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Expert Analysis

The Beat of Business Divorce Litigation Continued in 2008

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The economic maelstrom that struck last year might lead some to predict a surge in business divorces of closely held companies. In reality, financial success and growth opportunity can place as much if not more strain on relations between business owners as financial decay. So the beat of business divorce litigation goes on through fat or lean times, with 2008 being no exception.

This article reviews some of last year's most interesting court decisions resolving disputes among co-owners of closely held New York corporations and limited liability companies. The cases cover a variety of important issues including the interplay between LLC operating agreements and the LLC law's default rules; whether an LLC's lack of profitability is ground for dissolution; the discount for built-in capital gains in stock valuation proceedings; and fiduciary duties among business co-owners.

New York's LLC law contains default rules that apply in the absence of contrary provision in the operating agreement. Two appellate rulings last year act as reminders that an operating agreement's silence on an issue may not be golden, especially for minority members.

In *Manitaras v. Beusman*, 56 AD3d 735 (2d Dept., 2008), a 49 percent member objected to the majority's proposed sale of the LLC's sole real estate asset and sued for a declaration that under the operating agreement, unanimous member approval was required. Although the operating agreement had no provision explicitly addressing the asset sale, the plaintiff argued that the sale fell within the provision requiring unanimous member consent for voluntary dissolution since, under another provision, the sale automatically triggered dissolution.

The Second Department upheld the lower court's finding that the operating agreement was silent concerning the voting requirement for the asset sale and that, accordingly, approval by a bare majority sufficed under the default rule of LLC Law §402(d)(2).

Ross v. Nelson, 54 AD3d 258 (1st Dept., 2008), concerned the voting requirements for the ouster of an LLC manager. The default statute, LLC Law §414, authorizes removal with or without cause by a majority of the members. The operating agreement had a provision requiring the three member-managers, including the plaintiff, to vote for one another in any election of managers. Another provision specifically mentioned manager expulsion as a dissolution trigger event unless a majority of the members vote to continue the business and elect a replacement manager. In a 3-2 decision, the First Department affirmed the lower court's order sustaining the plaintiff's expulsion.

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The majority agreed that §414 applied in the absence of express provision addressing the voting requirement for manager removal, consistent with the operating agreement's dissolution provision. The dissenters concluded that the operating agreement's provision for manager election displaced §414 regardless of the dissolution provision.

LLC Law §702 authorizes judicial dissolution when "it is not reasonably practicable to carry on the business in conformity with the articles of organization or the operating agreement." Does the statute authorize dissolution on the ground the LLC is failing financially? A decision some years ago in *Schindler v. Niche Media Holdings, LLC*, 1 Misc 3d 713 (Sup Ct. NY Co. 2003), suggested in dicta that a court may do so, but not until last year's ruling in *Matter of Youngwall*, 2008 NY Slip Op 30811(U) (Sup Ct. Nassau Co. 2008), did a court directly confront the issue.

Youngwall stemmed from a bitter dispute between two brothers as 50-50 members of a manager-managed LLC, after their father died. The LLC's sole asset was commercial realty profitably leased for many years by another family-owned company, the control of which passed to one of the brothers who let the lease lapse, relocated the operating company and, in apparent alliance with the LLC's non-member manager, took no steps to re-let the building. The other brother petitioned for dissolution, alleging that the LLC's building had become a liability.

The court granted the petition and appointed a receiver based on "the intense personal animosity" between the brothers, the "lack of any proof of the current profitability of the LLC," and the LLC's apparent inability to function profitably as intended.

When an oppressed minority shareholder petitions for judicial dissolution under BCL §1104-a, the corporation or other shareholders can elect to purchase the petitioner's shares for fair value under BCL §1118.

In a valuation proceeding, *Murphy v. U.S. Dredging Corp.*, 2008 NY Slip Op 31535 (Sup Ct. Nassau Co. May 19, 2008), the court addressed application of a discount for built-in capital gains (BIG) on appreciated assets of a real-estate holding C corporation. The BIG discount has been frequently litigated in estate and gift tax cases applying a fair market value standard, but rarely in a fair value setting.

In *Murphy*, the net asset valuation by

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the purchaser's expert appraiser assumed liquidation of the real estate portfolio on the valuation date and took a dollar-for-dollar BIG discount of $11.6 million.

This is the approach adopted by the Eleventh Circuit in its estate tax ruling in *Estate of Jelke*, 507 F.3d 1317 (11th Cir. 2007). The selling shareholder's expert took a $3.4 million BIG discount based on the present value of the future gains taxes assuming a 19-year holding period.

Noting that the determination of fair value under BCL §1118 "is not identical to the procedure of Tax Court," the court agreed with the seller's expert's use of a partial BIG discount based on evidence that the controlling shareholders intended to hold the properties until retirement of financing 19 years hence.

Implied Authority

In *Hellman v. Hellman*, 19 Misc 3d 695 (Sup Ct. Monroe Co. 2008), the court addressed the interplay between officer and board authority in a dispute between two brothers, the corporation's two equal shareholders and directors, concerning one brother's authority as the corporation's president to execute a lease without prior board approval and over his brother's objection.

After examining the governing statutes and corporate by-laws, the court found that the by-laws placed no restrictions on the president's authority in fulfilling management duties as chief executive officer, and that the actual past conduct of the business defined the president's presumptive authority to enter into the lease without prior board authorization.

The evidence demonstrated that the president had made most if not all major management decisions without board vote and taking into consideration input from his brother only as he saw fit. The president thus had presumptive implied authority to execute the lease without board pre-approval and even knowing of his brother's objection.

Equitable Remedies

In *Tal v. Superior Vending, LLC*, 20 Misc 3d 1103(A) (Sup Ct. Westchester Co. 2008), the court devised a novel, equitable remedy to resolve an LLC dissolution marked by missteps by each of the LLC's two 50 percent members. The LLC operated a vending machine business. After two years of increasing acrimony, the members had a falling out including a physical altercation. The plaintiff was locked out of the business office and removed from the company bank accounts.

The plaintiff filed an action for judicial dissolution, but after two years it was dismissed for failure to prosecute, allegedly without plaintiff's knowledge. Meanwhile, the defendant member set up a new company, owned 100 percent by his wife, into which he commingled the old company's assets with newly acquired assets.

The plaintiff then filed a second dissolution action. The defendant consented to dissolution but insisted that the court could only distribute equipment worth $32,500 that was directly traceable to the dissolved LLC. The plaintiff's expert valued his 50 percent interest at $1.4 million as of the filing of the second dissolution action including the new company's assets.

The court criticized both sides' approaches as "plainly inequitable and unfair." The defendant was offering to pay the plaintiff $16,250 notwithstanding his use for years of plaintiff's original $170,000 cash investment in the business. On the other hand, the plaintiff was seeking an interest in a business that the defendant had subsequently acquired and financed independently. Both sides were to blame for the resulting morass.

The court's practical solution required the plaintiff to surrender his membership interest in return for reimbursement by the defendant of plaintiff's $170,000 investment and certain note payments, with interest from the date of the plaintiff's exclusion from the business.

Fiduciary Duties

Two significant cases decided last year clarify fiduciary duties, first, of controlling shareholders in the context of stock issuance and dilution of minority shareholders and, second, of LLC members in the context of the de facto dissolution of an LLC.

In *Dingle v. Xtenit, Inc.*, 20 Misc 3d 1123(A) (Sup Ct NY Co. 2008), the plaintiff obtained in lieu of salary 15 percent of 10 million authorized and issued shares when he became the company's chief operating officer. The plaintiff left the company a little over a year later, and two years after that the defendant controlling shareholder allegedly convened a special board meeting to authorize and issue an additional 490 million shares to the controlling shareholder without any payment, thereby diluting plaintiff's interest to less than one percent. The plaintiff sued for breach of fiduciary duty, seeking rescission of the stock issuance and damages.

The defendant shareholder moved to dismiss the claims, arguing that the board's action was authorized under provisions of the BCL and also was protected by the business judgment rule.

The court disagreed, finding that, although a "'departure from precisely uniform treatment of stockholders may be justified, of course, where a bona fide business purpose indicates that the best interests of the corporation would be served,'" the defendant shareholder failed to present any evidence of a bona fide purpose for the dramatic increase in the number of authorized and issued shares, especially since the increase appeared to have benefited only himself to the detriment of the minority shareholder.

Matter of Beverwyck Abstract, LLC, 53 AD3d 503 (3d Dept., 2008), involved a title agency organized as an LLC, owned 51 percent by two individuals with a mortgage brokerage business and 49 percent by a title abstract firm owned by an attorney. The arrangement lasted two years before tensions flared. The members met and orally agreed that the 49 percent member and its attorney-owner would stop providing services for the title agency. The 51 percent members sent the attorney a membership assignment form but she never signed it. These 51 percent members nonetheless continued to operate the title agency for almost a year, after which they began operating a newly formed title agency company under a similar name. They also filed a judicial proceeding for dissolution, which was granted.

Both the 51 and 49 percent members disagreed on the date of dissolution for accounting purposes. The 51 percent members argued by analogy to partnership law, that the members' fiduciary duties to one another, including the duty to account, terminated upon the de facto termination of the business relationship by oral agreement at the member meeting. The trial court disagreed and ruled that the 51 percent members must account for all profits through the date of judicial dissolution.

On appeal, the Third Department also rejected the partnership analogy. The court emphasized that the parties are bound by the operating agreement's provisions requiring written consent or formal member vote to cause a voluntary dissolution.

Derivative Actions

Last, but by no means least, the Court of Appeals in *Tzolis v. Wolff*, 10 NY3d 100 (2008), resolved a departmental split on the question whether members of New York LLCs may bring derivative actions.

A number of courts including the Second Department had dismissed LLC member derivative actions based on the LLC law's legislative history indicating the deliberate omission of express statutory authority such as that given corporation shareholders and limited partners.

By 4-3 vote and over a vigorous dissent, the Court authorized derivative suits for LLCs, finding the legislative history "too ambiguous to permit us to infer that the Legislature intended wholly to eliminate, in the LLC context, a basic, centuries-old protection for shareholders, leaving the courts to devise some new substitute remedy."

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