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Expert Analysis

Review of Business Divorce Cases in 2010


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Last year New York courts generated an unusually high number of important appellate and trial court decisions in business divorce cases involving judicial dissolution and other disputes among co-owners of closely held business entities. Continuing a trend noted in last year's review, the majority of these cases arise from limited liability companies (LLCs) which, although enabled less than 20 years ago in New York and most other states, have become the preferred entity for privately owned businesses.

This review highlights some of the more notable decisions from last year resolving controversies surrounding the standards for dissolution of LLCs, authority to expel LLC members, LLC promoter liability, equitable buyout remedies, mandatory buybacks triggered by the filing of dissolution petitions, stock valuation, and receiver compensation.

Standard for LLC Dissolution

Last year's "blockbuster" business divorce decision is *Matter of 1545 Ocean Avenue, LLC*, 72 AD3d 121 (2d Dept. 2010), where the Second Department resolved over 15 years of uncertainty regarding the standard for LLC dissolution under the sparsely-worded LLC Law (LLCL) §702, which provides for judicial dissolution "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement."

The case involved a manager-managed LLC formed to purchase and develop specific commercial real estate. The LLC consisted of two 50 percent member companies, each of which designated its principal to co-manage the LLC under an operating agreement. The agreement authorized either manager individually to act on behalf of the LLC unless unanimous approval otherwise was required. After disputes over the hiring of contractors for the project arose, and one of the managers refused to meet on a regular basis, the other manager announced his intention to withdraw his investment and demanded that all work on the project cease. When the demand was ignored, and the managers were unable to settle on a buyout arrangement, the aggrieved member petitioned for dissolution based on deadlock and obtained injunctive relief temporarily preventing further work on the project. The lower court summarily granted the petition, finding that the LLC was "unable to function as intended."

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On appeal, the Second Department carefully distinguished LLC dissolution under the LLC Law from corporate and partnership dissolution under the Business Corporation and Partnership Laws, noting that "the existence and character of these various entities are statutorily dissimilar as are the laws relating to their dissolution." Focusing on the language of §702, which expressly links the basis for dissolution to the articles of organization or operating agreement, the court decreed a fundamentally contract-based standard for dissolution:

> [F]or dissolution of a limited liability company pursuant to LLCL 702, the petitioning member must establish, in the context of the terms of the operating agreement or articles of incorporation, that (1) the management of the entity is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved, or (2) continuing the entity is financially unfeasible.

Applying the new standard in light of the provision in the operating agreement allowing for unilateral management of the LLC, as well as the company's purpose in developing specific commercial real estate, the Second Department reversed the lower court, holding that despite the disagreements between the managing members, the LLC effectively was operating under the agreement and was meeting the purpose for which it was created—namely, to develop the property.

LLC Member Expulsion

In a pair of decisions last year, courts addressed the circumstances under which controlling members of LLCs and courts may expel a minority member.

Jain v. Rasteh, Index No. 109920-09 (Sup Ct New York Co. Feb. 1, 2010), involved a two-member, New York-based Delaware LLC that was formed to provide investment advisory services to a hedge fund. The operating agreement expressly provided for involuntary "withdrawal" of the minority member and authorized the majority to compel withdrawal "for cause," defined to include any "material breach" of the operating agreement. The majority member terminated the minority member for his refusal to disclose personal trading information in connection with an SEC audit.

The minority member sued, and the majority member moved to dismiss on the basis of documentary evidence. Relying in large part on a series of e-mails, which evidenced the minority member's failure to provide his personal trading information as requested, the court upheld the majority's contractual right of expulsion for cause and granted the motion.

The Second Department in *Chiu v. Chiu,* 71 AD3d 646 (2d Dept. 2010), otherwise confirmed that absent an express provision in the operating agreement, courts have no statutory authority to expel a member for misconduct. The case involved a real estate holding company owned by two feuding brothers whose membership interest was split 75 percent/25 percent. There was no operating agreement.

After the minority brother unilaterally transferred the company's property to a personal trust and the majority brother obtained a judgment voiding the transfer as fraudulent, the majority sued for the expulsion of his brother as a member based on the fraudulent transfer. The minority brother moved to dismiss, and the lower court granted the motion on the ground that the LLC Law does not authorize judicial expulsion absent

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express language in the operating agreement.

The majority brother appealed, citing LLCL §701, which provides for non-judicial dissolution of an LLC upon the expulsion of a member unless the remaining members authorize its continuation, and *Tzolis v. Wolf*, 10 NY3d 100 (2008), in which the Court of Appeals arguably opened the door to non-statutory, equitable remedies by establishing a common-law basis for LLC derivative actions. Without addressing *Tzolis*, the Second Department rejected the majority brother's arguments and affirmed, holding that although §701 mentions member expulsion, "there is no statutory provision authorizing the courts to impose such a remedy" and that because "the LLC did not have an operating agreement setting forth a mechanism for the expulsion of members, the plaintiff failed to state a cause of action for this relief."

Equitable Buyout

In *Matter of Superior Vending, LLC*, 71 AD3d 1153 (2d Dept. 2010), the court upheld a compelled buyout as an equitable remedy in lieu of judicial dissolution. After finding that the petitioner established adequate ground for dissolution, the lower court considered the parties' widely disparate valuations of the subject vending-machine business, which it deemed "plainly inequitable and unfair," and instead imposed a practical solution requiring the aggrieved member to surrender his interest in return for his initial investment. The Second Department affirmed, holding that "[a]lthough the Limited Liability Company Law does not expressly authorize a buyout in a dissolution proceeding," the lower court "properly determined…the most equitable method of liquidation in this case."

Promoter Liability

In *Roni LLC v. Arfa*, 74 AD3d 442 (1st Dept. 2010), the First Department upheld an apparent revival of the old common-law doctrine of corporate promoter liability in the context of the LLC Law, which otherwise does not acknowledge "promoters" or other potential LLC members. The case involved a group of foreign investors solicited by a group of local real estate developers to invest in a series of LLCs formed to purchase and develop apartment buildings in New York City. The investors eventually sued, alleging that the developers breached their fiduciary duties by failing to disclose, before the formation of the LLCs, the fact that the developers would earn millions of dollars in commissions paid by the property sellers and mortgage brokers involved in the deal.

The lower court denied the developers' motion to dismiss, finding that their status as "promoters" meant they had a fiduciary duty to disclose these "secret profits." Citing cases from the late 1800s and early 1900s regarding corporate promoter liability, the First Department affirmed, labeling the developers "promoters" and holding that their planning of the business venture was sufficient to establish a fiduciary relationship.

Buyback Provisions

Courts continue to grapple with the circumstances under which a corporate dissolution petition contractually triggers the petitioner's obligation to convey his shares back to the corporation or his fellow shareholders.

Matter of Stevens (Allied Builder's Inc.), 74 AD3d 1757 (4th Dept. 2010), involved a dissolution petition under BCL §1104-a brought by a minority shareholder alleging oppression. The minority shareholder acquired his shares in the company by way of an option agreement, which provided that a shareholder shall not transfer his shares "whether voluntarily or through any bankruptcy or other insolvency proceedings, adjudication of insanity, death or otherwise" without first offering them to the other shareholders. The majority shareholders moved to dismiss on the ground that the filing of the petition constituted a transfer under the agreement, requiring the petitioner to sell his shares to them.

The lower court granted the motion, finding that "the failure of the [transfer provision] to explicitly enumerate as one of its triggering mechanisms the institution of a dissolution proceeding does not deprive [the provision] of its unambiguous effect on the petition in this case." But the Fourth Department reversed and reinstated the petition, holding that "[a] dissolution proceeding pursuant to Business Corporation Law §1104-a…is an involuntary transfer, and [the provision] of the option agreement does not prohibit involuntary transfers except as explicitly listed, e.g., through bankruptcy."

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In *Matter of Piekos (Home Studios Inc.)*, 28 Misc.3d 1220(A) (Sup Ct Westchester Co. 2010), which also involved a minority shareholder seeking dissolution on the basis of oppression under BCL §1104-a, the court addressed a mandatory buyback provision that required a shareholder to sell his shares to the corporation upon certain defined events, including an event that "would bring about a succession to a third person by operation of law or a court." The majority shareholders opposed the petition, contending that the minority was required to sell his shares to the corporation because the filing of the petition ultimately would result in a court order, which in turn would bring about a succession of his shares to a third person.

The court agreed, concluding that the commencement of a dissolution proceeding constituted a transfer event under the agreement because "the general authority of shareholders to run their business as they determine is disrupted and ultimate decision-making authority is transferred to the court." Recognizing, however, that it would be "unconscionable to permit the majority to oppress a minority into signing a shareholders' agreement that would trigger an unfavorable buyout, thereafter oppress the minority to such an extent that it is compelled to seek judicial relief, and then assert that the oppressed minority must sell out under unfavorable terms," the court ordered a hearing to assess the circumstances around the signing of the shareholders' agreement, as well as the meaning and purpose of the terms of the buyback provision.

Stock Valuation, Receivership

Two other decisions from last year addressed interesting and novel issues related to valuation and receiver compensation.

In *Matter of Murphy (United States Dredging Corp.)*, 74 AD3d 815 (2d Dept. 2010), which involved the buyout and valuation of shares in a real estate holding company, the Second Department affirmed the lower court's application of a 15 percent discount for lack of marketability against the company's entire enterprise value. In doing so, the court effectively overruled 15 years of its own precedents restricting such discounts to a company's good will and eliminated an inter-departmental split with other Appellate Divisions.

Matter of Eklund Farm Machinery Inc., 73 AD3d 1319 (3d Dept. 2010), involved a computation of commissions due a receiver appointed under BCL §1113 to oversee the dissolution of a family-owned business. The Third Department rejected the receiver's argument that the statutory commission percentage should be applied separately to sums received and then again to sums disbursed. The court read BCL §1217's percentage commissions on "sums received and disbursed" literally, reluctantly holding that the statute contemplates a single calculation "based upon the total amount that passed through the receiver's hands." The court then exhorted the Legislature "to afford a court discretion to fix a receiver's commission based upon the value of the services rendered in those cases where, as here, dissolution and the consequent disposition of corporation property are not effectuated."