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BY PETER A. MAHLER

A Review of 2004 Business Divorce Cases

Business divorce aficionados will be pleased but not surprised to know that last year the New York courts decided a number of highly interesting decisions involving dissolution of closely held companies.

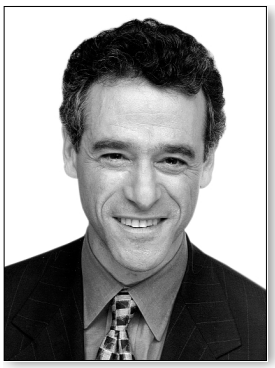
This annual case-law review highlights several species of business divorce including minority shareholder freeze-out, deadlock dissolution, partnership break-ups and dissolution of limited liability companies (LLC).

The LLC category boasts last year's most intriguing dissolution decision, in *Matter of Spires (Lighthouse Solutions, LLC)*.[1] The petitioner in *Spires* obtained an order dissolving the LLC under §702 of the Limited Liability Company Law (LLCL) which authorizes the supreme 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."

The issue posed by *Spires*, answered affirmatively by the court, is whether the statutory default provisions of the LLCL may function as the operating agreement for §702 purposes in the absence of a written operating agreement among the LLC members.

The facts in *Spires* are straightforward. Petitioner and two others formed a member-managed LLC in 1999. They filed perfunctory articles of organization but never adopted a written operating agreement as required by LLCL §417(a).[2] Disagreements concerning the business and its operations arose in 2003. Following unsuccessful negotiations to purchase the petitioner's interest, the other two members changed the office locks and computer passwords. Petitioner unilaterally withdrew $120,000 from the business bank account.

The petitioner initially contended that the entity never became an LLC because the members never adopted an operating agreement, and therefore the entity had to be deemed a partnership dissolvable at will under Partnership Law §62. The court disagreed, finding that the LLC legally existed upon the filing of articles under LLCL §203 and that, despite the mandatory language in LLCL §417 ("the members … shall adopt a written operating agreement"), the statute imposes no penalty for noncompliance.[3]



In support of dissolution under LLCL §702, the petitioner claimed "the complete failure" of the LLC's business purpose and failure of "the original intention of the members."[4] In a ruling of first impression, the court held that "[w]hen there is no written Operating Agreement, [the] statutory default provisions become the terms, conditions, and requirements for the conduct of the members for the operation of the [LLC]" and the court therefore must ascertain under LLCL §702 whether it is not reasonably practicable to carry on the business in conformity with the "statutorily established operating agreement."[5]

The court granted dissolution, finding that, in light of the parties' mutual desire (if not agreement on how) to end their relationship, the business could not be carried on in conformity with LLCL §606(a).[6] The section prohibits member withdrawal from the LLC prior to its dissolution except in accordance with the operating agreement.

Certainly, an argument can be made that the court's recognition of a "statutory operating agreement" is contrary to LLCL §102(u)'s definition of operating agreement as a written agreement of the members. *Spires* also can be criticized as effectively overriding the 1999 amendment to LLCL §606(a) which eliminates a member's right to withdraw from the LLC in the absence of any contrary provision in an operating agreement.

LLCs have existed in New York only 10 years. The case law applying LLCL §702's enigmatic prescription for dissolution is sparse and uneven.[7] Absent appellate guidance, the holding and reasoning of *Spires* likely will generate vigorous debate in other LLC dissolution contests in which, as is too often the case, business partners fail to enter into a written agreement addressing essential ownership, management and succession issues.

Deadlock Dissolution

Business Corporation Law (BCL) §1104 authorizes a 50 percent shareholder of a closely held corporation to petition for dissolution based on board deadlock respecting corporate management, shareholder deadlock at a board election, or when there is internal dissension and two or more shareholder factions are so divided that dissolution would be beneficial to the shareholders. Particularly when the petitioner relies on internal dissension, and even more so when the corporation continues to operate profitably despite the turmoil, these are among the thorniest dissolution cases around.[8]

Two cases decided last year illustrate the problem. In *Matter of Fazio Realty Corp.*,[9] the Second Department reversed a lower court order of dissolution and dismissed the petition alleging internal dissension among the shareholders of a company that owned several apartment buildings. The court acknowledged "considerable and apparently ever-increasing internal corporate conflict" but nonetheless held that the petitioners "failed to demonstrate that the dissension … resulted in a deadlock precluding the successful and profitable conduct of the corporation's affairs."[10]

In contrast, the court in *Matter of Weingarten (Transit Systems Ltd.)*[11] without conducting a hearing ordered dissolution of a taxi medallion management business based on internal dissension. The petitioners offered tax returns showing that the company and its shareholders

Peter A. Mahler *is a partner at Farrell Fritz.*

have "enormous indebtedness." The respondent shareholder, opposing dissolution, argued that the business was "extremely profitable," that the tax returns "do not tell the whole story," and that there was no deadlock as to the day-to-day management. Siding with petitioners, the court stated that the "record clearly demonstrates that the differences and animosity between the shareholders prevents the continued efficient operation" of the business, as evidenced by the prior terminations of two shareholders, the parties' inability to reach any agreement on dissolution and the sale of the company's assets, and the parties' involvement in several lawsuits.

No bright-line rules exist to explain the different outcomes in *Fazio* and *Weingarten*. The only clear thing is that the courts will continue to grapple with such cases so long as the Legislature fails to provide respondent shareholders in deadlock dissolution cases with a statutory right to purchase the petitioner's shares for fair value, as exists in freeze-out cases brought by minority shareholders under BCL §1104-a.

As just mentioned, under BCL §1118 the corporation and any non-petitioning shareholder have the right to purchase for fair value the shares of the petitioning shareholder in dissolution proceedings brought under BCL §1104-a. For tax and other reasons, the controlling shareholder frequently causes the corporation to elect to purchase.

Last year's decision by the U.S. District Court in *Fraternal Composite Services, Inc. v. Karczewski*[12] reminds counsel for petitioners to consider carefully the corporation's financial capability to pay a valuation award. In *Karczewski* the subject company produced photograph composite portraits for college fraternities and sororities. The majority shareholder caused the corporation to elect to purchase after the minority shareholder sought dissolution under BCL §1104-a. A referee valued petitioner's shares at over $800,000. Interest accruing from the valuation date put the prospective award over $1 million.

One day prior to a hearing on the corporation's motion challenging the payment terms, and before judgment on the award was entered, the corporation filed for bankruptcy under Chapter 11. Upon the minority shareholder's motion the Bankruptcy Court dismissed the Chapter 11 petition as premature.

The corporation appealed to the District Court which affirmed the dismissal on the ground the bankruptcy petition was not filed in good faith. The court found that the corporation was able to meet its current obligations and that, essentially, it improperly filed for bankruptcy in an effort to litigate in an alternate forum state-court issues concerning the terms of payment of the valuation award.[13]

Karczewski is but one illustration of the collection risks faced by an unsecured petitioner in buyout proceedings under BCL §1118. Counsel for petitioners always should give serious thought to making an application under BCL §1118(c)(2) which gives the court discretion to require, at any time before actual purchase of the shares, the posting of a bond or other security for the fair value of petitioner's shares.[14]

The courts will struggle if the Legislature fails to provide respondent shareholders with a right to buy petitioner's shares for fair value, as in BCL §1104-a freeze-out cases.

Partnership Break-up

Partnership law generally is more conducive to nonjudicial dissolution than the laws governing corporate dissolution, hence cases involving judicial dissolution of partnerships are relatively rare. Business divorce litigation involving partnerships is more likely to involve disputes over winding-up issues, or enforcement of the dissolution provisions of a partnership agreement.

The latter took center stage in *Urban Archeology Ltd. v. Dencorp Investments, Inc.*,[15] where the First Department reversed an order extending the offeree-partner's time to respond to the offeror-partner's exercise of a 90-day buyout option.

Urban involved two partners in a highly successful business selling architectural antiques and reproductions. The partnership agreement contained a put-and-call buyout option (also known as a "shotgun") under which either partner, upon deciding that dissolution is warranted, can give written notice of offer to sell its interest to the other at a specified price. The offeree has 90 days to accept the offer followed by 90 days to close. If the offeree fails to accept within 90 days, the offeree must sell its interest to the offeror at the same purchase price specified in the offeror's notice.

The skirmishing began in February 2003 when inside Partner A told outside Partner B of its probable intent to implement the option. Partner A claimed that, in response, Partner B engaged in a course of conduct designed to force an exorbitant lump-sum buyout or forgo implementation of the option.

On May 1, 2003, Partner A simultaneously served written notice of intent to exercise the option at a $6 million purchase price and commenced an action for specific performance of the option free from interference by Partner B. Partner B counterclaimed seeking an audit and moved for preliminary injunction tolling the 90-day exercise period that expired July 31, 2003. Partner B contended that Partner A blocked access to corporate records thereby preventing it from fairly evaluating the option's terms.

The court entered a series of orders extending the option exercise period through Nov. 17, 2003, to permit a "knowing" exercise of the option and to arrange for necessary financing. On Nov. 13, 2003, Partner B gave notice of its intention to exercise the option at the $6 million purchase price.

On appeal by Partner A, the First Department invoked the rule that an optionee may only exercise a purchase option in "strict accordance" with its terms and that the court's authority to extend the option is limited to "exceptional circumstance" upon satisfaction of the traditional tripartite test for injunctive relief.[16] Calling Partner B's allegation of blocked access to information "unsubstantiated," and noting that the partnership agreement had no financing contingency clause, the court held that the orders extending the exercise period violated the agreement's express terms.

Thus did Partner A win *Urban* warfare.

1. 4 Misc 3d 428, 778 NYS2d 259 (Sup Ct Monroe Co 2004).

2. The members executed two limited-duration interim agreements, one of which expired in 2002 and the other, although still in effect when petitioner filed for dissolution in 2003, dealt only with voting rights for routine business matters and did not address business operation or other member rights. Id. at 430, 778 NYS2d at 261-62.

3. Id. at 431, 778 NYS2d at 262.

4. Id. at 432, 778 NYS2d at 263.

5. Id. at 436, 778 NYS2d at 266.

6. Id. at 438, 778 NYS2d at 267.

7. See P. Mahler, "When Limited Liability Companies Seek Judicial Dissolution, Will the Statute Be Up to the Task?", N.Y. St. Bar Assoc. J. Vol. 74, No. 5 (June 2002).

8. See P. Mahler, "Shareholder Wars: Internal Disputes in Close Corporations Do Not Always Lead to Judicial Dissolution", N.Y. St. Bar Assoc. J. Vol. 76, No. 8 (October 2004).

9. 10 AD3d 363, 781 NYS2d 118 (2d Dept 2004).

10. Id. at 365, 781 NYS2d at 118.

11. Index No. 2437/04 (Sup Ct Queens Co May 11, 2004).

12. 315 B.R. 253 (NDNY 2004).

13. Id. at 257-58.

14. See *Matter of Kastleman (Elliot Kastle, Inc.)*, 234 AD2d 181, 651 NYS2d 485 (1st Dept 1996) (ordering $1 million bond based on serious allegations of waste and mismanagement and respondent's questionable ability to complete purchase).

15. 783 NYS2d 330 (1st Dept 2004).

16. Id. at 335-36.