Proportionate Liability for Diversion of a Corporate Opportunity

By Leo K. Barnes Jr.

Whoever coined the phrase "partners are only good for square dancing" must have been a defendant in a breach of fiduciary duty claim. One can understand some of the cynicism, as the fiduciary duty imposed upon directors and officers has been described as a "stringent," "undivided and undiluted loyalty," an "inflexible rule of fidelity" (*Birnbaum v Birnbaum*, 73 N.Y.2d 461, 466 (1989)), which is enforced with "uncompromising rigidity" (*Meinhard v Salmon*, 249 N.Y. 458, 464 (1928)).

One aspect of the duty owed is an obligation not to "divert and exploit for [his or her] own benefit any opportunity that should be deemed an asset of the corporation" (*Commodities Research Unit [Holdings] v Chemical Week Assoc.*, 174 A.D.2d 476, 477, 571 N.Y.S.2d 253 (1st Dep't 1991); *see Owen v Hamilton*, 44 A.D.3d 452, 457 (n 3), 843 N.Y.S.2d 298 (1st Dep't 2007); *Pangia & Co., CPAs v Diker*, 291 A.D.2d 539, 540, 741 N.Y.S.2d 242 (2nd Dep't 2002).

Furthermore, directors and officers of corporations, in the performance of their duties, stand in a fiduciary relationship to their corporation []. As such, they owe the corporation their undivided loyalty and "may not assume and engage in the promotion of personal interests which are incompatible with the superior interests of their corporation"

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Inasmuch as there may be a natural tendency to analyze the future without a partner, as with any relationship, an ounce of prevention is worth a pound of cure, and it is best to confirm that the prior relationship has been properly resolved before proceeding with the next venture. Failure to do so may get very expensive.

For example, in *A.G. Homes, LLC v Gerstein*, 52 A.D.3d 546, 860 N.Y.S.2d 582 (2nd Dep't 2008) plaintiff and defendant entered into a joint venture (AG Homes) for the purpose of purchasing real property, and AG Homes purchased 521 DeKalb Avenue in Brooklyn. Plaintiff and AG Homes allege that in order to obtain more favorable financing, the deed to the property was transferred to the defendant, who promised to re-convey the property to AG Homes. However, the plaintiffs allege that the defendant refused to re-convey the property after obtaining financing. The plaintiffs sought the imposition of a constructive trust on 521 DeKalb.

Defendant's answer asserted a counterclaim to impose a constructive trust, to the extent of a 50 percent ownership interest, on another piece of property known as 513 DeKalb Avenue. The defendant alleged that plaintiff Azaria purchased that parcel without his knowledge after initially expressing a lack of interest in it. The Second Department reversed that aspect of the Supreme Court Order which denied defendant's motion for summary judgment on his counterclaim to impose a constructive trust on 513 DeKalb, observing:

Azaria and the defendant, as parties to the joint venture in AG Homes, owed each other a duty of undivided loyalty (*see Meinhard v Salmon*, 249 NY 458 [1928]). The defendant demonstrated that in May 2004 he and Azaria were approached by Sixto De Los Santos with an offer to purchase 513 DeKalb. The defendant wished to go through with the transaction, but Azaria was not interested because he did not believe it would be a good deal. Approximately one month later, on June 24, 2004, a contract of sale for 513 DeKalb was entered into between Victor Aloyo, as seller, and AG Homes and Sixto De Los Santos, as purchasers. On that very same day, Sixto De Los Santos assigned his rights under the contract of sale to Azaria for an agreed fee of $30,000, and AG Homes assigned its interest in the property to Azaria for $10. The assignments were made without the defendant's knowledge and resulted in Azaria obtaining 100 percent of the property's title.

The record demonstrates, *prima facie*, that at the time Azaria entered into the contract of sale for 513 DeKalb, he owed a fiduciary duty to the defendant and breached it by concealing his dealings and failing to disclose pertinent information to the defendant.

The court rejected Azaria's argument that no fiduciary duty was owed as a result of his claimed dissolution of the partnership because AG Homes was not properly dissolved and was still an operational entity at the time (noting that AG Homes had contracted to purchase 513 DeKalb and executed

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a written assignment of its interest in the property to Azaria in exchange for consideration of $10).

Accordingly, the Second Department observed defendant was entitled to a constructive trust to the extent of a 50 percent ownership interest in 513 DeKalb subject to "expenses incurred by Azaria toward the purchase price of the property, losses potentially incurred by him since the purchase, the cost of the property's maintenance and upkeep by him, and any other relevant deductions."

More recently, the Second Department confirmed the potential for proportionate liability in a usurped opportunity equal to a prior vested interest in *Volodarsky v Moonlight Ambulette Serv., Inc*., 122 A.D.3d 619, 996 N.Y.S.2d 121 (2nd Dep't 2014). There, plaintiff (who held a 29.5 percent interest in defendant Moonlight Ambulette Services) commenced an action "alleging that the other owners of Moonlight wrongfully wound down the corporation and formed other corporations to conduct Moonlight's business so as to deprive him of his ownership interest." Plaintiff sought to impose a constructive trust on 29.5 percent of the shares of certain defendant corporations for the benefit of the plaintiff individually. On appeal, the Second Department affirmed that aspect of defendant's cross motion seeking summary judgment dismissing the cause of action to impose a constructive trust on 29.5 percent of the shares of certain defendant corporations for the benefit of the plaintiff individually – the same percentage of interest that the plaintiff possessed in the parties' prior relationship. See also *Young v. Chiu*, 49 A.D.3d 535, 853 N.Y.S.2d 575 (2nd Dep't 2008):

Here, the defendant Cathy Chiu diverted a corporate opportunity in breach of her fiduciary duty as an officer of YNC Ltd., and CNY Ltd., by secretly establishing a competing entity and acquiring the property at issue in action No. 2, in which YNC Ltd., and CNY Ltd., had a "tangible expectancy" (*Adirondack Capital Mgt., Inc. v Ruberti, Girvin & Ferlazzo, P.C.,* 43 AD3d 1211, 1215 [2007], *lv denied* 9 NY3d 817 [2008]; *see American Baptist Churches of Metro. N.Y. v Galloway,* 271 AD2d 92, 99 [2000]). *Accordingly, the court properly directed the transfer of 50 percent of the property at issue in action No. 2 to the plaintiff, a 50 percent shareholder in both YNC Ltd., and CNY Ltd. [emphasis added].*

When the music stops and the square dance is complete, a usurped corporate opportunity may result in an award, to the jilted partner, equal to his or her proportionate interest in the prior entity.

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