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Expert Analysis

Business Divorce Cases of 2013 Include Important Appellate Rulings

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The improved economic climate last year saw no let up in the volume of business divorce litigation in New York courts. Indeed, there's an argument to be made that a bigger "pie" resulting from higher profits and rosier business prospects foster more, not less, infighting among co-owners of closely held business entities contributing to a higher incidence of legal disputes.

The most striking aspect of last year's business divorce decisions is the number of important appellate rulings concerning various forms of business entities. The cases featured in this annual review include decisions by the Court of Appeals and all four departments of the Appellate Division concerning dissolution and valuation contests involving partnerships, corporations, and limited liability companies.

Grounds for LLC Dissolution

The Second Department's landmark decision in *Matter of 1545 Ocean Avenue, LLC,* 72 AD3d 121 (2d Dept. 2010), distinguished the standard for dissolution of an LLC under Limited Liability Company Law §702 from that of a corporation under Business Corporation Law Article 11, adopting an approach that gives priority to the terms of the operating agreement and focuses on the business of the LLC rather than on incidents of minority oppression.

The First Department's decision last year in *Doyle v. Icon LLC,* 103 AD3d 440 (1st Dept. 2013), is the first New York appellate decision outside the Second Department to follow *1545 Ocean Ave.* and its crucial distinction between dissolution under the LLCL and the BCL. *Doyle* involved a night club operated by an LLC owned equally three ways. One of the members sued for dissolution, alleging that he had been "systematically excluded" from the company's business affairs and denied his share of the LLC's profits. The LLC moved to dismiss, contending that plaintiff failed to state a cause of action. The lower court denied the motion, finding that plaintiff's allegations regarding exclusion from the business were sufficient to state a claim under LLCL §702.

On appeal, the First Department reversed and dismissed plaintiff's dissolution claim, citing *1545 Ocean Ave*. in holding that plaintiff's allegations of exclusion "are insufficient to establish that it is no longer 'reasonably practical' for the company to carry on its business" and that his allegation regarding denial of profits actually "shows that the company is financially feasible."

Documentary Evidence

In *Born to Build LLC v. 1141 Realty LLC,* 105 AD3d 425 (1st Dept. 2013), the First Department reversed the lower court and granted a real estate holding company's motion to dismiss a dissolution petition based on documentary evidence showing that petitioner did not hold a membership interest in the company.

Born to Build involved a hotel construction project that encountered financial difficulties and delays resulting in foreclosure and lien-enforcement proceedings. The general contractor sued the developer, who ultimately was indicted on federal charges and skipped town. The contractor took a default judgment against the developer and enforced the judgment by execution sale at which it purchased the developer's purported membership interest in the LLC that owned the hotel property. The contractor then petitioned to dissolve the LLC and liquidate and distribute its assets.

The LLC moved to dismiss on the basis of an operating agreement, which the contractor did not know existed. The agreement established that the developer, whose purported membership interest was acquired at the execution sale, was never a member of the LLC. The contractor opposed the motion with affidavits averring that the developer had exhibited indications of ownership, including negotiating the sale of, and personally guaranteeing, the mortgage on the property. The lower court denied the motion, finding that the contractor raised sufficient fact issues regarding whether the developer was an owner.

The First Department reversed and dismissed the petition, holding that the contractor's affidavits merely "assert that the affiants were told by [the developer]…that he was actually an owner"; that the petition was "premised only upon information and belief"; and that the [contractor] failed to raise fact issues regarding "the authenticity of the operating agreement." In so holding, the Appellate Division emphasized the crucial distinction between a dissolution petition, which is akin to a summary judgment motion based on admissible evidence, and a dismissal motion, which turns on a lesser sufficiency-of-the-pleadings standard.

Standing and documentary evidence of ownership in dissolution proceedings also were front and center in *Matter of Sunburst Associates, Inc.,* 106 AD3d 1224 (3d Dept. 2013), in which the Third Department, in deference to the lower court's "better position" with respect to assessing conflicting documents and weighing the credibility of witnesses, affirmed the dismissal of a dissolution petition.

The parties in *Sunburst* co-founded as equal owners a company that operated a chain of tanning salons. After partnering in the business for more than a decade, the parties executed a "stock certificate agreement" providing that petitioner was indebted to respondent and requiring him to deliver to respondent a certificate representing his 50 percent interest in the company to be held in escrow as security. The parties thereafter signed an unrelated "statement of corporate action" stating that respondent was sole shareholder.

Petitioner commenced a deadlock dissolution proceeding under BCL §1104. Respondent

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moved to dismiss on the ground petitioner had transferred his interest and lacked standing to bring the proceeding. The lower court directed the parties to a hearing solely on the issue of petitioner's ownership status.

Respondent primarily relied on the certificate agreement and corporate statement, contending that petitioner transferred his stock due to his "indebtedness to respondent." Petitioner countered that the documents were part of a larger "façade to secure financing" and that the parties never intended for him to divest his stock interest. Petitioner also relied on corporate tax returns and related K-1s, which reflected the parties as equal owners in the years following the alleged stock transfer. Respondent denied the authenticity of the returns, contending that they were prepared by petitioner's "good friend." The lower court rejected petitioner's testimony as lacking in credibility and found for respondent.

The Third Department affirmed, noting that information in corporate records, including tax returns, "is not necessarily dispositive," especially when such returns were prepared by "a friend of petitioner [who] did not verify the information regarding ownership contained therein." The Appellate Division noted that "a contrary finding would not have been unreasonable," but chose to "give appropriate deference" to the trial court.

LLC Equitable Buyout

Several years ago, in *Matter of Superior Vending LLC,* 71 AD3d 1153 (2d Dept. 2010), the Second Department affirmed an order requiring the return of the petitioner's capital contribution in exchange for his membership interest as an "equitable method of liquidation" in a dissolution proceeding under the LLCL. The Second Department's decision last year in *Mizrahi v. Cohen,* 104 AD3d 917 (2d Dept. 2013), extended its holding in *Superior Vending* to provide for a compelled buyout of a membership interest in an LLC as an equitable remedy upon dissolution.

The *Mizrahi* decision is the latest iteration in a protracted litigation involving the dissolution of a real estate holding company and its mixed-use office building owned equally by brothers-in-law. After affirming the lower court's grant of dissolution under *1545 Ocean Ave.*, the Second Department reversed the denial of plaintiff's request for a compelled buyout of defendant's interest in the LLC upon dissolution. The Appellate Division held that while compelled buyout is not expressly authorized by statute, the remedy may be appropriate under certain facts and circumstances, particularly where "the provisions of the LLC agreement regarding dissolution do not preclude an order authorizing a buyout upon the judicial dissolution."

Stock Valuation

Sullivan v. Troser Mgt., Inc., 104 AD3d 1127 (4th Dept. 2013), involved an agreement between an employee-shareholder and the company, providing that the employee would be entitled to an 18 percent interest in the company after five years of employment. The agreement contained a buy-sell provision allowing for the company's option to repurchase the shares if his employment ceased. The buy-sell provision was set up to provide for a fixed-price valuation method, but the parties never agreed upon a specific value to be annexed to the agreement.

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Plaintiff sued the company for specific performance. After multiple lower-court orders and interim appeals, it was determined that plaintiff was entitled to an 18 percent stock interest in the company; that the purchase price for his interest was indeterminable under the buy-sell provision because the parties failed to agree upon a fixed price; and that his shares should be valued "on the basis of his percentage interest." In this latest appeal, the company challenged the lower court's denial of its motion for summary judgment fixing the purchase price of plaintiff's shares at book value.

The Fourth Department affirmed, holding that plaintiff's shares should be valued on the basis of his interest but noting that "no particular valuation method was specified" in its prior ruling. The court also held that "issues of fact remain with respect to the appropriate method of valuing those assets" to be determined by the lower court.

Competing appraisal methodologies advanced by opposing experts were the focus of last year's decision in *Ruggiero v. Ruggiero,* 2013 NY Slip Op 31955[U] (Sup Ct, Suffolk County 2013). *Ruggiero* involved a family-owned deli in which the wife of one of the co-founding brothers sued the other brother, alleging that following the death of her husband, her brother-in-law sought to squeeze her family out by terminating their employment and health-insurance benefits and denying access to the premises. The surviving brother alleged that his brother had been stealing from and otherwise mismanaging the business prior to his death. The court ultimately put the matter down for a hearing on the fair value of the business in an effort to determine which of the two shareholders was the proper party to buy out the other and at what price.

The estate's expert relied on the market approach, utilizing a "price to revenue" method by which he normalized revenues and operating profits over the period of the deli's operation and the years remaining on its lease. The estate's expert then applied a 0.4 multiple to the annual gross revenue "based upon his experience in the business valuation field" and deducted a working capital deficit to arrive at a fair value of $709,000 for the business or $354,000 for the estate's interest.

The surviving brother's expert relied on the income approach, utilizing a discounted cash-flow analysis by which he reviewed the deli's book of daily cash transactions, its payments to vendors and for payroll and its invoices and actual receipts. The surviving brother's expert then applied a 20 percent marketability discount to arrive at a fair value of approximately $240,000 for the business or $120,000 for the surviving brother's interest.

The court largely sided with the surviving brother's expert, crediting testimony that there was a sufficient record of the "true revenues and expenses of the business" to support the income approach and criticizing the estate's expert's use of the 0.4 multiple as lacking "sufficient explanation." The court, however, rejected the application of a marketability discount, crediting testimony that the deli was a "unique niche business." The court ultimately determined a fair value of approximately $295,000 for the business or $147,500 for a 50 percent interest therein, which the surviving brother was entitled to purchase based on his involvement in the business since inception.

Partnership Dissolution

Issues of dissolution and valuation also were addressed last year in the context of New York's Partnership Law. In *Gelman v. Buehler,* 20 NY3d 534 (2013), the Court of Appeals considered whether an oral agreement to launch a "search fund" venture—organized by two partners for the purpose of obtaining investment funds, targeting an unspecified business for acquisition, increasing its value, and selling at a profit—included a "definite term" by which the venture would terminate or identified a "particular undertaking" it was formed to achieve under Partnership Law §62. The high court concluded that the parties' "search fund" agreement was too indefinite as to duration and objective to constitute anything other than a common law partnership at will, which was dissolved as a matter of law when defendant unilaterally withdrew.

Finally, in *Breidbart v. Wiesenthal,* 108 AD3d 492 (2d Dept. 2013), the Second Department considered the question whether post-dissolution gain on the sale of real property owned by a partnership constituted "profits" under Partnership Law §73 to which the estate of a deceased partner was entitled in lieu of interest from the date of dissolution. The court concluded that the fair market value of real estate is fixed as of the date of dissolution, precluding plaintiff's right to any appreciation of the property thereafter.

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