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Expert Analysis

Complex Questions Addressed In Business Divorce Cases of 2014

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In the annals of business divorce litigation, 2014 will go down as the year in which New York courts issued some of the most important and interesting decisions in dissenting shareholder and buyout appraisal proceedings involving closely held corporations.

The valuation decisions highlighted in this annual review, all emanating from Commercial Division justices, involve complex and controversial issues concerning application of the discounted cash flow method under the income approach, the discount for lack of marketability, and forensic accounting techniques.

This review also highlights important decisions last year involving standing to seek LLC dissolution, the Limited Liability Company Law's safe-harbor statute, and the proper-purpose requirement in books-and-records proceedings.

The AriZona Iced Tea Case

In what likely is the biggest statutory fair-value award ever in New York courts involving a closely held company, the Nassau County Commercial Division last year issued a post-trial decision in *Ferolito v. AriZona Beverages* (2014 NY Slip Op 32830[U] [Sup Ct, Nassau County 2014]), awarding the petitioning shareholder approximately $1.5 billion for his 50 percent interest in the hugely successful beverage company that markets AriZona Iced Tea.

The valuation contest followed years of multiple litigations and a buyout election by the respondent 50 percent shareholder in response to a dissolution petition. The post-trial decision features a number of important rulings on novel issues, including the court's exclusive reliance on the discounted cash flow (DCF) method under the income approach. The court rejected petitioner's expert's weighted DCF analysis based on "comparable transactions," finding AriZona to be an "incomparable company." The court also rejected the expert's use of synergistic transactions involving "hypothetical third-party purchasers" purportedly willing to pay a premium to integrate AriZona's product lines with their own. The court found such synergies to be "too speculative to quantify with any certainty."

The court also rejected petitioner's evidence of various expressions of interest from other companies, including international giants Nestle and Tata, to acquire all or part of AriZona for as much as $4.5 billion. The court found that the companies expressing interest did not perform any due diligence or seek board approval in connection with the proposed acquisitions. The court characterized as mere "bluster" evidence of the petitioner's own offer, made during trial, to purchase the respondent's 50 percent interest for $2 billion because it lacked any corresponding evidence of "appropriate financial backing."

The court also awarded the petitioner 9 percent pre-judgment interest on the fair-value award from the filing of the dissolution petition in late 2011, adding several hundred million dollars to the eventual judgment.

Marketability Discount

For nearly 30 years, New York case law has upheld application of a discount for lack of marketability (DLOM) while forbidding a discount for lack of control a/k/a minority discount (DLOC) under the fair-value standard in dissenting shareholder and elective buyout proceedings under §§623 and 1118 of the Business Corporation Law (BCL).

DLOM takes into account the risks associated with the greater amount of time normally required to sell shares in a closely held business as compared to publicly traded shares. In the AriZona case, for example, the court applied a 25 percent DLOM. DLOC is prohibited because it unfairly deprives minority

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shareholders of their proportionate interest in the value of the corporation and effectively treats unequally stockholders within the same class of shares.

Last year, in *Zelouf Int'l v. Zelouf* (45 Misc.3d 1205[A] [Sup Ct, NY County 2014]), the Manhattan Commercial Division entered new territory by rejecting a DLOM in valuing a family-owned business under BCL §623 based on a finding that the controlling shareholders were unlikely to sell the business in the foreseeable future. The court reasoned that, since the controllers would never incur a DLOM, imposing one on the minority shareholder would be tantamount to imposing a prohibited DLOC. In other words, wrote the court, "if [the majority] will never pay a price for the company's theoretical illiquidity, then there is nothing 'fair' about artificially depressing [the minority's] recovery due to a hypothetical sale that will never occur."

The Zelouf court's novel ruling likely will be tested on appeal by the controllers, who undoubtedly will argue that the court's no-likelihood-of-sale rationale for rejecting a DLOM is contrary to the traditional definition of fair value used by courts in New York, based on what a hypothetical willing purchaser, in a hypothetical arm's-length transaction, would offer for the corporation as an operating business.

Conditional Dissolution

Valuation of a closely held company also was at issue in a novel ruling from the Commercial Division in Kings County last year in which the court conditioned its order of dissolution of a restaurant business on the majority owners' failure to purchase the minority's shares for $1.2 million.

In *Cortes v. 3A N. Park Ave. Rest* (2014 NY Slip Op 24329[U] [Sup Ct, Kings County 2014]), plaintiff, a 17-percent shareholder of a company that owned a Mexican bar and restaurant, sued the two majority owners asserting individual and derivative claims based on allegations that the majority owners had been looting the bulk of the restaurant's cash receipts over the last decade. Because plaintiff's ownership interest did not meet the statutory threshold of 20 percent under BCL §1104-a, he also asserted a claim for common-law dissolution and sought a compelled buyout of his shares at fair value.

> The Nassau County Commercial Division awarded a shareholder approximately $1.5 billion for his 50 percent interest in the beverage company that markets AriZona Iced Tea.

Following trial, during which the parties presented extensive forensic accounting evidence, the court found that defendants had in fact diverted nearly $4 million in cash receipts since opening the restaurant in 2003. The court's findings primarily were based on the statistical projections of plaintiff's forensic expert who, because of defendants' "deliberate concealment" of the daily server reports generated by the restaurant's point-of-sale system, was forced to calculate the restaurant's credit-card-to-cash revenue ratio over a 10-year period based on the one year of server reports produced by defendants in the course of the litigation.

After applying pre-judgment interest at 9 percent, the court awarded approximately $5 million in damages to the company, having found that the company—as opposed to plaintiff—was the party to have suffered directly the harm resulting from defendants' diversion of millions of dollars in cash to themselves.

The court also found that defendants' fiduciary breach in this regard was egregious enough to support plaintiff's claim for common-law dissolution but concluded that a compelled buyout of plaintiff's interest was a more appropriate remedy. Accepting plaintiff's expert's valuation of the company at approximately $3 million, and adding to that its damages award for the diverted cash receipts, the court determined that plaintiff was entitled to over $1 million for his pro rata interest in the company. The court directed defendants to purchase plaintiff's shares within 90 days or face dissolution of the company. It also ordered the appointment of a liquidating trustee who would be empowered to enforce the company's money judgment against defendants, which ultimately would be distributed to plaintiff according to his interest therein.

Safe-Harbor Statute

The First Department issued a first-impression ruling last year concerning the safe-harbor provisions of §409 of the LLC Law in which it rejected an LLC manager's defense to a claim for breach of fiduciary duty, that he acted on the advice and instruction of an outside accountant.

Pokoik v. Pokoik (115 AD3d 428 [1st Dept. 2014]), involved a dispute between managers of various family-owned real estate holding companies. In 2006, the parties entered into a settlement agreement in which plaintiff, a minority member of the realty LLCs, ceded management control to defendant, the majority member, after it was allegedly discovered that plaintiff misappropriated millions of dollars in rental income. Plaintiff agreed to reimburse the companies in an amount less than the amount in dispute, the balance of which was then "written off" in the companies' books in exchange for defendant's release of all claims based on the alleged misappropriation. Plaintiff later sued defendant for breach of fiduciary duty after defendant unilaterally reduced his capital account and corresponding distributions in the years following the settlement.

The parties cross-moved for summary judgment. Defendant asserted a safe-harbor defense under LLCL §409, arguing that he was shielded from any liability when, on the advice and instruction of the companies' outside accountant, he reduced plaintiff's capital accounts and distributions by the amount of allegedly misappropriated funds "written off" under the settlement agreement. Plaintiff argued that any responsibility he had for financial and tax-reporting purposes was limited to the amount he reimbursed the companies under the settlement agreement and that defendant had waived all other claims related to the alleged misappropriation. The lower court denied summary judgment, and both parties appealed.

The First Department granted summary judgment for plaintiff, holding that defendant failed to show that he relied in good faith on the advice of the accountant as required by §409. The appellate court found that defendant's unilateral reduction of plaintiff's capital accounts and distributions, while it may have been on the advice of the accountant, was discriminatory and essentially self-interested in that he acted outside the authority provided in the companies' operating agreements, as well as the parties' settlement agreement, and altogether failed to notify plaintiff of the accountant's advice or the corresponding reductions.

Standing

The Queens County Commercial Division last year addressed the issue of standing in the context of the LLC Law's default provisions concerning the death of an LLC member.

Article 6 of the LLC Law provides that while a successor to a deceased member's LLC interest may inherit the member's economic interest, the deceased member's management and voting rights cannot be transferred absent the surviving members' consent.

Budis v. Skoutelas (Short Form Order, Index No. 702060/13 [Sup Ct, Queens County 2014]), involved a real estate holding company owned equally by three siblings. After one of the siblings died, her husband sued the remaining owners for mismanagement of the company's assets without effectuating the transfer of his wife's interest to a trust as provided by her will.

The Queens County Commercial Division last year addressed the issue of standing in the context of the LLC Law's default provisions concerning the death of an LLC member.

The surviving siblings moved to dismiss, contending that the husband lacked standing to assert derivative claims on behalf of the company because the deceased member's estate was not a member of the company. The surviving members cited the LLC Law's default provisions concerning non-member interest holders, as well as the company's operating agreement, which similarly provided that "upon the occurrence of an involuntary withdrawal, the successor of the withdrawn member shall thereupon become an interest holder, but shall not become a member."

Because the deceased member's estate was a non-member interest holder under both the LLC Law's default rules and the company's operating agreement, the court ruled in favor of the surviving members, holding that "to have standing in a derivative suit regarding an LLC, a plaintiff must own portions of the LLC as a member."

Books & Records Proceedings

The First Department's decision last year in *Retirement Plan for General Employees v. McGraw-Hill* (120 AD3d 1052 [1st Dept. 2014])—in which the court held that an investigation into board activity, even if it yields no evidence of misconduct, is a proper purpose supporting a shareholder's right to inspect corporate records—provided renewed vitality in corporate books-and-records proceedings under statutory and common law.

The petitioning shareholder in the case, a pension fund, alleged that the board of directors of respondent McGraw-Hill, the parent company to the credit-rating agency Standard & Poor's, failed to oversee S&P's ratings of various mortgage-backed securities and collateralized-debt obligations, which contributed to the economic crisis of 2008-09.

Petitioner alleged that the board's oversight failures, which were driven by a desire to attract additional business from the issuers of the toxic securities, exposed McGraw-Hill to substantial potential liability in multiple federal and state actions and investigations. Petitioner made a formal demand upon respondent for 15 categories of documents under BCL §624 and common law, asserting among other "proper" purposes, the "investigation of potential wrongdoing, mismanagement, and breaches of fiduciary duty."

The petitioner commenced a books-and-records proceeding after McGraw-Hill rejected petitioner's demand. In opposition, McGraw-Hill argued that petitioner failed to cite any specific instances of misconduct that would merit further investigation. The lower court agreed and dismissed the petition, finding that petitioner's demand went "beyond the proper purpose" instead amounting to an improper effort to obtain pre-litigation discovery.

The First Department reversed and granted the petition, holding that "investigating alleged misconduct by management and obtaining information that may aid legitimate litigation are, in fact, proper purposes for a BCL §624 request, even if the inspection ultimately establishes that the board had engaged in no wrongdoing." Look for increased filings of books-and-records proceedings by minority shareholders of public and closely held corporations in the wake of *McGraw-Hill*.