New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 255—NO. 17
WEDNESDAY, JANUARY 27, 2016

Outside Counsel

Expert Analysis

# LLCs Dominate Business Divorce Cases of 2015


By **Peter A. Mahler**

And **Matthew D. Donovan**

It's been over 20 years since legislatures in New York and across the nation gave birth to the limited liability company. The LLC filled the need for a hybrid form of business entity featuring limited liability, partnership taxation, and default rules that provide substantially greater ownership and management flexibility through the LLC operating agreement than that permitted by the statutes regulating subchapter S corporations and limited partnerships.

The LLC has proven massively popular, becoming the entity of choice for newly formed business organizations in most if not all jurisdictions, in some instances by an overwhelming majority. New York has been somewhat slower in the evolution toward LLC dominance, arguably due to its singular and expensive publication requirement upon formation.

As the LLC movement has grown, inevitably so too has the proportion of business divorce cases involving LLCs, as evidenced by the fact that, for the first time since this annual review was published in these pages 16 years ago, all of the cases from 2015 highlighted below stem from disputes over the standard for LLC dissolution, LLC operating agreements, LLC valuation, and dissolution of foreign LLCs. Also featured in this year's review are several important Delaware Chancery Court decisions in LLC business divorce cases.

## LLC Dissolution Standard

It's been over five years since the Second Department in *Matter of 1545 Ocean Avenue, LLC* (72 AD3d 121 [2d Dept. 2010]) differentiated the standard for judicial dissolution under the LLC Law from the standards under the statutes governing corporations and partnerships. As *1545 Ocean Avenue* established, a petition for LLC dissolution under LLC Law §702 will be granted only when, in the context of its operating agreement and articles of organization, the company's stated purpose no longer is being achieved or it is financially unfeasible to carry on its business.

Two years ago, in *Doyle v. Icon, LLC* (103 AD3d 440 [1st Dept. 2013]) the First Department held that oppression in the form of "systematic exclusion" of a minority member did not measure up to the 1545 Ocean Avenue standard. The First Department last year furthered its jurisprudence in this regard, holding that allegations of majority-member "oppression" in connection with a functioning and viable real-estate holding company were insufficient to warrant dissolution under Section 702.

> As the LLC movement has grown, inevitably so too has the proportion of business divorce cases involving LLCs.

PETER A. MAHLER *is a litigation partner at the Manhattan office of Farrell Fritz.* MATTHEW D. DONOVAN *is counsel at the firm.*

In *Barone v. Sowers* (128 AD3d 484 [1st Dept. 2015]), plaintiff, a 20 percent non-managing member of a single-asset realty holding company, sued for dissolution, alleging "oppressive" acts by the 80 percent managing member. Drawing in large part from the statute for corporate dissolution by a minority owner (BCL §1104-a), plaintiff alleged that the majority member failed to realize the true value of the property by selling it, prohibited plaintiff's access to company records, offered discount leases to his lawyers, and failed to account for proceeds derived from refinanced mortgages.

Despite citing only one provision in the LLC's operating agreement concerning the right of access to the company's records, plaintiff claimed that the majority's conduct presented circumstances in which it was not reasonably practicable to carry on the company's business in accordance with its stated purpose. The majority member moved to dismiss, and the lower court granted the motion. Plaintiff appealed.

Citing *1545 Ocean Avenue* along with its own decision in *Doyle v. Icon*, the First Department affirmed, holding that plaintiff was not entitled to dissolution under Section 702 because the operating agreement's broadly stated purpose of the company was to "'acquire, improve, own, manage, sell, dispose of, and otherwise realize on the value of' the premises," and because plaintiff's allegations "do not show that [defendant] is 'unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved, or [that] continuing the entity is financially unfeasible.'"

The Manhattan Commercial Division last year also continued the break from the BCL's dissolution standard as initiated by *1545 Ocean Avenue* by dismissing a petition for dissolution of a real-estate holding LLC based on allegations of deadlock between 50/50 owners.

*Goldstein v. Pikus* (2015 NY Slip Op 31455[U] [Sup Ct, N.Y. Co. 2015]) involved feuding co-managers of an apartment building in Manhattan's West Village, one of which (plaintiff) eventually sought a declaration that the other's (defendant's) management authority under the company's operating agreement was limited to decisions regarding the sale and financing of the building. Defendant opposed plaintiff's request by alleging the existence of an oral agreement modifying the operating agreement's management provisions, giving him co-equal authority over daily operations and entitling him to management fees.

Defendant eventually filed for dissolution, alleging that plaintiff's discounted rents to his children and his "stockpiling" of apartments for future purchase were counter to the company's purpose. Defendant also argued that plaintiff's lawsuit clearly demonstrated deadlock between the parties concerning the management of the business. Plaintiff moved for summary dismissal, contending that defendant's allegations were insufficient to warrant dissolution under *1545 Ocean Avenue* because the company was financially viable and achieving its purpose and because allegations of deadlock, alone, are not enough in the LLC context.

The court granted plaintiff's motion, finding that deadlock is not an "independent ground for dissolution" under the LLCL; that "[i]t is only where discord and disputes by and among the members are shown to be inimical to achieving the purpose of the LLC will dissolution under the 'not reasonably practicable' standard…be considered by the court." In other words, the court in *Goldstein* found that the discord between the parties did not interfere with the company's ongoing viability and purpose, which, as in *Barone*, was broadly stated to "acquire, own, hold, expand, renovate, lease, manage, sell, operate the real property…and such other business activities and operations that are reasonably related thereto."

### Unilateral Adoption

In a first-impression ruling last year in *Shapiro v. Ettenson* (2015 NY Slip Op 31670[U] [Sup Ct, N.Y. Co. 2015]), the court permitted majority LLC members to adopt and enforce against a non-signatory minority member an operating agreement that, among other features, authorized capital calls with the prospect of dilution for a member who does not make a pro rata contribution.

*Shapiro* involved a member-managed LLC whose three co-equal members founded the company without an operating agreement, which they later drafted and negotiated but never executed. Almost two years later, by written consent in lieu of a meeting, two of the three members (defendants) adopted an operating agreement that authorized capital calls by majority vote and allowed such contributions to result in an alteration of percentage ownership interests in the event that any member failed to meet the call.

Defendants then eliminated the minority member's (plaintiff's) salary and issued a $10,000 capital call from each member with notice to plaintiff that, if he failed to meet the call, his membership interest was subject to dilution. Plaintiff objected and brought suit, requesting that defendants' unilateral actions and the operating agreement be declared invalid, particularly because he could not be bound by an agreement he never signed. Defendants counterclaimed, seeking the opposite relief and contending that their adopting of the operating agreement was authorized by LLCL §402(c)(3), which states that "[e]xcept as provided in the operating agreement,…the vote of a majority in interest of the members entitled to vote thereon shall be required to…adopt, amend, restate or revoke the…operating agreement." Both parties moved for summary judgment.

The court sided with defendants, ruling that under Section 402(c)(3), defendants "were each entitled to vote in proportion to their one-third ownership interests in order to 'adopt, amend, restate or revoke the articles of organization or operating agreement'" and that, in doing so, they "clearly constitut[ed] a majority sufficient…to adopt the Operating Agreement" which therefore was "valid and enforceable." The court also found that, under the default rules in LLCL §§401-02, defendants' actions eliminating plaintiff's salary and issuing the capital call "were valid even in the absence of an operating agreement."

## Marketability Discount

The applicability of a discount for lack of marketability (DLOM) in fair-value appraisal proceedings has been a continuing source of controversy. Last year's Second Department decision in *Chiu v. Chiu* (125 AD3d 824 [2d Dept 2015]) arguably is more important for what it doesn't say on the subject than what it does say. The appellate court in *Chiu* affirmed without comment the lower court's approval of a zero percent DLOM in determining the fair value of a minority membership interest in a single-asset, real estate holding LLC. The lower court had found that the company's business consisted of "easily marketable" realty, but it also acknowledged that "the illiquidity of the membership interests should be taken into account" and implied that it might have applied an "appropriate" DLOM south of 25 percent had the purchasing member's expert appraiser offered supporting evidence.

> The Commercial Division in 'Kuafu' concluded that it lacked subject matter jurisdiction to dissolve a Delaware LLC, which was the exclusive province of the Chancery Court under the Delaware LLC Act. The court issued its ruling with some caution, however.

Given the lower court's perfunctory and equivocal comments on DLOM, and the Second Department's subsequent affirmance without comment, expect both proponents and opponents of DLOM to cite or distinguish *Chiu* in future fair value appraisal proceedings.

## Jurisdiction—Foreign LLCs

The Manhattan Commercial Division's decision last year in *Matter of Activity of Kuafu Hudson Yards LLC* (Sup Ct, N.Y. Co., April 14, 2015, Index No. 650599/15), demonstrated that New York courts continue to wrestle with the issue of subject matter jurisdiction over the dissolution of foreign business entities.

*Kuafu* involved a dissolution petition based on deadlock between the managers of a Delaware LLC engaged in the commercial and residential development of Manhattan's west side rail yards. The company's operating agreement contained a Delaware choice-of-law provision alongside a separate venue provision in which the members "consent[ed] to the jurisdiction of any court located in New York County" and "waive[d] the right to commence an action…in any court outside of New York County."

The respondent-managers moved to dismiss, citing appellate precedent—including the First Department's 2007 decision in *Appell v. LAG Corp.* (41 AD3d 277 [1st Dept. 2007]) and the Second Department's 2009 decision in *Matter of MHS Venture Mgmt. Corp. v. Utilisave* (63 AD3d 840 [2d Dept. 2009])—standing for the proposition that New York courts lack subject matter jurisdiction over the dissolution of foreign business entities. Respondents also argued that the Delaware Chancery Court has exclusive jurisdiction to dissolve Delaware LLCs under §18-802 of the Delaware LLC Act.

Petitioner opposed the motion, emphasizing the general adherence to freedom of contract in Delaware law and related jurisprudence honoring the intent of contracting LLC members as expressed in their operating agreements. Petitioner also relied on the First Department's 1994 decision in *Matter of Hospital Diagnostic Equipment Corp.* (205 AD2d 459 [1st Dept. 1994]) in which the court found the lack of subject matter jurisdiction argument "to be without merit" in a proceeding seeking judicial dissolution of a Delaware corporation, holding instead that the case should be litigated in Delaware on forum non conveniens grounds.

The court in *Kuafu* held for respondents, concluding that it lacked subject matter jurisdiction to dissolve a Delaware LLC, which was the exclusive province of the Chancery Court under the Delaware LLC Act. The court issued its ruling with some caution, however, acknowledging the apparent split in authority and noting that "[a]t some point we will get final authority on this issue, but at this point I'm not so sure that the case law I have… supports the argument that…I have subject matter jurisdiction over this case."

## Highlights, Delaware LLC Law

Speaking of Delaware law, last year saw some novel rulings from the Delaware Chancery Court concerning judicial dissolution of LLCs, including the related standards and requisite standing, as well as unique remedies for irreparable dysfunction among LLC members.

*In re Carlisle Etcetera LLC* (2015 WL 1947027 [Del. Ch. April 30, 2015]) involved an assignee of a membership interest in an LLC, which, according to the Chancery Court, lacked standing to seek statutory dissolution because the entity to which the interest was assigned was neither a member nor a manager of the LLC as required under §18-802 of Delaware LLC Act, but nonetheless had standing to seek equitable dissolution by virtue of the court's powers as a court of equity.

In *Meyer Natural Foods LLC v. Duff* (2015 WL 3746283 [Del. Ch. June 4, 2015]), the Chancery Court applied an uncharacteristic "contextual interpretation" to the operating agreement of a beef distributer and looked outside the plain language of its broad purpose clause—namely, to a contemporaneous and exclusive supply agreement with a related cattle supplier—in order to conclude that it was no longer reasonably practicable to carry on the business of the company according to its original vision after the supply agreement was terminated.

Finally, in *Shawe v. Elting* (2015 WL 4874733 [Del. Ch. Aug. 13, 2015]), which involved a highly toxic relationship between two 50/50 owners of a lucrative translation-services business, the Chancery Court opted for the "unusual" remedy of appointing a custodian to sell the company in order to achieve a much-needed business divorce between the owners while preserving the successful enterprise they founded and maximizing shareholder value.