To Be Argued By:
DAVID J. KATZ, ESQ.
Time Requested: 15 Minutes

Court of Appeals

STATE OF NEW YORK

RONI LLC, ESHEL PROPERTIES, LLC, GILI HOLDINGS, LLC, and KRR INVESTMENTS, LLC, Assignees, and A.G. DOR INVESTMENTS, LLC, BANAGA LLC, MORDECHAI GOLDENBERG, ELORY LLC, ELUNGER, INC., HOD INTERNATIONAL EQUITES LLC, JOSSIFOFF LLC, KALINA & SONS LLC, KARSH N. DYAZ LLC, LYDGAT, LLC, MAZELDIK LLC, RISING STAR, LLC, ROKCOM LLC, S.I. DAR LLC, SBGR LLC, SINTRA REAL-ESTATE LLC, TAMR LLC, TATIVA FINANCE LTD., WASTED DREAMS, LLC, YALI, LLC, YORAM BAUMANN, LLC, ELI UNGER, JEOSHUA DOR, EREZ ZENOV, NIR KRIEL, EYAL SCHIFF, OVED SASON, AZARIA JOSSIFOFF, URI KALINA, ZVI KARSH, RON BAHAT, YEHUDA KEREN, JACOB PERRY, SHALOM PAPIR, RAFI RACHMAN, AMOS LASKER, ELI MOR, YORAM DAR, SHLOMO MASHAIACH, EYTAN STIBBE, RON GUTTMAN, PNINA GOLDBERG, SHUKI WEISS, ILAN CALIC, and YORAM BAUMANN, as Assignors,

Plaintiffs-Respondents,

-against-

RACHEL L. ARFA, ALEXANDER SHPIGEL, AMERICAN ELITE PROPERTIES, INC., and LAWRENCE A. MANDELKER, in his Official capacity as Court-Appointed Temporary Receiver, pursuant to CPLR Art. 64 of HARLEM HOLDINGS, LLC,

Defendants-Appellants,

GADI ZAMIR, HARLEM ACQUISITION LLC, MINTZ LEVIN COHN FERRIS GLOVSKY & POPEO, P.C., JEFFREY A. MOERDLER, EDWARD LUKASHOK, AUBREY REALTY CO., AUBREY REALTY, LLC, 42ND STREET REALTY, LLC, TAMMAZ REALTY, LLC, and ELUL ACQUISITION, LLC,

Defendants.

BRIEF FOR DEFENDANTS-APPELLANTS

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STATE OF NEW YORK COURT OF APPEALS

RONI, LLC, *et al.*, *Plaintiffs-Appellants,* *-against-* RACHEL L. ARFA, *et al.*, *Defendants-Respondents.*	N.Y. Co. **Index No.: 601224/2007** **22 N.Y.C.R.R 500.1(f) DISCLOSURE STATEMENT OF DEFENDANTS-RESPONDENTS RACHEL L. ARFA, ALEXANDER SHPIGEL, AND AMERICAN ELITE PROPERTIES, INC.**

Defendants-Respondents Rachel L. Arfa, Alexander Shpigel, and American Elite Properties, Inc. ("AEP"), by their attorneys Schlam Stone & Dolan LLP, hereby submit this 22 N.Y.C.R.R. 500.1(f) disclosure statement and state that none of them has any corporate parents or subsidiaries and that none of them has any affiliates, except that Harlem Holdings LLC, AmElite Management Services, Inc., Harlem Maintenance Services, LLC, and Argelt LLC are all affiliates of AEP.

Dated: New York, New York
June 21, 2010

Respectfully submitted,
SCHLAM STONE & DOLAN LLP.

By: ______________________

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Defendants-Appellants Rachel L. Arfa, Alexander Shpigel, and American Elite Properties, Inc. ("AEP") (collectively, "Appellants") submit this brief in support of their appeal from the order of the Appellate Division, First Department (David Friedman, J.P., John W. Sweeny, Jr., Helen E. Freedman, and Sheila Abdus-Salaam, JJ.) (the "Appellate Division"), entered on June 3, 2010, that affirmed on the law the order of the Supreme Court, New York County (Charles E. Ramos, J.S.C.) (the "Motion Court"), to the extent it denied Appellants' motion to dismiss on the pleadings the breach of fiduciary duty, accounting, and constructive fraud claims, and granted in part and denied in part Appellants' motion to dismiss on the pleadings the affirmative fraud cause of action in Plaintiffs-Respondents' Amended Complaint. The decision below is reported at 74 A.D.3d 442, 903 N.Y.S.2d 352 (1st Dep't 2010).

PRELIMINARY STATEMENT

The decision below is the first in New York—and as far as Appellants are aware, in the United States—to hold, *as a matter of law*, that someone who prepares and files a limited liability company's articles of organization and who then solicits people to invest in that limited liability company is a fiduciary to anyone he or she solicits to invest. Indeed, the Appellate Division reached this remarkable conclusion notwithstanding its express finding that the factual allegations in Respondents' Amended Complaint failed, as a matter of law, to

plead the traditional fiduciary badges of trust and confidence or superior skill and expertise. In reaching this unprecedented result, the Appellate Division relied on an 1890 decision from this Court involving fiduciary duties between promoters of business corporations and prospective investors in those corporations that has not been cited by any court in New York since 1939 and that was decided long before closely held entities like limited liability companies existed and thus failed to consider the fundamental differences between fiduciary duties owed in the context of organizing corporations versus organizing limited liability companies. If allowed to stand, the Appellate Division's decision will deter anyone interested in starting a new business venture and raising funds from potential investors from forming a limited liability company in New York.

In addition to creating an unprecedented new fiduciary duty for organizers of New York LLCs, the Appellate Division also held that the anti-fraud provision of New York's Martin Act applies only to public offerings of securities. In reaching this unprecedented result, the Appellate Division obliterated the distinction made in the text of the Act between regulating the *registration* of securities—which the Act expressly states it regulates only in the context of public offerings of securities—and fraudulent conduct in the *sale* of securities, which the Act states it regulates but without placing any limitations on whether the securities are offered for public or private sale. The decision below is the first in New York to interpret

the Martin Act in this unprecedented way. Indeed, the Appellate Division's decision is at odds with the statutory schemes in the federal securities laws and the Blue Sky laws of every other state, and at odds with the position taken by the New York Attorney General expressed in an *amicus curiae* letter filed with this Court in December 2010, requesting that this Court remove this appeal from its SSM Docket.

In reaching this result, the Appellate Division also avoided resolving the question—on which there is a division of authority among the federal courts in New York and Appellate Divisions—of whether the Martin Act preempts common-law tort claims involving securities offerings that do not require a showing of scienter, such as Respondents' breach of fiduciary duty, accounting, and constructive fraud claims. This issue was recently and squarely presented to this Court by way of an order entered by the Appellate Division, First Department on February 18, 2011, in *Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management Inc.*, 80 A.D.3d 293, 915 N.Y.S.2d 7 (1st Dep't 2010), granting the motion filed by defendants in that action for leave to appeal to this Court. (This appeal and the *Assured Guaranty* appeal are presently being briefed on the same briefing schedule.) If this Court finds it necessary to reach this issue in this appeal, Appellants hereby incorporate by reference the arguments made by the defendants-appellants and any of their *amici* in that appeal to the extent that they are consistent

with the arguments made herein, and urge this Court to reverse the decision below on the alternative grounds that the anti-fraud provision of the Martin Act applies to the private securities offerings in this action and that Respondents' breach of fiduciary duty, accounting, and constructive fraud claims are preempted by the Martin Act.

The third basis for reversal of the Appellate Division's decision is that the court permitted Respondents' fraud and constructive fraud claims to go forward in the absence of any factual allegations that Respondents suffered out-of-pocket losses in connection with the arm's-length transactions that are the subject of these claims. Thus, the Appellate Division permitted Respondents, on the one hand, to rescind transactions that they claimed were fraudulently induced while, on the other hand, it allowed them to reap the benefits of those transactions, in direct contradiction of controlling precedents from this Court prohibiting such a windfall. The decision below allowing investors who profited on their investments but believed that their profits should have been higher to plead a fraud claim would effectively transform those who organize and seek to capitalize closely held entities into guarantors of those entities' profitability. Thus, this Court should reverse the decision below and order that Respondents' fraud and constructive fraud claims be dismissed on the ground that Respondents failed to plead fraud damages as a matter of law.

In sum, if this Court leaves the Appellate Division's decision undisturbed, the results will be: (i) a radical alteration of the fiduciary duties of those seeking to organize and capitalize closely held entities in the financial capital of the world; (ii) the exemption of the Martin Act's anti-fraud provision to those activities if they are not part of a public offering of securities; and (iii) creation of a rule that would permit fraud claims to be brought by investors who profited on their investments but believed that their profits should have been higher.

Finally, as discussed below, this Court has already received briefing from the parties to this appeal last year when this appeal was initially placed on this Court's SSM Docket. Given that this is the second time that these issues are being briefed to the Court, Appellants respectfully submit that there are two important themes that emerged from the earlier briefing schedule and that this Court should consider in deciding the merits of this appeal.

First, Respondents' letter brief contained repeated references to a fraudulent scheme perpetrated on them by Appellants, implying that there was something *per se* improper about the transactions entered into by Appellants and Respondents. As discussed below, the record is clear that nothing could be further from the truth. There are no allegations in Respondents' pleadings that they were solicited by Appellants to invest in a *Ponzi* scheme or that the funds Respondents invested in these transactions: (i) were either converted for Appellants' personal use or used to

pay Appellants an undisclosed fee or commission; or (ii) that the residential real properties in which the parties beneficially invested did not exist or were something other than what they were presented to be. Rather, the only allegation of impropriety made by Respondents against Appellants is that Appellants received real estate brokerage commissions from the Sellers of the residential real properties in which the parties invested and that Appellants did not disclose or misrepresented these commissions to Respondents. In other words, assuming that these commissions had been disclosed by Appellants to Respondents, then there would not have been anything improper about Appellants receiving them. Thus, this case is, at bottom, about the sufficiency of disclosures made to Respondents by Appellants regarding otherwise legitmate compensation Appellants received from third parties for risks they assumed in these transactions that Respondents did not.

Second, Respondents' letter brief made a straw man argument that people who organize New York LLCs and solicit individuals to invest in those LLCs should not be permitted to engage in allegedly improper acts with impunity and that it is Appellants' position that these LLC organizers can never be sued for breach of fiduciary duty. This could not be farther from the argument Appellants are making. As discussed below, it is Appellants' position that the same test that is applied in every other case alleging a breach of fiduciary duty should be applied to the organizer of a New York LLC, *i.e.*, whether a plaintiff has sufficiently pled that

he or she reposed trust or confidence in a defendant and whether that defendant possessed superior skill or knowledge compared to the plaintiff to justify holding that defendant to the high standards of conduct imposed on fiduciaries. Thus, Appellants recognize that an investor in a New York LLC may very well be able to state a claim for breach of fiduciary duty against an organizer of a New York LLC. In contrast, Appellants are defending the unprecedented position taken by the Appellate Division that an organizer of a New York LLC will *always* owe a fiduciary duty to those who invest in the LLC, even in cases—such as this one—where trust and confidence and superior skill and knowledge have not been pled as a matter of law. Accordingly, for the reasons set forth below, the decision and order of the Appellate Division must be reversed and all claims alleged against Appellants dismissed on the pleadings.

STATEMENT OF THE QUESTIONS PRESENTED

1. In an arm's-length transaction with sophisticated prospective investors, is the organizer of a New York limited liability company a fiduciary, as a matter of law, of the investors he or she solicits to become members, in the absence of legally sufficient allegations that (a) the prospective members placed trust and confidence in the organizer, or (b) the organizer possessed superior skills or expertise compared to the prospective investors?

Answer below: Yes.

2. Does the anti-fraud provision in New York's Martin Act, N.Y. Gen. Bus. Law § 352-c, apply only to a public offering or sale of securities? If the answer to this question is "no," does this anti-fraud provision preempt common-law claims of breach of fiduciary duty, constructive fraud, and accounting?

Answers below: Yes and not answered, respectively.

3. Is an investor who alleges that he was fraudulently induced to invest in a special purpose entity permitted to recover fraud damages even if he receives a return on his investment that is at least as much as he initially invested?

Answer below: Yes.

STATEMENT OF JURISDICTION

This Court has jurisdiction over this appeal pursuant to CPLR 5602(b) because (i) this action originated in the Supreme Court of the State of New York, County of New York, (ii) the Appellate Division order appealed from did not finally determine this action, (iii) Appellants timely moved for an order from the Appellate Division granting them leave to appeal to this Court, and (iv) in an order entered on September 23, 2010, the Appellate Division granted Appellants permission to appeal to this Court on the following certified question: "Was the order of this Court, which affirmed the order of [the] Supreme Court, properly made?" (R. 12)[1]

[1] References to "R." are to Appellants' Record on Appeal.

STATEMENT OF THE CASE

A. Transactions That Are the Subject of This Appeal

This action relates to investments made by Respondents, numerous Israeli accredited investors in one or more of seven New York special purpose limited liability companies ("Property LLCs") that were formed for the single purpose of acquiring specific parcels of real estate in Manhattan and the Bronx in arm's-length commercial transactions at expressly disclosed prices. This action arises out of the disclosures that allegedly were, or were not, made in connection with Respondents' purchase of their membership interests in the Property LLCs.

Each Property LLC is a New York limited liability company that, until August 2006, owned one or more multi-dwelling residential properties in New York, New York. (R. 58, 63) From the time each Property LLC was formed until in or about November 2005, the Managers of each Property LLC were Appellant Alexander Shpigel, former Defendant Gadi Zamir,[2] and Defendant-Appellant Harlem Holdings LLC, 60% of which is beneficially owned by Appellants Ms. Arfa and Mr. Shpigel and 40% of which is beneficially owned by Mr. Zamir. (*Id.* at 59-60)

The facts giving rise to this appeal relate to each Property LLC's arm's-length acquisition of its respective residential properties from various non-party

[2] In or about November 2009, Mr. Zamir settled with Plaintiffs and is no longer a Defendant in this action. (R. 484).

sellers (collectively, "Sellers"). The closing dates for each of these acquisitions occurred between October 2002 and February 2005. (*Id.* at 66) Ms. Arfa, Mr. Shpigel, and Mr. Zamir allegedly organized each of the Property LLCs and allegedly acted as a "promoter" of each of the Property LLCs and of the property acquisitions made by the Property LLCs "to the investors who now own" the Property LLCs. (*Id.* at 59-60, 63) Appellant AEP is wholly-owned by Ms. Arfa and allegedly acted as a real estate broker in connection with the property acquisitions made by the Property LLCs. (*Id.* at 60-61)

According to the Amended Complaint,[3] the time line of Respondents' activities in connection with the acquisition of two of the Property LLCs' properties was similar to the time line with respect to the other Property LLCs. (*Id.* at 63-76). Specifically, Mr. Zamir allegedly first executed a purchase contract for the acquisition of the properties that were eventually purchased by two of the Property LLCs. (*Id.* at 64) The buyer identified in the purchase contract was Defendant Harlem Acquisition, LLC, which the Property LLCs allege was wholly owned by Harlem Holdings. (*Id.*) On the same date that the purchase contract was executed, a "secret" commission agreement allegedly was executed by (i) one or

[3] In a prior ruling concerning the original Complaint filed in this action on behalf of only four Plaintiffs, the Motion Court granted Appellants' motion for compulsory joinder as Plaintiffs of about twenty additional individuals and limited liability companies. Respondents appealed this ruling but did not timely perfect their appeal. Instead, Respondents filed an Amended Complaint joining as Plaintiffs the additional entities and individuals required by the Motion Court.

more of the real estate brokerage entities controlled by one or more of Ms. Arfa, Mr. Shpigel, or Mr. Zamir and (ii) the Seller(s). (*Id.*)

The gravamen of the Amended Complaint is that Appellants and Mr. Zamir allegedly made insufficient disclosures to Respondents of certain "secret commissions" received from Sellers by Harlem Holdings, Mr. Zamir, Mr. Shpigel, and Ms. Arfa. (*Id.* at 69-77) Specifically, Mr. Zamir, Mr. Shpigel, and Ms. Arfa allegedly, directly and through Harlem Holdings, organized each of the Property LLCs, solicited various investors to purchase membership interests in the Property LLCs to fund the acquisitions and the operation of Property LLCs and then acted as Managers of the Property LLCs. (*Id.* at 69-71) In connection with these transactions, written promotional materials were provided to Respondents accurately disclosing the prices at which the real estate previously contracted for by Appellants and Mr. Zamir was then being offered to the investors and how their funds would be used to acquire that real estate. (*Id.* at 68) It is not in dispute that (i) the price stated in the promotional materials was, in fact, the price stated in the purchase contract for the real estate, (ii) the information otherwise presented in the promotional materials was accurate, and (iii) the projected results were based on the stated purchase price for the real estate. What allegedly was not disclosed to Respondents was that, at the time the contracts of sale were signed with the Sellers of the real estate, a separate brokerage agreement was signed by the Sellers and

AEP, pursuant to which AEP would receive a brokerage commission *from the Sellers* in the event that these transactions closed.[4] (*Id.* at 69) According to Respondents, Appellants and Mr. Zamir "did not disclose to [Respondents] that [Appellants and Mr. Zamir], directly or through companies controlled by them . . . , would and did solicit and receive substantial additional payments from the sellers of the Properties, characterized as brokerage fees, in connection with the acquisition of the Properties and that the purchase price of the properties would be substantially increased on account of these payments to them." (*Id.* at 67)

Furthermore, Respondents allege that Appellants "repeatedly advised [Respondents] . . . that they were not taking or being paid any fees other than the disclosed Acquisition Fees in connection with the organization of the [Property] LLCs and acquisition of the Properties." (*Id.*) Respondents further allege that, absent these omissions or misrepresentations, they would not have invested in the Property LLCs. (*Id.* at 85) With respect to the few Respondents who lost money in these transactions, Respondents seek not the out-of-pocket losses sustained in these transactions as their fraud damages but instead disgorgement of the compensation received by Appellants. (*Id.* at 86)

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[4] AEP was, at all times, a licensed real estate brokerage firm in the business of arranging real estate transactions for which it was paid a commission negotiated with the seller. Although AEP was controlled by Ms. Arfa and Mr. Shpigel, at no time was AEP alleged to be in partnership with any of the Respondents. As noted below and as found by the Appellate Division, in all the promotional materials AEP distributed to prospective investors, AEP made clear that the proposed transaction was an arm's-length transaction in which the prospective investors were responsible for conducting their own due diligence.

B. **Proceedings Below**

The decision below arose from an appeal of a decision and order entered on April 17, 2009, by the Motion Court ruling on pre-answer motions to dismiss by Appellants. (R. 20-44) Respondents' Amended Complaint alleged causes of action against Appellants for breach of fiduciary duty, accounting, constructive fraud, waste, and fraud. (R. 118-30) In that decision and order, the Motion Court denied Appellants' motion to dismiss all of Respondents' claims, except: (i) Respondents' fraud claims, which the Motion Court granted leave to replead solely on the ground that the facts giving rise to the fraud had not been pled with the requisite particularity required by CPLR 3016(b), and (ii) Respondents' waste claim, which the Motion Court held Respondents did not have standing to bring. (R. 20-44)[5]

In a decision and order dated June 3, 2010, the Appellate Division unanimously affirmed the Motion Court's order. *See Roni v. Arfa*, 74 A.D.3d 442, 903 N.Y.S.2d 352. There, the Appellate Division held that: (i) the anti-fraud

[5] Plaintiffs did not seek appellate review of the Motion Court's dismissal of their waste claim. In a separate order, the Motion Court granted the motions to dismiss the aiding and abetting claims filed by Plaintiffs against the remaining Defendants in this action. The dismissal of those claims was affirmed by a different panel of the Appellate Division, which (in a 3-2 decision) held that Plaintiffs had failed, as a matter of law, to plead the substantial assistance element of their aiding and abetting claims. In reaching this result, both the majority and dissenting opinions assumed, but did not decide, that Plaintiffs had sufficiently pled that the Appellants in this appeal owed a fiduciary duty to Plaintiffs. *See Roni v. Arfa*, 72 A.D.3d 413, 897 N.Y.S.2d 421 (1st Dep't 2010). In September 2010, this Court summarily affirmed the Appellate Division's decision without addressing the issue of whether Plaintiffs had sufficiently pled that Appellants in this appeal owed Plaintiffs a fiduciary duty. *See Roni v. Arfa*, 15 N.Y.3d 826, 909 N.Y.S.2d 1 (2010).

provision of the Martin Act, Gen. Bus. Law § 352-c, did not preempt the causes of action alleged against Appellants for breach of fiduciary duty, accounting, and constructive fraud because that provision did not apply to private securities offerings; (ii) Respondents had *not* sufficiently pled the existence of a fiduciary duty between themselves and Appellants in these arm's-length transactions based on the black letter touchstones of superior knowledge or expertise or trust and confidence; (iii) Respondents nevertheless had pled the existence of a fiduciary duty between themselves and Appellants, as a matter of law, based on (a) the allegations in the Amended Complaint that Appellants had planned the parties' business ventures, organized the limited liability companies through which Respondents made their investments, and solicited Respondents to invest in those LLCs, and (b) corporate law treatises, federal case law from the turn of the twentieth century, and a case decided by this Court in 1890, all of which purportedly hold that a promoter of a business corporation acts as the fiduciary to the corporation and its present and anticipated shareholders both before and after the corporation comes into existence; and (iv) Respondents had sufficiently pled fraud damages, even though they had failed to allege any out-of-pocket losses. (R. 3-9)

In an order dated September 23, 2010, the Appellate Division granted Appellants' motion for leave to appeal to this Court upon the following certified

question: "Was the order of [the Appellate Division], which affirmed the order of Supreme Court, properly made?" (*Id.* at 12). While this Court initially placed this appeal on the Court's SSM Docket, by letter dated February 17, 2011, the Court removed this appeal from its SSM Docket and set it down for plenary briefing and oral argument.

ARGUMENT

I. THE DECISION BELOW SHOULD BE REVERSED BECAUSE, AS A MATTER OF LAW, NO FIDUCIARY DUTY WAS ALLEGED TO EXIST BETWEEN APPELLANTS AND RESPONDENTS

This Court has warned against giving too-willing credence to allegations of fiduciary duties in commercial contexts: "If the parties find themselves or place themselves in the milieu of the 'workaday' mundane marketplace, and if they do not create their own relationship of higher trust, courts should not ordinarily transport them to the higher realm of relationship and fashion the stricter duty for them." *Northeast Gen. Corp. v. Wellington Adver., Inc.*, 82 N.Y.2d 158, 162, 604 N.Y.S.2d 1, 3 (1993). Instead, in determining whether fiduciary duties exist between sophisticated parties in arm's length commercial transactions, this Court has mandated that a plaintiff plead facts establishing that "a higher level of trust than [is] normally present in the marketplace" be placed in a defendant by a plaintiff or that a plaintiff repose confidence in a defendant's superior knowledge

and expertise. *See, e.g., EBC, I v. Goldman Sachs & Co.*, 5 N.Y.3d 11, 19-21, 799 N.Y.S.2d 170, 175-76 (2005).

Indeed, in *EBC, I*, this Court emphasized that its holding that a plaintiff had sufficiently pled the existence of a fiduciary duty based on the facts alleged in the complaint relating to trust and confidence and superior knowledge and skill should not be construed as a *per se* rule that underwriters like Goldman Sachs were fiduciaries to their issuer clients based on their status as underwriters: "This holding is not at odds with the general rule that fiduciary obligations do not exist between commercial parties operating at arm's length—even sophisticated counseled parties—and we intend no damage to that principle." 5 N.Y.3d at 22, 799 N.Y.S.2d at 176.

Here, Respondents and Appellants were engaged in arm's length business transactions pursuant to which Respondents were negotiating to purchase membership interests in the Property LLCs, which the investors were told were being formed to engage in a single purpose, arm's length commercial transaction, *i.e.*, the acquisition of a specifically identified piece of real estate from the Sellers at a purchase price that was disclosed to Respondents. Indeed, the offering materials that were provided to the investors expressly state:

> The attached information is based upon information provided to [AEP] by the owner(s) of the property(ies) described and neither AEP, nor any of its principals, owners, officers, employees or affiliates assumes any responsibility for the

> accuracy of this information. Projected returns are estimates only and actual results may vary significantly.

(R. 137, 151, 170, 184) In addition, the pages containing financial projections and other financial information bore the following legend at the bottom of each page:

> The foregoing projections are based on available information and actual results may vary. Neither AEP, nor any of its respective principals, owners, officers or employees assumes any responsibility for the accuracy of the information regarding the property. Projected returns are estimates only and there is no guarantee that these results will be achieved. Purchasers/Investors are solely responsible for determining whether to acquire an interest in the property and for evaluation of the consequences of any such investment.

(*Id.* at 135-93)

Indeed, the Appellate Division expressly found that the touchstones of a fiduciary duty articulated by this Court in *EBC I* and its previous decisions did not exist. As that court explained:

> Although plaintiffs allege that the investors, who were Israelis, "had little or limited knowledge of New York real estate or United States laws, customs or business practices with respect to real estate or investments" and that the promoter defendants held themselves out as experienced experts in these areas, plaintiffs do not claim that the promoter defendants misled them about how particular real estate and investing practices in New York and the United States would affect the transactions in question. . . . . Plaintiffs also allege that the promoter defendants "play[ed] upon the cultural identities and friendship" of the Israeli investors, but personal connections of that sort alone between parties to business transactions do not establish a fiduciary relationship.

Roni, 74 A.D.3d at 444, 903 N.Y.S.2d at 355 (R. 6)

Notwithstanding those findings, the Appellate Division ultimately affirmed the Motion Court's conclusion that a fiduciary duty had been sufficiently pled by reaching the unprecedented holding that Respondents had pled the existence of a fiduciary duty as a matter of law. To support this legal conclusion, the Appellate Division reasoned:

> [P]laintiffs' allegations that the promoter defendants planned the business venture, organized the [Property] LLCs, and solicited plaintiffs to invest in them are sufficient to establish a fiduciary relationship (*see Dickerman v Northern Trust Co.*, 176 U.S. 181, 203-204 [1900]). It is well settled that both before and after a corporation comes into existence, its promoter acts as the fiduciary of that corporation and its present and anticipated shareholders (*see Brewster v Hatch*, 122 N.Y. 349, 358 [1890]; *Gates v Megargel*, 266 F. 811, 816-817 [2d Cir. 1920], *cert. denied*, 254 U.S. 639 [1920]; *see also* 1A Fletcher, *Cyclopedia of Corporations* § 192.10, at 340-350 [Perm ed]). By extension, the organizer of a limited liability company is a fiduciary of the investors it solicits to become members (*see generally* Limited Liability Company Law § 203[a][iii]).

Id. (R. 7)

In reaching this legal conclusion, the Appellate Division resurrected case law that: (i) has lay dormant for roughly a century, (ii) rested on a status-based jurisprudence that this Court abandoned during the era of the New Deal, and (iii) makes no sense when applied to closely held entities such as limited liability companies. Indeed, it appears that this is the first case in which a court in New York or any other jurisdiction has held that a fiduciary duty exists, as a matter of

law, between, on the one hand, one who organizes an LLC and solicits its investors and, on the other hand, the prospective investors he solicits. For the reasons discussed below, this Court should not endorse the sweeping holding reached by the Appellate Division.

First, the only New York authority relied on by the Appellate Division[6]—*Brewster v. Hatch*, 122 N.Y. 349, 25 N.E. 505 (1890)—did not establish a *per se* rule that promoters of corporations were fiduciaries as a matter of law. There, the defendants organized a corporation to purchase mining properties and sold shares in the corporation to investors but failed to disclose to investors that they had entered into an agreement with the corporation to acquire a majority of the corporation's shares for no consideration. According to this Court, the question presented in *Brewster* was whether "the relation between these litigants [was] simply that of vendors and vendees of shares to be issued, or *was it one of trust and confidence*, binding the defendants to the exercise of good faith, and to disclose such information as they possessed affecting the value of the property in

[6] The two federal cases relied on by the Appellate Division—*Dickerman v Northern Trust Co.*, 176 U.S. 181 (1900), and *Gates v Megargel*, 266 F. 811 (2d Cir. 1920)—were decided under federal common law, a basis that the Supreme Court later rejected in *Erie Railroad v. Tompkins*, 304 U.S. 64 (1938) (abolishing federal common law in cases based on federal courts' diversity jurisdiction). Even if *Dickerman* were still good law at the federal level, this Court need not defer to it in deciding New York law. Indeed, in *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U.S. 206, 211-12 (1908), Justice Holmes characterized the discussion in *Dickerman* of a promoter's fiduciary duties as *dicta* and refused to apply a blanket rule that the promoters were fiduciaries.

which the plaintiffs were induced to purchase an interest?" 122 N.Y. at 359, 25 N.E. at 507 (emphasis added).

Instead of relying simply on the defendants' status as "promoters," this Court held that the "true relation existing between these parties must be sought for in the contracts found by the court to have been entered into, in the prospectus which the defendants put forth, and in the circumstances involved in the transaction." 122 N.Y. at 360, 25 N.E. at 507. In finding that a fiduciary duty existed, this Court emphasized that the record demonstrated that "the defendants [had] fixed the terms and conditions upon which the corporation should be organized," including an undisclosed agreement by the corporation allowing defendants to acquire a majority of its shares for no consideration. *Id.* This Court also relied on the fact that the

> documents clearly indicate that the defendants, as trustees, were to control and direct such proceedings as should be taken anterior to the formation of the corporation, as well as after. The prospectus so states, and they actually performed or directed everything that was done preliminarily to the organization when these defendants, and they only, executed the certificate by which the corporation was brought into existence, making themselves trustees for the first year.

122 N.Y. at 361, 25 N.E. at 508. Based on these specific facts and circumstances, this Court held that "[t]hese defendants were the promoters of the corporation, and occupied before its organization a position of trust and confidence towards those whom they induced to invest in the enterprise." 122 N.Y. at 362, 25 N.E. at 508.

Thus, the Appellate Division mischaracterized this Court's decision in *Brewster*—and ignored future decisions of this Court—when it stated that it was "well settled that both before and after a corporation comes into existence, its promoter acts as the fiduciary of that corporation and its present and anticipated shareholders." Indeed, even in this age of status-based jurisprudence, this Court in *Brewster* agreed with Justice Holmes' famous warning that "[g]eneral propositions do not decide concrete cases." *Lochner v. N.Y.*, 198 U.S. 45, 76 (1905) (Holmes, J., dissenting); *see also Gass v. Gass*, 42 A.D.3d 393, 401, 840 N.Y.S.2d 58, 65 (1st Dep't 2007) (quoting Holmes).[7]

Second, even if this Court had held in *Brewster* that a promoter of a corporation *always* owes a fiduciary duty to the corporation's prospective investors as a matter of law—which it did not—for the reasons discussed above, this Court no longer adheres to this status-based jurisprudence, as evidenced by the failure of any state or federal court to cite this decision after 1939. In any event, any status based-rule of fiduciary duty articulated by this Court in 1890 with respect to the relationship between a corporation and its promoter should not be blindly and

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[7] The general corporate law treatise cited by the Appellate Division also does not stand for the broad proposition for which it is cited either. Instead, it simply says: "The trust relation *may* extend to persons holding stock in the corporation, whether by an original subscription, or a subsequent purchase, or by an exchange of stocks of another corporation, to a minority shareholder and to creditors with whom the promoter deals. *It does not, as an invariable rule, extend to any of these.*" 1A *Fletcher, Cyclopedia of Corporations* § 192.10 (footnotes omitted & emphasis added).

axiomatically applied to organizers of limited liabilities companies, which did not even exist in New York until they were created by statute in 1994.

The decisions relied on by the Appellate Division discussing the fiduciary duties owed by corporations' promoters to their corporations' prospective investors had several attributes in common that have no applicability to closely held special purpose entities such as limited liability companies. Specifically, promoters of nineteenth-century corporations possessed the modern day badges of fiduciaries (*i.e.*, superior skill and knowledge and repositories of investors' trust and confidence) given their roles in creating the capital and governance structures of corporations. For example, these promoters drafted and filed a corporation's articles of incorporation, which established the corporation's capital structure (*e.g.*, number of authorized shares, attributes of common and preferred shares, number of outstanding shares, par value of shares, *etc.*). They also drafted a corporation's bylaws, which established the corporation's governance structure (*e.g.*, composition and powers of the Board of Directors, what actions required shareholder approval, mechanics of shareholders' and Board of Directors' meetings). Finally, during this era of no federal or state securities regulation, promoters of corporations often entered into self-interested and undisclosed transactions between themselves and the corporation that prospective investors could not have discovered using ordinary due diligence, and they had complete

discretion over how to use the monies provided by investors when they subscribed to shares in the corporation's stock.[8]

In contrast, the organizers of limited liability companies do not engage in similar activities. Instead, Section 203(a)(iii) of New York's Limited Liability Company Law provides:

> One or more persons may act as an organizer or organizers to form a limited liability company by (i) preparing the articles of organization of such limited liability company in accordance with subdivision (e) of this section, (ii) executing such articles of organization in accordance with section two hundred seven of this article and (iii) filing such articles, entitled "Articles of organization of... (name of limited liability company) under section two hundred three of the Limited Liability Company Law," in accordance with section two hundred nine of this article.[9]

Moreover, Section 203(e) of New York's Limited Liability Company Law contains bare bones provisions requiring a New York LLC's articles of organization to include the name of the LLC, the county in which the LLC's principal place of

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[8] *See* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems,* 62 Univ. of Chicago L. Rev. 1047, 1067 (1995) ("The real issue for debate in the late 1800s was under what circumstances a vendor/promoter had to disclose the amount of his profit" in transactions between himself and the corporation); *see also Dickman*, 176 U.S. 181 (promoters of corporation that produced paper purchased 39 paper mills for $2,788,000 and then immediately thereafter caused the corporation to repurchase the mills from themselves for $5 million); *Brewster*, 122 N.Y. 349, 25 N.E. 505 (promoters organized corporation to purchase mining properties and sold shares to investors but failed to disclose to investors that they had entered into an agreement with the corporation to acquire a majority of the corporation's shares for no consideration).

[9] Thus, the Appellate Division's "*see generally*" citation to Section 203(a)(iii) for the proposition that "[b]y extension, the organizer of a limited liability company is a fiduciary of the investors it solicits to become members" completely mischaracterizes this provision of the statute and brings to mind Judge Cardozo's warning that "[m]etaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it." *Berkey v. Third Ave. Ry. Co.*, 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926).

business is located, and the name and address, if any, of the LLC's registered agent.

In contrast to a corporation, the capital and governance structures of a New York LLC are matters of contract that are to be included in the LLC's operating agreement, which must be signed by the LLC's members. *See* N.Y. Limited Liab. Co. Law. § 417(a). Thus, trust and confidence and superior skill and knowledge that were (and in some instances still are) attributable to promoters of corporations are nowhere to be found with respect to organizers of LLCs. Indeed, while the word "promoter" has been traditionally used in corporate law treatises to describe individuals who, in the distant past, were held to be fiduciaries of corporations and corporations' prospective shareholders, the word "promoter" appears nowhere in the New York Limited Liability Company Law, the Revised Uniform Limited Liability Company Act ("RULLCA"), or the Revised Uniform Partnership Act ("RUPA").[10] The activities of Appellants set forth in the record, and their lack of discretion concerning the use of the funds invested by Respondents (discussed below) demonstrate why the term "promoter" does not appear in the statute. Most significantly, the nation's leading treatise on limited liability company law does not state that organizers of limited liability companies have been held, as a matter

[10] *See* RULLCA §§ 409-10 (no provision for pre-formation fiduciary duties to those who are not members); RUPA § 403(c) of the RUPA (providing for disclosure by "[e]ach partner and the partnership" to "a partner," thereby excluding a duty to one who is not yet a partner); *id.* § 404 (providing that partners have duties of loyalty and care in the conduct of winding up of the partnership but not in the formation of the partnership).

of law, to be fiduciaries to the prospective members of LLCs. *See* 1 *Ribstein & Keating on Limited Liability Companies* ch. 4 (formation of limited liability company) & ch. 9 (fiduciary duties); *see also id.* § 1:3 ("the relationship of the members, managers and the [LLC] is largely governed by an agreement among them or, where the parties have not agreed to the contrary, by the default rules of the state statute."). Indeed, in a blog post discussing the Appellate Division's decision below, Professor Ribstein writes: "I'm not aware of any LLC case law on [this] issue," and "[t]here is no reason to think that the old corporate promoter cases were a better source of law on this issue than uncorporation law." *See* Larry Ribstein, "Pre-Formation Fiduciary Duties in LLCs: Another NY Problem," posted at http://truthonthemarket.com (June 21, 2010) (hereinafter "Ribstein, Truth on the Market Blog Post").

Third, there is nothing in the record in this case to support the legal conclusion reached by the Appellate Division that Appellants possessed the attributes of a promoter of a corporation identified above. For example, the capital and governance structures of the Property LLCs were contained in operating agreements that were reviewed and executed by Respondents *only after they contributed their funds to the Property LLCs*; their funds were provided to Appellants for the exclusive purpose of making a specifically identified real property acquisition. (R. 66, 106, 398-402) Indeed, if Respondents had refused to

sign the operating agreements, they would have been entitled to receive their investments back.

Moreover, Respondents' funds were provided to Appellants for the exclusive purpose of engaging in a single, arm's-length commercial transaction to acquire specifically identified real property at a disclosed price that was the subject of the promotional materials Respondents received prior to their decisions to invest in the Property LLCs, (R. 106-08). Thus, Appellants had absolutely no discretion over how these funds could be used, unlike promoters of a corporation. Indeed, LLCs and other pass-through special purpose entities are often formed in New York's real estate sector to engage in a single, arm's length commercial transaction with investors' funds that are solicited for that specific purpose.

In short, on this record, it is undisputed that Appellants did not unilaterally set up the governance and capital structures of the Property LLCs before Respondents were solicited to become members of these LLCs and that Appellants did not have any discretion concerning what do to with the investors' funds, which had to be used exclusively to purchase the real properties that the special purpose Property LLCs were formed to acquire. Indeed, as discussed above, the Appellate Division recognized as much when it held that Respondents' Amended Complaint failed, as a matter of law, to plead the traditional fiduciary indicia of superior expertise and knowledge or trust and confidence. As the record shows, these

transactions could just as easily have been structured so that Respondents directly invested in the real properties that were acquired by the Property LLCs instead of using a special purpose, pass-through entity like an LLC to make these investments. It is clear that, had Respondents made their real estate investments directly without using LLCs to make these acquisitions, the Appellate Division would not have held that Appellants were Respondents' fiduciaries as a matter of law.

Moreover, all the terms of the transactions between the Property LLCs and Appellants and the fees to be paid to Appellants were disclosed (e.g., acquisition fees, upside fees, management fees). The only transactions that allegedly were not disclosed were the sales commissions paid to AEP *by the Sellers* who sold the properties to the LLCS. These transactions between Appellants and the Sellers were entered into *before* the Property LLCs were even formed or investors even solicited. They allegedly were included in the purchase prices that the Property LLCs agreed to pay, all of which were presented to, and reviewed by, each investor prior to making his or its investment decision.

Finally, permitting the Appellate Division's decision to stand will have an immediate and very practical impact on commercial transactions in New York. According to a recently published academic study, New York already ranks near

the bottom when it comes to the percentage of new entities formed as LLCs.[11] If the rationale for the Appellate Division's decision is accepted, it is unlikely that anyone interested in starting a new business venture and raising funds from potential investors will form an LLC in New York to do so. Indeed, Professor Larry Ribstein—the nation's leading authority on the law of LLCs and other closely held business entities—agrees:

> [T]he [Appellate Division's] reasoning using hoary old corporate promoter cases to create a pre-formation fiduciary duty to disclose in LLC cases *promises to make a mess out of NY LLC law.* It also creates significant problems for business people who now have a fiduciary duty, with uncertain disclosure duties, imposed on what the court itself recognized is basically an arms' length market relationship. It's not even clear how parties can contract out of this duty, since the whole problem is that they do not yet have a contract. *It seems the[] only way NY business people involved in business formation can avoid this problem is to avoid New York.*

Ribstein, Truth on the Market Blog Post (emphasis added).

Accordingly, for all the reasons set forth above, this Court should reverse the decision below on the ground that, as a matter of law, no fiduciary duty was pled.

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[11] *See* Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 Fordham J. Corp. & Fin. L. 459 (2010) (in 2007, nationwide, 63.6% of all new entity filings were LLCs, whereas the percentage in New York was 40%).