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Business Divorce Cases in 2007

John D. Rockefeller is quoted as saying that "a friendship founded on business is a good deal better than a business founded on friendship."[1] Judging from the onslaught of business divorce cases decided by New York courts last year, it is safe to assume that many friends continue to go into business together.

There were a number of interesting and important decisions last year involving breakups of closely held business corporations, limited liability companies (LLC) and limited liability partnerships (LLP). The cases highlighted below raise diverse issues concerning first refusal rights, judicial authority to appoint temporary receivers for LLCs, oppression of minority shareholders, restrictive covenants arising from buyouts, enforceability of pre-incorporation agreements, and liability of LLP partners.

Right of First Refusal

The Second Department's 1986 decision in *Matter of Doniger (Rye Psychiatric Hospital Center, Inc.)*[2] held that the filing of a dissolution petition can trigger a mandatory buyback under a right of first refusal (RFR) in a shareholders' agreement, depending on the breadth of the RFR's language. The case law more or less hibernated for the next 20 years until jolted awake by the First Department's 2006 ruling in *Matter of Johnsen (ACP Distribution, Inc.)*.[3] There, the court discounted limiting language in the *Doniger* RFR, that referred to the disposition of shares by judicial order, and thereby opened up *Doniger's* holding to any RFR containing boilerplate language such as "otherwise disposing of stock in any manner whatsoever."[4]

Two lower-court decisions last year illustrate ongoing uncertainty as to *Johnsen's* turbo-charged rendition of *Doniger*. *Matter of Schwimmer (El-Roh Realty Corp.)*[5] involved a deadlock dissolution petition brought by a 50 percent shareholder of a family holding company that owned all of the shares of a steel and metal recycling business. The shareholders' agreement contained an RFR triggered by "any other form of lifetime transfer" of shares "including without limitation, transfers that are voluntary, involuntary, by operation of law or with or without valuable consideration." Citing *Johnsen* the court held that the dissolution petition triggered the buyout provisions of the shareholders' agreement.

The court in *Matter of Schneck (R&J Components Corp.)*[6] reached the opposite conclusion based on language in an RFR not materially different from the RFR in *Schwimmer*. *Schneck* likewise involved a deadlock dissolution petition by a 50 percent shareholder. The *Schneck* RFR provided that no shareholder shall convey "or otherwise dispose of any of the Shares…except as expressly provided in this Agreement." The court distinguished *Johnsen* on the ground the RFR there, in addition to using the phrase "or otherwise dispose," contained the phrase "in any manner whatsoever" which was lacking in the *Schneck* RFR.

The practical impact of a buyback trigger can be enormous since, in many if not most instances, the shareholders' agreement uses a pricing mechanism weighted heavily against the selling shareholder. We can only hope for future appellate clarification. In the meanwhile, counsel must exercise extreme diligence before filing for dissolution when there is a shareholders' agreement with an RFR.

Temporary Receiver for LLC

Petitioners for judicial dissolution of closely held business corporations frequently apply at case inception under §1113 of the Business Corporation Law (BCL) for appointment of a temporary receiver to preserve corporate assets. While the standard for appointment of a temporary receiver in dissolution cases is fairly high,[7] arguably the court has greater latitude compared to applications for receivership under Article 64 of the Civil Practice Law and Rules (CPLR).

In contrast, Article 7 of the LLC Law (LLCL), governing dissolution of LLCs, has no provision similar to BCL §1113. Rather, LLCL §703(a) merely authorizes the court to appoint a receiver or liquidating trustee for the purpose of winding up the LLC's affairs after dissolution has occurred.

This divergence between the BCL and the LLCL is highlighted in *At the Airport, LLC v. Isata, LLC*,[8] where a 20 percent member of an LLC sought appointment of a temporary receiver in a dissolution case based on allegations of income diversion, financial mismanagement and denial of access to company records. Referring to LLCL §703(a), the court commented that the petitioner "is putting the cart before the horse since there must first be a finding of the right to judicial dissolution before a receiver can be appointed." The court also found that the petitioner failed to make an adequate factual showing of jeopardy to the company's assets to warrant a temporary receiver under CPLR Article 64.

Minority Shareholder Oppression

BCL §1104-a enables a 20 percent or more shareholder to seek judicial dissolution where those in control have engaged in illegal, fraudulent or oppressive conduct or have looted, wasted or diverted corporate assets. Under the reasonable expectations test established by the Court of Appeals in *Matter of Kemp & Beatley, Inc.*,[9] oppressive conduct generally entails unwarranted exclusion of the minority shareholder from participation in corporate management or loss of employment or other means of receiving reasonable return on investment.

In two cases of interest decided last year, the courts denied §1104-a dissolution petitions, in one case with a hearing and, in the other, without. In *Matter of Cheung (Ho Foong Shiu Realty Corp.)*,[10] the petitioner claimed he owned 50 percent of a realty company's shares and that the respondent had frozen him out and wrongfully identified herself as 100 percent owner. Respondent contended that petitioner relinquished his shares and abandoned all participation in the company for 10 years before the litigation. The court concluded after a hearing that

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the petitioner failed to prove he was an oppressed shareholder based largely on his absence from the company's affairs for the 10 years and because he had no reasonable expectation of receiving any benefits from the company.

Matter of Livolsi (111 Glen Street Corp.)[11] involved a real estate holding company that leased its property to a film production business wholly owned by the respondent 50 percent shareholder and of which petitioner was an employee. The respondent terminated petitioner's employment and sued him for breach of fiduciary duty and conversion. After petitioner made a failed attempt to sell out his interest to respondent, petitioner sought dissolution of the holding company. The court summarily denied the petition upon finding no evidence of oppression, looting or other misconduct by respondent.

The fact that the 50 percent petitioners in *Cheung* and *Livolsi* claimed oppression under §1104-a rather than shareholder deadlock under §1104(a) suggests a gamble by both that the respondents would elect to buy out their interests for court-determined fair value under §1118, which does not apply in deadlock cases, rather than risk dissolution. If so, they lost their bets.

Buyout, Nonsolicitation Pact

Under the Court of Appeals' seminal ruling in *Mohawk Maintenance Co. v. Kessler*,[12] the seller of a business including its good will is under an implied covenant not to solicit the seller's former customers. Yet to be decided by the same court, although it has come close on a couple of occasions, is whether a stock buyout resulting from a BCL §1118 election to purchase in a dissolution proceeding likewise triggers the implied covenant. The key issue in these cases in whether the sale is deemed to be one "under compulsion" and therefore not within the *Mohawk Maintenance* rule. Lower-court decisions have been less than uniform in their approach and the results.

The trial court's decision last year in *Matter of Autz (Ronald C. Fagan, M.D. and Arthur L. Autz, M.D., P.C.)*[13] raised the issue anew in an unusual context. The antagonists were minority and majority shareholders in a professional corporation that operated walk-in medical clinics. The petitioner sought dissolution as an oppressed minority shareholder under BCL §1104-a. The majority shareholder did not elect to purchase the petitioner's shares. Rather, he consented to dissolution and asked the court to determine that the corporation is not a going concern, and to order a liquidation sale of the corporation's hard assets and the division of its receivables. The petitioner sought a sale of the corporation as a going concern, inclusive of good will, along with a determination that such a sale is voluntary and therefore imposes a restrictive covenant upon the selling shareholder.

The court ruled that there was evidence that the corporation had saleable good will, but that a transfer of shares resulting from an involuntary dissolution, in the absence of an election to purchase the petitioner's shares for fair value under BCL §1118, is a sale under compulsion and thus does not implicate the nonsolicitation covenant.

Preconversion Agreements

The First Department rendered an important decision last year in *Matter of Hochberg (Manhattan Pediatric Dental Group, P.C.)*[14] concerning the enforceability in the corporate dissolution context of a previous partnership agreement.

In *Hochberg*, two dentists went into practice as a general partnership with an agreement containing an arbitration clause. The agreement also mandated that a partner seeking dissolution first offer his interest to the other. Years later they converted the practice to a professional corporation (PC), but without making a new agreement.

Partnership Law §26(b) says…that no partner of an LLP 'is liable… for any debts, obligations or liabilities of…the [LLP]…whether arising in tort, contract or otherwise.'

When one of them later sought dissolution of the PC, the other sought to compel arbitration under the old partnership agreement. The trial court denied arbitration on the authority of the Second Department's ruling in *Weiner v. Hoffinger, Friedland, Dobrish & Stern, P.C.*,[15] which in turn drew from the Court of Appeals' decision in *Weisman v. Awnair Corp.*,[16] holding that a partnership may not exist where the business is conducted in corporate form, and parties may not be partners between themselves while using the corporate shield to protect themselves.

The First Department declined to follow *Weiner* and directed arbitration under the old partnership agreement. The court instead adopted the reasoning of the Third Department in *Blank v. Blank*[17] which qualified *Weisman* to the extent of enforcing a preconversion partnership agreement so long as the rights of third-party creditors are not involved and the parties' rights under the partnership agreement are not in conflict with the corporation's functioning. Judicial dissolution of the dental practice would be inappropriate, the court added, in that it would enable avoidance of the buyout provisions.

The LLP Liability Shield

In one of its final decisions in 2007, the Court of Appeals in *Ederer v. Gursky*[18] held that partners in registered LLPs are not protected by §26(b) of the Partnership Law against personal liability for breaches of the partnership's or partners' obligations to each other. While the decision does not directly address rights of partnership dissolution—generally speaking LLPs like general partnerships are dissolvable at will—it nonetheless has important ramifications for myriad disputes that can arise from the breakup of a professional practice.

Ederer involved a small law firm initially formed as a PC and later re-organized as an LLP with five partners, two of whom held 30 percent and 55 percent partnership interests. Those two had a falling out following which the 30 percent partner entered into a written withdrawal agreement with the LLP setting forth various financial and case-sharing arrangements. Six months later, the now-former partner sued the LLP and each of its four remaining partners personally, claiming breach of the withdrawal agreement and seeking an accounting and certain profit shares.

In an opinion by Judge Susan Phillips Read, and over a strong dissent by Judge George Bundy Smith in which Chief Judge Judith Kaye concurred, the court affirmed lower-court rulings rejecting the defendant partners' argument that Partnership Law §26(b) shielded them against any personal liability. That section provides, subject to certain exceptions pertaining to professional misconduct or negligence and agreements to accept vicarious liability, that no partner of an LLP "is liable… for any debts, obligations or liabilities of…the [LLP]… whether arising in tort, contract or otherwise." The majority opinion held that the section only provides a personal liability shield against vicarious liability claims by third parties.

The majority opinion closes with the observation that the Partnership Law's provisions for the most part, including the right to an accounting under §74, are default rules subject to variance by partnership agreement. Accordingly, like most causes for dispute in business breakups, the best antidote is a thoroughly considered and carefully drafted written agreement made at the outset of a business relationship.

1. "Friends Don't Always Make Good Partners," The New York Times, Sept. 7, 2006 (available online at http://www.nytimes.com/2006/09/07/business/07sbiz.html?partner=rssnyt&emc=rss).
2. 122 AD2d 873 (2d Dept 1986).
3. 31 AD3d 172 (1st Dept 2006).
4. See P. Mahler and M. Schoenberg, "Dissolution Petition Can Unwittingly Trigger Stock Buyback," NYLJ, July 21, 2006, p. 4, col. 4.
5. 14 Misc3d 1212(A) (Sup Ct Onondaga Co 2007) (Donald A. Greenwood, J.). In a decision on appeal dated Feb. 1, 2008, the Appellate Division, Fourth Department, agreed with the lower court's determination but ordered reinstatement of the dissolution petition pending the respondent's actual exercise of its right to acquire the petitioner's shares. 2008 NY Slip Op 00921.
6. 2007 NY Slip Op 32966(U) (Sup Ct Nassau Co Sept. 25, 2007) (Stephen A. Bucaria, J.).
7. See, e.g., *Matter of Chiovitti (Alpine Motor Cars, Inc.)*, 280 AD2d 412 (1st Dept 2001) (reversing order appointing receiver).
8. 2007 NY Slip Op 51148(U) (Sup Ct Nassau Co June 6, 2007), motion for renewal granted and, upon reconsideration, appointment of receiver denied, 2007 NY Slip Op 52440(U) (Sup Ct Nassau Co Dec. 7, 2007) (Leonard B. Austin, J.).
9. 64 NY2d 63 (1984).
10. 2007 NY Slip Op 30669(U) (Sup Ct NY Co March 1, 2007) (Nicholas Figueroa, J.).
11. 2007 NY Slip Op 32911(U) (Sup Ct Nassau Co. Sept. 13, 2007) (Stephen A. Bucaria, J.).
12. 52 NY2d 276 (1981).
13. 16 Misc3d 1140(A) (Sup Ct Nassau Co 2007) (Leonard B. Austin, J.).
14. 41 AD3d 202 (1st Dept. 2007).
15. 298 AD2d 453 (2d Dept. 2002).
16. 3 NY2d 444 (1957).
17. 222 AD2d 851 (3d Dept. 1995).
18. 2007 NY Slip Op 09960 (Ct App Dec. 20, 2007).