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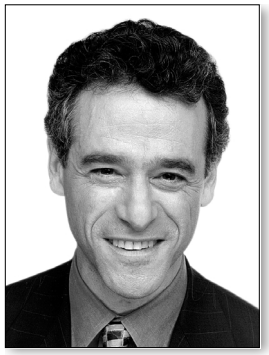
A Review of 2003 Shareholder 'Freeze-Out' Cases

This fifth annual review of shareholder freeze-out proceedings under Business Corporation Law (BCL) §§1104-a and 1118 highlights decisions of interest concerning standing to seek dissolution; remedies available under §1104-a versus §1104 governing deadlock proceedings; removal of dissolution proceedings to Surrogate's Court; interim remedies; the effect of a buy-out agreement; corporate liquidation and the valuation of minority stock.[1]

Corporate dissolution practitioners know all too well the personal antagonism that can erupt between divorcing business partners, and that all too often infects litigation tactics. A respondent majority shareholder, smarting from the minority shareholder's accusations of oppressive conduct and looking to counterpunch, may seek dismissal on the ground the petitioner is not a shareholder or holds less than the minimum 20 percent interest required for §1104-a standing. Typically this occurs with smaller enterprises that may not issue certificates, prepare minutes or maintain a stock ledger.

The tactic initially succeeded in the trial court but ultimately succumbed to a sharply worded reversal by the Appellate Division, Second Department, in *Matter of Capizola (Vantage Int'l Ltd.)*.[2] Respondent denied petitioner's stockholder status based on the non-consummation of the shareholders' agreement and petitioner's receipt of salary as a corporate employee, which apparently convinced the trial court. The Second Department's order of reversal recites "overwhelming" evidence to the contrary, including petitioner's contribution of the business concept and introduction of the other shareholders; a stock certificate in petitioner's name on which respondent wrote "Void"; the unsigned shareholders' agreement's recital that petitioner was already a shareholder; and a Schedule K-1 and franchise tax return reporting petitioner as a 20 percent shareholder.

The court also discounted respondent's credibility based on his destruction of stock transfer records, his "absurd" testimony that petitioner was removed as president a year before being told so, and respondent's dubious account of the theft of corporate records from his car. In a final blast that captures the behavior in many a dissolution contest, the court wrote that respondent "demonstrated through his testimony, his opposition to the search of his computer hard drives to overcome the destruction or loss of documents, and his destruction of a document, that his posture in this lawsuit is dictated by pure animosity to the petitioner and a motive to thwart the petitioner's claims at any cost. The Supreme Court erred in accepting this imperious stance."



The grant of interim relief such as preliminary injunction, appointment of a temporary receiver or an undertaking effectively can dictate the outcome of dissolution proceedings. Last year saw several interesting decisions in this area.

1104-a versus 1104

A 50 percent shareholder may seek dissolution under §1104-a for oppression, fraud, illegality, corporate waste and looting, or under §1104 for deadlock and internal dissension, or both. A petition brought solely under §1104 precludes the respondent from exercising buy-out rights under §1118 which only applies in §1104-a proceedings.

The statutory distinction makes little sense but is strictly enforced by the courts. For example, last year in *Matter of Oak Street Management, Inc.*,[3] the Second Department reversed the trial court's sua sponte appointment of a referee for an appraisal for the purpose of encouraging a buy-out.

"Absent an agreement between the parties to sell the shares of the corporation to each other or to an outside buyer, the only authorized disposition of corporate assets is liquidation at a public sale," the court wrote.

Concurrent Proceedings

BCL §1112 mandates commencement of dissolution proceedings in Supreme Court. In *Porazzo v. Danaher*,[4] the defendant executrix of the estate of her deceased husband, who owned 50 percent of the corporation, successfully moved to remove the dissolution to Surrogate's Court where the estate concurrently brought a turnover proceeding against the other shareholder based on the shareholders' agreement. Supreme Court held that it did not need the Surrogate's prior consent to the transfer, that Surrogate's Court may properly adjudicate corporate dissolution, and that removal effectuated judicial economy because the shareholders' agreement was inextricably connected with a contested will.

Interim Remedies

The grant of interim relief such as preliminary injunction, appointment of a temporary receiver or an undertaking effectively can dictate the outcome of dissolution proceedings. Last year saw several interesting decisions in this area.

In *Matter of C-Air Customhouse Brokers-Forwarders, Inc.*,[5] the Second Department affirmed an order granting petitioner's motion to enjoin respondents from adding or removing directors pending the dissolution proceeding.

In *Matter of Kaye (PTAK Brothers, Inc.)*,[6] petitioner unsuccessfully sought to enjoin operation of respondent's separate, competing jewelry business. The court found that petitioner's allegations raised serious questions about respondent's breaches of fiduciary duty and shareholders' agreement, but denied the "drastic" remedy of a shut-down because petitioner did not

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demonstrate that the decline in the corporation's business was attributable to respondent's business. The court did, however, enjoin respondents from using corporate funds to pay counsel fees in the dissolution.

Matter of Springer (Rapid Recovery Enterprises, Inc.),[7] raised a novel legal issue when respondent opposed petitioner's motion for appointment of a receiver under BCL §1113 after respondent failed to provide a previously ordered undertaking to secure a buy-out. Respondent argued that once he elected to purchase under §1118, the proceeding no longer was one for judicial dissolution under Article 11 and therefore no appointment could be made under §1113. The court disagreed, reasoning that "judicial dissolution" merely refers to the title of Article 11 and does not limit its application.

Effect of Buy-Out

Two Second Department rulings in 2003 involve disputes following a buy-out agreement over the disposition of corporate assets not expressly dealt with in the agreement.

In *Matter of Lipton (Carmel Professional Office Park, Inc.)*,[8] Supreme Court appointed a temporary receiver of the corporation's real estate business. Respondent thereafter made an agreement to buy out petitioner. Supreme Court, after a hearing, directed that almost $7,000 of the funds in the temporary receiver's account be distributed to petitioner.

The Second Department reversed based on BCL §1116 which requires the temporary receiver to redeliver all remaining property to the corporation upon discontinuance of a dissolution proceeding. The appeals court held that the dissolution proceeding no longer existed once the parties made their buy-out agreement, and it ordered the $7,000 returned to the corporation.

In *Matter of Brooklyn Resources Recovery, Inc.*,[9] the parties settled their valuation dispute after respondents elected to purchase petitioners' shares. The settlement included petitioners' general release of the corporation from all future claims, including claims for debts, with the exception of the dissolution petition as it had been pleaded as of the date of the settlement. The petitioners subsequently sought leave to assert a claim for repayment of shareholder loans with interest totaling almost $1.7 million. The Second Department affirmed an order denying petitioners' motion, pointing to the petition's omission of any such claims and to the unambiguous language of the general release.

Several decisions last year resolved novel issues involving corporate liquidation and the valuation of minority stock interests under §1118.

In *Matter of Leslie & Penny for Penny Preville, Inc.*,[10] the husband and wife respondents started a business in the 1970s designing, manufacturing and selling high-quality jewelry. They incorporated the business in 1990 as Penny Preville, Inc., after the wife's maiden name. In 1993, upon petitioner's purchase of a 50 percent stock interest in the corporation, the parties entered into a shareholders' agreement providing that upon dissolution and regardless of fault, respondents "shall have the exclusive rights to the continued use of the trade name 'Penny Preville' ".

As profits grew in the 1990s so did dissension among the shareholders culminating with petitioner's commencement of a §1104-a dissolution proceeding in 2001. Respondents agreed to dissolution and appointment of a receiver. Citing the shareholders' agreement, respondents asserted the exclusive right to use the trade name "Penny Preville" and to the substantial value of the corporation's goodwill associated therewith which, they claimed, was not distributable upon dissolution.

In 'Matter of Koufalis,' the court ruled that the valuation formula in the parties' shareholders' agreement does not dictate 'fair value' and is used only as a 'guide.'

Affirming the trial court, the Second Department ruled that the agreement only gave respondents the exclusive right to use of the trade name upon dissolution and did not create a mere license of the trade name to the corporation. The agreement did not explicitly give respondents the right to the value of the corporation's goodwill associated with the trade name, nor did it except such goodwill or the trade name from the corporation's assets distributable upon dissolution. The court thus ordered that the goodwill associated with the trade name must be distributed along with the corporation's other assets upon dissolution.[11]

Matter of La Sala (Andrea La Sala & Sons, Inc.),[12] involved the valuation of several related companies of which the most substantial owned a residential apartment complex appraised by both sides' experts at $14 million to $14.5 million using sales comparison and income approaches. The court accepted the higher value and applied to the net asset value a 25 percent discount for lack of marketability (DLOM) based on "ample precedent" in appellate case law. In a ruling of apparent first impression, the court rejected respondents' claim for a discount based upon potential capital gains tax liability upon the subchapter C corporation's future sale of the appreciated realty.

In *La Sala*, the petitioner's and respondents' experts cited different data in urging the court to apply 10 percent and 35 percent DLOMs, respectively. The court labeled the opinions "at opposite extremes and unpersuasive." To this writer, applying the same discount simply because it has been used by courts in other valuation cases encourages the parties to advocate the "extreme" positions shunned by the court on the theory that the court will split the difference.

'Fair Value' Not Dictated

Finally, in *Matter of Koufalis (3864 Merrick Restaurant Corp.)*,[13] the court ruled that the valuation formula in the parties' shareholders' agreement does not dictate "fair value" under §1118 and is used only as a "guide." The court largely adopted the valuation of petitioner's expert who determined that the restaurant business's gross receipts as reported to tax authorities were understated by as much as two-thirds. Using sales figures recorded by respondent in a "black notebook," and applying the multiplier in the shareholders' agreement together with a 10 percent DLOM, the expert valued petitioner's one-third interest in the low $400,000s.

Then *Koufalis* gets interesting. Respondent testified that the business borrowed $140,000 from loan sharks. Loan repayments to "Mafia" were listed in the corporate records. The court observed that although it "does not normally take into consideration outstanding loans to the 'Mafia' as liabilities, it appears, there being no 'loud' objection, that such loans were actually made and still exist." The court reduced the value of petitioner's shares to $331,000.

(1) The author's previous annual reviews were published on Feb. 25, 2000, Jan. 3, 2001, Feb. 8, 2002 and Jan. 2, 2003. For a comprehensive review of case law under BCL §§1104-a and 1118, see the author's two-part article published in the May/June and July/August 1999 issues of the N.Y. State Bar Journal, Vol. 71, Nos. 5-6.

(2) 2003 WL 23099087 (2d Dept 12/29/03). Other notable decisions last year rejecting standing challenges include *Matter of Musano (Sisto Funeral Home, Inc.)*, 300 AD2d 302, 754 NYS2d 548 (1st Dept 2003), and *Litvin v. O'Neal*, Index No. 23170/02 (Sup Ct Kings Co 3/27/03).

(3) 307 AD2d 320, 762 NYS2d 522 (2d Dept 2003).

(4) NYLJ 6/9/03, p. 34 col. 6 (Sup Ct Nassau Co).

(5) 303 AD2d 499, 756 NYS2d 435 (2d Dept 2003).

(6) Index No. 102578/03 (Sup Ct NY Co 3/7/03).

(7) Index No. 8512/02 (Sup Ct Suffolk Co 4/18/03).

(8) 308 AD2d 452, 764 NYS2d 124 (2d Dept 2003).

(9) 309 AD2d 931, 766 NYS2d 121 (2d Dept 2003).

(10) 303 AD2d 508, 757 NYS2d 302 (2d Dept 2003).

(11) The trial court subsequently denied petitioner's motion, based on his expert's report, to value the trade name and goodwill without a hearing at $9.5 million. NYLJ , Sept. 18, 2003 p. 25 col. 3 (Sup Ct Nassau Co). Respondent's expert's report valued the same asset at $580,000. The court instead appointed a referee to hear and report on the value of all of the assets of the dissolved corporation.

(12) NYLJ 2/6/03 p. 24 col. 1 (Sup Ct Westchester Co).

(13) Index No. 20335/00 (Sup Ct Nassau Co 12/16/03).