

To Be Argued By:  
JOHN VAN DER TUIN, ESQ.  
Time Requested: 20 Minutes

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# Court of Appeals

STATE OF NEW YORK

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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, JOSSIOFF 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 JOSSIOFF, 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.*

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## BRIEF FOR PLAINTIFFS-RESPONDENTS

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BALBER PICKARD MALDONADO  
& VAN DER TUIN, P.C.  
*Attorneys for Plaintiffs-Respondents*  
1370 Avenue of the Americas, 7th Floor  
New York, New York 10019-4602  
Phone No. (212) 246-2400  
Fax No. (212) 765-4212

*Of Counsel:*  
JOHN VAN DER TUIN, ESQ.  
JANE Y. GINNS, ESQ.

*Brief Completed on: May 31, 2011*

**COURT OF APPEALS RULE 500.1(f) DISCLOSURE STATEMENT**

Plaintiff-Respondent limited liability companies state that they have no parents, subsidiaries or affiliated companies.

**STATUS OF RELATED LITIGATION**

Subsequent to the order of the Motion Court here at issue, Respondents served a Second Amended Complaint to replead their fraud cause of action with more particularity. Appellants' motion to dismiss the Second Amended Complaint was denied in an order that is not the subject of this appeal. Discovery then proceeded during the pendency of this appeal in the Appellate Division, resulting in the exchange of voluminous documents and the taking of thirty-three depositions in New York and in Israel. Further proceedings below were then stayed on the consent of the parties pending the instant appeal.

In a related case, *Arfa, et al., v. Zamir, et al.*, N.Y. Co. Index No. 603602/05, an appeal involving the Appellants in this appeal, but not the Respondents, was argued in this Court on April 27, 2011, Doc. No. 92. Other proceedings in *Arfa v. Zamir* are stayed.

## PRELIMINARY STATEMENT

This brief is submitted on behalf of all Plaintiffs-Respondents (collectively “Respondents”)<sup>1</sup> in support of their argument that the decision and order of the Appellate Division, First Department, entered June 3, 2010, affirming the order of the Supreme Court, New York County, (the “Motion Court”) should be affirmed.

### COUNTERSTATEMENT OF QUESTIONS PRESENTED

1. Whether a promoter who solicits funds from investors to use in an enterprise to be organized, managed and controlled by the promoter owes the investors a fiduciary’s duty of full disclosure of hidden profits to be obtained by the promoter from the enterprise?

The courts below properly answered the question in the affirmative.

2. Whether the Amended Complaint and motion papers show that Appellants created a fiduciary relationship with Respondents by reason of their solicitations of overseas investors through personal relationships and cultural affinity, claims of special knowledge and expertise to select and manage the investments, and promises of mutual interests?

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<sup>1</sup> Respondents are (i) the limited liability companies that Appellants required each investor to form (the “Investor LLCs”) to hold their membership interests in the seven Property LLCs later formed by Appellants to own the real properties and (ii) an individual member of each Investor LLC. At the commencement of this action, the interests of all the Investor LLCs had been assigned to Plaintiffs-Respondents Roni, LLC, Eshel Properties, LLC, Gili Holdings, LLC, and KKR Investments, LLC, to pursue their collective claims. For reasons unrelated to this appeal, the Motion Court required each of the additional Investor LLCs and an individual investor member of each to intervene as co-plaintiffs in this action.

The Appellate Division erroneously answered the question in the negative; the Motion Court properly answered the question in the affirmative.

3. Whether New York State's Martin Act silently pre-empts pre-existing common law claims, such as Respondents', that are not based on allegations of violation of the Martin Act's disclosure obligations?

The Appellate Division did not reach this question because it properly held that the investment offerings at issue in this case were private offerings not subject to the Martin Act. The Motion Court properly held both that the Martin Act did not apply to these offerings and that, if it did apply, it does not pre-empt common law claims.

4. Are Respondents entitled to recover damages on their constructive fraud claim based on the amount that the purchase price of the acquired properties was inflated by the hidden kick-backs to Appellants? Are Appellants entitled to raise the same argument with respect to the actual fraud claim of the Amended Complaint where the actual fraud claim has been repleaded in a Second Amended Complaint pursuant to leave of the Motion Court, and the Second Amended Complaint is not the subject of this appeal?

Both Courts below properly answered the first question in the affirmative. The Appellate Division properly answered the second question in the negative.

## INTRODUCTION

This appeal arises out of a scheme in which Appellants, and their former partner Gadi Zamir,<sup>2</sup> solicited funds from investors in Israel through personal contacts and friendships to purchase<sup>3</sup>, mortgage, manage, rehabilitate and then sell or refinance for a profit a series of seven packages of rent-regulated multi-family buildings in Harlem and the Bronx<sup>4</sup>. The solicitations were both oral and by written "Set Up" that purported to describe the nature of the buildings, their existing and projected financials and the role, profits and fees of the Appellant promoters. Appellants disclosed that they would, directly or through companies they controlled, contribute a small portion of the equity and take certain fees or commissions. Specifically, they disclosed that they would take an "Acquisition Fee" of 1.5-2.5% of the property price for their work to locate the buildings and organize the investments, would take a management fee of 6% of rents for management of the properties after purchase and, upon successful refinancing or sale of the buildings, would take a share of the profit proportionate to their equity interest plus, on some of the buildings, an "Upside" fee of 20% of the profit.

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<sup>2</sup> Respondents have settled with Mr. Zamir and he is not a party on this appeal.

<sup>3</sup> In all instances, investor funds were contributed prior to closings, and in some instances prior to contracts, on properties. In no instance did the promoters first close on a building purchase and then seek investors to purchase an interest in the building. Investors also were told that their funds were at risk and might be retained to pay expenses if a particular transaction did not close.

<sup>4</sup> Seven separate investments and transactions are involved, each having between four and thirteen investors. Some Respondents are in only one investment, some are in all and some are in more than one but not all.

Nothing in the Set Ups indicated Appellants had any relationship with the property sellers or anticipated any other profits or fees.

What Appellants did not disclose<sup>5</sup>, and that is at issue in this litigation, is that they also negotiated a fee or commission amounting to 9-15% of the purchase price of each of the building packages to be separately paid to them at or after closing by the sellers of the buildings.<sup>6</sup> These undisclosed or secret commissions, which were in addition to the commissions paid by the sellers to the actual third-party brokers on the transactions, totaled approximately \$4.5 million.<sup>7</sup>

Appellants' agreements with property sellers to be paid these commissions placed Appellants' interests in clear conflict with the investors' interests: Appellants profited at closing of the property purchases, whether the properties were subsequently profitable or not. It was thus in Appellants' interest to find properties whose sellers would pay the exorbitant and undisclosed fees, rather than properties that were the best value. It was also in Appellants' interest to negotiate purchase prices that were high enough to motivate or allow sellers to kick back a

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<sup>5</sup> Respondents learned of the secret commissions only after all the investments at issue had been completed when disputes and litigation broke out between Mr. Zamir, on the one hand, and Appellants Arfa and Shpigel on the other (*Arfav. Zamir.*, N.Y.Co. Index No. 603602/05), and Mr. Zamir revealed the commissions to the Israeli investors.

<sup>6</sup> Appellants' undisclosed kick-backs from mortgage brokers on the transactions and disgorgement of Acquisition Fees are also at issue.

<sup>7</sup> Appellants now do not dispute that the commissions were taken, or their amount; they dispute only whether disclosure was required or was sufficient. (R. 275 Arfa Aff. at ¶3.)

substantial portion of the purchase price, rather than to negotiate the lowest possible purchase price.

Appellants now appeal the denial of their pre-answer motion to dismiss the accounting, breach of fiduciary duty and constructive fraud causes of action of Respondents' Amended Complaint.<sup>8</sup> Each of these causes of action is premised on Appellants' duty, as promoters of the investment scheme at issue, to fully disclose the profits or fees that they would gain from the scheme.

In this appeal, Appellants seek to have this Court roll back the law of New York to make investors more vulnerable to unscrupulous promoters who conceal hidden profits from the enterprises they promote and who put their financial interests in undisclosed conflict with those of the investors they solicit. The courts below refused to legitimize Appellants' wrongdoing and should be affirmed.

There are two central issues.

The first is whether promoters who solicit investors to fund enterprises that the promoters will organize, control and manage have a fiduciary's duty to fully disclose to the investors the material profits or fees the promoter will obtain from the enterprise. The common law as to corporations, partnerships and joint ventures

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<sup>8</sup> The motion court granted Appellants' motion to dismiss the actual fraud cause of action, with leave to replead with more specificity. Appellants subsequently did so in a Second Amended Complaint that also alleges the same accounting, breach of fiduciary duty and constructive fraud claims as were alleged in the Amended Complaint that is the subject of this appeal. Appellants contend that Respondents' actual fraud cause of action should be dismissed for failure to properly plead damages, notwithstanding that Respondents' subsequent motion to dismiss the repleaded fraud cause of action was denied and not appealed.

has long been that there is such a duty of full disclosure, *see, e.g., Brewster v. Hatch*, 122 N.Y. 349, 361-362 (1890). It has been buttressed by the federal and state securities laws that require full disclosure, *see, e.g., Secs. and Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186, 84 S.Ct. 275, 280 (1963).

Appellants contend, however, that because the enterprises in this case were ultimately organized as limited liability companies the disclosure rules applicable to promoters of other business entities are not applicable. Appellants acknowledged in argument below that after the limited liability companies were organized they, as managers, owed fiduciary duties to the investor-members. They contend on appeal, however, that as promoters soliciting and using the Respondents' money to acquire the properties - before the limited liability companies were formed and before investors became formal members - they had no duties and were free to conceal profits and material conflicts of interest. That is not, and should not be, the law of the State of New York. Both courts below

correctly held that Appellants did have a duty of full disclosure.<sup>9</sup>

The second central issue is whether New York's Martin Act, enacted as an investor protection statute, silently pre-empts and bars pre-existing common law claims - such as Respondents' breach of fiduciary duty, accounting and constructive fraud claims - that are based upon a failure to make disclosures required by common law duties. The Motion Court correctly held both that the Martin Act does not apply to this non-public offering solely to foreign investors and that, even if it did, it does not pre-empt Respondents' claims. The Appellate Division concurred that the Martin Act does not apply to this private offering, and did not reach the pre-emption issue. The weight of authority in the Appellate Divisions and in the federal courts that have addressed this issue is, correctly, that pre-existing common law causes of action are not pre-empted by a statute absent an express provision for pre-emption. The Martin Act contains no such pre-emption provision. Indeed, the poorly-reasoned decisions that find a silent pre-emption are antithetical to the Martin Act because they would convert an investor

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<sup>9</sup> The Appellate Division rested its holding on its correct view that Appellants, as promoters, had a fiduciary's duties of full disclosure to their investors, though it erroneously asserted in *dictum* that the factual allegations in the Amended Complaint and motions papers would have otherwise been insufficient to describe a fiduciary relationship. The Motion Court properly found both that Appellants, as promoters, owed Respondents a fiduciary's duties of full disclosure, and that the factual allegations of the Amended Complaint and motion papers showed a relationship of superior expertise, control and trust that, if proven, also required Appellants to fulfill a fiduciary's duties. The order of the Appellate Division should be affirmed based either on its reasoning and holding or on the alternative reasoning and holding of the Motion Court.

protection statute into a fraud protection statute by stripping common law protections from injured investors.

For the reasons set forth below, the order of the Appellate Division should be affirmed.

### **STATEMENT OF FACTS**

The individual Respondents are residents of Israel who were solicited by defendants Arfa, Shpigel and Zamir (together with defendant American Elite Properties, Inc., the “Promoters”)<sup>10</sup> to provide the equity funds to acquire seven packages of residential buildings in the Harlem and Bronx areas of New York City. As alleged in the Amended Complaint,<sup>11</sup> the individuals making the investments (the individuals named as plaintiffs in the caption, who in some instances had family members or friends who invested with them) were required by the Promoters to form limited liability companies or corporations (the LLC or corporate plaintiffs in the caption) to hold the Investors’ membership interests in the seven limited liability companies later formed by the Promoters to own the real properties (the “Property LLCs”).

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<sup>10</sup> Arfa and Shpigel have not disputed that their role was as “Promoters.” Their attorney, Mr. Katz, described them as such to the Court below. (R. 279-80, Transcript at p. 10 line 15 to p. 11 line 3.) The counsel representing the Property LLCs and Appellants in the property acquisitions, likewise so-described them in the litigation below. (R. 239, Van Der Tuin Aff. quoting Memorandum of Law of co-defendant Mintz Levin Cohn Ferris Glovsky & Popeo, P.C..)

<sup>11</sup> R. 51 et seq. at ¶¶ 23-26.

The investors were solicited in Israel principally by Appellant Shpigel, who maintained a residence there, by written disclosure statements – the “Set Up” – and by oral presentations. Respondent Arfa, an attorney licensed in New York, and former defendant Zamir, were principally involved in the governance, transactional and administrative activities of the enterprise in New York City.<sup>12</sup> The investment plan, as disclosed to the Investors, was that the Investors would provide the bulk of the equity capital to acquire buildings identified by the Promoters as attractive investments. The Promoters would contract for the purchase by an entity they owned, via an assignable contract with a long closing date, and then assign the contract to and close in the name of the Property LLC with the funds provided by the Investors and by bank mortgage loans. (Amended Complaint, R. 64-65, 71-76.) Again, as alleged in the Amended Complaint (R. 63-67) and described in more detail in the Set-Ups (R. 135, *et seq.*) the Promoters represented that they would contribute a 5% to 25% portion of the equity capital and retain a comparable membership interest in the Property LLC (*e.g.* R. 139 “HH Participation” line) and would be paid a modest 1.5%-2% “Acquisition Fee” on some of the deals to compensate them for their efforts to locate the property and organize the transaction (*e.g.* R. 139 “Acquisition Fee” line.) The Promoters were also, with

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<sup>12</sup> (Amended Complaint R. 63 at ¶ 24, R. 64 at ¶ 26 (i), R. 68 at ¶ 36; “Set-Ups” R.135-193.) The oral misrepresentations have been set forth in more detail and particularity in a Second Amended Complaint that is not the subject of this appeal. *See* n. 20, below.

respect to some of the Property LLCs, entitled to a preferential 20% “Upside” payment (in addition to the share proportionate to their equity interest) from the profits realized on refinancing or selling the buildings after nonpaying tenants had been evicted, apartments and buildings improved and rent rolls increased (*e.g.* R. 147 “Upside Fee” line.) The Promoters would use other companies, owned by them, to manage the properties (for a management fee), maintain and upgrade the properties (for a fee), and lease apartments (for brokerage commissions) (*e.g.* R. 65, Amended Complaint at ¶26(x); R. 137 Set Up discussing renovation and leasing.) This was all disclosed to the Investors and agreed to by them.

There were no subscription agreements or documents describing the structure or legal nature of the investments or enterprise, however. Documentation of the form of the limited liability company was not disclosed to investors until after the funds were contributed and properties purchased.<sup>13</sup> If property transactions did not close, investors were at risk to share in the expenses of the failed transaction.<sup>14</sup>

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<sup>13</sup> R. 64-65, Amended Complaint at ¶26; R. 243, 398, 403; Van Der Tuin Aff. at n. 18 and Ex.s U and V emails concerning post-closing preparation of operating statements; R. 253 Keren Aff. at ¶8; R. 382-385 and 409-410 emails and correspondence concerning collection of contributions from investors.

<sup>14</sup> R. 384-385 reciting that if transactions did not close, funds contributed will be returned “net of your pro rata share of costs and expenses”.

After all the property acquisitions had closed, however,<sup>15</sup> acrimonious disputes arose between the Promoters – Arfa and Shpigel on one side and Zamir on the other – that resulted in litigation between them in October 2005.<sup>16</sup> As a result of those disputes, and apparently in an effort to obtain the support of the Investors, Promoter Zamir disclosed to the Investors that the Promoters had obtained substantial, undisclosed payments, characterized as brokerage commissions, from the property sellers in each of the seven transactions by which the Property LLCs acquired their properties. As alleged in the Amended Complaint these “Secret Commissions” equaled 9-15% of the property acquisition prices (the commission percentage varied from deal to deal) and totaled in excess of \$4.5 million. (R. 69 at ¶ 41; R. 73-77 at ¶¶ 61, 63-64, 72 and 82-85).<sup>17</sup>

Appellants do not dispute that these commissions were taken. (R. 275 Arfa Aff. at ¶ 3)<sup>18</sup>. They dispute only whether disclosure of the commissions was required or was sufficient. (*Id.*) At argument before the Motion Court, their counsel conceded that disclosure would have been required if the commissions

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<sup>15</sup> The seven acquisitions at issue closed over a period from October 2002 through February 2005. (R. 66.)

<sup>16</sup> *Arfa v. Zamir*, S.Ct. N.Y. Co. Index No. 603602/2005. See Court of Appeals Dock. No. 92, argued April 27, 2011. See R. 284-294 Zamir letter to investors describing dispute.

<sup>17</sup> These undisclosed commissions were in addition to the disclosed Acquisition Fees that totaled in excess of \$600,000. (R. 66 at ¶¶ 28-29; R. 75 at ¶ 67.)

<sup>18</sup> The commission agreements on certain of the transactions are at R. 295, 297, 308-313 and 469. A table of the commissions on each transaction and the amount as a percentage of the purchase price, and the transmittal email of same from defendant Zamir to investor Keren in 2006 after the disputes arose, is at R. 467-468.

were taken after the Property LLCs were organized and the investors became members, but contended that in the pre-organization period when investors' money was solicited and contributed, no disclosure was required. (R. 521 at lines 7-25.)

In this action, the Respondents seek to recover the Secret Commissions and other profits taken by their disloyal fiduciaries.<sup>19</sup> At issue on this appeal is the defendant Promoters' pre-answer motion to dismiss the Investors' First (accounting), Third (breach of fiduciary duty), and Seventh (constructive fraud) claims against them.<sup>20</sup> Appellants offer three arguments as to why Justice Ramos and the unanimous Appellate Division erred in denying their dismissal motion:

First, Appellants claim that in promoting investments in these enterprises, they had no duty to disclose material facts – even as to the substantial commissions from sellers and disguised self-interests as in this case – to the investors they solicited to be their co-members. They seek to distinguish promoters of investments schemes structured as LLC's from investment schemes structured as

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<sup>19</sup> An action was originally brought on behalf of the Property LLCs. *546-552 West 146<sup>th</sup> Street LLC v. Arfa*, S.Ct.N.Y. Co. Index No. 603041/06. The Court below, affirmed by the Appellate Division, held that the claims belonged to the Investors, not the Property LLCs. This action was then commenced asserting largely the same claims.

<sup>20</sup> Appellants also assert that the Investors' Sixth cause of action, for actual fraud based upon various misrepresentations as to the nature of the investments, should be dismissed for failure to plead fraud damages. That assertion is both wrong – as damages were properly pled - and is not properly before this Court. The order appealed from (R. 22, *et seq.*) granted the motion to dismiss the Sixth, fraud, claim with leave to replead. A Second Amended Complaint was thereafter filed by the Investors that restated the First, Third and Seventh claims, and repleaded the Sixth claim with more particularity. Appellants' motion to dismiss the Sixth Claim of the Second Amended Complaint was thereafter denied and is not the subject of this appeal.

corporations, partnerships or joint ventures. This claim is contrary to well-established law and, if adopted, would be exceedingly bad policy.

Alternatively, even if the Appellants did not, as promoters, have the duty to disclose to potential investors their conflicting financial interests in the enterprises, the Amended Complaint clearly alleges, as Justice Ramos properly held (R. 34-36), that these Promoters assumed positions of special trust and obligation to these investors by emphasizing their special expertise, by soliciting funds from remote overseas investors through relationships of friendship, family and cultural affinity based on little more than a handshake and by having complete control over the investors' funds and the legal counsel, management, improvement and sale or disposition of the properties. (Amended Complaint at R. 63-65.)

The allegations of the Amended Complaint were substantiated and supplemented by the papers submitted on the motions below. Investors were not solicited to take interests in completed transactions, but were solicited to pool their funds with the Appellants under Appellants' expertise and control. (R. 258 Investor Kriel Aff. at ¶ 7.) Investors' funds were needed and contributed prior to acquiring properties, and were at risk to be used for expenses of transactions that failed to close. (R. 382-385, 409, 451 pre-closing emails soliciting collection of investor funds and reciting investor risk for expenses; R. 449-450 attorney escrow

listing receipt of investor funds to be controlled by Harlem Holdings<sup>21</sup> prior to transaction closings.) LLC operating agreements were prepared only after the investor funds were delivered and used to purchase properties. (R. 243 at n.18; R. 253 Investor Keren Aff. at ¶8; and R. 398 and 403, emails discussing post-closing preparation and distribution of operating agreements.) The attorneys representing the Property LLCs in the purchase of the properties were instructed by Appellants to conceal information concerning the commissions. (Amend. Compl. R. 70-71, 80; R. 461 & 466, emails concerning deletion of brokerage agreements from closing binders.)

The Appellate Division erred in reasoning that the Amended Complaint did not plead this relationship of trust and consequent obligation to disclose. Its order may be affirmed and Appellants' motion denied upon this alternative ground.

Second, Appellants also cynically claim that the New York State's investor protection statute, the Martin Act, silently pre-empts the Investors' common law non-disclosure claims even though the Promoters did not register as broker-dealers or register these offerings pursuant to the Martin Act. This pre-emption theory has been roundly rejected by recent and persuasive decisions in the Appellate Divisions and in the federal district court for the Southern District of New York.

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<sup>21</sup> Harlem Holdings LLC is the entity owned by Arfa, Shpigel and Zamir that held their equity interest in the Property LLCs and acted as a co-manager of the Property LLCs once they were formed. (R. 60 at ¶13.)

To conclude otherwise would make the Martin Act, an investor protection statute, a fraud protection act. The Appellate Division did not reach this issue because it properly held that the Martin Act did not apply to these transactions because the offering to a limited number of offerees, all overseas and related by family or friendship, did not constitute a public offering within or from New York. (R. 5.) Justice Ramos, in a well-considered opinion reasoned both that the offering at issue did not fall within the ambit of the Martin Act, because the offering was made and negotiated exclusively in Israel to a small number of persons and was therefore not within or from New York, and that even if the Martin Act applied it does not preempt common law claims of the type here at issue that are not premised upon a failure to disclose facts required by the Act or implementing regulations. (R. 30-33.) The Appellate Division's order should be affirmed. Furthermore, even if this Court concludes that the Martin Act does apply to the transactions here at issue, the order below should be affirmed because the Martin Act does not pre-empt the Investors' common law causes of action.

Third, Appellants claim that the Investors' constructive fraud cause of action should be dismissed because it does not properly plead fraud damages. As explained above, n. 20, Appellants also improperly seek to address this argument to the Investors' fraud cause of action. Appellants misconstrue the law and their argument is entirely without merit. The inflation of the purchase price of the

properties to fund the undisclosed commissions being kicked back by the sellers to the Promoters is a proper measure of the loss suffered by the Investors by reason of Appellants' constructive fraud.<sup>22</sup>

For the reasons set forth below, the order of the Appellate Division should therefore be affirmed.

## ARGUMENT

### Standard of Review

On a CPLR 3211 motion to dismiss, "the court must afford the pleadings a liberal construction, take the allegations of the complaint as true, and provide plaintiff the benefit of every possible inference." *EBC I, Inc. v. Goldman Sachs & Co.*, 5 N.Y.3d 11, 19 (2005). The factual allegations in a plaintiff's complaint are to be deemed true for purposes of deciding whether the complaint sets forth a cognizable cause of action. *Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Wise*, 19 A.D.3d 273, 275 (1st Dep't 2005). Moreover, "affidavits and other evidence may be used freely to preserve inartfully pleaded but potentially meritorious claims, and the court's attention should be focused on whether the plaintiff has a

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<sup>22</sup> Record documents show this inflation of the prices paid. (R. 297-298 is a commission agreement between a seller on one of the seven transactions and two brokerage companies controlled by the Appellants, executed by Appellant Arfa, providing for a commission of \$480,000 and also providing in its penultimate paragraph that if commission were not paid the sales price and transfer tax would be accordingly reduced.) Subsequent discovery, that has proceeded while these appeals were pending and that is not of record on this appeal, also confirmed that this is exactly what occurred – the Promoters agreed with sellers to pay a higher price for the buildings to compensate for the commissions being kicked back.

cause of action, rather than whether he has properly stated one.” *Rovello v. Orofino Realty Co.*, 40 N.Y.2d 633, 636 (1976) (emphasis added).

Thus, the Court must deny dismissal if the allegations of Respondents’ Amended Complaint, when given every favorable inference and considered with the evidence submitted, are sufficient to “come within the ambit of any cognizable legal theory.” *Merrill Lynch, Pierce, Fenner, & Smith*, 19 A.D.3d at 275; *Salles v. Chase Manhattan Bank*, 300 A.D.2d 226, 228 (1st Dep’t 2002) (“court’s role is simply to determine whether the facts, as alleged, fit into any valid or legal theory”).

As demonstrated below, this standard was correctly applied by the Appellate Division and its decision and order should be affirmed.

#### Point I

**A PROMOTER WHO SOLICITS FUNDS FROM INVESTORS TO USE IN AN ENTERPRISE TO BE ORGANIZED, MANAGED AND CONTROLLED BY THE PROMOTER OWES THE INVESTORS A FIDUCIARY’S DUTY OF FULL DISCLOSURE OF HIDDEN PROFITS TO BE OBTAINED BY THE PROMOTER FROM THE INVESTMENT**

Appellants contend that during the period they were soliciting and using the investors’ funds, prior to the investors’ formal membership in the Property LLCs, they occupied a special position free of any duty to disclose to investors their hidden commissions and conflicting interests. This contention is contrary to well-

established law and seeks to open a gaping hole in the structure of common and statutory laws that protect investors from dishonest, self-interested promoters. The Appellate Division properly rejected it and that decision should be affirmed by this Court. Alternatively, as shown in Point II, below, the record in this case – liberally construed in favor of Respondents as it must be – demonstrates that these Appellants in this investment scheme did take on a role of special expertise, control and trust that required them to disclose to these investors Appellants’ hidden fees and consequent financially conflicting interests.

The breach of fiduciary duty, accounting and constructive fraud causes of action of Respondents’ Amended Complaint are premised on the allegation that Appellants owed them a fiduciary’s duty of full disclosure of their hidden commissions and conflicting financial interests because of their role as both promoters (R. 77 at ¶87; R. 79 at ¶100) and as managers (R. 77 at ¶87; R. 79 at ¶99) of the enterprises at issue. As described above, at pp.7-13, and more fully below at Point II, the supporting details of Appellants’ claimed special expertise, of Respondents’ unfamiliarity with and remoteness from the New York City real estate market, of Appellants’ play on friendship and cultural affinity, and of Appellants’ complete control of the investors’ funds and of management of the enterprise are explicit in the Record.

Appellants acknowledged below (R. 521 at lines 23-24) that once the investors became formal members of the Property LLCs, fiduciary duties attach. *See McKinney's Limited Liability Law* §§ 409(a) and 417(a)(1) (duty of good faith and prudence imposed on managers; operating agreement may not absolve managers of liability for bad faith, intentional misconduct or personal financial gain). The Practice Commentaries observe that "The LLCL provisions governing duties and liabilities of managers, including fiduciary duties, conflicts of interest and limitation on liability, follow corporate concepts for directors and almost word-for-word track the borrowed BCL provisions." Rich, *McKinney Practice Commentary*, Limited Liability Company Law Article 4 ("Duties and Liabilities of Managers").

Appellants argue on appeal, however, that Respondents' claims are premised upon Appellants' actions and omissions as promoters – the solicitation and use of the investors' funds, the negotiation and organization of the real property transactions, the instruction of counsel, the negotiation and taking of the undisclosed commissions – all of which were concluded prior to distributing operating agreements and membership interests to the investors. (Appellants'

Memorandum at p. 25.)<sup>23</sup> During this promotional period, prior to formal organization, Appellants assert they had no disclosure duties either because they were promoting interests in limited liability companies, rather than corporations, partnerships or other business forms, or because their relationship with the investors was commercial and arms' length. These arguments are completely lacking in merit.

The law is well-established, in common law and statute, that promoters of business ventures – those who seek funds from investors to be applied to a business to be organized, controlled and managed by the promoter – owe a fiduciary's duty of full disclosure to those investors of any profits or financial interests the promoter may have in the enterprise. In a seminal case, *Brewster v. Hatch*, 122 N.Y. 349 (1890), this Court addressed the disclosure duties of persons who, like Appellants, arranged to purchase a property on terms that included a secret profit for themselves and then solicited investors to purchase shares in the corporation organized by the promoters to close on the purchase. This Court held:

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<sup>23</sup> The assertion at pp. 25-26 of Appellants' Memorandum that if an investor had refused to sign an operating agreement his or her funds would have been returned is completely without basis in the Record. It is contrary to the Record documents showing that Appellants were anxious to collect the investor funds needed just to close the transactions (R. 382-385), showing that investors were told that if transactions did not close a portion of their funds would be used for expenses (R. 409-410), and showing that operating agreements were not even prepared until after the investor funds had been spent (R. 253 at ¶8; R. 398 and 403; affidavit and emails that operating agreements not prepared and distributed until after closings on property transactions.)

They [the defendant promoters] knew that they, and they only, absolutely controlled the scheme, and were to determine whether it should be carried out, and if so, when and how. We think that the plaintiffs were led to believe, and had a right to believe, from the documents and from the circumstances that the defendants were acting in the interests of all the investors, and that they knew that the plaintiffs so believed. These defendants were the promoters of the corporation and occupied, before its organization, a position of trust and confidence towards those whom they have induced to invest in the enterprise.

*Id.* at p. 361-62; see *Northridge Cooperative Section No. 1, et al. v. 32<sup>nd</sup> Ave. Constr. Corp.*, 2 N.Y.2d 514 (1956); *Gramercy Equities Corp. v. Dumont*, 72 N.Y.2d 560, 565 (1988) (fiduciary duty of managing joint venturer to non-managing joint venturer); *Hutchinson v. Simpson*, 92 A.D. 382 (1st Dep't 1904); *Shore Terrace Coop., Inc. v. Roche*, 268 N.Y.S.2d 278 (2d Dep't 1966); *Hifler v. Calmac Oil & Gas Corp.*, 10 N.Y.S.2d 531, 540 *aff'd.* 248 A.D. 78 (4th Dep't 1939); *Huang v. Sy*, 859 N.Y.S.2d 903 (Table), 2008 WL 553646, 2008 N.Y. Slip Op. 50391(U) (Sup.Ct. Queens Co. Feb. 28, 2008), *aff'd* 63 A.D.3d 660, 879 N.Y.S.2d 729 (2d Dep't 2009); see also *Dymm v. Cahill*, 730 F. Supp. 1245, 1264 (S.D.N.Y. 1990) (applying New York partnership law.)

The duty is likewise well-established in other jurisdictions. See, e.g., *Smith v. Binner*, 319 N.W.2d 196 (Iowa 1982) ("A promoter stands in a fiduciary position towards both the corporation and its stockholders and is prohibited from acquiring a secret personal advantage from any action taken on behalf of the

corporation.”); *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich. 582 (Mich. 1946) (“Every person acting by whatever name in the forming and establishing of a company at any period prior to the company’s becoming fully incorporated is considered in law as occupying a fiduciary relation towards the corporation.”); *Golden v. Oahe Enters., Inc.*, 295 N.W.2d 160 (S.D. 1980) (“As a promoter of Oahe, Emmick stood in a fiduciary relationship to both the corporation and its stockholders and was bound to deal with them in the utmost good faith.”); *Norbonne, N.V. v. Lake Bryan Int’l Props.*, 689 So.2d 322 (Fla. Dist. Ct. App. 1997); *Topanga Corp. v. Gentile*, 249 Cal. App. 2d 681 (Cal. Ct. App. 1967) (“Well established is the principle that promoters of a corporation formed for the express purpose of purchasing a particular piece of property occupy a fiduciary relation to their co-subscribers, requiring that they truthfully disclose to their associates any personal interest that they may have in the matter of the purchase.”); *see also, Der v. Hill*, 113 B.R. 218, 230 (Bankr. D. Md. 1989) (fiduciary duty of promoter of partnership interests). *See generally* Herbert B. Chermiside, Jr., *Corporation’s measure of recovery against promoter who has made secret profit in sale of property to corporation*, 84 A.L.R. 3d 162 §2(a) (1978) (“A promoter is likewise guilty of a breach of trust if he accepts a secret bonus or commission from a third person who sells property to the corporation, and in either event it is immaterial that the property was worth the price paid for it by the corporation.”).

This common law duty is also consistent with the statutory obligations of full disclosure of material facts that have been enacted for promoters of securities investments in the years since *Brewster*. See, e.g., Securities Act of 1933 §12, 15 U.S.C. §77l (liability of any person who offers or sells a security by means of a prospectus or oral communication "...which includes an untrue statement of a material fact or omits to state a material fact..."); Mihaly & Kaufmann, *McKinney Practice Commentary*, General Business Law Art. 23-A, at §IVB, p. 25:

As noted throughout this Practice Commentary, the fundamental purpose of the Martin Act is to insure that prospective purchasers of securities, commodities and real estate securities offered or sold in or from New York are furnished with sufficient factual information for them to make intelligent investment decisions, a purpose accomplished by means of dissemination of full and fair disclosure of all "material" facts.

As the United States Supreme Court reasoned, referring to the group of federal securities offering statutes enacted in the 1930's:

A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.

*Secs. and Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

Liability under the foregoing well-established law is based on the defendants' undertaking the role of promoter of the enterprises at issue – accepting

investor funds and controlling or managing the enterprise – and not on a fine-grained analysis of the specific or relative knowledge, sophistication or circumstances of the parties involved. It is premised upon a clear rule rather than on case-by-case or investor-by-investor factual analysis, just as this Court has promulgated and applied clear rules of fiduciary or disclosure duties to govern other relations involving advice, trust or control. Brokers are fiduciaries because their role is one of advising, negotiating and representing, *e.g.*, *Dubbs v. Stribling & Assoc., et al.*, 96 N.Y.2d 337 (2001); IPO underwriters are fiduciaries where they advise their issuers, *e.g.*, *EBC I, Inc. v. Goldman, Sachs & Co.*, 5 N.Y.3d 11 (2005); managing partners (whether of partnerships, tenancies in common or joint ventures) are fiduciaries, *e.g.*, *Birnbaum v. Birnbaum*, 73 N.Y.2d 461 (1989); but finders whose duties entail solely identifying or introducing opportunities with no continuing obligation to provide advice, to control funds or property or to manage an enterprise are not fiduciaries, *Northeast General Corp. v. Wellington Advertising, Inc.*, 82 N.Y.2d 158 (1993). As this Court has reasoned, quoting the *Restatement [Second] of Torts* § 874, *Comment b*, “liability is not dependent solely upon an agreement or contractual relation between the fiduciary or beneficiary but results from the relation”. *EBC I, Inc., v. Goldman, Sachs & Co.*, *supra*, 5 N.Y.3d

at 20.<sup>24</sup> Promoters who solicit and control funds for their use in organizing and managing the enterprise undertake a fiduciary's relation and duties.

Appellants, relying largely on the blog posts of Professor Ribstein<sup>25</sup>, argue that promoters of limited liability company interests should be different. However, the Appellate Division's extension of corporate promoter principals to LLC promoters is well founded. As noted above in the *Practice Commentaries to New York Limited Liability Company statute*, the concepts enacted for limited liability companies closely track the concepts in the Business Corporation Law. Rich, *McKinney Practice Commentary, Limited Liability Company Law Article 4*

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<sup>24</sup> Ascribing fiduciary duties to specific relations – whether brokers, underwriters, managing partners or promoters – does not, of course, mean that the parties to such a relationship may not be able to contractually limit, supplement or expand those duties. But no such contractual limitation or supplementation is at issue in this case. There is no contract or disclosure limiting or disavowing Appellants' duty to disclose to potential investors material facts about the enterprise at issue - particularly their substantial, adverse financial interests and hidden profits. The disavowals to which Appellants point (e.g., Appellants' Brief at pp. 16-17) – statements in the Set Ups disavowing personal responsibility for the accuracy of the descriptions of the buildings and rents at issue, warning that projected profits may not be realized and asserting that investors must make their own investigations and decisions as to the investment – are of no relevance. The disavowals say nothing to qualify or limit the Promoters' obligation of disclosure or loyalty. There is no statement, as there easily could and should have been, that "American Elite Properties, Inc., is acting as broker for the seller of this property pursuant to a separate commission agreement for which it will receive a fee of \$ \_\_\_\_\_" or that "Companies related to American Elite Properties have entered into a brokerage agreement with the seller of the property and will receive a fee of \$ \_\_\_\_\_ at closing."

<sup>25</sup> Professor Ribstein is a well-known extreme proponent of the University of Chicago view that business relations should be unencumbered by legal or judicial constraints. He has also written that insider trading "...generally helps the market by making it more efficient," *Death to Insider Traders*, February 16, 2011, <http://truthonthemarket.com>; that "...corporations are a voice for economic liberty..." *Why Corporate Political Spending is Awesome*, *Business Insider Law Review*, January 29, 2010, <http://www.businessinsider.com>; and that the financial crisis was created by Hollywood, Larry E. Ribstein, *How Movies Created the Financial Crisis*, 2009 Mich. St. L. Rev. 1171 (Winter 2009).

(“Duties and Liabilities of Managers”) at p. 201. In a scholarly article in the Fordham Journal of Corporate and Financial Law, Professor Daniel S. Kleinberger traces the development of limited liability company law, places LLC’s within the context of corporate and partnership law and argues that exempting limited liability companies from the fiduciary duty rules that have been developed in the corporate and partnership law context would be a grave mistake. He concludes:

It is wrong to treat limited liability companies as involving a unique relationship between contract and fiduciary duty. To do so both ignores the place of limited liability companies in the history of unincorporated business organizations and misunderstands the general relationship between contract and fiduciary duty. Fiduciary duty attaches to particular contractual relationships for the same base reason applicable in other contexts – to proscribe and constrain abuses of power.[n] Abuse of power is no less a threat under operating agreements than under partnership agreements.

\* \* \*

The problem is not merely historical and conceptual. The following five points explain the substantial practical risks involved in killing off Cardozo and turning contract into deity:

\* \* \*

Daniel S. Kleinberger, *Two Decades of “Alternative Entities;” From Tax Rationalization Through Alphabet Soup to Contract as Deity*, 14 Fordham J. Corp. & Fin. L. 445 (2009).

Indeed, this Court, and others, have frequently applied law developed in the corporate context to limited liability companies by analogy or extension. *See, e.g., In the Matter of Estate of Hausman*, 13 N.Y.3d, 408, 412 (2009) (“The statutory

schemes of the Business Corporation Law and the Limited Liability Company Law are very similar and we see no principled reason why the de facto corporation doctrine should not apply to both corporations and limited liability companies.”); *Blue Chip Emerald, LLC v. Allied Partners, Inc.*, 299 A.D.2d 278 (1st Dep’t 2002) (applying law of partnership fiduciary duties to duties of joint venturers structured as an LLC); *Mobilevision Medical Imaging Servs., LLC v. Sinai Diagnostic & Interventional Radiology, P.C.*, 66 A.D.3d 685 (2d Dep’t 2009) (“Relevant case law regarding Business Corporation Law §1312(a), an analog of Limited Liability Company Law §808(a), supports the petitioner’s contention that, under the circumstances presented, it was entitled to a reasonable opportunity to cure its non-compliance with the statute before dismissal of the proceeding should be considered”); *see also Bay Ctr. Apartments Owner, LLC, v. Emery Bay PKI, LLC*, C.A. No. 3658-CS, 2009 WL 1124451 at \* 8, n.33 (Del. Ch. Apr. 20, 2009) (“The LLC cases have generally, in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation ... [citations omitted].... Moreover, when addressing an LLC case and lacking authority interpreting the LLC Act, this court often looks for help by analogy to the law of limited partnerships”); *Credentials Plus, LLC v. Calderone*, 230 F. Supp. 2d 890, 898-99 (N.D. Ind. 2002) (“Because limited

liability companies are relatively new business entities, courts are forced to grapple with financial and liability issues in terms of LLCs' similarities to partnerships and corporations .... For the foregoing reasons, this Court finds that Indiana LLCs, being similar to Indiana partnerships and corporations, impose a common law fiduciary duty on their officers and members in the absence of contrary provisions in LLC operating agreements.”). *See generally*, 54 C.J.S. *Limited Liability Companies* §31 (2010) (“Common law fiduciary duties, similar to the ones imposed on partnerships and closely held corporations, are applicable to limited liability companies.”).

Appellants' argument that there is no reference in New York's Limited Liability Company Law to “promoters” (Appellants' Brief at p.24) is true; but there is also no reference to “promoters” in New York's Business Corporation Law; Appellants' argument proves nothing.

Appellants' argument that the percentage of new business filings in New York that are limited liability companies is lower than the percentage nationwide (Appellants' Brief at pp. 27-28) and will be exacerbated by the Appellate Division's holding lacks any relevance or logical basis. The lower percentage of such filings in 2007 (in the study to which Appellants refer) could hardly have been based on anticipation of the Appellate Division ruling in 2010. More likely it was due to the additional publication fees imposed on the formation of limited

liability companies in New York but not imposed on formation of corporations. See Jeffrey Unger, *New York's Irrational LLC Publication Requirements Hurt Business Owners and Benefit Special Interests* (May 20, 2011), <http://www.eminutesonline.com/new-york%E2%80%99s-irrational-llc-publication-requirements-hurt-business-owners-and-benefit-special-interests/>.

In short, there is no basis in policy or law to exempt promoters of enterprises later organized as limited liability companies from the same duties of full disclosure that would apply if the enterprises were ultimately organized as corporations, partnerships or joint ventures. In each, where the investor is being asked to hand over her funds to a promoter for an interest in an enterprise the promoter will organize, manage and control, the promoter has the duty to fully disclose profits, fees or conflicting financial interests the promoter will gain from the enterprise.

## Point II

**THE AMENDED COMPLAINT AND MOTION PAPERS SHOW THAT APPELLANTS CREATED A FIDUCIARY RELATIONSHIP WITH RESPONDENTS BY REASON OF THEIR SOLICITATIONS OF OVERSEAS INVESTORS THROUGH PERSONAL RELATIONSHIPS AND CULTURAL AFFINITY, CLAIMS OF SPECIAL KNOWLEDGE AND EXPERTISE TO SELECT AND MANAGE THE INVESTMENTS, AND PROMISES OF MUTUAL INTERESTS.**

Fiduciary duties arise whenever the parties create a relationship of higher trust in which one is under a duty to act or give advice for the benefit of the other upon matters within the scope of the relationship. In the present case, even if the Appellants were not required, as promoters, to fulfill a fiduciary's duty of full disclosure as shown in Point I, *supra*, the facts alleged in the Amended Complaint or submitted on the motion demonstrate that these Appellants and these Respondents did create for themselves a relationship of trust, dependence and duty to disclose conflicting interests. The dictum of the Appellate Division to the contrary was in error and this transaction-specific relationship of trust is an alternate ground upon which the order of the Appellate Division should be affirmed.

Parties may create for themselves a fiduciary relationship. "A fiduciary relationship 'exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the

relation.”” *EBC I, Inc. v. Goldman, Sachs & Co.*, 5 N.Y.3d 11, 19 (2005) quoting Restatement [Second] of Torts §874, Comment *a. Accord.*, *Marmelstein v. Kehillat New Hempstead*, 11 N.Y.3d 15, 21 (2008). *See also Northeast Gen. Corp. v. Wellington Advertising, Inc.*, 82 N.Y.2d 158, 162 (1993); *Birnbaum v. Birnbaum*, 73 N.Y.2d 461, 465-66 (1989). De facto control and dominance by one party are attributes of a fiduciary relation. *Id.*

The Amended Complaint alleges relationships and facts that show that these Appellants, on these ventures, had a relationship of trust and control with these investors that required a fiduciary’s full disclosure of material facts, including the substantial secret profits that Appellants were to gain from the property purchases and that placed their economic interest in conflict with those of the investors. The dictum of the Appellate Division to the contrary was error.

The Amended Complaint, which must be liberally construed and with all inferences drawn in favor of Respondents, alleges that these Appellants represented to investors that they had “... particular experience and expertise in these matters...,” and that Appellants solicited only remote investors overseas in Israel “who had little or limited knowledge of New York real estate or United States law, customs or business practices with respect to real estate or investments” and little ability from a distance of 5,000 miles to monitor Appellants’ activities or the use of their funds. (R. 51, Amended Complaint at ¶¶ 23-24.) The parties had

no contractual restrictions, agreements or protections to govern their relationship or Appellants' activities. Appellants "...play[ed] upon the cultural identities and friendship..." of the investors (*id.* ¶ 24) and "... solicited investors in Israel through personal relationships" (*id.* ¶ 26(iv)). Appellants solicited, and obtained, the "...control and use..." of the investors' funds. (*Id.*) "Non-party companies owned by the Promoters were hired by the managers of the Property LLC's – Shpigel, Zamir and Harlem Holdings – to manage the real estate, perform maintenance and repair or improvements to the real estate and broker apartment rentals at inflated fees." (*Id.* ¶ 26(x).) Appellants made false representations to investors that they were *not* receiving undisclosed fees or profits from the transactions and would profit from the venture only together with the investors. (*Id.* ¶¶ 34, 35.)

The investor affidavits submitted on the motion below also addressed their relationship with the Promoters:

The Promoter Defendants could not organize these investments or close the property purchases without the funds of the investors. We were pooling our funds and investing together with the Promoters who claimed expertise and experience in these types of properties; not purchasing pieces of completed deals owned by the Promoters. This is not a situation in which the Promoter Defendants invested their own funds to buy properties, create LLCs, and then sell interests in completed deals to investors.

(*See* R. 300, 306, 312 and 318, Affidavits of Investors Yehuda Keren, Nir Kriel, Ilan Calic and Eli Mor at ¶7 of each.) The investors were at risk to lose some

portion of their funds for expenses incurred by the Promoters if the property transactions did not close. (R. 382-385, 409 and 451.) The Promoters selected and controlled counsel. (R. 449-450.)

The Supreme Court, in reviewing these allegations, correctly concluded that a fiduciary relationship had been created:

Under the circumstances of the parties' alleged relationship, Plaintiffs had reason to believe that the Promoters would treat them with good faith and integrity, and not conceal from them that they were secretly receiving commissions.

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Here, in contrast [to the facts of *Stuart Silver Assocs., Inc. v. Baco Dev. Corp.*], Plaintiffs allege that they are overseas investors who had little or no knowledge of New York real estate or American law, customers [sic] or business practices, and that the Promoters induced the investments by representing that they possessed superior knowledge and expertise of the New York real estate market. At this early pre-answer stage, the court must accept these allegations as true.

(R. 36-37, Opinion dated April 14, 2009, at pp. 14-15.)

The dictum of the Appellate Division to the contrary was in error. In the event that this Court does not affirm the holding of the Appellate Division that Appellants, as promoters of the investments, owed a duty of full disclosure to their investors, it should nonetheless affirm the order denying dismissal of Plaintiffs' breach of fiduciary duty, constructive fraud and accounting causes of action. The specific relationship of trust created by these Appellants with these investors elevated them from the caveat emptor world of arms-length commercial

transactions to the more demanding world of fiduciary relations as properly found by the Supreme Court.

### Point III

#### **NEW YORK STATE'S MARTIN ACT DOES NOT SILENTLY PRE-EMPT PRE-EXISTING COMMON LAW CLAIMS, SUCH AS RESPONDENTS', THAT ARE NOT BASED ON ALLEGATIONS OF VIOLATION OF THE MARTIN ACT'S DISCLOSURE OBLIGATIONS**

Appellants contend that even if Plaintiffs' claims premised upon non-disclosure (those for an accounting, breach of fiduciary duty and constructive fraud) state good causes of action, they must be dismissed because the interests the Appellants offered were securities subject to regulation by New York's Martin Act (Art. 23-A of New York's General Business Law)<sup>26</sup> and that such common law claims are silently pre-empted by the Martin Act.<sup>27</sup> Both of the courts below properly rejected this contention.

The Supreme Court rejected the contention for two reasons. First, Appellants' offering of investment interests may not be a "public" offering "in or

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<sup>26</sup> Appellants do not claim that they ever took any steps to comply with the Martin Act in connection with the offering of these investment interests. Appellants' contention that the Martin Act applies also, of course, should subject them to the broad legal consensus that those who engage in securities offerings have stepped out of the work-a-day world of caveat emptor commercial transactions and into the world of fiduciary obligation of full disclosure. See Point I at pp. 21-22, above.

<sup>27</sup> The issue of Martin Act pre-emption of common law causes of action is also the subject of the appeal in *Assured Guaranty (UK) Ltd., v. J.P. Morgan Investment Management Inc.*, S.Ct. N.Y. Co. Index No. 603755/08. This appeal and the *Assured Guaranty* appeal are being briefed on the same schedule and Respondents here join in the arguments of Respondents in *Assured Guaranty*.

from New York” because the allegations show a small number of investors and offers made solely in Israel. Second, even if Appellants activities did fall within the scope of the Martin Act, that Act does not pre-empt common law causes of action such as Plaintiffs’. (R. 29-33.)

The Appellate Division affirmed upon the rational of the Supreme Court’s first reason – Appellants’ activities fell outside the scope of the Martin Act - and did not reach the second, pre-emption, issue. (R. 5, Opinion at p. 3.)

**(a) The Martin Act Does Not Apply to This Non-public Offering in Israel.**

The Act exempts from its registration requirements “limited” offerings to 40 or fewer persons. *Gen. Bus. L. §359(f)(2)(d)*. From the Act’s inception, Courts have reasoned that its anti-fraud provisions are applicable only to “public” offerings. *See, People v. Federated Radio Corp.* 244 N.Y.33, 39 (1926); *People v. Landes*, 84 N.Y.2d 655 (1994); *People v. F.H.Smith Co.*, 230 A.D.268, 269 (1st Dep’t 1930) (all emphasizing the purpose of the Act in protecting the public). *See also, Fraternity Fund Ltd, v. Beacon Hill Asset Management LLC*, 376 F. Supp. 2d 385 (S.D.N.Y. 2005); *Lehman Bros. Commercial Corp. v. Minmetals Int’l. Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 159 (S.D.N.Y. 2001).

In *Landes*, this Court adopted the analysis of “public” securities from federal law that depends on four factors: (i) the number of offerees involved, (ii) the

number of units offered, (iii) the size of the offering and (iv) the manner of the offering.

*Lehman Bros.* is instructive as to the additional “within or from New York” element. Defendants counterclaimed for breach of fiduciary duty and negligent misrepresentation arising from the sale of securities. 179 F. Supp. 2d at 172. Plaintiff alleged the counterclaims were pre-empted and barred by the Martin Act. *Id.* The Court concluded that even though the investment instruments at issue would be “securities” under the Martin Act, the Act did not bar the counterclaims because the securities were not sold “within or from” New York, where the sales were negotiated by traders in London and Hong Kong with a Hong Kong investor. *Id.* at 163-64; *see also, Fraternity Fund Ltd*, 376 F. Supp. 2d at 410 (finding that Martin Act did not extend to interests marketed outside New York.)<sup>28</sup>

Appellants have offered no facts to support application of the Martin Act. The facts that are in the record show that the interests in the Property LLCs were offered by Appellants, particularly Shpigel, in Israel to a limited number of Israeli residents based upon pre-existing friendships. (*E.g.*, R. 63-64, Amend. Complaint at ¶¶ 23, 24 and 26(i).) Each Property LLC had only four (Harlem I LLC and

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<sup>28</sup> The pleadings in *Fraternity Fund* alleged that the defendants conducted substantial activities in New York, met with certain plaintiffs in New York and that their conduct in New York caused plaintiffs’ losses. Nevertheless, the Court concluded that the “within or from” requirement was not met where the securities were marketed in New Jersey to non-New York residents. Substitute “Israel” for “New Jersey” and the present case is no different. As Appellants point out (Appellants’ Brief at p.21), only three of the twenty-six investors are alleged in the Second Amended Complaint to have had *any* dealings in New York.

Harlem II LLC) to thirteen (100-102 E. 124<sup>th</sup> Street Package LLC) investors in addition to the Promoters.<sup>29</sup> There is no evidence of any offering to the public at large, or even to any potential investors other than the twenty-six who funded these seven Property LLCs. Accordingly, the Courts below properly denied Appellants' motion because "...the small number of offerees, their alleged close relationship and the absence of any advertising are all indicia of a private offering." (Motion Court opinion at R. 30; *also* Appellate Division at R. 5.) At a minimum, there is no record factual basis to conclude that the Martin Act is applicable.

**(b) The Martin Act Does Not Pre-empt  
Pre-existing Common Law Claims.**

Appellants' pre-emption claim should be rejected and the order of the Appellate Division affirmed whether or not Appellants are correct (and the courts below in error) that their activities were securities offerings within the scope of the Martin Act.

A clear consensus has emerged that the Martin Act does not pre-empt pre-existing common law claims, such as those for breach of fiduciary duty, constructive fraud or breach of contract. Private litigants may have no new cause of action to enforce the statutory and regulatory provisions of the Martin Act, but the Act does not pre-empt existing common law causes of action, such as those

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<sup>29</sup> The number of investors in each of the seven deals can be ascertained by computing the equity interests alleged in the Amended Complaint (R. 52-57.)

pleaded by these Plaintiffs. Appellants' contention to the contrary, relying on now-discredited and superseded authorities, is without merit.

The consensus has most clearly been articulated in the recent decisions of the Appellate Division, First Department, in *Assured Guaranty (UK) Ltd. v. J.P.Morgan Investment Management, Inc.*, 80 A.D.3d 293 (1st Dep't 2010)<sup>30</sup>, and of the federal district court for the Southern District of New York, in *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d 354 (S.D.N.Y. 2010). Each reviewed the history and language of the statute and this Court's prior decisions in *CPC Int'l. v. McKesson Corp.*, 70 N.Y.2d 268 (1987), and *Kerusa Co., LLC v. W10Z/515 Real Estate Ltd. Partnership*, 12 N.Y.3d 236 (2009). As the First Department correctly reasoned:

The plain language of the Martin Act does not explicitly preempt all common-law claims. "The general rule is and long has been that 'when the common law gives a remedy, and another remedy is provided by statute, the latter is cumulative, unless made exclusive by the statute.'" *Burns Jackson Miller Summit & Spitzer v. Lindner*, 59 N.Y.2d 314, 324 (1983)...

*Assured Guar.*, 80 A.D.3d at 300<sup>31</sup>. The Court also noted approvingly the recent decision of U.S. District Judge Marrero in the *Anwar* case and the *amicus* brief filed by New York's Attorney General:

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<sup>30</sup> See, n. 27, *supra*. The *Assured Guaranty* decision was issued after the Appellate Division order in this case.

<sup>31</sup> The Fourth Department had reached this correct conclusion many years earlier. *Scalp & Blade, Inc. v. Advest, Inc.*, 281 A.D.2d 882 (4th Dep't 2001)

Indeed, in an exhaustive analysis of this issue, Judge Victor Marrero of the Southern District of New York argues cogently and forcefully that, to hold the Martin Act preempts properly pleaded common-law actions actually serves to “leave [] the marketplace arguably less protected than it was before the Martin Act’s passage, which can hardly have been the goal of its drafters” (*Anwar v. Fairfield Greenwich Ltd.*, 2010 U.S. Dist. LEXIS 78425 \*59 [2010]). Indeed, the Attorney General, in his amicus brief filed on this appeal, argues that “the purpose or design of the Martin Act is in no way impaired by private common-law claims that exist independently of the statute, since statutory actions by the Attorney General and private common-law actions both further the same goal, namely, combating fraud and deception in securities transactions.”

*Id.*, 80 A.D.3d at 302. The Court concludes, in *Assured Guaranty*:

In short, there is nothing in the plain language of the Martin Act, its legislative history or appellate level decisions in this State that supports defendant’s argument that the act preempts otherwise validly pleaded common-law causes of action.

*Id.*, 80 A.D.3d at 304.

The First Department’s decision in *Assured Guaranty* is but the most recent of a wave of Appellate Division and federal district court decisions that reach the same conclusion. See, e.g., *Board of Managers of Marke Gardens Condo. v. 240/242 Franklin Ave., LLC*, 71 A.D.3d 935 (2d Dep’t. 2010); *Caboara v. Babylon Cove Dev.*, 54 A.D.3d 79 (2d Dep’t 2008); *Rasmussen v. A.C.T. Env’t Servs., Inc.*, 292 A.D.2d 710 (3d Dep’t 2002) (following *Scalp & Blade* to implicitly conclude against pre-emption argument); *Scalp & Blade, Inc. v. Advest, Inc.*, 281 A.D.2d

882 (4th Dep't 2001); *see also Anwar*, 728 F. Supp. 2d at 371; *Cromer Fin., Ltd. v. Berger*, No. 00 CIV 2498, 2001 WL 1112548, at \*4 (S.D.N.Y. Sept. 19, 2001).

In a scholarly 40-page opinion, Judge Marrero, in *Anwar*, traces the history and purpose of the statute and analyzes both the cases that, erroneously, conclude that the statute implicitly pre-empts certain common-law causes of action, and those that correctly conclude that the statute has no such pre-emptive effect. He concludes:

[M]ore recent decisions of the state appellate divisions hold or colorably suggest that the Martin Act is not preclusive of parallel state law claims, the New York Court of Appeals has explained what it means for a claims to be independent of the Martin Act, and the Attorney General has now staked out a clear position against preemption. These authorities, along with a more nuanced understanding of those that preceded *Castellano*, persuade this Court that New York's highest tribunal would hold that the Martin Act does not preclude state common law causes of action that do not derive from or rely upon the Martin Act to establish a required element of the claim.

*Anwar*, 728 F.Supp.2d at 371.

The decisions upon which Appellants rely, principally from the federal courts, and all before *Assured Guaranty*, *Anwar*, *Marke Gardens* and *Caboara*, are bad law and worse policy. They mistakenly graft an unspoken pre-emption into the Martin Act that has no basis in law and that, as Judge Marrero in the Southern District and Justice Sweeny for the First Department trenchantly observe,

“...actually serves to ‘leave [] the marketplace arguably less protected than it was before the Martin Act’s passage, which can hardly have been the goal of its drafters.’” *Assured Guar., supra.*

Thus, even if this Court disagrees with the First Department and Supreme Court that the securities offering at issue was not within the scope of the Martin Act, Appellants’ contentions must be rejected and the order of the First Department should be affirmed.

#### Point IV

**APPELLANTS MAY NOT ATTACK THE FRAUD CLAIM IN THE AMENDED COMPLAINT ON THIS APPEAL, WHERE THE FRAUD CLAIM HAS BEEN REPLEADED IN A SECOND AMENDED COMPLAINT THAT IS NOT THE SUBJECT OF THIS APPEAL; RESPONDENTS ARE, IN ANY EVENT, ENTITLED TO RECOVER DAMAGES ON THEIR FRAUD CLAIMS BASED ON THE AMOUNT THAT THE PURCHASE PRICE OF THE ACQUIRED PROPERTIES WAS INFLATED BY THE HIDDEN KICK-BACKS TO APPELLANTS**

**(a) The Court Has No Jurisdiction to Review  
The Actual Fraud Claim.**

As an initial matter, Appellants cannot challenge Plaintiffs’ pleading of actual fraud damages on this appeal because that claim is not before the Court; that claim was repleaded with leave from the Motion Court and is proceeding separately in the lower court outside of this appeal. The Appellate Division

recognized this, stating that “the issue whether the fraud claims was adequately pleaded is not properly before this Court, since the motion court granted [Appellants’] motion to dismiss the claim with leave to re-plead, and that ruling has not been appealed.” *Roni LLC v. Arfa*, 74 A.D.3d 442, 445, n.2 (1st Dep’t 2010); (R. 8.) Appellants cite no authority to show why this Court should consider the damages aspect of a claim that is not before it, nor can they, for the Court has no jurisdiction to review such claims. Accordingly, Appellants’ argument that this Court should review the pleading of Plaintiffs’ actual fraud claim must be denied.

**(b) Respondents Properly Pleaded Constructive Fraud Damages.**

Appellants turn the case law upside down in their argument that Respondents fail to sufficiently allege that the Investors suffered out-of pocket losses in connection with the alleged frauds or omissions because some of Respondents ultimately made profits on their investments.

As Appellants’ own case law clearly states, “recovery of profits” is not the issue in an out-of-pocket loss analysis. *See Lama Holding Co. v. Smith Barney Inc.*, 88 N.Y.2d 413, 421 (1996)<sup>32</sup>. Instead, the proper fraud damages inquiry is “the actual pecuniary loss sustained as a direct result of a fraud which induces

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<sup>32</sup> There is also no record evidence to support the assertion in Appellants’ Brief (at p. 33) that most of the Respondents have recovered profits from their investments. Whether they have lost money or profited, Respondents have suffered pecuniary losses because the Property LLCs that the Respondents owned overpaid for the properties in the amount of the 9-15% of the purchase price immediately kicked back by the property sellers to the Appellants as “commissions”.

purchase ... [i.e.] *the difference between the amount paid and the value of the article received ....*" *Hotaling v. A.B. Leach & Co., Inc.*, 247 N.Y. 84, 87-88 (1927) (emphasis added); *see also Orbit Holding Corp. v. Anthony Hotel Corp. et al.*, 121 A.D.2d 311, 315 (1st Dep't 1986) (where defendant sold building to plaintiff and concealed a lease to which the property was subject, ultimate profit by plaintiff from conversion of building "did not vitiate any damages to which it was entitled"). The measure of damages for constructive fraud applies the same principle. *See Brown v. Lockwood*, 76 A.D.2d 721, 731 (2d Dep't 1980).

In this case, Respondents expressly allege that Appellants' undisclosed commissions caused the Property LLCs to pay more for the properties they purchased than those properties were actually worth because the purchase price of the buildings was increased by the amounts of the Secret Commissions. (Amended Complaint, R. 67 at ¶32; R. 69 at ¶¶40-43; R. 87 at ¶142; R. 88 at ¶¶147-148.) Indeed, the commission agreement between the property seller and Appellant American Elite Properties, Inc., signed by Appellant Rachel Arfa, on one of the seven transactions expressly recites that the purchase price was increased by the amount of the undisclosed commission. (R. 298, at penultimate paragraph.) Respondents allege that each Respondent was therefore damaged in the amount of its pro-rata share of these inflated prices, and that Respondents are entitled to compensatory damages or disgorgement in the amounts of the Secret

Commissions: the difference between the amount actually paid and the amount that should have been paid without the secret commissions. This is precisely “the difference between the amount paid and the value of the article received” contemplated in *Hotaling*. 247 N.Y. at 87-88, 159 N.E. 870.

Thus, Respondents seek to recover the amounts that they paid out of pocket in excess of the actual worth of the property sold to them based on Appellants’ misleading representations. This Court’s recent decision in *Continental Casualty Co. v. PricewaterhouseCoopers, LLP*, 15 N.Y.3d 264 (2010), only supports Plaintiffs’ position. The Court reasoned that loss in a fraud action is measured by taking difference between “the value of the bargain which a plaintiff was induced by fraud to make and the amount of value of the consideration exacted as the price of the bargain” *Id.*, 15 N.Y.3d at 271.

Moreover, the out-of-pocket fraud damages rule is inapplicable to the extent a plaintiff seeks disgorgement of ill-gotten fees and commissions based on a breach of fiduciary duty, as these Plaintiffs do (Amended Complaint, R. 76-77 at ¶¶ 148, 150.) *See, e.g., Diamond v. Oreamuno*, 24 N.Y.2d 494, 499 (1969) (no out of pocket damages required where relief sought is disgorgement of disloyal fiduciary’s gains); *see also Feiger v. Iral Jewelry*, 41 N.Y.2d 928, 394 N.Y.S.2d 626 (1977).

Respondents’ damages are properly pled.

**Conclusion**

For the reasons set forth above the order of the Appellate Division should be affirmed.

Respectfully submitted,

BALBER PICKARD MALDONADO  
& VAN DER TUIN, P.C.  
Attorneys for Respondents

By:



John Van Der Tuin

Jane Y. Ginns

1370 Avenue of the Americas  
New York, New York 10019  
212-246-2400

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