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Business Divorce Cases of 2021

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Selecting the most noteworthy decisions from a year's worth of business divorce cases normally is a daunting challenge given the volume and diversity of such cases involving corporations, partnerships, and the new, reigning champion among closely held business entities—the LLC. But not for 2021, a year in which a series of important rulings by the Commercial Division and the Appellate Division, First, Second, and Fourth Departments, unquestionably led the pack in clarifying both substantive and procedural rules governing disputes among business co-owners.

Cases of the procedural ilk highlighted in this year's review include a decision declining subject matter jurisdiction in a dissolution case involving a foreign LLC despite a forum selection clause placing jurisdiction exclusively in New York courts, and a decision granting judicial dissolution in a summary proceeding where the respondents failed to proffer evidentiary support for their position or to request an evidentiary hearing.

On the substantive side, this year's review features decisions holding that common law dissolution is not an available remedy for LLCs; that allegations of oppression and squeeze-out typically found adequate in dissolution cases involving close corporations generally do not have traction in LLC cases; that noncompliance with notice provisions in an operating agreement will invalidate dilutive capital calls; and, in what likely is last year's most consequential decision, that the fraud/illegality exception to the exclusive appraisal remedy following a cash-out merger involving a close corporation does not apply to cash-out mergers involving LLCs.

LLC Dissolution

Five years ago in this column, we reported on the First Department's decision in *Raharney Capital LLC v. Capital Stack LLC*, 138 A.D.3d 83 (1st Dep't 2016), which resolved a split in appellate authority and held that New York courts lack subject-matter jurisdiction over the dissolution of foreign business entities. But what happens if the owners of a New York-based foreign company consent to the exclusive jurisdiction of New York courts via a forum-selection clause in their operating agreement? The Manhattan Commercial Division addressed the issue last year in *Durst Buildings Corp. v. Edelman Family Co.* (Decisions and Orders (Sup. Ct., NY County, July 8 and 15, 2021, Index No. 652036/2021)).

In *Durst*, two 50/50 members of a Manhattan based art-leasing business organized as a Delaware LLC found themselves litigating claims concerning the dissolution of the company in a New York court without either of them raising a *Raharney*-type objection to forum—likely due to a provision in their operating agreement providing that "[t]he Company and each of the Members consent to the jurisdiction of any state or federal court sitting in … Manhattan," and waiving any right

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to commence an action in any court outside of Manhattan.

Despite hearing no such objection from the parties, the court sua sponte questioned its authority to dissolve a Delaware company and ultimately directed the parties to brief the issue based on *Raharney* and other New York and Delaware precedent, including case law standing for the proposition that "[a]lthough the Court generally will respect the parties' choice of forum, the parties cannot contract for jurisdiction where it otherwise is unavailable."

The court ultimately dismissed the case without prejudice, holding that "this court lacks subject matter jurisdiction over [the dissolution-related claims, which] can and should proceed in Delaware."

The Commercial Division last year also addressed the availability (or lack thereof) in the LLC context of certain time-honored grounds for corporate dissolution.

The Second Department made clear over a decade ago in the landmark case of *Matter of 1545 Ocean Ave. LLC*, 72 A.D.3d 121 (2d Dep't 2010), that the standard for judicial dissolution of an LLC is found exclusively in §702 of the LLC Law, i.e., not in the Business Corporation Law or Partnership Law. The Kings County Commercial Division reiterated that holding last year in *Pachter v. Winiarsky* (Decision and Order (Sup. Ct., Kings County, July 12, 2021, Index No. 502779/2020)), when it ruled that the doctrine of common law dissolution of close corporations, recognized by the Court of Appeals in *Leibert v. Clapp*, 13 N.Y.2d 313 (1963)), is inapplicable in the LLC context.

Pachter involved four realty holding LLCs, each of which was owned 50/50 by the petitioner and respondents. The petitioner alleged a classic scheme of oppression, freeze-out, and misappropriation of more than $6 million of company income on the part of the respondents. Presumably aware of the unavailability of minority shareholder oppression as a ground for LLC dissolution, the petitioner asserted claims for dissolution of the LLCs under both LLCL §702 and the common law.

Having initially upheld the petitioner's common law dissolution claim on a prior pre-answer motion to dismiss, the court was given a second opportunity to consider the claim in an amended pleading. This time, the court reversed itself and dismissed the claim based on certain unidentified "technicalities" in the law as between dissolution of corporations and LLCs. On the petitioner's motion for leave to reargue, the court held firm on its reversal: "[T]his court is bound by *Matter of 1545 Ocean Avenue* which interpreted [LLCL §702] as foreclosing all other forms of dissolution."

The Appellate Division, First Department last year also indirectly touched on the concept of minority owner oppression in the LLC context in *Simon v. Moskowitz*, 193 A.D.3d 520 (1st Dep't 2021)). The decision's backstory involved allegations of minority oppression by a controlling majority in a realty holding LLC in the Bronx. The octogenarian minority member claimed she was the subject of a calculated squeeze-out scheme implemented to force the sale of her 19% interest to the majority for a pittance—including the majority's cut-off of distributions on which she relied for retirement income and to cover personal tax liabilities on her share of the company's net income; the build-up of millions of dollars in retained capital for no apparent business reason; and the unilateral refinancing of the building's mortgage, which added more than a million dollars to the company's cash reserves.

Presumably recognizing the unavailability of oppression as a means to force dissolution under *1545 Ocean Avenue*'s restrictive reading of LLCL §702, the minority in *Simon* marshalled her allegations to support direct and derivative claims for breach of fiduciary duty, conversion, and an accounting. The majority ultimately obtained summary judgment dismissing the complaint, successfully arguing that despite being characterized as "oppressive," its acts concerning the company's distribution policy, retention of cash reserves, and mortgage refinancing were protected by the broad authority afforded LLC managers under the company's operating agreement and LLCL §202, as well as by the

common law business judgment rule. The minority appealed.

The First Department sided with the majority, holding that "[t]he motion court properly found that [the minority] … acted contrary to [the LLC's] legitimate purposes," and that "the operating agreement provided [the majority] with authority to determine when and if to make distributions, and the court will not second guess a decision protected by the business judgment rule."

Family-Owned Business Disputes

The Appellate Division also was busy last year addressing family-owned business disputes, especially upstate in the Rochester-based Fourth Department.

Matter of Brady v. Brady, 193 A.D.3d 1434 (4th Dep't 2021), which involved a petition brought under BCL §1104-a by a son against his father and brother to dissolve the family farm business including extensive acreage, presented an archetypal family-owned business dispute, showcasing all the hallmarks of such disputes: an elderly patriarch unwilling to cede control to the next generation; no succession planning; brotherly infighting; no shareholder agreement; an absence of corporate formalities; messy books and records; and personal use of corporate assets.

Matter of Brady also exhibited some of the procedural particularities commonly associated with summary dissolution proceedings brought under Article 4 of the CPLR which effectively require the litigants to support their claims and defenses with evidentiary materials in the manner of a summary judgment motion. The petitioner apparently did his homework in this regard, supporting the statements made in his verified petition with documentary evidence of share issuances, corporate tax returns, and K-1s all establishing his requisite percentage ownership, as well as with other evidence of respondents' "fraudulent and oppressive conduct." In contrast, the respondents merely offered "unsubstantiated denials or allegations of a purported lack of knowledge or information" and did not otherwise ask to be heard on the petitioner's claims. As a result, the lower court granted the petition to dissolve the farm business. Respondents appealed.

The Fourth Department affirmed, concluding that "the [lower] court properly determined on the record before it that dissolution was required inasmuch as respondents engaged in oppressive actions toward the complaining shareholder, i.e., petitioner." The court also held that because they did not request an evidentiary hearing, "respondents' contention that the [lower] court abused its discretion in ordering dissolution summarily, without a hearing, is unpreserved."

The Fourth Department last year also addressed an issue of corporate informality in *McGuire v. McGuire*, 197 A.D.3d 897 (4th Dep't 2021), involving a dispute among four siblings in a family-owned, real-estate development empire overseen by an LLC management company managed by one of the siblings. The dispute arose amidst buyout negotiations between three of the siblings and their manager-brother, and primarily concerned the dilution of their ownership interests as a result of their brother issuing by email a series of capital calls under the company's operating agreement to which they did not respond. The operating agreement's capital-call provision authorized dilution of the interests of any member who chose not to answer the call, and the three siblings soon learned from the company's tax filings that their respective interests effectively had been halved while their brother's interest doubled.

The buyout negotiations went sideways, and the three siblings brought suit against their brother, alleging inter alia that the dilution was improper—in part because he failed to follow the notice provision in the agreement, which required him to send notice of capital calls by regular mail rather than by email. The lower court ultimately granted summary judgment in the brother's favor and dismissed the siblings' complaint, finding that they waived their right to object to the emailed notices as improper. The siblings appealed.

Citing the standard for waiver and taking into account the "unique business context of the contested capital calls—i.e., that they were all made at a time when [the sib-

lings] were in active negotiations with [their brother] about a buyout where [they] would exit [the company]"—the Fourth Department reversed and held that "there is no historical pattern of conduct that would support the conclusion that [the siblings] waived the notice requirement prior to any of the capital calls at issue here," and that the siblings' communications at the time of the capital calls "do not reflect any intent to waive the notice requirement."

LLC Dissenting Member Appraisal Rights Defined

We close this year's column with a long-awaited appellate decision from the Second Department in *Farro v. Schochet*, 190 A.D.3d 689 (2d Dep't 2021), on the scope of a dissenting minority member's rights following a cash-out merger under the LLCL.

When a cashed-out minority member dissents from a merger, LLCL §1005(b) provides that if the parties fail to agree on the price to be paid for the former member's interest, the procedure provided for in BCL §623 for judicial appraisal proceedings "shall apply" to determine the fair value of the interest. BCL §623(k), in turn, includes a common law fraud or illegality exception, which permits a dissenting shareholder in the corporation context to "bring or maintain an appropriate action to obtain relief on the ground that [the merger] will be or is unlawful."

The issue squarely presented in *Farro* was whether a dissenting minority member of an LLC can challenge a cash-out merger under the fraud/illegality exception found in BCL §623(k) even though the exception is absent in LLCL §1002 (g), which provides that the dissenting member in the LLC context "shall not have any right at law or in equity … to attack the validity of the merger … or to have the merger … set aside or rescinded."

In *Farro*, the two majority members of the LLC, by written consent in lieu of meeting, approved a merger of the company into a surviving entity in which the third member would not be a member, but instead would be offered the cash value for his former membership interest. The minority member filed an action to rescind the merger under the fraud/illegality exception in BCL §623 (k), claiming that one of the two majority members had acquired his ownership interest under fraudulent pretenses. The lower court allowed the plaintiff to proceed on his rescission claim, altogether ignoring the defendants' arguments based on *Appleton Acquisition, LLC v. National Housing Partnership*, 10 N.Y.3d 250 (2008), where the Court of Appeals held that the statutory provisions governing mergers in the RLPA—from which the corresponding provisions in the LLCL were lifted almost *verbatim* including its incorporation of BCL §623(k)—prohibit a dissenting limited partner from seeking rescission and damages based on allegations of fraud or illegality in connection with the merger, and that the dissenting partner's exclusive statutory remedy is an appraisal proceeding. The defendants appealed.

In an important decision of first impression by an appellate court, the Second Department reversed the lower court's ruling and dismissed all of the plaintiff's claims, citing *Appleton* in support of its holding that the plaintiff's membership in the LLC "was terminated by the merger" and that "the language of [LLCL §1002(g)] makes clear that an appraisal proceeding is the member's 'sole remedy,' and no exception exists for alleged fraud or illegality in the procurement of the merger."

In a second first-impression ruling by an appellate court, the Second Department in *Farro* also affirmed the defendants' right to approve the merger by written consent in lieu of meeting, holding that the default rule under LLCL §407 (a), authorizing action by written consent, trumped LLCL §1002 (c)'s provision for approval of mergers at a meeting of the members held on at least 20 days' notice.