Knox, LLC v Lakian
2018 NY Slip Op 32191(U)
September 5, 2018
Supreme Court, New York County
Docket Number: 651880/2012
Judge: Eileen Bransten
Cases posted with a "30000" identifier, i.e., 2013 NY Slip Op 30001(U), are republished from various New York State and local government sources, including the New York State Unified Court System's eCourts Service.
This opinion is uncorrected and not selected for official publication.

SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY: IAS PART THREE

----------X

KNOX, LLC d/b/a KNOX, LLC OF NEW YORK and DJW ADVISORS, LLC,

Plaintiffs,

- v -

JOHN R. LAKIAN and JRL INVESTMENT GROUP, INC.,

Defendants.

----------X

Index No. 651880/2012

Motion Date 3/24/17

Mot. Seq. 011

DECISION AND ORDER

BRANSTEN, J.

In this action, Plaintiffs Knox, LLC d/b/a Knox, LLC of New York ("Knox") and DJW Advisors, LLC ("DJW" and collectively "Plaintiffs") seek to recover their investments made with Defendants John R. Lakian and JRL Investment Group, Inc. ("JRL" and collectively "Defendants"). Presently before the Court is Plaintiffs' motion for summary judgment on their Eighth Cause of Action for fraudulent inducement, Ninth Cause of Action for fraud, and Tenth Cause of Action for constructive trust. Plaintiffs also seek a hearing on the amount of attorneys' fees and disbursements due to Plaintiffs. For the reasons that follow, Plaintiffs' motion for summary judgment is granted in part and denied in part.

I. BACKGROUND[1]

This matter arises from Plaintiffs' investment in Capital L Group, LLC ("Capital L"), a financial services business run by Defendant John R. Lakian, the Chief Executive Officer. Subsequent to the commencement of this action, a federal criminal action and an arbitration proceeding were commenced against Mr. Lakian in connection with his strategy to acquire registered investment advisors. Background on the instant action and the two related proceedings are provided below.

A. The Instant Action

Plaintiffs first learned of Capital L in June 2010 when Donald J. Whelley, DJW's sole manager and member, attended a meeting with Mr. Lakian in New Haven, Connecticut. (Plaintiffs' 19-a Statement ("Pl. 19-a") ¶ 15.) At the meeting, Mr. Lakian introduced Capital L's strategy to acquire registered investment advisors in a series of roll-up transactions. (*Id.* ¶ 16.)

1. *Mr. Whelley Performs Due Diligence on Plaintiffs' Behalf*

In July 2010, Mr. Whelley scheduled a due diligence trip to Capital L's offices in Charlotte, North Carolina, on behalf of both DJW and Knox. (*Id.* ¶¶ 17-18.) Mr.

[1] Unless otherwise noted, the Court cites only those statements of material facts that are unopposed. Plaintiffs submitted a Rule 19-a Statement in support of their motion for summary judgment (NYSCEF No. 340) and Defendants submitted a Rule 19-a Statement in opposition (NYSCEF. No. 401).

Whelley met with Mr. Lakian and Diane Lamm, Capital L's Chief Operating Officer, discussed Capital L's business model and acquisition strategy, and inspected Capital L's offices.[2] (*Id.* ¶ 20-21.) At the July 2010 meeting, Mr. Lakian told Mr. Whelley that he was looking to raise approximately $4 million to $5 million in capital contributions to complete the acquisition of registered investment advisors. (*Id.* ¶ 23.) Furthermore, Mr. Lakian indicated that acquisitions were already being made, and presented Mr. Whelley with some material showing a pipeline of different acquisition opportunities for Capital L. (*Id.* ¶ 24.) At the conclusion of the due diligence trip, Mr. Lakian reiterated that Capital L was seeking capital contributions from investors for purposes of acquiring registered investment advisors and rolling them up. (*Id.* ¶ 25.)

On October 18, 2010, Mr. Whelley met with Mr. Lakian and Ms. Lamm in New York City and subsequently made a follow-up two-day due diligence trip to Capital L's Charleston, South Carolina offices. (*Id.* ¶¶ 26-27.) On both occasions, Mr. Lakian represented to Mr. Whelley that Capital L continued to have significant acquisition opportunities. (*Id.*)

Initially, Mr. Whelley did not recommend investing in Capital L because he believed Capital L needed to improve its back-office and reporting capabilities in order for the acquisition strategy to succeed. (*Id.* ¶ 28.) However, in December 2010,

[2] Capital L and Ms. Lamm were initially named Defendants in this action. A default judgment was entered against Capital L on March 27, 2014 (NYSCEF No. 93) and the parties entered into a Stipulation of Discontinuance with Prejudice as to Ms. Lamm, dated March 13, 2015 (NYSCEF No. 148). Accordingly, this motion is brought against the remaining Defendants, Mr. Lakian and JRL.

Defendants advised Mr. Whelley that Capital L planned to acquire Capital Guardian Holding LLC ("Capital Guardian"), and Mr. Whelley believed the acquisition would provide the back-office support Capital L needed. (*Id.* ¶ 29.)

2. *Plaintiffs Invest in Capital L*

On February 1, 2011, Capital L provided Plaintiffs with proposed subscription agreements outlining the terms of their investment in Capital L. (Defendants' Rule 19-a Statement ("Def. 19-a") ¶ 30d.) On the following day, February 2, 2011, Mr. Whelley contacted Mr. Lakian by telephone and notified him of Plaintiffs' interest in making a combined total investment of $2,050,000 in Capital L. (Pl. 19-a ¶ 30.) During the February 2nd phone call, Mr. Whelley asked Mr. Lakian why the Capital L Subscription Agreements required Plaintiffs to wire their investment funds to Defendant JRL rather than to Capital L directly. (*Id.* ¶ 31.) Mr. Lakian responded that this was being done for "regulatory purposes." (*Id.*)

As of February 4, 2011, Mr. Whelley was aware that Capital L had acquired Capital Guardian, thus resolving Mr. Whelley's concerns over Capital L's back office and reporting deficiencies. (*Id.* ¶¶ 32-33.) Accordingly, on February 4, 2011, Plaintiff Knox executed a Subscription Agreement and agreed to invest $2,000,000 in Capital L. (*Id.* ¶ 34.) On the same day, Plaintiff DJW executed a separate Subscription Agreement and agreed to invest $50,000 in Capital L. (*Id.* ¶ 35.) Pursuant to the Subscription Agreements, the capital contributions were to "be used by the LLC [Capital L] in

connection with its ongoing business opportunities." (*Id.* ¶ 37; Ex. 3 § 1(b).) On or about February 7, 2011, Plaintiffs made wire transactions in the respective amounts of $2,000,000 and $50,000 that were deposited into JRL's Carolina First Bank account (the "JRL Account"). (*Id.* ¶ 38.)

3. *Funds are Transferred Out of the JRL Account and Capital L Account*

On February 15, 2011, before any money was transferred to Capital L's bank account, Ms. Lamm transferred $350,000 out of the JRL Account to non-party JRL Investment II Inc.'s Carolina First Bank account (the "JRL II Account"). (*Id.* ¶ 39.) On the same day, Ms. Lamm transferred money from the JRL II Account to personal bank accounts belonging to Ms. Lamm and Mr. Lakian. First, Ms. Lamm transferred $200,000 from the JRL II Account to Mr. Lakian's personal Chase account. (*Id.* ¶ 40.) Second, Ms. Lamm transferred $50,000 from the JRL II Account to her personal Carolina First Bank account. (*Id.* ¶ 41.) Third, Ms. Lamm transferred $100,000 from the JRL II Account to Mr. Lakian and Ms. Lamm's joint Carolina First Bank account. (*Id.* ¶ 42.)

In late February 2011, approximately $2,030,000 was transferred from the JRL Account to Capital L's First Bank account (the "Capital L Account"). On February 25, 2011, $120,000 was transferred to the Capital L Account and on February 28, 2011, $1,910,000 was transferred. (Def. 19-a ¶ 43a.)

In March 2011, a total of $325,000 was transferred from the Capital L Account to a bank account for Roadside Kitchens, a chain of restaurants owned by Mr. Lakian. (Pl.

19-a ¶¶ 9, 44.) First, $40,000 was transferred to Roadside Kitchens' bank account on March 11, 2011. (*Id.* ¶ 44(a).) Second, $210,000 was transferred to Roadside Kitchens on March 17, 2011. (*Id.* ¶ 44(b).) Third, $50,000 was transferred to Roadside Kitchens on March 21, 2011. (*Id.* ¶ 44(c).) Finally, $25,000 was transferred to Roadside Kitchens on March 31, 2011. (*Id.* ¶ 44(d).)

4. *Procedural History*

On May 31, 2012, Plaintiffs commenced this action by filing the Verified Complaint, which asserted causes of action for (1) breach of the Subscription Agreements, (2) breach of the Capital Operating Agreement, (3) breach of the implied covenant of good faith and fair dealing, (4) breach of fiduciary duty, (5) inspection of Capital L's books and records, (6) accounting, (7) conversion, (8) fraud in the inducement, (9) fraud, and (10) constructive trust. Plaintiffs subsequently amended the Complaint on October 5, 2012. Defendants moved to dismiss the Amended Verified Complaint on November 13, 2012. By Decision and Order dated July 22, 2013, the Court granted Defendants' motion to dismiss as to the breach of fiduciary duty and conversion claims and otherwise denied Defendants' motion. Defendants filed a Verified Answer on August 28, 2013.

B. The Pangea Arbitration

In November 2012, Pangea Capital Management, LLC ("Pangea") and its manager, Mark Branigan, commenced an arbitration proceeding against Mr. Lakian and various Lakian-owned entities (the "Pangea Arbitration"). The dispute arose out of Pangea's investment in Mr. Lakian's financial services company, Aegis Capital LLC ("Aegis"). (Pl. 19-a ¶¶ 3-5.) Aegis was later renamed Capital L in February 2010. (*Id.* ¶ 7.)

In June 2009, Mr. Lakian began negotiations for Pangea's acquisition of a controlling interest in Aegis. (*Id.* ¶ 3.) During negotiations, Mr. Lakian provided Mr. Branigan with an "Acquisition Model," a document that described Aegis' strategy to acquire registered investment advisors. (*Id.* ¶¶ 3-4.) On October 9, 2009, Mr. Branigan wired $3,000,000 from Pangea's account to Aegis to acquire a controlling interest in Aegis. (*Id.* ¶ 5.)

Instead of using Pangea's investment funds to acquire registered investment advisors, Mr. Lakian transferred the Pangea funds to his personal bank account and accounts controlled by JRL in order to purchase a hotel and several restaurants. (*Id.* ¶ 10.) Ultimately, Mr. Lakian diverted $2,224,659.47 of Pangea's $3,000,000 investment for a down payment on the Chequit Inn, a hotel on Shelter Island, New York, and to purchase furniture and other items for the hotel. (*Id.* ¶¶ 6, 8.) In addition, Mr. Lakian used Pangea funds for his restaurant chain, Roadside Kitchens. (*Id.* ¶ 9.)

In connection with the Pangea Arbitration, the Arbitrator issued a 180-page Amended Partial Final Award, dated January 15, 2016 (the "Award"), finding Mr. Lakian liable for, *inter alia*, fraud and violations of the Racketeer Influenced and Corrupt Organizations Act. Pursuant to the Award, the Arbitrator found (1) Mr. Lakian presented the terms of the Aegis acquisition to Mr. Branigan through the Acquisition Model, (2) Mr. Branigan relied on Mr. Lakian's representations, (3) Mr. Lakian knew the information he presented was false, and (4) Mr. Lakian already had designs to use the money Pangea invested in Aegis for his own purposes. (*Id.* ¶ 12.) The Award was confirmed by the District Court for the Southern District of New York and Defendants appealed the decision to the Court of Appeals for the Second Circuit. On March 17, 2017, the parties dismissed the appeal.

C. The Federal Criminal Proceeding

On February 3, 2015, Mr. Lakian was charged in a five-count Indictment (the "Indictment") issued in a federal criminal action entitled *United States of America v. John R. Lakian & Diane M. Lamm*, Case No. 15-00043 (E.D.N.Y.) (Block, J.) (the "Criminal Proceeding"). (Pl. 19-a ¶ 48.) Count Three of the Indictment alleged Mr. Lakian committed securities fraud by perpetrating a "Registered Investment Advisor Scheme" between February 2009 and December 2011, whereby Mr. Lakian allegedly defrauded investors by telling them that their investments would be used to acquire registered investment advisor firms, when in fact those funds were used for Mr. Lakian's personal

purposes unrelated to the acquisition of registered investment advisors. (*Id.* ¶ 50.) Mr. Lakian pled guilty to Count Three of the Indictment on February 4, 2016. (*Id.* ¶ 51.)

II. ANALYSIS

Presently before the Court is Plaintiffs' motion for summary judgment on their Eighth Cause of Action for fraudulent inducement, Ninth Cause of Action for fraud, and Tenth Cause of Action for constructive trust.

A. Summary Judgment Standard

The standards for summary judgment are well-settled. The movant must tender evidence, by proof in admissible form, to establish the cause of action "sufficiently to warrant the court as a matter of law in directing judgment." CPLR 3212(b); *Zuckerman v. City of N.Y.*, 49 N.Y.2d 557, 562 (1980). "Failure to make such showing requires denial of the motion, regardless of the sufficiency of the opposing papers." *Winegrad v. N.Y. Univ. Med. Ctr.*, 64 N.Y.2d 851, 853 (1985). Once such proof has been offered, to defeat summary judgment "the opposing party must show facts sufficient to require a trial of any issue of fact." CPLR 3212(b); *Zuckerman*, 49 N.Y.2d at 562. When deciding a motion for summary judgment, the Court must view the evidence in the light most favorable to the non-movant. *Branham v. Loews Orpheum Cinemas, Inc.*, 8 N.Y.3d 931, 932 (2007).

B. The Eighth Cause of Action – Fraudulent Inducement

Plaintiffs' Eighth Cause of Action relates to representations made prior to the Subscription Agreements that allegedly induced Plaintiffs to enter into the transaction. In order to establish a cause of action for fraud, a plaintiff must allege "a material misrepresentation of a fact, knowledge of its falsity, an intent to induce reliance, justifiable reliance by the plaintiff and damages." *Eurycleia Partners, LP v. Seward & Kissel, LLP*, 12 N.Y.3d 553, 559 (2009).

1. *Material Misrepresentations of Fact*

Plaintiffs' fraudulent inducement claim is based on Mr. Lakian's representations that (1) Plaintiffs' investments in Capital L were to be wired to JRL for "regulatory purposes," and (2) Plaintiffs' investments in Capital L would be used for the sole purpose of acquiring registered investment advisors. Plaintiffs offer Mr. Whelley's deposition testimony as evidence that Mr. Lakian made those representations to Plaintiffs.

Mr. Whelley testified that on February 2, 2011, Mr. Lakian represented to Mr. Whelley on a phone call that Plaintiffs' investments were required to be sent to JRL instead of Capital L for "regulatory purposes." (Pl. 19-a ¶ 31). Defendants note there is a discrepancy between Mr. Whelley's testimony and the allegation in the Amended Complaint, which alleges that the investments needed to be wired for "regulatory reasons." (Def. 19-a ¶ 31a.) However, the Court finds the difference between the words "reasons" and "purposes" does not render the statement immaterial. Furthermore,

Defendants contend that the "money was wired to JRL to track the flow of money from equity investors in Capital L." (*Id.* ¶ 31b.) Yet, Defendants have not provided any evidence that this representation was ever made to Plaintiffs.[3] Therefore, Defendants fail to dispute that Mr. Lakian represented that Plaintiffs' investment funds were transferred to JRL for "regulatory purposes."

Mr. Whelley also testified that Mr. Lakian represented on numerous occasions leading up to Plaintiffs' investment that Capital L's strategy was to acquire registered investment advisors in a series of roll-up transactions. (Pl. 19-a ¶¶ 16, 22, 25.) Generally, out of court statements are not admissible for the truth of the matter asserted. *People v. Huertas*, 75 N.Y.2d 487, 492 (1990). However, a party's guilty plea represents an admission and is not violative of the rule against hearsay. *See Ando v. Woodberry*, 8 N.Y.2d 165, 167 (1960).

At Mr. Lakian's February 5, 2016 plea allocution in the Criminal Proceeding, Mr. Lakian stated "[b]etween 2009 to 2011, I and others made representations to Capital L investors that the funds they invested would be used to purchase and consolidate small to medium-sized registered investment advisor firms, RIAs, into a larger entity." (Pl. 19-a ¶ 51, Ex. 24 at 33:3-7.) Mr. Lakian's guilty plea constitutes an admission that he made representations to Capital L investors about how their investments would be used.

[3] Defendants cite to the Answers and Objections to Plaintiffs' First Set of Interrogatories, which cannot be used as evidence of the statement. In addition, Mr. Lakian did not provide any testimony on the alleged representation, as he invoked the Fifth Amendment in response to each question at his deposition.

Furthermore, Defendants do not dispute that Mr. Lakian made those representations to Plaintiff. Accordingly, Plaintiffs proffer admissible evidence regarding Mr. Lakian's representations to Plaintiffs that their investment would be used to acquire registered investment advisors.

A misrepresentation is considered material to a fraud claim if it is "the type of misrepresentation likely to be deemed significant to a reasonable person considering whether to enter into the transaction." *See Moore v. PaineWebber, Inc.*, 189 F.3d 165, 170 (2d Cir. 1999); *see also State v. Rachmani Corp.*, 71 N.Y.2d 718, 726 (1988). Defendants cannot argue that these representations were not material, as the representations addressed Capital L's business strategy and the central purpose for Plaintiffs' investments. Thus, Plaintiffs have established that Mr. Lakian made material representations that Capital L's business strategy was to acquire registered investment advisors.

2. *Falsity*

Plaintiffs assert that Mr. Lakian's representation that Plaintiffs' funds would be used to acquire registered investment advisors was false and not a single dollar of their $2,050,000 investment was used to acquire registered investment advisors. Plaintiffs provide the expert report of Richard Barbash, who was hired to identify and trace the

movement of Plaintiffs' funds.[4] Mr. Barbash analyzed bank statements and related records for JRL, JRL Investment II Inc., JRL Group III, LLC, Capital L, Capital Guardian, Mr. Lakian, Ms. Lamm, and Roadside Kitchens from February 7, 2011 through December 31, 2011 using two different methods of tracing Plaintiffs' funds: (1) a "simple tracing" method[5] and (2) a "commingled funds" method.[6] (Barbash Affid. Ex. A at 2.)

Ultimately, utilizing the "commingled funds" method, Mr. Barbash concluded that none of Plaintiffs' $2,050,000 investment was used to acquire registered investment advisors and Plaintiffs' entire investment in Capital L had been fully disbursed by April 25, 2011. (Barbash Affid. ¶ 6.) The transfers from the JRL Account and the Capital L Account can be categorized as transfers to Roadside Kitchens, Mr. Lakian and Ms. Lamm's Personal Accounts, and distributions for Capital L's operating expenses.

a. Transfers to Roadside Kitchens

On four separate occasions in March 2011, a total of $325,000 was transferred out of the Capital L Account to Roadside Kitchens' bank account. Plaintiffs' expert, Mr. Barbash, attaches as an exhibit to his report, a summary of Capital L's monthly bank

[4] Mr. Barbash is a Certified Public Accountant, Certified Fraud Examiner, and Partner at Citrin Cooper.

[5] Under the "simple tracing" method, Mr. Barbash assumed the funds representing Plaintiffs' investment in Capital L were the first monies being disbursed. (Barbash Affid. ¶ 4.)

[6] Under the "commingled funds" method, Mr. Barbash assumed the funds representing Plaintiffs' investment in Capital L were being disbursed on a pro rata basis, given that bank accounts from which disbursements were made contained monies from other third parties. (Barbash Affid. ¶ 4.)

statements which shows four transfers out of the Capital L Account to Roadside Kitchens' bank account in March 2011. (Barbash Affid. Ex. A at 18.) Pursuant to the "commingled funds" method, Mr. Barbash concluded approximately $227,593 of Plaintiffs' funds were transferred to Roadside Kitchens. Therefore, Plaintiffs met their burden of establishing that Capital L funds were transferred to Mr. Lakian's restaurant business.

Defendants offer the expert report of Michael J. Garibaldi to rebut Plaintiffs' allegations and the conclusions contained in Plaintiffs' expert report.[7] Defendants do not contest that these transfers were made to Roadside Kitchens. Instead, Mr. Garibaldi argues Aegis Capital was the source of funding in Roadside Kitchens. (Garibaldi Affid. Ex. 1 at 4.) Mr. Garibaldi asserts over $3,400,000 was transferred from Aegis Capital to Capital L between January 2010 and November 30, 2011. (*Id.*)

However, Mr. Garibaldi has not provided any evidence establishing that Aegis Capital transferred funds to Capital L for a specific reason. In fact, it is unclear which documents Mr. Garibaldi relied upon in reaching that conclusion, as Mr. Garibaldi merely cites to an "analysis of monies to Capital L from Aegis Capital." (*Id.*) Other than Mr. Garibaldi's assertion, there is no evidence that Aegis Capital transferred funds to Capital L to be invested in Roadside Kitchens. *See Fleming v. Pedinol Pharmacal, Inc.*, 70 A.D.3d 422, 422 (1st Dep't 2010) (finding expert failed to raise issue of material fact

[7] Mr. Garibaldi is a Certified Public Accountant with an Accreditation in Business Valuation, Certified in Financial Forensics, Chartered Global Management Accountant and shareholder at Israeloff, Trattner & Co., CPAs, P.C.

where opinion was conclusory and contradicted by the record). In addition, Mr. Garibaldi's conclusion is further undermined by the fact that in March 2011 there was only one deposit of funds from Aegis Capital in the amount of $9,194.10. (Barbash Affid. Ex A at 33.) Therefore, Defendants fail to raise a material issue of fact regarding the transfer of funds from Capital L to Roadside Kitchens.

b. Transfers to Personal Accounts

Plaintiffs further argue their funds were transferred to Mr. Lakian and Ms. Lamm's personal accounts. Plaintiffs' expert, Mr. Barbash, annexes a summary of transactions from the JRL II Account on February 15, 2011 as an exhibit to his expert report. (Barbash Affid. Ex. A at 15.) Applying the "commingled funds" approach, Mr. Barbash determined that Plaintiffs' funds represented 69% ($242,934) of the $350,000 transferred to Mr. Lakian and Ms. Lamm's personal accounts on February 15, 2011. (Barbash Reply Affid. ¶ 10.) This analysis was based on the JRL Account balance immediately prior to the transaction, wherein Plaintiffs' funds represented 69% of the total funds in the JRL Account. In total, using the "commingled funds" method, Mr. Barbash concluded $362,117 of Plaintiffs' funds were diverted to Mr. Lakian and Ms. Lamm's personal accounts from February 7, 2011 to April 25, 2011. (Barbash Affid. Ex. A ¶ 6.) Therefore, Plaintiffs have proffered evidence that Defendants transferred funds, including Plaintiffs' funds, to Mr. Lakian's personal accounts.

Defendants argue there is a genuine issue of material fact as to the distributions to Mr. Lakian's personal accounts. Defendants contend the $350,000 transferred out of the JRL II Account on February 15, 2011 did not belong to Plaintiffs. Mr. Garibaldi analyzed the transactions using the "simple tracing by specific identification" method, which links certain transfers of funds into the JRL II Account with certain transfers out of the account. For example, Mr. Garibaldi points to a February 11, 2011 wire into the JRL Account from Robert M. Sullivan, Jr., and a transfer out of the account to the Capital L Operating Account on the same day. (Garibaldi Affid. Ex. 3 at 4.)

Using the "simple tracing by specific identification" method, Mr. Garibaldi concluded that Plaintiffs' funds were not transferred on February 15, 2011 because at the end of the day the JRL II Account had a balance of $2,561,688.89 remaining. (Garibaldi Affid. Ex. 1 at 3.) Mr. Garibaldi also concluded that all of Plaintiffs' funds were transferred from the JRL II Account to the Capital L account, based on two transactions of $120,000 on February 25, 2011 and $1,910,000 on February 28, 2011.[8]

However, Mr. Garibaldi has not offered any evidence that Plaintiffs' funds were segregated or otherwise identifiable from other funds. It is undisputed that Plaintiffs' $2,050,000 investment was held in the JRL II Account with funds from other sources. Nor has Mr. Garibaldi offered any evidence that the $350,000 transferred to the personal accounts was tied to a specific source of funds other than Plaintiffs' investment. The

[8] Mr. Garibaldi acknowledged there is a difference of $20,000 for which he was unable to account. (Garibaldi Affid. Ex. 3 at 4 fn. 5.)

mere fact that there was money left over in the JRL II Account after the February 15, 2011 transfers and that an amount approximate to Plaintiffs' $2,050,000 investment was eventually transferred to the Capital L Account fails to raise a material issue of fact.

c. Distributions for Capital L's Operating Expenses

The Court notes there is a dispute regarding the distributions for Capital L's operating expenses. Using the "commingled funds" method, Mr. Barbash concluded that approximately $1,460,290 of Plaintiffs' investment was used for (1) Capital L payroll ($214,052), (2) Capital L and JRL operating expenses ($516,158), and (3) holding expenses, loans to brokers, and transfers to Holding Branch Accounts at BB&T Bank ($730,080). (Barbash Affid. Ex. A at 8.)

Plaintiffs argue the majority of Plaintiffs' investment went to the operating expenses of Capital L and JRL and thus was not used to acquire registered investment advisors. Defendants contend these transfers were consistent with the Subscription Agreements because the money was used in furtherance of Capital L's business purposes. Nevertheless, the Court finds these issues do not raise a triable issue of fact in light of the undisputed evidence that Defendants diverted funds to Roadside Kitchens and Mr. Lakian and Ms. Lamm's personal accounts, and, thus, all of Plaintiffs' invested funds were not used as intended.

3. *Knowledge of Falsity and Intent to Induce Reliance*

Plaintiffs assert Mr. Lakian knew that his statements were false at the time he made them. "Fraudulent intent, by its very nature, is rarely susceptible to direct proof and must be established by inference from the circumstances surrounding the allegedly fraudulent act." *Setters v. AI Props. & Devs. (USA) Corp.*, 139 A.D.3d 492, 493 (1st Dep't 2016). The timing of an alleged fraudulent transfer of funds may be considered evidence of a defendant's intent to defraud a plaintiff. *See Marine Midland Bank v. Murkoff*, 120 A.D.2d 122, 128 (2d Dep't 1986) (finding timing of conveyance of defendant debtor's interest in home shortly after bankruptcy commenced was "clear indication" of intent to defraud creditors). Here, Mr. Lakian transferred funds from the JRL Account to his personal accounts one week after the funds were invested and transferred funds to Roadside Kitchens one month after the funds were invested.

Plaintiffs further argue Mr. Lakian is collaterally estopped from disputing his liability due to his guilty plea in the Criminal Proceeding and the Pangea Arbitration Award. In addition, Plaintiffs request that the Court draw a negative inference from Mr. Lakian's invocation of the Fifth Amendment in response to each question in his deposition.

a. Mr. Lakian's Guilty Plea and the Arbitrator's Award

Plaintiffs argue Mr. Lakian should be collaterally estopped from arguing the issue of liability based on his guilty plea in the Criminal Proceeding and the Award in the

Pangea Arbitration. Collateral estoppel applies where an issue that is decisive in the present action was necessarily decided in a prior action and defendant had a full and fair opportunity to contest the prior determination. *Simmons-Grant v. Quinn Emanuel Urquhart & Sullivan LLP*, 116 A.D.3d 134, 138 (1st Dep't 2014). Moreover, a plaintiff in a civil action may invoke the doctrine of collateral estoppel to bar a defendant from relitigating the issue of liability based on a criminal conviction, where the plaintiff shows an identical issue was previously decided by a guilty plea or trial. *See Hughes v. Farrey*, 30 A.D.3d 244, 247 (1st Dep't 2006), *lv. dismissed*, 8 N.Y.3d 841 (2007). The party seeking the benefit of collateral estoppel bears the burden of demonstrating the identity of the issues, whereas the party opposing its application bears the burden of demonstrating a lack of a fair and full opportunity to litigate the issue in the prior action. *Simmons-Grant*, 116 A.D.3d at 138.

The Court finds the identical issue of liability for fraud could not have been decided in the Pangea Arbitration or the Criminal Proceeding. While it is true that in both cases, Mr. Lakian was found liable for defrauding investors, neither proceeding specifically found Mr. Lakian liable for defrauding Knox or DJW. Accordingly, the identical issue was not necessarily decided and collateral estoppel cannot apply. *See Kaufman v. Eli Lilly & Co.*, 65 N.Y.2d 449, 456-57 (1985). Nevertheless, the Court finds the guilty plea and the Arbitrator's Award are highly probative evidence of scienter.

"Evidence of other similar acts can be introduced to establish intent in fraud cases." *1515 Summer St. Corp. v. Parikh*, 13 A.D.3d 305, 307 (1st Dep't 2004). The

Criminal Proceeding and Pangea Arbitration undoubtedly establish Mr. Lakian was engaged in a fraudulent scheme regarding registered investment advisors. (Pl. 19-a ¶ 11, Ex. 1 at 174, 178, 180; *Id.* ¶ 50, Ex. 23 ¶¶ 6-8, 22-23.) Moreover, it is clear that Mr. Lakian's representations to Plaintiffs were part of the fraudulent scheme at issue in the Criminal Proceeding and Pangea Arbitration.

In fact, in Mr. Lakian's plea to the securities fraud claim in the Indictment, he admits that between 2009 and 2011 he represented to Capital L investors that their investments would be used to purchase registered investment advisors, when in fact he diverted those investment funds. (Pl. 19-a ¶ 51, Ex. 24 at 33:3-9.) Furthermore, counsel in this matter has represented the fraud claims at issue here are "identically at issue in Mr. Lakian's criminal matter . . . and involve the same conduct as Counts One and Three of the Indictment." (Pl. 19-a ¶ 52.) Similarly, the Arbitrator in the Pangea Arbitration found "[Knox] and [DJW] are 2 of the investors against which Lakian directed racketeering activities similar to those directed at Pangea. The activities directed at Knox, LLC and DJW Advisors, LLC form part of the pattern of racketeering activity that support Pangea's RICO claim." (*Id.* ¶ 13.)

Therefore, Plaintiffs have provided evidence of Mr. Lakian's knowledge of the fraudulent scheme and intent to induce Plaintiffs to invest in Capital L. Defendants fail to produce any evidence that raises a genuine issue of material fact regarding scienter.[9]

[9] Defendants arguments regarding scienter are limited to the application of collateral estoppel to Mr. Lakian's plea in the Criminal Proceeding and the Arbitrator's Award. As noted above, the Court has found that collateral estoppel does not apply.

b. Mr. Lakian's Invocation of the Fifth Amendment

Plaintiffs also ask this Court to draw a negative inference against Mr. Lakian. During Mr. Lakian's deposition on January 7, 2016, he invoked the Fifth Amendment in response to every question posed by Plaintiffs' counsel. Mr. Lakian invoked the Fifth Amendment in response to general questions, such as his current home address and whether he is familiar with Capital L. (Pl. 19-a ¶ 45.) Likewise, Mr. Lakian invoked the Fifth Amendment in response to specific questions regarding Plaintiffs' investments and the purposes for which Plaintiffs' investment funds were used. (*Id.*)

"When a party in a civil action, capable of testifying on the issues, refuses to testify by the claim of privilege, he must thereupon bear all of the legitimate inferences flowing from the adverse evidence against him, and this without regard to his reasons for silence." *Republic of Haiti v. Duvalier*, 211 A.D.2d 379, 386 (1st Dep't 1995). "The Fifth Amendment does not forbid adverse inferences . . . where the privilege is claimed by a *party to a civil cause*." *Id.* (internal quotation marks omitted) (emphasis in original). Here, it is clear that Mr. Lakian refused to answer any questions at his deposition not only because it would have incriminated him, but also because it would have been unfavorable to him in this action. Accordingly, Plaintiffs are entitled to a negative inference against Mr. Lakian regarding scienter.

In light of the timing of the disputed transfers, the Award in the Pangea Arbitration, Mr. Lakian's guilty plea in the Criminal Proceeding, and Mr. Lakian's invocation of the Fifth Amendment in response to every question at his deposition, the

Court finds there are no issues of fact regarding Mr. Lakian's knowledge of the falsity of his representations to Plaintiffs and his intent to induce Plaintiffs to invest in Capital L.

4. *Justifiable Reliance and Causation*

Plaintiffs allege they justifiably relied on Defendants' representations when they invested in Capital L. "New York law imposes an affirmative duty on sophisticated investors to protect themselves from misrepresentations made during business acquisitions by investigating the details of the transactions and the business they are acquiring." *Glob. Minerals & Metals Corp. v. Holme*, 35 A.D.3d 93, 100 (1st Dep't 2006), *lv. denied*, 8 N.Y.3d 804 (2007). A sophisticated investor may be precluded from alleging fraud if he fails to exercise ordinary intelligence to discover the truth or real quality of the subject of the representation, unless the facts represented are matters peculiarly within the defendant's knowledge. *See Swersky v. Dreyer & Traub*, 219 A.D.2d 321, 327 (1st Dep't 1996). Moreover, when a plaintiff has been placed on notice of a potential fraud, a heightened degree of diligence is required of it. *See Glob. Minerals*, 35 A.D.3d at 100.

It is undisputed that Plaintiffs are sophisticated investors who engaged in approximately eight months of due diligence. During the months leading up to Plaintiffs' decision to invest, Mr. Whelley personally visited Capital L's North Carolina offices on multiple occasions, met with Capital L's executives and employees, and reviewed documents relating to Capital L's business strategy and pipeline of different acquisition

opportunities. While Mr. Whelley initially did not recommend investing in Capital L, his concerns were alleviated after Capital L acquired Capital Guardian. (Pl. 19-a ¶ 33, Ex. 2 at 132:15-20.) This is evidence that Plaintiffs considered Capital L's structure and business model, and those factors influenced Plaintiffs' decision to invest.

Defendants argue Plaintiffs could not have reasonably relied on Mr. Lakian's representations that the investments would solely be used to acquire registered investment advisors because the Subscription Agreement provided the funds would be used "in connection with ongoing business opportunities." (Pl. 19-a ¶ 37, Ex. 3 § 1(b).) In essence, Defendants argue that the representations did not induce Plaintiffs to invest because they would have invested in the business anyway. (Def. 19-a ¶ 36.)

Yet, even if the Court were to accept Defendants' contention that Plaintiffs interpreted the "in connection with ongoing business opportunities" language in the Subscription Agreements to mean a general investment in Capital L, this does not break the causal link between Mr. Lakian's misconduct and Plaintiffs' investment. As noted above, there is no dispute that funds were diverted from the Capital L Bank Account to Roadside Kitchens and Mr. Lakian's personal bank account. There is no possible interpretation of Mr. Lakian's representations or the representations contained in the Subscription Agreement that would have warned Plaintiffs that the funds would be diverted for Mr. Lakian's personal use.

In addition, Defendants do not provide any evidence that Plaintiffs could have discovered through ordinary due diligence that Defendants would divert investment funds

for their own personal gain. Courts decline to apply the sophisticated investor defense where the facts misrepresented were peculiarly within Defendants' knowledge. *See China Dev. Indus. Bank v. Morgan Stanley & Co., Inc.*, 86 A.D.3d 435, 436 (1st Dep't 2011). Thus, Defendants fail to provide any evidence that raises a genuine issue of material fact regarding Plaintiffs reliance on Defendants' representations.

5. *Damages*

Plaintiffs assert that the injury they suffered as a result of Defendants' fraud is the full amount of Plaintiffs' $2,050,000 investments in Capital L. The measure of damages for fraudulent inducement is "indemnity for the actual pecuniary loss sustained as the direct result of the wrong," also known as out-of-pocket damages. *Lama Holding Co. v. Smith Barney*, 88 N.Y.2d 413, 421 (1996). "Under this rule, the loss is computed by ascertaining the difference between the value of the bargain which a plaintiff was induced by fraud to make and the amount or value of the consideration exacted as the price of the bargain." *Id.* (internal quotation marks omitted).

Here, Plaintiffs have established injury by demonstrating Defendants induced Plaintiffs to invest. There is no dispute that Plaintiffs invested $2,050,000 in Capital L. Defendants have not proffered any evidence that creates an issue of fact regarding Plaintiffs' damages. Accordingly, Plaintiffs are entitled to summary judgment on the Eighth Cause of Action for fraudulent inducement.

However, the Court finds there is an issue regarding the amount of damages. Neither party has proffered any evidence that Plaintiffs received any distributions from Capital L when they were members. Moreover, there is no evidence of what ultimately happened to Plaintiffs' shares in Capital L. In 2014, the shares of Capital L were converted to new shares of Capital Guardian and sold to an entity called Southport Lane. (Defendants' Brief in Opposition ("Def. Opp.") at 18). Based on the record currently before the Court, it is unclear whether Plaintiffs divested their shares in Capital L or obtained a share of the profit from the sale to Southport Lane. Under the out-of-pocket damages rule, any element of profit is excluded from pecuniary loss. *See Lama Holding*, 88 N.Y.2d at 421. Thus, the amount of any distributions, returns, or payments Plaintiffs received from Capital L and any profits Plaintiffs received from the sale of their shares in Capital L must be determined.

Accordingly, while Plaintiffs are entitled to summary judgment on liability, the Court orders an inquest as to the amount of damages.

C. The Ninth Cause of Action – Fraud

In the Ninth Cause of Action for fraud, Plaintiffs allege Defendants' fraudulently represented to Plaintiffs that their investments in Capital L were being used in the operation of Capital L's business when, in fact, they were being diverted for Mr. Lakian's personal gain. Plaintiffs allege these representations took place after Plaintiffs made their investments on February 4, 2011. However, Plaintiffs have not identified any of

Defendants' alleged representations or conduct that occurred after February 4, 2011 in their Rule 19-a Statement of Facts. Accordingly, Plaintiffs fail to establish Defendants made material misrepresentations after February 4, 2011 and Plaintiffs' motion for summary judgment on the Ninth Cause of Action for Fraud is denied. *See Winegrad v. N.Y. Univ. Med. Ctr.*, 64 N.Y.2d at 853.

D. The Tenth Cause of Action – Constructive Trust

Plaintiffs seek the imposition of a constructive trust on all bank accounts and assets to which Plaintiffs' $2,050,000 investment funds were diverted. In order to establish "entitlement to a constructive trust" a party "must establish (1) a confidential or fiduciary relation, (2) a promise, express or implied, (3) a transfer made in reliance on that promise, and (4) unjust enrichment." *Wachovia Sec., LLC v. Joseph*, 56 A.D.3d 269, 271 (1st Dep't 2008). The purpose of a constructive trust is to prevent unjust enrichment and thus a constructive trust will not be imposed absent a showing of unjust enrichment. *See Simonds v. Simonds*, 45 N.Y.2d 233, 242 (1978).

To establish unjust enrichment, a plaintiff must show that: "(1) the other party was enriched, (2) at that party's expense, and (3) that it is against equity and good conscience to permit the other party to retain what is sought to be recovered." *Mandarin Trading Ltd. v. Wildenstein*, 16 N.Y.3d 173, 182 (2011).

Here, Plaintiffs established that $227,593 of Plaintiffs' funds were diverted to Roadside Kitchens and $362,117 was diverted to Mr. Lakian and Ms. Lamm's personal

accounts.[10] Yet, Plaintiffs fail to proffer evidence that Defendants were unjustly enriched by the distributions to Capital L's Operating Account. The parties dispute whether the Subscription Agreements provided for distributions to the Capital L Operating Account. Thus, Plaintiffs are not entitled to a constructive trust for their entire $2,050,000 investment.

In addition, Defendants argue that there is no specific property identified or funds as the *res* to which any such trust may attach. Units of Capital L were sold to a third party and the bank accounts belonging to the various JRL entities had zero balances as of the end of 2011. (Def. Opp. at 17-18.) Moreover, neither Plaintiffs nor Defendants made representations as to whether Roadside Kitchens still exists. Therefore, Plaintiffs' motion for summary judgment on the Tenth Cause of Action for a constructive trust is denied.

E. Attorneys' Fees and Prejudgment Interest

Plaintiffs seek an award of prejudgment interest and attorneys' fees. Pursuant to CPLR 5001, "[i]nterest shall be recovered upon a sum awarded because . . . of an act or omission depriving or otherwise interfering with title to, or possession or enjoyment of, property." CPLR § 5001(a). "The purpose of interest is to is to require a person who owes money to pay compensation for the advantage received from the use of that money over a period of time." *Mfr.'s & Traders Tr. Co. v. Reliance Ins. Co.*, 8 N.Y.3d 583, 589

[10] This number was calculated by Plaintiffs' expert using the "commingled funds" method.

(2007). Prejudgment interest may be awarded in actions for common law fraud because the defendant has the advantage of using the money that plaintiff was fraudulently induced to contribute and plaintiff is deprived of his use thereof. *See De Long Corp. v. Morrison-Knudsen Co.*, 14 N.Y.2d 346, 348 (1964); *Whittemore v. Yeo*, 117 A.D.3d 544, 545 (1st Dep't 2014). Here, Plaintiffs have established entitlement to a judgment on their fraudulent inducement claim. Thus, Plaintiffs are entitled to prejudgment interest running from the date of their investment, February 4, 2011, at the statutory rate of 9% pursuant to CPLR 5004.

Plaintiffs also seek an award of attorneys' fees. Generally, a prevailing party may not collect attorneys' fees and disbursements from another party unless an award is authorized by an agreement between the parties, statute, or court rule. *A.G. Ship Maint. Corp. v. Lezak*, 69 N.Y.2d 1, 5 (1986). An exception to the general rule exists when "through the wrongful act of his present adversary, [a party is] involved in earlier litigation with a third person in bringing or defending an action to protect his interests." *Coopers & Lybrand v. Levitt*, 384 N.Y.S.2d 804, 807 (1st Dep't 1976) (citations omitted). Plaintiffs do not cite to statutory or contractual authority establishing entitlement to attorneys' fees. Moreover, this action does not fall within the exception, as there was no previous litigation. Therefore, Plaintiffs' request for attorneys' fees and disbursements is denied.

III. CONCLUSION

Accordingly, it is hereby

ORDERED that Plaintiffs' motion for partial summary judgment is GRANTED IN PART as to liability under the Eighth Cause of Action for fraudulent inducement;

ORDERED that Plaintiffs' motion for partial summary judgment is DENIED as to the Ninth Cause of Action for fraud; it is further

ORDERED that Plaintiffs' motion for partial summary judgment is DENIED as to the Tenth Cause of Action for constructive trust; it is further

ORDERED that Plaintiffs' request for prejudgment interest is GRANTED, running from the date of investment, February 4, 2011, at the statutory rate of 9%; it is further

ORDERED that Plaintiffs' request for attorneys' fees and costs is DENIED.

WHEREAS the appointment of a referee to determine is proper and appropriate pursuant to CPLR 4317(b) in that an issue of damages separately triable and not requiring a trial by jury is involved; it is now hereby

ORDERED that a Judicial Hearing Officer ("JHO") or Special Referee shall be designated to determine the following individual issue of fact, which is hereby submitted to the JHO/Special Referee for such purpose: to determine the amount of Plaintiffs' damages, specifically, if Plaintiffs received any distributions, payments, or returns during their time as members of Capital L or realized any profits as a result of the sale of their membership interests that would offset their damages; it is further

ORDERED that the powers of the JHO/Special Referee shall not be limited beyond the limitations set forth in the CPLR; it is further

ORDERED that this matter is hereby referred to the Special Referee Clerk (Room 119, 646-386-3028 or spref@nycourts.gov) for placement at the earliest possible date upon the calendar of the Special Referees Part (Part SRP), which, in accordance with the Rules of that Part (which are posted on the website of this court at www.nycourts.gov/supctmanh at the "References" link), shall assign this matter at the initial appearance to an available JHO/Special Referee to determine as specified above; and it is further

ORDERED that counsel shall immediately consult one another and counsel for Plaintiffs shall, within 15 days from the date of this Order, submit to the Special Referee Clerk by fax (212-401-9186) or e-mail an Information Sheet (accessible at the "References" link on the court's website) containing all the information called for therein and that, as soon as practical thereafter, the Special Referee Clerk shall advise counsel for the parties of the date fixed for the appearance of the matter upon the calendar of the Special Referees Part; and it is further

ORDERED that the Plaintiffs shall serve a pre-hearing memorandum within 24 days from the date of this order and the Defendants shall serve a pre-hearing memorandum within 20 days from service of Plaintiffs' papers and the foregoing papers shall be filed with the Special Referee Clerk prior to the original appearance date in Part SRP fixed by the Clerk as set forth above; and it is further

ORDERED that the parties shall appear for the reference hearing, including with all witnesses and evidence they seek to present, and shall be ready to proceed with the hearing, on the date fixed by the Special Referee Clerk for the initial appearance in the Special Referees Part, subject only to any adjournment that may be authorized by the Special Referees Part in accordance with the Rules of that Part; and it is further

ORDERED that, except as otherwise directed by the assigned JHO/Special Referee for good cause shown, the trial of the issue(s) specified above shall proceed from day to day until completion and counsel must arrange their schedules and those of their witnesses accordingly and it is further

ORDERED that counsel shall file memoranda or other documents directed to the assigned JHO/Special Referee in accordance with the Uniform Rules of the Judicial Hearing Officers and the Special Referees (available at the "References" link on the court's website) by filing same with the New York State Courts Electronic Filing System (see Rule 2 of the Uniform Rules).

This constitutes the decision and order of the Court.

Dated: New York, New York
September 5, 2018

ENTER:

HON. EILEEN BRANSTEN
J.S.C.