New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

Web address: http://www.nylj.com

VOLUME 237—NO. 17 THURSDAY, JANUARY 25 2007 ALM

OUTSIDE COUNSEL

BY PETER A. MAHLER

Business Divorce Cases of 2006

The novelist John Updike wrote, "By the time a partnership dissolves, it has dissolved."[1] Had he meant partnership of the business type, instead of the intimate sort, he might have had to rewrite it, less succinctly, as "By the time a partnership dissolves, depending if it's a corporation, limited liability company, general or limited partnership, and depending if the principals entered into a comprehensive written agreement with reasonably fair buyout provisions, it may or may not be legally dissolved after protracted litigation."

Less compelling prose—but a more fitting introduction to last year's leading business divorce cases decided by New York courts.

Business Corporations

There were several important decisions last year involving dissolution of closely held corporations under Business Corporation Law (BCL) §§1104 and 1104-a. Foremost is *Matter of Johnsen (ACP Distribution, Inc.)*[2] where the First Department held that the filing of a deadlock dissolution petition by a 50 percent shareholder triggered the forced sale of the petitioner's shares to the other shareholder at a below-market formula price under the right of first refusal (RFR) contained in the shareholders' agreement.

Johnsen is the first appellate word on the subject since *Matter of Doniger (Rye Psychiatric Hospital Center, Inc.)*,[3] decided 20 years earlier, where the Second Department also held that the petition triggered the RFR. In both cases, the shareholders' agreement contained typical language requiring a shareholder who desires to sell "or otherwise dispose" of shares first to offer them for sale to the corporation or the other shareholders at a formula price.

In *Doniger*, unlike *Johnsen*, the RFR also referred to the involuntary passage of shares by judicial order—language that a number of post-*Doniger* trial court decisions viewed as critical to the outcome. Without addressing that point the *Johnsen* court nonetheless concludes that the case falls "squarely within the holding" of *Doniger*.[4] After *Johnsen*, shareholder counsel must review carefully any RFR in the shareholders' agreement before commencing a dissolution proceeding that may result in the compelled sale of their client's shares on unfavorable terms.[5]

Peter A. Mahler, *a partner at Farrell Fritz, specializes in complex business litigation.*

Matter of Marciano (Champion Motor Group, Inc.)[6] illustrates the difficulties that can arise in the dissolution context when business partners fail to memorialize adequately their respective stock holdings. In *Marciano* the petitioner claimed 38 percent ownership of shares in a luxury car dealership notwithstanding that he had not been issued a stock certificate, he had never signed a shareholders' agreement and the corporation's tax returns identified him as holding less than 1 percent of its stock.

'Matter of Johnsen' said the filing of a deadlock dissolution petition by a 50 percent shareholder triggered the forced sale of petitioner's shares to the other shareholder at a below-market formula price under the right of first refusal.

The respondents, in support of their argument that petitioner lacked the minimum 20 percent shares required to seek dissolution under BCL 1104-a, alleged that petitioner took a minimal stock interest at his own request, and that his reason for doing so only became apparent several years later when he was indicted for unrelated stock fraud. Respondents also argued that the petition was barred by petitioner's unclean hands and because they acted reasonably in excluding petitioner from the business after his indictment.

The court denied respondents' motion to dismiss the petition, finding that there were disputed issues of fact surrounding petitioner's stock ownership, that they could not show the requisite injury to themselves required by the unclean-hands doctrine, and that the proof of negative impact on the business from petitioner's indictment was inconclusive.

In *Matter of Markman (Exterior Delite, Inc.)*[7] the court addressed an important procedural point concerning the interplay of stock valuation proceedings under BCL 1118 and claims against the purchasing shareholder for misappropriation of corporate assets. After conducting a valuation hearing, the special referee in *Markman* rejected the petitioner's evidence of excessive compensation and other alleged misappropriation by the majority shareholder on the ground the petitioner did not bring a derivative action.

The court, however, granted the petitioner's motion to vacate that part of the referee's report, stating that the 1118 election does not moot the petitioner's allegations of financial improprieties affecting valuation. As the court explained, although a petitioner may bring a concurrent derivative action, which normally will be consolidated with the valuation proceeding, the petitioner need not do so in view of the court's authority under BCL 1104-a(d) and 1118(b) to adjust stock valuations for any transfer of corporate assets for inadequate consideration.

Many business divorce cases result in buyout settlements. *Gabel v. Gabel*[8] highlights the importance to the seller of anticipating and, if need be, seeking indemnification for, tax liabilities relating to the company's yet-to-be filed tax returns for any tax year in which the seller was a shareholder.

Following a buyout settlement, the plaintiff-seller in *Gabel* brought an action seeking to enjoin the company and the purchaser from issuing a Form K-1 for the year in which they settled, based on defendants' projections showing almost $400,000 taxable income to plaintiff. Plaintiff contended that the corrected K-1 should show a small loss. Defendants argued, and the court agreed, that the federal anti-injunction statute[9] deprives the court of subject matter jurisdiction to hear the claim and that plaintiff's recourse, if any, is to pursue administrative remedies with the Internal Revenue Service (IRS) and, if still aggrieved, in the federal tax court.

Limited Liability Companies

Section 702 of New York's LLC Law (LLCL), enacted 12 years ago, has a cryptic provision for judicial dissolution, modeled after the limited partnership statute, stating that a court may decree dissolution "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." Since then the LLC has become the preferred form of closely held business organization and the number of dissolution cases has gone from a trickle to a steady stream.

Several cases decided last year suggest that the law of LLC dissolution is still experiencing growing pains. One reason is the dearth of appellate cases interpreting §702. The lone Appellate Division decision last year addressing the standard for LLC dissolution, in *Widewaters Herkimer Co. v. Aiello*,[10] without elucidation upheld the dismissal of a dissolution claim brought by a minority member who alleged breach of fiduciary duty and oppressive conduct by the majority members.[11]

The absence of an operating agreement set the stage for a highly instructive decision in *Matter of Horning (Horning Construction, LLC)*,[12] where the petitioner was sole founder of a successful construction business. Years later he formed an LLC to which he transferred the business, retaining a one-third membership interest for himself while giving one-third interests to each of two employees with the idea that eventually they would assume day-to-day responsibilities of running the business. The members were unable to conclude an operating agreement.

After the relationship deteriorated, and following unsuccessful buyout negotiations, the petitioner sought dissolution primarily due to the intense animosity between him and the other two members. Petitioner relied on *Matter of Spires (Lighthouse Solutions, LLC)*[13] to argue that dissolution of an LLC without an operating agreement is mandated whenever a member desires to sever his relationship with the LLC due to untenable circumstances. The respondents countered that the business, which had 40 employees, was thriving notwithstanding the personal friction with petitioner, that revenues had doubled since respondents joined the LLC and that there was no impediment to the LLC's continued operation under the majority rule of the two respondents.

While expressing sympathy with petitioner's plight, the court concluded that petitioner could not meet the "strict" standard for dissolution under §702 and therefore dismissed the petition. The court's opinion discusses in depth the additional barriers to member withdrawal and dissolution created by the 1999 amendments to LLCL 606 and 701, observing that they place members in petitioner's position "at the mercy of other members' conduct…particularly in view of the fact that there is no buy out provision in the LLCL similar to that in the BCL and other like statutes."[14] The court also refused to read *Spires* as mandating dissolution whenever a member seeks to withdraw from an LLC that has no operating agreement.

The First Department's decision last year in *Lyons v. Salamone*[15] raises novel issues concerning alternative remedies in LLC dissolution cases. There, a 20 percent member petitioned to dissolve an LLC that operated an exercise club and gym, accusing the 80 percent member of diverting funds and failing to manage the LLC in a businesslike manner. The trial court ordered dissolution and appointed a receiver due to the LLC's severe operating losses and management disarray.

Over the petitioner's objection, however, the court authorized the receiver to sell the business as a going concern pursuant to a mutual buyout procedure under which the receiver first determines the fair market value (FMV) of each member's interest. The two members then have the option to bid an amount equal to the FMV of the opposing party's interest, less the opposing party's share of the LLC liabilities, plus the bidder's share of the receiver's fees. If both parties wish to bid, the receiver must accept the "highest bid."[16]

On appeal the First Department approved the buyout remedy, although it also modified the lower court's order to require that the receiver's valuation and sale be subject to court confirmation, stating:

> We reject plaintiff's argument that the absence of a provision in the [LLCL] expressly authorizing a buyout in a dissolution proceeding rendered the IAS court without authority to grant the parties mutual buyout rights, and find that it is an equitable method of liquidation to allow either party to bid the fair market value of the other party's interest in the business, with the referee directed to accept the highest legitimate bid.[17]

The buyout in *Lyons* raises several questions. First, courts previously have held that, in the absence of statutory authority, a member opposing LLC dissolution has no right to compel a sale by the petitioning member.[18] Although the *Lyons* buyout gives both members bidding rights, the petitioner's apparent antipathy to bidding for the other member's 80 percent interest effectively turns the mutual buyout into an involuntary sale of the petitioner's 20 percent interest to the other member.

Second, the court's reference to the buyout as a method of "liquidation" is puzzling, particularly in light of the subject LLC's severe financial distress. In a true liquidation for the benefit of the company's creditors, the receiver or liquidating trustee is obligated to maximize proceeds which normally will be achieved by public auction of the company's assets.

Finally, the court's use of FMV as the standard of value is equally puzzling. The several statutes governing buyouts and appraisal rights in the corporate and partnership arena uniformly use "fair value" rather than FMV, the principal difference being the former's exclusion of any minority discount for lack of control. Application of a minority discount under the circumstances in *Lyons*, where the 20 percent petitioner prevailed on her request for dissolution, is counter to prevailing doctrine.

Partnerships

No list of last year's important business divorce cases is complete without mention of *Bailey v. Fish & Neave*[19] where the First Department unanimously upheld amendment of a partnership agreement by majority vote, the effect of which was to financially penalize partners of a law firm who withdrew from the firm in advance of the firm's anticipated merger. Making matters more interesting, the Court of Appeals recently granted the plaintiffs leave to appeal.

Justice Williams' opinion for the court frames the key issue as follows: "whether or not the parties' partnership agreement, which provides that a majority partnership interest vote is conclusive on 'all questions relating to the partnership business (including dissolution of the partnership),' was properly amended by majority vote on the issue of compensation of withdrawing partners."[20] The court sanctioned the amendment on the ground that the agreement's section governing partner withdrawal does not qualify the majority rule provision, as the agreement does in certain other matters. The court also found that the amendment was voted in accordance with §40 of the Partnership Law which requires unanimous consent to modify a partner's rights "subject to any agreement between them."

As reported in this journal,[21] a Court of Appeals decision in *Bailey* could have a major impact on law firm mergers that, typically, spawn departures to other firms of partners with substantial claims for return of capital and other compensation. The decision likely will have a far broader impact on partnerships of all types, by clarifying the contours of majority rule versus protection of individual partner rights under the Partnership Law.

1. J. Updike, "Couples," p. 453 (Knopf 1968).
2. 31 AD3d 172, 814 NYS2d 142 (1st Dept 2006).
3. 122 AD2d 873, 505 NYS2d 920 (2d Dept 1986).
4. 31 AD3d at 177, 814 NYS2d at 145. Two months after *Johnsen*, and without citing *Johnsen* or *Doniger*, the Third Department in *Eklund v. Pinkey*, 31 AD3d 908, 816 NYS2d 912 (3d Dept 2006), rejected a similar attempt to force a sale under the RFR following commencement of dissolution proceedings. The Court of Appeals recently denied leave to appeal in *Eklund*. 2007 NYSlipOp 60401 (Ct App Jan. 9, 2007).
5. For a more thorough analysis of the *Johnsen* case, see P. Mahler and M. Schoenberg, "Dissolution Petition Can Unwittingly Trigger Stock Buyback," NYLJ, July 21, 2006, p. 4, col. 4.
6. Decision & Order, Index No. 1264/06 (Sup Ct Nassau Co Sept. 5, 2006) (Warshawsky, J.).
7. 2006 NY Slip Op 52416(U) (Sup Ct Bronx Co Dec. 18, 2006) (Renwick, J.).
8. NYLJ, Aug. 8, 2006, p. 21, col. 1 (Sup Ct NY Co) (Cahn, J.).
9. 26 USC §7421(a) provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed."
10. 28 AD3d 1107, 817 NYS2d 790 (4th Dept 2006).
11. *Widewaters* sits uncomfortably alongside the very first appellate application of §702, in *Matter of Roller (W.R.S.B. Development Co.)*, 259 AD2d 1012, 689 NYS2d 897 (4th Dept 1999), where the court affirmed the denial of a motion to dismiss a dissolution complaint based largely on allegations of oppression and breach of fiduciary duty.
12. 12 Misc3d 402, 816 NYS2d 877 (Sup Ct Monroe Co 2006) (Fisher, J.).
13. 4 Misc3d 428, 778 NYS2d 259 (Sup Ct Monroe Co 2004) (Stander, J.). *Spires* has drawn criticism in this annual column and elsewhere as inconsistent with the 1999 amendment to LLCL 606 governing member withdrawal. See P. Mahler, "A Review of 2004 Business Divorce Cases," NYLJ, March 30, 2005, p. 4, col. 4; Horning, 12 Misc3d at 408, 816 NYS2d at 881, fn. 1.
14. 12 Misc3d at 409, 816 NYS2d at 882; see generally P. Mahler, "When Limited Liability Companies Seek Judicial Dissolution, Will the Statute Be Up to the Task?," NYS Bar Assoc. J. Vol. 74, No. 5 (June 2002).
15. 32 AD3d 757, 821 NYS2d 188 (1st Dept 2006).
16. The trial court's unpublished Decision & Order, Index No. 24290/04 (Sup Ct Bronx Co Dec. 6, 2005) (Stinson, J.), does not explain whether the referee is to select the higher of two bids for disparate interests based on price-per share or gross dollars. Comparing the bids is even more problematic if the referee includes a minority discount and/or control premium in assessing the FMV of the respective 20 percent and 80 percent interests.
17. 32 AD3d at 758, 821 NYS2d at 188.
18. See *Matter of Molina (Extreme Wireless, LLC)*, Decision & Order, Index No. 19864/01 (Sup Ct Westchester Co May 24, 2002) (Rudolph, J.), aff'd, 299 AD2d 549, 750 NYS2d 520 (2d Dept 2002); *Vattes v. Tiffany Properties, LLC*, Decision & Order, Index No. 8518/02 (Sup Ct Nassau Co Oct. 22, 2002) (Warshawsky, J.).
19. 30 AD3d 48, 814 NYS2d 104 (1st Dept), leave to appeal granted, 7 NY3d 713, 824 NYS2d 605 (2006).
20. Id. at 51-52, 814 NYS2d at 107 (quoting partnership agreement).
21. "Top Court to Consider Firm's Right to Defer Compensation," NYLJ, Nov. 7, 2006, p. 1, col. 3.