New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 249—NO. 30
THURSDAY, FEBRUARY 14, 2013

Outside Counsel

Expert Analysis

Annual Review of Business Divorce Cases in 2012

Lawyers who counsel and litigate on behalf of owners of closely held companies, along with business appraisers and planning professionals, are heavily dependent on the guidance provided by judicial opinions in cases involving dissolution, buyout and other disputes between co-owners. After all, court decisions in business divorce cases generally highlight one or another deficiency or omission in the firm's organic documents such as a shareholder agreement for a close corporation or operating agreement for a limited liability company (LLC). One business owner's litigation success or failure is another's drafting solution.

Last year, New York appellate and trial courts issued many important decisions affecting the rights and relations of business co-owners in corporations, partnerships and LLCs. The cases featured in this annual review include decisions addressing fiduciary duty and waiver, a court's power to remove and replace the general partner of a limited partnership, the procedure for LLC members to dissent from mergers, and valuation discounts.

By
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Waiver of Fiduciary Duties

A number of decisions in recent years reflect sharp debate within the First Department, and between that court and the Court of Appeals, over the proper judicial role in mediating disputed buyout transactions between co-fiduciaries, where the seller claims the buyer violated a duty of disclosure and the buyer relies on the seller's express release or fiduciary disclaimer.

Last year, in *Pappas v. Tzolis*, 20 NY3d 228 (2012), the Court of Appeals seemingly placed an exclamation point on what is now a trilogy of decisions from that court, including *Centro Empresarial Cempresa v. America Movil, S.A.B. de C.V.*, 17 NY3d 269 (2011), and *Arfa v. Zamir*, 17 NY3d 737 (2011), collectively holding that the purchasing fiduciary's duty of disclosure will be subordinated to the seller's contractual release or waiver when the co-owners' relationship is no longer one of "unquestioning trust."

In *Pappas*, two members of an LLC that held a valuable long-term lease for commercial property sold for $1.5 million their combined 60 percent membership interest to the 40 percent member who, about six months later, sold the lease to a third party for $17.5 million. The purchase agreement included an express waiver of the buyer's fiduciary duty in connection with the sale. Upon learning of the subsequent sale of the lease, the selling members sued the purchasing member for breach of fiduciary duty of disclosure, alleging that he surreptitiously negotiated the sale of the lease before he bought their interests in the LLC.

The Court of Appeals, in reversing the First Department's decision upholding the complaint, focused on the "antagonistic" relationship between the members leading up to the buyout, imposing on the sellers a "heightened degree of diligence" in which "the principal is aware of information about the fiduciary that would make reliance on the fiduciary unreasonable." The court also emphasized that the sellers were "sophisticated businessmen represented by counsel" in the transaction, and that the buyout pricing made "obvious" their "need to use care to reach an independent assessment of the value of the lease."

Fiduciary disclaimers also were at issue in *Kagan v. HMC-New York,* 94 AD3d 67 (1st Dept. 2012). In *Kagan*, the

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non-managing member of two Delaware LLCs that served as investment fund managers brought claims for breach of contract and fiduciary duty against the LLCs' managing members. The complaint alleged the failure to pay him over $62 million for performance-based compensation. The trial court denied defendants' motion to dismiss the contract claims but rejected the fiduciary breach claims as duplicative of the contract claims. Both sides appealed.

The First Department unanimously ruled that the lower court should have dismissed the contract claims against the managing members under a limitation of liability provision in the LLC agreement. A three-judge majority of the panel also agreed with the lower court's dismissal of the fiduciary breach claim on the ground it was based on the same facts underlying the contract breach claim and therefore precluded under Delaware case law.

Alternatively, the majority held that the fiduciary breach claim was barred by the LLC agreement's language stating that "no manager…shall have any liability to…any member…for any loss" other than for intentional misconduct, violation of law, or gross negligence. According to the majority, this provision, and particularly its enumeration of some exceptions but not others, precluded fiduciary breach claims. The two dissenting justices, under their analysis of Delaware statutory and case law, would have sustained the fiduciary breach claims because the LLC agreement's disclaimer language did not "explicitly eliminate" the manager's traditional default fiduciary duties.

Removal of General Partner

It is rare for a court to remove the general partner of a limited partnership (LP), and rarer yet to replace that general partner with a non-partner entity controlled by limited partners. But in *Garber v. Stevens*, Index No. 601917/05 (Sup. Ct., N.Y. County June 6, 2012), the court did just that. The subject LP, formed to hold ownership to real property, was comprised of two general partners and eight limited partners, with management rights vested exclusively with the general partners. In their lawsuit, the limited partners alleged that the general partners entered transactions without their consent, failed to distribute proceeds, and engaged in self-dealing. The court granted summary judgment to the limited partners on the issue of liability, appointed a receiver, and ordered a trial on damages.

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After discovering that the general partners had placed the LP's real property at risk of foreclosure, the limited partners, with the receiver's support, moved to replace the general partners with a non-partner LLC they owned. In opposition, the general partners argued that the partnership agreement expressly forbade limited partner participation in management, and that the partnership agreement's silence on general partner removal precluded this judicial remedy.

In granting the limited partners' motion and removing the general partners in favor of the limited partners' LLC, the court noted that its broad equity powers are not constrained by a provision in the partnership agreement confining management to the general partners. "The power of equity is as broad as equity and justice require," the court noted, and "having obtained jurisdiction of the parties and subject matter in this action [the court] must adapt its relief to the exigencies of the case." The import of *Garber* cannot be overstated, particularly in light of a partnership's fundamental characteristic—the freedom to "pick one's partners."

Dissent to LLC Merger

Article 10 of the LLC Law provides members the right to dissent from proposed mergers and receive cash payment for the fair value of their interest. With minor differences, LLC Law §1005 incorporates the BCL's procedures for contesting an LLC's cash offer. *Alf Naman Real Estate Advisors v. Capsag Harbor Management,* 2012 NY Slip Op 32559(U) (Sup. Ct., N.Y. County Oct. 3, 2012), in which a dissenting member got tripped up by the statute's deadlines, is one of the few reported cases applying the statute.

Capsag involved an LLC that provided design and consulting services for a major real estate development project. The LLC's majority member sent written notice to the minority member that the LLC would be merging with another company affiliated with the majority member and stating that, if it dissented, the minority member would receive the fair value of its interest in the amount of $465.

When, pursuant to LLC Law §1005, the minority member dissented from the merger, the LLC repeated its $465 offer, which was again rejected. The LLC had 20 days within which to commence a judicial valuation proceeding under BCL §623(h), but failed to do so, triggering the minority member's right to commence such a proceeding within 30 days. When the minority member also failed to do so, the LLC sent notice that the right to dissent had expired and enclosed a $465 check.

At that point, the minority member petitioned for a fair value appraisal of its ownership, which it contended was worth not $465 but millions of dollars. The court dismissed the petition, ruling that, under BCL §623(h)(2), a dissent-

er's appraisal rights are forfeited by the failure to timely commence a judicial valuation. The minority member had argued that it was entitled to additional time referenced in the preamble of BCL §623, but the court disagreed. Rather, the additional time mentioned in the BCL §623(h) preamble "refers back" to BCL §623(g), which, unlike BCL §623(h), was not adopted by LLC Law §1005. The court also determined that the minority member's delay in seeking an appraisal was not excusable for "good cause," which the court defined as some inability, "beyond any party's control," to meet the statutory time deadlines.

Valuation Discounts

Recent years have seen emerging trends in the valuation arena, particularly the application of valuation discounts such as discounts for lack of marketability (DLOM) and built-in capital gains (BIG). DLOM is a percentage deducted from the value of an ownership interest to reflect the relative absence of marketability compared to publicly traded securities. BIG, on the other hand, reflects the diminished value of a C-corporation resulting from the application of capital gains taxes at the corporate level to the sale of its appreciated assets upon liquidation. Two decisions from last year continued the emerging trend of adjustment and refinement in this area.

Chiu v. Chiu, Index No. 21905/07 (Sup. Ct., Queens County Aug. 30, 2012), involved two feuding brothers and a real estate holding LLC, in which one brother claimed 100 percent ownership while the other claimed a 75 percent-25 percent split. When the minority brother withdrew from the LLC and demanded the fair value of his claimed ownership interest pursuant to LLC Law §509, disputes erupted as to his ownership percentage and its value.

After determining that the withdrawing brother owned a 10 percent interest in the LLC based on their relative capital contributions, the court turned to calculating the LLC's "fair value"—a term undefined by LLC Law. The primary source of contention was not the company's base fair value, but whether, and to what extent, to apply a DLOM. The majority brother argued for a DLOM of 25 percent based upon similar figures in prior case law; the withdrawing brother, relying on cases rejecting DLOM for real estate holding companies (including the trial court decision in *Giaimo*, discussed below) argued for no DLOM.

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The court agreed with the withdrawing member and rejected DLOM. While noting that "the illiquidity of the membership interests should be taken into account," the court ultimately recognized that the LLC is "essentially real property placed in a LLC package" and that the LLC, like the real property it owned, "is easily marketable."

The *Giaimo* case cited in *Chiu* was itself modified later in 2012 on appeal in *Giaimo v. Vitale*, 101 AD3d 523 (1st Dept. 2012). That case involved the valuation of two C-corporation real estate holding companies owned, as in *Chiu*, by feuding siblings. After one sibling petitioned for dissolution under the shareholder oppression statute (BCL §1104-a), the other elected to purchase the petitioner's shares for fair value under BCL §1118. The trial court applied a BIG discount based on the present value of future taxes assuming a 10-year holding period. On the other hand, the trial court rejected DLOM because the subject portfolio of properties had unique attributes rendering the corporations' shares readily marketable.

The First Department modified the decision by directing a 16 percent DLOM. In so doing, it recognized that "[t]here are increased costs and risks associated with corporate ownership of the real estate in this case that would not be present if the real estate was owned outright. These costs and risks…should be accounted for by way of a discount." The court adopted a 16 percent DLOM employing the "build up" method championed by the purchaser's expert, which calculates the discount based upon the projected real estate-related and due diligence costs of selling a real estate holding company.

As for BIG, both parties had appealed the trial court's ruling, with the seller arguing that there should be no BIG discount and the buyer arguing for a BIG discount of 100 percent of the projected tax assuming liquidation as of the valuation date. The First Department satisfied neither party by affirming the trial court's deduction of projected future gains tax after 10 years discounted to present value. Such a discount, the court noted, "appropriately adjusts for embedded capital gains taxes that will not be paid until sometime in the future."