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Outside Counsel

Business Divorce Cases of 2018

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In recent years, most of the new and noteworthy case law developments in the business divorce field predictably have involved limited liability companies which, as business entities go, are newcomers relative to business corporations and partnerships. Last year bucked the trend.

Among the cases featured in this annual review are important appellate and trial court rulings addressing the valuation of the interest of a partner found to have caused a wrongful dissolution of a general partnership; grounds for common-law and statutory dissolution in cases brought by minority shareholders of close corporations alleging oppression; standing to seek director deadlock dissolution; and standing to bring derivative claims on behalf of a limited partnership. LLCs were not completely left out of the running, making their mark in a significant decision granting a minority member's dissolution petition.

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Variety of Issues

Business divorce practitioners last year were treated to a number of important appellate decisions, including rulings by the Appellate Division addressing the legitimacy and scope of common-law dissolution and derivative claims. The Fourth Department, in *Feldmeier v. Feldmeier Equipment*, 164 A.D.3d 1093 (4th Dept. 2018), for example, upheld the dismissal of a minority shareholder's common-law dissolution claim alleging exclusion from "de facto" or "disguised" dividends where the defendants established that the disputed payments to the other shareholders constituted legitimate bonus compensation, there was no history of the company declaring dividends, and the payments were not commensurate with their respective stock percentages.

And in *Pokoik v. Norsel Realties*, 159 A.D.3d 459 (1st Dept. 2018), the First Department reinstated a limited partner's standing to assert derivative claims against the general partner after the lower court had disqualified him from "fairly" representing the interests of the partnership due to his allegedly acrimonious and litigious nature.

But the biggest news to come from the New York appellate ranks last year was to be found in *Congel v. Malfitano*, 31 N.Y.3d 272 (2018), in which the Court of Appeals upheld the application of multiple valuation discounts in the context of a wrongful partnership dissolution—including discounts for lack of marketability (DLOM), lack of control (DLOC), and good will—which amounted to approximately 80 percent off of the partnership interest's top-line value.

As we reported in this column a couple years ago, *Congel* involved a minority partner's unilateral attempt to dissolve a commercial real estate partnership by written notice under Partnership Law §62. His majority co-partners later sued for damages resulting from

an alleged wrongful dissolution under their partnership agreement, which subjected voluntary dissolution to majority vote. The majority partners ultimately prevailed and proceeded to trial on the value of their wrongfully-withdrawn partner's interest under Partnership Law §69.

The trial court began with a stipulated value of the minority partner's interest of $4.85 million, then deducted approximately $4 million in damages and discounts, including a 35 percent DLOM. The majority partners sought an additional 66 percent DLOC, but the trial court rejected their argument based on longstanding case law prohibiting the application of DLOC in fair-value proceedings under BCL §§623 and 1118. An appeal followed.

The Second Department ruled in favor of the majority partners, distinguishing the case law applying the "fair value" standard in the corporation context from the "fair market value" standard applicable to partnership interests under Partnership Law §69. Because DLOC is appropriate in fair-market value proceedings, the Appellate Division further discounted the minority partner's interest by an additional 66 percent. Another appeal followed.

The Court of Appeals affirmed in March of last year, holding that the prohibition of DLOC in fair-value proceedings under BCL §§623 and 1118 did not apply in the context of Partnership Law §69, which "does not contemplate a valuation of the entire business as if it were being sold on the open market, but rather a determination of the fair market value of the wrongfully dissolving partner's interest as if that interest were being sold piecemeal and the rest of the business continuing as a going concern." Such an interest, ruled the high court, "is worth less to anyone buying that interest alone." The ruling was not all bad news for the withdrawn partner, who convinced the Court of Appeals that the majority partners' huge legal fees in the lawsuit were not recoverable damages under Partnership Law §69(2)(a)(II).

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Of perhaps greater than its affirmance on the discount issues, however, was the high court's adoption of a contract-centric approach to the wrongful-dissolution issue. The trial court and Appellate Division both agreed that the partnership was not at-will and that the minority partner had wrongfully dissolved under Partnership Law §62—the trial court because the partnership agreement specified a "particular undertaking," and the Appellate Division because the agreement specified a "definite term." The Court of Appeals came to the same conclusion but altogether dispensed with the at-will analysis under the statute, determining instead that "Partnership Law §62 has no application here, because the parties to the agreement clearly specified under what terms [the partnership] could be properly dissolved, i.e., what would constitute a dissolution under the agreement and what would constitute a dissolution in contravention of it."

Dissolution

What would an annual survey of important business divorce cases be without a handful of decisions concerning statutory dissolution under the Business Corporation and LLC Laws? The Commercial Division in New York and Nassau Counties last year gave us at least three decisions worthy of note in this area.

In *Balkind v. Nickel* (2018 NY Slip Op 31703[U] (Sup Ct. NY County, July 16, 2018)), the Manhattan Commercial Division read New York's deadlock dissolution statute, BCL §1104(a), to trump the parties' shareholders agreement when the court denied the petitioner standing to bring a dissolution proceeding based on the two-member board's inability to agree upon the

price at which to list and sell the corporation's sole asset, a building on the Upper East Side.

Section 1104(a) of the BCL provides that "the holders of shares representing one-half of the votes of all outstanding shares of a corporation entitled to vote in an election of directors may present a petition for dissolution" based on deadlock. There was no dispute that the petitioning shareholder-director held a 49 percent stock interest. But the management provisions in the parties' shareholders agreement otherwise gave the parties equal control on a two-member board, requiring unanimous consent on essentially all board and shareholder actions.

The petitioning shareholder-director chose the contractual route. Acknowledging that as a matter of percentages she held a minority stock interest, the petitioner nonetheless argued that "the focus of BCL §1104 is not equal ownership but equal power" and that "because the parties have equal power to elect directors under the terms of the shareholder agreement, [she] ha[d] standing to seek judicial dissolution."

Manhattan Commercial Division Justice Saliann Scarpulla was not persuaded and, despite an express acknowledgement that her decision would "put the parties back at the starting gate" with respect to ongoing efforts to settle their dispute, held to a strict interpretation of the statute. Specifically, the court held that "[u]nder the plain meaning of the statute, [the petitioner], as the holder of 49 percent of the voting stock does not have standing," essentially reasoning that "voting stock ownership…is not the same as equal voting power… in the context of BCL §1104's standing requirement."

The Manhattan Commercial Division also had occasion last year to read New York's shareholder oppression statute, BCL §1104-a, to exclude issues of inspection and transparency from the traditional "reasonable expectations" analysis employed by courts in deciding whether to grant petitioners dissolution of corporations in which they hold minority ownership interests.

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Vaccari v. Vaccari, 2018 NY Slip Op 3546[U] (Sup Ct. NY County, March 28, 2018) involved another real estate holding corporation, which owned a West Side building that housed a second-generation, wholesale-butchery business founded by the parties' grandparents in the 1920s. The case pitted two brothers, collectively holding a 25 percent interest in the company, against a third brother who held a 75 percent controlling interest in the business.

The petitioning brothers sought dissolution under BCL §1104-a which permits a court to dissolve a corporation on the basis of, among other misconduct, the control-owners' "oppressive actions toward the complaining shareholders." Case law over the years has interpreted "oppressive actions" to mean the kind of conduct that defeats the minority owners' "reasonable expectations" associated with joining the business.

Petitioners in dissolution proceedings brought under BCL §1104-a often complain that the control-owners have frustrated their expectations of ownership by, for example, arbitrarily terminating their employment, discontinuing their receipt of distributions and dividends, or removing them from the board of directors. But not the petitioners in *Vaccari*. They instead claimed that their brother had oppressed them based on his "failure to provide business records, coupled with the lack in transparency of [his] business decisions."

Recently-retired Manhattan Commercial Division Justice Eileen Bransten was not receptive, finding that a "[f]ailure to grant access to books and records does not, alone, constitute the type of shareholder oppression warranting corporate dissolution." This is particularly

true, found the court, when the petitioners have "admitted to receiving certain books and records" and when they otherwise "fail to supply the corporation with the required affidavits" under BCL §624.

The court also rejected the minority brothers' claim concerning transparency, citing the basic rule of corporate governance that "decision-making power respecting corporate policy will be reposed in the holders of a majority interest in the corporation." Thus, as with the majority brother's alleged denial of the petitioners' rights of inspection, "the failure to include the minority shareholders in decisions made during the ordinary course of business, and [his] unilateral decisions which affect the corporation, do not give rise to a cause of action for minority shareholder oppression."

Finally, we would be remiss not to highlight a case involving LLC dissolution, which, as business divorce practitioners no doubt know by now, involves a standard altogether different from the traditional standards of deadlock and oppression associated with corporations.

Ever since the Second Department's seminal *1545 Ocean Avenue* decision in 2010, which expressly divorced LLC Law §702 from the law as it has developed under BCL §§1104 and 1104-a, dissolution of an LLC requires the petitioning member of an LLC to show either that (1) management is unable or unwilling to promote the business to achieve its stated purpose, or (2) continuing the business is financially unfeasible. *In re 1545 Ocean Ave., LLC*, 72 A.D.3d 121 (2d Dept. 2010).

In *Matter of D'Errico*, Decision & Order, Index No. 610084/2016 (Sup Ct. Nassau County, Aug. 21, 2018), the Nassau County Commercial Division analyzed *1545 Ocean Avenue*'s standard to find, post-trial, that the subject company had been relegated to "puppet" status and its continued existence rendered meaningless by the majority members' misconduct.

Matter of D'Errico involved a company called Epic Gymnastics, LLC (Epic) formed to operate a local gymnastics and exercise facility. The parties never entered into an operating agreement for Epic, but testimony during trial established that the purpose of the company was to "jointly operate a high quality gymnastics facility," which purpose later was expanded to include other exercise classes.

Epic soon fell on hard financial times and began racking up debt, much of it personally incurred or guaranteed by one of the minority petitioners. Meanwhile, the majority respondents locked the petitioners out of the company's facility and bank account and formed a related company called BeyondEpic in which petitioners had no ownership interest. BeyondEpic began collecting from Epic's customers, depositing the funds into Epic's account, and utilizing the facility from which the petitioners had been excluded.

Following a trial on the dissolution claim, in what amounts to a rare victory for a minority member of an LLC suing under §702, Nassau Commercial Division Justice Timothy S. Driscoll promptly ordered dissolution, finding that "it appears that BeyondEpic has reduced Epic to a marionette to be manipulated at will by BeyondEpic," and that it was therefore "nihilistic for [Epic] to continue."

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