ALM | LAW.COM

New York Law Journal

Business Divorce Cases of 2023

By Peter A. Mahler and Matthew D. Donovan

February 26, 2024

A trio of significant rulings by the Appellate Division dominated the business divorce caselaw arena in 2023. The Second Department weighed in with a pair of rulings limiting the lower courts' authority to order a closed auction sale of a dissolved corporation's assets and, in an apparent ruling of first impression, recognized an estate's standing to seek judicial dissolution of a limited liability company under Section 608 of the LLC Law.

The First Department also contributed a novel ruling giving life to an oral voting agreement among members of an LLC.

Not to be left out of the spotlight, last year the Manhattan Commercial Division handed down a thoughtful decision reconciling case precedent concerning the circumstances under which a non-managing member of an LLC nonetheless can be saddled with fiduciary duties.

Corporate Dissolution and Liquidation in the Second Department

It's no secret that business-divorce litigators regularly turn to the provisions for judicial dissolution under Article 11 of the Business Corporation Law in a strategic effort to force a liquidity event for their clients.

By **Peter A. Mahler**

And **Matthew D. Donovan**

A common strategy is to compel an equitable buyout of one owner's stock interest by the other for "fair value" under the Court of Appeals' seminal 1984 decision in *Matter of Kemp & Beatley* and its progeny, which afford courts a discretionary alternative to bringing about the demise of an otherwise functional business.

The case-law remedy of a judicially-compelled equitable buyout, however, is limited to dissolution sought on the grounds of shareholder "oppression" under BCL §1104-a, as opposed to "deadlock" under BCL §1104. When proceeding under BCL §1104, dissolution means dissolution.

Once a corporation is dissolved under BCL §1104, the shareholders may agree on the wind-up and disposition of the company's

PETER A. MAHLER *is a business divorce partner and* MATTHEW D. DONOVAN *is a commercial litigation partner at Farrell Fritz.*

assets under BCL §1005 ("Procedure after dissolution"). If they can't agree as often is the case, the court has the discretion under BCL §1111 ("Judgment or final order of dissolution") to include in its dissolution order directives concerning "the distribution of the property of the corporation to those entitled thereto according to their respective rights." But according to the Second Department in *ANO, Inc. v. Goldberg* (216 AD3d 766 [2d Dept. 2023]), that discretion does not extend to directives ordering a private sale.

Last year's *ANO* decision arose out of a particularly contentious litigation involving 50/50 owners of a New York corporation, ANO, Inc., that owned a Massachusetts commercial property indirectly through majority interests in two other companies. The protracted litigation, which to date has spanned the better part of 15 years, first involved fights over the parties' percentage ownership of ANO, Inc. followed by a petition for dissolution under BCL §1104 based on deadlock and an inability to elect directors in one of the underlying companies.

The First and Second Departments were not the only courts last year to address novel issues and arguably fashion new precedent for businessdivorce litigators in the coming years.

The Nassau County Commercial Division ultimately issued an order granting the dissolution petition without any directives as to the wind-up of ANO, Inc.'s business, *i.e.*, the sale of its majority interest in the underlying company.

After the Second Department affirmed, the parties went back to the trial court to address their disputes over the disposition of ANO, Inc.'s assets, including the petitioner's motion to have a temporary receiver appointed to oversee the sale of its stock in the underlying company.

Anthony deLorenzi/Adobe Stock

The trial court granted the motion and appointed a receiver to oversee a closed private auction at which the parties would each submit sealed bids to purchase the other's 50% interest.

The respondent moved to vacate the order of appointment, including the private-auction directives, arguing that it unfairly would require him as winning bidder to remove petitioner as personal guarantor of an outstanding $600,000 mortgage loan on the property. At the private auction, which was held while the motion was pending, the respondent failed to submit a bid, and the petitioner was declared the winner.

The trial court ultimately denied the respondent's motion to vacate. The respondent took another appeal, arguing that the private auction was invalid because he never consented to any terms concerning the disposition of the mortgage loan and the petitioner's personal guarantee.

The Second Department agreed, holding that "[w]hen the parties cannot reach an agreement amongst themselves with respect to the sale of the corporation's assets either to one another or to a third party, the only authorized disposition of corporate assets is liquidation at a public sale.

Because the parties were not able to reach a full agreement as to the terms of the private sale,

the Supreme Court did not have the authority to authorize the sealed-bid auction" (citations and quotations omitted).

LLC Dissolution and Standing in the Second Department

The Second Department last year issued a novel ruling on the subject of dissolution in *Andris v. 1376 Forest Realty, LLC* (213 AD3d 923 [2d Dept. 2023])—specifically, on the subject of standing to seek judicial dissolution under Articles VI and VII of the Limited Liability Company Law.

There is an important distinction throughout the LLCL between a *bona fide* "member" entitled to the full panoply of rights and powers associated with owning and operating an LLC and an "assignee" whose ownership status is limited to an "economic interest holder." Under LLCL §603, an assignee holding a mere economic interest is simply "entitle[d]…to receive, to the extent assigned, the distributions and allocations of profits and losses to which the assignor would be entitled."

> The Manhattan Commercial Division, for example, considered the existence and scope of fiduciary obligations of non-managing LLC members amidst the backdrop of what it deemed "unclear" jurisprudence on the topic in 'Doeblin v. MacArthur.

This distinction often is highlighted under circumstances involving the death of an LLC member whose interest passes to her estate. Absent an operating agreement containing specific provisions addressing the death of a member, the deceased member's estate is relegated to assignee status.

Section 608 of the LLCL would appear to address such circumstances, providing that "[t]he member's executor, administrator, guardian, conservator or other legal representative may exercise all of the member's rights for the purpose of settling his or her estate or administering his or her property, including any power under the operating agreement of an assignee to become a member."

Prior lower court decisions denying estate representatives standing to bring derivative actions on an LLC's behalf arguably implied the same restriction on judicial dissolution proceedings.

Andris proved otherwise. The case involved 50/50 owners of a real estate holding company with no written operating agreement. A few years after one of the members died, her estate sought dissolution of the LLC based on allegations of the surviving member's mismanagement and overall financial unfeasibility of the business. The estate also asserted a cause of action for an accounting.

The surviving member moved to dismiss the accounting claim, and the estate cross-moved for summary judgment on its claim for dissolution. After Supreme Court, Richmond County denied the estate summary judgment, the surviving member made her own motion for summary judgment dismissing the estate's dissolution claim, which the court granted. Neither party raised the issue of standing in the course of their briefing. Nor did the trial court raise the issue in its decisions on the parties' motions.

The estate appealed both summary judgment decisions concerning its dissolution claim. Again, neither party raised the issue of standing in their appellate briefs. The Second Department decided in the estate's favor and reinstated its petition for dissolution, holding *sua sponte* that "[a]lthough the death of a member of a limited liability company does not trigger dissolution of that limited liability company, Limited Liability Company Law §608 provides that a deceased member's executor may exercise all of the member's rights for the purpose of settling his or her estate.

Thus, contrary to the respondents' contention, the petitioner, as executor of the decedent's estate, has the authority to exercise the decedent's rights in the LLC for the purpose of settling the estate" (citations and quotations omitted).

LLC Member Voting Agreements in the First Department

In another novel appellate ruling, the First Department last year in *Tsai v. Lo* (212 AD3d 547 [1st Dept. 2023]), deemed enforceable an oral LLC *member* voting agreement despite longstanding precedent strictly construing *shareholder* voting agreements in the corporation context.

The limited liability company has been with us since 1994 when the legislature adopted the New York Limited Liability Company Law. In the decade or so that followed, with little precedent to draw upon, New York courts often borrowed from Business Corporation Law jurisprudence when deciding cases involving LLCs. But over time, courts have come to acknowledge and appreciate the LLC at is its own animal, separate and distinct from the corporate and partnership species, and have generally determined that – to quote the Second Department's seminal decision on the topic in *Matter of 1545 Ocean Avenue* (72 AD3d 121, 126 [2d Dept. 2010]) – "it would be inappropriate…to import [legal principles] from the Business Corporation Law or Partnership Law to the Limited Liability Company Law."

Take the subject of voting agreements, for example. New York courts have long held under BCL §620 ("Agreements as to voting") that shareholder voting agreements, which generally permit shareholders to agree in advance to vote their shares in a certain way, cannot wholesale deny a shareholder the right to vote; can be analyzed by courts to determine whether they promote a proper corporate purpose; and, most particularly, must be "in writing and signed by the parties thereto." Not so for LLC voting agreements, at least according to the First Department in *Tsai*.

Tsai involved a dispute between 50/50 family factions (the Tsai family and the Lo family) in a real estate holding company called Kissena HTL, LLC, through which they purchased a building in Flushing, Queens to be renovated and sold for a profit. In order for Kissena to purchase the building, Tsai loaned Lo more than $6 million so that Lo could make the requisite contribution to Kissena to consummate the transaction. Tsai's loan was secured by Lo's interest in Kissena. After Lo defaulted on the loan, Tsai brought suit to foreclose on Lo's interest.

Lo answered and counterclaimed for specific performance, alleging that the parties entered into a contemporaneous oral agreement by which Tsai agreed to cause Kissena to sell the building upon Lo's request to allow Lo to repay Tsai's loan. Lo alleged that Tsai rejected offers made by multiple buyers presented by Lo, refused to vote Tsai's Kissena units for the sale of the property, and instead commenced the foreclosure action. Tsai ultimately prevailed at trial in Supreme Court, New York County, which read the oral agreement as an agreement for the sale of real property that violated the statute of frauds requiring such agreements to be in writing.

On appeal by Lo, the First Department reversed, holding that the parties' oral agreement "was not an unenforceable oral contract for the sale of real property, as it did not provide for the sale or transfer of real property or any party's interest in real property." Instead, the court found that Lo "sufficiently pled that the oral agreement was effectively an LLC voting agreement under which plaintiff agreed to vote her membership interest in favor of defendants' sale of their membership interests or a sale of the property."

Non-Manager Fiduciary Liability in the Commercial Division

The First and Second Departments were not the only courts last year to address novel issues and arguably fashion new precedent for business-divorce litigators in the coming years. The Manhattan Commercial Division, for example, considered the existence and scope of fiduciary obligations of non-managing LLC members amidst the backdrop of what it deemed "unclear" jurisprudence on the topic in *Doeblin v. MacArthur* (2023 NY Slip Op 30133[U] [Sup Ct, NY County 2023).

Doeblin involved disputes over the management of a fledgling, uptown Manhattan location of a small chain of independent bookstores called Book Culture. The subject disputes, which included allegedly unauthorized and self-interested negotiations with the store's landlord, arose between two feuding members, neither of whom held a majority interest in the LLC.

In his complaint alleging various business torts, including breach of fiduciary duty, the plaintiff claimed that the defendant-member "breached his duty to him and [the company] when he attempted to negotiate a new lease for a different bookstore with the landlord of the [uptown location]."

Specifically, the plaintiff alleged that the defendant-member "went behind [the plaintiff's] back and commenced his own negotiations with the landlord in order to secure the retail space for a competing bookstore," and that by doing so "was effectively negotiating against [the company's] interest by trying to secure a lease at the Book Culture location for a competing company."

According to the company's operating agreement, however, the plaintiff was the sole manager of the business with complete authority and discretion to act on its behalf. The defendant moved to dismiss for failure to state a claim, arguing that the plaintiff failed to allege the existence of any fiduciary duty owed by the defendant as a non-managing member.

In opposition, the plaintiff pointed to allegations in the complaint that, notwithstanding the management provisions in the operating agreement, the defendant "regularly injected himself into management activities"; "act[ed] in a managerial capacity"; and was "entrusted by [the plaintiff] to contact the landlord for the purpose of exploring whether [the defendant] could assume the role of personal guarantor of the lease."

The court launched its analysis by acknowledging the existence of a lacuna in the law as concerns non-manager fiduciary liability in the LLC context, noting that "[w]hile managing members of an LLC owe non-managing members a fiduciary duty, it is not entirely clear, in this jurisdiction, whether a non-managing member, like [the defendant-member], owes a fiduciary duty to [the plaintiff], the managing member."

The court then addressed prior case law on the issue and synthesized the following new rule from the unsettled precedent: "Taken together,… it appears that a fiduciary duty is imposed upon the non-managing member who shares management duties or takes control of management duties where management duties are not shared."

The court applied its newly-formulated rule to the allegations in the plaintiff's complaint and dismissed his claim for breach of fiduciary duty "concerning the negotiation of the lease behind [the plaintiff's] back." The court found that "the [complaint] and the facts in opposition are devoid of any allegations that [the defendant] shared management duties with [the plaintiff] or assumed any managerial duties at the time [the defendant] allegedly spoke with the landlord," and that the plaintiff otherwise failed to allege "whether these activities are managerial duties."

Reprinted with permission from the February 26, 2024 edition of the NEW YORK LAW JOURNAL © 2024 ALM Global Properties, LLC. All rights reserved. Further duplication without permission is prohibited, contact 877-256-2472 or asset-and-logo-licensing@alm.com. # NYLJ-2272024-54678