NOT FOR PUBLICATION WITHOUT APPROVAL OF THE COMMITTEE ON OPINIONS

RICHARD TUSCANO, individually and derivatively on behalf of NORTHEASTERN IMPORT-EXPORT, INC., A New York Corporation, TEXTILE RECOVERY SERVICES INC., a New Jersey Corporation, ISLAND TEXTILE, INC., a New York Corporation, and VENTURE LEASING, a New York Corporation, Plaintiffs, v. RONALD TUSCANO, individually; NORTHEASTERN IMPORT-EXPORT, CORP., a Delaware Corporation; ABC, INC. 1-10 and ABC, LLC 1-10, being fictitious names for certain unknown incorporations, limited liability corporations and professional corporations, Defendants.	SUPERIOR COURT OF NEW JERSEY CHANCERY DIVISION MERCER COUNTY DOCKET NO. C-42-10 CIVIL ACTION **MOTION DECISION**

Jacobson, Mary C., P.J.Ch.

Lewis Pepperman, Esq. (*Stark & Stark, P.C.*), argued for Plaintiff Richard Tuscano.

Jeffery D. Ullman, Esq. (*Ullman, Furhman & Platt, P.C.*), argued for Defendant Ronald Tuscano.

Introduction

Plaintiff Richard Tuscano ("Richard" or "Plaintiff") and his brother Defendant Ronald Tuscano ("Ronald" or "Defendant") each own 50% of Northeastern Import-Export, Inc. ("Northeastern"), Textile Recovery Services, Inc. ("TRS"), Island Textile, Inc. ("Island"), and Venture Leasing ("Venture") (hereinafter collectively referred to as

"the corporations"). The corporations own, maintain, operate, and service collection bins designed to receive products that can be recycled, including used clothing. The recycling of the products generates revenue for various charitable organizations that sponsor the bins. Plaintiff and Defendant have operated the corporations for approximately 25 years. Plaintiff and Defendant are the only shareholders of the corporations and the only two members of the corporations' Boards of Directors, with Defendant serving as President and Plaintiff as Vice President.

Factual and Procedural History

Plaintiff filed his complaint on May 24, 2010. Plaintiff alleged minority oppression, breach of fiduciary duty and the duty of loyalty, requested a court ordered buyout of his interest in the corporations, and simultaneously included a derivative action on behalf of the corporations for breach of fiduciary duties. Plaintiff included allegations that Defendant had formed another corporation, Northeastern Import-Export, Corp. ("Delaware corporation"), in Delaware in April of 2008, without the knowledge or consent of Plaintiff, and in direct competition with the other corporations. Defendant filed his answer on July 13, 2010. Defendant asserted eight (8) affirmative defenses: that the derivative claims were not pleaded with particularity, that plaintiff failed to allege a claim upon which relief can be granted, and that the claims are barred by unclean hands, waiver and estoppel, statute of limitations, the doctrine of laches, ratification, and failure to comply with the New York Business Corporation Law ("BCL").

Extensive motion practice followed the filing of Defendant's answer, beginning on August 11, 2010, when Plaintiff submitted a motion seeking entry of an order awarding temporary injunctive relief while the action was pending. Plaintiff sought the

reinstatement of his salary, the appointment of a provisional director or receiver for the corporations, and access to the corporations' financial books and records. On September 21, 2010, argument was heard on the motion. The court thereafter entered an order requiring that Defendant make all books and financial records of the corporations available to Plaintiff, that Defendant make John B. Caliendo, CPA, available to answer questions about those books and records, and additionally ordered that the parties file supplemental papers regarding the appointment of a provisional director and the reinstatement of officer salaries. The court reserved decision on the appointment and reinstatement pending the receipt of the supplemental papers and ordered the motion to be returnable on October 29, 2010.

On September 30, 2010, Defendant submitted a motion for *pro hac vice* admission of Andrew E. Curto, Esq. Mr. Curto, an attorney duly licensed to practice law in the State of New York, has acted as counsel for the corporations for almost twenty (20) years. (Curto Cert. at ¶2). Mr. Curto's name appeared on Defendant's answer, and Mr. Curto was listed as substitute trial counsel. Plaintiff opposed the application, alleging a conflict of interest. After hearing oral argument, this court denied the motion because of the conflict of interest between Mr. Curto's representation of the corporations and representation of Defendant in this matter.

On November 9, 2010, after hearing additional oral argument and reviewing the supplemental submissions of the parties, the court entered an order granting Plaintiff's motion to appoint a provisional director. The court appointed Edward Bergman, Esq., as provisional director of the corporations in accordance with N.J.S.A. 14A:12-7. Mr. Bergman was given the power to examine financial books and records, review existing

contracts, act as a tiebreaker on areas of deadlock between Plaintiff and Defendant, and was required to submit reports to the court every ninety (90) days regarding the status of the deadlock and the corporations' business, with the first report due on February 8, 2011.

On December 10, 2010, non-party Countrywide Transport Inc. ("Countrywide") filed a motion to quash the subpoena *duces tecum* that Plaintiff had served on Countrywide and to enter a protective order. Countrywide is a New York corporation that does business in New Jersey, and is owned by Defendant's son, Joseph Tuscano ("Joseph"). While Countrywide is not a party in this action, Plaintiff made allegations in his complaint that Defendant was wasting corporate assets through his use of Countrywide to transport clothing collected in New Jersey to the corporations' New York Facility at rates that "greatly exceeded" the market rates of other corporations for shipping similar goods over similar distances, and through his alleged failure to charge Countrywide for the use of storage and business offices at the New York Facility. (Compl. at ¶¶58-62). The court heard oral argument on the motion, and on January 21, 2011, denied the motion to quash, but required a protective order to govern the production of financial information. The order required that Countrywide provide the documents listed in the subpoena by March 4, 2011, and that the parties negotiate, with the aid of Mr. Bergman, a protective order. On February 7, 2011, Mr. Bergman requested an extension of time for the filing of his initial report due to the motion practice between the parties and Countrywide that delayed his review of the Countrywide documents. The parties did not object, and the court granted Mr. Bergman's request by order dated February 9, 2011, and also ordered that the first report be due on March 30, 2011.

On January 12, 2011, nearly eight months after the filing of the complaint, Defendant filed a motion to amend his answer and to dismiss the complaint. Defendant argued that he be allowed to amend his answer to include four (4) additional affirmative defenses, asserting that the claims of Plaintiff are barred by the entire controversy doctrine, *res judicata*, the doctrine of collateral estoppel, and for the failure to join an indispensable party for the derivative claims, and that the complaint be dismissed upon application of these defenses. Additionally, Defendant argued that the Plaintiff's complaint should be dismissed due to the improper inclusion of both direct and derivative claims in his complaint. Plaintiff filed opposition on February 7, 2011.

At issue in Defendant's motion is a previous action filed by Plaintiff in the United States District Court, Eastern District of New York, on April 25, 2005 ("the federal action"). In the complaint, Plaintiff alleged derivative claims for breach of fiduciary duty against Ronald, unjust enrichment against named defendants Joseph Tuscano and Countrywide, injunctive relief against Ronald, Joseph, and Countrywide, restitution and disgorgement of legal fees and legal malpractice against Forchelli, Curto, Schwartz, Mineo, Carlino & Cohn, LLP, injunctive relief against Ronald to prevent Ronald from retaining the Forchelli firm, accounting malpractice against Eugene Lotardo, injunctive relief against Ronald to prevent Ronald from retaining Mr. Lotardo's services, and six (6) counts involving allegations of violations of RICO against Ronald, Joseph, Countrywide, Mr. Lotardo, and Donna Lotardo.

Defendants in the federal action filed motions to dismiss the complaint and, on December 12, 2005, District Judge Spatt issued a decision. Judge Spatt held that "the Court lacks jurisdiction over the plaintiff's derivative RICO causes of action because the

plaintiff has failed to join the Corporations who are necessary under Fed. R. Civ. P. 19 for proper adjudication of this action. As such, there is no basis for federal jurisdiction." Tuscano v. Tuscano, 403 F.Supp. 2d 214, 229-30 (E.D.N.Y. 2005). Judge Spatt also noted that, "at this time, the Court declines to determine the sufficiency of the plaintiff's remaining state-law claims" and specifically stated earlier in his opinion that "the Court is not exercising supplemental jurisdiction over the plaintiff's State Law causes of action…" Id. at 225. Judge Spatt also gave Plaintiff the opportunity to file an amended complaint consistent with his Decision within thirty (30) days of the Decision. Id. at 230. Plaintiff did not file an amended complaint, however, and Judge Spatt issued an Order dated January 28, 2006, dismissing the case. Judge Spatt also issued a Judgment on January 30, 2006, that stated: "Ordered and Adjudged that plaintiff take nothing of defendants; and that plaintiff's complaint is hereby dismissed."

Defendant's counsel, Jeffery D. Ullman, Esq., certified that he was personally unaware of the prior federal action until November 19, 2010, when Ronald made reference to it. (Ullman Cert. at ¶7). Until that time, Mr. Ullman asserts he was only aware of a prior New York State Supreme Court action in 2003 through which Plaintiff sought access to corporate records, which action had been referenced in the application for the admission of Mr. Curto, *pro hac vice*. It should be noted, however, that at the time of the filing of the federal action, Mr. Curto was a partner in the firm Forchelli, Curto, Schwartz, Mineo, Carlino & Cohn, LLP, which was a named defendant in the federal action. Mr. Ullman explained that once he learned of the federal action, he proposed to Plaintiff's counsel that the parties agree, by stipulation, to Defendant's filing of an amended answer with additional affirmative defenses. Defendant's time to amend as a

matter of course pursuant to R. 4:9-1 expired on October 12, 2010. The parties were unable to reach an agreement, and the present motion was filed on January 12, 2011. This court heard oral argument on the motion to dismiss and reserved decision on the motion.

Discussion

Rule 4:9-1 provides that leave to amend pleadings "shall be freely given in the interest of justice." The New Jersey Supreme Court has made it clear that "Rule 4:9-1 requires that motions for leave to amend be granted liberally" and that "the granting of a motion to file an amended complaint always rests in the court's sound discretion." Kernan v. One Washington Park Urban Renewal Associates, 154 N.J. 437, 456-57 (1998); see also, Notte v. Merchants Mut. Ins, Co., 185 N.J. 490, 501 (2006).

The court's exercise of discretion "requires a two-step process: whether the non-moving party will be prejudiced, and whether granting the amendment would nonetheless be futile." Notte, supra, 185 N.J. at 501. In Notte, the Court agreed with the Appellate Division's holding that there was no prejudice to defendants when "the newly asserted claims are based on the same underlying facts and events set forth in the original pleading." Ibid. While the trial court has discretion in denying motions to amend "where the interests of justice require…the achievement of substantial justice is the fundamental consideration" and "denial of such a motion in the interests of justice is appropriate only where there would be undue prejudice to another party." Franklin Med. v. Newark Public Schools, 362 N.J. Super. 494, 506 (App. Div. 2003).

However, the analysis is not complete "until the requested amendment is examined to determine whether it is futile, that is, whether the amended claim will nonetheless fail and, hence, allowing the amendment would be a useless endeavor."

Notte, supra, 185 N.J. at 501. The Court stated that "while motions for leave to amend are to be determined without consideration of the ultimate merits of the amendment, those determinations must be made in light of the factual situation existing at the time each motion is made." Ibid. Finally, the Court explained that "courts are free to refuse leave to amend when the newly asserted claim is not sustainable as a matter of law. In other words, there is no point to permitting the filing of an amended pleading when a subsequent motion to dismiss must be granted." Ibid.

Defendant filed both a motion to amend and a motion to dismiss based on the proposed amendments to the complaint. The court will address each of the defenses proposed by Defendant in the context of the motion to dismiss. Should the court determine that these defenses are futile and in turn deny the motion to dismiss, the court, in its discretion, will also deny Defendant's motion to amend the complaint.

Motion To Dismiss the Complaint

Defendant lists several different theories under which the complaint in this case should be dismissed: *res judicata*, the entire controversy doctrine, collateral estoppel, failure to join the corporations as parties to the action, and the joining of both derivative and individual claims in one action.

Res Judicata

The doctrine of *res judicata* "provides that a cause of action between parties that has been finally determined on the merits by a tribunal having jurisdiction cannot be relitigated by those parties or their privies in a new proceeding." Velasquez v. Franz, 123 N.J. 498, 505 (1991). *Res judicata* ordinarily does not apply "where the parties have not had an adjudication on the ultimate merits." Central R.R. Co. v. Neeld, 36 N.J. 172, 177

(1958). In Velasquez, the Court held that "a valid and final personal judgment for defendant does not bar another action by plaintiff on the same claim if the judgment is a dismissal for lack of jurisdiction, improper venue, or non-joinder or misjoinder of parties." Id. at 506. "A judgment of involuntary dismissal or a dismissal with prejudice constitutes an adjudication on the merits as fully and completely as if the order had been entered after trial." Id. at 507 (citing Gambocz v. Yelencsics, 468 F.2d 837 (3d Cir. 1972)). The court went on to explain, however, that increasingly, "statutes, rules and court decisions operate to bar retrial of judgments that do not pass directly on the substance of the claim." Id. at 506.

The dismissal in Velasquez was based upon a prior federal court action where the federal court dismissed the matter pursuant to a motion under Fed. R. Civ. P. 12(b)(6) for failure to state a claim on which relief can be granted. Id. at 507. The plaintiff argued that a dismissal for failure to state a claim was a like a dismissal for improper venue or lack of diversity, neither of which reach the merits or bring *res judicata* considerations into play. Ibid. However, the Court found that under both federal and New Jersey law, the federal judgment was an adjudication on the merits because Fed. R. Civ. P. 41(b) and R. 4:37-2(d) both provide that, unless the order otherwise specifies, a dismissal other than a dismissal for lack of jurisdiction, for improper venue, or for failure to join a party operates as an adjudication on the merits, and a dismissal for failure to state a claim on which relief may be granted, "represents a decision on the merits of the claim." Id. at 509, 511.

In Watkins v. Resorts International Hotel and Casino, Inc., 124 N.J. 398 (1991), the New Jersey Supreme Court found that a federal court's dismissal for insufficient

service of process or lack of standing does not preclude relitigation in state court. In Watkins, the plaintiffs filed suit in the United States District Court for the District of New Jersey, the court granted the defendant's motion to dismiss the complaint for plaintiff's lack of standing to sue on November 27, 1985, and dismissed the remaining counts of the action in an order stating: "it appearing that it has been reported to the Court by plaintiffs' counsel that plaintiffs do not wish to proceed any further in this matter; It is on this 27th day of May, 1987, Ordered that this action is hereby Dismissed with prejudice." Id. at 404-05. The plaintiffs did not appeal, but brought suit in the Superior Court of New Jersey, Law Division. Id. at 405. The complaint filed in state court was based on the same facts as the federal suit, but the claims were based entirely on state law. Ibid. The defendants moved to dismiss the state complaint, arguing that the claims were barred by the entire controversy doctrine, *res judicata*, and collateral estoppel. Ibid. The trial court agreed that the state cause of action was essentially the same as the federal action, determined that the entire controversy doctrine barred relitigation of the matter, and dismissed the complaint for failure to state a cause of action. Ibid. On appeal, the plaintiffs argued that the federal court had not determined the matter on the merits, and that neither *res judicata*, collateral estoppel, nor the entire controversy doctrine should bar the claims. Ibid. The Appellate Division affirmed the dismissal, holding that the dismissal for lack of standing was a resolution on the merits and the state court action was barred by *res judicata* or collateral estoppel. Ibid.

In Watkins, the New Jersey Supreme Court stated, "when a state court considers the binding effect of a federal court judgment, nothing less is at stake than the integrity of federal judicial power and the coherence of the federalist system…Consequently, a cause

of action finally determined on the merits by a competent federal court cannot be relitigated by the same parties or their privies in a state court." Id. at 410-11. The Court explained that, in general, the binding effect of a judgment is determined by the law of the jurisdiction that rendered it…Federal law determines the effects under the rules of res judicata of a judgment of a federal court." Id. at 411. The Court explained that while there are issues of semantics as to what a judgment "on the merits" means, that "the rule remains that a dismissal based on a court's procedural inability to consider a case will not preclude a subsequent action on the same claim, but a judgment can be preclusive even if it does not result from a plenary hearing on the substantive claims." Id. at 416. The court held that the federal court order dismissing the plaintiff's individual claims for insufficient process was necessarily without prejudice under Fed. R. Civ. P. 4(j). Ibid.

As to the dismissal for lack of standing, however, the Court found the issue less clear, because standing is not included in the Fed. R. Civ. P. 41(b) exemptions. Ibid. However, the Court found that Fed. R. Civ P. 41(b) "is interpreted pragmatically, not rigidly," and "adjudications not on the merits under Rule 41(b) include those dismissals which are based on a plaintiff's failure to comply with a precondition requisite to the Court's going forward to determine the merits of the substantive claim." Id. at 417. The court found that a dismissal on standing is like a dismissal for lack of jurisdiction in that it is a threshold issue, and thus, not a dismissal on the merits. Id. at 421. Finally, the Court examined the plaintiffs' claims and their dismissals in light of both issue and claim preclusion, explaining that, "unlike claim preclusion, issue preclusion can result from a judgment even if that judgment was not rendered on the merits." Id. at 422. Thus, the Court determined that "a federal court dismissal based on a determination that plaintiffs

lacked standing under the federal civil rights law, although not on the merits, precludes reconsideration of that issue. Such a determination would preclude relitigation of the federal standing issue." Nevertheless, the Court held that "because issue preclusion is limited to those issues actually litigated and decided, the determination of standing under federal law does not estop plaintiffs from subsequently asserting state claims arising from the same facts." Id. at 423. On the issue of claim preclusion, the Court found that two of the requirements for claim preclusion, identity of the parties and of the claim, were satisfied, but found that the dismissal for lack of standing was not on the merits and the claims were not barred from being raised in state court. Id. at 424. As to the federal court's subsequent dismissal "with prejudice," the Court determined that this order "applied only to those claims remaining at that time" and "could not affect the previously dismissed claims of the individual plaintiffs." Ibid.

In the Tuscano federal action, the December 12, 2005 decision explicitly stated, in apparent reference to the federal RICO claims, that "this action must be dismissed because the plaintiff has failed to join a party necessary for proper adjudication." Tuscano, supra, 403 F. Supp. 2d at 220. Such a dismissal is not on the merits and would not bar a subsequent lawsuit on the same claims in a New Jersey Court. However, the federal court did address some issues similar to ones raised here in its opinion. But it then stated explicitly that, "[t]o the extent that the Court otherwise addresses the remainder of the plaintiff's allegations, it does so for the purpose of providing guidance to the plaintiff should he attempt to filed an amended complaint." Ibid. By the federal court's own admission, therefore, the dismissal was based on failure to join a necessary party and its remaining analysis was dicta – that is, "guidance" for Plaintiff to follow if he chose to

amend the complaint to cure the defects articulated by the court. Notably, the federal court dismissed the federal RICO claims, stating that, "the Court lacks jurisdiction over the plaintiff's derivative RICO cause of action because the plaintiff has failed to join the Corporations who are necessary under Fed. R. Civ. P. 19 for proper adjudication on the merits. As such, there is no basis for federal jurisdiction." Id. at 229-30.

Plaintiff was "granted leave to file an amended complaint," and the court explained that the amended complaint, "if any," shall be filed within 30 days of the date of the decision. Ibid. This adjudication was not a final decision on the merits because the complaint was dismissed without prejudice and was dismissed for failure to join a necessary party. Such a ruling falls within the exception of the non-joinder or misjoinder of parties in Velasquez as well as under Fed. R. Civ. Pro. 41(b), which provides that "unless the dismissal order states otherwise, a dismissal under this subdivision (b) and any dismissal not under this rule—except one for lack of jurisdiction, improper venue, or failure to join a party under Rule 19—operates as an adjudication on the merits." The present case is distinguishable from Velasquez because the initial dismissal in Velasquez was for failure to state a claim on which relief may be granted, not for failure to join a party or lack of jurisdiction as it was in Tuscano. The grounds upon which the federal case in Tuscano was initially dismissed are those specifically exempted from substantive finality under Fed. R. Civ. P. 41(b). Both Defendant and Plaintiff agree that this initial decision was not an adjudication on the merits and does not have *res judicata* effect.

Where the parties differ, however, is as to the meaning and application to this case of two subsequent orders entered by Judge Spatt after the thirty days afforded to Richard Tuscano to amend the complaint expired. On January 28, 2006, Judge Spatt entered an

order explaining that no amended complaint had been filed, and "accordingly, the case is dismissed," and on January 30, 2006, Judgment was entered that "Ordered and Adjudged that plaintiff take nothing of defendants; and that plaintiff's motion is hereby dismissed." (Exh C to Ullman's Cert.). Defendants contend that Plaintiff's failure to timely file an amended complaint and Judge Spatt's subsequent January 2006 order and judgment amount to an involuntary dismissal or a dismissal with prejudice that "constitutes an adjudication on the merits as fully and completely as if the order had been entered after trial," and that therefore operates as a bar to several counts of the present suit. Velasquez, supra, 123 N.J. at 507. Plaintiff argues, however, that although he decided not to file an amended complaint in the federal lawsuit, the dismissal was still based on lack of jurisdiction, was not a final adjudication on the merits, and thus does not bar any claim in this state court action.

As in Watkins, the federal claims in Tuscano were dismissed for lack of jurisdiction for failure to name a party. In Watkins, the Court found that a dismissal on standing is like a dismissal for lack of jurisdiction in that it is a threshold issue, and therefore, not a dismissal on the merits. Watkins makes it clear that a dismissal based on a court's procedural inability to consider a case will not preclude a subsequent action on the same claim. Watkins, supra, 124 N.J. at 416. In the Tuscano federal action, the first dismissal was without prejudice as to the entirety of the complaint for lack of jurisdiction, essentially preventing the court from reaching any of the substantive issues underlying the claims. Moreover, while not explicitly stated, it appears that once Judge Spatt decided he could not exercise jurisdiction over the federal RICO claims, he determined not to exercise pendent jurisdiction over the remaining state law claims. Pendent jurisdiction

> is essentially a discretionary doctrine designed to permit a party to try in one judicial proceeding all claims arising out of a 'common nucleus of operative fact,' with regard to their federal or state character, where to do so would promote convenience and sound judicial administration. The power of the court to exercise pendent jurisdiction, though largely unrestricted, requires, at a minimum, a federal claim of sufficient substance to confer subject matter jurisdiction to the court." Tully v. Mott Supermarkets, Inc., 540 F.2d 187, 195-96 (3d Cir. 1976) (citing United Mine Workers of America v. Gibbs, 383 U.S. 715, 725 (1966)).

In Tully, the Third Circuit explained that, "if it appears that the federal claim is subject to dismissal under F.R. Civ. P. 12(b)(6) or could be disposed of on a motion for summary judgment under F.R. Civ. P. 56, then the court should ordinarily refrain from exercising jurisdiction in the absence of extraordinary circumstances." Id. at 196. Significantly, in Tully, the court explained that the insufficient justification "to sustain the district court's exercise of pendent jurisdiction," did not prejudice the plaintiff's legal rights "since they may obtain a full adjudication of their state law claims" in a pending state court proceeding that had been stayed by agreement until a final judgment was rendered in the federal action. Id. 196-97. Judge Spatt specifically stated that his court lacked jurisdiction over the federal RICO claims and that, therefore, there was no basis for federal jurisdiction. When the federal claims were dismissed without prejudice for lack of jurisdiction, and Plaintiff did not cure the federal jurisdictional problem in an amended complaint, the entire case was dismissed with prejudice. However, Judge Spatt specifically explained that he would not be exercising supplemental jurisdiction over the state law claims, and any comments as to those state claims were meant to be "guidance." From this statement and from the general rule that federal courts should only exercise pendent jurisdiction over state law claims where there remains a federal claim to confer federal subject matter jurisdiction, it is clear that Judge Spatt did not exercise pendent

jurisdiction over Plaintiff's state law claims, and thus, there was no adjudication of those state law claims in the federal action. As a result, *res judicata* does not require dismissal of the case currently pending before this court. See generally, Watkins, supra, 124 N.J. at 404-416.

Denying *res judicata* effect to this District Court dismissal is also warranted because this motion was brought belatedly. Defendant's time to amend as a matter of course pursuant to R. 4:9-1 expired on October 12, 2010. *Res judicata* is an affirmative defense that, when not pleaded or otherwise timely raised, is deemed to have been waived. R. 4:5-4; see also Pressler, Current N.J. Ct. R., comment 1.2.1 on R. 4:5-4 (2011). Clearly, at this stage of the litigation, where this court has already expended significant judicial resources on motion practice and has deemed it necessary to appoint a provisional director due to the ongoing deadlock between the brothers in the operation of the corporations, a dismissal based on a late-filed defense would be inefficient and unfair. Additionally, it is clear that the present suit would continue in some form even if *res judicata* principles applied to bar some claims. The present suit involves some claims that arose after the dismissal of the federal action, including Plaintiff's claims as to the formation of the Delaware corporation, and Plaintiff's claims regarding a recent failure to pay him compensation. This court has already determined that the deadlock between the brothers justified the appointment of a provisional director for the corporations, and that provisional director has been in place since November 9, 2010. In fact, while this motion was pending, the provisional director filed a lengthy report and recommendations with the court. These circumstances counsel against allowing Defendant to assert a late defense based on *res judicata* principles.

Therefore, because the federal court dismissal was for lack of jurisdiction for failure to name an indispensable party under Fed. R. Civ. P. 19, and because Judge Spatt did not exercise pendent jurisdiction over Plaintiff's state law claims in the federal action, this court finds that Plaintiff did not have a full adjudication of his state law claims in federal court and will not dismiss the current state court action on grounds of *res judicata*. This result is also supported by the late filing of the *res judicata* defense, which should not be considered based on principles that foster the efficient administration of justice.

Collateral Estoppel

The rule of collateral estoppel requires that "(1) the discrete issue to be precluded is identical to an issue in the prior proceeding; (2) the issue was 'actually litigated' in the prior proceeding; (3) the court in the prior proceeding issued a 'final judgment on the merits;' (4) the determination of the issue was 'essential' to the prior judgment; and, (5) the party against whom the doctrine is asserted was a 'party to or in privity with' a party to the earlier proceeding." Hennessey v. Winslow Township, 183 N.J. 593, 599 (2005). If any of these five elements is not established by the Defendant, the Court's inquiry ends. Perez v. Rent-A-Center, Inc., 186 N.J. 188, 199 (2006).

The issues that Defendant argues should be given preclusive effect here are whether Plaintiff may pursue derivative claims without joining the corporations as parties, and whether Plaintiff may simultaneously bring direct and derivative claims in the same action. Judge Spatt granted Defendants' motion to dismiss as to Plaintiff's derivative shareholder claim for failure to join a necessary party. Tuscano, supra, 403 F. Supp. 2d at 225. As to Plaintiff's cause of action for appointment of a receiver, the court

concluded that this claim should be dismissed for failure to state a claim because, under New York law, a shareholder plaintiff may not join derivative and individual causes of action. Id. at 225-26. It is difficult to reconcile this statement with Judge Spatt's finding of no federal jurisdiction without amending the complaint, and his ruling that he would not exercise pendent jurisdiction over any of the state law issues presented in the federal action. Ibid. Despite this lack of clarity in the decision, because Judge Spatt was providing only "guidance" on the state law claims, this court will not give collateral estoppel effect to his comments on state law.

Defendant argues, however, that these issues were fully considered and resolved in the federal action, that they were actually litigated, and that the entry of a judgment of dismissal is evidence of a final judgment on the merits. Plaintiff contends that the federal action was not actually litigated because it was dismissed pursuant to Fed. R. Civ. P. 19, and a dismissal pursuant to that rule is not an adjudication on the merits, as well as the fact that the present state action involves claims that occurred after the dismissal of the federal action.

In his reply, Defendant relies on the First Circuit decision, In Re: Sonus Networks, Inc., 499 F.3d 47 (1st Cir. 2007), on the issue of collateral estoppel. In Sonus, the case originated in Massachusetts state court, where the court dismissed the case, without leave to amend, for failure to comply with a Massachusetts court rule that requires a shareholder in a derivative action to allege with particularity any efforts made by the shareholder plaintiff to obtain the action he desires from the directors or any reasons for not making that effort. Id. at 54-55. The plaintiff first appealed, but then withdrew the appeal. Id. at 55. In the meantime, the plaintiffs in the consolidated federal

cases that had been filed shortly after the state complaint by different shareholders filed an amended complaint including all of the allegations in the state complaint as well as allegations that had occurred after the state court complaint was dismissed. Ibid. The defendants moved to dismiss the amended complaint on the ground that the dismissal in the state suit barred the federal suit, and the district court granted the motion, finding that the plaintiffs were barred by issue preclusion from litigating the issue of the futility of the demand. Id. at 56. In Sonus, the First Circuit discusses some circumstances where issue preclusion is applicable to bar suit even where the dismissal giving rise to issue preclusion is a dismissal for lack of jurisdiction or failure to join an indispensable party, "which are expressly denominated by Rule 41(b) as not being 'on the merits.'" Id. at 59. The court affirmed the district court's dismissal on the ground of issue preclusion, and explained,

> [t]he principle applies that although, where a judgment for the defendant is not on the merits, the plaintiff is not precluded from maintaining a new action on the same cause of action he is precluded from relitigating the very question which was litigated in the prior action." Id. at 60.

In this case, however, the circumstances are different from those presented in the Sonus case. First, the state court dismissal in Sonus was based on a Massachusetts court rule regarding pleading the futility of demand in derivative actions. Second, the First Circuit made its decision on issue preclusion based on Massachusetts law. The court directly addresses the Massachusetts law of issue preclusion and derivative actions under both Massachusetts and Delaware law. The most significant difference in these two cases however, is that in the case presently before this court, Judge Spatt specifically states that there is no federal jurisdiction over Plaintiff's action and that he will not be exercising supplemental jurisdiction over the state law claims. This circumstance, which is key to

determining the preclusive effect of the Tuscano federal action on the current state court action, has no parallel in Sonus. Additionally, Sonus is a First Circuit case based on Massachusetts law, and not binding on this court.

The New Jersey Supreme Court addressed issue preclusion in Watkins v. Resorts International Hotel and Casino, Inc., supra, 124 N.J. at 406-23.There the Court found that

> Unlike claim preclusion, issue preclusion can result from a judgment even if that judgment was not rendered on the merits. Under issue preclusion, therefore, when an issue of fact or law is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, the determination is conclusive in a subsequent action between the parties, whether the same or a different claim. Id. at 422-23.

The Court nevertheless held that, "because issue preclusion is limited to those issues actually litigated and decided, the determination of standing under federal law does not estop plaintiffs from subsequently asserting claims arising under the same facts." Ibid. Nor should a decision based on a plaintiff's failure to comply with a precondition requisite to the court's going forward to determine the merits of a claim be given preclusive effect. Id. at 417.

New Jersey law also clearly states that the doctrine of collateral estoppel is an equitable doctrine, and "therefore will not be applied when it is not fair to do so." Kozlowski v. Smith, 19 N.J. Super. 672, 675 (App. Div. 1984). The Appellate Division has also noted that "the application of the collateral estoppel doctrine is discretionary and must be applied equitably, not mechanically." Auerbach v. Jersey Wahoos Swim Club, 368 N.J. Super. 403 (App. Div. 2004) (citing Azurak v. Corporate Prop. Investors, 347 N.J. Super. 516, 523 (App. Div. 2002). While the doctrine is designed "to protect litigants from relitigating identical issues and to promote judicial economy," the court must nevertheless "in its exercise of discretion, weigh economy against fairness." Barker v.

Brinegar, 346 N.J. Super. 558, 566 (App. Div. 2002). Additionally, "efficiency is subordinated to fairness, and consequently, if the court is satisfied that efficiency would lead to an unjust result, its application should not be tolerated." Ibid.

Notably, not only is the doctrine of collateral estoppel within the court's equitable discretion under New Jersey precedents, but, more importantly, there was no final adjudication on the merits in the federal action in Tuscano, thus undermining application of collateral estoppel in this case. Judge Spatt did not exercise pendent jurisdiction over Plaintiff's state law claims in the federal action because he found that – without an amendment that Plaintiff never made, there was no federal jurisdiction due to Plaintiff's failure to join an indispensable party, and he dismissed the action without prejudice. When Plaintiff failed to file an amended complaint, the federal jurisdictional defect was not corrected, and Judge Spatt dismissed the complaint with prejudice. It is clear that Plaintiff could not relitigate his federal RICO claims, and he has not sought to do that in this case. Nevertheless, not having exercised pendent jurisdiction, the state law claims were never fully adjudicated and the doctrine of collateral estoppel does not apply. Additionally, the number of months that have passed since the inception of this case, the fact that the court has found the deadlock between the two brothers severe enough to appoint a provisional director, the extensive motion practice that has occurred between the parties, and the reasonable expectations of Plaintiff from the procedural history of the federal case that he could seek adjudication of all but the federal RICO claims in a future action, support a rejection of Defendant's motion to dismiss significant claims in this case on the basis of collateral estoppel. Therefore, the court will deny Defendant's motion to apply issue preclusion here.

Entire Controversy Doctrine

R. 4:30A provides, "non-joinder of claims required to be joined by the entire controversy doctrine shall result in the preclusion of the omitted claims to the extent required by the entire controversy doctrine, except as provided by R. 4:64-5 (foreclosure actions) and R. 4:67-4(a) (leave required for counterclaims or cross-claims in summary actions)." The entire controversy doctrine is

> an equitable preclusionary doctrine whose purposes are to encourage comprehensive and conclusive litigation determinations, to avoid fragmentation of litigation, and to promote party fairness and judicial economy and efficiency, was originally conceived of as a claim-joinder mandate, requiring all parties in an action to raise in that action all transactionally related claims each had against any other whether assertable by complaint, counterclaim, or cross claim. [Pressler, Current N.J. Ct. R., comment 1 on R. 4:30A (2011)].

"The equitable nature of the doctrine bars its application where to do so would be unfair in the totality of the circumstances and would not promote any of its objectives, namely, the promotion of conclusive determinations, party fairness, and judicial economy and efficiency." Id. at comment 3.2.

The entire controversy doctrine is an equitable principle where "applicability is left to judicial discretion based on the particular circumstances inherent in a given case." Mystic Isle Development Corp. v. Perskie & Nehman, P.C., 142 N.J. 310, 323 (1995). "The polestar for the application of the entire controversy rule is judicial fairness." Allstate New Jersey Insurance Co. v. Cherry Hill Pain and Rehab Institute, 389 N.J. Super. 130, 140 (App. Div. 2006) (citing K-Land Corp. No. 28 v. Landis Sewerage Auth., 173 N.J. 59, 74 (2002)). Most importantly, "in considering fairness to the party whose claim is sought to be barred, a court must consider whether the claimant has had a fair and reasonable opportunity to have fully litigated that claim in the original action."

Id. at 140. However, as with the doctrines of *res judicata* and collateral estoppel, the entire controversy doctrine will operate as a bar to the filing of a subsequent action only where "a prior action based on the same transactional facts has been tried to judgment or settled." Arena v. Borough of Jamesburg, 309 N.J. Super. 106, 111 (App. Div. 1998).

Defendant argues that the entire controversy doctrine should bar the current litigation because Plaintiff had the opportunity to "conclusively dispose of" the current matter in the prior action in 2005. Defendant explains that the bulk of the allegations in this case arose from events occurring before or during the pendency of the federal action, that the only new facts concern matters relating to the incorporation of the Delaware corporation, and that the claims are therefore part of the same "transactional nexus" as the federal action and thus barred by the entire controversy doctrine. Plaintiff contends that the current action is not barred by the entire controversy doctrine because the federal action was not adjudicated on the merits and involves different claims arising after the dismissal of the federal action.

Here, the state action clearly includes claims that occurred after the dismissal of the federal action. While Plaintiff does make allegations about a reduction in salary beginning in about 2002-2003, he also makes new allegations that on or about April 13, 2010, Defendant unilaterally reduced Plaintiff's salary by 50% without notice and without allowing Plaintiff to review the corporations' financial records. (Compl. at ¶¶81, 83). Additionally, Plaintiff makes new allegations regarding Defendant's formation of the Delaware corporation and its competition with the other family corporations that occurred after the dismissal of the federal litigation. (Compl. at ¶¶87-88). These claims had not accrued during the federal suit, and are therefore not barred by the entire

controversy doctrine. Also, as explained above in the analysis of the doctrines of *res judicata* and collateral estoppel, this court has concluded that the district court did not exercise pendent jurisdiction over the state law claims in the federal action, and that the state law claims were not adjudicated on the merits. Therefore, because there was no prior final adjudication on the merits and because this action includes claims that had not accrued while the federal suit was pending, this court will not dismiss the complaint based on the application of the entire controversy doctrine.

Failure to Name the Corporations as Parties

Defendant also argues that even if the court does not dismiss the case on *res judicata*, collateral estoppel, or entire controversy grounds, that the complaint should nevertheless be dismissed on the merits for failure to join the corporations as defendants in the derivative action and for joining individual and derivative claims simultaneously in the suit.

In Tuscano, Judge Spatt granted the defendants' motion to dismiss the complaint for failure to join a necessary party because "it is well settled that a shareholder derivative action brought pursuant to Fed. R. Civ. P. 23.1 cannot proceed in the absence of the corporations whose rights are being asserted." Tuscano, supra, 403 F. Supp. 2d at 225. The court found that it lacked jurisdiction over the plaintiff's derivative federal RICO causes of action because Plaintiff failed to join the corporations, which were necessary parties to the action, and that therefore there was no basis for federal jurisdiction. Id. at 229-30. Finally, the court stated that it "declines to determine the sufficiency of the plaintiff's remaining state-law claims. These determinations are best-reserved for a later time, should the plaintiff properly re-plead a complaint establishing an

independent basis of federal jurisdiction," and proceeded to grant defendants' motions to dismiss the state-law causes of action pursuant to Fed. R. Civ. P. 12(b)(1). Id. at 230.

The United States Supreme Court has held that in Shareholder Derivative Actions brought pursuant to Fed. R. Civ. P. 23.1, that "the corporation is a necessary party" to a derivative action and "without it, the case cannot proceed" because "although named as a defendant, it is the real party in interest, the stockholder being at best the nominal plaintiff." Ross v. Berhnard, 396 U.S. 531, 538 (1970).

Plaintiff first contends that the corporations are listed as parties to the complaint in the opening paragraphs to the complaint and that "there is no doubt that the corporate entities have been named and identified as real parties in interest to this action." (P's Opp. at 15-16). Plaintiff also asserts that New Jersey law does not require that a corporation be named as a party to the litigation, arguing that Defendant's reliance on Fed. R. Civ. P. 23.1 as opposed to R. 4:23-3 is misplaced. However, both the Federal Rule and the New Jersey Rule are nearly identical in language, with both stating, "the derivative action may not be maintained if it appears that the plaintiff does not fairly represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association." Looking at the Complaint, the Corporations are not named in the caption as Defendants, except for Northeastern Delaware, and while all of the corporations are listed under the "parties" section of the complaint, they are not identified as defendants. (Compl. at 2, Ullman Cert., Exh. A.). While the court found no published case law interpreting the New Jersey Rule, the fact that it is identical to the Federal Rule suggests that a reasonable interpretation would be to require a plaintiff to name the corporation as parties to the litigation, and Plaintiff has not done so.

Nevertheless, New Jersey is a notice pleading state and R. 4:5-7 provides that all "pleadings shall be liberally construed in the interest of justice." Additionally, Plaintiff notes that R. 1:4-11 provides that failure to comply with all of the caption and format requirements of the rule does not constitute a jurisdictional defect and may be corrected by an amendment to the pleadings. Therefore, Plaintiff will be allowed to amend his pleadings to name the corporations as defendants to this action for the purposes of the derivative claims in the complaint. Due to the nature of the corporations, however, in that they are owned by the two brothers who are already parties here, the court invites the parties to consider entering a consent order to treat those corporations as nominal defendants so that they will not need to retain counsel, and thus conserve corporate funds.

Joining of Direct and Derivative Claims

While in the federal action Judge Spatt noted that there is an inherent conflict in having a party assert both individual and derivative claims in the same action, the court could find no published New Jersey case law to this effect. There are cases, discussed more below, that address the distinctions between individual and derivative claims, but no published precedent directly addresses the potential for conflict. Obviously, the New York district court made no ruling on any New Jersey law issues.

While it seems clear that New York federal courts have addressed this potential conflict of interest when individual and derivative claims are joined in the same action, the same cannot be said for New Jersey courts. In Strasenburgh v. Straubmuller, 146 N.J. 527, 550 (1996), the New Jersey Supreme Court does address derivative suits and notes that "shareholders cannot sue for injuries arising from the diminution in value of their shareholdings resulting from wrongs allegedly done to their corporations." (Citing Pepe

v. General Motors Acceptance Corp., 254 N.J. Super 662 (App. Div. 1992)). The Court explained that "the general rule that claims of diminution in share value are derivative permits a 'special injury' exception" that exists "where there is a wrong suffered by a plaintiff that was not suffered by all stockholders generally or where the wrong involves a contractual right of the stockholders, such as the right to vote." Ibid. (Citing In re Tri-Star Pictures, Inc., 634 A.2d 319, 330 (Del. 1993). However, the case presently before this court does not address a shareholder attempting to sue individually for a diminution in value to his shares, but raises claims of oppression of a minority shareholder.

The Strasenburgh Court addressed the "long recognized sharp distinction between derivative and individual actions" by explaining how to determine whether a claim is derivative or individual depending on the wrongs alleged in the body of the complaint. Id. at 550-51. The Court cites to Delaware case law which has found that a shareholder may maintain an individual action if the shareholder sustained a special injury, which is defined as "a wrong inflicted upon the shareholder alone or a wrong affecting any particular right which the plaintiff is asserting, such as pre-emptive rights as a stockholder, rights involving the control of the corporation, or a wrong affecting the stockholders and not the corporation." Id. at 551, (citing Elster v. American Airlines, Inc., 34 Del. Ch. 94, 100 A.2d 219 (1953)). The Court goes on to explain that certain claims are always derivative, such as claims of waste, whereas claims of breach of fiduciary duty on the part of directors are generally regarded as derivative, "unless the injury to shares is unique" or if the breach causes a special injury. Ibid. Finally, the Court determined that the potential injuries due to self-dealing on the part of the directors applied to all shareholders.

While the Court in Stransenburgh thoroughly discussed the distinctions between direct and derivative claims, the Court did not address the particular issue facing this court. In this case, the particular issue in question is whether derivative and direct claims can be joined in a case involving a closely held corporation where there are only two shareholders. In Brown v. Brown, 323 N.J Super. 30, 36 (App. Div. 1999), the court held that under certain circumstances where the corporation in question is closely held, a court, in its discretion, may treat an action raising derivative claims as a direct action and "exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery." A court may follow this guidance if its finds "that to do so will not unfairly expose the corporation or the defendants to a multiplicity of actions, materially prejudice the interests of creditors of the corporation, or interfere with a fair distribution of the recovery among all interested persons." Ibid.

The court cited to Section 7.01 of the American Law Institute's Principles of Corporate Governance (2005), which discusses Direct and Derivative Actions.[1] Section 7.01(d) provides that, "in the case of a closely held corporation, the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery…." The comment to the section provides further explanation regarding closely held corporations, that "the normal policy reasons for requiring a plaintiff to employ the form of the derivative action may not be present or will be less weighty, even though the action alleges in substance a corporate injury…Similarly, the concept of a corporate

[1] While still considered a minority position, sixteen states including New Jersey have adopted the ALI approach of permitting direct shareholder actions in close corporation disputes. Allan B. Cooper, et al., *Too Close for Comfort: Application of Shareholder's Derivative Actions to Disputes Involving Closely Held Corporations*, 9 U.C. DAVIS BUS. L.J. 171, 182-83 (2009).

injury that is distinct from any injury to the shareholders approaches the fictional in the case of a firm with only a handful of shareholders." (Comment e to ALI §7.01).

In Brown, the court specifically addressed the minority shareholder freeze-out context, and explained that "because of the difficulty in determining if a suit must be brought as a direct or a derivative action, an increasing number of courts are abandoning the distinction between a derivative and a direct action because the only interested parties are the two shareholders…" Id. at 38 (citing Richards v. Bryan, 879 P.2d 638, 647 (Kan. Ct. App. 1994)). The Appellate Division explained that in Brown they saw "merit in plaintiff's contention that it would be inequitable to allow [the defendants] to avoid answering for their conduct by invoking rules of standing that have been developed to meet concerns not present here" and "as a matter of equity," the court permitted the plaintiff to proceed by way of a direct action." Id. at 39. Finally, the court stated that "we have adopted the approach of the ALI's §7.01(d), and we are satisfied on this record that it would be a mistaken exercise of discretion to dismiss the case on standing grounds." Ibid.

Additionally, in Brown the court cites to, though does not directly apply, §7.01(c) which provides that, "if a transaction gives rise to both direct and derivative claims, a holder may commence and maintain direct and derivative actions simultaneously, and any special restrictions or defenses pertaining to the maintenance, settlement, or dismissal of either action should not apply to the other." Brown, supra, 323 N.J. Super. at 36. The comment to this section explains that "in many cases, a wrongful act will both deplete corporate assets and deprive shareholders of a personal right attaching to their shares…No policy suggests that the plaintiff should be forced to elect between these

remedies." (Comment f to ALI §7.01). Finally, the comment provides that while in theory parallel direct and derivative actions brought by the same shareholder could involve a potential conflict, "in general…combining direct and derivative actions both conserves judicial resources and serves the interests of the shareholders not represented in the direct action. In particular it guards against the risk of inconsistent verdicts…" Ibid. While the court in Brown does not specifically endorse this part of § 7.01, the reasoning behind this approach is persuasive to this court in the present context where the only two shareholders of the corporations are parties before the court.[2]

While Brown dealt with a standing issue in that the plaintiff was attempting to continue a shareholder's derivative action after she transferred her shares of stock to her ex-husband in a divorce settlement, the use of the ALI approach is equally applicable in this case. Here, the Tuscano brothers are the only two shareholders in these closely held corporations, and the traditional concerns governing the types of claims that should be called direct and those that should be called derivative are not present. Allowing both types of claims to proceed will not unfairly expose the corporations to a multiplicity of actions or interfere with the fair distribution of recovery among the interested parties because the only two shareholders of the corporations are both involved in this litigation. Also, the wrongful acts alleged by Plaintiff have the potential to harm both the corporations and the individual shareholders, and allowing direct and derivative claims in this case will both conserve judicial resources and guard against inconsistent verdicts. Therefore, using the ALI approach, this court finds that it is appropriate for one 50%

[2] While this court has found that Plaintiff may amend his pleadings to include the corporations in this case as parties, and has invited the parties to consider entering a consent order as to the nominal nature of the corporations as parties, the court also notes that the naming of the corporations as parties in a situation involving closely held corporations where there are only two shareholders may be one of the "special restrictions" envisioned as not applicable to closely held corporations by the ALI in Section 7.01.

shareholder to bring both derivative and individual claims in one action where the only other shareholder is also a party.

Conclusion

For the reasons stated above, and because of both the lateness and futility of the amendment, Defendant's motions to amend and to dismiss are denied.