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Business Divorce Cases of 2019

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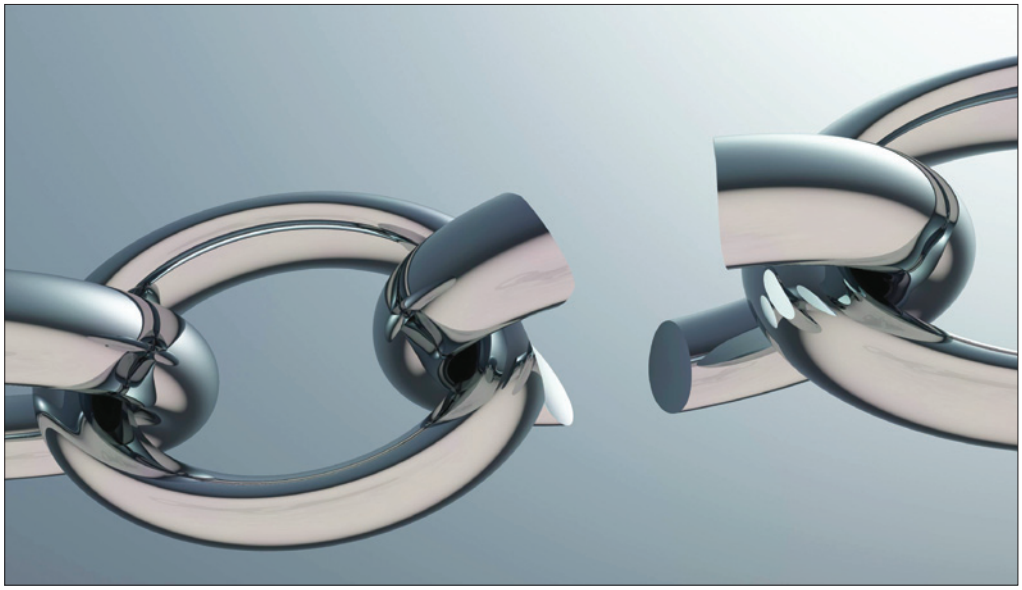

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Last year's most noteworthy business divorce cases are marked by a diversity of subject matter, spanning a gamut of disputes among co-owners of limited liability companies, limited liability partnerships, and business and professional corporations. They also feature geographic diversity, with an unusual number of important decisions rendered by upstate judges.

Among the cases highlighted in this year's review are trial court rulings: applying partnership law to law firm dissolution cases brought by lawyers with a "partner" title whose status as equity partners was disputed; finding that a female minority shareholder of a professional corporation accounting firm was oppressed by her fellow shareholders who failed to take appropriate action against offensive workplace behavior; addressing an allegedly oppressed minority shareholder's "reasonable expectations" concerning the allocation of proceeds from the sale of a family-owned company; and resolving several disputes among LLC members involving dissolution, "quasi-dissolution" of a foreign LLC, and manager removal.

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Law Partnership Breakups

These days New York courts rarely publish decisions addressing business-divorce issues within the context of the antiquated Partnership Law. One sector that defies the trend, and continues to generate partnership disputes with some regularity, is the legal industry, owing to the many law firms organized as limited liability partnerships that are governed by the general Partnership Law.

In *Barrison v. D'Amato & Lynch, LLP*, 2019 NY Slip Op 30905[U] (Sup. Ct. NY County, April 2, 2019), the Manhattan Commercial Division addressed the age-old "indicia of ownership" issue arising out of a claim by the plaintiff-former partner that he was a bona fide equity partner of the defendant-law firm, entitling him to seek dissolution of the firm and an accounting under Partnership Law §§62-63, and that the firm was estopped as a matter of law from claiming otherwise. Barrison's primary evidence of ownership: more than a decade of K-1 tax forms filed

by the firm showing him as a "general partner" with a "capital account."

The court disagreed with Barrison and granted summary judgment for the firm, holding that "[t]ax returns, without any other indicia of partnership, are insufficient." Instead, true equity status depends on a number of factors, "including sharing in profits and losses, exercising joint control over the business, and making capital investment and possessing an ownership interest in the partnership." Because Barrison could not show that he "actually contributed capital to, possessed an ownership interest in or shared in the losses of the firm," or that he had any "control over the firm's policies," the court found that he was not a true equity partner.

The legal industry's fluid use of the term "partner" also played a part last year in *Capizzi v. Brown Chiari LLP*, 2019 NY Slip Op 51471[U] (Sup. Ct. Erie County, Sept. 13, 2019). In *Capizzi*, the Erie County Commercial Division addressed virtually identical issues of ownership in the context of the plaintiff-former partner's resignation, which he too claimed caused dissolution of the defendant-law firm and entitled him to an accounting under the Partnership Law. The protracted history of the *Capizzi* litigation, however, led the court to rely on an additional estoppel doctrine to arrive at a different conclusion.

Following a lengthy trial, the court ruled in favor of Capizzi, concluding that the firm was "collaterally estopped"—based on the opposite position it took in a prior trial involving the same parties and a different withdrawing partner—from denying that Capizzi was an equity partner. The court also relied on the tax estoppel doctrine to conclude that the firm "may not take a position contrary to a position taken in an income tax return"—which included years of K-1 tax forms identifying Capizzi as a partner with a capital account and "certifying that he was personally responsible for [the firm's] debts." Thus, based on its application of both estoppel doctrines, the court found that "Capizzi was an equity partner as of the date of his resignation."

Creatures of contract that they are, **LLCs and the terms of the operating agreements** under which they exist and function, continued to be the subject of business-divorce decisions in 2019.

Other Important Upstate Decisions

Speaking of Erie County, last year saw two additional, important business-divorce decisions by upstate courts, including one from the state's capital. In *Hanley v. Hanley*, 2019 NY Slip Op 50970[U] (Sup. Ct. Albany County, June 13, 2019), the Albany County Commercial Division addressed a fight among three siblings over tens of millions of dollars in proceeds from the sale of a family-owned business. After the deal closed, two of the siblings, representing a 75% majority, presented an ultimatum to their 25% minority brother: Take a "severance package" worth around $11 million—which essentially accounted for his pro rata share of the amount paid at closing but shorted him out of certain future earn-out payments that also were part of the transaction—or redeem his shares for "fair market value" as determined by the company's accountant under an involuntary redemption provision in their shareholder's agreement. Seeing that the decks were stacked against him, the minority brother petitioned for dissolution under New York's shareholder oppression statute, §1104-a of the Business Corporation Law (BCL).

The majority siblings moved to dismiss the petition, arguing that their $11 million "severance package" offer negated their brother's claim that his reasonable expectations as a shareholder had been "substantially defeated"—the standard for establishing oppression under BCL 1104-a. The court disagreed and denied the motion, finding that the reasonableness of the package was "open to question," especially given the future earn-out omission, and given the company accountant's "troubling" calculation of the value of their brother's minority interest.

The Supreme Court, Erie County also adjudicated a novel §1104-a

dissolution petition in *Matter of Straka v. Arcana Zucarelli Lenda & Assocs. CPAs P.C.*, 2019 NY Slip Op 29017 (Sup. Ct. Erie County, Jan. 9, 2019). *Straka* involved a four-partner accounting firm, only one of whom was female. According to the petition, almost immediately after joining the firm, the female partner was subjected to demeaning remarks by a senior accountant at the firm, including for example: "Oh, are you the one who makes me coffee?"; "When did they make the CPA exam easier for women?"; and "In my next life, I want to come back as a woman because they don't do anything." When the female partner raised this offensive behavior with her partners, they allegedly told her to just "hang in there" and await the senior accountant's impending retirement. This was an unacceptable response, of course, and when coupled with allegations that she was not being fairly compensated and that her ownership interest had been diluted by the unilateral addition of another shareholder, she petitioned for dissolution of the firm.

After an evidentiary hearing, the court found that the female partner had indeed been subject to oppressive conduct by her partners, paving the way for some novel rulings on the topic—namely, that "disrespectful and unfairly disproportionate treatment of a female shareholder by the male majority in a closely held corporation constitutes oppression under BCL §1104-a (a) (1)," and that majority shareholders "and indeed, any shareholder of any corporation, should know that a female shareholder reasonably expects to be treated with equal dignity and respect as male shareholders forming the majority."

Other Cases of First Impression

Meanwhile, back downstate, the Manhattan Commercial Division dealt with a couple of its own cases of first impression last year. In *Advanced 23, LLC v. Chambers House Partners, LLC*, 2019 NY Slip Op 30173[U] (Sup. Ct. NY County, Jan. 22, 2019), the court arguably applied for the first time in the LLC context the "bad-faith petitioner" defense, which first emerged as dicta 35 years ago in the context of corporate dissolution in the Court of Appeals' seminal *Matter of Kemp & Beatley*, 64 N.Y.2d 63 (1984) decision.

Advanced 23 involved a dispute between equal owners (and occupiers) of a single-asset real estate holding LLC primarily over a proposed refinancing of a mortgage on the building. The petitioning member ultimately sued for dissolution under §702 of the Limited Liability Company Law (LLCL), claiming that his co-owners—an elderly couple—had been harassing him about having a live-in girlfriend and had diverted company funds to a separate bank account to which he had no access. The respondents countered that the dissolution proceeding was a ruse to force a buyout in his favor, which proceeding the petitioner himself had brought about by refusing to extend or renew the mortgage.

After an evidentiary hearing before a special referee, the referee found for the respondents based on testimony that the petitioner gambled that his elderly co-owners could not make an upcoming mortgage payment and therefore refused to go along with an extension of the mortgage in order to "push the [respondents] out of the building" and force them to sell their interest at a pittance. The referee concluded that the petitioner had refused to meet quarterly with his co-owners and to attempt to resolve their mortgage deadlock through ADR, both as required under their operating agreement, and that he did so deliberately "to attempt to force dissolution of [the LLC]." The court confirmed the referee's report as "substantially supported by the record."

In *Rosania v. Gluck*, 2019 NY Slip Op 32087[U] (Sup. Ct. NY County, July 8, 2019), the Manhattan Commercial Division addressed subject matter jurisdiction in the context of dissolution proceedings, considering the novel question whether—despite the clear prohibition on the dissolution of a foreign entity by a New York court as held in *Matter of Raharney Capital*, 138 A.D.3d 83 (1st Dept. 2016)—New York courts have jurisdiction to grant other equitable relief

in similar, quasi-dissolution actions. The answer, at least under the facts and circumstances of the *Rosania* case, was "no."

Rosania involved a number of Delaware LLCs formed to own and operate investment properties in Manhattan. The minority-member plaintiff initially (and expressly) sought the remedy of dissolution, which was met with a dismissal motion citing *Raharney*. The plaintiff quickly amended his pleading to eliminate the request for dissolution and instead asserted equitable claims for a "forced sale of assets" and a "forced buy/sell," which spawned a new dismissal motion on the part of the majority-member defendants. The court sided with the defendants, finding that the plaintiff's amended pleading seeking "equitable relief associated with judicial dissolution" was nothing more than "an ill-disguised attempt to make and end-run around the rule expressed in *Raharney*." Case dismissed.

Disputes Arising From LLC Operating Agreements

Creatures of contract that they are, LLCs and the terms of the operating agreements under which they exist and function, continued to be the subject of business-divorce decisions in 2019.

Roy Food and Wine LLC v. Meregalli, 2019 NY Slip Op 32875[U] (Sup. Ct. NY County, Sept. 25, 2019), for example, involved a dispute between an alleged managing-member restaurateur and his minority-member investors over their respective membership and voting interests. According to the plaintiff-investors, the defendant-restaurateur's plan was to capitalize his venture with $1 million, conveying to them a collective 40% interest in exchange for $400,000, and promising to contribute $600,000 of his own money in accordance with his 60% controlling interest. But the plaintiffs claimed that the defendant did not make his agreed capital contribution and instead misappropriated their capital accounts and the LLC's intellectual property toward a competing restaurant in which they had no interest.

The focus of the litigation, as the law would have it, was on the LLC's operating agreement—specifically, a removal provision allowing for the removal of the managing member by majority vote, as well as the "floating" membership-interest provisions which tied membership and voting percentages to the members' variable capital accounts. The agreement required the managing member to "maintain" the members' capital accounts in accordance with the member's initial capital contributions as increased or decreased by any future contributions, withdrawals, losses, etc. The plaintiffs sued for breach of contract and to enforce their alleged majority vote to remove defendant as manager, alleging that the defendant breached the operating agreement by failing to make his promised capital contribution and failing to maintain accurate books of account with respect to the members' capital accounts.

In opposition to the plaintiffs' motion for summary judgment, the defendant argued that his contributions to the venture were not limited to cash and that "capital contributions can be in the form of cash, services, assets, or payables"—essentially mirroring the default rule under LLCL §501 concerning the form of capital contributions, which provides that "the contribution of a member to the capital of a limited liability company may be in cash, property or services rendered … or any combination of the foregoing." The court denied the plaintiffs' motion, finding that the defendant's "[holding] himself out to have made contributions he didn't or that he does not own as much of the company as he claimed, … does not appear to be a violation of a provision of the operating agreement."