

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

~~HEPNER~~ CAHN

Index Number : 603277/2006

DINGLE, MARK E.

VS.

XTENIT

SEQUENCE NUMBER : 003

SUMMARY JUDGMENT

PART 49

INDEX NO. _____

MOTION DATE _____

MOTION SEQ. NO. _____

MOTION CAL. NO. _____

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

Notice of Motion/ Order to Show Cause – Affidavits – Exhibits ...

Answering Affidavits – Exhibits _____

Replying Affidavits _____

PAPERS NUMBERED

Cross-Motion: Yes No

Upon the foregoing papers, it is ordered that this motion

MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION IN MOTION SEQUENCE

FILED

JUL 21 2008

COUNTY CLERK'S OFFICE
NEW YORK

Dated: 7/16/08

Her Cahn

J.S.C.

Check one: FINAL DISPOSITION NON-FINAL DISPOSITION

Check if appropriate: DO NOT POST REFERENCE

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

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK : IAS PART 49

-----x
MARK E. DINGLE, individually and on
behalf of XTENIT INC. and all other
shareholders similarly situated,

Plaintiff,

-against-

XTENIT, INC. and BRIAN MCFADDEN

Defendants.

FILED

JUL 21 2008

COUNTY CLERK'S OFFICE
NEW YORK

Index No. 603277/06

Herman Cahn, J.:

Defendant Brian McFadden moves for summary judgment dismissing the amended complaint, and for attorneys' fees of \$20,000.00.

Plaintiff, a minority shareholder of a corporation, claims that the moving defendant, the majority shareholder, director and officer of the corporation, breached his fiduciary duty to plaintiff and other minority shareholders. The claimed breach occurred when defendant corporation adopted a resolution authorizing it to increase the number of its common shares from 10,000,000 to 500,000,000, which additional shares were awarded to current officers, that is, McFadden, and "future employees." Plaintiff asserts that this diluted his percentage interest in the corporation from 15% to less than 1%, while increasing McFadden's interest at plaintiff's expense. McFadden contends that the corporate action was protected by the business judgment rule, and that, therefore, there can be no breach of fiduciary duty as a matter of law.

BACKGROUND

Defendant Xtenit, Inc. is a closely-held New York corporation engaged in the business of developing, marketing and supporting computer software (Dingle Aff., ¶ 2). Defendant McFadden is its Chairman of the Board of Directors, Chief Executive Officer and majority shareholder (*id.*, ¶ 3; Def.'s Rule 19-a Statement of Material Facts).

On June 8, 2001, plaintiff Mark Dingle signed an employment agreement to serve as the Chief Operating Officer of Xtenit (Notice of Mot., Exh. A). The employment agreement included a compensation agreement (Dingle Aff., Exh. 2). Under the compensation agreement, because Xtenit was a relatively new corporation, plaintiff was to forego "cash compensation" until such time as Xtenit had sufficient funds to pay its executives. Instead, plaintiff was to be compensated by receiving 1,500,000 shares, which constituted a 15% equity interest in the 10,000,000 shares issued and outstanding of Xtenit (Def.'s Rule 19-a Statement of Material Facts, ¶ 2; Dingle Aff., ¶ 7, Exh. 2). These shares would fully vest at the end of one year of employment (Dingle Aff., Exh. 2).

On June 1, 2002, plaintiff received 1,500,000 shares of Xtenit, equaling 15% of the Xtenit shares then issued and outstanding (Dingle Aff., ¶ 8).

In September 2002, plaintiff resigned his position with Xtenit, but retained his 1,500,000 shares (*id.*, ¶ 9).

On October 12, 2004, McFadden, as Chairman of the Board, convened a special meeting of the board (Notice of Mot., Exh. B). At that meeting, McFadden advised that the meeting was called to approve and adopt a corporate resolution authorizing Xtenit to increase the number of its common authorized shares from 10,000,000 to 500,000,000 (*id.*). According to the meeting

minutes, these extra shares “will be awarded to current officers of [Xtenit] and future employees” (id.). The minutes further stated that “[n]o additional provisions will be made for existing shareholders of [Xtenit’s] common stock” (id.).

In March 2006, plaintiff contacted McFadden to ask how Xtenit was doing financially, and to assess the value of his shares (Dingle Aff., ¶ 10). McFadden informed plaintiff that he no longer had a 15% interest, since new shares had been issued (id.).

Plaintiff asserts that as far as he was aware, McFadden was the only director and officer of Xtenit, and that McFadden received all of the additional shares without paying Xtenit for them (id., ¶¶ 13-14). Plaintiff also asserts that he did not receive any notice that the directors were planning to meet to increase the number of shares (id., ¶ 15).

In September 2006, plaintiff commenced this action against McFadden, originally seeking a rescission of the corporate resolution and cancellation of the additional issued shares, an accounting based on McFadden’s unjust enrichment and damages for breach of fiduciary duty (Notice of Mot., Exh. C). McFadden moved to dismiss for lack of standing, which motion was granted with leave to serve an amended complaint.

The amended complaint asserts derivative claims for rescission, unjust enrichment and breach of fiduciary duty, and individual claims seeking recovery in quantum meruit and unjust enrichment. Defendants served their answer to the amended complaint in December 2007, denying the material allegations. The parties have not conducted any discovery.

In his motion, McFadden argues that the business judgment rule prohibits inquiry into his actions as a corporate director of Xtenit, so long as there was no breach of fiduciary duty. He further argues, in a conclusory manner, that plaintiff has failed to demonstrate that he and Xtenit

have not acted within their legitimate rights under various sections of the Business Corporation Law, including sections regarding a corporation's right to amend its certificate of incorporation to increase the shares it is authorized to issue, and to create and issue the number of shares stated in its certificate of incorporation (citing NY BCL §§ 501 and 801). Finally, McFadden contends that, pursuant to BCL § 627 governing derivative actions, plaintiff has failed to deposit security to cover the reasonable expenses of the corporation on whose behalf he is suing.

In opposition, plaintiff asserts that there are many significant factual issues regarding his claims as a minority shareholder for the wrongful issuance of the shares of Xtenit common stock, and the dilution of his and other minority shareholders' interests in the corporation. He further contends that there has been no discovery, and that the facts surrounding the wrongful issuance and dilution are in the defendants' control (CPLR 3212 [f]). Plaintiff asserts that defendants have completely failed to prove any legitimate business purpose for the dilution of his interest, and the benefit to McFadden, in breach of McFadden's fiduciary duty. With regard to the posting of security, plaintiff argues that the only reason this provision would apply is because McFadden wrongfully diluted plaintiff's interest in Xtenit to less than 5%. Thus, plaintiff contends that he should not be required to post security. Moreover, plaintiff urges that McFadden has not made an application for the posting of such security, and there is no court order requiring plaintiff to post it.

DISCUSSION

The motion for summary judgment and for attorneys' fees is denied. Plaintiff has presented a prima facie case of unequal shareholder treatment, McFadden has failed in his burden of coming forward with a bona fide business purpose for such treatment, and there are factual

issues raised warranting denial of the motion.

The claims in the amended complaint revolve around plaintiff's assertions that McFadden, as the director and majority shareholder of Xtenit, breached his fiduciary duty to plaintiff and other minority shareholders. Directors and majority shareholders of a corporation have the power to manage the affairs of the corporation. Thus, they are in a fiduciary role as the guardians of the welfare of the corporation (Alpert v 28 Williams St. Corp., 63 NY2d 557, 568 [1984], citing Leibert v Clapp, 13 NY2d 313, 317 [1963]; see Richbell Information Servs. v Jupiter Partners, L.P., 309 AD2d 288, 300 [1st Dept 2003] [majority shareholder in a close corporation is in fiduciary relationship with the minority shareholder]). As fiduciaries, they are obligated to exercise their responsibilities in good faith. They must treat all shareholders, majority and minority, fairly (Alpert, 63 NY2d at 569; see Schwartz v Marien, 37 NY2d 487, 491 [1975]; Katzowitz v Sidler, 24 NY2d 512, 518 [1969]). In issuing new stock, directors, being fiduciaries, must treat existing shareholders fairly (Katzowitz, 24 NY2d at 518; Dunlay v Avenue M Garage & Repair Co., 253 NY 274, 278-80 [1930] [citations omitted] [{"d]irectors may not authorize the issue of unissued stock to themselves for the primary purpose of converting them from minority to majority stockholders. Such conduct . . . is inequitable in the highest degree"}]). "Actions that may accord with statutory requirements are still subject to the limitation that such conduct may not be for the aggrandizement or undue advantage of the fiduciary to the exclusion or detriment of the stockholders" (Alpert, 63 NY2d at 569 [citations omitted]).

The Court of Appeals in Schwartz (37 NY2d at 492-93), set forth the parameters of this fiduciary duty, in terms that are particularly relevant to the instant action:

Departure from precisely uniform treatment of stockholders may be

justified, of course, where a bona fide business purpose indicates that the best interests of the corporation would be served by such departure. The burden of coming forward with proof of such justification shifts to the directors where, as here, a prima facie case of unequal stockholder treatment is made out. Particularly is this so when it appears that members of the board of directors favored themselves individually over the complaining shareholder

(id. at 492). The Court went on to add that disturbance of equality of stock ownership in a corporation closely held by the members of two families requires special justification that it was sought to achieve a bona fide independent business objective, and that the “objective could not have been accomplished substantially as effectively by other means which would not have disturbed proportionate stock ownership” (id.). The Court, in denying summary judgment, found that a determination of whether the defendant directors’ actions were undertaken in good faith, for a legitimate corporate purpose, and whether there were other available means to achieve their goals, involved issues of the directors’ motives and their credibility, which are triable issues.

Similarly, in Goldberg v Goldberg (139 AD2d 695, 696-97 [2d Dept 1988]), the Appellate Division, Second Department, applied Schwartz and also denied summary judgment. In Goldberg, the plaintiff, a minority shareholder in a closely held corporation, alleged that the defendant majority shareholders breached their fiduciary duty to him when they “issued stock options and bonuses to themselves without at the same time granting him the opportunity to purchase shares on the same terms in proportion to his shares” (id. at 696). The Court, relying upon Schwartz, held that there were triable issues of fact as to whether defendants’ actions were undertaken in good faith, which involved an appraisal of their motives and credibility, and, therefore, summary judgment was denied to the defendants (id. at 697; see also Collins v Telcoa Intl. Corp., 283 AD2d 128, 133-34 [2d Dept 2001] [alleged additional issuance of shares without

a valid business purpose for the purpose of diluting plaintiff's percentage of ownership states a claim against majority shareholders]).

Under these well-established standards, there clearly are triable issues as to McFadden's good faith in issuing new shares to himself to plaintiff's, and possibly other minority shareholders', detriment. Plaintiff has presented a prima facie case of unequal shareholder treatment by proof that new shares were authorized and issued, that they were not offered to plaintiff, and that McFadden obtained the new shares, with the result that plaintiff's percentage interest in Xtenit went from 15% to less than 1%. McFadden has failed to present even a scintilla of evidence regarding a bona fide purpose for the dramatic increase in the number of authorized and issued shares in Xtenit. The statement in the minutes of the special meeting of the Board at which this action was approved, that the "extra shares will be awarded to current officers of the Corporation and future employees" fails to provide any such justification (Notice of Mot., Exh. B). In fact, no business justification at all is offered to sustain the authorization and issuance (see Katzowitz, 24 NY2d at 520). Even if McFadden had offered a corporate purpose for this increase, which appears to have benefitted only himself, there would be factual issues as to his motives and credibility (Schwartz, 37 NY2d at 493; Goldberg, 139 AD2d at 697). Moreover, without any discovery, plaintiff has not even had the opportunity to determine the facts and motives surrounding the authorization and issuance (see CPLR 3212 [f]).

To the extent that McFadden relies upon the business judgment rule to shield his actions from scrutiny, his reliance is misplaced. "It is black-letter, settled law that when a corporate director or officer has an interest in a decision, the business judgment rule does not apply" (In re Croton River Club, Inc., 52 F3d 41, 44 [2d Cir 1995] [applying New York law], citing Alpert, 63

NY2d at 569). The business judgment rule prohibits inquiry into actions taken in good faith for the lawful furtherance of corporate purposes, and the issue here is whether there was such good faith.

McFadden's reliance on sections of the BCL similarly is misplaced. As the Court of Appeals stated in Alpert (63 NY2d at 568-69), actions that may accord with the statutory requirements are still subject to the limitation that they may not be for the undue advantage of the fiduciary at the expense of shareholders such as plaintiff.

Finally, McFadden's argument regarding plaintiff's failure to post security is rejected. As plaintiff correctly contends, McFadden has not made an application for the posting of such security (see Notice of Mot.). Moreover, the purpose of section BCL § 627, which is to discourage baseless strike suits against large corporations by shareholders with small interests (Roach v Franchises Intl., Inc., 32 AD2d 247, 250 [2d Dept 1969]), would not be served here where it is the defendant's alleged wrongful actions which caused the statute's minimum shareholding standard to be triggered. In Roach, the Appellate Division, Second Department, affirmed the trial court's holding that the plaintiffs, who owned over 5% of the stock at the start of the action, were not required to post security where the corporation had increased the shares issued, thereby reducing the plaintiff's ownership percentage to less than the minimum under the statute (id.). The court found that to hold otherwise would have destroyed, by the corporation's own action, the balance between protecting from strike suits and supporting a shareholder's right to redress wrongs by the corporation's management (id. at 252). Here, it is undisputed that at the time of the wrongs complained of, plaintiff was a 15% shareholder, and that he did not voluntarily reduce his shares, but rather, they were reduced below the statutory 5% by

defendants' actions. Therefore, plaintiff is not required to post security under that section of the BCL.

Defendants' request for attorneys' fees also is denied. Defendants have failed to provide any basis for the award of such fees.

Accordingly, it is

ORDERED that defendants' motion for summary judgment and attorneys' fees is denied.

Dated: July 16, 2008

ENTER:



J.S.C.

FILED
JUL 21 2008
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