demonstrate prima facie that at the time of the offering, the share price was insufficient. Specifically, there are no facts offered indicating that Magnetic's circumstances were the same in the past as they were at the time in issue.

The alleged failure to provide only the Zahakoses with requested financial information is an individual claim. In addition, the assertion that James Zahakos was improperly removed

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as a director fails to state a derivative claim, since the answer alleges no particular financial harm to Magnetic as a result of that removal. All that the answer alleges is that prior to Jacobs' de facto control of Magnetic (Answer, ¶ 67), the rejection of Jacobs' offer to purchase the Zahakoses' shares, and the scheme to dilute the stock through the offering, James Zahakos was improperly removed as a director so that Jacobs could attempt to force the Zahakoses to sell their stock at an inadequate price. Such allegations fail to allege a derivative claim, but allege potential harm directed at only the Zahakoses. In fact, that harm did not eventuate, since the Zahakoses rejected Jacobs' offer.

Further, under the bylaws, only the shareholders can remove a director, whether by vote of the requisite number of stockholders at a special meeting (bylaws, § 3.4 [b]), on written notice to each stockholder (*id.*, § 2.4 [a]), or by the procedures governing action without a meeting, which allows for removal of a director on the written consent of the required number of shareholders. *Id.*, § 2.10. The latter means of removing a director requires that "prompt notice" of such action be given in writing to shareholders who have not consented in writing. *Id.*,

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§ 2.10 (a). Although the answer is unclear, it appears to allege that Zerega and Schrader informed James Zahakos that he was removed as a director when no steps had been taken by the shareholders to remove him, and that thereafter James Zahakos was removed as director by way of the procedures governing action without a meeting. To the extent that the answer asserts that Zerega and Schrader improperly informed James Zahakos that he was no longer a director, without having him removed by the shareholders, the Zahakoses are alleging a usurpation of the shareholders' rights, clearly not a derivative claim, but a direct one.

As to the answer's apparent allegation that thereafter James Zahakos was improperly removed by the shareholders, the answer asserts that the Zahakoses received neither notice of a meeting nor notice of the corporate action. However, the answer and Peter Zahakos's affidavit indicate that all shareholders, other than the Zahakoses, were asked to sign the corporate action letter removing James Zahakos as director and that some or all of the shareholders signed that letter which, according to the answer, contained false information, primarily about James Zahakos's conduct as president.

As to Peter Zahakos' claim that James' removal as director was improper because he and his son had no notice of a special meeting to remove James, the mere fact that the Zahakoses were not given notice of a special meeting does not mean that James Zahakos was improperly removed as a director, since he could be removed by shareholder action without a special meeting. There is no allegation that an insufficient number of shareholders consented in writing to James Zahakos's removal or that there was in fact a special meeting. Additionally, the allegation that the Zahakoses received no notice of what happened, pursuant to the action without a meeting, does not, in and of itself, mean that James Zahakos was improperly removed under the bylaws. While the bylaw provision governing action without a meeting recites that removal, via that method, would be ineffective if the consents were not delivered to Magnetic in accordance with the requirements of that provision, such provision does not state that removal would be ineffective if there was a failure to give prompt notice of the removal to the nonconsenting shareholders. Bylaws, § 2.10 (a). At best, the answer alleges that the shareholders were given improper information upon which to make their determination to remove James Zahakos as a director, a

wrong against the shareholders, not Magnetic.

The answer also alleges no financial injury to Magnetic as a result of the allegedly improper removal of James Zahakos from his positions as an officer. Further, the answer fails to set forth any specific financial injury to Magnetic as a result of the alleged improprieties regarding the sale of the shares of stock, including that they were not authorized by the amended certificate of incorporation; that Egan was allegedly not a director when he signed the resolution pertaining to the stock offering; and that there were only two directors on the board when Zerega and Egan approved the increase in the number of shares and the stock offering. Also, to the extent that the Zahakoses' original and proposed amended answers are urging that the resolution approving the amendment of the certificate of incorporation to authorize the issuance of additional shares was improper because its motivation was to dilute the Zahakoses's substantial holding and/or the nominal holdings of others, those pleadings allege no injury to Magnetic, including that the offering price per share was inadequate. *See Bennett v Breuil Petroleum Corp.*, 34 Del Ch at 15.

To the extent that it is urged that the stock offering was

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improper because the amended certificate of incorporation was never further amended to increase the number of authorized shares, such claim asserts a direct claim, since it effectively alleges a usurpation of the shareholders' rights. Specifically, under Delaware's General Corporation Law § 242 (b) (1), while the board of directors can adopt a resolution declaring the advisability of an amendment to the certificate of incorporation to, among other things, increase the corporation's stock *(id.*, § 242 [a] [3]), only the shareholders can effectuate the amendment. *Id.*, § 242 (b) (1). Accordingly, the answer sets forth a direct claim for improper dilution of the Zahakoses' shares.

Moreover, the resolution, which Egan claims that Zerega, Jacobs, and Schrader pressed him to sign, which Zerega himself signed, and which Schrader allegedly drafted, clearly indicated twice that shareholder approval was required to amend the certificate of incorporation. These circumstances, along with numerous other factors, are adequate, for pleading purposes, to state that Zerega and Jacobs, through his alleged agent, Schrader, acted knowingly and in bad faith in allegedly, respectively, issuing and/or preparing the letters offering the sale of shares. These factors include: Schrader's alleged

expertise in securities law; the offering letters Schrader allegedly drafted, at least one of which was signed by Zerega, indicating that the board (rather than the shareholders) had authorized making the shares available; the confrontation between Zerega and James Zahakos, when he charged Zerega with corporate waste; the proposed purchase/settlement agreements, allegedly drafted by Schrader, which mention Jacobs' counsel; the timing of the resolution and the first stock offering, apparently within days after Jacobs' offer to purchase the Zahakoses' shares fell through, and the fact that it is questionable that Jacobs would have purchased shares offered by Magnetic after purchasing the Zahakoses' shares; and the allegations that Zerega and Jacobs, through his agent, Schrader, had devised the scheme to authorize and issue the shares to render the Zahakoses' substantial holdings worthless.

Contrary to the Schrader counterclaim defendants' assertion, CPLR 4547 would not render the entire drafts of the purchase/settlement agreements inadmissible, since CPLR 4547 specifically provides that "the exclusion established by this section shall not limit the admissibility of such evidence when it is offered for another purpose ... ," and here the drafts

serve another purpose, namely, to show that the Schrader counterclaim defendants were representing Jacobs.

The foregoing, when coupled with Egan's affidavit regarding Jacobs' presence at Magnetic, are adequate for pleading purposes to permit the inference that the Schrader counterclaim defendants were also acting in Jacobs' interests in connection with the share offerings; that they knowingly assisted in the alleged breaches of fiduciary duty (*Yuko Ito v Suzuki*, 57 AD3d 205, 208 [1st Dept 2008]); and that after the purchase of the Zahakoses' shares fell through, Jacobs had de facto control of Magnetic. The Schrader counterclaim defendants' assertion that the aiding and abetting counterclaim must be dismissed, since Magnetic owes no fiduciary duty to the Zahakoses, is without merit, since the counterclaim does not allege that Magnetic breached any fiduciary duty to them.

Because no financial injury to Magnetic has been alleged, the branch of the Schrader counterclaim defendants' motion which seeks an order dismissing the derivative claims asserted under the aiding and abetting counterclaim is granted, and all derivative claims are dismissed under the second counterclaim set forth in the original answer. For the same reason, the third

counterclaim is dismissed. Since all derivative claims have been dismissed from the first and second counterclaims, there is no reason to dismiss the direct claims asserted under those counterclaims on the ground of the impermissible mixing of direct and derivative claims under one cause of action.

Because the counterclaim plaintiffs have failed to adequately plead any derivative claims, their cross-motion to amend the answer to assert the first and second counterclaims on behalf of only Magnetic is denied. Further, since it is not readily apparent whether the cross-motion was made under the misapprehension that the first and second counterclaims only asserted derivative claims or because of a conscious strategy, the Court declines to dismiss the balance of the first and second counterclaims. The counterclaim plaintiffs are always free to discontinue the remaining claims of these two counterclaims if they so choose.

The branch of the Schrader counterclaim defendants' motion, which seeks an order dismissing the fourth through the sixth counterclaims on the sole ground that they are improper parties to those counterclaims, is granted, and those counterclaims are dismissed as to the Schrader counterclaim defendants, since the

counterclaim plaintiffs do not oppose this branch of the motion or dispute that such counterclaims are inappropriately directed toward them.

In conclusion, it is

ORDERED that the motion of Thomas Zerega, Norman Jacobs, and Magnetic Media Holdings, Inc. is granted, and the derivative claims asserted under the first counterclaim are dismissed; and it is further

ORDERED that the branch of the motion of David A. Schrader and Schrader & Schoenberg LLP for an order dismissing the second counterclaim is granted solely to the extent that the derivative claims asserted under that counterclaim are dismissed; and it is further

ORDERED that the branch of the motion of David A. Schrader and Schrader & Schoenberg LLP for an order dismissing the third counterclaim is granted, and that counterclaim is dismissed; and it is further

ORDERED that the branch of the motion of David A. Schrader and Schrader & Schoenberg LLP for an order dismissing the fourth through the sixth counterclaims is granted and those counterclaims are dismissed as to them; and it is further

ORDERED that the cross-motion of James Zahakos, Peter Zahakos, and Magnetic Media Holdings, Inc. for leave to replead their answer and counterclaims, in the form set forth in their proposed amended answer and counterclaims, is denied; and it is further

ORDERED that defendants David A. Schrader and Schrader & Schoenberg, LLP shall serve their reply to the counterclaims within twenty days of service of a copy of this order with notice of entry; and it is further

ORDERED that counsel are directed to appear for a preliminary conference in Room 311, 71 Thomas Street, on June 5, 2013 at 2:00 PM.

Dated: March 25, 2013

ENTER:

A.J.S.C.