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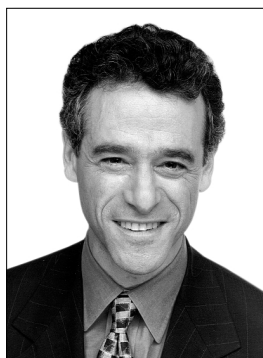
A Review of 2005 Business Divorce Cases

Fallings-out between co-owners of closely held businesses frequently lead to dissolution proceedings and related litigation in which courts adjudicate not only the management rights and financial interests of embittered adversaries, but also the life or death of the business enterprise.

This annual review of business divorce cases highlights decisions of interest involving corporations, partnerships and limited liability companies.

When a minority shareholder claiming oppression by the majority petitions for judicial dissolution under §1104-a of the Business Corporation Law (BCL), the majority shareholders can avoid dissolution by purchasing the petitioner's shares for fair value under BCL §1118. A protracted valuation contest may follow during which the petitioner retains shareholder status but typically receives no financial benefits from the company. A further financial squeeze may occur pending the buyout if the company is a subchapter S corporation and reports nondistributed or "phantom" net income taxable to the shareholders.

Last year in *Matter of Matco-Norca, Inc.*¹ the Second Department affirmed the lower court's denial of the petitioner's motion, made during a valuation proceeding, to compel the corporation to make an immediate cash distribution of its reported net income. The court



rejected the petitioner's claim that the shareholders' agreement mandated distributions sufficient to cover the shareholders' personal taxes on the corporate income deemed to have passed through

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to them. According to the court, under the plain and unambiguous language of the shareholders' agreement, distributions of net income were discretionary, not mandatory.²

Matter of Johnsen (ACP Distribution, Inc.)³ draws attention to an interesting and recurrent issue concerning whether the bringing of a dissolution proceeding itself can trigger a mandatory buyback of

the petitioner's shares under the shareholders' agreement. The *Johnsen* petitioner, a 50 percent shareholder, sought dissolution based on deadlock under BCL §1104 which, unlike §1104-a, does not activate buyout rights under BCL §1118. The *Johnsen* shareholders' agreement contained a typical transfer restriction clause stating that no shareholder "shall at any time...donate, hypothecate, pledge, transfer or otherwise dispose" of their stock without first offering it for sale to the company at a formula price, in this case equal to book value less 30 percent.

Citing the Second Department's ruling compelling a buyback in *Doniger v. Rye Psychiatric Hospital Center, Inc.*,⁴ the respondents in *Johnsen* argued that the petitioner was required to sell her shares at the formula price. The trial court disagreed, finding that neither the petitioner's pre-litigation buyout discussions with respondents nor the bringing of the proceeding triggered the obligation to sell under the shareholders' agreement. The court distinguished *Doniger* on the ground the shareholder agreement in that case expressly covered the passage or disposition of shares under judicial order or legal process.

An unusual issue arose in *Matter of Cocolicchio* (Charles Rizzo & Associates, Inc.)⁵ in which a 25 percent shareholder claiming oppression petitioned for dissolution of a closely held corporation under BCL §1104-a. The majority shareholder did not elect to purchase the

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petitioner's shares. Instead, about eight months later and pursuant to a plan of liquidation adopted at a shareholder meeting over the petitioner's objection, the majority shareholder filed with the Department of State a certificate of voluntary dissolution and thereafter moved to dismiss the petition as moot. The petitioner then brought a second proceeding to nullify the voluntary dissolution. Calling the respondent's action an "end-run around the salutary protections afforded by BCL 1104-a to petitioner," rather than annulling the dissolution the court suspended it under BCL §1008 pending trial of the petitioner's oppression allegations.

The court in *Maxon v. Mirror Show Management, Inc.*⁶ issued a rare, reasoned decision addressing the propriety and scope of discovery in a BCL §1104-a dissolution proceeding that had been stayed and converted to a valuation proceeding upon the respondent's §1118 buyout election. The petition, filed in early 2004, also included derivative claims for breach of fiduciary duty, corporate waste and looting. The petitioner sought discovery of business and financial records for all of 2004 and 2005. The respondent opposed on the grounds, first, that the election to purchase rendered superfluous all claims of wrongdoing and, second, that petitioner was not entitled to discovery of events post-valuation date, i.e., after early 2004.

The court rejected both arguments, holding that a buyout election does not foreclose inquiry of separate claims for misappropriation of corporate assets and that such inquiry can extend post-valuation date.

Case law remains unsettled concerning whether the so-called internal affairs doctrine bars a petition brought in a New York court to dissolve a foreign corporation whose business operations are based in New York.⁷ In an action to dissolve a Delaware corporation under

BCL §1104-a, the trial court in *Sokol v. Ventures Education Systems Corp.*⁸ acknowledged its technical inability to order Delaware officials to dissolve the corporation. The court nonetheless held that it could exercise jurisdiction with the power to award lesser or alternative relief such as a compelled buyout of the complaining minority shareholder. The court noted that other than its incorporation in Delaware the company had no contacts in that state whereas its principal place of business was in New York, its board meetings were held in New York, and its records and many of its officers and employees were located in New York. Having established jurisdiction, the court proceeded to hold that the minority shareholder's allegations did not state sufficient grounds for relief.

Partnership Winding Up

Last year's decision in *Polner v. Monchik Realty Co.*⁹ required the trial court to construe various provisions of the Partnership Law and the partnership agreement in a dispute over distributions due limited partners upon the expiration of the stated term of a real estate holding company 30 years after its formation.

The petitioning limited partners sought orders directing the winding up of the partnership, the sale of its assets, the satisfaction of its liabilities and the distribution of all remaining sums as provided in the partnership agreement. Specifically, the petitioners claimed they were entitled to a 4 percent interest in the partnership assets upon dissolution in proportion to their initial capital investment, consistent with their historical receipt of 4 percent of the partnership's annual profit distributions.

The respondent partners contended that the petitioners were entitled only to a return of their original \$1,200 investment, relying on the certificate of partnership that included a provision stating that upon dissolution, "the

interest of the Limited Partner...shall be returned to him, in cash, out of the partnership assets and he shall not be entitled to demand and receive property other than in cash for his contribution." The respondents also cited Partnership Law §112(1)(c) providing that, following payment to creditors, the limited partners are to be paid "in respect to the capital of their contributions."

The court agreed with the petitioners, noting that §112 expressly is made subject to any statement in the certificate or to any subsequent agreement. The court found unsupported the respondents' allegation that the partnership agreement was made prior to the certificate of partnership, instead concluding they were contemporaneous writings to be co-construed and harmonized. The court accordingly found controlling the paragraphs of the partnership agreement providing that upon dissolution a limited partner is entitled to receive a specified percentage of the net assets based on the amount invested.

LLC Dissolution

Section 702 of the Limited Liability Company Law (LLCL) authorizes the court to decree dissolution "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." In this writer's opinion, the sparsely worded statutory standard plus a number of other factors have impeded development of a consistent body of dissolution case law since adoption of the LLCL in 1994.¹⁰

One such factor is the absence of appellate court guidance. Typical is last year's ruling by the First Department in *Artigas v. Renewal Arts Realty Corp.*¹¹ The court there upheld the dismissal of a dissolution petition under LLCL §702. In its decision, the court merely noted that the BCL does not govern such a case and concluded that "the petition did not

plead the requisite grounds for dissolution of a limited liability company.”

In actuality, the BCL's dissolution provisions and case precedents are routinely cited in many trial court decisions in proceedings under LLCL §702. *Dahlberg v. Clipper Holding Associates LLC*¹² is a good example. The two petitioners there were employed as traders in a private investment company in which they held an aggregate 50 percent membership interest. The other two members provided the financing. The petitioners argued that the company could no longer carry on its business because the market environment had shifted, rendering their investment strategy ineffective; that retirement of the fund would protect investor profits; that the respondents desired to continue the business while petitioners wished to discontinue trading thereby creating deadlock; and that investors would seek redemption of their shares when the traders departed. The respondents maintained that the company was viable and that there was no genuine impasse.

The court characterized most of the petitioners' arguments as “otiose” and openly doubted their stated motive to protect client investments. The court nonetheless granted dissolution on the grounds that there was a deadlock over whether to continue trading activity, and because dissolution would be noninjurious to the public and beneficial to the “shareholders.”

Business divorce practitioners will immediately recognize these reasons as lifted straight out of BCL Article 11. Moreover, the *Dahlberg* opinion quotes extensively from case law involving deadlock petitions under BCL §1104, including cases holding that the issue of fault is immaterial to the existence of deadlock. The court's reliance on BCL deadlock rules arguably obscures the central question under LLCL §702, namely, whether a member's unilateral desire to withdraw when the business

is not otherwise failing makes it no longer reasonably practicable to carry on the business in conformity with the operating agreement.

‘Matter of Lucere’

Matter of Lucere (*Fulton Investment Fund LLC*)¹³ also involved a petition to dissolve a private investment fund, but unlike in *Dahlberg* the petitioner walked away empty-handed. The petitioner, who was one of six member-managers of the fund, primarily alleged that she improperly was denied access to the fund's bank statements. Examining the fund's articles of organization and operating agreement, the court concluded that petitioner's allegations notwithstanding, it remained “reasonably practicable” to continue the fund's business within the meaning of LLCL §702 given that the other five members desired the fund's continued existence and did not want to remove petitioner as a member. Rather, the court found, it was petitioner who wanted to breach the operating agreement and prematurely withdraw as a member.

Finally, in *Matter of 458/460 West 51st Street Realty LLC*,¹⁴ a 16 percent member of a limited liability company that owned the apartment building in which she rented learned a hard lesson about the perils of withdrawing as a member before ascertaining the amount to be paid for her interest. In an exchange of letters between the respondent and the company's outside counsel that followed a contentious meeting of the members, the respondent initially stated that she saw “no other recourse but to dissociate [her]self from the LLC.” A short time later respondent wrote a second letter stating that by disassociating she “meant withdraw as a member of the LLC.”

When the respondent later disavowed any intent to withdraw, the company petitioned for an order declaring that she had withdrawn from membership and compelling her to accept payment for her

interest as computed by the company, reduced substantially for withdrawal damages including mortgage expenses incurred to pay respondent what she was due, the company's legal expenses, and post-withdrawal rent increases. The court granted the petition in all respects, finding that the respondent's correspondence constituted a valid, irrevocable withdrawal, that the respondent had “accepted” the property appraisal used to value her interest, and that respondent had failed to dispute the company's damages claims.



1. 22 AD3d 495, 802 NYS2d 707 (2d Dept 2005).
2. Cf. *Deborah Int'l Beauty, Ltd. v. Quality King Distributors, Inc.*, 175 AD2d 791, 573 NYS2d 189 (2d Dept 1991) (in valuation proceeding, ordering company to distribute funds sufficient to cover petitioner's tax obligation for her share of “paper” profits based on uncontested shareholder agreement).
3. Index No. 109565/04 (Sup Ct NY Co Feb. 3, 2005) (Roslyn Richter, J.).
4. 122 AD2d 873, 505 NYS2d 920 (2d Dept 1986).
5. 6 Misc 3d 1041, 800 NYS2d 344 (Sup Ct NY Co 2005) (Herman Cahn, J.).
6. 7 Misc 3d 1015, 801 NYS2d 236 (Sup Ct Monroe Co 2005) (Kenneth R. Fisher, J.).
7. See P. Mahler, “Twenty Years of Court Decisions Have Clarified Shareholder Rights Under BCL 1104-a and 1118,” NYS Bar J, Vol. 71, No. 5, p. 30 (May 1999).
8. 10 Misc 3d 1055, 2005 WL 3249447 (Sup Ct NY Co 2005) (Richard B. Lowe, III, J.).
9. 9 Misc 3d 755, 803 NYS2d 370 (Sup Ct Kings Co 2005) (Carolyn E. Demarest, J.).
10. See P. Mahler, “When Limited Liability Companies Seek Judicial Dissolution, Will the Statute Be Up to the Task?,” NYS Bar J, Vol. 74, No. 5 (June 2002).
11. 22 AD3d 327, 803 NYS2d 12 (1st Dept 2005).
12. Index No. 115592/04 (Sup Ct NY Co Jan. 3, 2005) (Richard B. Lowe, III, J.).
13. Index No. 015742/04 (Sup Ct Nassau Co Feb. 28, 2005) (Ira B. Warshawsky, J.).
14. Index No. 104002/05 (Sup Ct NY Co Nov. 18, 2005) (Sheila Abdus-Salaam, J.).

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