

AJETTIX INCORPORATED and
SUE NEWHOUSE,

Plaintiff,

v.

JAMES D. RAUB,

Defendant.

DECISION AND ORDER

Ind # 2003/08653

This is a dispute involving former fifty-percent shareholders of a close corporation, Ajettix Incorporated (Ajettix). Plaintiffs commenced this action seeking legal and equitable relief for breach of fiduciary duty and fraud in connection with the agreement of Ajettix to redeem the stock owned by its vice president and secretary, James D. Raub (defendant). Ajettix's agreement to redeem the stock for approximately \$500,000 was guaranteed by the other shareholder, Ajettix's president and treasurer Sue E. Newhouse (plaintiff). The action rests upon the allegation that defendant failed to disclose in conjunction with that transaction that he had been negotiating with a competitor (Croop-LaFrance, Inc. [Croop]) to finance a buy-out of plaintiff and that, during those negotiations, he gave the competitor confidential proprietary information of Ajettix. Plaintiffs have moved for summary judgment on their claim for equitable relief, seeking judgment as a matter of law rescinding the transaction on the ground of breach of fiduciary duty. Defendant has moved simultaneously for

summary judgment dismissing the complaint in its entirety and reimbursing him his legal fees in accordance with the terms of the guarantee. The motions are supported by a joint submission of the deposition testimony, as well as separate affidavits.

The court concludes that plaintiffs have established their entitlement to judgment as a matter of law on their claim for rescission and that there are no issues of fact regarding defendant's breach of the fiduciary duty defendant owed to the corporation in connection with this transaction. The court therefore grants plaintiffs' motion and denies that part of defendant's motion seeking summary judgment dismissing the claim for breach of fiduciary duty. Additionally, the court denies that part of defendant's motion seeking summary judgment dismissing the fraud claims. Because the court grants plaintiffs' motion and rescinds the transaction, the court also denies that part of defendant's motion seeking legal fees under the guaranty.

I.

For the purpose of this decision only, the following facts are assumed. Ajettix is a software development company formed by plaintiff and defendant in 1994 and it is in direct competition with Croop. In June 2001, growing animosity between plaintiff and defendant led to discussions between those parties concerning the redemption of plaintiff's stock in Ajettix or the liquidation

of the corporation. During those discussions, agreement could not be reached regarding the company's fair market value, so defendant told plaintiff that, "I would investigate selling the business as a going concern to a third party to ascertain its fair market value" (defendant affidavit [12/21/04] at ¶ 23).

Thereafter, without telling plaintiff, defendant arranged a meeting for June 19, 2001 with John Smith, the president of Brite Computers (Brite) and a person with broad experience in acquiring companies, to seek assistance in determining Ajettix's fair market value. In anticipation of that meeting, defendant obtained confidential proprietary information that he felt would be relevant on that issue, including "a list of inventory, a schedule of employees and their customers, the customer's contact information, and a schedule of Ajettix employees, their pay rates and billing rates, Ajettix financial statements and Ajettix marketing material" (Leclair affidavit [6/25/04] at ¶ 13). He obtained that information from Ed Hanchett, Ajettix's director of finance, after telling Hanchett only that he was "going to speak to an investor" (defendant EBT at 256). Also in advance of that meeting, defendant had his personal attorney, not corporate counsel, prepare a non-disclosure agreement.

Before any discussions took place at the meeting, defendant signed the non-disclosure agreement as vice president of Ajettix, and John Smith signed the agreement as president of Brite,

thereby binding Brite, as well as, its "employees, consultants and professional advisors... [to] hold ... [Ajettix's proprietary] information confidential" (§ 2, non-disclosure agreement [6/19/01]). After the agreement was signed, John Smith invited his son Justin Smith and his brother Jim Smith into the meeting where they, along with John Smith, were given the confidential proprietary information.

During the course of the meeting, defendant became aware that Justin Smith was affiliated with Brite and that Jim Smith was a part-owner of Croop, which is located in the same building as Brite. Unbeknownst to defendant at the time, John Smith also was a principal of Croop.¹ Defendant did not require Justin or Jim Smith to sign the non-disclosure agreement because defendant believed that they were bound by the agreement as employees or consultants of Brite.

The focus of the meeting, which had been called to value Ajettix, changed when John Smith indicated a desire to become an investor in Ajettix. After extended discussion, the participants in the meeting agreed in principal that Brite would finance defendant's purchase of plaintiff's share of Ajettix and thereafter "the Smiths would acquire majority ownership of Ajettix" (defendant affidavit [12/21/04] at ¶ 28). The plan

¹ Defendant has indicated that he did not become aware of John Smith's affiliation with Croop until John Smith's EBT (defendant affidavit [12/21/04] at ¶ 26).

anticipated, not only defendant's continued employment with Ajettix, but also the continued employment of all the current employees of Ajettix.

Following the meeting, defendant entered into negotiations with plaintiff to purchase plaintiff's share of Ajettix. Although an agreement was reached regarding a selling price, there was continuing disagreement about certain details, and the transaction did not close as scheduled on July 13, 2001. At no time during those negotiations did defendant reveal his dealings with the Smiths.

Shortly thereafter, defendant decided against purchasing plaintiff's shares and determined instead to sell his shares and, no later than July 16, 2001, he informed the Smiths about his change of mind. Upon learning of defendant's decision, the Smiths "either returned to [defendant] or destroyed the Ajettix documents [defendant] had provided to them" (defendant affidavit [12/21/04] at ¶ 35). At a meeting on July 16, 2001, plaintiff on behalf of the corporation accepted the offer of defendant to sell his shares for approximately \$500,000.

The transaction was finally consummated on July 20, 2001. As part of that transaction, plaintiff signed a promissory note as president of Ajettix obligating Ajettix to pay defendant the sum of approximately \$500,000 to redeem defendant's stock in the company. The note was secured by plaintiff's personal guarantee.

Plaintiff also signed general releases on behalf of herself and Ajettix.

Prior to closing the deal, defendant did not tell plaintiff about the previous meeting with the Smiths, the agreement reached at that meeting or the release of confidential proprietary information. Nor did he tell plaintiff about the non-disclosure agreement, even though he signed that agreement on behalf of Ajettix. At best, some time around July 16th, defendant told only Dave Madison, a member of the management committee of Ajettix, that "[he] had turned down an offer to sell the business" (defendant EBT at 281). When asked by Hanchett prior to July 20th² "who this offer had come from," defendant declined to answer, believing that disclosure of that information was unnecessary due to the "NDA" (defendant EBT at 281; see defendant affidavit [12/21/04] at ¶ 38). Plaintiff did not discover Smiths' involvement until sometime after completion of the transaction.

II.

In moving for summary judgment on their claim for rescission, plaintiffs contend that defendant breached a fiduciary duty by failing to disclose, prior to the July 20th transaction, his dealings with the Smiths. Defendant contends that his fiduciary duty encompassed only the obligation to avoid

² Apparently after talking to Madison.

self-dealing and that, in any event, there was no fiduciary relationship with respect to the July 20th transaction because his relationship with plaintiff was hostile and their dealings at arms' length.

The law clearly supports plaintiffs' contention. Defendant's fiduciary obligations to Ajettix arose from the status of defendant as a corporate officer and director (see *Albert v 28 Williams St. Corp.*, 63 NY2d 557, 568, rearg denied 64 NY2d 1041; *Jacobson v Brooklyn Lumber Co.*, 184 NY 152, 162; *Busino v Meachem*, 270 AD2d 606, 609) and were not extinguished by his acrimonious relationship with plaintiff so long as defendant did not withdraw from the corporation (see *Fender v Prescott*, 101 AD2d 418, 423, *affd* 64 NY2d 1077; see also *Blue Chip Emerald LLC v Allied Partners*, 299 AD2d 278, 279). Beyond that, the "relationship between shareholders in a closed corporation, vis-á-vis each other, is akin to that between partners and imposes a high degree of fidelity and good will" (*Fender*, 101 AD2d at 422; see *Brunetti v Musallam*, 11 AD3d 280, 281). Even on dissolution, partners owe a continuing fiduciary duty to one another with respect to dealings effecting the winding up of the partnership and the preservation of the partnership assets (see generally 15A NY Jur 2d, Business Relationships § 1465; see *Matter of Silverberg*, 81 AD2d 640, 641; *Old Harbour Native Corp. v Afognak Joint Venture*, 30 P3d 101, 106 [Sup Ct Alaska]; *Ebker v Tan Jay*

Intl. Ltd., 741 F Supp 448, 469 [US Dist Ct, SD NY], *affd* 930 F2d 909, *cert denied* 502 US 853, *reh denied* 502 US 1000). Thus, despite the acrimony here, defendant continued to owe a fiduciary duty to plaintiff with respect to a transaction involving the redemption of his shares of the corporation (*cf. Matter of T.J. Ronan Paint Corp.*, 98 AD2d 413, 421). The court therefore concludes that defendant's fiduciary obligations to the corporation and plaintiff personally continued until the July 20th transaction closed (*see Blue Chip*, 299 AD2d at 279; *Fender*, 101 AD2d at 423).

The court rejects the contention of defendant that his fiduciary duty encompassed only an obligation to avoid self-dealing. "[A] fiduciary owes a duty of undivided and undiluted loyalty to those whose interests the fiduciary is to protect. This is a sensitive and 'inflexible' rule of fidelity, barring not only blatant self-dealing, but also requiring avoidance of situations in which a fiduciary's personal interest possibly conflicts with the interest of those owed a fiduciary duty" (*Birnbaum v Birnbaum*, 73 NY2d 461, 466, *rearg denied* 74 NY2d 843). Thus, there is an obligation of utmost candor (*see Alpert*, 63 NY2d at 569; *Kavanaugh v Kavanaugh Knitting Co.*, 226 NY 185, 193), strictly obligating a fiduciary "to make full disclosure of any and all material facts within his or her knowledge relating to a contemplated transaction with the other party to the

relationship" (60A NY Jur 2d, Fraud and Deceit § 99). "[W]hen a fiduciary, in furtherance of its individual interests, deals with the beneficiary of the duty in a matter relating to the fiduciary relationship, the fiduciary is strictly obligated to make 'full disclosure' of all material facts" (*Blue Chip*, 299 AD2d at 279 quoting *Birnbaum*, 73 NY2d at 466; see *Arlinghaus v Ritenour*, 622 F2d 629, 636-637 [2d Cir], cert denied 449 US 1013; 3A Fletcher Cyclopedia of Private Corp. § 1171).

The transaction, here, without question, concerned a matter relating to defendant's fiduciary relationship with plaintiffs. Defendant, therefore, was obligated in negotiating that transaction "to disclose any information that could reasonably bear on plaintiffs' consideration of [his] offer" (*Dubbs v Stribling & Assocs.*, 96 NY2d 337, 341). Stated another way, defendant was "under a duty to disclose ... the full facts ... affecting the value of the stock which [he] was selling" (*Saville v Sweet*, 234 App Div 236, 238, *affd* 262 NY 567). "Absent such full disclosure, the transaction is voidable" (*Blue Chip*, 299 AD2d at 279-280; see *Birnbaum v Birnbaum*, 117 AD2d 409, 416). Indeed, where a fiduciary relationship exists between the parties, there must be clear proof of the integrity and fairness of a transaction between them, "'or any instrument thus obtained will be set aside or held as invalid'" (*Matter of Gordon v Bialystoker Center and Bikur Cholim*, 45 NY2d 692, 698 quoting *Ten*

Eyck v Whitbeck, 156 NY 341, 353).

Defendant contends that full disclosure of his dealings with the Smiths was unnecessary because the release of confidential proprietary information to them was limited to those documents essential and necessary to valuing his stock and the corporation was protected by a non-disclosure agreement. The issue here, however, is not whether defendant breached his fiduciary duty by contacting the Smiths and releasing confidential proprietary information to them (*cf. Leviton Mfg. Co. v Blumberg*, 242 AD2d 205, 208). The issue is whether defendant's obligation of full disclosure included the obligation to disclose everything about his dealings with the Smiths, including the fact that he released confidential proprietary information to them under a non-disclosure agreement.

Defendant also challenges the materiality of that information in light of the non-disclosure agreement. Again, however, defendant misses the point. The point is that the value of a corporation is affected by the release of its confidential proprietary information to persons associated with a competitor and, while a non-disclosure agreement may diminish that effect, or eliminate it entirely, there is no way for the corporation or a shareholder like plaintiff to make that determination without knowledge of the agreement and an opportunity to review it. Given the fiduciary relationship that existed, it was the

obligation of defendant to disclose everything about his dealings with the Smiths, including the fact that he released confidential proprietary information to them under a non-disclosure agreement, because "that information could reasonably bear on plaintiffs' consideration of [defendant's] offer" (*Dubbs*, 96 NY2d at 341). Additionally, defendant entered into the non-disclosure agreement on behalf of the corporation. That agreement was a corporate document that he had no right to withhold from plaintiffs.

Defendant nevertheless contends that he had no duty to disclose because he had no reason "to believe that the information [was] material and germane to [the] contemplated transaction" (*Botti v Russell*, 180 AD2d 947, 950). In support of that contention, defendant cites evidence indicating he had no reason to believe that plaintiff harbored any enmity for the Smiths. The relevant question, however, is not whether defendant had any reason to believe that there was any enmity but whether he had any reason to believe that one or more of the persons to whom he released confidential proprietary information were associated with a competitor of Ajettix. Defendant admits such knowledge and thus it is irrelevant whether he had any reason to believe that plaintiff harbored any enmity for the Smiths.

Equally irrelevant to the question at hand is defendant's additional contention that proof of scienter is lacking. Because plaintiffs seek on their motion rescission and not damages,

"proof of scienter is not necessary; even an innocent misrepresentation is sufficient for rescission" (*Steen v Bump*, 233 AD2d 583, 584, *lv denied* 89 NY2d 808).

Finally, the court rejects defendant's contention that plaintiffs' claim for rescission is barred by the releases signed in conjunction with the July 20th transaction. "[A] fiduciary cannot by contract relieve itself of the fiduciary obligation of full disclosure by withholding the very information the beneficiary needs in order to make a reasoned judgment whether to agree to the proposed contract" (*Blue Chip*, 299 AD2d at 280; see *H.W. Collections v Kolber*, 256 AD2d 240, 241). The court therefore concludes that plaintiffs' motion for summary judgment directed to the First Cause of Action should be granted because, upon all the papers and proof submitted, the claim for rescission based on the defendant's breach of fiduciary duty in connection with the July 20th transaction has been established as a matter of law (see CPLR 3212 [b]).³

III.

The court next examines plaintiffs' fraud claims. The complaint states claims for actual fraud in connection with the July 20th transaction. The claim of actual fraud rests upon the

³ The court does not consider that plaintiffs' motion for summary judgment concerns the Third Cause of Action, which is separately denominated "rescission." Nor does the court consider that plaintiffs' motion concerns the Fourth or Fifth Causes of Action.

allegation that defendant intentionally concealed his dealings with the Smiths. Plaintiffs assert that they have also pled a claim of constructive fraud, based on the allegation that defendant breached a fiduciary duty by failing to disclose those dealings.

In order to make out a prima facie case of fraud, it must be shown that there was a misrepresentation of a material fact by the defendant, done for a fraudulent intent, and justifiably relied upon by the plaintiffs to their detriment. In other words, there must be proof "of a representation of material fact, falsity, scienter, reliance and injury" (*Small v Lorillard Tobacco Co.*, 94 NY2d 43, 57). "A fraud cause of action may be predicated upon acts of concealment where the defendant had a duty to disclose material information" (*Standish-Parkin v Lorillard Tobacco Co.*, 12 AD3d 301, 786 NYS2d 13, 15). "Thus, where a fiduciary relationship exists, 'the mere failure to disclose facts which one is required to disclose may constitute actual fraud, provided the fiduciary possesses the requisite intent to deceive'" (*Kaufman v Cohen*, 307 AD2d 113, 120 quoting *Whitney Holdings Ltd. v Givotovsky*, 988 F Supp 732, 748 [US Dist, SD NY]).

Constructive fraud is similar to fraudulent concealment except that the element of scienter need not be proven (*Klembczyk v DiNardo*, 265 AD2d 934, 936. "[T]he element of scienter ... is

dropped and is replaced by a requirement that the plaintiff prove the existence of a fiduciary or confidential relationship" (*Brown v Lockwood*, 76 AD2d 721). Thus, constructive fraud refers to "'an act done or omitted, not with actual design to perpetrate positive fraud or injury upon other persons, but which, nevertheless, amounts to positive fraud, or is construed as fraud by the court because of its detrimental effect upon public interests and public or private confidence'" (*Bank v Bd. of Educ. of City of New York*, 305 NY 119, 123 quoting *Eaton on Equity*, § 125).

Here, defendant established in support of his motion that he did not act with fraudulent intent. His evidence indicates that his dealings with the Smiths were for a legitimate purpose and that, although he intentionally refused to disclose those dealings to plaintiffs, his intent was not fraudulent but the product of a mistaken belief that disclosure was unnecessary due to the non-disclosure agreement. In response, plaintiffs cite evidence indicating that defendant was aware of plaintiff's enmity towards the Smiths and her reluctance to deal with them. Although this evidence was of no moment to the breach of fiduciary duty claim, since scienter was not required, it is relevant here. Notwithstanding the fact that defendant refutes plaintiff's proof, the conflicting affidavits on the issue of whether defendant was aware of plaintiff's enmity towards the

Smiths creates an issue of fact on the requisite element of scienter, thereby precluding summary judgment in favor of defendant dismissing the actual fraud claim (the Second Cause of Action) against him. Similarly, that part of plaintiffs' motion seeking summary judgment on the actual fraud claim is also denied.

The parties spar over whether the Complaint states a constructive fraud claim even though one was not separately denominated as such. The Complaint may fairly be read as pleading a constructive fraud claim, but the court declines to order relief with respect to it other than what has been ordered above in connection with the breach of fiduciary duty claim. As already indicated, proof of scienter is unnecessary to establish constructive fraud. The same evidence already discussed with reference to the breach of fiduciary claim also establishes the constructive fraud claim as a matter of law. Although defendant contends that requisite proof of injury is lacking, it appears that, if nothing else, the transaction itself is the damage flowing from the fraud.

The court rejects defendant's additional contention that the fraud claims are not pled with requisite specificity (see CPLR 3016). The court therefore denies defendant's motion in its entirety.

SO ORDERED.

KENNETH R. FISHER
JUSTICE SUPREME COURT

DATED: February __, 2005
Rochester, New York