New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 247—NO. 30
WEDNESDAY, FEBRUARY 15, 2012

Outside Counsel

Expert Analysis

Business Divorce Cases of 2011

"In business partnerships and marriage partnerships, oh, the cheating that goes on."

It is an old American proverb that also explains a fair portion of the many lawsuits brought every year in New York courts between co-owners of closely held businesses. The year 2011 was no exception.

This review highlights a number of important rulings issued last year by appellate and trial courts, deciding procedural and substantive issues involving promoter liability, fiduciary breach, venue, standing, appraisal rights, and valuation in connection with closely held corporations, limited liability companies, and professional corporations.

Promoter Liability

In our review of 2010's top business divorce cases, we reported on *Roni LLC v. Arfa*, 74 AD3d 442 (1st Dept. 2010), in which the First Department held that the organizer of a limited liability company (LLC) can be held liable to investors under a status-based, corporate "promoter" theory as a fiduciary for certain pre-formation nondisclosure. In that case, foreign investors sued local real-estate developers who solicited investments for the purpose of developing residential property in New York without disclosing to the investors certain brokerage commissions they stood to receive in connection with the deal.

Upon a grant of leave to appeal, last year the Court of Appeals affirmed the First Department's ruling, 2011 NY Slip Op 09163 (Ct. App. Dec. 20, 2011), although it expressly declined to do so on the stand-alone basis of the defendants' status as promoter. Rather, the Court rested its decision on traditional fiduciary theory, based on the complaint's allegations regarding the plaintiffs' limited knowledge of the New York real-estate market, the particular experience and expertise of the defendants in that area, and the position of trust and confidence the defendants thereby assumed.

Fiduciary Breach and Releases

Also on the topic of fiduciaries, the Court of Appeals in *Centro Empresarial Cempresa S.A. v. America Movil, S.A.B. de C.V.*, 17 NY3d 269 (2011), closed the door on previous appellate precedent that arguably precluded a fiduciary involved in a self-interested transaction with a fellow owner from relying on a release given as part of the transaction to avoid liability in connection with the failure to disclose material information.

By **Peter A. Mahler**

And **Matthew D. Donovan**

Centro involved the plaintiffs' sale in 2002-03 of their minority interest in a telecommunications company to the majority owners under a put right, which the plaintiffs allegedly exercised on the basis of the defendants' dismal portrayal of the company's finances. The purchase agreement contained a broad release in the defendants' favor of all claims relating to plaintiffs' interest in thecompany.

> In 'Barasch,' the court ruled in favor of the dissenting shareholder over the objection of the controlling shareholders who denied a complex corporate reorganization triggered the right to dissent and seek appraisal.

After a 2008 audit allegedly disclosed that, at the time the plaintiffs exercised their put right, the company was in much better financial shape than had been represented by the defendants, the plaintiffs sued for breach of fiduciary duty and fraudulent inducement. The lower court denied the defendants' motion to dismiss based on the parties' release. The First Department reversed.

In its affirmance of the First Department, the Court of Appeals disposed of the appellate authority relied upon by the plaintiffs, particularly *Littman v. Magee*, 54 AD3d 14 (1st Dept. 2008), that arguably would enervate the release based on a non-releaseable fiduciary duty among owners to disclose material financial information in connection with such a transaction. "A sophisticated principal is able to release its fiduciary from claims," the Court wrote, "so long as the principal understands that the fiduciary is acting in its own interest and the release is knowingly entered into."

Based on allegations in the complaint that the plaintiffs, who were sophisticated corporations advised by counsel, knew that the defendants had not given them a complete financial picture of the company and nonetheless pursued the transaction "without conducting even minimal diligence to determine the true value of what they were selling," the Court upheld the release and affirmed dismissal of the complaint.

Venue

In *Matter of Supplier Distrib. Concepts Inc.*, 80 AD3d 869 (3d Dept. 2011), the Third Department reversed an order departing from the statutory mandate, requiring that a proceeding for judicial dissolution under Article 11 of the Business Corporation Law (BCL) be commenced in the judicial district that correlates with the county identified as place of business in the certificate of incorporation.

The petitioning shareholder sought dissolution of a corporation and limited liability company in Broome County where he resided and his lawyer practiced, and allegedly where the companies had an office. The respondents moved to transfer the proceeding to Monroe County where the companies' offices were located as listed in the State Department filings. The petitioner cross-moved to retain venue in Broome County for the convenience of material witnesses. The trial court sided with petitioner and retained venue in Broome County. The respondents appealed.

The Third Department reversed, relying on the companies' officially designated offices in Monroe County and the fact that the petitioner sought no relief beyond an order of dissolution. The appellate court further held that the petitioner failed to meet his burden in establishing the materiality of his proposed witnesses and the manner in which they would be inconvenienced by a trial in Monroe County.

PETER A. MAHLER *is a litigation partner at Farrell Fritz.*
MATTHEW D. DONOVAN *is an associate at the firm.*

Standing

In *Matter of Bernfeld* (Michael Bernfeld, D.D.S. and Yakov Kurilenko, D.D.S., P.C.), 86 AD3d 244 (2d Dept. 2011), the Second Department affirmed that the widow of a deceased majority shareholder in a dental practice had no standing to seek judicial dissolution of a professional corporation.

After the minority shareholder objected to the dissolution and sale of the practice to another dentist as proposed by majority vote of his deceased partner's wife, the wife sought judicial dissolution of the practice, also by majority vote, under BCL §1103. The statute permits shareholders to adopt a resolution to dissolve if, among other grounds, "they deem a dissolution to be beneficial to the shareholders." The minority shareholder moved to dismiss on the ground that the petitioner, as a non-professional transferee of her deceased husband's majority interest, lacked standing under BCL §1511. Section 1511 limits the voting rights of a non-professional shareholder to the disposition of the assets of the practice under BCL §909, or non-judicial voluntary dissolution of the practice under BCL §1001. The lower court granted the respondent's motion and dismissed the petition.

On appeal, the Second Department affirmed, holding that BCL §1511 specifically provides for voluntary dissolution under BCL §1001, but not judicial dissolution under BCL §1103. Citing the petitioner's "misapprehension of the distinctions between voluntary dissolution under [BCL] article 10 and judicial dissolution under [BCL] article 11," the appellate court noted that, had the petitioner filed a certificate of dissolution with the Secretary of State following her majority vote to dissolve and sell the practice as required under BCL §1001, her proposed sale may have been authorized.

Appraisal Rights

The issue of standing was also addressed in the context of a dissenting shareholder appraisal proceeding where the court in *Barasch v. Williams Real Estate Co.*, 33 Misc.3d 1219(A) (Sup. Ct. N.Y. Co. 2011), ruled in favor of the dissenting shareholder over the objection of the controlling shareholders who denied that a complex corporate reorganization triggered the right to dissent and seek appraisal.

The petitioner, the lone dissenting shareholder to a multi-layered plan of corporate reorganization and acquisition, sought a fair-value appraisal of her stock interest in a real estate company under BCL §623. Section 623 permits a dissenting shareholder in the context of a merger or sale of corporate assets under BCL Article 9 to petition the court for an appraisal of her shares.

In opposition to the petitioner's motion for summary judgment, the respondents argued that the petitioner was not entitled to relief under BCL §623 because the proposed transaction, which they contended merely involved the movement of the company's business and personnel to new entities, did not result in a substantive disposition of all or substantially all of the company's assets under BCL §909.

The court disagreed, finding that while the company's business and personnel were essentially the same following the transaction, they were owned and controlled by wholly new entities as a result. Because the respondents failed to make an offer to purchase the petitioner's shares and failed to bring their own proceeding under §623 to determine her rights, the court also awarded the petitioner the costs and expenses she incurred in being forced to bring the proceeding herself.

Stock Valuation

Issues of valuation rather than eligibility predominated another BCL §623 proceeding last year where the court endorsed a discounted cash-flow method and rejected post-merger tax benefits in valuing a company's real estate holdings.

In *Matter of Harlem River Yard Ventures Inc.*, Index No. 602341-07 (Sup. Ct. N.Y. Co. July 12, 2007), the controlling shareholders of a real-estate development company approved a merger that would result in, among other things, the new company electing to be taxed as a subchapter "S" corporation. The merger plan effectively squeezed out the minority shareholder, a cooperative association, because co-ops by law cannot own stock in "S" corporations. The co-op rejected the corporation's offer of $900,000 for its shares before petitioning the court for a fair-value appraisal under BCL §623.

After a valuation hearing at which the petitioner's expert presented a figure of $128 million for the total value of the company, and the respondents' expert presented a figure of $31 million, the court resolved a number of valuation issues to arrive at a total value of $61 million and valued the petitioner's shares at $2.8 million. The court addressed a number of valuation-related issues, including the method for valuing future cash flows; whether to consider future tax benefits from the subchapter "S" election; whether to consider shares personally received by the individual respondent-owner in connection with company leases; minority and marketability discounts; discount rates; and other asset-specific disputes.

Among other rulings, the court concluded that because the petitioner could not legally be an owner in the surviving "S" corporation, the tax benefit resulting from the election would not be considered as part of the total value of the company. The court also concluded that the $13 million worth of shares that the individual respondent-owner personally received in connection with company leases was a misappropriation of corporate assets and would be considered in the valuation.

Some of the same valuation issues were addressed in *Matter of Giaimo (EGA Associates Inc.)*, 31 Misc.3d 1217(A) (Sup. Ct. N.Y. Co. 2011), in which the court applied a discount for built-in capital gains (hereinafter, BIG) but refused to apply a discount for lack of marketability (hereinafter, DLOM) in connection with the value of two real-estate holding companies.

Matter of Giaimo involved two feuding siblings who owned two holding companies, which in turn owned 19 real properties in New York City. The feud was sparked by their brother's assignment to one of them of a share in one of the companies, which prompted, among other lawsuits, proceedings by the minority sibling for judicial dissolution of the companies based on shareholder oppression under BCL §1104-a. The respondent then elected under BCL §1118 to buy out her brother for fair value.

What followed was an 18-day hearing before a special referee on the value of the companies and the properties held by them, which included eight expert witnesses and more than 165 exhibits. After the referee's report was issued, the siblings each moved to confirm and reject in part the report relative to the referee's findings regarding DLOM and BIG.

While voicing its disagreement with the referee's reasons for not applying DLOM, the court confirmed the report, finding support in the record for the referee's findings of fact and conclusions of law. Specifically, citing the Court of Appeals' ruling in *Matter of Friedman (Beway Realty Corp.)*, 87 NY2d 161 (1995), the court rejected the referee's conclusion that DLOM has no theoretical basis in fair value analysis. The court nonetheless upheld the non-application of DLOM based on the market exposure period built into the underlying realty appraisals and based on the extremely limited availability of similar real property portfolios.

The court also confirmed the referee's BIG discount at present value assuming a 10-year holding period rather than dollar-for-dollar as argued by the respondent. The court distinguished the First Department's decision in *Wechsler v. Wechsler*, 58 AD3d 62 (1st Dept. 2008), which applied a 100 percent BIG discount in the absence of any expert testimony regarding an alternative present-value discount, and instead applied Second Department precedent in *Matter of Murphy (United States Dredging Corp.)*, 74 AD3d 815 (2d Dept. 2010), which applied a present-value BIG discount under similar factual circumstances.

In 'Matter of Bernfeld,' the Second Department affirmed that the widow of a deceased majority shareholder in a dental practice had no standing to seek judicial dissolution of a professional corporation.