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Expert Analysis

Courts Address Key Issues In Business Divorce Cases of 2016

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Last year New York courts decided a number of important cases involving business divorce and related litigation between co-owners of closely held companies, highlighted by a pair of Appellate Division, First Department decisions addressing subject-matter jurisdiction over petitions to dissolve foreign entities and shareholder rights to inspect books and records of a corporation's wholly-owned subsidiary. This annual review also features a number of significant decisions from Second Department trial and appellate courts concerning partnership dissolution and valuation, tie-breaker authority and liability, and limited liability company (LLC) member fiduciary duty.

Foreign Business Entities

A year ago in this column we reported on the Manhattan Commercial Division's decision in *Matter of Kuafu Hudson Yards* (Sup Ct, NY County, April 14, 2015, Index No. 650599/15), in which the court granted a Delaware LLC's motion to dismiss a co-manager's dissolution petition for lack of subject-matter jurisdiction despite a New York forum-selection clause in the company's operating agreement. In doing so, the court acknowledged a split in appellate authority and noted that "[a]t some point we will get final authority on this issue."

The First Department provided that final authority last year in *Raharney Capital v. Capital Stack* (138 A.D.3d 83 [1st Dept. 2016]). *Raharney* involved deadlocked 50/50 co-members, both New York residents, of a Delaware LLC operating in New York without a written operating agreement. Citing the First Department's ruling in *Matter of Hospital Diagnostic Equipment* (205 A.D.2d 459 [1st Dept. 1994]), which found the argument against dissolution by a New York court based on a lack of subject-matter jurisdiction "to be without merit," the petitioning member argued that a dissolution decree from a New York court would be proper because the company's sole, ministerial connection to Delaware was its state of formation.

The respondent-member moved to dismiss the petition, citing Second and Third Department decisions holding contrary to *Hospital Diagnostic*, that New York courts lack subject-matter jurisdiction over the dissolution of foreign business entities. The motion court sided with respondent and dismissed the petition. Petitioner appealed.

The First Department affirmed, aligning itself with its "sister departments of the Appellate Division," as well as with the "overwhelming

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majority of courts outside New York," and expressly overruled *Hospital Diagnostic*. The court adopted what has become a "near universal" rationale—namely, that "[b]ecause a business entity is a creature of state law, the state under whose law the entity was created should be the place that determines whether its existence should be terminated." The court was careful to limit its jurisdictional holding to the dissolution context, however, "recogniz[ing] that New York state courts play a critical role in resolving disputes involving business entities" and reiterating "the authority of our courts to adjudicate the myriad disputes involving foreign entities doing business in this state."

Inspection of Records

In *Retirement Plan for General Employees v. McGraw-Hill* (120 A.D.3d 1052 [1st Dept. 2014]), the First Department held that a shareholder's investigation into a company's board activities, whether or not any misconduct ultimately is uncovered, is considered proper for purposes of a non-controlling, minority shareholder's right to inspect corporate books and records. Last year in *Matter of Pokoik v. 575 Realties*, (143 A.D.3d 487 [1st Dept. 2016]), the First Department further expanded the scope of its ruling in *McGraw-Hill* by holding that the right to inspect extends to wholly-owned subsidiaries of the company in which the petitioning shareholder has an interest.

Matter of Pokoik involved a minority shareholder in a family-owned real-estate holding company who petitioned to inspect the records of both the holding company and its wholly-owned subsidiary, a property-management company that was controlled by the same majority who controlled the holding company. Petitioner brought the proceeding in order to "investigate possible fiduciary mismanagement and wasteful dissipation of corporate assets through the payment of excessive salaries and compensation."

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The motion court granted the petition to the extent of requiring the parent company to produce records in response to petitioner's demands but denied relief with respect to the subsidiary due to his lack of shareholder status in that company. After the parent claimed that it did not have any responsive records, petitioner renewed his application to obtain access to the subsidiary's records. The motion court again denied the request, and petitioner appealed.

Citing its *McGraw-Hill* decision, the First Department held that petitioner's concern regarding mismanagement and waste was a facially proper purpose for inspection "even if the inspection ultimately establishes that the board had engaged in no wrongdoing." The court then went a step further by applying the right to the subsidiary, holding that a strict limitation of the right on the basis of ownership in this family-owned, closely-held business context "would allow respondents to shield their alleged misdeeds from scrutiny, as the books and records of [the subsidiary] would never be discoverable by anyone other than [the parent's] board of directors."

Valuation of Interests

Disputes concerning the valuation of minority interests in closely-held companies, particularly with respect to marketability discounts in the context of "fair value" appraisal proceedings under the Business Corporation Law, have become hot-button issues for New York courts in recent years. The Second Department last year in *Congel v. Malfitano* (141 A.D.3d 64 [2d Dept. 2016]) highlighted an important distinction within the controversy over discounts when analyzed in the partnership context.

The genesis of the *Congel* case traces back to 2006 when the defendant-minority partner attempted unilaterally to dissolve a commercial real estate partnership by written notice under §62 of the Partnership Law. His co-partners then sued him for damages resulting from what they claimed to be a wrongful dissolution based on a provision in their partnership agreement subjecting voluntary dissolution to majority vote. The plaintiff-majority partners eventually prevailed, and the parties were ordered to a bench trial on "the value of [defendant's] interest in the partnership, less any damages caused to his copartners by the dissolution" as provided for under section 69 of the Partnership Law.

The stipulated topline value of defendant's interest was $4.85 million, from which the trial court deducted approximately $4 million in damages and discounts, including a 35 percent marketability discount. Plaintiffs argued for a further 66 percent discount for lack of control (a/k/a minority discount) based on expert testimony, which defendant's expert altogether failed to address because he "was advised, under the relevant statutes, that a minority discount was not applicable."

The trial court agreed with defendant's expert, citing *Friedman v. Beway Realty* (87 N.Y.2d 161 [1995]) and *Matter of Murphy v. U.S. Dredging* (74 A.D.3d 815 [2d Dept. 2010]), which together stand for the proposition that minority discounts are improper in fair-value proceedings under BCL §§623 and 1118 because they unfairly deprive minority owners of their proportionate interest in the value of the company and subject stockholders within the same class of shares to unequal treatment. Plaintiffs appealed.

The Second Department sided with plaintiffs, concluding that "a [minority] discount may be applied, and that it should have been applied under the facts of this case." In doing so, the court distinguished *Beway* and *Murphy* as minority shareholder appraisal proceedings under BCL §§623 and 1118 governed by the "fair value" standard prohibiting the application of minority discounts. *Congel*, on the other hand, concerned the "value" of a partnership interest under Partnership Law §69, which courts have interpreted to be governed by the "fair market value" standard allowing for minority discounts. Because the defendant's expert neglected to provide any minority-discount analysis or computation, the court adopted the testimony of plaintiffs' expert and further discounted defendant's interest by an additional 66 percent.

Congel isn't over. In January 2017, the Court of Appeals granted defendant's motion for leave to appeal. The high court's anticipated decision later this year could have a major impact on partnership law governing non-judicial dissolution and valuation of partnership interests.

Tie-Breaker Provisions

The Commercial Division in Nassau and Queens counties last year addressed alternative forms of tie-breaker provisions in shareholder and operating agreements in the context of deadlocked owners feuding over the management of their respective companies.

Matter of Hudson (*Pure Lime USA*) (Sup Ct, Nassau County, June 16, 2016, Index No. 600127/16) involved 50/50 shareholders of a New York company that marketed and sold fitness wear in the United States, one of which was a Danish corporation that designed and manufactured the clothing for sale to the New York company. The four-member board was made up of the two petitioners, who operated the company stateside, and two designees of the Danish corporate shareholder, one of whom was designated "chairman" under the shareholder agreement which also contained a tie-breaker provision that, "[i]n case of a tie vote, the chairman shall cast the deciding vote."

The petitioning shareholders ultimately sought dissolution of the company based on allegations of deadlock under BCL §1104, although the substance of the petition centered around more specific allegations of oppression—namely, that the respondent corporate shareholder was diverting company profits to itself while failing to pay company salaries and creditors. Respondent moved to dismiss the petition, arguing that the agreement's designation of one of its own designees as "chairman," combined with the tie-breaker provision, necessarily precluded deadlock dissolution.

The Nassau County Commercial Division agreed with respondent, finding that "[b]ecause the chairman of the … board has the power to break ties, by the express terms of [the] shareholder agreement, there cannot be a deadlock." The court dismissed the petition without prejudice, however, granting petitioners "leave to file an amended petition seeking dissolution … on the ground of oppressive conduct pursuant to BCL §1104-a."

Fakiris v. Gusmar Enterprises (53 Misc. 3d 1215(A) [Sup. Ct., Queens County 2016]) concerned a different form of tie-breaker provision, designed to equalize management control through the designation of a neutral, non-owner for purposes of casting a tie-breaking vote, in which the Queens County Commercial Division considered the novel issue whether the designated tie-breaker can be held liable for breach of fiduciary duties owed to the company's owners.

Fakiris involved 50/50 sibling owners of a real estate holding LLC whose operating agreement designated the company's comptroller as the neutral tie-breaker "in the event that the company decisions result in a stalemate between the managing members." The neutral also served as comptroller of the defendant-brother's unrelated company and allegedly was the beneficiary of college tuition payments made to her children by the LLC as authorized solely by defendant.

After personal relations between the siblings soured, the neutral "relinquished her authority to cast the decisive vote" on certain business matters, including mortgage refinancing and tenancy, and the parties failed to designate a replacement as required by the operating agreement. The plaintiff-sister eventually brought suit against her brother, also naming the neutral as a defendant based on allegations that the agreement's tie-breaker provision "created a fiduciary duty between herself and [the neutral] and that [the neutral] breached her fiduciary duty by refusing to resolve stalemates between the plaintiff and [her brother]." The neutral moved for summary dismissal of the claim.

The court denied the neutral's motion, "find[ing] that there was a fiduciary relationship between the plaintiff and [the neutral] arising from the operating agreement" but that there were issues of fact concerning, among other things, "whether [the neutral] was ever requested to act as a tie-breaker and whether she took improper … college tuition payments for her children from [the LLC]."

Finally, in another case also raising a novel issue of fiduciary duty, the Nassau County Commercial Division last year in *Gilbert v. Weintraub* (Sup Ct, Nassau County, Jan. 29, 2016, Index No. 602290/15) attempted to reconcile an LLC managing member's fiduciary duties to his co-managing member with his right under LLC Law §415 to resign as manager and thereafter form a competing venture within a week of resigning. In doing so, the court found that the resigning member's duty to his co-member may have continued beyond his formation of the competing LLC based on his "closer relationships … with the LLC's vendors and sales representatives," and ordered the parties to conduct further discovery on that discrete issue.