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In the Matter of the Application of
CAROLINA GARDENS, INC., LIFE MANAGEMENT
CORP., KINGS HIGHWAY PROPERTY CORP.,
AND VIRGINIA GARDENS, INC.,

Petitioners,

Index No. 112637/93

To Determine the Rights of Respondents
as Dissenting Shareholders and to Fix
the Fair Value of Their Shares Pursuant
to § 623 of the Business Corporation Law

-against-

HAROLD MENOWITZ, FREDERICK A. MENOWITZ
and CAROL PENN, as Trustees for Trust A
Under the Will of Sophie Menowitz and
FREDERICK A. MENOWITZ and CAROL PENN,
as Trustees for Trust B Under the Will
of Sophie Menowitz,

Respondents.

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HERMAN CAHN, J.:

Consolidated here for determination are the following motions:
(1) petitioners' "Omnibus motion" (a) for an order directing that
the within appraisal proceeding be heard by a judge rather than a
referee, (b) for an order "reaffirming" the severance of
respondents' counter-claims from the appraisal of petitioners'
assets and (c) allowing petitioners' discovery with regard to the
counterclaims; (2) respondents' cross-motion for (a) partial
summary judgment determining March 22, 1993 to be the statutory
valuation date, and (b) a pre-trial order directing the parties to
exchange the identities of expert witnesses and expert witness
reports; (3) petitioners' motion for partial summary judgment

dismissing the counterclaims.¹

Respondents were minority shareholders in the various petitioner corporations prior to a series of cash-out mergers between the corporations and their wholly-owned subsidiaries which took place March 23, 1993, in which the corporation's majority shareholder, Samuel Lefrak, became the sole holder of all of the merged corporations' outstanding shares of common stock.

Prior to the mergers respondents had commenced a derivative action in this court alleging numerous acts of corporate waste and mismanagement on the part of Samuel Lefrak (Harold Menowitz, et al v. Samuel J. Lefrak, Index No. 1070/1990). Respondents moved in this action to enjoin the mergers, alleging the illegality of the mergers, and the unfairness of the price which respondents had been offered for their stock.

In a decision dated November 24, 1992, this Court (Lobis, J.) determined that the mergers could proceed. However, the fairness of the price offered for respondents' shares could not be determined at that time, since respondents had argued that the price offered for their shares was not fair because, among other things, it failed to take into account the value of respondents' derivative claims. The issue of the "impact" of the derivative claims upon the value of the stock could not be determined without resolving these claims on the merits. Justice Lobis stated that "any derivative claims that the plaintiffs have can clearly be

¹There is also extant a motion in limine concerning certain appraisals and valuation testimony of petitioners' experts which has been referred to the trial judge.

determined in the context of the statutory appraisal proceeding," and that the valuation proceeding "will clearly protect plaintiffs' rights to preserve any derivative claims they may have even though they are no longer shareholders of the corporations".

Following this determination, the parties entered into a stipulation in which they agreed to the dismissal of the derivative suit based on plaintiffs' lack of standing, and agreed that "[i]n accordance with Judge Lobis' Order of January 22, 1993, the value of the claims asserted in this action ... shall be determined in the context of an appraisal proceeding pursuant to B.C.L. section 623(h)." Under the stipulation Lefrak and the corporations retained all their objections and defenses cognizable at law against the derivative claims.

Petitioners then commenced the instant proceeding pursuant to BCL § 623. Respondents, in their answer to the petition, have re-asserted as counterclaims all of the allegations of waste and mismanagement raised in the original derivative action, including demands for punitive damages and attorneys' fees.

Petitioners now seek summary dismissal of these counterclaims on the grounds of respondents' lack of standing, and the general impropriety of counterclaims in an appraisal proceeding. Petitioners argue, alternatively, that respondents should be equitably estopped from pursuing these claims in light of their alleged acquiescence in and knowledge of the management of the corporations by Samuel Lefrak.

It is clear that the respondents cannot pursue the derivative

claims as counterclaims to the appraisal proceeding. By their very nature, counterclaims, similar to complaints contain demands for relief or recovery. Here the demands are for statutory damages and fees. Such demands can not be brought as counterclaims any more that they can be brought in a separate lawsuit. Respondents lost their standing to pursue the derivative claims when they lost their status as shareholders on the consummation of the mergers, Rubinstein v. Catacosinos, 91 AD2d 445, aff'd 60 NY2d 890; Bronzcraft v. Grumman Corporation, 162 Misc.2d 281, 616 NYS2d 863. Their only recourse is appraisal of their stock and payment pursuant to the statutory scheme, Willcox v. Stern, 18 NY2d 195; see also Breed v. Barton, 54 NY2d 82 (dissenting shareholder who elects statutory appraisal under BLC § 623 ceases to have any rights of a shareholder except the right to be paid the fair value of his shares). Consequently, the counterclaims must be dismissed rendering any motion concerning severance of these claims, or discovery as apart from that permitted under BCL § 623 moot.

The dismissal of respondents' counterclaims does not, however, end the matter. Respondents insist that the value of the derivative claims must be considered by the appraisal judge as an element of the value of respondents' shares because the derivative action existed, and respondents had standing to bring it, on the statutory valuation day, one day prior to the consummation of the merger (see BCL §§ 623(a) and (h)(4)). Respondents cite case law which identifies derivative claims brought by shareholders to vindicate wrong done the corporations as assets of the

corporations, see, Glenn v. Hoteltron Systems, Inc., 72 NY2d 383, which states that the scope of an appraisal to determine the value of stock prior to a corporate action against which the minority shareholder dissents will include "every item of value that can be established such as corporation causes of action which might have accrued", Willcox v. Stern, supra at 204. Based on these cases, and others, respondents argue that the appraisal judgment must take into account, and thus resolve, the derivative claims as they existed prior to the merger as part of the valuation of respondents' stock.

None of the cases cited by respondents holds that derivative claims which exist immediately prior to the corporate action which divests the dissenting shareholders of standing to pursue the claims, and which the surviving corporation has no intention of or interest in pursuing, can be restored to life by commencement of the appraisal proceeding, whether in the guise of counterclaims, or as aspects of the value of the stock in question. Tabulating Card Company, Inc. v. Leidesdorf, 17 Misc2d 573, to which the Willcox court cited in setting forth the broad reach of the appraiser, finds that the appraiser may consider "the value of corporate causes of action, whether against its officers and directors or against strangers", because the corporation might have "a valuable cause of action" against a thieving officer or director "having an important bearing upon the value of its common stock"; id at 574, but this decision never addresses the question of whether such claims would have any value without any party in existence capable

or willing to pursue them.

It is certain, however, that a director or officer's misdeeds with respect to the management of the corporation could have a negative impact on the value of the corporation's assets, and hence, on the value of its stock.

In the dissenting opinion of Justice Mangano in Walter J. Schloss Associates v. Arkwin Industries, Inc., 90 AD2d 149, upon which the Court of Appeals relied in reversing the majority opinion (61 NY2d 700), it is stated that, "the full and proper monetary recovery of the fair value of the dissenters' shares may be obtained in appraisal proceedings in which the discharge of the majority's fiduciary duty to the minority can be weighed in determining fair value ...", id at 161, and so called for the dismissal of a separate action for damages brought outside BCL § 623 by the dissenting shareholders' alleging self dealing and other wrongs on the part of the corporations' management.

Thus, it is clear that the claimed failure of the discharge of the majority's fiduciary duty to the respondents can be considered in the appraisal proceeding without utilizing the fiction of an existing derivative action, or engrafting such an action on a proceeding meant to streamline and expedite the appraisal of respondents' stock. ²

²The procedures for appraisal of the dissenting shareholder's stock "should be as simple as possible and dissenting shareholders should be entitled to receive payment for their shares on an expedited basis", Legislative Finding for 1982 Amendment, McKinneys Cons. Laws of NY, Book BCL § 623 at 305.

In ruling that the respondents' allegations of waste and mismanagement should be considered as a possible factor relating to the value of the stock, the Court makes no final determination as to the actual relevance of any claim to the value of the respondents' stock. That is an issue which is best left to the discretion of the finder of fact in the appraisal proceeding.

The parties are admonished to keep in mind, however, that:

"[a]n appraisal proceeding should be kept within reasonable bounds depending on the requirements of the particular case. An appraisal need not be an exhaustive excursion into every conceivable angle. It must be objectively fair, and if it is that by the most pertinent objective standards there is no occasion for a more extended investigation. A due sense of proportion must be observed lest the expense of the appraisal be inordinately costly and the right and machinery of appraisal be abused" Application of Marcus, 273 AD 725, 729.

The present decision does not contradict any of its prior decisions, and there is therefore no question of judicial or collateral estoppel. Nor does the statute of limitations pose any bar to the court's consideration of respondents' allegations if it so chooses.

Petitioners urge this Court to estop the respondents from making any challenge to the propriety of any pre-merger management acts under the general rule that a shareholder who ratifies, participates in or has knowledge of wrongful act of corporate management cannot proceed against the alleged wrongdoers on behalf of the corporation, see, Diamond v. Diamond, 307 NY 263, 266-267. Based on the submissions of both parties it is evident that the

question of knowledge or ratification of the corporate managements' claimed wrongdoing is a question of fact, necessarily left to the trier of fact to determine.

The issues remaining are quickly disposed of. The entire appraisal proceeding has been referred to a single justice, mooted the first prong of petitioners' omnibus motion. The dismissal of the counterclaim moots the second prong. All of the issues relating to the appraisal shall be considered as a whole. No further discovery concerning the dismissed counterclaims shall be permitted beyond that permissible under BCL § 623(h)(4), and all further discovery requests related to the appraisal proceeding should be directed to the appraisal justice who shall also determine the pending motion in limine.

Respondents' cross-motion for a declaration that March 22, 1993 is the statutory valuation date is granted.

Accordingly, it is

ORDERED, that petitioners' omnibus motion is denied to the extent indicated herein; and it is further

ORDERED, that respondents' cross-motion for partial summary judgment declaring March 22, 1993 the statutory valuation date is granted; and it is further

ORDERED, that the part of the cross-motion seeking further discovery is referred to the appraisal justice and it is further

ORDERED, that the petitioner's motion for partial summary judgment dismissing the counterclaims is granted.

DATED:

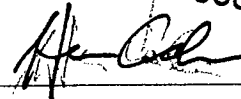
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FILED

MAR 9 1995

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