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| Khan v Garg |
| 2018 NY Slip Op 31061(U) |
| May 30, 2018 |
| Supreme Court, New York County |
| Docket Number: 652334/2013 |
| Judge: Andrea Masley |
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL PART 48

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RAZA KHAN, individually, in his official capacity as
50% owner of, and on behalf of EDUCATION
INVESTMENT FINANCE CORPORATION,

Plaintiff,

-against-

VISHAL GARG, EDUCATION INVESTMENT
FINANCE CORPORATION, 1/0 CAPITAL LLC and
EMBARK HOLDCO I, LLC,

Defendants.
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Index No.: 652334/2018
Mot. Seq. No.: 012

Decision and Order

Masley, J.:

In motion sequence number 012, defendants Vishal Garg, Education Investment Finance Corporation (EIFC), 1/0 Capital LLC (Capital), and Embark Holdco, I, LLC (Holdco) (collectively, defendants) move, pursuant to CPLR 3211 (a) (7), for an order: (1) dismissing the fourth cause of action (fraud) as against all defendants; and (2) dismissing the entire amended complaint as against Holdco.

Brief Procedural History

On July 2, 2013, plaintiff Raza Khan commenced this action by filing the original complaint, and simultaneously moved, by order to show cause, for a temporary restraining order to disgorge his business partner, Garg, of funds Garg paid himself from EIFC's account (*see generally* NYSCEF Doc. Nos. 151, 158 [Oing, J.] [04/02/2014 so-ordered tr] [granting motion and freezing funds]).

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On March 6, 2014, Khan moved for leave to amend the complaint (NYSCEF Doc. No. 132 [Mot. Seq. No.: 005] [proposed amended complaint]). That motion was denied; however, the court noted that Khan “may amend the complaint to conform to the proof” under CPLR 3025 (c) (NYSCEF Doc. No. 168 [06/23/2014 order] [Oing, J.]). On February 3, 2017, Khan filed the amended complaint that is the subject of this motion for partial dismissal (see Khan’s amended complaint [compl.], NYSCEF Doc. No. 335).

Background

Except as otherwise noted, the following allegations are taken from the February 3, 2017 amended complaint.

In 2009, Khan and Garg founded EIFC to provide asset management and advisory services for private student loan portfolios and mortgage-backed securities. Originally, Khan and Garg each owned 50% of EIFC, and each served as EIFC’s Co-Chief Executive Officers. Khan was responsible for the “execution side” of EIFC, such as its technology and product development, while Garg was responsible for EIFC’s sales and finances, and exercised authority over EIFC and EIFC-related bank accounts (compl. ¶¶ 7-16).

Garg’s Mismanagement of EIFC, Falsification of Records, and Misappropriation of Funds

In early 2012, the working relationship of Khan and Garg deteriorated, and they became deadlocked as to EIFC’s continuing operations (*id.* ¶¶ 37-41).

Khan alleges that Garg falsified EIFC’s records to reflect that Khan had not made capital contributions to EIFC; instead, the falsified records reflected, inaccurately, that

EIFC owed Garg approximately \$1.6 million for capital contributions that Garg had not made. Khan asserts that Garg then misappropriated EIFC funds, transferring those funds into Garg's personal bank account, based on the falsified records of EIFC "and those of its related entities" (*id.* ¶¶ 42-45).

EIFC's Purchase of Shares of a Secured Note

Khan alleges that non-party entities Embark Corp. and Embark Online (collectively, Embark) create and manage college application software, and are affiliated with EIFC. Garg is Embark's vice president and a member of its board of directors, and Garg's wife is Embark's chief executive officer. Khan was an Embark board member until June 20, 2013. Khan states that Embark borrowed \$2.1 million from a non-party lender in exchange for a senior secured term note (Note) that became due in June 2010. Around 2010, Khan and Garg agreed that EIFC would begin to purchase the Note's principal balance, and, in 2011, Garg used EIFC's funds to purchase 54% of the Note's principal; however, Garg allegedly converted EIFC's interest in the Note by "directing" those shares to defendant Holdco, a company owned solely by Garg (*see id.* ¶¶ 27-28; 92-99).

Garg's May 2013 Misappropriation of EIFC Funds

On May 3, 2013, Garg withdrew \$1,067,000 from EIFC accounts to satisfy Garg's "pro-rata share of [EIFC's] excess capital" (*see id.* ¶¶ 53-54). On May 10, 2013, EIFC's corporate counsel advised Garg to return the funds, but Garg declined (*see id.* ¶¶ 53-58). Khan alleges that Garg's pro-rata share of excess capital was an illusion created

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by Garg's manipulation of the records of EIFC and related entities (e.g. NYSCEF Doc. Nos. 151, 158).

Amended Complaint

In February 2017, Khan filed the amended complaint "individually, in his official capacity as 50% owner of, and on behalf of [EIFC]." Khan raises the following claims: (1) deadlock as to EIFC; (2) breach of fiduciary duty as to Garg; (3) conversion of EIFC assets by Garg; (4) fraud "by Garg" for falsifying EIFC's financial records/tax returns to benefit Garg and entities owned/controlled by Garg; (5) tortious interference by Garg and Capital; (6) Garg's failure to execute corporate documents on behalf of a non-party EIFC subsidiary; (7) conversion of EIFC funds by Garg to a MRU Lending (MRU), a company owned solely by Garg; (8) unjust enrichment against Garg as a result of EIFC payments to MRU; and (9) accounting.

Defendants move, pursuant to CPLR 3211 (a) (7), to dismiss the fraud cause of action against all defendants, and to dismiss the entire amended complaint as against Holdco.

Discussion

"On a motion to dismiss pursuant to CPLR 3211, the pleading is to be afforded a liberal construction. [The court] accept[s] the facts as alleged in the complaint as true, [and] accord[s] plaintiff[] the benefit of every possible favorable inference" (*Leon v Martinez*, 84 NY2d 83, 87–88 [1994] [citation omitted]).

1. Motion to Dismiss the Fourth Cause of Action (Fraud) Against All Defendants

Preliminarily, defendants contend that the fraud claim must be dismissed as to EIFC, Capital, and Holdco (collectively, Corporate Defendants) because Khan's fraud claim implicates only Garg. Khan does not respond to that argument, or address whether the fraud claim is directed against the Corporate Defendants, in opposition to this motion. Thus, to the extent the fraud claim is raised against the Corporate Defendants at all, it is deemed waived, and the fraud claim is dismissed as to the Corporate Defendants.

With respect to Garg, defendants contend that the fraud claim inadequately pleads the elements of intent, reliance, and injury.

A fraud claim must allege "a misrepresentation or a material omission of fact which was false and known to be false by [the] defendant, made for the purpose of inducing the other party to rely upon it, justifiable reliance of the other party on the misrepresentation or material omission, and injury" (*Pasternack v Laboratory Corp. of Am. Holdings*, 27 NY3d 817, 827 [2016] [internal quotation marks and citations omitted] [alteration in original], *rearg denied* 28 NY3d 956). "Where a cause of action or defense is based upon . . . fraud, . . . the circumstances constituting the wrong shall be stated in detail" (CPLR 3016 [b]). The Court of Appeals has explained:

"[CPLR] 3016(b) should not be so strictly interpreted as to prevent an otherwise valid cause of action in situations where it may be impossible to state in detail the circumstances constituting a fraud. . . . Necessarily, then, [CPLR] 3016 (b) may be met when the facts are sufficient to permit a reasonable inference of the alleged conduct. On a CPLR 3211 motion to dismiss, a court may consider affidavits to remedy pleading problems" (*Sargiss v Magarelli*, 12 NY3d 527, 530-531 [2009] [internal quotation marks and citations omitted]). 6 of 11

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Preliminarily, the court notes that Khan does not specify whether the fraud claim is direct or derivative; however, the allegations supporting the fraud claim indicate that it is intended to be direct (see e.g. compl. ¶¶ 169-175 [alleging that Garg “falsified EIFC’s financial records to reflect that Plaintiff (Khan) had failed to contribute capital to EIFC when, in fact, Plaintiff (Khan) had,” and that Khan relied upon Garg’s representations “and the representations contained in EIFC’s financial records”]).

“[A] stockholder has no individual cause of action against a person or entity that has injured the corporation,” even if the alleged wrongful acts diminished the value of the shares of the corporation or where a shareholder incurred personal liability (*Serino v Lipper*, 123 AD3d 34, 39 [1st Dept 2014]). A shareholder “may not obtain a recovery that otherwise duplicates or belongs to the corporation” (*id.* at 40, citing *Herbert H. Post & Co. v Sidney Bitterman, Inc.*, 219 AD2d 214, 225 [1st Dept 1996]), except under the narrow exception applicable “where the wrongdoer has breached a duty owed directly to the shareholder which is independent of any duty owing to the corporation” (*Serino*, 123 AD3d at 39, citing *Abrams v Donati*, 66 NY2d 951 [1985]).

As directed by the First Department in *Yudell v Gilbert* (99 AD3d 108, 114 [1st Dept 2012]), to determine whether a claim is direct or derivative, “a court should consider (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)” (*id.* [internal quotation marks and citation omitted]). Direct claims fail as a matter of law where the harm alleged is anything other than harm to the individual shareholder alone: if the allegations confuse the complaining

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shareholder's derivative and individual rights, even if some of the claims are direct in nature, the claims cannot stand (*id.* at 115).

Here, the allegations supporting Khan's fraud claim confuse Khan's direct and derivative rights; therefore, the claim must be dismissed (*see id.*). Khan alleges that Garg intentionally induced Khan to rely on the EIFC financial records falsified by Garg, and those records made it appear that EIFC owed Garg \$1.6 million (*see* compl. ¶¶ 170-172). Thus, though Khan seeks to plead a direct claim for fraud, there is no individual harm alleged in the amended complaint: Khan does not allege that he sustained any harm separate from that sustained by EIFC.

Construed as a purely derivative fraud claim, dismissal is still required. Khan does not adequately allege that Garg made a misrepresentation of fact (falsified EIFC's records) with the intent of inducing EIFC's reliance; instead, the allegations pertaining to Garg's intent to induce reliance, and the resulting reliance on Garg's misrepresentations, are assertions pertaining to Khan in his individual capacity (*see e.g.* Khan's mem at 9-10 [arguing in opposition that Garg deceived Khan by misrepresenting capital contributions to EIFC with the intent to "trick . . . Khan" into believing that EIFC owed Garg money, that Khan owed money to EIFC and/or Garg, and that Garg could permissibly pay himself EIFC funds], citing compl. ¶¶ 169-174]). The amended complaint does not adequately plead a derivative fraud claim; indeed, Khan alleges that EIFC was the vehicle by which Garg defrauded Khan, individually, not EIFC in general.

The claim also fails as a purely direct cause of action because there is no individual harm to Khan alleged; "[i]t is only through loss to [the corporation] that

plaintiff[] suffer[s] a loss at all” (see *Yudell*, 99 AD3d at 114-115). Accordingly, the fraud claim is dismissed against all defendants.

2. Motion to Dismiss All Claims Against Holdco

Defendants seek dismissal of the entire amended complaint as against Holdco because none of the nine causes of action are asserted against it. Khan responds only that the third cause of action, alleging conversion, is properly raised against Holdco. Because Khan does not assert that, or address whether, any of the other eight claims are asserted against Holdco, those other claims are deemed waived, and are dismissed, as against Holdco.

Khan’s third claim, “Conversion by Garg of EIFC Assets,” asserts, overall, that Garg wrongfully transferred \$2,867,769.56 from EIFC’s business accounts into Garg’s “personal bank account(s) and/or directed the funds to third parties” (see compl. ¶¶ 160-168). As to Holdco, Khan alleges only that Garg purchased shares of the Note “for the benefit of and/or using EIFC funds,” then “placed [those] shares in [Holdco], of which . . . Garg[] . . . is the sole shareholder, thereby converting the shares . . . for his own personal benefit” (*id.* ¶ 166; see also *id.* ¶¶ 28, 94-99 [stating that Khan and Garg agreed EIFC would “begin to purchase” the Note’s principal, Garg used EIFC funds to make two such purchases in March and July 2011, and, “on both occasions, (Garg) directed the shares of the . . . Note into (Holdco) for his own personal benefit”]). Holdco is otherwise mentioned, in relevant part, in the requested relief paragraphs of the amended complaint, in which Khan seeks an order: “invalidating” the transfer of those shares from EIFC to Holdco, or ordering Garg to reimburse EIFC the approximately

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\$1.6 million used to purchase the shares; and enjoining Garg from restructuring, selling, or liquidating Holdco in violation of Garg's fiduciary duties to EIFC (*see id.* at 31).

As defendants argue, the amended complaint asserts that the purchase and transfer of the shares was conducted by Garg in his capacity as an officer of EIFC, for the benefit of EIFC, and Khan does not allege that Garg transferred the shares to benefit Holdco, or in his capacity as a Holdco officer.

Nevertheless, a cause of action for conversion "is concerned with possession, not title" (*Kaufman v Provident Sav. Bank & Tr. Co. of Cincinnati*, 23 NYS2d 637, 644 [Sup Ct, NY County 1940] ["(T)he gist of . . . conversion is the injury to the right of possession."], *affd* 263 AD 703 [1st Dept 1941]). Accepting the facts alleged in the amended complaint as true, Holdco had dominion over the Note shares that were rightfully the property of EIFC, and, thus, EIFC's right to control those shares was infringed by Holdco. That Khan asserts that the transfer was unauthorized and executed by Garg for Garg's personal benefit is of no matter; likewise, Khan is not required to allege that Holdco obtained dominion or control over the shares in bad faith (*see id.* at 644).

Accordingly, the amended complaint sufficiently pleads a claim for conversion against Holdco; therefore, the motion is denied to the extent that the third claim survives against Holdco.

Accordingly, it is

ORDERED that the motion of defendants VISHAL GARG, EDUCATION INVESTMENT FINANCE CORPORATION, 1/0 CAPITAL LLC, and EMBARK HOLDCO

I, LLC is granted, and the fourth cause of action, "Fourth Count (Fraud by Garg)," is dismissed as against all defendants; and it is further

ORDERED that the first, second, fourth, fifth, sixth, seventh, eighth, and ninth causes of action are dismissed as against defendant EMBARK HOLDCO I, LLC; and it is further

ORDERED that defendants are directed to serve an answer to the amended complaint within 20 days after service of a copy of this order with notice of entry; and it is further

ORDERED that the parties shall appear for a status conference at 60 Centre Street, Room 242, New York, NY 10007 at 10³⁰ on June 26, 2018

am

Date: 5/30/18

ENTER:

HON. ANDREA MASLEY
Hon. Andrea Masley, J.S.C.