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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

# A Court Is A Poor Place To Air Dirty Linen

*Law360, New York (April 07, 2014, 6:31 PM ET)* -- Dramatic charges of wrongdoing in the international high-end art market were lobbed about in Mosionzhink v. Chowaiki et al., Index No. 650434/2009 (Sup. Ct. N.Y. Co.). Justice Shirley Werner Kornreich rendered a decision in July 2013 on dueling motions to dismiss and for summary judgment, and the parties thereafter settled.

Although the settlement agreement is confidential, four years of pleadings are publicly available on the electronic docket. Oscar Wilde and others have said that there is no such thing as bad publicity, but it is unlikely that these parties would agree. Lesson to counsel: litigation in a public forum may be "a loser" for the interests of each and every party. When mud gets slung about, everyone gets dirty.

**The Facts**

According to her amended complaint, Luba Mosionzhnik is an "internationally acclaimed and renowned expert and dealer specializing in 19th and 20th century impressionist, expressionist and modern art," and defendant Ezra Chowaiki "has worked as an unsuccessful screenwriter and then as an ice cream salesman for his father-in-law."

Notwithstanding these apparent differences, in 2004, Mosionzhnik and Chowaiki decided to establish an art gallery to deal in modern art by well-known artists in the collections of private collectors and dealers. Chowaiki approached an individual described as a director of various Fortune 500 companies to be a passive investor, and the three of them moved forward.

On behalf of all three principals, counsel organized Chowaiki Mosionzhnik Gallery Ltd. (later renamed Chowaiki & Co. Fine Art Ltd.) ("gallery"), and drafted a shareholders' agreement and employment agreements for Mosionzhnik and Chowaiki. Under the shareholders' agreement, the passive investor owned 50 percent of the shares, Mosionzhnik and Chowaiki each owned 25 percent, and all three were directors.

Mosionzhnik and Chowaiki had virtually identical employment agreements. These agreements were for an indefinite term, provided $120,000 in annual salaries, and designated Chowaiki as president and gallery director and Mosionzhnik as vice-president, secretary and gallery director.

The shareholders' agreement expressly permitted self-dealing. Mosionzhnik and Chowaiki would be permitted to "continue to deal with and in fine art, including private transactions and the creation of a hedge fund [provided that he/she would use] best efforts to enable the gallery to share in the fees [each] may earn ... after the opening of the gallery."

From inception, Chowaiki informed Mosionzhnik that he was engaged in discussions with a “foreign heiress” who was in estate litigation to establish ownership of extremely valuable paintings, with the goal of permitting the gallery to acquire the art if the heiress were successful. Counsel who prepared the other corporate documents formed “Zelco” to fund the estate litigation in exchange for the right to acquire the subject paintings at agreed prices (“Project Gamma”).

The complaint alleges that although Zelco was to be owned equally by Mosionzhnik and Chowaiki, unbeknown to Mosionzhnik, Chowaiki caused himself to be named Zelco’s sole shareholder and director. The gallery performed all of Zelco’s obligations, including spending more than $3.4 million to fund the estate litigation. The gallery’s accounting records reported Project Gamma as a substantial asset.

Upon formation of the gallery, Mosionzhnik went to Russia to generate business for the gallery. Mosionzhnik and a Russian citizen opened a Moscow gallery in 2007. Mosionzhnik alleged that an informal agreement existed between herself, Chowaiki and the Russian that the gallery would receive 50 percent of the net profits from the Moscow gallery business.

In 2008, Chowaiki and the passive investor confronted Mosionzhnik, claiming that she had been stealing from the gallery and demanded that she resign. She refused. After negotiations failed, the gallery terminated her employment for cause. In that connection, pursuant to the shareholders’ agreement, the gallery retained an accounting firm that valued her shares at $170,000.[1]

Because the gallery claimed that Mosionzhnik owed the gallery much more, it refused to pay her for her shares. Mosionzhnik, for her part, claimed that Chowaiki improperly received an additional $6,000 monthly net income and withdrew gallery funds to pay personal expenses, including his personal mortgage. In addition, at the commencement of the case, each party was in possession of artworks he/she acknowledged were owned by the other.

**The Litigation**

***The Complaint.*** Believing that she was owed money under both the shareholders’ and employment agreements, Mosionzhnik filed an extremely colorful 12-count complaint.[2] She alleged oppressive conduct toward a minority shareholder, a scheme in violation of state and federal RICO laws, defamation and defamation per se, fraud and fraudulent inducement (including an allegation that defendants fraudulently misrepresented that the gallery would have to file for bankruptcy if Mosionzhnik did not approach her rich Russian cousin with a fabricated story to induce the cousin to buy expensive paintings from the gallery), and numerous other claims. She sought monetary damages, dissolution and/or purchase of her shares, an accounting, and demanded an injunction.

***The Answer and Counterclaims.*** These are every bit as colorful as the complaint, which the answer claims is “of a piece with the numerous frauds which prompted her termination for cause ... nothing more than a mask for looting the gallery, ...” All defendants asserted affirmative defenses.

The gallery asserted counterclaims in excess of $20 million in actual damages plus punitive damages for breach of contract, fraud, breach of fiduciary duty, conversion and unjust enrichment arising from Mosionzhnik's alleged:

(a) conversion of funds through an unauthorized Swiss bank account;

(b) false representations that the Pushkin State Museum in Moscow would conduct an exhibition of abstract expressionist art for the benefit of the gallery, which caused the gallery to send paintings to Moscow and incur substantial costs and "public embarrassment and a devastating blow to its reputation;"

(c) wrongful use of art consigned by private investors to the gallery as collateral for unauthorized personal sales of art;

(d) misrepresenting herself as gallery chief executive, forging Chowaiki's signature and falsifying bank documents;

(e) improper art purchases and sales and misrepresentations about the value of artwork created by her boyfriend artist; and

(f) fraudulent use of the gallery's credit card and improper gifts of gallery assets to her parents.

***The Decision.*** Four years after litigation began, and after an extraordinary number of motions and court conferences and substantial discovery in the United States and abroad pursuant to commissions, both sides moved to dismiss and/or for partial summary judgment.[3]

Kornreich dealt with and simplified a morass of competing claims and dismissed the bulk of them, substantially decreasing the amount of potential damages and leaving defamation, tortious interference and breach of contract for trial.

However, she directed the parties to mediation given the relatively small amount at stake and the significant trial costs. As she noted, allegations "made in a public trial, often have the potential for significant reputational harm for all participants, regardless of who obtains a favorable verdict."

***The Fraud Issues.*** Kornreich noted that Mosionzhnik "admitted to committing the most egregious of the alleged improper acts. She secretly opened a Swiss bank account which she used to divert approximately $500,000 [in kickbacks] related to the gallery's art sales and used over $13 million of art consigned by the gallery's clients as collateral for loans without the clients' knowledge or consent." (footnotes omitted)

She rejected Mosionzhnik's "defenses" that her admitted kickbacks, while not ethical, "happens because it's the art world," and that Chowaiki told her it was accepted practice in the industry to use client art as collateral and that Chowaiki also improperly did the same thing.

The court held that Mosionzhnik's admissions were sufficient to grant the gallery summary judgment for breach of fiduciary duty. However, Mosionzhnik's admissions were irrelevant to her right to receive the proper value of her shares under the shareholders' agreement, which was an independent agreement that was not vitiated by her fraud.

The court referenced the "faithless servant doctrine" as a ground to deny Mosionzhnik any compensation under her employment agreement.[4] Arguably, the court could have used the doctrine to hold that Mosionzhnik also forfeited her rights under the shareholders' agreement, as another Supreme Court justice, sitting in Suffolk County, did in a virtually contemporaneous decision involving a similar situation, Trimarco v. Data Treasury Corp., Index # 30324/03 (Sup. Ct. Suffolk Co. Oct. 30, 2013.[5]

***The Fiduciary Duty Issues.*** The court divided both sides' allegation against the other for breach of fiduciary duty into two categories: "diversion of corporate opportunities and flat-out illegal activity." The court ruled that Mosionzhnik was required to disgorge the $500,000 she secretly transferred to the Swiss bank account as a diversion of corporate opportunities, notwithstanding her reliance on the provision in the shareholders' agreement permitting self-dealing and private art transactions.

Because the kickbacks arose from gallery business, not her personal business, and "fiduciaries must disgorge all wrongful benefits obtained by their disloyalty," the court granted the gallery summary judgment but stayed execution pending the conclusion of trial because of Mosionzhnik's potential set-offs as to the remaining claims.

However, as to the remaining improprieties that Mosionzhnik and Chowaiki each claimed the other committed, all those bad acts were imputed to the gallery and barred under the doctrine of in pari delicto, which "mandates that courts will not intercede to resolve a dispute between two wrongdoers ... Imputation 'is a legal presumption that governs in every case, except where the corporation is actually the agent's intended victim'" — i.e., the adverse interest exception.

However, the exception applies "only where the agent has 'totally abandoned his principal's interests ... it cannot be invoked merely because [the agent] has a conflict of interest or where the agent is not acting primarily for his principal.'" (citations omitted).

Here, the record unequivocally establishes that the legality of the gallery's business practices ranged from the questionable (the champertous funding of European litigation) to the impermissible (using client property as loan collateral). The gallery cannot recover against [Mosionzhnik] for her bad acts because the gallery benefited from them .... There is also no question of fact that [Chowaiki] knew of the questionable nature of [Mosionzhnik's] conduct ... The gallery cannot reap the benefits of [Mosionzhnik's] bad acts when times are good and later protest when its relationship with her soured ... Likewise, questions of fact about whether [Chowaiki's] alleged wrongdoing rose to the level of severity of [Mosionzhnik's] actions are irrelevant. [Mosionzhnik] lacks standing to sue … because such a claim is derivative and belongs to the gallery. However, even if [Mosionzhnik] could maintain such a claim, it, nonetheless, would be barred by the in pari delicto doctrine for the same reasons that the gallery's claims are precluded. (citations and footnotes omitted)[6]

***Breach of the Shareholders Agreement.*** Because the "bad acts" that led to Mosionzhnik's termination as an employee were irrelevant to her right to be paid for her shares, the only issue was whether her shares were worth more than the $500,000 she was required to disgorge from her Swiss account.

The court first pointed out that under the shareholders' agreement, Mosionzhnik did not have a right to procure her own accounting report if she disagreed with the gallery's report. The court then noted that Mosionzhnik's accountants, who valued her shares at over $4 million, objected to the gallery's accountants' theory, but did not allege that those accountants made any errors or misstated amounts in their valuation.

The court found that even though Mosionzhnik did not have a direct equity interest in Zelco, the gallery funded Project Gamma so that the interest of both Mosionzhnik and Chowaiki in Zelco was equal to their respective 25 percent equity interest in the gallery.

However, notwithstanding the millions the gallery invested in the project or its appearance on its books

as a multimillion-dollar asset, neither side's dueling accountants ascribed any independent value to Project Gamma. Therefore, the court did not attribute any value to Project Gamma in valuing Mosionzhnik's shares.[7]

The accountants used different theories, but both were generally accepted accounting principles. Because the gallery's accountants followed the valuation protocol set forth in the shareholders' agreement, the court accepted its $170,000 valuation.[8]

Both sides filed notices of appeal, but then decided to cut their losses and settle. Although not apparent from the record whether mediation occurred, in a victory for sanity over public acrimony and mudslinging, they reached a confidential settlement agreement and dismissed the litigation with prejudice.

**The Takeaway**

This case teaches lessons both to counsel and businesspeople.

- First is the golden rule that honesty and transparency in business dealings is the best policy. The corollary is the related rule that dishonesty and subterfuge have consequences if you are caught.

- Ideally we should be prescient and anticipate the future and plan accordingly. Unfortunately, we lack that skill. While as lawyers, we can make reasoned predictions, we can never know what will actually occur. With hindsight, however, from the record, we know some of the ways in which the participants erred.

- All three principals used one counsel to draft all the operative agreements, including Chowaiki's "private" Project Gamma. There may not have been a conflict among the parties at the outset and the decision to economize on legal fees is understandable. However, this may have been a poor decision. Separate counsel representing the parties individually would have been subject to the attorney-client privilege and unlikely to be required to give deposition testimony, as occurred in this case. Individual counsel may have seen dangers lurking in the documentation and negotiated different provisions to protect his/her client if relationships went sour.

- For example, while the shareholders' agreement provided a detailed method to value gallery shares upon transfer under various scenarios, it did not consider the implication of a "faithless servant" or include a provision for challenging valuation where the shares were to be valued in the context of a "business divorce" as occurred here. The absence of such provisions in a closely held business is neither unusual nor necessarily wrong. The agreement, as drafted, provides a simple and cost-effective mechanism agreed to in advance by all interested parties at a time when none of them knows whether the provisions ultimately will be to his/her/its advantage or disadvantage. However, each party gives up prospectively substantial rights to challenge potentially improper valuations. While there is no automatic "right" or "wrong" answer whether to adopt such provisions, separate counsel may have helped the parties come to different decisions.

- It is obvious that reputation is extremely important in the international art business. Regardless of what Mosionzhnik and Chowaiki may have thought about each other at the outset, it certainly would not have been farfetched to foresee conflict down the road. Rather than expose their dirty linen to potential clients — indeed the entire international art market — in the event of discord, we believe that they should have required mandatory confidential arbitration in their agreements. If, for whatever reason, all the parties agreed that arbitration was not the best solution when a dispute actually arose, they could have waived arbitration and proceeded to mediation or court.

- Instead, the shareholders' agreement provided for jurisdiction in the New York federal and state courts. Court dockets are now published online. The days of going through boxes in storage facilities in Bayonne, N.J., are long gone. Anyone with a computer can read virtually any allegation in any pleading, regardless of the ultimate outcome of the dispute. It seems fair to say that none of the parties to this dispute is better off for the publicity, notwithstanding Oscar Wilde.

- Even though the shareholders' agreement did not provide for mandatory mediation, we believe that once the parties realized the potential downside of publicly filed litigation, they certainly should have given it a try. While mediation, obviously, does not guaranty settlement, it is confidential and has no downside, other than a relatively modest cost. At minimum, it could have narrowed the issues between the parties. For instance, each acknowledged that the other was holding artwork belonging to the other, and countersued for conversion. Although the parties presumably could have straightened this out on their own without outside intervention, it was not until four years into the litigation that they exchanged the pieces each acknowledged the other owned, and withdrew those claims. This portion of their dispute could have been facilitated by mediation.

- Not all relationships are made in heaven, but there seems to be no reason why this one had to end in the circle of destruction and public hell.

—By Joan M. Secofsky and Richard I. Janvey, Diamond McCarthy LLP

*Joan Secofsky is senior counsel and Richard Janvey is a partner in the firm's New York office.*

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[1] Under the shareholders' agreement, absent a base valuation per share within the prior two years pursuant to the procedure set forth (and there was none here), "the purchase price shall be the fair market value of the shares of stock to be sold determined by the accountants servicing the company using generally accepted accounting principles, consistently applied."

[2] Defendants were Chowaiki, the passive investor, a gallery employee, the gallery, Zelco, Chowaiki & Co. Fine Art, Ltd. and various Jane and John Does.

[3] Mosionzhnik moved for summary judgment on her claims for a declaratory judgment and

conversion. The gallery moved for summary judgment on its breach of contract and breach of fiduciary duty counterclaims and all defendants moved to dismiss the other causes of action. While the motions were sub judice, Mosionzhnik withdrew her conversion claim, and the gallery partially withdrew its conversion claim upon the parties' exchanges of art belonging to the other.

[4] The "faithless servant doctrine" is a state common law doctrine established in 1886 by the Court of Appeals in Murray v. Beard, 102 N.Y. 505 (1886), under which employers may refuse to compensate employees for the time the employees were unfaithful to their duties. Some, but not all, states have incorporated the doctrine into their common law. In Phansalkar v. Andersen Weinroth & Co., LP, 344 F.3d 184 (2d Cir. 2003), the Second Circuit reversed the district court's award of $4.4 million on a former employee's claim for conversion of shares of stock he received as partial compensation under his employment agreement. After an extensive analysis of New York's case law, the court predicted future developments of New York law. It held that the employee forfeited all compensation after his first disloyal act, including the value of the shares at issue, not, as the district court held, only compensation derived from transactions as to which he was disloyal.

[5] The Trimarco decision after a bench trial is contrary. The case involved a consulting agreement whereby Michael Trirmarco agreed to provide certain services to Data Treasury and an option agreement granting Trimarco 1.5 million stock options exercisable over a 10-year period (valued in the range of $10 million to $14 million), regardless of whether he remained employed (and he did not). Both sides relied on Phansalker. Justice Emily Pines, noting that plaintiff was a Harvard Business School graduate, found that "his disloyal behavior ... began early in his consultancy ... were both a violation of the covenant of good faith and fair dealing ... and a breach of his fiduciary duty to that entity as an employee, chief operating officer, an executive vice president and a member of the board of directors." Although the stock option agreement was not dependent on Trimarco's continuing employment, she found that it had to be read in conjunction with his consulting agreement. While Trimarco could have departed from employment without losing his stock option benefits, "infidelity is a bar to a claim for enforcement ..." Because Trimarco's disloyalty extended throughout his relationship with Data Treasury, he was not entitled to exercise any options. (Data Treasury failed to demonstrate that Trimarco's disloyalty was a substantial factor causing it damage and she dismissed Data Treasury's counterclaims).

[6] In addition to being barred by in pari delicto, the court found that many of Mosionzhnik's claims were derivative in nature and would belong to the gallery.

[7] Accordingly, the court granted summary judgment and dismissed Mosionzhnik's claim for a declaration that she continued to own a 25 percent interest in Project Gamma.

[8] "[I]t is unsurprising (aside from the usual expectation that the experts of adverse parties will disagree) that [the experts] came to drastically different conclusions about the value of the gallery. Regardless, the court must accept the [gallery] report because it was prepared in accordance with the terms of the shareholders' agreement. If the parties, who constitute all of the involved individuals that formed the gallery and drafted the shareholders' agreement, wished to grant a terminated employee a more substantive right to participate in or challenge the valuation of her shares, they could have drafted the shareholders' agreement differently. As they did not, they are bound by the express term of the shareholders' agreement they all agreed to."

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