New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

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An ALM Publication

VOLUME 259—NO. 32

FRIDAY, FEBRUARY 16, 2018

Outside Counsel

Expert Analysis

Business Divorce Cases of 2017 Focus On Oppression, Valuation and LLC Issues

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New York courts last year decided an impressive array of business divorce cases involving closely held corporations, partnerships, and limited liability companies. Among the cases featured in this annual review are important rulings by the First, Second, and Third Departments of the Appellate Division addressing shareholder oppression, marketability discounts in fair-value contests for realty holding companies, the "purposeless purpose clause" in LLC operating agreements, and the interplay between LLC member withdrawal and statutory buy-out rights. Also featured is a novel dissolution dispute between brothers in which the trial court found both sides at fault but nonetheless ordered dissolution conditioned on the majority owner purchasing his brother's interest for fair value.

Shareholder Oppression—Family Style

As any business-divorce litigator knows, shareholder oppression cases can be particularly contentious, especially when they involve family-owned businesses. The Third Department's decision in *Matter of Twin Bay Village*, 153 A.D.3d 998 (3d Dept. 2017), which involved a family feud over a Lake George resort, took the cake last year for exemplifying the most egregious forms of shareholder oppression.

The case pitted a 48 percent passive minority faction against a 52 percent controlling majority, both making up the second and third generation of owners of Twin Bay Village, the company that operated the lakefront resort since its founding in 1957. The control owners, who apparently had built up some resentment from maintaining the property and operating the resort for decades without any assistance from the outside minority, ultimately attempted to force their passive relatives to redeem their shares at a drastically depressed value. According to the petitioning minority—who commenced a dissolution proceeding under Business Corporation Law §1104-a, New York's oppression statute—the majority's conduct represented a classic "freeze-out" scheme in which they selfishly looted, wasted, and otherwise diverted the company's assets to suit their own interests to the minority's detriment.

And freeze out they did. The court-appointed referee to whom the Supreme Court, Warren County referred the matter for a hearing on the merits of the petitioners' claims issued an order

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of dissolution based on over 100 pages of findings of fact and conclusions of law, which included that the respondents:

- took tens of thousands of dollars in annual bonuses that were not contingent on their performance or the company's financial stability and ultimately were carried as debt on the company's books, which had the effect of undervaluing the company and prioritizing the respondents as creditors upon a sale;
- intentionally diluted the petitioners' interests by issuing themselves additional shares of company stock without notice to the petitioners and without regard to their preemptive rights;
- amended the by-laws of the company without notice to the petitioners to allow for a forced sale of their interests at an undervalued price per share upon a discretionary yet binding determination whether they were "actively involved" in the business; and
- took hundreds of thousands of dollars in cash from the company off the books, falsely reported their earnings to the tax authorities, and then funneled a portion of the funds back into the company by way of fictitious shareholder loans, again with the intention of undervaluing the company and prioritizing themselves as creditors.

The Third Department unanimously affirmed the referee's order, expressly rejecting the respondents' narrative that their lopsided involvement in the business justified their treatment of the passive petitioners, and holding that the standard for oppressive conduct "is not focused on the complaining shareholders' level of involvement with the corporation but, rather, their reasonable expectations and whether those expectations were defeated."

We also were treated last year to the latest chapter in a longstanding familial fracas between two brothers over the management of two realty holding companies in Jamaica, Queens—one an LLC, the other a corporation—which the brothers owned 75 percent/25 percent. In *Kassab v. Kasab*, 56 Misc.3d 1213[A] (Sup. Ct., Queens County 2017), after losing his bid to dissolve the LLC and force an equitable buyout of his minority interest therein, the younger brother sought statutory and common-law dissolution of the corporation based on allegations that his older brother froze him out of its management and misappropriated corporate assets, specifically by underreporting the number of cars parking on the undeveloped lot owned by the company.

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The court's grant of dissolution in *Kassab* was of particular interest in at least two respects. First, the court found that, both pre- and post-petition, the parties both engaged in the fiduciary misconduct proscribed by statute and the common law—namely, "by using profits for personal purposes"—and that the "fault on *both* parties" warranted statutory and common-law dissolution as "a viable option to prevent further conduct of this kind."

Second, the court took advantage of the discretionary authority afforded by *Matter of Kemp & Beatley*, 64 N.Y.2d 63 (1984) and its progeny to fashion a suitable remedy in the context of a dissolution proceeding, giving the respondent brother the option to purchase the petitioner's 25 percent stock interest for $3.17 million (as well as an option to purchase petitioner's 25 percent interest in the LLC notwithstanding the prior dismissal of the LLC dissolution petition) within 90 days after which time the court's order of dissolution would take effect.

Appellate Split Over Marketability Discounts?

In determining fair value of the minority brother's shares in *Kassab*, the Queens County Supreme Court adopted the business appraisal of the petitioner's valuation expert, which excluded any separate discount for lack of marketability (DLOM) on the theory that adjustments for market exposure already were baked into the underlying real estate appraisals.

In doing so, the court followed recent Second Department precedent in *Chiu v. Chiu*, 125 A.D.3d 824 (2d Dept. 2015), in which the Appellate Division upheld a 0 percent DLOM in determining the value of a single-asset, realty holding company.

But DLOM seemingly remains alive and well in the First Department, as evidenced by last year's decision in *Matter of Levine v. Seven Pines Associates, L.P.*, 156 A.D.3d 524 (1st Dept. 2017), in which the Appellate Division followed its own precedent in *Matter of Giamo v. Vitale*, 101 A.D.3d 523 (1st Dept. 2012) (applying 16 percent DLOM to realty holding entities) by upholding a 25 percent marketability discount in a proceeding to appraise the petitioner's ownership interest in a limited partnership under Partnership Law §121-1105, which incorporates by reference the procedure to enforce a shareholder's right to receive payment for his shares set forth in BCL §623. As with the corporation in *Kassab*, the partnership in *Seven Pines* was a realty holding entity.

Unlike the Second Department in *Chiu*, however, the First Department continues to recognize the "corporate wrapper" in which the underlying property is held by applying a marketability discount to real estate holding companies, as also reflected in a Manhattan Supreme Court fair-value decision last year in *Matter of Burntisland II LLC*, 2017 NY Slip Op 32482(U) (Sup. Ct., NY County Nov. 20, 2017]) applying the same 16 percent DLOM to a realty holding LLC that was applied by the First Department in *Giaimo*.

Disputes Over Key Provisions In Operating Agreements

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In *Mace v. Tunick*, 153 A.D.3d 689 (2d Dept. 2017), the Second Department addressed the all-important purpose clause contained in an operating agreement of a two-member realty holding LLC in the context of an action for dissolution. We say all-important because, under the well-known *1545 Ocean Avenue* standard for involuntary LLC dissolution, a member can demonstrate entitlement to dissolution by showing, "in the context of the terms of the operating agreement …, that the management of the entity is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved."

The operating agreement in *Mace* contained a standard, boilerplate purpose clause providing that the LLC was formed to conduct "any lawful business," but the plaintiff-member alleged in his complaint that the realty holding company specifically was formed to house a separate chemical company, formerly co-owned by the same parties, which the defendant-member recently had moved out of state. Because the chemical company had vacated the premises and was no longer paying rent to the LLC, the plaintiff claimed that its purpose was no longer being served. The defendant moved to dismiss, essentially arguing that because the LLC's stated purpose was to conduct "any lawful business," and because the property was subsequently leased to an unrelated tenant, it was impossible to conclude that its purpose was not being realized or achieved.

The lower court rejected the defendant's argument as "too facile"—insofar as it would effectively preclude judicial dissolution of any LLC whose operating agreement contained a broad purpose clause—but nonetheless dismissed the complaint, concluding from contemporaneous lease documentation that the purpose of the LLC was to acquire and manage

the property, which purpose was being achieved.

The Second Department, however, reversed the lower court's conclusion as "an impermissible finding of fact" given that the express terms of the operating agreement "did not set forth any particular purpose for [the LLC]." "Neither the operating agreement nor the leases of the property," held the court, "utterly refuted the plaintiff's allegation as to [the LLC's] purpose so as to conclusively establish a defense as a matter of law."

Given the large proportion of LLCs with operating agreements similarly containing "any lawful business" purpose clauses, it remains to be seen whether *Mace* opens a new avenue for non-controlling LLC members to obtain judicial dissolution under the *1545 Ocean Avenue* standard, or at least to demand an evidentiary hearing on the LLC's purpose.

In *Jacobs v. Cartalemi*, 156 A.D.3d 635 (2d Dept. 2017), the Second Department addressed "right of first refusal" transfer provisions contained in an operating agreement of a two-member realty holding LLC in the context of member withdrawal. Notably, the LLC at issue was formed in 1995, when the statutory default rules codified in §§509 and 606 of New York's Limited Liability Company Law authorized as-of-right member withdrawal and a corresponding fair-value payment for the withdrawing member's interest. When the New York State Legislature amended LLCL §606 in 1999 to reverse the default rule on member withdrawal—i.e., prohibiting members from withdrawing absent authority under an operating agreement—it included a grandfather provision preserving the former withdrawal right for members of pre-1999 LLCs unless their operating agreement provide otherwise.

After the parties' business relationship soured, the minority member commenced two consecutive lawsuits asserting both direct and derivative damages claims based on fiduciary breach. During the pendency of those actions, the minority member served notice of withdrawal from the LLC under the former LLCL §606 and demanded payment for the fair value of his 20 percent interest under LLCL §509. When the majority member refused to consent to fair-value buy-out, the minority member commenced a third, declaratory-judgment action claiming that he was entitled to withdraw from the LLC as of right and receive fair value for his interest.

The majority member did not contest minority member's right to withdraw under the former LLCL §606, but did challenge his right to receive payment under LLCL §509 based on the right-of-first-refusal provisions in the operating agreement. The pertinent provision required that any member wishing to sell his interest must first offer it for sale to the other member and only then, if the offeree member did not purchase, to an outside buyer. The plaintiff did not comply with the provision which, the majority member argued, displaced the default rule in §509 providing for a fair-value buy-out by the LLC. The lower court agreed and dismissed the minority member's claim.

On appeal, the Second Department affirmed, holding that the right-of-first-refusal provision in the operating agreement unambiguously "establishe[d] procedures to be used where a member has not received an offer of sale, but nonetheless wishes to relinquish … his … membership interest and to be compensated for the same." In two related appeals decided the same day, the Appellate Division also held that the minority member's withdrawal from the LLC stripped him of standing to pursue his derivative claims in the first two damages actions.

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