SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF BRONX: IAS PART 8

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KATHERINE LYONS,

Plaintiff, INDEX № 24290/2004

-against-

DECISION/ORDER

ADRIANA SALAMONE, and
STAR FITNESS U.S.A., L.L.C.,

Defendants.

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FILED
DEC 23 2005
BRONX COUNTY CLERK'S OFFICE

HON. BETTY OWEN STINSON:

This motion by plaintiff for sanctions for contempt of court, cross-motion for vacatur of this court's order dated February 7, 2005 and petition by plaintiff/petitioner for an order of dissolution of the defendant/respondent Star Fitness U.S.A., L.L.C., ("Star Fitness") are all consolidated for disposition and granted to the extent that the limited liability company is hereby dissolved and Ronald Charles Maday Esq. c/o Wurman Birnbaum & Maday, PLLC 1 Fulton Ave., Hempstead, NY 11550 516-481-6500. is appointed as receiver of Star Fitness, directed to ascertain whether to sell the business as a whole or dispose of its assets, to carry out same and to distribute proceeds of the sale to the members, if any proceeds are remaining, after paying the cost of administration by the receiver and any outstanding debts. Cross-motion for vacatur or modification of this court's February 7, 2005 order is granted to the extent defendants/respondents need not make payments of gross proceeds to plaintiff/petitioner. The motion for sanctions is denied.

In May 2004, plaintiff/petitioner Katherine Lyons ("Lyons") and defendant/respondent

Adriana Salomone ("Salomone") entered into an agreement whereby Salomone would provide 80% of the cost of starting up an exercise club and gym, which she estimated to be $900,000, and Lyons would provide 20% in the amount of $180,000. Both would then have a corresponding interest in the business, which was duly organized as a limited liability company with the name Star Fitness U.S.A., LLC. They agreed that if start-up costs exceeded $900,000, they would each contribute to the additional amount needed in proportion to their interest. The only writing between the parties memorializing that agreement is a document, comprising no more than a paragraph, titled "Promissory Note" and containing the above terms. The last sentence of the agreement reads: "Katherine Lyons will receive twenty percent of the gross proceeds and Adriana Salomone will receive eighty percent of the gross proceeds."

The parties agree that Lyons gave Salomone $180,000, meaning that Lyons was now a 20% owner of the business. There is no dispute that Lyons contributed an additional amount of $10,000 for unanticipated construction costs. It is not entirely clear, however, what Salomone's understanding was of that part of the agreement allowing the parties to "receive" a combined total of 100% of the "gross proceeds". The agreement does not specify when this distribution was to be accomplished or how the operating expenses would be met. Salomone avers she did not understand the meaning of the term "gross proceeds", although she provided the draft of the agreement, and urges that the phrase should be understood to mean "net proceeds". This still does not account for the timing of distribution.

Lyons', on the other hand, insists it was the parties' understanding that gross revenue numbers would be determined on a weekly or biweekly basis, distribution made at that time and expenses determined on a monthly basis with each party remitting funds back to the business to

cover the expenses of the previous month. A reserve of $25,000 would be maintained to meet expenses until remittance was made. Lyons also alleges the parties had agreed Lyons would be a "managing member" of the business, employed as a bookkeeper, and her husband would have employment in the business as well. Salomone denies knowledge of any such terms.

The business opened in July 2004 under Salomone's management. By August 1, 2004, Star Fitness had received approximately $130,000 in membership fees. Lyons immediately demanded her 20% share and Salomone replied that the money had gone to pay bills. Eventually, Salomone paid Lyons $14,300, made in monthly payments. There is no indication Lyons ever remitted any portion of that amount back for expenses incurred by the business or ascertained whether $25,000 had been kept in reserve before demanding distribution.

When Salomone refused to hire Lyons' husband to work in the gym, stating that he threatened and frightened patrons, acrimony and distrust between the parties began to grow. Police were called to the gym on more than one occasion when Lyons' husband reportedly confronted employees and patrons of the business. Lyons suspected that Salomone was secreting profits. Salomone offered to return Lyons' investment, but Lyons refused the offer. Finally, Lyons brought this action for an order enforcing the agreement to pay her 20% of the gross proceeds. The court issued an interim order on February 7, 2005 directing the parties to retain a mutually agreed-upon accountant to determine the financial state of the business and, in the interim, directing that Salomone make certain monthly payments to Lyons.

Salomone did not make any of the ordered payments and fired her lawyer who had agreed to the terms of the order. She did, however, provide half of the cost of retaining an independent accounting firm to examine the company's financial affairs. The firm, Sperduto, Spector &

Company ("Sperduto"), examined the books and records, such as they were, from July 2004 through July 31, 2005. Since Salomone admittedly had no business or record-keeping experience, it took a long time to reconstruct the documentation of expenses and revenues and some were not possible to document at all. Most of the business had been carried out on a cash-only basis. At some point, Salomone hired an accountant of her own, Mark M. Horton ("Horton"), to help regularize her business affairs.

Because of the more-than-anticipated time taken to provide documented information about the business and Salomone's failure to make the court-ordered payments, Lyons made a motion to sanction Salomone for contempt of court. Salomone cross-moved to vacate or modify the interim order. Lyons responded by formally petitioning the court to dissolve the limited liability company and appoint a receiver to liquidate the business and distribute the assets.

Under New York Law, a limited liability company ("LLC") is owned by one or more "members" who may or may not be actual managers of the business. According to Limited Liability Company Law ("LLCL") § 702, "[o]n application by or for a member, the supreme court . . . may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." This standard has been interpreted to mean that judicial dissolution will be ordered only where the complaining member can show the business is unable to function as intended or is failing financially. Schindler v. Niche Media Holdings, LLC, 1 Misc.3d 713 (Sup. Ct., New York Co., 2003)(dissolution denied because company financially profitable).

A member may withdraw from an LLC only at the time or upon the happening of events specified in the operating agreement. LLCL § 606(a). Unless the operating agreement provides

otherwise, a member may not withdraw from an LLC prior to the dissolution and winding up of the LLC. Id. Where the parties have not executed a written operating agreement, as required by LLCL § 417(a), and a member wishes to withdraw from the LLC, one New York court has ruled that the member's desire to do so thereby mandates dissolution. Matter of Spires v. Lighthouse Solutions, LLC, 4 Misc.3d 428 (Sup. Ct., Monroe Co., 2004).

In opposition to the motion for sanctions and petition for dissolution, Salomone argued that she was unable to make payments to Lyons as ordered because the business is operating at a "severe loss". According to an affidavit by Horton, Star Fitness had a net loss of $186,927 for 2004. The net loss for the month of January 2005 was $5,502 and for February was $30,861. Horton stated that payment of even a portion of the amounts ordered in the court's February 7, 2005 order would force Star Fitness into bankruptcy. She acknowledged her tardiness in providing information to Sperduto, but stated that it took a great deal of time to document past transactions which had not been properly accounted for due to her business inexperience. Salomone argued, nevertheless, that the business could continue as a going concern and opposed dissolution. As an alternative, she urged that she be allowed to wind up the affairs of the business herself, calculate the outstanding payables, deduct those from a purchase price for the company (to be determined by the court or through auction), and pay Lyons 20% of the net sale amount.

In support of her petition, Lyons offered the affidavit of Robert B. Nuccio from Sperduto, who set forth his difficulties in obtaining the information necessary to make a timely report of Star Fitness' financial status. His findings, in spite of the incomplete information, included the following:

1) Records supporting counter sales (drinks, snacks, health supplements) are insufficient.

2) There are no records of payroll tax withholding or payroll tax returns being filed.

3) The gym does not retain their copy of membership renewal contracts.

4) The gym has no business, liability, workers compensation or disability insurance.

5) Inaccurate and incomplete sales tax returns are being filed.

6) Support for certain claimed capital expenditures has not been produced.

Lyons argued that these findings demonstrate that Salamone has used Star Fitness for her own personal profit to the detriment of the minority member and has failed to manage the LLC in a businesslike manner. She urges further that dissolution should be granted pursuant to the holding in Spires because the parties did not execute an operating agreement and therefore the statutory default provisions apply.

This court declines to follow the holding in Spires that would mandate dissolution when there is no operating agreement simply because a member wishes to withdraw from the LLC. At least one commentator has characterized that interpretation as "misconstruing" the LLCL statutory provisions and this court agrees. See J. William Callison and Maureen A. Sullivan, Limited Liability Companies: A State-by-State Guide to Law And Practice, Ch. 10, fn. 3. There is no evidence Salamone has been hiding profits from Lyons, but there is also no conclusive evidence to the contrary, given that the records are still incomplete.

On the other hand, Salamone produced an affidavit by her accountant which adequately demonstrates that the business is failing financially as it is presently operated, which is sufficient reason to order dissolution. See Schindler, supra. The "severe" operating losses described by Horton are even more significant given that the business is also not meeting all of its tax obligations, its operations are totally uninsured and Salamone is "devoid of experience with

respect to financial practices". (Affidavit of Mark M. Horton, March 23, 2005). There is no indication from the records offered that the losses cited include amounts representing outstanding payroll or sales taxes. Salamone's inexperience also requires an additional ongoing investment in accounting services to reorganize the business internally so that it is profitable while also complying with applicable law. If the business had been well set up initially according to a competent business plan and then began to operate at a loss, proportional adjustments in the amounts charged for memberships or economies in the cost of management, or both, could be put into effect to offset continuing losses. As it is, no one yet appears to have a complete financial picture of the business, even Salomone herself when given every benefit of the doubt as to credibility.

Dissolution of the LLC does not necessarily mean that the business must close its doors. It appears possible that it could be appropriately reorganized. If the receiver determines that the enterprise can be sold intact, either party has the option of bidding an amount equal to the fair market value of the opposing party's interest in the business, as determined by the receiver, minus the opposing party's corresponding share of the outstanding obligations, as determined by the receiver, provided that the bid includes a sufficient net cash amount for payment in full of the receiver's services, the latter amount to be allocated to both parties in proportion to their respective interests.

For example, if the business were valued by the receiver at $1,000,000, merely to use a convenient number, and the outstanding debts amounted to $200,000, Salamone could bid 20% of $1,000,000 ($200,000), minus 20% of $200,000 ($40,000), for a total of $160,000 for purchase of the business. Assuming only for purposes of demonstration that the receiver's fee and related

administrative expenses amounted to $30,000, Lyon's share of that obligation would be 20% of $30,000 or $6,000, which would then be deducted from $160,000 and paid to the receiver, and Lyons would theoretically receive $154,000 in return for sale of her 20% interest. Salamone's bid under this arbitrary example would have to include an additional amount of $24,000 (her 80% share of the receiver's fee) to be paid by her to the receiver upon the purchase of Lyon's interest. If both parties wished to bid, the receiver would accept the highest bid, but only upon proof that the bid is legitimate; i.e., that the winning bidder is ready, willing and able to purchase the business.

The court is cognizant of the fact that Lyons received $14,300 from the business and remitted nothing back for expenses, assuming that her understanding of their agreement was accurate. Since there is apparently no way at this time to calculate whether Salamone also disbursed to herself, apart from salary, an amount roughly equal to four times that amount, or a corresponding 80%, none of the $14,300 will be charged against Lyons as owed for expenses, nor will any amount Salamone might have collected herself, over and above a reasonable salary, be charged against her if Lyons should wish to purchase the business.

This court's interim order, dated February 7, 2005, is hereby modified to delete those provisions requiring payments to be made by defendants/respondents to Lyons. Those portions of the order pertaining to the independent accountant remain in force. Lyons' original assertion that she is entitled to ongoing payments of 20% of all gross proceeds of the business pursuant to the written agreement between the parties, with no corresponding obligation for the payment of expenses, is completely infeasible from a business standpoint and inconsistent with her purported understanding of the agreement's unwritten terms (set forth in a footnote in her petition for

dissolution and requiring return of amounts needed for expenses). Lyons does not allege she ever remitted anything back from the amounts she received to offset expenses, in spite of the business's ongoing losses. If Salamone was only withdrawing a reasonable salary – and there is no evidence to the contrary – Lyon's insistence on immediate collection of gross proceeds from the fledgling enterprise has only contributed to the business's losses. That portion of the contract between them, originally interpreted by Lyons for purposes of her lawsuit to ignore any provision for business expenses, is unenforceable as having no possible, reasonable interpretation as written.

This constitutes the decision and order of the court.

Dated: December 6 , 2005
Bronx, New York

BETTY OWEN STINSON, J.S.C..