New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
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An ALM Publication
VOLUME 243—NO. 22
WEDNESDAY, FEBRUARY 3, 2010

OUTSIDE COUNSEL

Expert Analysis

Business Divorce Cases of 2009

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The year 2009—a year of continued financial upheaval unmatched since the Great Depression—witnessed many interesting court decisions arising from cases involving judicial dissolution of closely held business entities and related disputes between business co-owners. Particularly noteworthy is the high proportion of cases involving businesses organized as limited liability companies (LLCs), reflecting the growing dominance both nationally and in New York of the LLC as the entity form of choice for business owners.

This review of last year's most interesting business divorce cases highlights a number of important issues concerning capital contributions, standing to seek dissolution, stock valuation, and other issues specific to limited liability companies.

Compulsory Capital Calls

Two appellate decisions last year highlight both the potency and limits of compulsory capital contribution provisions in LLC operating agreements.

In *Fuiaxis v. 111 Huron Street, LLC*, 58 AD3d 798 (2d Dept. 2009), a 25 percent member of a real estate owning LLC petitioned for judicial dissolution under §702 of the LLC Law. The other members responded by approving a resolution demanding that each member, including the petitioner, make a $10,000 capital contribution to fund the LLC's legal expenses in the dissolution proceeding. The operating agreement provided that if a member failed to make the contribution, the other members could acquire his or her interest at a formula price.

The petitioner unsuccessfully moved the trial court to enjoin enforcement of the resolution and threatened buyout. On appeal, the Second Department affirmed the decision, holding that the resolution was proper under the operating agreement's capital contribution provision and that the provision was "consistent with the Limited Liability Company Law, which does not preclude a limited liability company from using its funds to defend itself in a judicial dissolution action."

In a pair of decisions last year, courts addressed interesting issues of standing to seek judicial dissolution of an LLC and shareholder standing to sue derivatively.

In contrast, in *Cooperstown Capital, LLC v. Patton*, 60 AD3d 1251 (3d Dept. 2009), involving an LLC that ran a baseball camp, the Third Department denied enforcement of a capital call made by the majority members amidst litigation with the minority member over financial obligations. The challenged capital call was made upon the minority member alone. The Third Department affirmed the lower court's finding that the parties' operating agreement, which permitted pro rata contributions from the members, did not authorize selective capital calls on one member. The Third Department held that while the operating agreement permits capital calls, it provides that such calls "'shall' be shared pro rata by the 'members' plural."

Decisions on Standing

In another pair of decisions last year, courts addressed interesting issues of standing to seek judicial dissolution of an LLC and shareholder standing to sue derivatively.

Caplash v. Rochester Oral & Maxillofacial Surgery Associates, LLC, 63 AD3d 1683 (4th Dept. 2009), involved judicial dissolution of a medical practice LLC brought by a 50 percent member alleging deadlock. The other 50 percent member challenged plaintiff's standing on the ground he previously submitted his written resignation from the LLC, which raised a threshold issue whether the attorney hired by the defendant 50 percent member had authority under the operating agreement to accept the resignation on the LLC's behalf.

The Fourth Department affirmed the lower court's finding that the attorney hired by the defendant lacked authority to accept the resignation and that the plaintiff therefore had standing to seek dissolution. The court held that under LLC Law §412, the appointment of an attorney-agent by a member, in order to bind the LLC, must be (a) for the purpose of carrying on the usual business of the company or (b) sanctioned by majority vote of the members as permitted by the operating agreement, neither of which was the case in *Caplash*.

The plaintiff did not fare as well in *Watkins v. JC Land Development, Ltd.*, Index No. 30678-07 (Sup Ct Suffolk Cty June 19, 2009). In *Watkins*, the plaintiff as purported 50 percent shareholder asserted derivative claims for diversion of assets against a defendant who claimed to be the 100 percent shareholder. The defendant argued that plaintiff was judicially estopped from asserting shareholder standing based on his failure to disclose his alleged 50 percent stock interest to probation authorities in federal criminal sentencing proceedings that took place shortly after formation of the business. The criminal court had declined to impose a fine

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against plaintiff upon its finding that he had no assets.

Supreme Court agreed with defendant and granted summary judgment dismissing the action, stating that "the Court cannot imagine a more apt scenario for application of the doctrine of judicial estoppel" and that "[t]he same litigant will not be permitted to utilize the State Court system to litigate his claims to real property or accountings based on funds he now states he began transferring at the precise time of his contradictory statements to probation, relied upon by a federal judge."

Valuation Cases

A threesome of decisions from last year addressed novel issues in the context of valuation disputes arising from the dissolution of a professional corporation, the surviving shareholders' takeover of an accounting firm's assets, and a corporate merger.

In *Matter of Ravitz (Gerard Furst and Marjorie Ravitz, DPM, P.C.)*, 65 AD3d 1049 (2d Dept. 2009), in which the authors' firm represented the petitioner, one of two equal shareholders in a podiatry practice petitioned under §1104 of the Business Corporation Law (BCL) for dissolution based on deadlock and internal dissension. After the court granted the petition and dissolved the corporation, the shareholders agreed to close one of their three offices and that each would take over one of the two remaining offices for their new, separate practices. The respondent thereafter unsuccessfully moved the trial court to conduct a hearing to determine the alleged, greater value of the goodwill associated with the office retained by petitioner for purposes of compelling an adjusting payment to respondent.

The Second Department affirmed the lower court's denial of the motion on the ground that the court lacks statutory authority in BCL §1104 proceedings to supervise post-dissolution distribution of corporate assets, adding that "[w]hen parties cannot reach an agreement amongst themselves with respect to the sale of the corporation's assets either to one another or to a third party, the only authorized disposition of corporate assets is liquidation at a public sale."

In *Matter of Verdeschi*, 63 AD3d 1084 (2d Dept. 2009), the estate of the deceased 35 percent shareholder of an accounting firm brought a dissolution proceeding in Surrogate's Court under BCL §1104-a alleging that the surviving shareholders had reconstituted using a new entity with an almost identical name, occupying the old firm's office and servicing its same clients. The court granted dissolution and referred the issue of valuation and appropriate remedy to a Judicial Hearing Officer. The JHO held a two-day hearing after which he adopted the appraisal of the estate's expert based on a multiple of adjusted gross revenues. The JHO sharply rejected the testimony of respondents' expert who had assigned zero value to the decedent's stock interest.

In its decision affirming Surrogate's Court's valuation award of $260,000 against respondents, the Second Department wrote that "the judicial hearing officer properly credited the testimony of the administrator's expert witness regarding the value of the decedent's share of the value of the corporation, including the value of goodwill, and properly rejected the testimony of the expert testifying for the surviving shareholders."

Matter of Jamaica Acquisition Inc., 25 Misc3d 1212(A) (Sup Ct Nassau Cty 2009), involved a dissenting shareholder appraisal proceeding under BCL §623 arising from the conversion of the former Green Bus Lines and related companies into a real estate investment trust. The parties' expert appraisers, whose respective valuations varied by over 250 percent, clashed over a number of issues including discounts for built-in capital gains (BIG) and post-merger corporate tax liabilities, marketability and minority discounts, and appropriate capitalization rate.

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Among other rulings, the court rejected the $58 million BIG discount proposed by the companies' expert based on statements in the merger proposal that the real estate would be held for at least 10 years. On the other hand, the court agreed with the companies' position applying a 25 percent marketability discount against the entire value of the enterprise and not against goodwill value only, as some decisions have suggested. The court also ordered the companies to reimburse the dissenters 50 percent of their costs and legal fees based on the significant discrepancy between the companies' $7 per share offer and the $11.69 per share award, and also due to the companies' "vexatious" proffering of multiple, changing fair value calculations even during trial.

Additional LLC Decisions

Two other decisions last year addressed important issues—one substantive, the other procedural—concerning the relatively undeveloped law governing LLCs.

Lawyers who follow LLC developments will recall from 2008 the controversial 4-3 decision by the New York Court of Appeals in *Tzolis v. Wolff*, 10 NY3d 100, recognizing a common law right of LLC members to bring a derivative action despite the apparent, deliberate omission of statutory authority for such action when the LLC Law was enacted. Last year, in *Gottlieb v. Northriver Trading Co., LLC*, 58 AD3d 550 (1st Dept. 2009), the First Department followed the path of *Tzolis* and ruled that members of an LLC may seek an equitable accounting under common law. The decision reversed the lower court's order which relied, first, on the company's compliance with its obligations under LLC Law §1102 to provide access to certain books and records and, second, on the absence of statutory authority in the LLC Law for the accounting remedy.

Finally, *Ficus Investments Inc. v. Private Capital Management, LLC*, NYLJ March 5, 2009 (Sup Ct NY Cty), addressed a procedural question surrounding the commencement of proceedings for judicial dissolution of an LLC. The governing statute, LLC Law §702, unlike its BCL counterpart governing corporate dissolution, offers no guidance as to the form or manner by which such a proceeding can be brought. In *Ficus*, a 50 percent member of an LLC sought judicial dissolution by way of cross-motion in an existing litigation between the members involving claims of mismanagement and financial abuse.

Noting that the LLC Law "appears not to deny Plaintiff the right to seek this relief by cross-motion," the court nonetheless denied the motion without prejudice to commencing a separate application for dissolution by way of petition in a special proceeding or complaint in a plenary action. The court's decision cites numerous examples in which LLC dissolution was sought by petition, complaint or counterclaim. The court also noted that such requirement "would provide Plaintiffs the opportunity to plead a cause of action for judicial dissolution, and it would enable [defendant] to answer this claim, rather than merely oppose the cross-motion."

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