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Basics of Business Dissolution and Partnership Breakups

July 31, 2018
Suffolk County Bar Center, Hauppauge, NY

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Business Dissolutions and Partnership Breakups
July 31, 2018
5:45 p.m. – 7:35 p.m.
SCBA Center, Hauppauge

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Basics of Business Dissolution and Partnership Breakups
Tuesday, July 31, 2018 from 5:45 p.m. - 7:35 p.m.
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Supplemental Annotated Outline

a) Partnerships (Partnership Law)

i) Withdrawal and Dissolution (Partnership Law § 62)

(1) At-will partnership

(a) Where there is no partnership agreement, or when the partnership agreement does not specify a "definite term" or "particular undertaking," a partner is free to withdraw at any time without exposure to liability (*Eskenazi v Schapiro*, 27 AD3d 312 [1st Dept 2006])

(b) Withdrawal automatically results in dissolution of the partnership (*id.*)

(2) Partnership by agreement

(a) Where there is an agreement setting forth a "definite term" or a "particular undertaking," a withdrawing partner is subject to liability for breach of contract, fiduciary duty, and/or wrongful withdrawal/dissolution (Partnership Law § 69)

(b) No automatic dissolution upon wrongful withdrawal, partners may "reconstitute" the partnership and buyout the departing partner (*id.*)

(3) Other causes of dissolution:

(a) By death of a partner

(b) By judicial order under Partnership Law § 63

(i) Grounds for judicial dissolution

1. Willful or persistent breach of the partnership agreement

2. Engaging in conduct rendering it not practicable to carry on the business of the partnership

3. Partnership can only be carried on at a loss

4. Equitable dissolution – *i.e.*, deadlock and dissention (*Seligson v Russo*, 16 AD3d 253 [1st Dept 2005])

(4) Valuation and Discounts

(a) Departing partner may have her ownership interest appraised and purchased:

(i) Upon wrongful withdrawal when other partners elect to continue (Partnership Law § 69 [2] [c])

(ii) Upon death or retirement under Partnership Law § 73 (*Vick v Albert*, 47 AD23d 482 [1st Dept 2008])

(b) Minority discount or discount for lack of control ("DLOC"), which is not available in fair-value appraisal proceedings under the BCL and LLCL (*see* below), may be applied in partnership context where the fair-market-value standard applies (*Congel v Malfitano*, 2018 NY Slip Op 02119 [2018])

(c) Discount for good will also uniquely available in partnership context (*id.*)

(5) Derivative claims

(a) Limited partnerships – limited partners are permitted to assert claims against one or more general partners derivatively on behalf of the partnership (*Riviera Cong. Assoc. v Yassky*, 18 NY2d 540 [1966]; *see also* § 121-1002)

(b) General partnerships – availability of derivative claims amongst general partners is not as clear (*see, e.g.*, Revised Uniform Partnership Act [1997], § 405[b], cmt, p. 73 ["Since general partners are not passive investors like limited partners, RUPA does not authorize derivative actions"])

b) Corporations (Business Corporation Law)

i) Dissolution

(1) Based on deadlock or dissension under BCL § 1104

(a) Statutory grounds

(i) Directors so divided regarding management of the business that they cannot act (BCL 1104 [a] [1])

(ii) Shareholders so divided that they cannot elect directors (BLC 1104 [a] [2])

(iii) Shareholders so divided that dissolution would be beneficial to them (BCL 1104 [a] [3])

(b) Some key distinctions

(i) Shareholder must have 50% voting interest to petition court for dissolution (BCL 1104 [a])

(ii) Respondent cannot statutorily elect to buy out Petitioner's interest in response to petition as in oppression statute (*see* below)

(iii) No compulsory equitable buyout remedy available to Respondent as an alternative to dissolution as in oppression statute (*see* below) (*Matter of Lake Mahopac Tailor, Inc.*, 146 AD2d 774 [2d Dept 1989])

(2) Shareholder oppression under BCL § 1104-a

(a) Statutory grounds

(i) Oppressive conduct on the part of the control owners (BCL 1104-a [a] [1])

1. Oppressive conduct is conduct that defeats shareholder's "reasonable expectations" in entering the business (*Matter of Kemp & Beatley, Inc.*, 64 NY2d 63 [1984])

(ii) Diversion of corporate assets for personal gain or other corporate waste (BCL 1104-a [a] [2])

(b) Some key distinctions

(i) Shareholder must have at least 20% voting interest to petition court for dissolution (BCL 1104-a [a])

1. Thus, shareholders holding 50% interest potentially may proceed under both BCL §§ 1104 and 1104-a (*Matter of Cristo Bros., Inc.*, 64 NY2d 975 [1985])

(ii) Respondent(s) may elect to buy out Petitioner's interest in response to petition, which effectively converts the dissolution proceeding into an appraisal proceeding (BCL § 1118)

(iii) Court may fashion a compulsory equitable buyout remedy as an alternative to dissolution (*Matter of Clever Innovations*, 94 AD3d 1174 [3d Dept 2012])

(3) Common law dissolution (*Ferolito v Vultaggio*, 99 AD3d 19 [1st Dept 2012]; quoting *Leibert v Clapp*, 13 NY2d 313 [1963])

(a) Basic grounds

(i) Control owners looting company assets at the expense of minority shareholders

(ii) Control owners continuing business solely to benefit themselves

(iii) Control owners forcing minority shareholders to sell their interest at a depressed value

(b) Some key distinctions

(i) Available to holders of non-voting shares

(ii) Available to holders of less than 20% of non-voting shares

(iii) Compulsory equitable buyout remedy available as with oppression statute (*Cortes v 3A N. Park Ave. Rest Corp.*, 46 Misc 3d 670 [Sup Ct, Kings County 2014])

ii) Valuation and Discounts

(1) Fair-value appraisal proceedings available to determine value of shareholder's interest in connection with buyout of that interest:

(a) When Respondent elects to purchase Petitioner's interest under BCL § 1118 in response to a dissolution petition under BCL § 1104-a

(b) When minority shareholder dissents from a merger under BCL § 910 (*e.g.*, "cash-out" or freeze-out" merger)

(c) When minority shareholder dissents from an amendment to the certificate of incorporation adversely affecting her ownership under BCL § 806 (b) (6)

(d) When court compels buyout as an alternative to dissolution under BCL § 1104-a (*Matter of Kemp & Beatley, Inc.*, 64 NY2d 63 [1984])

(2) Appraisal proceedings governed by strict procedural parameters of BCL § 623

(a) Rights of Petitioner generally limited to right to receive fair value

(i) Exception under BCL § 623 (k) allows Petitioner to seek other relief when corporate action dissented from was "unlawful or fraudulent"

1. Exception not available in Partnership context (*Appleton Acquisition, LLC v National Housing Partnership*, 10 NY3d 250 [2008])

2. Exception also not available in LLC context (*see* below)

(b) Discounts applicable in fair-value appraisal proceedings

(i) Discount for lack of marketability of stock in a private, closely-held business ("DLOM") (*Matter of Seagroatt Floral Co.*, 78 NY2d 439 [1991])

1. Appellate split on applicability of DLOM for realty holding companies

a. First Department recognizes "corporate wrapper" in such entities and will apply DLOM (*Matter of Giaimo v Vitale* (101 AD3d 523 [1st Dept 2012])

b. Second Department has held that DLOM already is effectively incorporated into the underlying real estate appraisals of the real property owned by the corporation and therefore should not be applied at the corporate level (*Chiu v Chiu*, 125 AD3d 824 [2d Dept 2015]).

(ii) Discount for lack of control ("DLOC") or minority discount not available (*Matter of Penepent Corp.*, 96 NY2d 186 [2001])

iii) Derivative claims

(1) Harm resulting from control-owner mismanagement primarily is to the company, not to the individual shareholder (*Yudell v Gilbert*, 99 AD3d 108 [1st Dept 2010])

(2) Individual shareholder therefore lacks standing to assert direct causes of action and must sue derivatively on behalf of the company (*Abrams v Donati*, 66 NY2d 951 [1985])

(3) Minority shareholders must specifically plead the efforts made to get board approval of the lawsuit or the reasons for not making such effort ("demand futility") (BCL § 626 [c])

(4) Shareholders suing derivatively must maintain their ownership status throughout the entirety of the lawsuit ("continuous ownership rule") (*Tenney v Rosenthal*, 6 NY2d 204 [1959])

a) LLCs (Limited Liability Company Law)

i) Dissolution

(1) Distinctive standard under LLCL § 702: Not reasonably practicable to carry on business in conformity with articles of organization or operating agreement

(a) Further defined by *Matter of 1545 Ocean Ave., LLC* (72 AD3d 121 [2d Dept 2010])

(i) Petitioner must establish in the context of the articles of organization or operating agreement that:

1. Managers are unable or unwilling to promote the stated purpose; or

a. All-purpose purpose clauses permitting "any lawful business" may result in an evidentiary hearing to determine true purpose (*Mace v Tunick* (153 AD3d 689 [2d Dept 2017])

2. Continuation of the business is financially unfeasible

(2) Some key distinctions

(a) Deadlock is not an independent ground for LLC dissolution (*Advanced 23, LLC v Chambers House Partners, LLC*, 2017 NY Slip Op 32662[U] [Sup Ct, 2017])

(b) Oppression is not an independent ground for LLC dissolution (*Doyle v Icon, LLC*, 103 AD3d 440 [1st Dept 2013])

(c) Compulsory equitable buyout available as in corporate oppression statute *Mizrahi v Cohen* (104 AD3d 917 [2d Dept 2013])

(d) No default rule authorizing withdrawal and triggering buyout of membership interest (LLCL §§ 509 and 606)

(i) Grandfather exception for LLCs formed before 1999 (*Matter of Jacobs v Cartalemi*, 156 AD3d 635 1st Dept 2017])

ii) Valuation and Discounts

(1) As with corporations, fair-value appraisal proceedings are available to members of LLCs for purposes of a buyout of their interests:

(a) When a minority member dissents from a merger under LLCL §§ 1002 and 1005

(i) Appraisal procedure mandated by BCL § 623 incorporated by reference under LLCL § 1005

1. Unlike corporations, a member's rights upon dissent are limited to payment of fair value (*Stulman v John Dory LLC*, 2010 NY Slip Op 339111[U] [Sup Ct, NY County 2010])

2. As with partnerships, parties can litigate claims concerning self-dealing, corporate waste, etc. as a part of the appraisal proceeding only insofar as they affect the valuation (*Appleton Acquisition, LLC v National Housing Partnership*, 10 NY3d 250 [2008])

(b) When a member withdrawals from an LLC formed prior to 1999 (*Chiu v Chiu*, 125 AD3d 824 [2d Dept 2015])

(c) When a court compels an equitable buyout of a member's interest (*Mizrahi v Cohen*, 104 AD3d 917 [2d Dept 2013])

(2) Applicable discounts in fair-value appraisals of LLC interests similar to that of corporations

(a) Discount for lack of marketability (DLOM) generally applicable (*Matter Friedman v Beway Realty Corp.*, 87 N.Y.2d 161 [1995])

(i) *But see* above regarding Appellate split for realty holding companies

(b) Discount for lack of control (DLOC) or minority discount prohibited (*Matter Friedman v Beway Realty Corp.*, 87 N.Y.2d 161 [1995])

iv) Derivative claims: NY case law governing derivative claims (*see* above) deemed applicable in the LLC context by the Court of Appeals in *Tsolis v Wolff* (10 NY3d 100 [2008])

New York Consolidated Laws, Partnership Law - PTR § 62. Causes of dissolution

Dissolution is caused:

1. Without violation of the agreement between the partners,

(a) By the termination of the definite term or particular undertaking specified in the agreement,

(b) By the express will of any partner when no definite term or particular undertaking is specified,

(c) By the express will of all the partners who have not assigned their interests or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking,

(d) By the expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners;

2. In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time;

3. By any event which makes it unlawful for the business of the partnership to be carried on or for the members to carry it on in partnership;

4. By the death of any partner;

5. By the bankruptcy of any partner or the partnership;

6. By decree of court under section sixty-three .

New York Consolidated Laws, Partnership Law - PTR § 63. Dissolution by decree of court

The court shall decree a dissolution.

1. On application by or for a partner whenever:

(a) A partner has been declared incompetent in any judicial proceeding or is shown to be of unsound mind,

(b) A partner becomes in any other way incapable of performing his part of the partnership contract,

(c) A partner has been guilty of such conduct as tends to affect prejudicially the carrying on of the business,

(d) A partner wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him,

(e) The business of the partnership can only be carried on at a loss,

(f) Other circumstances render a dissolution equitable;

2. On the application of the purchaser of a partner's interest under sections fifty-three or fifty-four :

(a) After the termination of the specified term or particular undertaking,

(b) At any time if the partnership was a partnership at will when the interest was assigned or when the charging order was issued.

New York Consolidated Laws, Partnership Law - PTR § 69. Rights of partners to application of partnership property

1. When dissolution is caused in any way, except in contravention of the partnership agreement, each partner, as against his copartners and all persons claiming through them in respect of their interests in the partnership, unless otherwise agreed, may have the partnership property applied to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners. But if dissolution is caused by expulsion of a partner, bona fide under the partnership agreement, and if the expelled partner is discharged from all partnership liabilities, either by payment or agreement under section sixty-seven, subdivision two , he shall receive in cash only the net amount due him from the partnership.

2. When dissolution is caused in contravention of the partnership agreement the rights of the partners shall be as follows:

(a) Each partner who has not caused dissolution wrongfully shall have,

(I) All the rights specified in subdivision one of this section, and
(II) The right, as against each partner who has caused the dissolution wrongfully, to damages for breach of the agreement.

(b) The partners who have not caused the dissolution wrongfully, if they all desire to continue the business in the same name, either by themselves or jointly with others, may do so, during the agreed term for the partnership and for that purpose may possess the partnership property, provided they secure the payment by bond approved by the court, or pay to any partner who has caused the dissolution wrongfully, the value of his interest in the partnership at the dissolution, less any damages recoverable under clause (II) of paragraph (a) of subdivision two of this section, and in like manner indemnify him against all present or future partnership liabilities.

(c) A partner who has caused the dissolution wrongfully shall have:

(I) If the business is not continued under the provisions of paragraph (b) of subdivision two of this section all the rights of a partner under subdivision (1), subject to clause (II) of paragraph (a) of subdivision two, of this section.

(II) If the business is continued under paragraph (b) of subdivision two of this section the right as against his copartners and all claiming through them in respect of their interest in the partnership, to have the value of his interest in the partnership, less any damages caused to his copartners by the dissolution, ascertained and paid to him in cash, or the payment secured by bond approved by the court, and to be released from all existing liabilities of the partnership; but in ascertaining the value of the partner's interest the value of the good-will of the business shall not be considered.

New York Consolidated Laws, Business Corporation Law - BSC § 1104. Petition in case of deadlock among directors or shareholders

(a) Except as otherwise provided in the certificate of incorporation under section 613 (Limitations on right to vote), the holders of shares representing one-half of the votes of all outstanding shares of a corporation entitled to vote in an election of directors may present a petition for dissolution on one or more of the following grounds:

(1) That the directors are so divided respecting the management of the corporation's affairs that the votes required for action by the board cannot be obtained.

(2) That the shareholders are so divided that the votes required for the election of directors cannot be obtained.

(3) That there is internal dissension and two or more factions of shareholders are so divided that dissolution would be beneficial to the shareholders.

(b) If the certificate of incorporation provides that the proportion of votes required for action by the board, or the proportion of votes of shareholders required for election of directors, shall be greater than that otherwise required by this chapter, such a petition may be presented by the holders of shares representing more than one-third of the votes of all outstanding shares entitled to vote on non-judicial dissolution under section 1001 (Authorization of dissolution).

(c) Notwithstanding any provision in the certificate of incorporation, any holder of shares entitled to vote at an election of directors of a corporation, may present a petition for its dissolution on the ground that the shareholders are so divided that they have failed, for a period which includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired or would have expired upon the election and qualification of their successors.

New York Consolidated Laws, Business Corporation Law - BSC § 1104-a. Petition for judicial dissolution under special circumstances

(a) The holders of shares representing twenty percent or more of the votes of all outstanding shares of a corporation, other than a corporation registered as an investment company under an act of congress entitled "Investment Company Act of 1940", 1 no shares of which are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or an affiliated securities association, entitled to vote in an election of directors may present a petition of dissolution on one or more of the following grounds:

(1) The directors or those in control of the corporation have been guilty of illegal, fraudulent or oppressive actions toward the complaining shareholders;

(2) The property or assets of the corporation are being looted, wasted, or diverted for non-corporate purposes by its directors, officers or those in control of the corporation.

(b) The court, in determining whether to proceed with involuntary dissolution pursuant to this section, shall take into account:

(1) Whether liquidation of the corporation is the only feasible means whereby the petitioners may reasonably expect to obtain a fair return on their investment; and

(2) Whether liquidation of the corporation is reasonably necessary for the protection of the rights and interests of any substantial number of shareholders or of the petitioners.

(c) In addition to all other disclosure requirements, the directors or those in control of the corporation, no later than thirty days after the filing of a petition hereunder, shall make available for inspection and copying to the petitioners under reasonable working conditions the corporate financial books and records for the three preceding years.

(d) The court may order stock valuations be adjusted and may provide for a surcharge upon the directors or those in control of the corporation upon a finding of wilful or reckless dissipation or transfer of assets or corporate property without just or adequate compensation therefor.

New York Consolidated Laws, Business Corporation Law - BSC § 1118. Purchase of petitioner's shares; valuation

(a) In any proceeding brought pursuant to section eleven hundred four-a of this chapter, any other shareholder or shareholders or the corporation may, at any time within ninety days after the filing of such petition or at such later time as the court in its discretion may allow, elect to purchase the shares owned by the petitioners at their fair value and upon such terms and conditions as may be approved by the court, including the conditions of paragraph (c) herein. An election pursuant to this section shall be irrevocable unless the court, in its discretion, for just and equitable considerations, determines that such election be revocable.

(b) If one or more shareholders or the corporation elect to purchase the shares owned by the petitioner but are unable to agree with the petitioner upon the fair value of such shares, the court, upon the application of such prospective purchaser or purchasers or the petitioner, may stay the proceedings brought pursuant to section 1104-a of this chapter and determine the fair value of the petitioner's shares as of the day prior to the date on which such petition was filed, exclusive of any element of value arising from such filing but giving effect to any adjustment or surcharge found to be appropriate in the proceeding under section 1104-a of this chapter. In determining the fair value of the petitioner's shares, the court, in its discretion, may award interest from the date the petition is filed to the date of payment for the petitioner's share at an equitable rate upon judicially determined fair value of his shares.

(c) In connection with any election to purchase pursuant to this section:

(1) If such election is made beyond ninety days after the filing of the petition, and the court allows such petition, the court, in its discretion, may award the petitioner his reasonable expenses incurred in the proceeding prior to such election, including reasonable attorneys' fees;

(2) The court, in its discretion, may require, at any time prior to the actual purchase of petitioner's shares, the posting of a bond or other acceptable security in an amount sufficient to secure petitioner for the fair value of his shares.

New York Consolidated Laws, Business Corporation Law - BSC § 910. Right of shareholder to receive payment for shares upon merger or consolidation, or sale, lease, exchange or other disposition of assets, or share exchange

(a) A shareholder of a domestic corporation shall, subject to and by complying with section 623 (Procedure to enforce shareholder's right to receive payment for shares), have the right to receive payment of the fair value of his shares and the other rights and benefits provided by such section, in the following cases:

(1) Any shareholder entitled to vote who does not assent to the taking of an action specified in clauses (A), (B) and (C).

(A) Any plan of merger or consolidation to which the corporation is a party: except that the right to receive payment of the fair value of his shares shall not be available:

(i) To a shareholder of the parent corporation in a merger authorized by section 905 (Merger of parent and subsidiary corporations), or paragraph (c) of section 907 (Merger or consolidation of domestic and foreign corporations); or

(ii) To a shareholder of the surviving corporation in a merger authorized by this article, other than a merger specified in subclause (i), unless such merger effects one or more of the changes specified in subparagraph (b) (6) of section 806 (Provisions as to certain proceedings) in the rights of the shares held by such shareholder; or

(iii) Notwithstanding subclause (ii) of this clause, to a shareholder for the shares of any class or series of stock, which shares or depository receipts in respect thereof, at the record date fixed to determine the shareholders entitled to receive notice of the meeting of shareholders to vote upon the plan of merger or consolidation, were listed on a national securities exchange or designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc.

(B) Any sale, lease, exchange or other disposition of all or substantially all of the assets of a corporation which requires shareholder approval under section 909 (Sale, lease, exchange or other disposition of assets) other than a transaction wholly for cash where the shareholders' approval thereof is conditioned upon the dissolution of the corporation and the distribution of substantially all of its net assets to the shareholders in accordance with their respective interests within one year after the date of such transaction.

(C) Any share exchange authorized by section 913 in which the corporation is participating as a subject corporation; except that the right to receive payment of the fair value of his shares shall not be available to a shareholder whose shares have not been acquired in the exchange or to a shareholder for the shares of any class or series of stock, which shares or depository receipt in respect thereof, at the record date fixed to determine the shareholders entitled to receive notice of the meeting of shareholders to vote upon the plan of exchange, were listed on a national securities exchange or designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc.

(2) Any shareholder of the subsidiary corporation in a merger authorized by section 905 or paragraph (c) of section 907 , or in a share exchange authorized by paragraph (g) of section 913 , who files with the corporation a written notice of election to dissent as provided in paragraph (c) of section 623 .

(3) Any shareholder, not entitled to vote with respect to a plan of merger or consolidation to which the corporation is a party, whose shares will be cancelled or exchanged in the merger or consolidation for cash or other consideration other than shares of the surviving or consolidated corporation or another corporation.

New York Consolidated Laws, Business Corporation Law - BSC § 806. Provisions as to certain proceedings

BCL § 806 (b) (6)

(a) The department of state shall not file a certificate of amendment reviving the existence of a corporation unless the consent of the state tax commission to the revival is delivered to the department. If the name of the corporation being revived is not available under section 301 (Corporate name: general) for use by a corporation then being formed under this chapter, the certificate of amendment shall change the name to one which is available for such use.

(b) The following provisions shall apply to amendments and changes under this article, except under section 808 (Reorganization under act of congress):

(1) The stated capital in respect of any shares without par value resulting from a change of issued shares shall be the amount of stated capital in respect of the shares changed or, if such stated capital is reduced by the amendment, the reduced amount stated in the certificate of amendment. No corporation shall change issued shares into both shares with par value and shares without par value unless the stated capital in respect of the shares so changed or, if such stated capital is reduced by the amendment, the reduced amount of stated capital stated in the certificate of amendment, exceeds the par value of the shares with par value resulting from such change; and the amount of such excess shall be the stated capital in respect of the shares without par value resulting from such change.

(2) No corporation shall increase the aggregate par value of its issued shares with par value, unless, after giving effect to such increase, the stated capital is at least equal to the amount required by subparagraph (a)(12) of section 102 (Definitions).

(3) No reduction of stated capital shall be made by amendment unless after such reduction the stated capital exceeds the aggregate preferential amount payable upon involuntary liquidation upon all issued shares having preferential rights in assets plus the par value of all other issued shares with par value.

(4) Any changes that may be made in the relative rights, preferences and limitations of the authorized shares of any class by any certificate of amendment which does not eliminate such shares from authorized shares or change them into shares of another class, shall not for the purpose of any statute or rule of law effect an issue of a new class of shares.

(5) No amendment or change shall affect any existing cause of action in favor of or against the corporation, or any pending suit to which it shall be a party, or the existing rights of persons other than shareholders; and in the event the corporate name shall be changed, no suit brought by or against the corporation under its former name shall abate for that reason.

(6) A holder of any adversely affected shares who does not vote for or consent in writing to the taking of such action shall, subject to and by complying with the provisions of section 623 (Procedure to enforce shareholder's right to receive payment for shares), have the right to dissent and to receive payment for such shares, if the certificate of amendment (A) alters or abolishes any preferential right of such shares having preferences; or (B) creates, alters or abolishes any provision or right in respect of the redemption of such shares or any sinking fund for the redemption or purchase of such shares; or (C) alters or abolishes any preemptive right of such holder to acquire shares or other securities; or (D) excludes or limits the right of such holder to vote on any matter, except as such right may be limited by the voting rights given to new shares then being authorized of any existing or new class.

New York Consolidated Laws, Business Corporation Law - BSC § 623. Procedure to enforce shareholder's right to receive payment for shares

(a) A shareholder intending to enforce his right under a section of this chapter to receive payment for his shares if the proposed corporate action referred to therein is taken shall file with the corporation, before the meeting of shareholders at which the action is submitted to a vote, or at such meeting but before the vote, written objection to the action. The objection shall include a notice of his election to dissent, his name and residence address, the number and classes of shares as to which he dissents and a demand for payment of the fair value of his shares if the action is taken. Such objection is not required from any shareholder to whom the corporation did not give notice of such meeting in accordance with this chapter or where the proposed action is authorized by written consent of shareholders without a meeting.

(b) Within ten days after the shareholders' authorization date, which term as used in this section means the date on which the shareholders' vote authorizing such action was taken, or the date on which such consent without a meeting was obtained from the requisite shareholders, the corporation shall give written notice of such authorization or consent by registered mail to each shareholder who filed written objection or from whom written objection was not required, excepting any shareholder who voted for or consented in writing to the proposed action and who thereby is deemed to have elected not to enforce his right to receive payment for his shares.

(c) Within twenty days after the giving of notice to him, any shareholder from whom written objection was not required and who elects to dissent shall file with the corporation a written notice of such election, stating his name and residence address, the number and classes of shares as to which he dissents and a demand for payment of the fair value of his shares. Any shareholder who elects to dissent from a merger under section 905 (Merger of subsidiary corporation) or paragraph (c) of section 907 (Merger or consolidation of domestic and foreign corporations) or from a share exchange under paragraph (g) of section 913 (Share exchanges) shall file a written notice of such election to dissent within twenty days after the giving to him of a copy of the plan of merger or exchange or an outline of the material features thereof under section 905 or 913 .

(d) A shareholder may not dissent as to less than all of the shares, as to which he has a right to dissent, held by him of record, that he owns beneficially. A nominee or fiduciary may not dissent on behalf of any beneficial owner as to less than all of the shares of such owner, as to which such nominee or fiduciary has a right to dissent, held of record by such nominee or fiduciary.

(e) Upon consummation of the corporate action, the shareholder shall cease to have any of the rights of a shareholder except the right to be paid the fair value of his shares and any other rights under this section. A notice of election may be withdrawn by the shareholder at any time prior to his acceptance in writing of an offer made by the corporation, as provided in paragraph (g), but in no case later than sixty days from the date of consummation of the corporate action except that if the corporation fails to make a timely offer, as provided in paragraph (g), the time for withdrawing a notice of election shall be extended until sixty days from the date an offer is made. Upon expiration of such time, withdrawal of a notice of election shall require the written consent of the corporation. In order to be effective, withdrawal of a notice of election must be accompanied by the return to the corporation of any advance payment made to the shareholder as provided in paragraph (g). If a notice of election is withdrawn, or the corporate action is rescinded, or a court shall determine that the shareholder is not entitled to receive payment for his shares, or the shareholder shall otherwise lose his dissenters' rights, he shall not have the right to receive payment for his shares and he shall be reinstated to all his rights as a shareholder as of the consummation of the corporate action, including any intervening preemptive rights and the right to payment of any intervening dividend or other distribution or, if any such rights have expired or any such dividend or distribution other than in cash has been completed, in lieu thereof, at the election of the corporation, the fair value thereof in cash as determined by the board as of the time of such expiration or completion, but without prejudice otherwise to any corporate proceedings that may have been taken in the interim.

(f) At the time of filing the notice of election to dissent or within one month thereafter the shareholder of shares represented by certificates shall submit the certificates representing his shares to the corporation, or to its transfer agent, which shall forthwith note conspicuously thereon that a notice of election has been filed and shall return the certificates to the shareholder or other person who submitted them on his behalf. Any shareholder of shares represented by certificates who fails to submit his certificates for such notation as herein specified shall, at the option of the corporation exercised by written notice to him within forty-five days from the date of filing of such notice of election to dissent, lose his dissenter's rights unless a court, for good cause shown, shall otherwise direct. Upon transfer of a certificate bearing such notation, each new certificate issued therefor shall bear a similar notation together with the name of the original dissenting holder of the shares and a transferee shall acquire no rights in the corporation except those which the original dissenting shareholder had at the time of transfer.

(g) Within fifteen days after the expiration of the period within which shareholders may file their notices of election to dissent, or within fifteen days after the proposed corporate action is consummated, whichever is later (but in no case later than ninety days from the shareholders' authorization date), the corporation or, in the case of a merger or consolidation, the surviving or new corporation, shall make a written offer by registered mail to each shareholder who has filed such notice of election to pay for his shares at a specified price which the corporation considers to be their fair value. Such offer shall be accompanied by a statement setting forth the aggregate number of shares with respect to which notices of election to dissent have been received and the aggregate number of holders of such shares. If the corporate action has been consummated, such offer shall also be accompanied by (1) advance payment to each such shareholder who has submitted the certificates representing his shares to the corporation, as provided in paragraph (f), of an amount equal to eighty percent of the amount of such offer, or (2) as to each shareholder who has not yet submitted his certificates a statement that advance payment to him of an amount equal to eighty percent of the amount of such offer will be made by the corporation promptly upon submission of his certificates. If the corporate action has not been consummated at the time of the making of the offer, such advance payment or statement as to advance payment shall be sent to each shareholder entitled thereto forthwith upon consummation of the corporate action. Every advance payment or statement as to advance payment shall include advice to the shareholder to the effect that acceptance of such payment does not constitute a waiver of any dissenters' rights. If the corporate action has not been consummated upon the expiration of the ninety day period after the shareholders' authorization date, the offer may be conditioned upon the consummation of such action. Such offer shall be made at the same price per share to all dissenting shareholders of the same class, or if divided into series, of the same series and shall be accompanied by a balance sheet of the corporation whose shares the dissenting shareholder holds as of the latest available date, which shall not be earlier than twelve months before the making of such offer, and a profit and loss statement or statements for not less than a twelve month period ended on the date of such balance sheet or, if the corporation was not in existence throughout such twelve month period, for the portion thereof during which it was in existence. Notwithstanding the foregoing, the corporation shall not be required to furnish a balance sheet or profit and loss statement or statements to any shareholder to whom such balance sheet or profit and loss statement or statements were previously furnished, nor if in connection with obtaining the shareholders' authorization for or consent to the proposed corporate action the shareholders were furnished with a proxy or information statement, which included financial statements, pursuant to Regulation 14A or Regulation 14C of the United States Securities and Exchange Commission. If within thirty days after the making of such offer, the corporation making the offer and any shareholder agree upon the price to be paid for his shares, payment therefor shall be made within sixty days after the making of such offer or the consummation of the proposed corporate action, whichever is later, upon the surrender of the certificates for any such shares represented by certificates.

(h) The following procedure shall apply if the corporation fails to make such offer within such period of fifteen days, or if it makes the offer and any dissenting shareholder or shareholders fail to agree with it within the period of thirty days thereafter upon the price to be paid for their shares:

(1) The corporation shall, within twenty days after the expiration of whichever is applicable of the two periods last mentioned, institute a special proceeding in the supreme court in the judicial district in which the office of the corporation is located to determine the rights of dissenting shareholders and to fix the fair value of their shares. If, in the case of merger or consolidation, the surviving or new corporation is a foreign corporation without an office in this

state, such proceeding shall be brought in the county where the office of the domestic corporation, whose shares are to be valued, was located.

(2) If the corporation fails to institute such proceeding within such period of twenty days, any dissenting shareholder may institute such proceeding for the same purpose not later than thirty days after the expiration of such twenty day period. If such proceeding is not instituted within such thirty day period, all dissenter's rights shall be lost unless the supreme court, for good cause shown, shall otherwise direct.

(3) All dissenting shareholders, excepting those who, as provided in paragraph (g), have agreed with the corporation upon the price to be paid for their shares, shall be made parties to such proceeding, which shall have the effect of an action quasi in rem against their shares. The corporation shall serve a copy of the petition in such proceeding upon each dissenting shareholder who is a resident of this state in the manner provided by law for the service of a summons, and upon each nonresident dissenting shareholder either by registered mail and publication, or in such other manner as is permitted by law. The jurisdiction of the court shall be plenary and exclusive.

(4) The court shall determine whether each dissenting shareholder, as to whom the corporation requests the court to make such determination, is entitled to receive payment for his shares. If the corporation does not request any such determination or if the court finds that any dissenting shareholder is so entitled, it shall proceed to fix the value of the shares, which, for the purposes of this section, shall be the fair value as of the close of business on the day prior to the shareholders' authorization date. In fixing the fair value of the shares, the court shall consider the nature of the transaction giving rise to the shareholder's right to receive payment for shares and its effects on the corporation and its shareholders, the concepts and methods then customary in the relevant securities and financial markets for determining fair value of shares of a corporation engaging in a similar transaction under comparable circumstances and all other relevant factors. The court shall determine the fair value of the shares without a jury and without referral to an appraiser or referee. Upon application by the corporation or by any shareholder who is a party to the proceeding, the court may, in its discretion, permit pretrial disclosure, including, but not limited to, disclosure of any expert's reports relating to the fair value of the shares whether or not intended for use at the trial in the proceeding and notwithstanding subdivision (d) of section 3101 of the civil practice law and rules .

(5) The final order in the proceeding shall be entered against the corporation in favor of each dissenting shareholder who is a party to the proceeding and is entitled thereto for the value of his shares so determined.

(6) The final order shall include an allowance for interest at such rate as the court finds to be equitable, from the date the corporate action was consummated to the date of payment. In determining the rate of interest, the court shall consider all relevant factors, including the rate

of interest which the corporation would have had to pay to borrow money during the pendency of the proceeding. If the court finds that the refusal of any shareholder to accept the corporate offer of payment for his shares was arbitrary, vexatious or otherwise not in good faith, no interest shall be allowed to him.

(7) Each party to such proceeding shall bear its own costs and expenses, including the fees and expenses of its counsel and of any experts employed by it. Notwithstanding the foregoing, the court may, in its discretion, apportion and assess all or any part of the costs, expenses and fees incurred by the corporation against any or all of the dissenting shareholders who are parties to the proceeding, including any who have withdrawn their notices of election as provided in paragraph (e), if the court finds that their refusal to accept the corporate offer was arbitrary, vexatious or otherwise not in good faith. The court may, in its discretion, apportion and assess all or any part of the costs, expenses and fees incurred by any or all of the dissenting shareholders who are parties to the proceeding against the corporation if the court finds any of the following: (A) that the fair value of the shares as determined materially exceeds the amount which the corporation offered to pay; (B) that no offer or required advance payment was made by the corporation; (C) that the corporation failed to institute the special proceeding within the period specified therefor; or (D) that the action of the corporation in complying with its obligations as provided in this section was arbitrary, vexatious or otherwise not in good faith. In making any determination as provided in clause (A), the court may consider the dollar amount or the percentage, or both, by which the fair value of the shares as determined exceeds the corporate offer.

(8) Within sixty days after final determination of the proceeding, the corporation shall pay to each dissenting shareholder the amount found to be due him, upon surrender of the certificates for any such shares represented by certificates.

(i) Shares acquired by the corporation upon the payment of the agreed value therefor or of the amount due under the final order, as provided in this section, shall become treasury shares or be cancelled as provided in section 515 (Reacquired shares), except that, in the case of a merger or consolidation, they may be held and disposed of as the plan of merger or consolidation may otherwise provide.

(j) No payment shall be made to a dissenting shareholder under this section at a time when the corporation is insolvent or when such payment would make it insolvent. In such event, the dissenting shareholder shall, at his option:

(1) Withdraw his notice of election, which shall in such event be deemed withdrawn with the written consent of the corporation; or

(2) Retain his status as a claimant against the corporation and, if it is liquidated, be subordinated to the rights of creditors of the corporation, but have rights superior to the non-

dissenting shareholders, and if it is not liquidated, retain his right to be paid for his shares, which right the corporation shall be obliged to satisfy when the restrictions of this paragraph do not apply.

(3) The dissenting shareholder shall exercise such option under subparagraph (1) or (2) by written notice filed with the corporation within thirty days after the corporation has given him written notice that payment for his shares cannot be made because of the restrictions of this paragraph. If the dissenting shareholder fails to exercise such option as provided, the corporation shall exercise the option by written notice given to him within twenty days after the expiration of such period of thirty days.

(k) The enforcement by a shareholder of his right to receive payment for his shares in the manner provided herein shall exclude the enforcement by such shareholder of any other right to which he might otherwise be entitled by virtue of share ownership, except as provided in paragraph (e), and except that this section shall not exclude the right of such shareholder to bring or maintain an appropriate action to obtain relief on the ground that such corporate action will be or is unlawful or fraudulent as to him.

(l) Except as otherwise expressly provided in this section, any notice to be given by a corporation to a shareholder under this section shall be given in the manner provided in section 605 (Notice of meetings of shareholders).

(m) This section shall not apply to foreign corporations except as provided in subparagraph (e)(2) of section 907 (Merger or consolidation of domestic and foreign corporations).

New York Consolidated Laws, Business Corporation Law - BSC § 626. Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor

BCL § 626 [c]

(a) An action may be brought in the right of a domestic or foreign corporation to procure a judgment in its favor, by a holder of shares or of voting trust certificates of the corporation or of a beneficial interest in such shares or certificates.

(b) In any such action, it shall be made to appear that the plaintiff is such a holder at the time of bringing the action and that he was such a holder at the time of the transaction of which he complains, or that his shares or his interest therein devolved upon him by operation of law.

(c) In any such action, the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reasons for not making such effort.

(d) Such action shall not be discontinued, compromised or settled, without the approval of the court having jurisdiction of the action. If the court shall determine that the interests of the shareholders or any class or classes thereof will be substantially affected by such discontinuance, compromise, or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to the shareholders or class or classes thereof whose interest it determines will be so affected; if notice is so directed to be given, the court may determine which one or more of the parties to the action shall bear the expense of giving the same, in such amount as the court shall determine and find to be reasonable in the circumstances, and the amount of such expense shall be awarded as special costs of the action and recoverable in the same manner as statutory taxable costs.

(e) If the action on behalf of the corporation was successful, in whole or in part, or if anything was received by the plaintiff or plaintiffs or a claimant or claimants as the result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff or plaintiffs, claimant or claimants, reasonable expenses, including reasonable attorney's fees, and shall direct him or them to account to the corporation for the remainder of the proceeds so received by him or them. This paragraph shall not apply to any judgment rendered for the benefit of injured shareholders only and limited to a recovery of the loss or damage sustained by them.

New York Consolidated Laws, Limited Liability Company Law - LLC § 702. Judicial dissolution

On application by or for a member, the supreme court in the judicial district in which the office of the limited liability company is located may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement. A certified copy of the order of dissolution shall be filed by the applicant with the department of state within thirty days of its issuance.

New York Consolidated Laws, Limited Liability Company Law - LLC § 509. Distribution upon withdrawal

Except as provided in this chapter, upon withdrawal as a member of the limited liability company, any withdrawing member is entitled to receive any distribution to which he or she is entitled under the operating agreement and, if not otherwise provided in the operating agreement, he or she is entitled to receive, within a reasonable time after withdrawal, the fair value of his or her membership interest in the limited liability company as of the date of withdrawal based upon his or her right to share in distributions from the limited liability company.

New York Consolidated Laws, Limited Liability Company Law - LLC § 606. Withdrawal of a member

(a) A member may withdraw as a member of a limited liability company only at the time or upon the happening of events specified in the operating agreement and in accordance with the operating agreement. Notwithstanding anything to the contrary under applicable law, unless an operating agreement provides otherwise, a member may not withdraw from a limited liability company prior to the dissolution and winding up of the limited liability company. Notwithstanding anything to the contrary under applicable law, an operating agreement may provide that a membership interest may not be assigned prior to the dissolution and winding up of the limited liability company.

(b) A limited liability company whose original article of organization were filed with the secretary of state and effective prior to the effective date of this subdivision shall continue to be governed by this section as in effect on such date and shall not be governed by this section, unless otherwise provided in the operating agreement.

New York Consolidated Laws, Limited Liability Company Law - LLC § 1002. Procedures for merger or consolidation

(a) In connection with a merger or consolidation under this chapter, rights or securities of, or interests in, a limited liability company or other business entity that is a constituent party to the merger or consolidation may be exchanged for or converted into cash, property, rights or securities of, or interests in, the surviving or resulting limited liability company or other business entity or, in addition to or in lieu thereof, may be exchanged for or converted into cash, property, rights or securities of, or interests in, a limited liability company or other business entity that is not the surviving or resulting limited liability company or other business entity in the merger or consolidation.

(b) The members of each domestic limited liability company or other business entity shall adopt (with respect to a domestic limited liability company, in the manner provided in subdivision (c) of this section) an agreement of merger or consolidation, setting forth the terms and conditions of the conversion of the membership interests of the members of the domestic limited liability company into interests in the surviving or resulting limited liability company or other business entity or the cash or other consideration to be paid or delivered in exchange for membership interests in each domestic limited liability company, or a combination thereof.

(c) The agreement of merger or consolidation shall be submitted to the members of each domestic limited liability company who are entitled to vote with respect to a merger or consolidation at a meeting called on twenty days' notice or such greater notice as the operating agreement may provide. Subject to any requirement in the operating agreement requiring approval by any greater or lesser percentage in interest of the members who are entitled to vote with respect to a merger or consolidation, which shall not be less than a majority in interest of those members who are so entitled to vote, the agreement shall be approved on behalf of each domestic limited liability company (i) by such voting interests of the members as shall be required by the operating agreement, or (ii) if no provision is made, by the members representing at least a majority in interest of the members.

(d) Notwithstanding authorization by the members, the agreement of merger or consolidation may be terminated or amended pursuant to a provision for such termination or amendment, if any, contained in the agreement of merger or consolidation.

(e) Any member that is a party to a proposed merger or consolidation who is entitled to vote with respect to such proposed merger or consolidation may, prior to that time of the meeting at which such merger or consolidation is to be voted on, file with the domestic limited liability company written notice of dissent from the proposed merger or consolidation. Such notice of dissent may be withdrawn by the dissenting member at any time prior to the effective date of the merger or consolidation and shall be deemed to be withdrawn if the member casts a vote in favor of the proposed merger or consolidation.

(f) Upon the effectiveness of the merger or consolidation, the dissenting member (referred to in subdivision (e) of this section) of any domestic limited liability company shall not become or continue to be a member of or hold an interest in the surviving or resulting limited liability company or other business entity but shall be entitled to receive in cash from the surviving or resulting domestic limited liability company or other business entity the fair value of his or her membership interest in the domestic limited liability company as of the close of business of the day prior to the effective date of the merger or consolidation in accordance with section five hundred nine of this chapter but without taking account of the effect of the merger or consolidation.

(g) A member of a domestic limited liability company who has a right under this chapter to demand payment for his or her membership interest shall not have any right at law or in equity under this chapter to attack the validity of the merger or consolidation or to have the merger or consolidation set aside or rescinded, except in an action or contest with respect to compliance with the provisions of the operating agreement or subdivision (c) of this section.

(h) A limited liability company whose original articles of organization were filed with the secretary of state and effective prior to the effective date of this subdivision shall continue to be governed by this section as in effect on such date and shall not be governed by this section, unless otherwise provided in the operating agreement.

New York Consolidated Laws, Limited Liability Company Law - LLC § 1005. Payment of interest of dissenting members

(a) Within ten days after the occurrence of an event described in section ten hundred two of this article, the surviving or resulting domestic limited liability company or other business entity shall send to each dissenting former member a written offer to pay in cash the fair value of such former member's membership interest. Payment in cash shall be made to each former member accepting such offer within ten days after notice of such acceptance is received by the surviving or resulting domestic limited liability company or other business entity.

(b) If a former member and the surviving or resulting limited liability company or other business entity fail to agree on the price to be paid for the former member's membership interest within ninety days after the surviving or resulting domestic limited liability company or other business entity shall have made the offer provided for in subdivision (a) of this section, or if the domestic limited liability company or surviving domestic limited liability company or other business entity shall fail to make such an offer within the period provided for in subdivision (a) of this section, the procedure provided for in paragraphs (h) , (i) , (j) and (k) of section six hundred twenty-three of the business corporation law (or any successor provisions or statute) shall apply, as such paragraphs may be amended from time to time.

(c) A payment under this section shall constitute a return of a member's contribution for the purposes of section five hundred eight of this chapter.

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64 N.Y.2d 975 (1985)

In the Matter of the Dissolution of Cristo Brothers, Inc. Nicholas A. Cristo, Appellant; Sebastian Cristo, Respondent.

Court of Appeals of the State of New York.

Argued February 8, 1985.
Decided March 26, 1985.

Jerome K. Frost for appellant.

Philip F. Calderone for respondent.

Chief Judge WACHTLER and Judges JASEN, MEYER, SIMONS, KAYE and ALEXANDER concur in memorandum.

976 *976MEMORANDUM.

The order of the Appellate Division should be affirmed, with costs, and the certified question answered in the negative.

The legislative history of Business Corporation Law § 1118 contains nothing to indicate why it accorded a buy-out privilege in any proceeding brought pursuant to section 1104-a but not with respect to a dissolution proceeding under Business Corporation Law § 1104. We agree with the Appellate Division, however, that the holder of 50% of a close corporation's stock is a holder "of twenty percent or more" of such a corporation's outstanding stock, that a proceeding for
977 dissolution brought under both Business Corporation Law §§ 1104 and 1104-a is a *977 "proceeding brought pursuant to section [1104-a]," and that, therefore, respondent, as the holder of 50% of the outstanding stock of Cristo Brothers, Inc., was entitled to buy out petitioner's shares pursuant to Business Corporation Law § 1118.

Petitioner argues that respondent should not be permitted to buy him out while at the same time denying the allegations of oppressive action and waste on which an 1104-a proceeding depends and that if permitted to do so respondent will unfairly obtain the sole advantage of the corporation's tax loss. Those factors may affect the "fair value" to be determined under section 1118 (b) (an issue on which we express no present opinion); but in light of the provisions of section 1118 (a) that the buy-out election must be exercised within 90 days after the filing of the petition unless that time is extended by the court, and of section 1118 (b) that after such an election the dissolution proceeding shall be stayed upon application by the prospective purchaser and that fair value is to be determined as of the day prior to the date on which the 1104-a petition was filed, it is clear that the Legislature did not regard either factor as an impediment to the exercise of the buy-out privilege it accorded other shareholders in such a proceeding.

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Order affirmed, etc.

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Matter of Clever Innovations, Inc. (Dooley)
2012 NY Slip Op 02536 [94 AD3d 1174]
April 5, 2012
Appellate Division, Third Department
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, May 23, 2012

In the Matter of the Dissolution of Clever Innovations, Inc. Christopher P. Dooley, Appellant; Gwen M. Nielsen, as Administrator of the Estate of Paul S. Nielsen, Deceased, Respondent. (And Another Related Proceeding.)

—[*1] Herbert Adler, White Plains, for appellant.

McNamee, Lochner, Titus & Williams, P.C., Albany (G. Kimball Williams of counsel), for respondent.

Spain, J. Appeal from an order of the Supreme Court (Williams, J.), entered September 1, 2010 in Saratoga County, which, among other things, granted respondent's application, in two proceedings pursuant to Business Corporation Law article 11, to direct the judicial dissolution of Clever Innovations, Inc.

In 2001, Paul S. Nielson (hereinafter decedent) formed Clever Innovations, Inc. (hereinafter the company), became the company's sole shareholder and director, and elected his now widow, respondent, as vice-president and treasurer. The couple ran the company from their home and respondent handled its banking and financial affairs. In 2002, the company issued 100 shares of stock to petitioner, thereby granting him a 50% share in the company. According to the company records, petitioner was never formally elected as an officer or director, but he shared with decedent in its day-to-day operation, drawing a salary in addition to dividends. [*2]

By all accounts, the company was extremely profitable. In 2009, decedent died unexpectedly and without a will. His shares became part of his estate, administered by

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respondent.[FN1] Thereafter, the relationship between respondent and petitioner quickly deteriorated; respondent refused to accept petitioner's assertion that he was an officer of the company. The company's bank froze its account, presumably because of the apparent dispute over who was authorized to act on behalf of the company. In May 2009, the parties met and agreed to an interim arrangement by which petitioner would operate the company's business, keeping respondent apprised of all financial transactions, while the parties worked toward negotiating a sale of the estate's one-half interest to petitioner.

Instead, a month later, petitioner commenced a proceeding alleging a deadlock between shareholders and seeking dissolution of the company pursuant to Business Corporation Law § 1104. Petitioner also opened a new bank account for the company, funded it with $280,000 from company customers, redirected the company's mail to be delivered to his home instead of respondent's and ignored her communications regarding negotiating a sale of the estate's interest in the company. By August 2009, respondent gave up attempting to negotiate with petitioner and she commenced a counter proceeding, based on petitioner's alleged oppressive conduct, seeking—on behalf of the estate—a mandatory buyout of its shares for their fair value (*see* Business Corporation Law §§ 1104-a, 1118; *Matter of Wiedy's Furniture Clearance Ctr. Co.*, 108 AD2d 81, 84 [1985]). Petitioner moved for summary judgment. Supreme Court denied petitioner's motion and instead granted respondent's application, ordering dissolution of the company pursuant to Business Corporation Law § 1104-a and ordering petitioner to purchase the estate's shares. Petitioner appeals, and we affirm.

Although both parties seek to have their business relationship terminated, they invoke different grounds and seek very different relief. Petitioner maintains that the parties were deadlocked, thereby warranting dissolution of the company pursuant to Business Corporation Law § 1104. That statute permits judicial dissolution where "shareholders are so divided that the votes required for the election of directors cannot be obtained" (Business Corporation Law § 1104 [a] [2]), or when "there is internal dissension" such that "dissolution would be beneficial to the shareholders" (Business Corporation Law § 1104 [a] [3]). Under such circumstances, the company would be dissolved and its assets distributed among the shareholders (*see* Business Corporation Law § 1111). Here, petitioner failed to set forth a prima facie case that the shareholders were deadlocked. Although the parties were experiencing disagreement and, while respondent

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is acting on behalf of the estate, each controls 50% of the company's shares, petitioner does not assert that an election was held or demonstrate that a deadlock was harming the shareholders. Rather, the record demonstrates instead that the parties had met and agreed upon an interim arrangement for operating the company, but that the arrangement was never fully implemented due to petitioner's unilateral decision to act in contravention of it by filing a petition for dissolution. Under these circumstances, Supreme Court properly denied petitioner's motion for summary judgment seeking dissolution of the company pursuant to Business Corporation Law § 1104 (*see Matter of Nelkin v H. J. R. Realty Corp.*, 25 NY2d 543, 549 [1969]; *Matter of Fazio Realty Corp.*, 10 AD3d 363, 365 [2004]). [*3]

Respondent, on the other hand, invoked Business Corporation Law § 1104-a, which provides a mechanism for shareholders of at least 20% of the outstanding shares of a nonpublicly traded corporation to petition for its dissolution when those in control of the corporation engage in illegal, fraudulent or oppressive actions toward the complaining shareholders or misappropriate corporate assets (*see* Business Corporation Law § 1104-a [a]; *Matter of Kemp & Beatley [Gardstein]*, 64 NY2d 63, 70 [1984]). Oppression has been defined as conduct of a controlling shareholder[FN2] that substantially defeats expectations that, viewed objectively, " 'were both reasonable under the circumstances and . . . central to the [oppressed shareholder's] decision to join the venture' " (*Matter of Upstate Med. Assoc.*, 292 AD2d 732, 733 [2002], quoting *Matter of Kemp & Beatley [Gardstein]*, 64 NY2d at 73). Where oppressive conduct is found, it falls to the discretion of the courts to consider the totality of circumstances surrounding the corporation and to determine whether a remedy other than dissolution constitutes a feasible means of satisfying the rights and interests of the shareholders (*see* Business Corporation Law § 1111 [b] [2]; *Matter of Kemp & Beatley [Gardstein]*, 64 NY2d at 73-74) or whether an alternate remedy is appropriate such as—as the court awarded here—a forced buy-out (*see Matter of Wiedy's Furniture Clearance Ctr. Co.*, 108 AD2d 81, 84 [1985]).

We hold that petitioner's admitted conduct in operating the company to the exclusion of respondent substantially defeated the estate's reasonable expectations for cooperation and disclosure of relevant business information between the parties (*see Matter of Kemp & Beatley [Gardstein]*, 64 NY2d at 71; *Matter of Upstate Med. Assoc.*, 292 AD2d at 733; *Matter of Wiedy's Furniture Clearance Ctr. Co.*, 108 AD2d at 84). Given petitioner's

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unwillingness to either negotiate a sale of the estate's shares or to include respondent in the operation of the company, we hold that Supreme Court properly determined that the estate established the "special circumstances" necessary to invoke Business Corporation Law § 1104-a. Further, we reject petitioner's assertion that he was entitled to a hearing on this issue; a hearing is required only when allegations contained in the pleadings present issues of fact (*see* Business Corporation Law § 1109; *Matter Carrabasset Sq. Mgt. Corp.*, 90 AD3d 1279, 1279-1280 [2011]). Here, the only factual issue in dispute is whether, despite the absence of an official appointment, petitioner had become an officer of the company. As this fact is not material to the issue of whether petitioner—a 50% shareholder—engaged in oppressive conduct, and given that he apparently never requested a hearing, we find that Supreme Court was not required to hold one (*see Matter Carrabasset Sq. Mgt. Corp.*, 90 AD3d at 1279-1280; *Matter of Quail Aero Serv.*, 300 AD2d 800, 803 [2002]; *Matter of Wiedy's Furniture Clearance Ctr. Co.*, 108 AD2d at 84).

Finally, recognizing that where a petitioner has demonstrated entitlement to dissolution pursuant to Business Corporation Law § 1104-a, "[a] court has broad latitude in fashioning alternative relief," we hold that Supreme Court did not abuse its discretion in directing a buyout of the estate's interest in the company (*Matter of Kemp & Beatley [Gardstein]*, 64 NY2d at 74; *see Matter of Wiedy's Furniture Clearance Ctr. Co.*, 108 AD2d at 85). It is undisputed that the parties no longer desired to continue in business together, but it is also clear from the record that, had they reached agreement on a price, petitioner would have purchased the estate's shares. With decedent's passing, petitioner maintained the primary relationship with the company's customers [*4]and, considering his actions designed to move the operation of the company beyond respondent's reach, Supreme Court was justified in finding that, through dissolution, petitioner seeks to avoid paying the estate the fair value of its shares while personally continuing to profit by operating the company's business either individually or through a new corporation. Under these circumstances, we cannot say that Supreme Court abused its discretion in ordering the extraordinary remedy of a forced buyout (*see* Business Corporation Law § 1118 [a]; *Matter of Kemp & Beatley [Gardstein]*, 64 NY2d at 75; *Matter of Wiedy's Furniture Clearance Ctr. Co.*, 108 AD2d at 85).

Mercure, A.P.J., Lahtinen, Stein and McCarthy, JJ., concur. Ordered that the order is affirmed, with costs.

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Footnotes

Footnote 1: Through intestacy, half of the shares—or their value—will pass to respondent and the other half to decedent's children from a prior marriage (*see* EPTL 4-1.1 [a] [1]).

Footnote 2: The protections of Business Corporation Law § 1104-a extend to 50% shareholders who can demonstrate oppression (*see Matter of Cristo Bros.*, 64 NY2d 975, 976-977 [1985]).

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Ferolito v Vultaggio
2012 NY Slip Op 05707 [99 AD3d 19]
July 24, 2012
Sweeny, J.
Appellate Division, First Department
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, October 31, 2012

[*1]

John M. Ferolito et al., Appellants, v Domenick J. Vultaggio et al., Respondents. (And Other Actions.)

In the Matter of John M. Ferolito, Appellant.

First Department, July 24, 2012

Ferolito v Vultaggio, 2011 NY Slip Op 31077(U), modified.

APPEARANCES OF COUNSEL

Boies, Schiller & Flexner LLP, New York City (*David A. Barrett*, *Nicholas A. Gavante, Jr.* and *Helen M. Maher* of counsel), for appellants.

Cadwalader, Wickersham & Taft LLP, New York City (*Louis M. Solomon*, *Colin A. Underwood* and *Michael S. Lazaroff* of counsel), for respondents.

{**99 AD3d at 22} OPINION OF THE COURT

Sweeny, J.

These are four related appeals from orders deciding motions made in the litigation involving the AriZona Iced Tea business and its principal operating company, Beverage Marketing USA, Inc. (BMU). The first order denied plaintiff/petitioner John M. Ferolito's

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motion for a declaration that BMU's election to purchase his shares of stock was invalid. Ferolito also appeals from the denial of his motion to disqualify Cadwalader, Wickersham & Taft LLP (Cadwalader) as counsel to BMU and from the order dismissing a common-law derivative dissolution proceeding brought against defendants. Lastly, Ferolito appeals from the order denying his motion to compel BMU to make cash distributions of profits to all shareholders. A review of the factual and historical background of this litigation is necessary to place these appeals in their proper context.

In 1992, plaintiff Ferolito and defendant Vultaggio formed the AriZona Iced Tea business, consisting of 21 entities known as the "AriZona Entities." BMU, which conducts the preponderance of the business of producing, marketing and distributing the AriZona Iced Tea line of beverages, is one of those entities. All of the AriZona Entities are owned equally by Ferolito and Vultaggio, along with members of their respective families (Owners Groups).

In 1997, due to strained relations between Ferolito and Vultaggio, the parties agreed that Vultaggio would assume primary responsibility for the day-to-day management of the AriZona Entities. Ferolito retained his voting rights and, as co-owner of BMU, his right to participate in corporate decision-making.

In 1998, Ferolito, Vultaggio and their respective Owner Groups entered into an "Owners' Agreement." Its purpose was to set out the method of corporate governance, to maintain appropriate and businesslike relationships among the parties, and to assure the continuity of ownership and management of the AriZona Entities.

Section 3.1 of the Owners' Agreement provides that "all material matters respecting [the AriZona Entities] shall be resolved by mutual agreement of the [Owner Groups]." Section 2.1 provides that the general intent of the parties is that each Owner Group shall receive 50% of all distributions of profits. The Owners' Agreement also limits the sale or transfer of interest in the enterprise to "Permitted Transferees" (the Transfer Covenants).

{**99 AD3d at 23}In August 2008, the Ferolito Owners Group attempted to transfer a block of its shares in [*2]the AriZona Entities to an outside purchaser without Vultaggio's consent. Ferolito commenced litigation in New York County, seeking, among other things, nullification of the Transfer Covenants to allow him to sell those shares

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without restriction. Vultaggio asserted counterclaims and both sides moved for summary judgment. The motion court dismissed Ferolito's cause of action challenging the transfer restriction, finding that the Transfer Covenants were valid and enforceable, and we affirmed. The remaining causes of action for breach of contract, unjust enrichment, etc., are still pending (Main Action).

Ferolito also filed a separate action in Nassau County in which his personal corporation sued BMU for breach of a promissory note. This action was transferred to New York County and consolidated with the Main Action.

Thereafter, as part of the Main Action, Ferolito filed an amended petition pursuant to Business Corporation Law § 1104-a seeking a judicial dissolution of BMU, alleging that such dissolution was a necessary remedy given the provision in the Owners' Agreement barring him from selling his interests in BMU without Vultaggio's permission. He also alleged that Vultaggio's oppressive conduct was part of a fraudulent scheme to exclude him from the corporate affairs of the AriZona Entities and force him to sell his shares below their fair value. On this issue, Ferolito alleged that in February 2008, as part of a scheme to pressure him to sell his shares of BMU at a low price, Vultaggio ordered a unilateral termination of a long-standing practice of distributing the vast majority of BMU's annual profits to the shareholders. His request for relief included a "Final Order" compelling BMU to resume making distributions to each Owner Group consistent with past practice.

Ferolito's Business Corporation Law § 1104-a petition triggered buyout rights on the part of Vultaggio, who notified the court and all parties of his election, pursuant to Business Corporation Law § 1118, to have BMU purchase its shares owned by Ferolito. This election stayed the Main Action. Ferolito moved to invalidate the Business Corporation Law § 1118 election, arguing that section 3.1 of the Owners' Agreement precluded BMU from exercising its buyout rights without obtaining Ferolito's consent. Vultaggio opposed, arguing that the Owners' Agreement did not require Ferolito's consent, particularly in light of his filing of the dissolution petition.{**99 AD3d at 24}

Ferolito also moved for an order compelling the cash distribution of 60% of the AriZona Entities' net income for the year 2010. Vultaggio opposed the motion, arguing that the decision not to distribute profits was necessitated by Ferolito's actions.

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Additionally, he argued that the money would be necessary to purchase Ferolito's BMU shares as a result of the Business Corporation Law § 1118 election made in response to Ferolito's petition for judicial dissolution.

The motion court denied Ferolito's motion to invalidate BMU's election, finding that applying section 3.1 of the Owners' Agreement as advocated by Ferolito under these circumstances would render the statutory scheme of Business Corporation Law §§ 1104-a and 1118 a nullity. The court also determined that the application for the cash distributions was tantamount to a request for a preliminary injunction compelling distributions on an interim basis pending final resolution of the actions. Since Ferolito could not meet the requirements for such relief, and since he was requesting the same relief as in part of the Main Action, the motion was denied.

Ferolito's motion to disqualify Cadwalader also has its genesis in the commencement of litigation in 2008. At that time, BMU's general counsel and CEO analyzed the potential conflict issue regarding one [*3]firm's dual representation of BMU and Vultaggio. They determined that dual representation was desirable and retained Lou Solomon, Esq., who at the time was a member of Proskauer Rose, LLP, and the attorney for Vultaggio. Ferolito objected to this arrangement. Nonetheless, in 2008, BMU entered into a Joint Defense and Prosecution Agreement (JDPA) between Vultaggio and the AriZona Entities in which BMU consented to the dual representation and "waived any and all potential conflicts that may arise" during the course of the litigations. When Solomon left Proskauer and joined Cadwalader, he continued his representation of both Vultaggio and BMU.

Ferolito first moved for disqualification in the Main Action in April 2009, but withdrew the motion without prejudice. He also moved for disqualification in the Nassau County action in 2009, which motion was denied. He once again moved for disqualification in Nassau County in 2010 after filing the initial dissolution petition, but, before a decision was rendered, the action was consolidated with the Main Action. Counsel ultimately withdrew the pending motion.

On March 4, 2011, following BMU's election to buy his shares, Ferolito filed another motion for disqualification of Cadwalader,[**99 AD3d at 25] citing alleged conflicts of interest. Cadwalader opposed, arguing that the JDPA resolved any potential conflicts. The motion court denied Ferolito's application.

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To further complicate matters, on January 13, 2011, Ferolito and the John Ferolito, Jr. Grantor Trust filed a new action alleging direct and derivative claims for breach of fiduciary duty against Vultaggio on behalf of BMU (the 2011 Action). Following BMU's election to purchase Ferolito's stock, he amended the complaint to add an additional claim on behalf of the Ferolito Trust for common-law dissolution. This action was based on allegations of Vultaggio's waste and oppression, including officer/director misconduct.

Vultaggio moved to dismiss the complaint in its entirety. After a hearing, the court dismissed the Trust's common-law dissolution claim on the basis that it failed to state a cause of action and failed to demonstrate that Vultaggio was "looting" BMU, which the Trust admitted was a healthy, billion dollar company (*Ferolito v Vultaggio*, 2011 NY Slip Op 31700[U]). The court also granted a stay of the remaining counts in the 2011 action, finding that the direct and derivative breach of fiduciary duty claims and officer/director misconduct claim were substantially the same as those alleged in the Main Action.

<u>The BMU Dissolution/Election Order</u>

Business Corporation Law § 1104-a gives holders of 20% or more of the outstanding voting shares of a close corporation the right to petition for judicial dissolution as a remedy for illegal, fraudulent or oppressive conduct (*see Fedele v Seybert*, 250 AD2d 519, 521-522 [1998]; *Matter of Public Relations Aids*, 109 AD2d 502, 507, 509 [1985]). However, pursuant to Business Corporation Law § 1118 (a), a petition alleging grounds specified in Business Corporation Law § 1104-a triggers the right of "any other shareholder or shareholders or the corporation" to "elect to purchase the shares owned by the petitioners at their fair value" (*see Fedele v Seybert*, 250 AD2d at 522; *Matter of Hung Yuk Ong*, 299 AD2d 173 [2002], *lv dismissed* 99 NY2d 610 [2003]). This election, once made, is irrevocable (*Matter of Chu v Sino Chemists*, 192 AD2d 315, 316 [1993]; *Matter of Doniger v Rye Psychiatric Hosp. Ctr.*, 122 AD2d 873 [1986], *lv denied* 68 NY2d 611 [1986]). Such an election "is superior to dissolution because it permits the continuation of the corporation's existence" (192 AD2d at 317; *Matter of Smith v Russo*, 230 AD2d 863, 864 [1996], *lv dismissed* 93 NY2d 848 [1999]). The buyout [**99 AD3d at 26] election "accommodates the interests of the respective parties in ensuring the continued [*4] functioning of the business, while also protecting the financial interest of the shareholders and creditors" (*Matter of Public Relations Aids*, 109 AD2d at 508).

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Ferolito does not contest Vultaggio's right to make such an election in his individual capacity. Rather, he argues that Vultaggio's unilateral election on behalf of BMU violated section 3.1 of the Owners' Agreement, which provides that "all material matters respecting [the AriZona Entities] shall be resolved by mutual agreement of the [Owner Groups]," and thus the election must be set aside. We find no merit to this position.

Generally, the terms of a shareholder agreement should be given effect (*Matter of Penepent Corp.*, 96 NY2d 186, 192 [2001]). Statutory dissolution and election rights may be restricted (but not nullified) by contract (*see Schimel v Berkun*, 264 AD2d 725, 728 [1999], *lv dismissed* 94 NY2d 797 [1999]; *Matter of Doniger*, 122 AD2d at 877). "[S] hareholders can agree in advance that an 1104-a dissolution proceeding will be deemed a voluntary offer to sell," as well as fix the "fair value" of the shares in the event of an 1118 election (*see Matter of Pace Photographers [Rosen]*, 71 NY2d 737, 747 [1988]; *Matter of Johnsen v ACP Distrib., Inc.*, 31 AD3d 172 [2006]). However, in the absence of an explicit agreement to that effect, a shareholder's agreement fixing the terms of a voluntary sale does not apply to limit Business Corporation Law § 1118 (a)'s "absolute" and "unconditioned" right to avoid dissolution by election, either by a shareholder or by the corporation itself (*Matter of Pace Photographers*, 71 NY2d at 744-745).

To adopt Ferolito's argument that a shareholder who commences a judicial dissolution proceeding can continue to assert management rights with respect to the corporation's right of election pursuant to Business Corporation Law § 1118 would thwart the statutory purpose of promoting the continuation of corporate enterprises. Absent an explicit agreement between the shareholders to limit the corporation's ability to exercise its statutory election right following the filing of a dissolution petition by one of its shareholders, the corporation may, without the consent of the petitioning shareholder, invoke its right of election pursuant to Business Corporation Law § 1118. Simply put, without an explicit and unequivocal agreement to the contrary, a shareholder who petitions for dissolution should not have the ability to veto the corporation's election right. To do so{**99 AD3d at 27} would fly in the face of logic as well as the purposes of the statutory scheme enacted by the legislature (*see Matter of Public Relations Aids*, 109 AD2d at 509).

Here, while the Owners' Agreement provides a general mechanism for authorization of all BMU "material matters," neither the Owners' Agreement nor the company bylaws

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explicitly state that a mutual agreement requirement applies to the making of a corporate Business Corporation Law § 1118 election. Without such an explicit provision, a non-petitioning shareholder who has day-to-day management of the corporation may unilaterally exercise, on behalf of the corporation, the right to elect to buyout the petitioning shareholder's shares (*Matter of Pace Photographers*, 71 NY2d at 747; *Matter of Johnsen*, 31 AD3d at 178). The court therefore properly denied Ferolito's motion.

Disqualification of Counsel

Disqualification is a matter that rests within the sound discretion of the trial court (*see Harris v Sculco*, 86 AD3d 481, 481 [2011]).

> "When considering a motion to disqualify counsel, a trial court must consider the totality of the circumstances and carefully balance the right of a party to be represented by counsel of his or her choosing against the other party's right to be free [*5]from possible prejudice due to the questioned representation" (*Abselet v Satra Realty, LLC*, 85 AD3d 1406, 1407 [2011] [internal quotation marks omitted]).

While the Rules of Professional Conduct generally prohibit a lawyer from simultaneously representing clients with differing interests, an attorney may represent such clients where a disinterested lawyer would believe that the lawyer can competently represent the interest of each client and that each consents to the representation after full disclosure of the implications of simultaneous representation as well as the advantages and risks involved (*see* Rules of Professional Conduct [22 NYCRR 1200.0] rule 1.7 [b]; Code of Professional Responsibility DR 5-105 [c] [22 NYCRR 1200.24 (c)]; *Develop Don't Destroy Brooklyn v Empire State Dev. Corp.*, 31 AD3d 144, 151 [2006], *lv denied* 8 NY3d 802 [2007]; *Matter of Gustavo G.*, 9 AD3d 102 [2004]).

To the extent Vultaggio and BMU have any differing interests in connection with the decision of which party, if any, would exercise the Business Corporation Law § 1118 (a) election right, a disinterested lawyer could believe that dual representation{**99 AD3d at 28} would be appropriate. In these circumstances, where the non-petitioning shareholder runs the day-to-day operations of the corporation threatened with dissolution, any "differing interest" with respect to the Business Corporation Law § 1118 election does not necessarily require separate counsel. Moreover, Vultaggio and BMU validly consented to the dual representation, thereby waiving any potential conflict. It is thus not objectively

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unreasonable to believe that one law firm can adequately represent both BMU and Vultaggio under these circumstances. Accordingly, the court properly denied Ferolito's motion to disqualify counsel.

Common-Law Dissolution

A claim for common-law dissolution is properly stated where it is alleged with sufficient factual detail that the shareholders in control have been looting the company's assets at the expense of the minority shareholders, "continuing the corporation's existence . . . for the sole purpose of benefitting those in control," and have sought "to force and coerce [the minority shareholders] to sell and sacrifice their holdings to those in control" (*see Leibert v Clapp*, 13 NY2d 313, 315-316 [1963] [internal quotation marks omitted]; *Gilbert v Hamilton*, 35 AD2d 715 [1970], *affd* 29 NY2d 842 [1971]). While the legislature supplemented this principle of judicially ordered equitable dissolution of a corporation by passing Business Corporation Law § 1104-a, it does not appear that it intended Business Corporation Law § 1104-a to be the exclusive remedy for aggrieved shareholders (*see Matter of Quail Aero Serv.*, 300 AD2d 800, 802 [2002]), and the courts continue to recognize the common-law cause of action (*see Matter of Kemp & Beatley [Gardstein]*, 64 NY2d 63, 69-70 [1984]; *Lemle v Lemle*, 92 AD3d 494 [2012]; *Matter of Dubonnet Scarfs*, 105 AD2d 339, 341 [1985]; *see also Collins v Telcoa Intl. Corp.*, 283 AD2d 128 [2001]; *Lewis v Jones*, 107 AD2d 931 [1985]).

Contrary to the motion court's finding, the allegations of fiduciary breaches by corporate management contained in the Ferolito Trust's cause of action are sufficient to state a claim for common-law dissolution. Furthermore, its timely filing subsequent to the filing of Ferolito's statutory dissolution petition did not prejudice BMU's election or Vultaggio's other rights. The fact that a corporation may be operating profitably is no bar to the grant of this type of relief in appropriate circumstances (*see Leibert*, 13 NY2d at 316). Moreover, the allegations of looting,[**99 AD3d at 29] [*6]when combined with the other allegations of oppression relating to the interests of the Ferolito Trust, are sufficient at this point in the litigation to state a claim for common-law dissolution (*see Lewis*, 107 AD2d at 932). Accordingly, that cause of action is reinstated.

The motion court, however, did not improperly stay the causes of action for direct and derivative claims for breach of fiduciary duty as well as the derivative claim for

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officer/director misconduct in deference to the Main Action based on the finding that the relief sought in both actions was substantially the same. Where a party's non-dissolution claims, direct or derivative, and a Business Corporation Law § 1118 valuation proceeding are "inextricably intertwined," we have ordered them to proceed in tandem before the same court, since the resolution of the non-dissolution claims may affect the "fair value" to be determined in the valuation proceeding (*see Edmonds v Amnews Corp.*, 224 AD2d 358, 358 [1996]).

Shareholder Distributions Claim

The court properly denied Ferolito's motion to compel distributions of profit to the shareholders. The court correctly found that issues of fact precluded the grant of Ferolito's prior motion for summary judgment on a breach of contract claim alleging damages as a result of Vultaggio's preventing him from participating in management decisions, including decisions involving the timing and amount of shareholder distributions. Ferolito's motion therefore violated the rule against successive summary judgment motions (*see Hoffeld v Lindholm*, 85 AD3d 635 [2011]; *Jones v 636 Holding Corp.*, 73 AD3d 409 [2010]), and denial would be appropriate due to the remaining issues of material fact.

Accordingly, the order of the Supreme Court, New York County (Martin Shulman, J.), entered June 2, 2011, which denied petitioner John M. Ferolito's motion for an order declaring invalid BMU's Business Corporation Law § 1118 election to purchase his shares, should be affirmed, with costs. The order, same court and Justice, entered June 3, 2011, which denied Ferolito's motion to disqualify Cadwalader, Wickersham & Taft LLP as counsel to BMU in the consolidated dissolution/valuation proceeding, should be affirmed, with costs. The order, same court and Justice, entered June 24, 2011, which, insofar as appealed from, granted defendant Vultaggio's motion to dismiss the Ferolito Trust's cause of action for common-law dissolution,{**99 AD3d at 30} and to stay the remaining causes of action should be modified, on the law, to deny the motion as to the common-law dissolution cause of action, the cause of action reinstated, and otherwise affirmed, without costs. The order, same court and Justice, entered April 14, 2011, which denied Ferolito's motion to compel shareholder distributions of profits, should be affirmed, with costs.

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Gonzalez, P.J., Saxe, Acosta and Renwick, JJ.

Order, Supreme Court, New York County, entered June 2, 2011, affirmed, with costs. Order, same court and Justice, entered June 3, 2011, affirmed, with costs. Order, same court and Justice, entered June 24, 2011, modified, on the law, to deny the motion as to the common-law dissolution cause of action, the cause of action reinstated, and otherwise affirmed, without costs, and order, same court and Justice, entered April 14, 2011, affirmed, with costs.

Cortes v 3A N. Park Ave. Rest Corp.
2014 NY Slip Op 24329 [46 Misc 3d 670]
October 28, 2014
Demarest, J.
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, April 15, 2015

[*1]

Porfirio Cortes, Individually and as Shareholder of 3A North Park Ave. Rest Corp., Suing in the Right of 3A North Park Ave. Rest Corp., Plaintiff,
v
3A North Park Ave. Rest Corp. et al., Defendants.

Supreme Court, Kings County, October 28, 2014

APPEARANCES OF COUNSEL

Andrew Rotstein, Brooklyn, for plaintiff.

Law Office of Thaniel J. Beinert, Brooklyn (*Jimmy F. Wagner* of counsel), for defendants.

{**46 Misc 3d at 672} OPINION OF THE COURT
Carolyn E. Demarest, J.

Plaintiff Porfirio Cortes commenced the instant action by filing his complaint on June 13, 2011, based upon his undisputed ownership of 16.67% of the shares of the corporate defendant, for which he paid $50,000 in 2003. Pursuant to a written agreement dated August 9, 2003, executed by Cortes and defendant Angelo Ramunni, if purchaser Cortes decided to sell his shares or resign his position as "managing partner" of the corporation, seller had the option of first refusal to purchase the shares "unless said resignation is caused by the demand of the seller and its principals for the Purchaser to engage in employment in an entity [*2]owned and operated by said Seller and

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principals" (agreement).[FN1] A handwritten addendum to the typewritten agreement, which is separately executed by Cortes and Ramunni, further provides: "Purchasers [sic] position with the corporation is a managing partner. In the event Mr. Cortes decides to resign his position as manager Sellers have the right to purchase back his shares and terminate the partnership." The business of the corporation is the operation of a Mexican restaurant known as Cabo, located in Rockville Centre, New York (Cabo).

Plaintiff complains that the individual defendants, each of whom owns 41.7% of the corporation, have breached their fiduciary duty to him and the corporation by siphoning off profits of the corporation, failing to hold shareholder meetings, failing to purchase his shares at fair value, and, against all defendants, for failure to declare a dividend in which he would receive his fair share of the profits in proportion to his ownership interest. Plaintiff seeks dissolution of the corporation on a common-law theory of fraudulent and oppressive conduct toward him and, derivatively on behalf of the corporation, the imposition of a constructive trust over the money, property and assets of Ramunni and Dominick DeSimone to secure the recovery of any judgment against them. The complaint originally pleaded 10 causes of action, including, pursuant to Business Corporation Law § 624, for inspection of books and records and financial statements (the first and second causes of action), and an equitable accounting (the fourth and ninth causes of action) which{**46 Misc 3d at 673} were dismissed, without opposition, upon defendants' motion for summary judgment, by order dated June 28, 2013.[FN2] The remaining claims include: an individual claim against the individual defendants for breach of fiduciary duty, for which plaintiff sought punitive damages (third cause of action); failure to declare a dividend (fifth cause of action); a demand that the individual defendants purchase plaintiff's shares at fair value (sixth cause of action); common-law dissolution of the corporation (seventh cause of action); and derivatively, breach of fiduciary duty by the individual defendants (eighth cause of action); and constructive trust (tenth cause of action). The claims for punitive damages were dismissed upon the prima facie motion based upon the failure to plead egregious or malicious conduct which would warrant such recovery.

Defendants interposed four counterclaims against Cortes claiming damages for conversion of money and corporate property for his own purposes, misrepresentation of corporate expenses, breach of the contract to sell his shares to defendants for the sum paid

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for such shares and various alleged breaches of his duty to perform his duties as manager in a responsible manner. This court dismissed defendants' first and second counterclaims for conversion and fraud as a matter of law based upon inadequacies in the pleading. In response to plaintiff's in limine motion prior to trial, the court precluded any evidence of sexual harassment as alleged in [*3]the fourth counterclaim as no such evidence had been adduced in response to discovery demands.

A trial was held before this court, sitting without a jury, commencing on May 12, 2014, and concluding with summations on July 7, 2014. Nine witnesses testified, four of whom gave testimony based upon their expertise in various fields. One witness, Bobby Kim, defendants' prior counsel, was produced from his place of incarceration, but it was determined that his testimony was unnecessary. Posttrial written submissions have now been received. The court makes the following findings of fact and reaches the following conclusions of law.

Findings of Fact

On his direct case, plaintiff testified that he had met defendant DeSimone while employed at Giovanni's restaurant in New York County and was offered a "partnership" in the new restaurant Cabo in return for $50,000, which he paid on August[**46 Misc 3d at 674] 9, 2003, to Ramunni and DeSimone, partly in cash and partly by check, as consideration for his 16.67% interest, for which he was promised a salary and his proportionate share of the profit from Cabo. He testified that he had borrowed the money from his brother-in-law, who had taken a bank loan. Plaintiff worked at Cabo as the day manager and was initially paid $700 per week, which was increased in 2005, apparently in response to the intervention of Robert Anker, Esq., an attorney hired by plaintiff, to $1,000 per week, in addition to cash received in an envelope in amounts between $250 and $1,500, totaling $25,000. While he paid taxes on the salary he received by check, he did not pay taxes on the cash and there is no documentation of such cash payments. In 2009, the cash payments ceased. Plaintiff described Ramunni as in charge of financial matters and the one to whom he most frequently spoke about his share of profits and the opportunity to review the books of Cabo. Plaintiff testified that DeSimone "oversaw" the dining room, but only appeared at the restaurant, for 20 minutes, three or four times a week. Generally, plaintiff was in charge of all aspects of day-to-day management. At the

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end of each shift, he would turn over to Nathan Birkenfeld, the night manager, the server reports that had been generated in the course of the day.

Cortes admitted that he consumed substantial amounts of alcohol while on the job and that he occasionally fell asleep. This problem was discussed with defendants who asked him to stop. He attended an alcohol treatment program briefly, but continued to drink at work, explaining that he was required to taste the sangria and margaritas prepared daily to be served to patrons. Following the expansion of the restaurant from 74 to 150 or 160 tables, in 2010, because he was "miserable," working long hours and commuting to his home in Brooklyn 21/2 hours each way, he "quit." Cortes insisted he was not fired and that his compensation was never cut during his employment, nor was his job performance affected by his consumption of a bottle of wine each day, although, after he commenced suit, defendants accused him of stealing and sexually harassing women at work.

After terminating his employment, plaintiff sought to sell his shares to defendants, who, under the terms of the agreement, had the right to buy him out upon his failure to continue to serve as manager, but the price offered, $50,000, was not acceptable to plaintiff. Defendants have declined to offer more, insisting, as demanded in their third counterclaim, that plaintiff{**46 Misc 3d at 675} was obligated, under the agreement, to accept the return of his $50,000 investment in exchange for his shares. Plaintiff testified that he repeatedly asked for his 16.67% share of the profits, but was told defendants were going to recoup their investment first. The tax returns for the corporation, in [*4]evidence, show no, or only minimal, profit. However, it is plaintiff's contention, and the gravamen of his suit, that substantial sums of cash received daily from customers in payment, were not reported and were diverted to the individual defendants. Plaintiff testified that he observed stacks of cash in a safe in a locked basement office, to which he also had the combination, and that he had regularly accessed such cash to pay bartenders and vendors, as instructed by Ramunni.

Plaintiff called both individual defendants on his direct case. Angelo Ramunni, who is the chief financial officer for Cabo and was most directly involved in the day-to-day authorization of payments and monitoring of sales, testified that he owns three businesses, two, with DeSimone, whom he has known for 35 years. Ramunni acknowledged that not all of the cash collected at Cabo was deposited in the Cabo bank account, but that some vendors and employees were paid in cash. He would go to the restaurant daily in the

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morning to check the receipts against the cash. Ramunni testified that he gave the original daily server reports[FN3] to the corporate accountant, Alan Lipke, each month, without retaining a copy for the restaurant. Ramunni recalled that a demand for books and records had been made in the spring of 2011, but it was not until his deposition on July{**46 Misc 3d at 676} 19, 2012 that the existence of the server reports was revealed to plaintiff's counsel. The server reports, which proved critical to plaintiff's case, were not produced until October 5, 2012, in open court following a hearing, upon court order (*see* order of Oct. 5, 2012). Ramunni also acknowledged that there are no bylaws for the corporate defendant, no elections of officers or directors have been held and that, in fact, there are no directors.

Ramunni testified that Cabo opened in 2004,[FN4] but only became profitable in 2013, after plaintiff's departure. Ramunni stated that Cabo was never profitable prior to 2013 when business "exploded." In April 2012, a fire occurred which limited operation of the restaurant for four to [*5]six months. In the course of repair, seating and kitchen capacity were expanded and an outdoor patio was added which opened at the end of August 2012. Ramunni explained the substantial increased profitability in 2013 as the result of his and DeSimone's greater involvement in management after plaintiff's departure, better ordering of better quality food, and the absence of plaintiff in a drunken condition. However, Ramunni admitted that in 2009 or 2010, a New York State sales tax audit had concluded that sales had been underreported and that approximately $90,000 in tax was owed, which was paid without challenge.

DeSimone testified that he was employed at Caliente Cab Company and Peter's Clam Bar, as well as defendant 3A North Park Avenue Restaurant Corp. (3A North Park), and split his time among the various locations. He was primarily questioned on plaintiff's case with respect to an affidavit he had submitted regarding compliance with a document request. DeSimone stated that he did not manage the financial records and had only obtained the bank statements. He stated that he did not believe the server reports generated daily and turned over to the accountant for use in preparation of financial statements and tax returns are electronically stored information which were required to be provided to counsel in response to discovery demands. DeSimone testified that he thought the tax returns and bank statements adequately responded to plaintiff's demands. This court does not find this testimony credible. DeSimone testified that meetings regarding the business

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were held between himself and Ramunni and plaintiff, but that no minutes were kept. {**46 Misc 3d at 677}

This court presided over numerous attempts by plaintiff to obtain the records necessary to confirm his suspicions that the two majority shareholders—the only shareholders identified on the tax returns as 50/50 shareholders—had been diverting substantial sums of cash to themselves and had breached their fiduciary duty to him and the corporation. The court infers, from the pattern of delay and obfuscation in responding to the numerous requests for records, that the individual defendants deliberately frustrated plaintiff's efforts and, in failing to disclose to the minority shareholder the actual profits of the restaurant and refusing to give him his 16.67% thereof, breached their fiduciary duty to him. Had defendants responded timely to plaintiff's legitimate requests for sales records, the server reports, which ultimately proved critical to plaintiff's case, would have been more complete and would have provided a basis to determine the actual cash receipts on a daily basis. It is defendants' deliberate concealment of the sales records, particularly the server reports, that they knew would reveal their defalcations, that warrants acceptance of the projections of the expert based upon the limited records produced (*see Matter of Rothko*, 43 NY2d 305, 323 [1977]).

Plaintiff argued throughout the trial that the individual defendants were underreporting the restaurant's revenue, the majority of which was cash, that the individual defendants controlled the access to the cash, significant sums of which they did not deposit into the corporation's bank account, and that the individual defendants diverted cash funds from the corporation for their personal benefit in breach of their fiduciary duty to the plaintiff. Following the belated production of the server reports for the period between July 2011 and July 2012[FN5] (the only sales [*6]records produced to the plaintiff during discovery), in order to demonstrate that the reported revenue in the year-end income statements and federal tax filings was inaccurate, plaintiff sought an expert analysis of the limited information provided.[FN6] All credit card payments are processed by an independent servicer, Sterling Funding, which initially advances the sums charged by credit card and then deposits the funds directly into{**46 Misc 3d at 678} Cabo's bank accounts, less its processing fee.[FN7] Thus, the amount of income derived from credit card purchases is readily ascertainable and is reliable and precise, while, as Ramunni testified, not all of the cash was deposited into the corporation's bank account as certain vendors

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and employees required cash payments and some of the cash was paid to the servers as tips.

To calculate the sum of alleged damages, plaintiff sought to determine the ratio of the restaurant's revenues received in the known deposited credit card amounts to the cash received as reflected in the server reports. Using such ratio, plaintiff believed he would be able to ascertain the amount of unreported cash that had been received during the period of his stock ownership. As the server reports were voluminous and incomplete, plaintiff sought to select a sample of server reports that would accurately reflect the cash to credit ratio of revenue received by the restaurant. Plaintiff's counsel contacted the former chair of Columbia University's Department of Statistics, Dr. David Madigan, a professor of statistics who holds a Ph.D. in that field. Madigan was asked by plaintiff's counsel to select a number of random dates, during the time period for which server reports were available, that would constitute a statistically significant sample size in order to determine what percentage of the restaurant's revenue was received in cash. At trial, Madigan, who was acknowledged to be a statistics expert, testified that he had randomly selected 11 dates from the relevant time period, along with backup dates for each date in the event that the server report for the first selected date was not available, and had given the list to plaintiff's counsel. Each of the 11 dates was selected from a different month. Madigan testified that his work in this action was pro bono and he was not compensated for his services.

Madigan's randomly-selected sample was supplied to Michael J. Garibaldi, a New York State certified public accountant since 1984, with an extensive background in forensic accounting, business valuation and reconstruction of financials of closely held companies, and accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants. He is the president and CEO of Israeloff, Trattner & Company, an accounting firm. Although he testified [**46 Misc 3d at 679]that he had had no direct contact with Madigan, Garibaldi found the use of a sample of 11 dates from a single year to project business activity over a period of 11 years to be entirely appropriate and a generally accepted procedure in the forensic accounting community, which frequently uses sampling in [*7]both forensic accounting and auditing.

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Garibaldi was accepted as an expert in forensic accounting and business valuation. He prepared an expert report dated November 22, 2013 (plaintiff's expert report)[FN8] based upon 3A North Park corporate documents, including federal tax returns from 2003 through 2010, financial statements for the fiscal years ending July 31 for 2008 through 2011, monthly bank statements for the period December 2003 through September 2012, the server reports from July 2011 through July 2012, and deposition testimony and correspondence. Based upon defendants' failure to respond to notices to admit, the cash deposits reflected in the bank statements and the costs and expenses reported in the tax returns were deemed to be accurate.

Garibaldi reviewed the server reports from the 11 dates selected by Madigan (which numbered 92), calculated the total amount of cash actually received by the restaurant on those dates, and compared it to the actual credit card payments on the same dates, and concluded that, between July 2011 and July 2012, 45.6% of the revenue was paid by credit card and 54.4% of the revenue was received in cash (credit/cash ratio). After adjusting for an 8.625% sales tax and an 18% tip rate,[FN9] Garibaldi applied this credit/cash ratio to the automatic credit card bank deposits to estimate the cash revenue received during this period. As these server reports were the only documents provided to plaintiff that indicate the actual cash received by the restaurant, other than bank statements listing deposits which concededly do not correspond to the cash actually received, Garibaldi also applied this credit/cash ratio to all credit card deposits for the corporation from 2003 through 2013. When asked on cross-examination whether the 11-day sample was not{**46 Misc 3d at 680} representative of an entire year because of the number of weekend and holidays in the sample, which would increase the overall sales,[FN10] Garibaldi responded that he only used the sample dates to determine the ratio of credit card payments to cash payments and not to determine the total sales revenue. Thus, the presence of increased sales on any particular date would be irrelevant.

In his expert report, Garibaldi concluded that, based upon his credit/cash ratio analysis, the cash deposited in the corporation's bank account was only a small fraction of the total cash revenue received and the corporation's estimated profits were significantly underreported. He testified that, applying the credit/cash ratio to the credit revenue since the [*8]restaurant opened in November of 2003 through the end of 2013 to determine total revenue, and deducting the costs and expenses as reported in the tax returns, Cabo had a

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projected profit of $7,347,912. Accordingly, Garibaldi concluded that plaintiff's 16.67% share of those profits is $1,224,896.93. To determine the present value of the business, Garibaldi indicated "that a multiple of between 3 and 5 of net income is appropriate to estimate the value of the business." Accordingly, Garibaldi estimated the value of the corporation, based on his estimated adjusted net income of $1,093,048 for the year 2012, to be between $3,279,144 and $5,465,240. Plaintiff's 16.67% interest in the corporation would then be worth between $546,633 and $911,055.[FN11]

After reviewing defendants' expert report, prepared by Howard Cannon, CEO of Restaurant Operations Institute, Inc. in Chelsea, Alabama, who, though not an accountant, was accepted as an expert in "restaurant operations and business restaurant evaluation," Garibaldi issued a supplemental expert report, dated April 16, 2014 (plaintiff's supplemental expert report), addressing the daily consolidated system menu item sales summary (sales summary) relied upon by Cannon.[FN12] According to the sales summary, the net sales total in the one-month period{**46 Misc 3d at 681} between December 23, 2012 and January 23, 2013 was $202,421.70. Garibaldi concluded that this one-month total suggests yearly sales of at least $2.43 million,[FN13] more than double the revenue reported on the 2012 financial statement and substantially more than the $2,237,551 in revenue for 2012 estimated in the plaintiff's expert report based upon the server reports. Garibaldi then averaged the credit card deposits reflected in the bank statements for the months January and February for the years 2005-2012 and compared that average to the average monthly credit card deposits over the entire eight-year period, finding that the monthly January-February deposit is 22.5% lower than the overall monthly average. Multiplying the $202,421.70 from the sales summary for December 2012-January 2013 by 12, and adjusting for the 22.5% purported increase in projected actual revenue, he determined that the estimated yearly sales for 2012 would be closer to $2.98 million than $2.43 million. Accordingly, Garibaldi testified that the sales summary supports the plaintiff's contention that the revenues at the restaurant are significantly higher than had been reported. Garibaldi therefore recalculated the corporation's profits between 2003 and December 1, 2013, based upon the sales summary, to be $9.78 million, of which the plaintiff is entitled to $2.25 million (inclusive of interest). Garibaldi estimated the value of the corporation, based on [*9]his recalculation of the net income, to be between $4.35 million and $7.25 million. Deducting the $2.25 million owed to plaintiff for profits as

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calculated above as a corporate liability, Garibaldi concluded that plaintiff's 16.67% interest in the corporation is worth between $350,000 and $833,000.

Although the court agrees that the sales summary, supplied by defendants, does support the plaintiff's contention that sales at the restaurant were significantly higher than were reported in the financial statements, the court does not accept Garibaldi's recalculation of the lost profits in the plaintiff's supplemental expert report based entirely upon the proportional discrepancy between the revenue for the single month reflected in the sales summary and the average monthly sales for the entire eight-year period. Whereas the net income or profits in the{**46 Misc 3d at 682} plaintiff's expert report were methodically calculated based upon known deposited credit card amounts and reported expenses,[FN14] the plaintiff's supplemental expert report seeks to increase all of the previously calculated amounts by one third based on one 30-day sales summary that does not reference the corporation's expenses and is not, as acknowledged by Garibaldi, an accurate representation of a typical month. Further, there was undisputed testimony that the restaurant's kitchen was significantly altered after the fire in April of 2012 and seating was expanded, particularly with the opening of the outdoor patio in August, that would substantially account for the greater sales at the end of that year and into 2013. Accordingly, the court declines to accept Garibaldi's recalculation of lost profits in the plaintiff's supplemental expert report and those calculations are disregarded.

Plaintiff also called Alan Lipke, the accountant for 3A North Park since its formation in 2003, whose testimony was frequently contradictory and unreliable, at best. However, Lipke did acknowledge that Cabo had been the subject of a New York State tax audit for the years 2007 through 2009 which had determined a liability for unreported sales for which taxes were due. The results were uncontested and the tax due, approximately $69,000, plus interest and penalties of approximately $12,000, was paid. Lipke testified that he thought the sum alleged to be due was substantially accurate. A year later, a franchise tax audit was conducted and Lipke was asked to explain where the additional sales reflected in the sales tax came from and where the money went. According to Lipke, upon production of receipts for cash payments to vendors, the questioned returns were accepted without change. Lipke further testified that he did not know of Cortes' interest until the instant suit was commenced. In contradiction to Ramunni's testimony that he gave the original server reports to Lipke on a monthly basis, Lipke testified that, prior to

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the tax audit in 2009, he had no knowledge of the computerized daily server reports but first received them during the sales tax audit, so he could "figure out . . . what the percentage would be [of credit card to cash]," and had not seen them again since the end of that audit in 2009. He testified that, although he could not{**46 Misc 3d at 683} remember the ratio, it was "in the ballpark of the range of what normal restaurants in his [sic] caliber would be" (tr of May 19, 2014 at 22).

[*10]

Lipke testified that he acted as the accountant for approximately 20 full service restaurants and was stipulated to be an expert in full service restaurant accounting. He testified that he prepared financial documents, including tax returns, entirely from the corporation's bank statements and relied upon Ramunni's verbal statements regarding the amount of sales in cash in order to provide sales tax returns. No documentation accompanied such verbal reports and Lipke had no idea how such number was derived. Lipke was evasive regarding his review of the payroll records, responding that a payroll company was involved and that he did not know whether plaintiff received a salary. Lipke testified that the corporation lost a total of $65,353 from its inception through July 31, 2011 and never declared or paid a dividend, but only "paid salaries to shareholders as members" (Lipke aff of Dec. 20, 2012, plaintiff's exhibit 39). Since Cortes was never acknowledged to be a shareholder, it is clear that he did not receive compensation as a shareholder. Lipke explained that, despite earlier losses, in the year from November 1, 2012 to October 31, 2013, Cabo's sales increased to $2.7 million from the prior average of $1.1 to $1.2 million, due largely to the expansion of the facility after the 2012 fire. Lipke further stated that closely held restaurants do not generally pay dividends, but compensate the shareholders in salary, that the salaries paid to Ramunni and DeSimone were "in line" with industry standards, that he had found no indication of irregularities in the bank statements and that all funds were paid out for corporate purposes.

Lipke reviewed the plaintiff's expert report and, although he did not contest the specific mathematical computations in the report, he stated that Garibaldi's finding that only 45.6% of the sales were by credit card was "impossible" based upon his experience and familiarity with other restaurants. Lipke supplied his own projection of a cash to credit ratio based upon a ratio to the rent as applied to the credit card deposits made to the bank account, less tips and sales tax. Analyzing each year from 2004 through "all the

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years," he concluded that the ratio of cash to credit revenue averaged approximately 35/65.[FN15] He testified that the credit card percentage of income in the restaurant business{**46 Misc 3d at 684} generally was never below 60%. When asked if he had any basis for determining whether the cash to credit ratio would vary depending on a particular day of the week, Lipke testified that he did not have any basis for knowing one way or the other. Lipke also testified that he disagreed with Garibaldi's valuation of the restaurant and that the value of a restaurant is between 40 and 60% of the gross sales. This testimony is rejected, however, as without foundation and well beyond Lipke's field of expertise.

[*11]

Defendants argued throughout the trial that the restaurant was losing money each of its first 10 years and did not become profitable until 2013, as reflected in their profit and loss statements, as well as their tax filings. They offered no expert analysis to controvert Garibaldi's testimony regarding his projection of actual unreported cash revenue, other than the testimony of their accountant Lipke. However, they did offer an alternative expert valuation of the business.

At trial, defendants called Howard Cannon, a certified forensic consultant with a Master's degree in business administration and extensive practical experience in the restaurant industry, who had never testified as an expert in business valuation, had never taken a course or been certified in business valuation, had never published in the field of business valuation and did not belong to any professional organizations.[FN16] Cannon issued his expert report on December 4, 2013 (defendants' expert report), in which he relied upon a current menu for the restaurant, profit and loss statements for fiscal years 2010 through 2012, tax returns between 2009 and 2012, affidavits from the accountant Lipke and Ramunni, a letter from the New{**46 Misc 3d at 685} York State tax auditor regarding a franchise tax audit, and the sales summary from the restaurant for the period of December 23, 2012-January 23, 2013. Cannon indicated that he reviewed approximately 88 pages of documents in total, but did not review the restaurant's bank statements or the server reports relied upon in the plaintiff's expert report. In both his written report and in his trial testimony, Cannon emphasized the importance of reliable, accurate information regarding the volume of sales in assessing the value of the business,

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but relied exclusively on the affidavit of accountant Lipke and the tax returns and financial statements he prepared, together with verbal communications with defendants' attorney and the affidavit of Ramunni as a corporate officer, to determine the value, without reviewing any of the primary records or such independent source as the bank records to verify the accuracy of the information he was given. He testified that he did not consider any liabilities of the corporation in making his valuation, but was required to accept the numbers in the tax returns and rely upon the CPA Lipke and "the bookkeeper" (apparently Ramunni).

In his report, Cannon noted that there are three methods that can be used to determine the value of a restaurant, but "based on the limited number of documents [he was] provided to review for this matter, that one can only use the verifiable gross sales method to determine an initial value for this subject establishment." The defendants' expert report stated, "[a]s a general restaurant industry valuation rule, a restaurant valuation can most easily be gleaned by assessing a value that is equal to 30 to 35% of the verifiable gross sales of the business." Cannon relied upon an affidavit from Lipke that the gross sales volume for November 1, 2010 through October 31, 2013 was $5,014,424. Although not explicitly stated in the defendants' expert report, Cannon apparently divided this number by three and used it as the average of annual gross sales of the business. This was then multiplied by 30% and 35% to arrive at an "initial data-point for the Fair Market Value" for the restaurant of between $501,000 and $586,000. Cannon further stated that the "potential impact of yet-to-be determined minor influences of plus or minus [*12]fifteen-percent" would expand that range to $425,000 to $674,000, although Cannon was not provided the information necessary to assess such influences, rendering such opinion speculative. Based upon this analysis, plaintiff's 16.67% share of the corporation was projected by Cannon to be worth between $70,848 and $112,356. At trial, and in his expert report,{**46 Misc 3d at 686} Cannon stated that since plaintiff is a minority shareholder without decision-making authority, his shares are not desirable and this value would be further reduced by 30-50% to a range of $35,424 to $78,649. Cannon took particular note of the difficulty in determining the value of an independent restaurant, like Cabo, because such businesses are largely cash-based, making verification of "dividends" (the return to the owners), elusive. The court notes that such difficulty would also arise with respect to a valuation based on gross revenues if cash revenue is diverted or inaccurately recorded. Cannon did not address the issue of the restaurant's profits, if

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any, or plaintiff's share of those profits, as he was only asked to address the value of the business, describe his method in making the determination of value and set the value of plaintiff's shares on the open market.

The defendants' expert report includes a number of notable caveats. Cannon explained that for the gross sales method of valuation to be accurate, "gross sales numbers must be verifiable by a Certified Public Accountant (CPA) that is licensed in the state where the establishment is operating" and could not "stress enough that a valuation is only as good as the verifiable data and verifiable information that can be provided and used to assess the value from." Further, Cannon stated:

> "It should be noted that I am not a Certified Public Accountant, nor was I asked to review any of the numbers pertaining to this matter to determine if I had any opinion as to the accuracy or authenticity of the sales, expenses, and/or profits or losses of the subject establishment; rather, I was asked to opinion off of the numbers that I was provided and assuming that all numbers provided were true and accurate."

At the conclusion of the defendants' expert report, upon review of the plaintiff's expert report, Cannon noted:

> "Based on my very brief and initial cursory review of the [plaintiff's expert report] and prior to [defendants'] counsel requesting that I do not review and/or consider any further due to cost and time constraints, I recognized that clearly Mr. Garibaldi was provided access to significantly more financial information and significantly different data-points to consider than what I was provided. I am not a Certified Public Accountant and, therefore, cannot attest to the validity and/or accuracy of any of the financial data-points used and/or collected by Mr.{**46 Misc 3d at 687} Garibaldi in any way at any time. Further, I am not able to opine at this time about the methodology used or the opinions arrived at within Mr. Garibaldi's report without expending significantly more time on this matter."

As is evident from Mr. Cannon's own disclaimers, the expert opinion proffered by defendants is fraught with speculation, is without a reliable foundation in professional analysis, and begs the very question raised in this litigation: what were the actual sales revenues of the [*13]restaurant in the years prior to commencement of this action.[FN17] Although plaintiff's counsel accepted Cannon as an expert, this court does not find him

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qualified to provide a competent opinion regarding the value of Cabo as a business, particularly in light of the suspect nature of the information provided to him.

Testifying on their direct case, Ramunni and DeSimone described the agreement between Ramunni and Cortes as limited to a right to repurchase Cortes' shares at the $50,000 price he had paid for them if he ceased working as the daytime manager of Cabo. According to DeSimone, plaintiff was encouraged to "buy [himself] a job." Both defendants testified to plaintiff being drunk on the job and their efforts to get him alcohol treatment. They both also described plaintiff's performance as inadequate, that he was overpaying vendors for supplies, that he was overstaffing the restaurant, that his mismanagement had resulted in unspecified losses and that business declined because of his drinking. Although no allegation of outright stealing was pursued, defendants claimed that plaintiff sometimes failed to account for all of the sales at the end of the day and "misappropriated" funds by incurring inappropriate expenses. Both defendants testified that no dividends had ever been declared but that the salaries paid to them and plaintiff were their only compensation. Both defendants further testified that plaintiff never asked to review the financial records but that informal discussions were held regarding the business. Ramunni testified that his failure to advise Lipke of plaintiff's ownership interest was an "oversight."

{**46 Misc 3d at 688}Defendants' Counterclaims

At the close of defendants' case, plaintiff's CPLR 4401 motion to dismiss the remaining third and fourth counterclaims was granted as to the third counterclaim alleging a breach of the "contract" to accept $50,000 in return for his shares upon his departure from employment as the daytime business manger. Defendants claimed they had offered $50,000 for plaintiff's shares, but that he had refused their offer. They argued that they should not be required to increase the offer since the agreement only specified a right of first refusal. Counsel further contended that plaintiff's departure effected a termination of the business relationship. Ruling on the motion, the court found that the clear language of the agreement provides no indication that the purchase price was limited to $50,000. Nor, upon the evidence, would such limitation be rational. Plaintiff was employed elsewhere at the time he was solicited by DeSimone to manage Cabo and appears to have been making more than the $700 a week initially paid to him at Cabo. He was traveling hours each day and working at least 15 hours a day, until 1:00 or 1:30 a.m. Moreover, he borrowed the

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$50,000 from his brother-in-law who, in turn, had taken a loan. There is no reasonable possibility that plaintiff had purchased his shares just to secure the job as manager, without the promise, and expectation, that he would be sharing in the profits. Further, it does not [*14]appear that any relief is even requested in the third counterclaim as defendants were accorded their right of first refusal at the price they were willing to pay, unless defendants are seeking a direction to plaintiff to accept the $50,000 and convey his shares. Such direction is not warranted by the language of the agreement or the evidence. Accordingly, although the court initially reserved on the complete dismissal of the third counterclaim, upon the assumption that defendants also sought to enforce a right to buy plaintiff out upon his departure, there is no merit to the third counterclaim upon the evidence or as pleaded and it is dismissed.

Defendants' fourth counterclaim, insofar as it survives, is based upon plaintiff's alleged breach of his employment contract in continuing to be "inebriated on the job" and failing to perform his duties properly, thereby causing the business to lose "opportunities." As plaintiff's counsel pointed out, there is no claim or evidence of a faithless employee that would justify a recovery against plaintiff and there is no evidence of actual damages other than general claims of a diminution in business.[**46 Misc 3d at 689] Plaintiff himself admitted that he frequently consumed significant quantities of alcohol while working, but there is no actual contract of employment that defines the terms such that simply consuming alcohol would constitute a breach of contract. Defendants tolerated any inadequacies in plaintiff's performance, relying on him to manage the restaurant, pay vendors, purchase food and staff the restaurant, as well as collect the days' receipts, until he quit. This court does not credit the testimony of defendants with respect to plaintiff's inadequacies in light of their own admissions regarding the extent of his responsibilities, finding such testimony to be tailored and not credible. Moreover, the right of an employer to be compensated by an employee is limited to a breach of the employee's duty of loyalty and good faith by acts of actual misconduct and disloyalty that are contrary to the employer's interests, thereby depriving the employer of profit and enriching himself at the employer's expense (*see e.g. Phansalkar v Andersen Weinroth & Co., L.P.*, 344 F3d 184, 200-203 [2d Cir 2003]; *Lamdin v Broadway Surface Adv. Corp.*, 272 NY 133, 138-139 [1936]; *Rodgers v Lenox Hill Hosp.*, 239 AD2d 140, 147-149 [1st Dept 1997, Rubin, J., dissenting]). There is no evidence of any profit gained by plaintiff at defendants' expense or of any acts of disloyalty. Under such circumstances, defendants' only recourse, in the

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face of what they contend were inadequacies or negligence in plaintiff's job performance, was termination (*Burke v Steinmann*, 2004 WL 1117891, *7, 2004 US Dist LEXIS 8930, *20-23 [SD NY 2004, No. 03 Civ 1390 (GEL)]; *cf. Feiger v Iral Jewelry*, 41 NY2d 928 [1977]; *cf. Bravin v Fashion Week*, 73 Misc 2d 974 [Civ Ct, NY County 1973]). Despite their suggestion that plaintiff's performance was so tainted by his alcohol consumption during working hours that he was incompetent in executing his responsibilities, they never fired him and retained his services as the sole daytime manager, in control of all aspects of the business under Ramunni's direction, for seven years, until he quit.[FN18] Accordingly, defendants failed to prove their fourth counterclaim for breach of the employment contract and the claim is dismissed.

Plaintiff's Claims

[1] Addressing plaintiff's claims, considering the testimony of all witnesses, the expert [*15]reports, and the corporation's financial {**46 Misc 3d at 690}records in evidence, it is clear that significant cash receipts were not reported in the corporation's tax returns and records and plaintiff was thus deprived of his share of significant profits that were diverted by defendants. The server reports for the eight dates sampled between July 9, 2011 and April 1, 2012 (prior to the fire on Apr. 12) demonstrate that the restaurant received between $6,386 and $9,908 nightly in cash payments on the randomly selected Fridays and Saturdays (when the restaurant was busy and operated as a bar and club late into the early morning hours), and on non-holiday weekday nights, when the restaurant was fully operational,[FN19] the server reports for randomly selected dates indicate that the restaurant received between $1,327 and $1,815 in cash payments nightly. However, the bank account statements demonstrate that, during this same time period, no more than $5,300 in cash was deposited into the corporation's bank account in any given month. It is thus apparent that substantial receipts in cash were diverted. Defendants' explanation that cash was paid to certain vendors and employees is not corroborated with documentation of any kind and does not account for the sums actually unreported. While the total amounts of cash diverted from the corporation each year in plaintiff's expert report is based upon an extrapolation, using a formula based upon the proportion of credit to cash receipts as reflected in the only reliable evidence produced, the server reports for 11 months, the court finds the conclusions of plaintiff's expert, Garibaldi, with respect to the amount of cash diverted, to be reliable and grounded in competent analysis of the available data.

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Although challenged by defendants, the court finds the statistical random sample generated by Madigan from the server reports provided for 11 months to be an appropriate method of sampling for the purpose of projecting cash receipts over the entire period at issue where inadequate records have been provided and finds the particular sample to be statistically significant. It is noted that the Appellate Division, Third Department recently upheld the New York State Department of Taxation and Finance Audit Division's use of one sample day's cash to credit ratio, from a restaurant that kept inadequate cash{**46 Misc 3d at 691} sales records, in order to determine the cash revenue for a period of over 21/2 years (*Matter of Hwang v Tax Appeals Trib. of the State of N.Y.*, 105 AD3d 1151 [3d Dept 2013]; *see also Matter of King Crab Rest. v Chu*, 134 AD2d 51 [3d Dept 1987]). The evidence here of the findings of a sales tax audit by New York State in 2009 or 2010, for the preceding three years, in which it was determined that the corporation owed in excess of $80,000 in back sales tax, interest and penalties, which the corporation declined to contest and paid,[FN20] corroborates Garibaldi's conclusions that significant sums of cash were diverted from the corporation, which would have been profit, in which [*16]plaintiff would be entitled to share.

By his own testimony, it was established that Ramunni acted as the corporation's bookkeeper and was responsible for the distribution of the cash received by the corporation, as well as all financial reporting to the corporation's accountant. Each morning he compared the daily server reports to the amount of cash given to him as taken in the day before. Cortes testified to having observed stacks of cash in a safe in the basement office. Although Ramunni testified that cash withheld from the corporation's bank account was used to pay employees, vendors, and tips, the court does not find such explanation sufficient in light of the size of the discrepancy between the amount of unreported cash and the records of Cabo's expenses. While plaintiff did not contest the defendants' distribution of tips to servers in cash, which was accounted for in Garibaldi's calculations by deducting from the actual credit receipts a conservative estimate of 18%, [FN21] this court's review of the bank account statements admitted into evidence, and the corresponding financial statements, reveals that numerous vendors, employees, and the individual defendants themselves, were paid each month by check.[FN22] No receipts for cash, or even invoices for purchases, or employment records, which defendants are required by law to maintain,{**46 Misc 3d at 692} were offered in evidence to

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substantiate any cash payments. Accordingly, the defendants produced insufficient evidence to support their contention that large sums of withheld cash were used to pay the corporation's expenses, including employee's wages and vendor payments.

Lipke testified that the sole method by which he determined the corporation's cash revenue, for inclusion in its financial statements and tax returns, was from verbal reports by Ramunni without any documentary support. This testimony seriously undermines Lipke's professional competence as an accountant and renders him incredible as a witness regarding the corporate earnings. Any records he prepared were clearly inadequate as a reliable indicator of the value of the corporation. Accordingly, this court finds that the revenue reported in the corporation's financial statements and tax returns is inherently inaccurate. Similarly, as no accurate accounting was made of the cash received on a daily or monthly basis, the amount of cash deposited into the bank account of the corporation is also an unreliable means of determining the corporation's cash revenue.

In light of defendants' failure to provide any reliable records, other than the server reports, of actual revenue of the corporation, this court finds the projections of revenue based upon the credit/cash ratio, as described in plaintiff's expert report and the testimony of Garibaldi, to be the appropriate method by which to assess the extent of defendants' diversion of cash revenue and determine the true value of the corporation. The court is satisfied that Madigan randomly selected a statistically significant sample of server report dates for Garibaldi to review in order to [*17]determine the cash to credit card ratio and is satisfied that a rational basis exists for Garibaldi's calculations. Garibaldi is a recognized, and highly experienced forensic accountant, expert in the field of evaluation of closely held corporations, particularly where, as here, the parties have sought to hide the true value and the extent of their defalcation. Although the defendants repeatedly sought to discredit Garibaldi's conclusions at trial, the defendants did not provide their own expert, Cannon, with the server reports or bank statements relied upon by Garibaldi, precluded Cannon from reviewing Garibaldi's report, and did not retain Cannon, or any other independent expert, to analyze plaintiff's allegations of diverted cash and lost profits. Although Lipke testified that he never saw a restaurant with less than a 60% credit card to 40% cash ratio, he did not contest{**46 Misc 3d at 693} Garibaldi's method of calculating the estimated cash payments or contest Madigan's selection of random dates. While defendants challenged the application of the credit/cash ratio to any time frame outside the

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period of July 2011 to July 2012, arguing that the ratio was derived from the server reports for only that period, it is defendants' failure to maintain and/or produce records for any other period (other than, belatedly, for the sales summary period of Dec. 2012 to Jan. 2013) that has necessitated the use of the ratio for the entire relevant period. The defendants cannot be permitted to benefit from their purposefully inadequate record-keeping, as a means of concealing their diversion of funds, to defeat plaintiff's claims. The sole reason that the plaintiff's expert applied the credit/cash ratio over the course of a number of years is because the defendants maintained such inadequate, and obviously fraudulent, records. It is noted that the defendants' own expert witness, Cannon, testified at trial that the frequency of credit card use at restaurants has been increasing over the past 10 years, which suggests that the application of the credit/cash ratio, dating back to 2003, may actually be a conservative estimate of the earlier cash payments to the restaurant. [FN23] As the plaintiff presented proof of the diversion of assets, and the "difficulty faced in calculating damages is attributable to the defendant[s'] misconduct," the level of uncertainty with respect to Garibaldi's approximation of the loss is permissible (*Wolf v Rand*, 258 AD2d 401, 402-403 [1st Dept 1999]; *see Matter of Rothko*, 43 NY2d 305, 323 [1977]; *Gibbs v Breed, Abbott & Morgan*, 271 AD2d 180, 188-189 [1st Dept 2000]; *Milbank, Tweed, Hadley & McCloy v Boon*, 13 F3d 537, 543 [2d Cir 1994]).

Accordingly, the court finds that Garibaldi's application of the credit/cash ratio to all of the credit card deposit records of the corporation, in order to estimate the total amount of undisclosed cash that was diverted to the individual defendants, was warranted, given the defendants' misfeasance and malfeasance in providing adequate records. Accordingly, this court finds the application of the credit/cash ratio of 45.6% credit card payments to 54.4% cash payments to be reliably based upon the available records and such method of calculating the amount of cash diverted to be appropriate. Based upon Garibaldi's calculations,{**46 Misc 3d at 694} the court finds that $3,719,407 of the $11,246,703 in projected gross revenue for the period 2003 to the filing of the complaint on June 13, 2011, was diverted by defendants.

Conclusions of Law

[*18]Breach of Fiduciary Duty

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[2] "In order to establish a breach of fiduciary duty, a plaintiff must prove the existence of a fiduciary relationship, misconduct by the defendant, and damages that were directly caused by the defendant's misconduct" (*Kurtzman v Bergstol*, 40 AD3d 588, 590 [2d Dept 2007]). "A minority shareholder in a close corporation is owed a fiduciary duty by the majority shareholders" (*O'Neill v Warburg, Pincus & Co.*, 39 AD3d 281, 282 [1st Dept 2007]; *see Gjuraj v Uplift El. Corp.*, 110 AD3d 540 [1st Dept 2013]). As the plaintiff is a minority shareholder, he is owed a fiduciary duty by the individual majority shareholder defendants to scrupulously guard the assets of the corporation and honestly account to plaintiff for the application thereof. There was extensive testimony that Ramunni had control over the corporation's cash deposits, was responsible for comparing the cash placed in the safe to the cash reported in the server reports on a daily basis, reported the amount of cash received to the accountant, and directed how the cash was distributed or deposited into the corporation's bank account. While DeSimone appeared to have less involvement in the day-to-day management of the restaurant, he testified that he did not believe he had a duty to treat plaintiff as a shareholder entitled to share in the profit of the business but that plaintiff had merely "bought himself a job." DeSimone acknowledged plaintiff's $50,000 capitalization of Cabo and his extraordinary hours of work supervising the operation of the restaurant. In fact, it was DeSimone who induced plaintiff to invest in Cabo, soliciting him to leave his employment in Manhattan to participate in the management of Cabo. For the duration of the trial, Ramunni and DeSimone have been represented by the same attorney and at no time has either defendant raised any allegations against the other. In the absence of any evidence that the two individual defendants did not collude in the diversion of cash and the manipulation of corporate records to disguise their defalcation, the court infers that defendants shared the diverted cash and that each participated in the effort to cheat plaintiff out of his share of the return on his investment.

Upon review of the testimony and documents introduced into evidence, the court finds that the preponderance of evidence{**46 Misc 3d at 695} established that significant sums of unreported cash were diverted from the corporation and the accountant was given false information to be included in the corporation's financial reports and tax returns. Although Ramunni was in primary control of cash receipts on a daily basis, DeSimone, who was also regularly present at the restaurant, consented to, and appears to have shared in, the diversion of assets. Both individual defendants were experienced

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restauranteurs, were regularly on the premises, and together controlled all aspects of the business. This court finds the defendants' contention that the restaurant was not profitable for almost 10 years to be incredible in light of the evidence of expansion and the revenue reflected in the server reports. The defendants' claim that the restaurant was losing money for 10 years and then suddenly doubled its revenue and turned a profit upon the departure of Cortes and the expansion of a back patio, is not credible. Moreover, the limited reliable financial data provided further discredits the defendants' contentions. Clearly, defendants breached their fiduciary duty to plaintiff as a minority shareholder by diverting profits to themselves, without disclosure to plaintiff, depriving him of his right to share therein.

However, although "[a] minority shareholder in a close corporation is owed a fiduciary duty by the majority shareholders" (*O'Neill*, 39 AD3d at 282; *see Gjuraj*, 110 AD3d at 541), "allegations of mismanagement or diversion of assets by officers or directors to their own [*19]enrichment, without more, plead a wrong to the corporation only, for which a shareholder may sue derivatively but not individually" (*Abrams v Donati*, 66 NY2d 951, 953 [1985]; *see Wolf v Rand*, 258 AD2d 401, 403 [1st Dept 1999] ["(e)ven where the corporation is closely held, and the defendants might share in the award, the claims belong to the corporation, and damages are awarded to the corporation rather than directly to the derivative plaintiff"]; *Yudell v Gilbert*, 99 AD3d 108, 114 [1st Dept 2012] ["(a)llegations of mismanagement or diversion of corporate assets also plead a wrong to the corporation"]; *Albany-Plattsburgh United Corp. v Bell*, 307 AD2d 416, 419 [3d Dept 2003], *lv dismissed and denied* 1 NY3d 620 [2004]; *Glenn v Hoteltron Sys.*, 74 NY2d 386, 392-393 [1989]). While a shareholder may have an individual cause of action "when the wrongdoer has breached a duty owed to the shareholder independent of any duty owing to the corporation wronged" (*Abrams*, 66 NY2d at 953), plaintiff Cortes has not alleged any breach of an independent duty owed to the plaintiff by the individual [**46 Misc 3d at 696] defendants separate from his claim that profits were diverted from the corporation (*see Herbert H. Post & Co. v Sidney Bitterman, Inc.*, 219 AD2d 214, 225 [1st Dept 1996]).[FN24] Accordingly, plaintiff's third cause of action for defendants' breach of fiduciary duty brought in his individual capacity must be dismissed.

Although plaintiff may not recover individually against the individual defendants for their breach of fiduciary duty in diverting the assets of the corporation to themselves, as a shareholder, plaintiff has established his derivative claim on behalf of 3A North Park for

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breach of fiduciary duty. Defendants argue that the plaintiff's derivative causes of action must be dismissed as the plaintiff did not demand that the board of directors of the corporation commence this action prior to bringing this action derivatively (*see* Business Corporation Law § 626 [c]). However, the complaint specifically stated that the individual defendants, who are the majority shareholders, were responsible for all of the actions that form the basis of the complaint and any request to bring the present action would have been futile. This court finds that any request for the individual defendants to commence the present action would have been futile and the plaintiff was not required to do so pursuant to Business Corporation Law § 626 (c) (*see Bansbach v Zinn*, 1 NY3d 1, 9 [2003]).

Accordingly, judgment is granted to 3A North Park upon the plaintiff's derivative eighth cause of action for breach of fiduciary duty (*see Abrams*, 66 NY2d at 953; *Wolf*, 258 AD2d at 403; *Yudell*, 99 AD3d at 114; *Albany-Plattsburgh United Corp.*, 307 AD2d at 419; *Glenn*, 74 NY2d at 392-393). However, although the court has found Garibaldi's calculations based upon the credit/cash ratio with respect to the projected revenue to be reliable, the court declines to [*20]adopt the "net income" identified in the plaintiff's expert report as the basis for the calculation of{**46 Misc 3d at 697} damages because it appears to equate the amount of projected profit ("net income") with the sums of cash diverted without taking into account the cash revenues that were deposited into the bank account. The court finds that the appropriate measure of damages for defendants' breach of fiduciary duty to the corporation is the difference between the actual revenue deposited and the projected total sales based upon the credit/cash ratio. Accordingly, the revenue diverted from the corporation, through June 12, 2011, is $3,719,407. This calculation was reached by subtracting the actual revenue deposited from the total sales as projected by Garibaldi in the plaintiff's expert report.[FN25]

Pursuant to CPLR 5001, the recovery of interest is appropriate in this action as the individual defendants failed to properly account for the corporation's revenue for a number of years, during which time they benefitted from the use of the corporation's funds (*see Sexter v Kimmelman, Sexter, Warmflash & Leitner*, 43 AD3d 790, 795 [1st Dept 2007], citing *Aurnou v Greenspan*, 161 AD2d 438, 440 [1st Dept 1990], *lv denied* 76 NY2d 713 [1990]; *Eighteen Holding Corp. v Drizin*, 268 AD2d 371 [1st Dept 2000]). While the court finds Garibaldi's calculation of interest, from the midpoint of each tax

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year, to be consistent with CPLR 5001 (b), Garibaldi calculated that interest based upon plaintiff's individual recovery of his 16.67% of net income through December 1, 2013. Therefore, as the court is awarding a derivative judgment based on diverted revenue only through June 12, 2011, and as revenue was diverted on various dates over multiple years, pursuant to CPLR 5001 (b), a reasonable intermediate date between December 1, 2003 and June 12, 2011, October 1, 2007, appears to be more appropriate[FN26] (*see Hayden v P. Zarkadas, P.C.*, 18 AD3d 500, 501 [2d Dept 2005]; *Andersen v* [**46 Misc 3d at 698] *Weinroth*, 13 Misc 3d 1204[A], 2006 NY Slip Op 51681[U] [Sup Ct, NY County 2006]). Accordingly, the interest on the diverted revenue, calculated from October 1, 2007 to June 12, 2011, is $1,238,104.05.[FN27] Judgment shall enter on [*21]plaintiff's derivative cause of action in favor of 3A North Park for $4,957,511, with interest from June 13, 2011 to the date of entry.

Declaration of a Dividend

Plaintiff's fifth cause of action against all defendants seeks the declaration of a dividend. Both Lipke and the individual defendants testified that no dividend has ever been declared by 3A North Park. This evidence is undisputed. In addition, the records of the corporation, while perhaps fraudulent, do not reveal any earnings from which a dividend might have been paid. It is long-established that "[a] stockholder may not maintain an action against a corporation to recover a dividend until one has been declared" (*Godley v Crandall & Godley Co.*, 212 NY 121, 128 [1914]; *see also Jones v Van Heusen Charles Co.*, 230 App Div 694, 696 [3d Dept 1930]; *Giacopelli v Guiducci*, 2007 NY Slip Op 30893[U] [Sup Ct, Queens County 2007]). The rule does not preclude, however, recovery against individual directors who are guilty of fraud, breach of fiduciary duty and bad faith (*id.*), however, such relief has been sought and effectively granted under plaintiff's eighth cause of action. Accordingly, the fifth cause of action is dismissed.

Common-Law Dissolution

[3] Plaintiff's seventh cause of action seeks common-law dissolution of the corporation. "[T]he remedy of common-law dissolution is available *only* to minority shareholders who accuse the majority shareholders and/or the corporate officers or directors of looting the corporation and violating their fiduciary duty" (*Matter of Sternberg [Osman]*, 181 AD2d 897, 897-898 [2d Dept 1992], *motion for lv dismissed* 80

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NY2d 892 [1992]). These grounds parallel, to some degree, the statutory grounds for judicial dissolution set forth in Business Corporation Law § 1104-a, which is unavailable to plaintiff because he does not{**46 Misc 3d at 699} reach the threshold criteria of owning at least 20% of the corporation. However, the equitable remedy of judicial dissolution at common law remains available where

> "the shareholders in control have been looting the company's assets at the expense of the minority shareholders, 'continuing the corporation's existence . . . for the sole purpose of benefitting those in control,' and have sought 'to force and coerce [the minority shareholders] to sell and sacrifice their holdings to those in control' " (Ferolito v Vultaggio, 99 AD3d 19, 28 [1st Dept 2012], quoting *Leibert v Clapp*, 13 NY2d 313, 315-316 [1963]).

As explained by the Court of Appeals in *Matter of Kemp & Beatley (Gardstein)* (64 NY2d 63 [1984]), historically,

> "[m]inority shareholders were granted standing in the absence of statutory authority to seek dissolution of corporations when controlling shareholders engaged in certain egregious conduct . . . . Predicated on the majority shareholders' fiduciary obligation to treat all shareholders fairly and equally, to preserve corporate assets, and to fulfill their responsibilities of corporate management with 'scrupulous good faith', the courts' equitable power can be invoked when 'it appears that the directors and majority shareholders "have so palpably breached the fiduciary duty they owe to the minority shareholders that they are disqualified from exercising the exclusive discretion and the dissolution power given to them by statute" ' " (64 NY2d at 69-70 [citations omitted], quoting *Leibert*, at 317).

As the plaintiff has proved that the individual defendants have breached their duty to him as a minority shareholder by looting the corporation of its profits in violation of their fiduciary duty to the corporation, even going so far [*22]as to seek to compel his transfer to them of his entire interest for no more than his original investment, offering no consideration for the value of his share of the corporation, plaintiff has established his right to common-law dissolution.

Whether it is necessary to actually dissolve the corporation in order to redress plaintiff's grievances is, however, a matter to be considered independently once grounds for dissolution have been established (*cf. Leibert*, 13 NY2d at 318). Business Corporation Law § 1104-a (b) (1) directs the court, in analogous circumstances of a 20% shareholder

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action for dissolution based upon{**46 Misc 3d at 700} grounds comparable to those established here, to consider "whether liquidation of the corporation is the only feasible means whereby the petitioners may reasonably expect to obtain a fair return on their investment." Whereas judicial dissolution is an equitable remedy, the court has substantial discretion in determining the appropriate relief. In many situations, "a buy-out of plaintiff's interest for fair value . . . is the more appropriate remedy" (*Gjuraj v Uplift El. Corp.*, 110 AD3d 540, 542 [1st Dept 2013]; *see also Mizrahi v Cohen*, 104 AD3d 917, 920 [2d Dept 2013] ["in certain circumstances, a buyout may be an appropriate equitable remedy upon the dissolution of an LLC"]). In this case, in his sixth cause of action, plaintiff seeks just such relief and, in their dismissed third counterclaim, defendants sought to enforce a contract to purchase plaintiff's shares, albeit not at fair value. Clearly, the parties do not wish to continue their association in this highly profitable business, but liquidation, in order to recompense plaintiff for the injustices visited upon him by defendants, is not warranted unless defendants fail to buy him out at fair value.[FN28]

Pursuant to Business Corporation Law § 1118, in a proceeding pursuant to Business Corporation Law § 1104-a, any shareholder, or the corporation itself, may elect to purchase the petitioner's share in order to avoid dissolution and liquidation. Under the statute, upon such election, the dissolution proceeding is stayed so that the court may determine the fair value of the petitioner's shares "as of the day prior to the date on which such petition was filed . . . giving effect to any adjustment or surcharge found to be appropriate . . . under section 1104-a" (Business Corporation Law § 1118 [b]). This rule appears to be equally applicable to common-law dissolution (*see Robinson v Plaro Estates, Inc.*, 119 AD3d 542, 545 [2d Dept 2014]).

Two different methods for determining the value of the business were described in expert testimony at trial. Plaintiff's expert, Garibaldi, applied the net income method using his own projection of net income for the last full fiscal year of the corporation ending July 31, 2012, and multiplying by a factor of three and five to produce a range he testified is appropriate{**46 Misc 3d at 701} based upon professionally-accepted standards.[FN29] Defendants' expert, Cannon, based his determination of the [*23]value on the gross sales method and relied upon the information as reported by the restaurant's accountant, Lipke. Cannon's expert report noted that in order for his valuation to be accurate, he must have reliable data regarding the gross sales. As heretofore noted, since Lipke's affidavit

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regarding gross sales for November 1, 2010 through October 31, 2013, upon which Cannon relied, is completely unreliable in that the restaurant received a large percentage of its revenue in unreported cash and Lipke's report of revenue was premised entirely on Ramunni's verbal undocumented representations of cash, Cannon's valuation of the corporation is rejected as unreliable. Moreover, Cannon himself indicated that his conclusion was merely "phase one" of a more complex analysis that was never completed.

While the court finds Garibaldi's valuation method to be more accurate in the circumstances, Garibaldi does not address whether the marketability of the plaintiff's shares affect their value. Cannon testified that minority shares in a restaurant that do not give decision-making authority to the holder, are significantly less marketable and require a discount of 35 to 50% in order to attract a buyer. The application of such a "minority discount" based on lack of control has been expressly rejected in this State (*see Matter of Penepent Corp.*, 96 NY2d 186, 194 [2001]; *Matter of Murphy v United States Dredging Corp.*, 74 AD3d 815, 818 [2d Dept 2010]), but the lack of general marketability of shares in a closely held corporation is recognized to be a factor to be considered in valuing such shares (*see Murphy* at 818 [approving a discount of 15% for lack of marketability]). As no evidence was offered as to a discount specifically applicable to plaintiff's shares in this, apparently highly profitable, closely held corporation, the court will apply only a 10% discount for lack of marketability (*see Matter of Raskin v Walter Karl, Inc.*, 129 AD2d 642, 644 [2d Dept 1987]; *Matter of Blake v Blake Agency*, 107 AD2d 139, 149-150 [2d Dept 1985]).{**46 Misc 3d at 702}

Unfortunately, neither expert offered an estimate of the corporation's value on the valuation date, June 12, 2011, the date prior to the filing of the complaint (*see Murphy* at 817). It is therefore necessary to compute the value of the corporation on June 12, 2011, from the calculations supplied by Garibaldi of net income (profit) for the fiscal year 2010 ending July 31, 2011, as modified by eliminating the last two months and substituting the months of July and August from the prior year, so as to determine the net income for the year prior to commencement of suit. Using Garibaldi's computations in which he deducted expenses, as reported in the tax return, from the estimated total revenue, as derived by applying the credit/cash ratio to the total credit deposits contained in the bank statements, a net income for the year of $1,072,059 is determined. In accord with Garibaldi's testimony that the value of the business is equal to three to five times the net income for

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the preceding year, the court has multiplied $1,072,059 by 3,[FN30] to yield a base valuation of $3,216,177.

In *Matter of Exterior Delite, Inc.* (14 Misc 3d 910 [Sup Ct, Bronx County 2006]), in an action closely analogous to the case at bar in which claims of misappropriation of corporate funds were interposed in a proceeding seeking dissolution of the corporations pursuant to Business Corporation Law § 1104-a, the court rejected the finding of a referee that the evidence of diversion of [*24]assets should be disregarded in the valuation of the corporation for purposes of a buyout pursuant to Business Corporation Law § 1118, noting that "the alleged wrongdoing of misappropriation of corporate assets may play a role in the valuation determination [and is] relevant if [such misconduct] has had an adverse impact upon the corporation's value" (*id.* at 915). The court relied upon the language of Business Corporation Law § 1104-a (d), authorizing an adjustment to stock value upon a finding of wilful or reckless dissipation of assets, and the language of Business Corporation Law § 1118, directing that any such finding be given effect in determining the value of shares, concluding that a derivative action for misappropriation of assets is "intertwined with the determination of 'fair value' of petitioner's shares" (*id.* at 916, quoting *Matter of Tosca Brick Oven Bread [Lubena]*, 243 AD2d 416, 416 [1st Dept 1997]; *see also Matter of Gerzof v Coons*, 168 AD2d 619, 620 [2d Dept 1990]{**46 Misc 3d at 703} [finding the standard for determining fair value in the context of a Business Corporation Law § 1118 election is flexible and that misconduct that has had an adverse impact on the value of the corporation as an operating business may be considered]; *Edmonds v Amnews Corp.*, 224 AD2d 358 [1st Dept 1996] [issues raised in derivative action may affect fair value and should be heard in tandem with dissolution]). This court concurs in the *Exterior Delite* court's analysis and reasoning.

This court has determined that the individual defendants looted 3A North Park of cash over many years, depriving the corporation of its profits, and a judgment is to be entered for the sums diverted. That judgment is an asset of the corporation that should be added to the value calculated based upon the net income for a single year for the purpose of assessing the fair value of plaintiff's shares. Accordingly, upon the addition of $4,957,511 (the judgment for 3A North Park), to $3,216,177, the court finds the fair value of 3A North Park on June 12, 2011, to be $8,173,688. Plaintiff's 16.67% interest is, accordingly, valued at $1,362,554, less 10% as a discount for limited marketability

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($136,255), for a total fair value of $1,226,299. As required by law, this sum, less a credit of $25,000 acknowledged to have been received by plaintiff in cash, shall accrue interest from June 12, 2011, to the date of payment, at the statutory rate of 9% per annum (*see Matter of Blake*, 107 AD2d at 150). As defendants have indicated an interest in buying plaintiff's shares to avoid dissolution, and such forced buyout appears to be the preferable alternative to dissolution (*see Matter of Kemp & Beatley*, 64 NY2d at 73-75; *Gjuraj*, 110 AD3d at 542; *Mizrahi v Cohen*, 104 AD3d 917, 920 [2d Dept 2013]; *cf. Fedele v Seybert*, 250 AD2d 519, 521 [1st Dept 1998], citing to the Business Corporation Law § 1104-a mandate to consider whether liquidation is "only feasible means" to protect the interest of petitioner), the purchase of plaintiff's shares at the above price shall be closed within 90 days hereof, or as agreed between the parties. However, upon notice to this court that no purchase is anticipated, dissolution will be granted and a liquidating trustee will be appointed by the court.

Constructive Trust

Plaintiff's tenth cause of action seeks the imposition of a constructive trust, on behalf of the corporation, "over the money, property and assets of Ramunni and DeSimone and business entities to which they have diverted such funds." "A constructive trust is an equitable remedy, and may be imposed{**46 Misc 3d at 704} [w]hen property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest" (*Rowe v Kingston*, 94 AD3d 852, 853 [2d Dept 2012] [internal quotation marks and citation omitted]; *see LMT Capital Mgt., LLC v Gerardi*, 97 AD3d 546 [2d Dept 2012]). "The elements of a cause of action to impose a constructive trust are (1) the existence of a confidential or fiduciary relationship, (2) a promise, (3) a transfer in reliance thereon, and (4) unjust enrichment" (*Quadrozzi v Estate of Quadrozzi*, 99 AD3d 688, 691 [2d Dept 2012], citing *Sharp v Kosmalski*, 40 NY2d 119, 121 [1976]; *Rowe*, 94 AD3d at 853; *Poupis v Brown*, 90 AD3d 881, 882 [2d Dept 2011]). Although Ramunni and DeSimone are deemed to have had a fiduciary relationship to 3A North Park, there is no evidence of any specific promise made by them or of any reliance by the corporation thereon so as to justify imposition of a constructive trust. Moreover, no property was identified at trial that was purchased with diverted funds, nor was there any proof that other businesses owned by defendants were the recipient of the diverted funds (*see Ali v Ahmad*, 24 AD3d 475, 476 [2d Dept 2005]; *Pizzurro v Pasquino*, 201 AD2d

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635, 636 [2d Dept 1994]). Plaintiff failed, therefore, to prove any basis to impose a constructive trust. Further, "[a]s an equitable remedy, a constructive trust should not be imposed unless it is demonstrated that a legal remedy is inadequate" (*Bertoni v Catucci*, 117 AD2d 892, 895 [3d Dept 1986]; *Evans v Winston & Strawn*, 303 AD2d 331, 333 [1st Dept 2003]). As plaintiff has not demonstrated that the legal remedy of a money judgment for damages will be inadequate, a constructive trust cannot be imposed over the assets of Ramunni and DeSimone (*see id.*). Accordingly, the tenth cause of action is dismissed.

Conclusion Based upon Garibaldi's valuation using the estimated net income for the year preceding the filing of the complaint, the court finds that the fair value of the corporation on June 12, 2011 is $8,173,688, inclusive of the corporation's derivative judgment against the individual defendants. Taking into account the 10% discount for diminished marketability, this court values the plaintiff's interest in the corporation at $1,226,299. Deducting the $25,000 credit for prior cash payments to plaintiff, defendants are directed to buy out plaintiff's shares for $1,201,299, plus 9% interest from June 12, 2011 to the date of purchase, within 90 days of the date of this decision and order.{**46 Misc 3d at 705} The parties may extend the date of purchase, or modify the terms of sale, upon written stipulation signed by the parties personally, in addition to counsel, and filed with this court. It is further, ordered, that a judgment in the sum of $4,957,511 shall enter in favor of 3A North Park Avenue Restaurant Corp. against defendants Ramunni and DeSimone upon plaintiff's eighth derivative cause of action. And it is further, ordered, plaintiff's third, fifth and tenth causes of action are dismissed. And it is further, ordered, that the proceeding for common-law dissolution, as alleged in the seventh cause of action, is stayed pending compliance with the above direction for a buyout. And it is further ordered, that the relief demanded in the sixth cause of action, seeking a purchase at fair value, is granted to the extent directed above.

Footnotes

Footnote 1:The agreement was executed by Ramunni as seller, without designation as an officer or representative of the corporation. The language referencing the seller's "principals" suggests, however, that the corporation was meant to have the option to repurchase plaintiff's shares. The agreement also makes reference to the relationship of the parties as a partnership.

Footnote 2:Presumably, by this time, plaintiff's demands for an accounting were moot as discovery had been completed.

Footnote 3:Server reports are generated through a computerized ordering system in which

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the individual waiter or bartender inputs the data regarding the menu items purchased by each patron. Plaintiff called Tim Moran of Microsun Corporation, who has been employed by Cabo since January 2004 to provide the "point of sale" system designed "to assist restaurant owners to control their business and to just make sure that all the profits that they can get out of the business [are obtained]" (tr of May 13, 2014 at 23). Moran had visited Cabo approximately 50 times over the years. From the data entered by the individual server, the computer generates daily "server reports" for each server summarizing the amount and form of payment, whether cash or credit card, the tax and tips, and the amount of alcohol and food charges. In addition to server reports, the system is capable of generating other reports, including a breakdown of the specific food and drink items ordered so as to facilitate inventory monitoring and purchasing. Mr. Moran testified that the data is normally stored, and is retrievable, for one year (365 days) and cannot be altered or amended. It is inconceivable that the individual defendants, experienced restauranteurs, were unaware of the significance of the server reports and did not recognize that they constituted electronically stored information called for in the document demands.

Footnote 4:Other testimony and the records indicate that the restaurant commenced doing business in November 2003.

Footnote 5:The collection of server reports was incomplete, even for this limited time period. According to plaintiff's counsel, and uncontested by the defendants, two months of reports were missing and, in any given month, reports from certain days were missing.

Footnote 6:Each server report contains numerous pieces of information about the server's shift including, for example, a break down of the number of guests, checks, types of credit cards, and the amount of cash designated as server tips.

Footnote 7:There was no evidence of the fees deducted from the deposit of credit card charges, but, if anything, such deductions would reduce the total amount of such deposits such that the total amount of cash projected based on the ratio of credit to cash would be reduced.

Footnote 8:Some of the charts contained within the plaintiff's expert report were actually created within plaintiff's counsel's office, but Garibaldi testified that he had personally verified all of the entries from the documents in his possession and the court admitted the report over defendants' objection.

Footnote 9:The server reports do not identify what percentage of a customer's credit card payment was intended as a tip. Garibaldi assumed an 18% tip level, instead of the "conventional 15%," noting that he believed this to be a conservative estimate that effectively lowered the estimate of the corporation's profits.

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Footnote 10:Of the 11 days, there were two Sundays, one Monday, three Tuesdays, two Wednesdays, one Friday, and two Saturdays. One of the Tuesdays was Valentine's Day and another Tuesday was Eid al-Fitr, an Islamic holiday.

Footnote 11:If a judgment against the corporation of $1,692,263 (inclusive of interest at 9%) were awarded in plaintiff's favor for lost profits, creating a liability of the corporation, Garibaldi estimated the value of the business to be between $1,586,881 and $3,772,997, reducing plaintiff's 16.67% interest in the corporation to between $264,533 and $628,955.

Footnote 12:Cannon's report makes reference to several documents he used in formulating his opinion as to the value of Cabo as a business, including the sales summary, but defendants did not provide these documents in their trial exhibits even though they were part of the defendants' expert report. However, plaintiff did supply these documents in his trial binder of exhibits and did not oppose the admission into evidence of the defendants' expert report.

Footnote 13:Twelve times $202,421.70 equals $2,429,060.40.

Footnote 14:There has been no testimony or allegation that the corporation's expenses were underreported. Defendants stipulated that the expenses reported in the tax returns for 3A North Park were accurate and offered no evidence of actual expenses to controvert the records relied upon by Garibaldi.

Footnote 15:Garibaldi's expert report also contains an analysis of projected revenue calculated on a rent-based formula, as applied by the New York State Department of Taxation. The general formula assumes the average restaurant spends 8.5% of its revenue on rent and calculates sales by multiplying the rent by a factor of 11.76. Garibaldi rejected the reliability of applying this formula to Cabo because Cabo is open longer hours than most restaurants, offers takeout, has two bars in which sales per unit area and per dollar in rent are higher and has a "second life" as a nightclub on Fridays and Saturdays. A review of the server reports introduced at trial reveals that on Friday and Saturday, days with particularly high cash to credit card ratios, the cash sales were predominantly for alcohol in shifts ending after 3 a.m. It is noted that the server reports for such shifts also reveal higher overall total sales than on weekdays, thus corroborating Garibaldi's explanation as to why Cabo's credit/cash ratio may be atypical for a restaurant.

Footnote 16:In his report, Cannon listed authorities that had been supplied to him by his staff "that spoke towards evaluating of a restaurant." Cannon testified that he was otherwise unfamiliar with the sources and had "considered" them but did not "necessarily use all of the pieces of them" (tr of June 3, 2014 at 27).

Footnote 17:Cannon testified that, in order to obtain verification of his assessment, he had

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"reached out" to business brokers in New York State and had provided to Kenneth Lief, a business broker located in Valley Stream, Long Island, the same data he had used without identifying the name of the restaurant. According to Cannon, Lief gave a value of $460,000. Although the court appreciates Cannon's candor in acknowledging his own limitations, such hearsay testimony is neither admissible nor probative and is disregarded by this court.

Footnote 18:It is noted that, other than the parties to the action, no independent witness was produced to corroborate any of defendants' accusations that plaintiff was "falling down drunk" on the premises or that customers had complained, indicating that they would no longer patronize the restaurant.

Footnote 19:The server reports, introduced into evidence, included three dates after a fire occurred in the kitchen of the restaurant. According to the testimony at trial, business was dramatically reduced in the months immediately following the fire while repairs were being made. Those dates were therefore not included in making this comparison.

Footnote 20:In this court's summary judgment decision in this action, it was noted that the New York State Department of Taxation and Finance concluded that the corporation understated its revenues by $755,600.23 for the period from June 2006 to February 2009 (*Cortes v 3A North Park Ave. Rest. Corp.*, Sup Ct, Kings County, June 28, 2013, Demarest, J., index No. 013396/2011).

Footnote 21:Ramunni testified that the estimated server tip rate at the restaurant was closer to 15%. As noted, supra, Garibaldi's use of 18% would only reduce the amount of projected cash diversion, to defendants' benefit.

Footnote 22:In fact, when the total yearly payments by checks are computed from the bank statements for the fiscal years ending in 2009 and 2010, the total sum of expenses actually exceed the total expenses reported in the financial statements for those years.

Footnote 23:It is further noted that Garibaldi's "adjustment" of the credit card deposits, by deducting the taxes and 18% for tips, also had the effect of deflating the basis for determining the amount of cash actually received using the credit/cash ratio.

Footnote 24:*Collins v Telcoa Intl. Corp.* (283 AD2d 128 [2d Dept 2001]), cited by plaintiff, is distinguishable from the situation at bar in that, in *Collins*, the controlling shareholders sold substantially all of the assets of the corporation over the 5% shareholder's objection and without giving him proper statutory notice, in breach of their fiduciary duty owed directly to the plaintiff. The court found that because, rather than seeking appraisal of his shares pursuant to Business Corporation Law § 623, plaintiff sought common-law dissolution for defendants' acts of oppressive conduct in diluting the value of his shares and absconding with plaintiff's share of the profits from the sale of the

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assets, plaintiff was entitled to seek damages directly from the defendants for their breach of duty to him personally. Losses to the corporation were not at issue.

Footnote 25:The total sales projected by Garibaldi, from 2003 through the period of the June 2011 bank statement (ending June 8, 2011), was $11,246,703.23 after adjusting for tips and taxes. The total actual deposits as reflected in all the bank statements for the same period, as reported in the plaintiff's expert report, was $7,527,296.

Footnote 26:November 2003 is the first month with reported revenue for the corporation and the complaint was filed on June 13, 2011. While Garibaldi calculated the sums diverted through 2013, and there is some probability that cash continued to be diverted after this action was commenced, the sales summary provided for the end of December 2012 into January 2013 is likely to accurately reflect revenues for that period and it is improbable that defendants would have continued to divert cash in the magnitude of the sums projected by Garibaldi once litigation became active and plaintiff had access to the server reports. Moreover, the probability of recovery of the diverted sums from defendants, by the corporation, now to be exclusively controlled by defendants, is remote at best. The court has, therefore, determined, in its discretion, to award interest only from October 1, 2007, upon damages sustained through June 12, 2011.

Footnote 27:The yearly interest on the diverted revenue is $334,746.65 ($3,719,407.23 x 9%). That interest is divided by 365 days to determine that the daily interest is $917.11. This is multiplied by 1,350 days, the duration of time between October 1, 2007 and June 12, 2011, and this equals $1,238,104.05.

Footnote 28:It is noted that both plaintiff and defendants agree that, should the court find grounds to order dissolution analogous to the standard set forth in Business Corporation Law § 1104-a, Business Corporation Law § 1118 should also be implemented to permit a buyout of the minority interest.

Footnote 29:Garibaldi used his credit/cash ratio-based projection of actual revenue to estimate the recovery to which plaintiff would be entitled if he were granted judgment on his personal claims for a share of the profits over the nine years he has owned his shares. Thus, he calculated net profit for each year, took 16.67%, representing plaintiff's interest, and calculated interest through 2013. The court has not adopted such figures in light of the dismissal of the third and seventh causes of action seeking direct personal recovery of a share of projected profits.

Footnote 30:The court has chosen to use the lower multiple here to compensate for the addition of the judgment awarded to 3A North Park, which includes the projected diverted funds for the same period of time.

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13 N.Y.2d 313 (1963)

Kenneth V. Leibert, Appellant,

v.

Roger T. Clapp et al., Respondents.

Court of Appeals of the State of New York.

Argued October 31, 1963.
Decided December 30, 1963.

Gustave B. Garfield for appellant.

Frank A. Fritz, Jr., for respondents.

Chief Judge DESMOND and Judges DYE and SCILEPPI concur with Judge FULD; Judge VAN VOORHIS dissents in an opinion in which Judges BURKE and FOSTER concur.

315 *315FULD, J.

The plaintiff, a minority stockholder of Automatic Fire Alarm Company (of New York) — referred to as AFANY — sues on behalf of himself and all other minority stockholders similarly situated to compel the directors of that corporation to bring proceedings to effect its dissolution. The defendants moved to dismiss the amended complaint on the ground that it fails to state a cause of action (Rules Civ. Prac., rule 106 [CPLR 3211, subd. (a), par. 7]). The court at Special Term denied the motion but, on appeal, the Appellate Division reversed, granted the motion and dismissed the complaint, stating in part that "the factual allegations * * * are insufficient to establish a cause of action." We reach a different conclusion.

Although there is no explicit statutory authority for the relief of dissolution sought in this action, the entire court is agreed that it is available as a matter of judicial sponsorship. (See, e.g., *Gaines v. Adler*, 15 A D 2d 743; *Gross v. Price*, 284 App. Div. 964; *Fontheim v. Walker*, 282 App. Div. 373, 376 *et seq.*, affd. 306 N.Y. 926; *Lennan v. Blakeley*, 273 App. Div. 767; *Kroger v. Jaburg*, 231 App. Div. 641, 643 *et seq.*; *Drob v. National Mem. Park*, 28 Del. Ch. 254, 270; see, also, Hornstein, A Remedy for Corporate Abuse, 40 Col. L. Rev. 220, 221 *et seq.*; Hoffman, New Horizons for the Close Corporation, 28 Brooklyn L. Rev. 1, 13-14.) We differ only as to whether the allegations of the complaint before us, if proved, would warrant such judicial intervention.

No purpose is to be served by a detailed analysis of the contents of the complaint. It is enough to note that in our view it does recite, in sufficient factual detail (see *Abrams v. Allen*, 297 N.Y. 52; *Kalmanash v. Smith*, 291 N.Y. 142, 156-157; *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N.Y. 185, 197-198; see, also, CPLR 3013, 3014; 3 Weinstein, Korn & Miller, N. Y. Civ. Prac., p. 30-141 *et seq.*, p. 30-159 *et seq.*), that the directors and others in control of AFANY are and for many years past have been "looting" its assets, thereby enriching themselves at the expense of the minority stockholders, and continuing the corporation's "existence * * * for the sole purpose

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of benefitting those in control * * * at the expense of [such] minority stockholders and to force
316 and coerce [them] to sell and *316 sacrifice their holdings" to those in control of the corporation.[1] Such charges, if established upon a trial, will, as the authorities cited above demonstrate, furnish a basis for the relief requested by the plaintiff. It is certainly no bar to the grant of such relief that the corporation may be operating profitably (cf. Business Corporation Law, § 1111, subd. [b], par. [3]) or that the plaintiff might have sought relief from some of the numerous acts of oppression and wrongdoing in fragmented actions by way of stockholders' derivative suits or otherwise.

While it is quite true, as stated in the *Fontheim* case (282 App. Div. 373, 375, affd. 306 N.Y. 926, *supra*), that "More is * * * required to sustain such an action [as the present] than is required to sustain a derivative stockholders' action for waste", it is evident that much more is here alleged than is demanded for a derivative suit. As is apparent, the charges leveled against the directors and those in control of AFANY — that they are continuing the existence of the corporation solely for their own benefit at the expense of the minority shareholders, to force such shareholders to sell their holdings to them at a sacrifice and to freeze them out of the corporation — go far beyond charges of waste, misappropriation and illegal accumulations of surplus, which might be cured by a derivative action for injunctive relief and an accounting. (See *Fontheim v. Walker,* 282 App. Div. 373, 375-376, affd. 306 N.Y. 926, *supra*.)

The Legislature has constituted the directors and majority shareholders guardians of the corporate welfare, arbiters, as it were, of whether corporate dissolution is desirable under particular circumstances which have arisen and whether such dissolution is in the best interests of all the shareholders (cf. Business Corporation Law, § 1103). It is not the interests of the majority stockholders alone which determine the desirability or need for dissolution. Settled beyond peradventure is the proposition that, in cases such as this, directors and shareholder
317 *317 majorities — constituted, as we have said, guardians of the corporate welfare — are cast in the role of fiduciaries and must exercise their responsibilities as such with scrupulous good faith. (See *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N.Y. 185, 196, *supra*; *Ripley v. International Rys. of Cent. America*, 8 N Y 2d 430, 436.) Accepting the allegations of the complaint as true, as we must at this stage of the litigation, it appears that the directors and majority shareholders "have so palpably breached the fiduciary duty they owe to the minority shareholders that they are disqualified from exercising the exclusive discretion and the dissolution power given to them by statute." (Hoffman, New Horizons for the Close Corporation, 28 Brooklyn L. Rev. 1, 14.) The court should act to fill the decisional vacuum created by this disqualification.

In light of the serious charges of persistent corporate abuses by the directors and the majority shareholders, it would be inadequate and, therefore, inappropriate to remit the minority shareholders to the exclusive remedy of a derivative suit. The thrust of the complaint is, in effect, that the directors and the majority are refusing to dissolve the corporation for the very purpose of continuing their corporate depredations at the expense of the minority. AFANY is one of a complex of corporations, headed by defendant Grinnell Corporation, and it is alleged, *inter alia*, that the primary, if not the sole, purpose of preserving AFANY's separate existence is to effect an unlawful diversion of large portions of its earnings to its parent corporation and other

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members of the group. If this and the other allegations of misconduct be established, it follows that to restrict the minority shareholders to a derivative suit would be to commit them to a multiplicity of costly, time-consuming and difficult actions with the result, at most, of curing the misconduct of the past while leaving the basic improprieties unremedied. It is the traditional office of equity to forestall the possibility of such harassment and injustice.

The argument that to sanction a suit such as the present one permits the plaintiff to escape the requirements imposed by statute upon minority shareholders who bring derivative actions (General Corporation Law, § 61-b, now Business Corporation Law, § 627) diverts us from the question posed by this appeal, namely, the legal sufficiency of the complaint. The Legislature
318 *318 has decided as a matter of policy that in a derivative action the plaintiff may be required to post security for expenses unless his shareholdings are substantial. The Legislature has not, however, chosen to impose a similar requirement for the maintenance of any other type of action. Once, therefore, it be decided that a complaint states a cause of action not derivative in character, it follows that the plaintiff is privileged to maintain the action without posting security, no matter how small his holdings. Accordingly, where, as here, a cause of action is properly alleged to compel a dissolution, a cause concededly not derivative, the court has no alternative but to sustain the complaint.

It is hardly necessary to add that whether the plaintiff will be able to prove his allegations is a question which must necessarily await a trial, as is also the further question whether, if the plaintiff does prove those allegations, the court should grant either the relief of dissolution which the plaintiff seeks or, alternatively, such other relief as might seem more appropriate once the actual facts and circumstances are ascertained. All that we are now deciding is that the complaint states a cause of action which would, in a proper case, enable the court to grant the remedy of dissolution which the plaintiff requests.

The judgment appealed from should be reversed, with costs in this court and in the Appellate Division, and the defendants' motion to dismiss the amended complaint denied.

VAN VOORHIS, J. (dissenting).

None of the decisions cited in the majority opinion or in the briefs supports a reversal of the judgment entered upon the order of the unanimous Appellate Division, holding this amended complaint to be insufficient in law. The action is patently an attempt by a shareholder, holding an infinitesimally small proportion of the outstanding shares, to evade the public policy expressed by the Legislature in the enactment of section 61-b of the General Corporation Law, and analyzed by this court in no uncertain terms in *Lapchak v. Baker* (298 N.Y. 89), without pretending to comply with the requirements of that section, prompted by the multitude of minority stockholder suits at the instance of shareholders owning no substantial interest in the enterprise. The endeavor here is to escape the requirements of that section by changing the label on an action for waste or misappropriation against directors or majority shareholders. Such an action,
319 like an *319 action to compel the declaration of increased dividends, is derivative rather than representative (*Gordon v. Elliman*, 306 N.Y. 456).[1] It has to comply with section 61-b of the

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General Corporation Law. But if, instead, so the reasoning goes, it can be cast in the form of an action by minority shareholders to compel the dissolution of a corporation, then everything which could be done in a representative action for waste, misappropriation or to compel the declaration of larger dividends could be accomplished as in a representative action without being subject to the limitations prescribed by the Legislature in section 61-b of the General Corporation Law. Even before the enactment of that section, this court had made it clear that in a minority stockholders' suit allegations of waste, misappropriation and the like, however highly colored by the multiplication of adjectives, were to be regarded as conclusions of law and of no effect in a complaint. This was applied to allegations such as those charging the purchase or sale of assets at far above or below market value, or the sale of shares at prices below actual value (Kalmanash v. Smith, 291 N.Y. 142). This rule was adopted having in mind the ease with which such lurid characterizations can be fashioned in a complant, in actions the main object of which is to establish a nuisance value. The *Kalmanash* case, and others such as *Eighteen Fulton St. Corp. v. Appel* (272 App. Div. 602, 603) which have followed in its train, certainly brand as mere conclusions of law such allegations as are contained in this amended complaint charging defendants with "looting the assets of AFANY, thereby enriching Grinnell Corporation, AFADEL and another of the subsidiaries of Grinnell Corporation, to wit ADT and thereby enriching themselves at the expense of the minority stockholders", or that: "The existence of AFANY is being continued for the sole purpose of benefitting those in control of AFANY, i.e., Grinnell Corporation and its subsidiaries, at the expense of the minority stockholders and to force and coerce the said minority stockholders to sell and sacrifice their holdings to Grinnell Corporation or its subsidiaries."

The importance of these conclusory allegations is that they are essential if the complaint be
320 deemed to be sufficient to allege *320 a cause of action for compulsory dissolution at the instance of minority shareholders under the existing New York law. That law was accurately stated in the memorandum of the Appellate Division in this case in saying that the allegations of this amended complaint are insufficient in law in that "They fail to show that the capital of the corporation was impaired by the majority of the corporation looting the assets and thereby enriching themselves at the expense of the minority, or that the existence of the corporation is being continued for the sole purpose of benefiting those in control, at the expense of the other stockholders (Gross v. Price, 284 App. Div. 964; Aliotta v. Samperisi, 2 A D 2d 901)." We recognize that there are factual allegations in other portions of the complaint which would be sufficient to sustain a cause of action for waste or misappropriation, but the action is not brought for that relief. It is conceded that the corporate enterprise is highly profitable, and that there is no impairment of capital, and the amended complaint can be sustained only, as an action for compulsory dissolution by minority shareholders, on the conclusory allegation quoted in the majority opinion, that this corporation is being continued for the sole purpose of benefiting those in control. Allegations of facts showing waste and misappropriation are not enough to sustain an action of this kind for compulsory dissolution, nor even allegations that might be appropriate in an action to compel the declaration and payment of increased dividends. The distinction was well stated per PECK, P. J., at the Appellate Division in Fontheim v. Walker (282 App. Div. 373, 375, affd. without opinion 306 N.Y. 926) as follows: "A derivative stockholders' action seeks to

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benefit the corporation by restoring property to it or compensating it for losses suffered. Such an action is aimed at strengthening the corporation. An action for dissolution, however, the aim of which is to end the corporate life, cannot possibly benefit the corporation and can only be judged by a standard of whether it is more to the interest of the stockholders to end the corporation's life than it is to continue it."

This amended complaint admits that dividends of 60 cents per share have been paid on the common stock of this corporation. True enough, it alleges that larger dividends should have been paid, but it is inconceivable how the continuance of the corporation could be held to have
321 been for the sole purpose of benefiting *321 those in control, when all of the outstanding shares were receiving annual dividends of at least 60 cents per share.

The situation described in this amended complaint has none of the essential aspects of compulsory dissolution at the instance of a minority. This is not a case where a majority of the shareholders have applied for dissolution, nor where the stockholdings are equally divided so that a deadlock has arisen, or where dissolution is sought at the instance of creditors or at the instance of the public in an action by the Attorney-General, which are the only statutory instances of applications for dissolution (General Corporation Law, arts. 7, 9), nor do any facts alleged bring it within the case law upon the subject. This is a very drastic form of relief. It will certainly result in a multiplicity of suits if all that be necessary, without supplying security under section 61-b of the General Corporation Law, is for the owner of a single share or of 48 shares, as in this instance, to threaten the life and continued existence of a prosperous corporation by this kind of maneuver.

An analysis of the case law and of this pleading can lead, as it seems to us, to no other conclusion than that this amended complaint is insufficient. The memorandum decision of the Second Department says in the *Gross* case (*Gross v. Price*, 284 App. Div. 964, 965): "An action by a minority stockholder to compel directors to take proceedings to dissolve the corporation may not be maintained where it does not appear from factual allegations in the complaint that the capital of the corporation was impaired by the majority of the corporation looting the assets and thereby enriching themselves at the expense of the minority, or that the existence of the corporation is being continued for the sole purpose of benefiting those in control, at the expense of the other stockholders. (*Kroger v. Jaburg*, 231 App. Div. 641; *Fontheim v. Walker*, 282 App. Div. 373, affd. 306 N.Y. 926; *Lennan v. Blakeley*, 273 App. Div. 767.)"

In *Lennan v. Blakeley* (273 App. Div. 767) a complaint was sustained in an action by the minority to compel dissolution, for the reason that its factual allegations indicated that "the directors are continuing the existence of the corporation for the *sole* purpose of benefiting those in control of the corporation at the expense of the other stockholders", and that its continued existence could
322 reasonably be expected to benefit nobody else *322 (italics supplied). In the case of *Kroger v. Jaburg* (231 App. Div. 641), on which appellant here lays some stress, the complaint alleged not only that the business of the corporation was being conducted at a loss as a result of which its capital had been impaired, but also that the business of the corporation had become obsolete

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and could not be conducted at a profit by reason whereof the purpose and object of the corporation had failed.

All of the New York cases except the last cited were decided after the publication of the article in 1940 in 40 Columbia Law Review by George D. Hornstein, entitled: "A Remedy For Corporate Abuse — Judicial Power to Wind Up a Corporation at the Suit of a Minority Stockholder." The author of that article, on which appellant relies, reaches no conclusion that a corporation should be dissolved at the instance of minority stockholders merely for the reason that the directors have violated their fiduciary obligations by engaging in waste, misappropriation or refusal to declare and pay dividends. The principal plea of the author is against a rigid rule that merely for the reason that the statutory law contemplates dissolution only at the instance of majority stockholders, or where the stockholders are evenly divided concerning the management of the corporation, or at the instance of the public through an action by the Attorney-General, or at the instance of judgment creditors (General Corporation Law, arts. 7, 9), there can be no intervention by a court of equity under any other circumstances at the instance of minority stockholders. Professor Hornstein recognizes, as did our courts in the *Fontheim* case (*supra*), that the wrong must be done by the majority stockholders (40 Col. L. Rev. 225), that a minority stockholder should not be compelled "to continue risking his property in ventures not originally contemplated or to stand idly by until the assets are completely dissipated without any possibility of income" (*id.*). That is not this case, nor does Professor Hornstein go farther in essentials than the New York courts have gone in the cases cited in this or the majority opinion. Only three instances are enumerated by him where dissolution in such instances should be decreed, viz., where corporate functions have been abandoned, where the main objects or purposes of the corporation have failed, or where the stockholders or management fail to work together for the
323 common interest, "and the trouble is so deep-seated *323 as to make a profitable corporate life improbable" (p. 226). None of those situations applies here.

Unless the amended complaint in this action alleged facts sufficient to indicate that the capital of the corporation is impaired or that the existence of the corporation is being continued for the sole purpose of benefiting those in control, it fails to state a cause of action either under the reasoning of the Columbia Law Review article or under the New York decisions. The case of Gross v. Price (284 App. Div. 964, *supra*), cited in the Appellate Division's memorandum, affirmed (insofar as is here relevant) an order of the Nassau County Special Term, CHRIST, J., presiding. Justice CHRIST wrote an opinion (unofficially published at 127 N. Y. S. 2d 729, 734-735), stating cogent reasons applicable here on account of which it was held that the complaint failed to state a cause of action for dissolution at the instance of minority stockholders.

The only allegations in the amended complaint which are other than conclusory relate to a derivative action for waste and misappropriation, or possibly to compel the declaration and payment of larger dividends. Even as to the last, it would be extraordinary if it were enough even to sustain a cause of action for increased dividends to allege that a corporation is earning $3.50 per share annually but paying 60 cents per share dividends on the common stock. Nor does the additional fact help that the corporation has several millions of dollars in its treasury invested in government bonds. If royalties are being paid under expired patents, and part of the income siphoned off in other ways, that goes no farther than waste or misappropriation. Possible violations of the Sherman Anti-Trust Law or accumulations in violation of the Federal tax laws have nothing to do with a cause of action for dissolution unless the purposes of the corporation are frustrated or the minority shareholders totally excluded.

The judgment appealed from should be affirmed, with costs.

Judgment reversed, with costs in this court and in the Appellate Division, and the matter remitted to Special Term for further proceedings in accordance with the opinion herein.

[1] Even if it were to be assumed, for purposes of argument, that the allegations (quoted above from paragraph 10 of the amended complaint) are purely conclusory, dismissal of the pleading would not be justified since those allegations are buttressed by others, such as those in paragraphs 13, 14, 24, 26, 30 and 31, unquestionably factual, detailing the illegal activity of the defendants which the plaintiff asserts threatens both suppression of the minority and jeopardy to the corporation's future. In other words, as noted above, the complaint, read in its entirety, states a cause of action for dissolution.

[1] *Gordon v. Elliman* was overruled by sections 626 and 627 of the new Business Corporation Law as to actions to increase dividends.

Appleton Acquisition, LLC v National Hous. Partnership
2008 NY Slip Op 02462 [10 NY3d 250]
March 18, 2008
Graffeo, J.
Court of Appeals
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, May 7, 2008

[*1]

Appleton Acquisition, LLC, et al., Appellants, **v** **National Housing Partnership et al., Respondents.**

Argued February 12, 2008; decided March 18, 2008

Appleton Acquisition, LLC v National Hous. Partnership, 34 AD3d 339, affirmed.

{**10 NY3d at 252} OPINION OF THE COURT

Graffeo, J.

When a limited partnership merges with another entity, Partnership Law § 121-[*2] 1102 grants limited partners the right to receive the fair market value of their partnership interests. The primary issue in this case is whether the statute allows a challenge by a limited partner to be brought in an action for rescission or money damages on the grounds that the transaction was premised on fraudulent or illegal acts by the general partner. We hold that a limited partner who objects to a merger on these grounds must raise them in an appraisal proceeding under the Partnership Law.

I

Beautiful Village Associates Redevelopment Company is a limited partnership created in 1978 for the purpose of acquiring and managing residential real estate. The sole general partner was defendant National Housing Partnership (NHP). NHP sold 33 units of

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limited partnership interest in Beautiful Village to 26 individuals (plaintiffs Limited Partners). Each limited partnership unit cost approximately $78,000.

Once the formation of Beautiful Village was complete, it purchased an apartment complex in Manhattan. Beautiful Village enrolled the building in the federal Department of Housing and Urban Development's (HUD) Section 8 low-income, affordable housing program and, as a result, received federal financing. By structuring the transaction in this manner, Beautiful Village was able to provide tax benefits to its limited partners.

The rents charged to tenants were governed by a schedule approved by HUD, which subsidized the difference between the rental rate specified in the contract and what a tenant could afford to pay. The contract between Beautiful Village and HUD{**10 NY3d at 253} was set to expire in 2000, at which time Beautiful Village could renew the contract or opt out of the Section 8 program. In June 2000, Beautiful Village renewed its contract with the federal government and the apartment complex continued to provide Section 8 housing.

Early the next year, Beautiful Village obtained an unsecured line of credit from defendant AIMCO Properties, LP, which owned NHP and was a subsidiary of defendant Apartment Investment and Management Company (AIMCO). Unable to meet its payments, by the summer of 2002 Beautiful Village owed AIMCO Properties over $1.5 million.

Rather than foreclosing on the apartment complex, NHP and its parent companies in August 2002 proposed that Beautiful Village be merged with a new limited partnership owned by AIMCO Properties. Each of the Limited Partners was offered $100 or 2.5 common units of AIMCO Properties (each unit being worth about $42) for their partnership shares.[FN1] A proxy statement was sent to the Limited Partners that disclosed the conflict of interest between NHP [*3]and AIMCO Properties, and informed the Limited Partners that rejection of the merger would most likely cause AIMCO Properties to foreclose on the property, resulting in significant, adverse tax consequences for the Limited Partners. The proxy included copies of relevant New York statutes relating to the partnership agreement and proposed merger, including the right to institute a judicial appraisal proceeding to determine the fair market value of the limited partnership interests. None of the Limited Partners chose to exercise that right. In September 2002, the

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merger was approved and the Limited Partners' interests in Beautiful Village were extinguished.

In 2005, plaintiff Appleton Acquisitions, LLC—a firm not previously involved in the Beautiful Village transactions—contacted the former Limited Partners and expressed its interest in purchasing their equitable or partnership shares, together with any legal claims they had against AIMCO Properties, the partnership and the partnership's agents. Appleton offered a nonrefundable deposit of $2,000 and, if it ultimately chose to buy the shares, each Limited Partner would receive an additional $18,000. All of the Limited Partners accepted Appleton's offer.{**10 NY3d at 254}

Appleton then initiated this action against NHP, AIMCO Properties and AIMCO. [FN2] The first three causes of action sought rescission of the Beautiful Village merger and ancillary money damages on the grounds of fraud, breach of fiduciary duty and negligent misrepresentation. In connection with these three causes of action, Appleton claimed that defendants' proxy statement included intentionally false or misleading statements for the purpose of inducing the Limited Partners to sell their interests. Appleton further alleged that NHP failed to properly manage the affairs of the partnership and caused the value of the limited partnership shares to be inadequate because it neglected to participate in the federal Mark-Up-To-Market program when the contract with HUD was renewed in 2000. [FN3] These allegations were also used to [*4]support the fourth and fifth causes of action, which sought monetary damages for breach of contract and aiding a breach of fiduciary duty.

Defendants moved to dismiss the complaint, in part claiming that a limited partner's exclusive remedy for challenging the validity of a merger was through a statutory appraisal proceeding under Partnership Law § 121-1102. Supreme Court denied the motion. The Appellate Division reversed, concluding that because the Limited Partners did not challenge the merger in an appraisal proceeding, Partnership Law § 121-1102 (d) barred any action by limited partners seeking to attack the validity of{**10 NY3d at 255} the merger, including those premised on allegations of fraud or illegality. We granted leave to appeal and now affirm.

II

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When a limited partnership merges with another entity, a limited partner who objects to the merger is "entitled to receive in cash . . . the fair value of his interest in the limited partnership" (Partnership Law § 121-1102 [c]). If the value of the limited partner's interest cannot be agreed upon, the limited partner is entitled to initiate a special appraisal proceeding under Partnership Law § 121-1105 (b).[FN4] Aside from the ability to request a judicial appraisal, Partnership Law § 121-1102 (d) specifies that a limited partner

> "shall not have any right at law or in equity under this article to attack the validity of the merger . . . , or to have the merger . . . set aside or rescinded, except in an action . . . [to contest] compliance with the provisions of the partnership agreement or [the notice provisions of section 121-1102 (a)]."

This language reveals a directive by the Legislature to make an appraisal proceeding the "sole remedy of a limited partner to attack the validity of a merger" (Rich, Practice Commentaries, McKinney's Cons Laws of NY, Book 38, Partnership Law art 8-A, 2008 Pocket Part, at 61). [*5]

Faced with this declaration of legislative intent, plaintiffs ask us to engraft a common-law exception onto Partnership Law § 121-1102 (d) for situations where a merger is alleged to be permeated with fraud or illegality. Plaintiffs note that the common law allowed shareholders of corporations to initiate a civil action based on these grounds and they urge that equity dictates that we recognize a similar cause of action for rescission by a limited partner.

In the common law, it has long been established that a corporate shareholder could challenge a merger on the grounds that it was induced by fraudulent or illegal activities (*see e.g. Breed v Barton*, 54 NY2d 82, 87 [1981]; *Eisenberg v Central Zone Prop. Corp.*, 306 NY 58, 68-69 [1953]; *Kavanaugh v Kavanaugh Knitting Co.*, 226 NY 185, 196 [1919]). When the Legislature enacted the Business Corporation Law, it decreed that a shareholder who dissented from a corporate merger transaction{**10 NY3d at 256} could initiate an appraisal proceeding to determine the fair market value of the shareholder's interest in the corporation (*see* Business Corporation Law § 623 [h] [2]). Significantly, the Legislature also codified the common-law exception for corporate mergers premised on fraud or illegality and expressly recognized that a dissenting shareholder may "bring or maintain an appropriate action to obtain relief on the ground that [the merger] will be or is *unlawful or fraudulent* as to him" (Business Corporation Law § 623 [k] [emphasis added];

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see Breed v Barton, 54 NY2d at 87; *Alpert v 28 Williams St. Corp.*, 63 NY2d 557, 567-568 [1984]).

In our view, a comparison of the text of Business Corporation Law § 623 (k) and Partnership Law § 121-1102 (d) is fatal to plaintiffs' argument. Both statutes share a common feature: the availability of an appraisal proceeding to determine the value of the interest held by a dissenting shareholder or limited partner. Yet the critical distinction is that section 623 (k) explicitly incorporates a common-law fraud or illegality exception to the exclusivity of the appraisal remedy, whereas Partnership Law § 121-1102 (d) does not. The Assembly sponsor explained that the Partnership Law was amended to promote the twin objectives of granting limited partners "appraisal rights similar to those shareholders [are given] under the Business Corporation Law" while also giving "greater assurance to the general partners as to the validity" and, thus, finality of a merger or consolidation (July 17, 1990 Letter from Assembly Sponsor, Bill Jacket, L 1990, ch 950, at 8). In light of the fact that section 623 (k) of the Business Corporation Law had been enacted many years earlier, the absence of the fraud or illegality exception in section 121-1102 (d) can be viewed only as an intentional legislative omission. Consequently, in the absence of a violation of the partnership agreement or inadequate notice of the proposed merger (*see* Partnership Law § 121-1102 [d]), the statute prohibits limited partners from relying on any form of relief other than a judicial appraisal—an approach that furthers the Legislature's interest in [*6]finality of mergers.[FN5] We therefore {**10 NY3d at 257} conclude that the first three causes of action were properly dismissed.

We nevertheless recognize that fraud or illegality perpetrated by a general partner against limited partners is a serious concern requiring redress. The Legislature has designed the Partnership Law so that the statutory appraisal proceeding is the appropriate means of challenging fraudulent or illegal conduct by a general partner. The appraisal procedures for limited partnerships are incorporated from Business Corporation Law § 623 (*see* Partnership Law § 121-1105 [b]). The purpose of an appraisal proceeding is to assist the court in determining "the fair value [of a limited partner's interest] as of the close of business on the day prior to the [merger's] authorization date" (Business Corporation Law § 623 [h] [4]). In calculating that figure, a court is to consider "the nature of the transaction giving rise to the [limited partner's] right to receive payment . . . and *all other relevant factors*" (*id.* [emphasis added]).[FN6] This broad language allows a dissenting

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limited partner to raise the issue of fraud, illegality, breach of fiduciary responsibility or other deceitful acts by the general partner that may have resulted in less compensation than the limited partner should have received (*see generally Fleming v International Pizza Supply Corp.*, 676 NE2d 1051, 1057-1058 [Ind 1997]; *Steinberg v Amplica, [*7]Inc.*, 42 Cal 3d 1198, 1209, 729 P2d 683, 690 [1986]). Ultimately, we are left with a legislative recognition that limited partners are entitled to be compensated for the fair value of their interests in a partnership—and general partners may be held accountable for their fraudulent, deceptive or illegal acts—via an appraisal proceeding, not a civil action that seeks to set aside or otherwise attack a merger.{**10 NY3d at 258}

III

Appleton and the Limited Partners alternatively maintain, and our dissenting colleagues accept, that the fourth and fifth causes of action seeking money damages should not have been dismissed under section 121-1102 (d) because they were premised on allegations of pre-merger breach of fiduciary and contractual duties stemming from the mismanagement of Beautiful Village. The statutory exception to the exclusivity of the appraisal proceeding is limited to civil actions that challenge a merger on the grounds that it was not effectuated in compliance with the terms of the partnership agreement or the notice requirements of section 121-1102 (a) (*see* Partnership Law § 121-1102 [d]). The dissent suggests that limited partners can avail themselves of this exception by simply alleging that a general partner breached its obligations under the partnership agreement by engaging in fraudulent conduct in connection with a merger. We do not think the Legislature intended such a result for two reasons.

First, general partners always have fiduciary responsibilities to limited partners (*see e.g. Lichtyger v Franchard Corp.*, 18 NY2d 528, 536-537 [1966]) and any fraud by a general partner necessarily constitutes a violation of that duty. Plaintiffs would allow limited partners to circumvent the appraisal process merely by pleading that the general partner had been involved in fraudulent activities and that such conduct violated the partnership agreement. In our view, this would effectively nullify the Legislature's intent to impose restrictions on actions "at law or in equity . . . to attack the validity of the merger . . . or to have the merger or consolidation set aside or rescinded" (Partnership Law § 121-1102 [d]).

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Second, and relatedly, the dissent incorporates the common-law fraud or illegality exception from Business Corporation Law § 623 (k) into Partnership Law § 121-1102 (d) by permitting fraud or illegality to be pleaded as a breach of the partnership agreement. Yet the dissent acknowledges that the plain language of section 121-1102 (d) does not codify the common-law corporate exception and instead prohibits allegations of this type—which are the basis of the first three causes of action—from being asserted in a cause of action for rescission of a merger. Under this view, the application of section 121-1102 (d) turns on the type of relief sought, a concept without support in light of the broad statutory language that prohibits "any" legal or equitable challenges to the validity of a merger, including actions{**10 NY3d at 259} for money damages. We conclude that the exception to section 121-1102 (d) pertains only to civil actions that seek to rescind or attack the validity of a merger on the grounds that there was a violation of the [*8] procedures specified in a partnership agreement for effectuating a merger or that there was a failure to comply with the notice requirements of subdivision (a) of the statute.

Close scrutiny of the allegations in the fourth and fifth causes of action discloses that plaintiffs focus on challenging the terms of the merger, the ultimate value of the Limited Partners' interests and the amount of compensation the Limited Partners received when the merger was approved—issues the Legislature has decreed must be addressed in an appraisal proceeding. Indeed, only one allegation in the complaint is arguably unrelated to the merger itself—defendants' failure to participate in the Mark-Up-To-Market program when the HUD contract was renewed in 2000. Significantly, however, this claim is used by plaintiffs to support their theory that they suffered a financial loss because defendants misrepresented "the valuation of the Limited Partners' interests in the Partnership[ ]" and "fail[ed] to advise the Limited Partners that the offering price for Units of Partnership in the Merger was inadequate and unfair." Hence, the Limited Partners allege that they were induced to accept an unfair price for their interests.

Acceptance of the Limited Partners' argument would allow them to bypass the appraisal process even though they are asserting that the compensation they received for their shares was inadequate. Although the fourth and fifth causes of action do not directly ask to rescind the merger, it is readily apparent that the claims are nevertheless veiled attacks on the validity of the merger—the propriety of the statements purportedly made by defendants and the adequacy of the compensation offered for approval of the

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merger—that section 121-1102 (d) prohibits from being raised outside the context of an appraisal proceeding. The fourth and fifth causes of action were therefore properly dismissed.[FN7]

Accordingly, the order of the Appellate Division should be affirmed, with costs.

Ciparick, J. (dissenting in part). I agree with the majority{**10 NY3d at 260} that plaintiffs' first three causes of action were properly dismissed. Because, however, Partnership Law § 121-1102 (d) only prohibits a limited partner from attacking the validity or seeking to set aside or rescind a merger or consolidation, and specifically exempts "an action or contest with respect to compliance with the provisions of the [*9] partnership agreement," I believe a common-law action for damages under a theory of breach of contract and aiding and abetting such breach would lie. I, therefore, disagree and respectfully dissent as to the dismissal of plaintiffs' fourth and fifth causes of action, as they do not directly attack the merger as such.

It is well established that statutory interpretation begins with the plain language of the statute. "As the clearest indicator of legislative intent is the statutory text, the starting point in any case of interpretation must always be the language itself, giving effect to the plain meaning thereof" (*Majewski v Broadalbin-Perth Cent. School Dist.*, 91 NY2d 577, 583 [1998]). We have always preferred a literal reading and look to the unambiguous language of the statute for guidance as to what the Legislature intended. Partnership Law § 121-1102 (d) provides that:

> "[a] limited partner of a constituent limited partnership who has a right under this article to demand payment for his partnership interest shall not have any right at law or in equity under this article to attack the validity of the merger or consolidation, or to have the merger or consolidation set aside or rescinded, except in an action or contest with respect to compliance with the provisions of the partnership agreement or [the notice provisions of] subdivision (a) of this section."

Nowhere does the text of the statute expressly prohibit the availability of the common-law right of a limited partner to seek damages as a result of a breach of contract premised on a general partner's alleged violation of a partnership agreement and the aiding and abetting of such breach by others. Neither does there exist a clear and specific

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legislative intent to abrogate the common-law remedy of breach of contract (*see Tzolis v Wolff*, 10 NY3d 100, 102 [2008]; *Hechter v New York Life Ins. Co.*, 46 NY2d 34, 38-39 [1978]). In fact, there exists no legislative history that supports defendants' and the majority's view that the Legislature purposefully intended to make appraisal rights the exclusive remedy for aggrieved limited partners. The statute is very specific that a limited partner has no right to attack the [** 10 NY3d at 261] validity of a merger and is relegated to exercising dissenter's appraisal rights, but it does not preclude a common-law action for failure to comply with provisions of the partnership agreement—a breach of contract claim.

I respectfully disagree with the majority that, by allowing the breach of contract actions to proceed, the limited partners will be allowed to "bypass the appraisal process" (majority op at 259) and that the claims are "veiled attacks on the validity of the merger" (majority op at 259). The complaint is simply an allegation asserting that National Housing Partnership (NHP) breached its contractual duty under the partnership agreement and that as a result of the alleged breach the limited partners suffered damages. Such a theory of liability does not "attack the validity of the merger or consolidation" or seek "to have the merger or consolidation set aside or rescinded," nor does it incorporate the common-law fraud or illegality exception from Business Corporation Law § 623 (k) as suggested by the majority (majority op at 258). The Legislature surely did not intend section 121-1102 to insulate a general partner from an action for damages resulting from a breach of contract merely because the merger or consolidation was successfully completed.

It is well settled that a court, when deciding whether to grant a motion to dismiss pursuant to CPLR 3211, must take the allegations asserted within a plaintiff's complaint as true, and accord plaintiff the benefit of every possible inference, determining only whether the facts as alleged fit within any cognizable legal theory. Here, plaintiffs assert that NHP not only breached its fiduciary duty owed to the limited partners under the partnership agreement, but also specifically breached the partnership agreement prior to the merger by its chronic mismanagement of the property. Plaintiffs also assert that NHP's failure to take advantage of readily available federal subsidies both decreased the value of the partnership itself and caused a financial loss to the partnership from the loss of additional rental income. Plaintiffs further assert that the AIMCO defendants aided and abetted these

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breaches by allowing its general partner to engage in transactions not reasonably competitive with those that could have been obtained from unaffiliated persons. Therefore, plaintiffs' fourth cause of action seeking recovery for damages, including loss of income, incurred as a result of NHP's alleged breach of contract and of its fiduciary duties under the {**10 NY3d at 262} partnership agreement is cognizable as is the fifth cause of action brought against the AIMCO defendants for allegedly aiding and abetting the breach, as both causes of action fall within the exception of section 121-1102.

Recently, in *Tzolis v Wolff* (10 NY3d 100 [2008]), we held that a limited liability company (LLC) member had the right to assert a derivative cause of action on behalf of the LLC under common law, despite the fact that the legislative history could not conclusively establish why the Legislature omitted text from the LLC statute that would specifically authorize LLC members to bring a derivative suit.

We held in *Tzolis* "that members of a limited liability company (LLC) may bring derivative suits on the LLC's behalf, even though there are no provisions governing such suits in the Limited Liability Company Law" (*Tzolis* at 102). Here, we have a statute prohibiting a limited partner, who had the right under Partnership Law § 121-1102 (d) to demand payment for its partnership interest, from seeking redress. This is so because if the limited partner fails to exercise appraisal rights, it loses its right to either attack the validity of or rescind the merger or consolidation. Nowhere does Partnership Law § 121-1102 (d) likewise prohibit a plaintiff from asserting a claim for damages under a breach of contract theory.

"To hold that there is no remedy when corporate fiduciaries use corporate assets to enrich themselves was unacceptable in 1742 and in 1832, and it is still unacceptable today" (*Tzolis* at 105).[FN*] The rule proposed by the defendants and adopted by the majority allows a merger transaction, in the limited partnership context, to become in effect a general release for a contractual claim for damages by a limited partner against a general partner, regardless of whether the damages arose pre- or post-merger. It relegates the aggrieved limited partner to asserting its rights by way of an appraisal proceeding, a remedy that is not always adequate and certainly would not be adequate here. {**10 NY3d at 263}

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Therefore, I would modify the order of the Appellate Division to reinstate plaintiffs' fourth and fifth causes of action.

Judges Read, Smith and Pigott concur with Judge Graffeo; Judge Ciparick dissents in part and votes to reinstate the fourth and fifth causes of action in a separate opinion in which Chief Judge Kaye and Judge Jones concur.

Order affirmed, with costs.

Footnotes

Footnote 1: Although not relevant to this appeal, some classes of limited partners were not given this choice and had to accept the cash offer.

Footnote 2: A prior federal action that Appleton filed against NHP was voluntarily withdrawn before commencement of the state case.

Footnote 3: The Mark-Up-To-Market program was created in June 1999 as an emergency initiative promulgated by HUD. Its purpose was to preserve affordable housing in certain residential real estate markets where rent subsidies resulted in below market rental values and, thus, it was financially attractive for owners to opt-out of the Section 8 program and convert the properties to private, market-rate operations (*see* Report of US Dept of Hous & Urban Dev accompanying Notice H 99-15, at 2; US Dept of Hous & Urban Dev, Off of Multifamily Hous, Section 8 Renewal Policy, *Guidance for the Renewal of Project-Based Section 8 Contracts* § 3-1 [A]). For properties that met specific criteria, the Mark-Up-To-Market program provided additional subsidies that raised the total rent collected by the owner to prevailing market rates while ensuring that the properties continued to provide Section 8 affordable housing for at least five years. Congress made the program permanent in late 1999 (*see* Pub L 106-74, tit V, § 531, 113 US Stat 1109 [106th Cong, 1st Sess, Oct. 20, 1999], amending Multifamily Assisted Housing Reform and Affordability Act of 1997 § 524 [42 USC § 1437f Note]). With respect to the case before us, we will presume that Beautiful Village would have been eligible to participate in the Mark-Up-To-Market program when it extended its contract with HUD in 2000.

Footnote 4: The procedures utilized in these proceedings are delineated in Business Corporation Law § 623 (h)-(k) (*see* Partnership Law § 121-1105 [b]).

Footnote 5: This conclusion is buttressed by our recent decision in *Tzolis v Wolff* (10 NY3d 100 [2008]). In that case, we held that members of a limited liability company may bring derivative suits on the LLC's behalf because they are not prohibited from doing so

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by the relevant statutory provisions, which are silent on the matter. Here, in contrast, section 121-1102 (d) expressly restricts dissenting limited partners from using an action for rescission or money damages to dispute the validity of a merger on grounds unrelated to the terms of the partnership agreement or the statutorily required notice.

Footnote 6: The statute also requires a court to consider the "effects on the [partnership] and its [partners], [and] the concepts and methods then customary in the relevant securities and financial markets for determining fair value of [interests in a partnership] engaging in a similar transaction under comparable circumstances" (Business Corporation Law § 623 [h] [4]). Notably, pretrial disclosure may be sought by the parties and authorized by the court, including "disclosure of any expert's reports relating to the fair value of the shares whether or not intended for use at the trial . . . and notwithstanding subdivision (d) of [CPLR] 3101" (*id.*). Given the scope of subdivision (h) (4), it is conceivable that the Limited Partners could have utilized an expert appraiser to establish that the failure to participate in the Mark-Up-To-Market program negatively affected the valuation of their shares in Beautiful Village.

Footnote 7: In light of our determination, defendants' alternative basis for an affirmance (which was not addressed by the Appellate Division) is academic.

Footnote *: Indeed, Chief Justice John Marshall wrote,

"[i]f, on tracing the right to contract, and the obligations created by contract, to their source, we find them to exist anterior to, and independent of society, we may reasonably conclude that those original and pre-existing principles are, like many other natural rights, brought with man into society; and, although they may be controlled, are not given by human legislation" (*Ogden v Saunders*, 12 Wheat [25 US] 213, 345 [1827]).

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78 N.Y.2d 439 (1991)

In the Matter of the Dissolution of Seagroatt Floral Company, Inc., Appellant.
James H. Riccardi et al., Respondents.
In the Matter of the Dissolution of Henry J. Seagroatt Co., Inc., Appellant.
James H. Riccardi et al., Respondents.

Court of Appeals of the State of New York.

Argued October 9, 1991.
Decided November 19, 1991.

Thomas G. Collins, Howard Sprow and *Patrick J. MacKrell* for appellants.

Jonathan P. Harvey for respondents.

Chief Judge WACHTLER and Judges SIMONS, ALEXANDER, TITONE, HANCOCK, JR., and BELLACOSA concur.

442 *442KAYE, J.

In this appeal by two closely held corporations — Seagroatt Floral Company and Henry J. Seagroatt Company — we are called upon to answer two questions. First, was the lack of a public market for the corporations' shares taken into account in valuing the companies for purposes of buying out petitioners' minority stockholdings under Business Corporation Law § 1118, and second, was it error to impose joint and several liability on the two corporations. We conclude that, while lack of marketability was considered in valuing the stock, the imposition of joint and several liability was error that requires modification of the Appellate Division order.

I.

In the early 1920s, petitioners' grandfather founded a rosegrowing operation, Henry J. Seagroatt, in Berlin, New York. A wholesale business, Seagroatt Floral, was added in 1948. Today, Henry J. Seagroatt sells all of its cut flowers to Seagroatt Floral. Seagroatt Floral distributes cut flowers purchased from Henry J. Seagroatt and other growers, as well as florist supplies.

In 1960 Henry J. Seagroatt and Seagroatt Floral were incorporated as separate entities. Henry J. Seagroatt in 1984 obtained "subchapter S" status pursuant to Federal tax regulations.

All common stock in the two corporations is owned by the founder's seven grandsons. In addition to common stock, Seagroatt Floral has outstanding 280 shares of preferred stock, owned by individuals other than the seven grandchildren. The two petitioning grandsons, James

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H. Riccardi and Edward A. Seagroatt, each own approximately 17% of the outstanding common shares of each corporation.

In 1987, petitioners became embroiled in a controversy with the managing shareholders, and sought dissolution of the corporations pursuant to Business Corporation Law § 1104-a. The petitions alleged that the directors had taken "oppressive action" against petitioners.

Each corporation separately elected to purchase petitioners' shares pursuant to Business Corporation Law § 1118. As a result, Supreme Court stayed the dissolution proceedings and,
443 the parties having been unable to agree upon a price, referred *443 the matter to a Referee to ascertain the fair value of the stock.

Extensive proceedings ensued before the Referee, including testimony from the shareholders and expert witnesses for both sides. The Referee held that, in order to determine a fair price for petitioners' shares, the corporations had to be valued as a single business with one consolidated financial statement. He specifically rejected the methods employed by the corporations' two valuation experts — one using liquidation value and the other assuming that the corporations operated independently.

Based on his findings as to the best method, the proper valuation of tangible assets, and the correct treatment of certain capital disbursements, the Referee adopted the conclusions tendered by petitioners' expert, with two exceptions. The Referee refused to accept the suggested valuation of the preferred shares (which no one contests), and he rejected as incredible the witness's testimony that he had taken lack of marketability into account.

While accepting petitioner's expert's opinion that the combined net asset value of the two businesses was $9,467,975, the Referee held that a lack-of-marketability discount had erroneously been ignored in the calculation; and on a theory that "a willing buyer would invest in the Seagroatt business only if he could buy a bargain," the Referee proceeded to discount the expert's combined net asset value by 25%. He then divided the discounted number ($7,096,481) by the total number of common shares in both corporations (692) to obtain a per-share value, and thus concluded that the 120 shares owned by each petitioner were worth $1,230,603. The Referee further held that each petitioner was entitled to judgment against the corporations, jointly and severally, in that amount. After setoffs and interest, judgment was entered accordingly.

Both sides appealed. Petitioners challenged the 25% lack-of-marketability discount; the corporations argued that it was error to impose joint and several liability. The Appellate Division upheld the imposition of joint and several liability based on the interrelated operation of the businesses. From its own review of the record, however, the court concluded that there was no evidence to support the conclusion that petitioners' expert had failed to take lack of marketability into account, and it set aside the 25% discount. The corporations now seek to overturn the Appellate Division's holdings both as to the discount and as to joint and several liability.

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*444We agree with the Appellate Division as to the discount; its holding that illiquidity had indeed been considered by petitioners' expert more closely comports with the weight of the evidence than that of the trial court adopting the Referee's findings. However, the imposition of joint and several liability — in effect making each separate corporation liable for the purchase of the other's shares — cannot stand.

II.

Section 1104-a of the Business Corporation Law, enacted in 1979, provides minority shareholders in close corporations with protection from oppressive conduct by majority interests (*see generally*, Matter of Pace Photographers [Rosen], 71 N.Y.2d 737, 744-745; *see also*, Sponsor's Mem in support of A 4408 [L 1979, ch 217], 1979 NY Legis Ann, at 144 ["This legislation will do much to bring fair play and equal rights to corporate shareholders."]).

The statute allows holders of 20% or more of the outstanding shares of a corporation to present a petition for dissolution based on any of several enumerated grounds, including oppressive acts by the directors or those in control of the corporation (Business Corporation Law § 1104-a [a] [1]). In order to afford the other shareholders the option to continue the enterprise as a going concern, a buyout provision was concomitantly added as section 1118 of the Business Corporation Law. Under that provision, those interested in maintaining the business — a class of "prospective purchasers" explicitly limited to the other shareholders or the corporation itself — may within 90 days of the filing of an 1104-a petition elect to purchase the shares owned by the petitioners (Business Corporation Law § 1118 [a], [b]). Thus, the Business Corporation Law protects both the right of the allegedly oppressed shareholder to liquidate an investment at fair value and the right of the remaining shareholders to preserve an ongoing — and likely prosperous — business (*see generally*, O'Neal, "Squeeze-Outs" of Minority Shareholders, at 613-614 [1975]; Davidian, *Corporate Dissolution in New York: Liberalizing the Rights of Minority Shareholders*, 56 St John's L Rev 24 [1981]).

Given these complementary sections of the Business Corporation Law, the ultimate issue for the courts often becomes fixing the fair value of the minority interest being purchased (*see, e.g.*, 445 *Matter of Joy Wholesale Sundries*, 125 AD2d 310; *445 *Matter of* Blake v Blake Agency, 107 AD2d 139, *lv denied* 65 N.Y.2d 609; *Matter of Fleischer*, 107 AD2d 97). In that the valuation proceeding avoids dissolution and allows the continuation of an operating business, the value to be ascertained is that of an interest in a going concern rather than a share of a business in the throes of liquidation (*Matter of Pace Photographers [Rosen]*, 71 NY2d, at 748, *supra*).

Thus, once Seagroatt Floral and Henry J. Seagroatt elected to buy out petitioners, the misconduct charges became irrelevant. The issue became one of valuation.

Business Corporation Law § 1118 offers no definition of fair value and no criteria by which a court is to determine price or other terms of the purchase (*see also*, Business Corporation Law § 623). Rather, fair market value, being a question of fact, will depend upon the circumstances of

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each case; there is no single formula for mechanical application (*see*, Amodio v Amodio, 70 N.Y.2d 5, 7; *see also*, Weinberger v UOP, Inc., 457 A2d 701, 712-713 [Del]).

The objective of a proceeding under Business Corporation Law § 1118 — including the one now before us — is to determine what a willing purchaser in an arm's length transaction would offer for petitioners' interest in the company as an operating business (*Matter of Pace Photographers [Rosen]*, 71 NY2d, at 748, *supra*; *Matter of* Blake v Blake Agency, 107 AD2d 139, 146, *supra*).

III.

Valuing a closely held corporation is not an exact science. Accordingly, courts in such proceedings confront a variety of evidence and methods aimed at determining the price of minority interests in closely held corporations — legal entities that by their nature contradict the concept of a "market" value (*see, e.g., Matter of* Raskin v Walter Karl, Inc., 129 AD2d 642, 644; *see also*, Donahue v Rodd Electrotype Co., 367 Mass 578, 328 NE2d 505). The 1979 amendments to the Business Corporation Law were motivated, in part, by recognition of the fact that shareholders in closely held corporations, as contrasted with shareholders in public companies, are unlikely to find prospective buyers for their shares (*see*, Sweet and Mallis, *Standing to Petition for the Judicial Dissolution Under the New York Business Corporation Law: A Needed Change*, contained in Bill Jacket, L 1979, ch 217). It follows that, whatever the
446 method of valuing an interest in such an *446 enterprise, it should include consideration of any risk associated with illiquidity of the shares (*see generally*, Haynsworth, *Valuation of Business Interests*, 33 Mercer L Rev 457 [1982]; 2 O'Neal and Thompson, O'Neal's Close Corporations § 9.34, at 162-163 [3d ed]).

Petitioners' expert testified that the method he employed was "capitalization of earnings." As he explained, he first found average annual earnings for the combined enterprise and next assessed the relative certainty with which those earnings could be counted upon to continue — in effect, he determined the value of those future earnings. The witness testified that he applied a 16% capitalization rate — within the range of Revenue Ruling 68-609, governing valuation of closely held companies for taxation purposes — to what he calculated as the entities' annual "excess earnings," and then combined that value with his "tangible asset" value to arrive at the total value for both businesses. He further testified that he did not thereafter apply an illiquidity discount to the value so determined, as he would have done if he had compared respondent corporations with publicly traded companies or over-all industry averages — because his method did not involve such comparisons.

Before us, respondent corporations do not challenge the methodology employed by petitioners' witness. Rather, their sole contention is that the witness did not properly consider the key risk factor of lack of marketability. They point to language in *Amodio* to the effect that whatever "method [of valuation] is used * * * must take into consideration inhibitions on the transfer of the corporate interest resulting from a limited market" (70 NY2d, at 7, *supra*). Based on this

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Before us, respondent corporations do not challenge the methodology employed by petitioners' witness. Rather, their sole contention is that the witness did not properly consider the key risk factor of lack of marketability. They point to language in *Amodio* to the effect that whatever "method [of valuation] is used * * * must take into consideration inhibitions on the transfer of the corporate interest resulting from a limited market" (70 NY2d, at 7, *supra*). Based on this

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language, the corporations argue that an identifiable discount must in all cases be applied against the value found — that the factor of illiquidity cannot be "buried" in the capitalization rate.

While lack of a public market for the shares of a closely held corporation should certainly be considered in determining what a willing purchaser would pay for such shares — which is the purport of the quoted language from *Amodio*, involving contractual restrictions on transfer — there is no single method for calculating that factor (*see generally*, Lyons and Whitman, *Valuing Closely Held Corporations and Publicly Traded Securities with Limited Marketability: Approaches to Allowable Discounts from Gross Values*, 33 Bus Law 2213 [1978]). Certainly, this
447 Court has never mandated *447 one. Thus, to the extent respondent corporations suggest that illiquidity can only be taken into account by the application of a percentage discount against value — such as the Referee applied — the argument fails as a matter of law.

The corporations' second argument is essentially factual: the Referee rejected as incredible the testimony of petitioners' expert that he factored the risk associated with lack of marketability into his formula to determine over-all value. The Appellate Division, on its review of the testimony, concluded otherwise. Our role in such a situation is to determine which findings more closely comport with the weight of the evidence (CPLR 5501 [b]).

Petitioners' expert testified that he used a capitalization rate he believed was reasonable in the circumstances for pretax earnings for a closely held corporation, taking into account its "position in the industry, its earnings and also lack of marketability, the fact it's a closely held company." Despite the Referee's statement that there was nothing in the record to justify the conclusion that the witness considered lack of marketability, on half-dozen or more occasions the witness repeatedly asserted and explained that lack of marketability had been a factor in his choice of capitalization rate.

The corporations point to what they consider the expert's outright denial that he had considered illiquidity. An examination of the record, however, indicates that the witness was in the process of explaining his decision not to value the corporations by comparison to publicly traded companies, and the consequent lack of necessity for any discount relevant to such a comparison. The witness's very next response makes clear that, although a comparative discount was not appropriate, he did indeed factor lack of marketability into his capitalization rate.

Thus, as to the only challenged valuation point, we conclude that there was no error of law, and that the Appellate Division's findings more closely comport with the weight of the evidence and should be sustained.

IV.

The corporations next argue that imposition of joint and several liability contravenes the explicit statutory grant to an issuing corporation and its shareholders of the right to purchase the
448 company's own shares (Business Corporation Law § 1118).[1] *448 Further, they contend that

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compelling Seagroatt Floral to satisfy the judgment would imperil both the interests of Seagroatt Floral's preferred shareholders and Henry J. Seagroatt's status as an "S" corporation. We agree that the imposition of joint and several liability was error.

At the outset, we note that the corporations do not challenge the Referee's finding that, owing to the business relationships between them, the financial statements of the two companies had to be considered on a consolidated basis in order to portray the fair value of the business. Instead, the corporations argue that consolidation for the purpose of determining value does not require or justify joint and several liability, and that separate values should have been assigned to each entity for purposes of a judgment against them. This argument was advanced at several points during the proceeding, most particularly in the companies' trial briefs urging that the ultimate issue was to value each entity separately.

Joint and several liability, primarily a tort law concept, imposes on each wrongdoer responsibility for the entire damages awarded, even though a particular wrongdoer's conduct may have caused only a portion of the loss (*see generally*, Siegel, NY Prac § 168A, at 247 [Prac 2d ed]). The rationale for such liability is that the wrongdoers are considered part of a joint enterprise and a mutual agency "such that the act of one is the act of all and liability for all that is done is visited upon each" (*Ravo v Rogatnick*, 70 N.Y.2d 305, 309). The concept of wrongdoing is, of course, alien to a proceeding under Business Corporation Law § 1118, which seeks to determine the fair value of petitioning shareholders' interests, not their initial allegations of misconduct.

As a general matter, moreover, joint and several liability is inconsistent with the language and goals of Business Corporation Law § 1118.

Section 1118 gives any shareholder or the corporation itself the "absolute right to avoid the
449 dissolution proceedings and any possibility of the company's liquidation by electing to *449
purchase petitioner's shares" (*Matter of Pace Photographers [Rosen]*, 71 NY2d, at 744-745, *supra*). The statute is quite specific as to which parties may exercise the buy-out option. Unless a second corporation is a shareholder in the company against whom the 1104-a petition has been filed, it does not have standing to make an election to purchase under Business Corporation Law § 1118. It follows from the language of the statute that an entity lacking standing to make the election to purchase cannot be forced to repurchase those very shares through the imposition of joint and several liability.

This reading of section 1118 is supported by sound policy considerations. The purpose behind enactment of a buy-out provision was to provide the corporation or its shareholders with a mechanism for preserving the enterprise as a going concern. Allowing a third party — by satisfying the entire "joint and several" judgment — to purchase the shares of the petitioning shareholder injects an element of uncertainty, a new ownership interest, into the continued operation of the enterprise.

While that consideration may pose less of a problem in cases like the present one, where management and operations overlap, there are other threatened effects on the status of these separate entities. Seagroatt Floral, for example, has an additional class of preferred

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shareholders; were Seagroatt Floral forced to satisfy the full judgment, the expenditure could affect its ability to pay preferred dividends or, in the event of liquidation, the ability of those shareholders to recoup their investment. Related to such financial concerns is respondents' argument that this substantial liability — making each potentially liable for the full price of petitioners' shares in both corporations — harms each entity in its efforts to obtain financing, as each carries the full burden of the judgment.

Similarly, Henry J. Seagroatt claims that purchase of its shares by Seagroatt Floral would jeopardize its status as an "S" corporation for Federal tax purposes. Under Federal regulations, close corporations must meet specific requirements in order to qualify for subchapter S standing, including the requirement that all shareholders must be individuals, estates, voting trusts, temporary conduit trusts, or trusts whose income is taxed to the grantor (*see generally*, 26 USC § 1361).

Petitioners contend, and the Appellate Division agreed, that imposition of joint and several
450 liability is appropriate here *450 because of the "numerous organizational, operational and financial" links between the companies, making them "in reality a single business" (167 AD2d 586, 587). While bearing on the propriety of consolidating the financial statements of the two entities in order to find the true value of petitioners' shares, those links do not mandate joint and several liability.

Imposition of joint and several liability, in practical effect, disregarded the fact that two legal entities stood before the court. Under ordinary circumstances, a corporation's independent existence cannot be ignored (*see*, *Port Chester Elec. Constr. Corp. v Atlas*, 40 N.Y.2d 652, 656). Allowing a court — through joint and several liability — to in effect pierce the corporate veils, without the proper inquiry and proof according to established guidelines, undermines bedrock principles of corporate law.

While concluding that it was error to impose joint and several liability on respondents, we do not determine whether the record must be supplemented in order to apportion the total value found, or whether that calculation can be made by the trial court on the present evidence. We note that the parties in their briefs have suggested that there is sufficient basis in the present record upon which the trier of fact might premise separate judgments against each corporation.

Finally, the corporations contend that certain asset valuations were not supported by the record. These valuations, having been found by the trial court, affirmed by the Appellate Division and supported by evidence in the record, are beyond our review (*Humphrey v State of New York*, 60 N.Y.2d 742).

Accordingly, the order of the Appellate Division should be modified, without costs, by reversing so much of the order as affirmed the imposition of joint and several liability, and remitting the matters to Supreme Court, Rensselaer County, for further proceedings in accordance with this opinion, and as so modified, affirmed.

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Order modified, without costs, in accordance with the opinion herein and, as so modified, affirmed.

[*] Petitioners argue that the joint and several liability issue has been mooted by payment of the judgment. Payment by a losing party does not terminate its right to appeal unless made by way of compromise or agreement not to pursue an appeal (*see*, Hayes v Nourse, 107 N.Y. 577; *see also*, CPLR 5523 [court reversing judgment may order restitution]). Moreover, respondents point out that, as a practical matter, they each remain liable for the full amount of the indebtedness that was incurred to satisfy the judgment and stop the running of interest on the judgment.

Matter of Giaimo v Vitale
2012 NY Slip Op 08778 [101 AD3d 523]
December 20, 2012
Appellate Division, First Department
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, February 6, 2013

In the Matter of Robert T. Giaimo, for the Judicial Dissolution of EGA Associates, Inc., Respondent-Appellant,
v
Janet Giaimo Vitale, Appellant-Respondent. In the Matter of Robert T. Giaimo, for the Judicial Dissolution of First Avenue Village Corp., Respondent-Appellant, v Janet Giaimo Vitale, Appellant-Respondent.

—[*1] Holland & Knight LLP, New York (Joseph P. Sullivan and Mitchell J. Geller of counsel), for appellant-respondent.

Putney, Twombly, Hall & Hirson LLP, New York (Philip H. Kalban of counsel), for respondent-appellant.

Judgments, Supreme Court, New York County (Marcy S. Friedman, J.), entered August 26, 2011 and September 13, 2011, respectively, in consolidated proceedings seeking dissolution of the subject closely held corporations and upon respondent's election pursuant to Business Corporation Law § 1118 (b) to purchase petitioner's shares, awarding petitioner the "fair value" of his shares in the corporations, plus interest, and bringing up for review an order, same court and Justice, entered April 26, 2011, which, to the extent appealed from, denied petitioner's motions to hold respondent in contempt of court, and confirmed so much of the June 30, 2010 report of the Special Referee that declined to apply a discount for lack of marketability (DLOM), reduced the value of the corporations' assets by the present value of taxes on built-in capital gains (BIG), valued the corporations' choses in action and concluded that the value of the choses should be placed in escrow, and awarded prejudgment interest at 4%, unanimously modified, on the law, to vacate the principal amounts awarded, apply a 16% discount for lack of marketability and

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direct petitioner to pay, in restitution, amounts he was paid in excess of fair value, and remand for [*2]further proceedings in accordance herewith, and otherwise affirmed, without costs. Appeal from the order unanimously dismissed, without costs, as subsumed in the appeal from the judgment.

Valuation of closely held corporations is not an exact science, and it is the "particular facts and circumstances" of each case that will dictate the result (*Matter of Friedman v Beway Realty Corp.*, 87 NY2d 161, 167 [1995]).

Here, the motion court correctly held that the method of valuing a closely held corporation should include any risk associated with the illiquidity of the shares (*see Matter of Seagroatt Floral Co. [Riccardi]*, 78 NY2d 439, 445-446 [1991]). It also properly rejected petitioner's contention that this Court's decision in *Vick v Albert* (47 AD3d 482 [1st Dept 2008], *lv denied* 10 NY3d 707 [2008]) limits the application of marketability discounts only to goodwill, or precludes such discounts for real estate holding companies such as the corporations at issue here. The motion court erred, however, in assessing that the marketability of the corporations' real property assets was exactly the same as the marketability of the corporations' shares (*see Seagroatt Floral*, 78 NY2d at 445-446). While there are certainly some shared factors affecting the liquidity of both the real estate and the corporate stock, they are not the same. There 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 have a negative impact on how quickly and with what degree of certainty the corporations can be liquidated, which should be accounted for by way of a discount.

Only respondent's expert, Jeffrey L. Baliban, quantified what, in his opinion, would be the appropriate DLOM discount. He employed a number of studies of reported sales that bore some related characteristics to these particular corporations. He also employed a build-up method related to anticipated costs of selling the corporation that included real estate related costs and due diligence costs arising in the sale of closely held corporations. The studies and method employed reported a DLOM range of 8% to 30%, with Baliban recommending 20%. Petitioner criticizes all of the data and methods relied upon by Baliban as inapplicable. Neither the Referee nor the motion court addressed these arguments because they never reached the issue of the quantification of the DLOM. Since the entire record is included on appeal, it is sensible and economical for us to decide this

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issue rather than remand the issue to the motion court for further consideration (see Wechsler v Wechsler, 58 AD3d 62, 77 [1st Dept 2008], *appeal dismissed* 12 NY3d 883 [2009]). We find that the build-up method, which makes calculations based upon expected projected expenses of selling a company holding real estate, best captures the DLOM applicable in this particular case. We conclude that a 16% DLOM against the assets of both corporations is appropriate and should be applied. Since the judgments have been paid, petitioner is directed to make restitution in an amount reflecting the discount (*see* CPLR 5523).

We reject petitioner's argument that a discount for embedded capital gains taxes can never be included in assessing fair value. It is recognized by courts of this state that embedded capital gains taxes in assets held by "C" corporations will affect what a hypothetical willing purchaser, with a reasonable knowledge of the underlying facts, will pay for the corporate stock (see Matter of Murphy v United States Dredging Corp., 74 AD3d 815 [2d Dept 2010]; Wechsler v Wechsler, 58 AD3d 62 [2008]). We also reject respondent's assertion that this Court's decision in *Wechsler* always requires that the BIG discount be calculated at 100% of the projected tax as of the date of valuation. In *Wechsler* we expressly left open issues about whether calculation methods employed by other courts to capture embedded capital gains were also proper (58 AD3d at 69). Applying a 100% discount in this [*3]case necessarily implies that following the hypothetical sale, the purchaser would immediately liquidate all of the real estate and realize the full capital gains impact. Not only is this contrary to a basic underlying assumption of fair valuation that the business will continue as an ongoing concern, but also to the motion court's finding that there is no financial reason in the foreseeable future for the properties to be sold. The BIG discount, as applied by the motion court, takes into account that the real estate will continue to be held by the corporations and will not immediately be sold even if the corporate stock is sold. Consequently, the reduction of BIG to present value appropriately adjusts for embedded capital gains taxes that will not be paid until some time in the future.

There is no basis to disturb the Special Referee's valuation of the corporations' choses in action against the estate of Edward Giaimo (*see Matter of F.P.D. Realty Corp.*, 267 AD2d 111, 112 [1st Dept 1999]). There is evidence in the record that Edward Giaimo's estate had sufficient assets to cover these claims and respondent's argument that the estate

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had a significant estate tax burden does nothing to disprove this evidence. Nor did petitioner support his contention that it was error to place the amounts of the choses in escrow.

There is no evidence that the Referee misread the testimony of petitioner's real estate expert. Rather, the evidence shows that the Referee rejected the expert's testimony regarding the appropriate appreciation rate for the corporations' properties. There is no basis for disturbing the Referee's determination (*see F.P.D. Realty Corp.*, 267 AD2d at 112).

Petitioner's argument that prejudgment interest should be 9% instead of 4%, based upon respondent's misconduct, is rejected. Interest is not awarded as a penalty or to punish a party, it is a cost imposed for having the use of another party's money over a period of time (*see Manufacturer's & Traders Trust Co. v Reliance Ins. Co.*, 8 NY3d 583 [2007]).

The motion court correctly held that respondent did not engage in "fraudulent and perjurious conduct during the course of judicial proceedings" regarding management fee receivables (*see 317 W. 87 Assoc. v Dannenberg*, 159 AD2d 245, 246 [1st Dept 1990]).

We have considered the parties' remaining arguments and find them unavailing. Concur—Gonzalez, P.J., Saxe, Catterson, Acosta and Gische, JJ.

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Man Choi Chiu v Chiu
2015 NY Slip Op 01427 [125 AD3d 824]
February 18, 2015
Appellate Division, Second Department
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, April 1, 2015

[*1]

Man Choi Chiu et al., Respondents-Appellants,
v
Winston Chiu, Appellant-Respondent. (And Another Title.) (Action No. 1.) Winston Chiu, Appellant-Respondent, v Man Choi Chiu et al., Respondents-Appellants. (Action No. 2.)

Schlam Stone & Dolan, LLP, New York, N.Y. (Michael C. Marcus, Jonathan Mazer, and Samuel L. Butt of counsel), for appellant-respondent.

Warshaw Burstein, LLP, New York, N.Y. (Bruce H. Wiener of counsel), for respondents-appellants.

In two related actions, inter alia, for a judgment declaring the parties' interests in a certain limited liability company, which were joined for trial, Winston Chiu appeals, as limited by his brief, from so much of a judgment of the Supreme Court, Queens County (Weiss, J.), entered February 6, 2013, as, upon a decision of the same court dated August 30, 2012, made after a nonjury trial, declared that he owned only a 10% membership interest in 42-52 Northern Blvd., LLC, directed Man Choi Chiu to pay the principal sum of only $1,044,974 to purchase his membership interest, and dismissed his causes of action to recover damages for breach of fiduciary duty, and Man Choi Chiu and 42-52 Northern Blvd., LLC, cross-appeal, as limited by their brief, from so much of the same judgment as awarded Winston Chiu the principal sum of $1,044,974, plus prejudgment interest in the sum of $469,980.63.

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Ordered that the judgment is modified, on the law and the facts, by (1) deleting the provision thereof declaring that Winston Chiu owns a 10% membership interest in 42-52 Northern Blvd., LLC, and substituting therefor a provision declaring that Winston Chiu owns a 25% membership interest in 42-52 Northern Blvd., LLC, (2) deleting the provision thereof awarding Winston Chiu the principal sum of $1,044,974, and (3) deleting the provision thereof awarding Winston Chiu prejudgment interest in the sum of $469,980.63; as so modified, the judgment is affirmed insofar as appealed and cross-appealed from, without costs or disbursements, and the matter is remitted to the Supreme Court, Queens County, for a new calculation of the amount to be awarded to Winston Chiu as his interest in the subject limited liability company plus prejudgment interest, and the entry of an appropriate amended judgment thereafter.

Brothers Man Choi Chiu and Winston Chiu commenced separate actions to, inter alia, determine the fair value of Winston Chiu's membership interest in 42-52 Northern Blvd., LLC (hereinafter the LLC), as of the date of his withdrawal (*see* Limited Liability Company Law § 509; Limited Liability Company Law former § 606). After a joint nonjury trial, the Supreme Court issued a decision finding that although Winston Chiu initially had a 25% membership interest in the LLC, subsequent capital contributions by Man Choi Chiu had the effect of reducing Winston Chiu's membership interest to 10% and increasing Man Choi Chiu's membership interest to 90%. Additionally, even though the Supreme Court adopted the net asset value of the LLC of $10,449,739 espoused by Man Choi Chiu's expert, no discount for lack of marketability was applied. Further, the Supreme Court awarded prejudgment interest from the date of Winston Chiu's withdrawal, February 8, 2008, at the statutory rate of 9%. Finally, the Supreme Court dismissed Winston Chiu's breach of fiduciary duty claims.

Since this case was tried by the court without a jury, the authority of this Court to review findings of fact is as broad as that of the trial court, and includes the power to render the judgment it finds warranted by the facts, taking into account in a close case that the trial judge had the advantage of seeing the witnesses (*see Northern Westchester Professional Park Assoc. v Town of Bedford*, 60 NY2d 492, 499 [1983]; *Pernell v 287 Albany Ave., LLC*, 95 AD3d 1094 [2012]; *Kun v Fulop*, 71 AD3d 832, 833 [2010]; *O'Brien v Dalessandro*, 43 AD3d 1123 [2007]).

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Here, the Supreme Court properly determined that the LLC's records, which included the LLC's tax returns for the years 1999 and 2000, established that Winston Chiu's initial membership interest was 25% (*see Reichman v Reichman*, 88 AD3d 680, 682 [2011]; *Man Choi Chiu v Chiu*, 38 AD3d 619, 621 [2007]; *Matter of Capizola v Vantage Intl.*, 2 AD3d 843, 844 [2003]). Although Man Choi Chiu contends that the LLC's records were incorrect, he cannot subsequently take a position contrary to that taken in the income tax returns which he admitted that he signed (*see Mahoney-Buntzman v Buntzman*, 12 NY3d 415, 422 [2009]; *Livathinos v Vaughan*, 121 AD3d 485 [2014]; *Winship v Winship*, 115 AD3d 1328 [2014]; *Czernicki v Lawniczak*, 74 AD3d 1121, 1125 [2010]; *Peterson v Neville*, 58 AD3d 489 [2009]). However, the Supreme Court incorrectly determined that the subsequent contributions by Man Choi Chiu should be treated as capital contributions, and not as loans, as the record was bereft of any evidence of an agreement between the members to such treatment (*see Mizrahi v Cohen*, 104 AD3d 917, 920 [2013]; *Matter of KSI Rockville v Eichengrun*, 305 AD2d 681 [2003]; Bruce A. Rich, Practice Commentaries, McKinney's Cons Laws of NY, Book 32A, Limited Liability Company Law, 2014 Pocket Part at 72). Accordingly, on the date of his withdrawal, Winston Chiu's membership interest remained at 25%.

The Supreme Court should have adopted the net asset value of $10,427,000, espoused by Winston Chiu's expert, as Winston Chiu's expert's treatment of Man Choi Chiu's contributions was more accurate than that of Man Choi Chiu's expert. The Supreme Court providently exercised its discretion in awarding prejudgment interest from the date of Winston Chiu's withdrawal, February 9, 2008, at the statutory rate of 9% (*see* CPLR 5001 [a]; *Matter of Murphy v United States Dredging Corp.*, 74 AD3d 815, 820 [2010]; *Matter of Superior Vending, LLC [Tal—Plotkin]*, 71 AD3d 1153, 1154 [2010]; *Matter of Blake v Blake Agency*, 107 AD2d 139, 149 [1985]).

The parties' remaining contentions are without merit. Rivera, J.P., Balkin, Hall and Sgroi, JJ., concur. **[Prior Case History: 2013 NY Slip Op 30033(U).]**

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96 N.Y.2d 186 (2001)
750 N.E.2d 47
726 N.Y.S.2d 345

In the Matter of the Dissolution of PENEPENT CORPORATION, INC. ESTATE OF FRANCIS PENEPENT, RESPONDENT; RICHARD S. PENEPENT, Appellant.

Court of Appeals of the State of New York.

Argued March 27, 2001.
Decided May 1, 2001.

187 *187 *Zdarsky, Sawicki & Agostinelli*, Buffalo (*K. Michael Sawicki* of counsel), for appellant.

188 *188 *Phillips, Lytle, Hitchcock, Blaine & Huber, L. L. P.*, Buffalo (*John M. Curran* and *Craig A. Leslie* of counsel), for respondent.

Chief Judge KAYE and Judges SMITH, LEVINE, CIPARICK and GRAFFEO concur; Judge WESLEY taking no part.

OPINION OF THE COURT

ROSENBLATT, J.

A shareholder in a close corporation petitioned for dissolution pursuant to Business Corporation Law § 1104-a. Invoking Business Corporation Law § 1118, his brother, another shareholder, elected to purchase his shares at fair value. After the election, but before a determination as to
189 fair value, *189 the petitioning shareholder died. A shareholder agreement provided that, upon the death of any shareholder, the shareholder's estate must surrender the deceased's stock to the corporation in exchange for a specified price. That price was less than fair value. The issue before us is whether the brother who elected to purchase the petitioning shareholder's stock at fair value remains bound by that election. We hold that he does.

I.

Anthony Penepent started a family business in 1937. His four sons, Richard, Francis, Angelo and Philip, helped him run it. In 1952, father and sons formed Penepent Corporation, in which they each took a 20% interest.

After incorporating, the five shareholders and the corporation entered into a shareholder agreement. It provided that upon the death of any shareholder, Penepent Corporation "shall" pay to the deceased's estate (either through a life insurance policy or directly) a set price for all

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the deceased's corporate stock.[1] The agreement further provided that "the stock so purchased shall be delivered and surrendered by the representative of the [deceased] to the Corporation, which shall thereupon retire such stock."

The corporation prospered over the next several decades. In 1979, the four brothers bought out their father's interest, each becoming a 25% shareholder. By the late 1980s, however, a rift had formed among the brothers over how to transfer the business to their children: Richard and Angelo were on one side; Francis and Philip on the other. In May 1990, Philip petitioned for the dissolution of the corporation under Business Corporation Law § 1104-a. Invoking Business Corporation Law § 1118, Richard and Angelo elected to purchase Philip's shares at "fair value." While awaiting a judicial determination as to fair value, Angelo died. Supreme Court permitted
190 Angelo's estate to *190 revoke his section 1118 election. Richard thus stood to acquire all of Philip's shares.[2]

In June 1990, just before Angelo's death, Francis commenced this proceeding, likewise seeking dissolution of the corporation under section 1104-a. Richard, in line to become the sole shareholder of the corporation, made a timely election under section 1118 to purchase Francis' shares at fair value. Although Supreme Court never fully consolidated Philip and Francis' dissolution proceedings, it decided to conduct a joint valuation hearing for Philip and Francis, followed by a second hearing to determine whether the fair value of Francis' shares should be further discounted since Francis filed for dissolution several weeks after Philip. In December 1991, however, before the joint valuation hearing was completed, Francis died. By stipulation of the parties, Francis' estate was substituted as petitioner.

Shortly after Francis' death, Richard, acting as secretary of the corporation, notified Francis' estate that it was obligated to sell Francis' shares to the *corporation* at the price specified in the shareholder agreement (which was less than fair value). Francis' estate ignored the notification.

In November 1992, Supreme Court entered a judgment establishing the fair value of Philip's shares. On appeal, that judgment was affirmed. Richard thereafter moved to dismiss Francis' dissolution proceeding for lack of standing, arguing that upon Francis' death his estate was contractually obligated to surrender Francis' shares pursuant to the shareholder agreement. In the alternative, Richard sought to revoke his section 1118 election. Supreme Court denied both motions, holding that Francis' right to be paid fair value "essentially vested when [Richard] elected to purchase [Francis'] shares" and such a right survived his death. Moreover, the court refused to allow Richard to revoke his election, finding no "equitable considerations" that favored revocation.

The Appellate Division affirmed and remanded to Supreme Court for a determination as to the fair value of Francis' shares. During the second valuation hearing, Richard's expert asserted that, due to the pendency of Philip's dissolution proceeding at the time Francis filed his petition
191 for dissolution, Francis' *191 shares were less marketable than Philip's and, thus, their fair value should be discounted. The referee rejected this argument, holding that to increase the illiquidity discount for Francis' shares would "effectively impair a dissenting shareholder's statutory right to

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be paid his proportionate interest in a going concern and that all shares of the same class receive equal treatment." Supreme Court adopted the referee's determination. The Appellate Division affirmed, as do we.

II.

Business Corporation Law § 1104-a empowers a holder of 20% or more of a closely held corporation's stock to file a petition for dissolution of the corporation on the grounds that those in control have either committed "illegal, fraudulent or oppressive actions toward the complaining shareholders" or have "looted, wasted, or diverted for non-corporate purposes" the corporation's assets (Business Corporation Law § 1104-a [a]). Business Corporation Law § 1118 is a corollary to section 1104-a. It grants non-petitioning shareholders, as well as the corporation itself, the right to avoid dissolution by timely electing to purchase the petitioning shareholder's shares "at their fair value" (Business Corporation Law § 1118 [a]).[3] Critically, any such election "shall be *irrevocable* unless the court, in its discretion, for just and equitable considerations, determines that [it] be revocable" (§ 1118 [a] [emphasis added]). If the parties are unable to agree on the fair value of the shares, the court "may stay the proceedings * * * and determine the fair value of the petitioner's shares as of the day prior to the date on which such petition was filed, exclusive of any element of value arising from such filing" (Business Corporation Law § 1118 [b]).

Francis petitioned for dissolution, and Richard (acting individually) made an irrevocable election to purchase Francis' shares at fair value. The court stayed the dissolution proceeding to determine fair value. After the election, but prior to the fair value determination, Francis died. The shareholder agreement provided that, in the event of a shareholder's death, the estate of
192 the deceased shareholder must surrender the *192 shareholder's shares to the corporation in exchange for a contractually agreed upon price.[4]

We must determine whether the mandatory buy-out provision in the shareholder agreement controls in the face of a section 1118 election made before the provision became operative, i.e., before Francis' death.

Richard argues that Francis was still a shareholder when he died and, thus, pursuant to the shareholder agreement, Penepent Corporation (not Richard individually) had a right to acquire Francis' shares at the set price and retire them. He would attach no legal significance to his section 1118 election. According to Richard, Francis remained subject to the mandatory buy-out provision until the court fixed fair value and the stock purchase transaction was actually completed.

In response, Francis' estate essentially argues that at the time of his death Francis was a shareholder in name only. Richard had already made an irrevocable election pursuant to section 1118 and thus became legally bound to purchase Francis' shares at fair value. We agree. Once a party makes an election, that party is obligated to purchase (and petitioner is obligated to sell) the petitioner's shares at their fair value. Absent an agreement otherwise, divestiture events

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under a mandatory buy-out agreement—e.g., death, retirement, termination—will not operate to frustrate a preexisting section 1118 election.

As a general rule, courts must enforce shareholder agreements according to their terms (*see,* Gallagher v Lambert, 74 NY2d 562, 567). Such agreements avoid costly, lengthy litigation (*see,* Allen v Biltmore Tissue Corp., 2 NY2d 534, 542-543) and promote "reliance, predictability and definitiveness" in relationships among shareholders in close corporations (*Gallagher v Lambert, supra*). The question before us, however, is not whether the mandatory buy-out provision in the shareholder agreement was enforceable. Rather, the question is whether it was controlling where a valid section 1118 election had already been made.

Our result follows the statute's evolution. As originally enacted, section 1118 permitted electing shareholders to revoke their elections at any time. The amendment was prompted by concerns that majority shareholders could make section 1118 elections, prolong negotiations as to the fair
193 value, and then *193 revoke their elections, thus delaying the dissolution proceeding and exhausting the petitioning shareholder's resources (Davidian, *Corporate Dissolution in New York: Liberalizing the Rights of Minority Shareholders,* 56 St John's L Rev 24, 71 [1981]). To prevent this mischief, the Legislature made section 1118 elections irrevocable and binding (L 1986, ch 861).

Appellate Division cases holding that shareholders lacked standing to petition for dissolution under section 1104-a after shareholder agreements operated to divest them of their shares are distinguishable (*see, e.g.,* Weiner v Anesthesia Assocs., 203 AD2d 455; *Matter of* Hesek v 245 S. Main. St., 170 AD2d 956, 957; Martin Enters. v Janover, 140 AD2d 587; *see generally,* Banks, *The Unresolved Tension Between the 1979 Amendments to the BCL and Shareholder Agreements in Close Corporations,* 67 New York St Bar J 16 [Feb. 1995]). In the case before us, the divestiture event under the shareholder agreement— Francis' death—did not occur until a year and a half *after* Francis commenced this dissolution proceeding and Richard made a valid election to purchase at fair value. Accordingly, we hold that, upon Richard's election, Francis had a vested right to recover fair value for his corporate stock and that right survived his death.

III.

Lastly, Richard argues that the value of Francis' shares in the corporation should be discounted because Philip's dissolution proceeding was pending against the corporation at the time Francis petitioned for dissolution. We disagree. Business Corporation Law § 1118 offers no definition of "fair value." It will depend on the circumstances of each case (*see, Matter of Seagroatt Floral Co. [Riccardi],* 78 NY2d 439, 445). The objective in calculating "fair value" is to determine "what a willing purchaser in an arm's length transaction would offer for petitioners' interest in the company as an operating business" (*Matter of Seagroatt Floral Co. [Riccardi], supra* [citing *Matter of Pace Photographers (Rosen),* 71 NY2d 737, 748]).

To be sure, any litigation pending against the corporation could be considered in assessing the fair value of the corporation's shares. Here, however, the pending dissolution proceeding had no

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bearing on fair value. When Francis commenced this dissolution proceeding, other shareholders—Richard and Angelo—had elected irrevocably to purchase Philip's shares under section 1118. The corporation itself was in no danger of dissolution. Moreover, the corporation
194 had not elected to *194 purchase any of Philip's shares at fair value and therefore had no financial interest in the litigation.

The referee correctly observed that, in determining fair value, a minority shareholder's stock should not be further discounted because of its minority status (*see, Matter of* Cawley v SCM Corp., 72 NY2d 465, 471). To impose upon petitioning minority shareholders a penalty because they lack control would violate two "central equitable principles of corporate governance." First, a minority discount would deprive minority shareholders of their proportionate interest in the corporation as a going concern. Second, it would result in shares of the same class being treated unequally (*see, Matter of* Friedman v Beway Realty Corp., 87 NY2d 161, 169). When Francis commenced his proceeding, all parties were aware that Philip's proceeding (in which Richard and Angelo had already made section 1118 elections to purchase Philip's shares at fair value) would result in Richard and Angelo owning all of Philip's stock. Under these settled principles, however, this fact can have no effect on the fair value of Francis' shares.

Accordingly, the order of the Appellate Division should be affirmed, with costs.

Order affirmed, with costs.

[1] The agreement also contained a mechanism by which the corporation could increase the set purchase price:

"The parties hereto agree that the value of the stock may be changed from time to time hereafter * * *. A revaluation must be signed by all of the Stockholders and the Corporation."

Originally, the set price was $10 a share. In 1957, it was changed to $15 a share. Finally, in 1984, the set price was increased to $200 a share.

[2] In accordance with the shareholder agreement, Penepent Corporation paid Angelo's estate the specified price for his own shares and retired them.

[3] A section 1118 election may be made "at any time within ninety days after the filing of [a § 1104-a petition for dissolution] or at such later time as the court in its discretion may allow" (Business Corporation Law § 1118 [a]).

[4] These are known as "mandatory buy-out" or "stock retirement" agreements (*see generally,* O'Neal & Thompson, O'Neal's Close Corporations § 7.10, at 53-56 [3d ed]).

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Yudell v Gilbert
2012 NY Slip Op 05896 [99 AD3d 108]
August 7, 2012
Moskowitz, J.
Appellate Division, First Department
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, November 7, 2012

[*1]

Martin D. Yudell et al., Appellants,
v
Jerrold Gilbert et al., Respondents, et al., Defendant.

First Department, August 7, 2012

APPEARANCES OF COUNSEL

Schwartz & Silverstein, LLP, New City (*Mark D. Lefkowitz, Leonard J. Sklerov* and *Jonathan E. Antone* of counsel), for appellants.

Frydman LLC, New York City (*David S. Frydman* of counsel), for Jerrold Gilbert and another, respondents. [*2]

D'Agostino Levine, Landesman & Lederman LLP, New York City (*George Tzimopoulos* of counsel), for Susan W. Finley and others, respondents.

{**99 AD3d at 110} OPINION OF THE COURT

Moskowitz, J.

This appeal, from the grant of a motion to dismiss the complaint, requires us to analyze the difference between direct and derivative claims. New York has lacked a clear approach for determining this difference. Instead, our jurisprudence consists of case by case analyses, that are sometimes difficult to apply to new fact patterns. Therefore, in this

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case, we adopt the test the Supreme Court of Delaware developed in *Tooley v Donaldson, Lufkin & Jenrette, Inc.* (845 A2d 1031, 1039 [Del 2004]). The *Tooley* test is consistent with New York law and has the added advantage of providing a clear and simple framework to determine whether a claim is direct or derivative.

At issue on this appeal are claims by trustees of one member of a joint venture against: (1) the managing agent of the joint venture's sole asset, a shopping center in Long Island, (2) the other members of the joint venture and (3) the joint venture as a nominal defendant.

In 1965, plaintiff Martin D. Yudell, Julius Yudell,[FN*] Joseph J. Weiser, and I. Roy Psaty formed Baldwin Harbor Associates (BHA). Each of the Yudells had a one-sixth interest, while Weiser and Psaty each had a one-third interest. Martin and Julius's interests were later reconfigured so that the Yudell Trust had a one-third interest in the joint venture. Julius Yudell, Joseph Weiser and I. Roy Psaty are deceased.

The purpose of the joint venture was to construct and manage a shopping center. Pursuant to a 1991 management agreement, BHA hired defendant Jerrold Gilbert as the managing agent for the shopping center. Prior to that time, Gilbert had no legal connection to the joint venture. Subsequently, Gilbert became one of two trustees of the Psaty Trust, the successor venture partner to I. Roy Psaty. One of the beneficiaries of the Psaty Trust is Gilbert's wife. Gilbert's compensation as the managing agent is 3% of the gross rentals of the shopping center. His responsibilities as manager include billing and collecting rents and providing for maintenance and repair of the premises.

In 2008, plaintiffs brought this action against Gilbert individually, the other members of the joint venture and BHA as a nominal defendant. The complaint purported to bring both derivative and direct claims and pleaded demand futility as follows:{**99 AD3d at 111}

> "Plaintiff Yudell Trust is bringing this action in both its individual capacity, and as a derivative action on behalf of BHA [i.e., the joint venture Baldwin Harbor Associates]. In view of the acts, practices and courses of conduct on the part of the defendants as alleged herein, a demand upon the joint venture [*3] partners of BHA to take action against the individual defendants would be futile."

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The complaint alleged, on information and belief, that Gilbert had "failed to timely, and in a regular manner, bill for and collect appropriate additional rents and charges at the Shopping Center, including but not limited to real estate tax escalation reimbursement (the 'Tax Obligations'), and common area maintenance ('CAM') charges, all required by the terms of the leases." The complaint specified:

> "(a) upon information and belief, Waldbaum's, Inc. . . . accrued a total of approximately $1,200,000 in unpaid Tax Obligations owed to BHA during the period of 1991 through 2007 and has also accrued a total of approximately $375,000 in unpaid CAM charges owed to BHA during the period of 1991 through 2007;
>
> "(b) upon information and belief, CVS/Caremark Corporation ('CVS') has accrued a total of approximately $340,000 in unpaid Tax Obligations owed to BHA during the period of 2001 through 2007;
>
> "(c) with the approval of [the Weiser and Psaty defendants], and over the objection of the Plaintiff, Gilbert has unilaterally granted . . . purportedly 'temporary' rent concessions to various tenants, . . . which have continued for years and have significantly reduced the revenues of the Shopping Center;
>
> "(d) during the past 17 years, Gilbert . . . failed to preserve the legal claims of BHA against Waldbaum's and CVS and other tenants for unpaid Tax Obligations, CAM and rent more than six (6) years old . . . ;
>
> "(f) Upon information and belief, Gilbert has hired third party real estate brokers to obtain tenants for the Shopping Center for compensation without having{**99 AD3d at 112} entered into written agreements with such brokers, and without having obtained the required unanimous consent of the Venture Partners."

The complaint further alleged:

> "Upon information and belief, Gilbert's failure to collect the Tax Obligations and CAM . . . and preserve the BHA legal claims against Waldbaum's . . . had the effect of . . . vesting Waldbaum's with superior bargaining power in the . . . negotiation . . . in No[*4]vember 2007 for a 20 year . . . lease extension and expansion of its space in the Shopping Center . . . This superior bargaining power . . . resulted in Waldbaum's obtaining an under-market rent from BHA for the next 20-years . . . ."

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The complaint also alleged that Gilbert had failed "to properly repair, upgrade and maintain the Shopping Center facilities during [the past 17] years . . . The deterioration of the Shopping Center has resulted in BHA's inability to obtain rents anywhere near the average market level for such a shopping center in its territory."

The complaint additionally alleged, "Since in or about April 2002, Gilbert . . . has continually failed to send to the Plaintiffs, on a regular basis and in a timely manner, the monthly operating statements with respect to the Shopping Center, and other material documents." For example, Gilbert allegedly "failed and/or refused to provide the Plaintiffs . . . with the revised year-end compilations for 2005 and 2006, the bank lease extension documentation, and monthly statements for August, September and December 2006, and October 2007." However, an exhibit to the complaint included the October 2007 monthly recap for the shopping center.

The first cause of action alleged that Gilbert had "squandered, mismanaged and wasted joint venture partnership funds and property, causing the joint venture partnership to suffer great loss." It also alleged that Gilbert had "failed properly to account to the joint venture partners." It sought damages in an "amount determined by an independent accounting."

The second cause of action alleged that Gilbert had breached the management agreement. It sought damages in an "amount determined by an independent accounting."

The third cause of action alleged that Gilbert, Weiser, and the Psaty defendants "owed a fiduciary duty to BHA and each of[**99 AD3d at 113] the joint venture partners" that they allegedly breached, causing "injury and damages to the Plaintiffs, including all additional, incidental and consequential amounts as shall be determined prior to trial" and sought damages "in an amount determined by the court." The alleged breach of fiduciary duty the Weiser and Psaty defendants committed was "their de facto alliance with Gilbert in support of [Gilbert's] exclusive management and control of virtually every BHA transaction during the past 17 years, and Gilbert's opposition to the exercise of the partnership rights of the Yudell Trust."

The fourth cause of action was against Gilbert for negligence. The sixth cause of action alleged that Gilbert breached the joint venture agreement. It specified, "Gilbert's

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unauthorized hiring of third party real estate brokers . . . without written agreements, has placed BHA in risk of being subject to claims from the third party real estate brokers for excessive commissions and expenses which are not limited by written agreements." Plaintiffs did not oppose dismissal of the fifth cause of action and did not appeal from the dismissal of the seventh cause of action.

Defendants answered and moved to dismiss the complaint. The Psaty defendants also moved to amend their answer to add the defenses of documentary evidence, release, and lack of a necessary party because plaintiffs had not effectuated service upon BHA, the joint venture.

The motion court determined that the first six causes of action were derivative in nature and granted defendants' motions to dismiss these causes of action for failure to plead demand [*5]futility with the requisite particularity (*Yudell v Gilbert*, 2010 NY Slip Op 33779[U] [2010]). On appeal, plaintiffs contend this was error because, according to plaintiffs, not every aspect of causes of action one through six was derivative in nature. In particular, plaintiffs contend the third cause of action for breach of fiduciary duty was a direct claim.

A plaintiff asserting a derivative claim seeks to recover for injury to the business entity. A plaintiff asserting a direct claim seeks redress for injury to him or herself individually. Sometimes whether the nature of the claim is direct or derivative is not readily apparent. New York does not have a clearly articulated test, but approaches the issue on a case by case basis depending on the nature of the allegations. For instance, where shareholders suffer solely through depreciation in the value of their stock, the claim is derivative (*Lewin v Lipper Convertibles*, 756 F Supp[**99 AD3d at 114] 2d 432, 441 [SD NY 2010]), even if the diminution in value derives from a breach of fiduciary duty (*Hahn v Stewart*, 5 AD3d 285, 286 [2004]). Allegations of mismanagement or diversion of corporate assets also plead a wrong to the corporation (*see Abrams v Donati*, 66 NY2d 951, 952 [1985]; *Albany-Plattsburgh United Corp. v Bell*, 307 AD2d 416, 419 [2003], *lv dismissed and denied* 1 NY3d 620 [2004]), as is a diversion of a corporate opportunity (*see Glenn v Hoteltron Sys.*, 74 NY2d 386, 393 [1989]).

Delaware law, however, provides a framework to determine whether a claim is direct or derivative:

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> "[a] court should look to the nature of the wrong and to whom the relief should go. The stockholder's claimed direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation" (*Tooley v Donaldson, Lufkin & Jenrette, Inc.*, 845 A2d 1031, 1039 [Del 2004]).

Thus, under *Tooley*, a court should consider "(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)" (*id.* at 1033).

Applying this common sense approach, plaintiffs' claim for breach of fiduciary duty is derivative, because any pecuniary loss plaintiffs suffered derives from a breach of duty and harm to the business entity, BHA. Plaintiffs' allegations of breach of fiduciary duty involve failure to collect rent, back taxes and common charges that tenants would have owed to BHA. Paragraph 17 of the complaint highlights the derivative nature of plaintiffs' claims when it refers to: "Gilbert's *failure to preserve BHA's rights* to collect the unpaid tax obligations, CAM and rent . . . ." It is only through loss to BHA that plaintiffs suffer a loss at all. Although plaintiffs may own a minority interest in the joint venture, all members suffer losses from the failure to collect rents and other obligations owed the joint venture. Moreover, *Tooley* suggests that we consider looking at who would receive the benefit of any recovery or other remedy, the joint venture or the members individually. Accordingly, here, any recovery would represent the value of lost rent, [*6]CAM charges and the like that inure to the benefit of the joint{**99 AD3d at 115} venture. Only if and when the joint venture receives this compensation would plaintiffs then be entitled to receive their proportionate share. Thus, plaintiffs' claims are derivative.

But, even if some of plaintiffs' claims were direct, "[a] complaint the allegations of which confuse a shareholder's derivative and individual rights will . . . be dismissed" (*Abrams v Donati*, 66 NY2d 951, 953 [1985]). To the extent, if any, that plaintiffs have asserted direct claims, they are embedded in an otherwise derivative claim for partnership waste and mismanagement. Accordingly, the motion court correctly determined that plaintiffs' causes of action are derivative and properly dismissed them because the complaint fails to plead demand futility with the requisite particularity (*see e.g. Bansbach v Zinn*, 1 NY3d 1, 8-9, 11 [2003]; *Marx v Akers*, 88 NY2d 189, 198, 200-

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202 [1996]). None of the grounds for excusing demand appear in the complaint. The complaint fails to allege that any of the defendants had some self-interest in the transactions, or in Gilbert's alleged neglect. The complaint does not allege that defendants "failed to inform themselves to a degree reasonably necessary about the [challenged] transaction[s]" (*Marx*, 88 NY2d at 198). Nor does the complaint allege that the challenged transactions were so egregious on their face that they could not have been products of sound business judgment.

Because the dismissal below was not with prejudice (*cf. Tico, Inc. v Borrok*, 57 AD3d 302 [2008]), it is not necessary for us to reach plaintiffs' argument on appeal that they should be allowed to amend their complaint.

Accordingly, the appeal from the order of the Supreme Court, New York County (Bernard J. Fried, J.), entered May 3, 2010, that, insofar as appealed from as limited by the briefs, granted the motions of defendants Jerrold Gilbert (individually), Susan W. Finley, Wendy W. Chayet, and Stanley Weiser, as trustees of the Weiser Family Trust, and Jerrold Gilbert and Jerrold Morgulas, as trustees of the Irene Psaty Trust, to dismiss the first, second, third, fourth, and sixth causes of action of the complaint, should be deemed an appeal from the judgment, same court and Justice, entered August 30, 2010, dismissing the complaint, and, as so considered, said judgment should be affirmed, with costs.

Tom, J.P., Friedman, Sweeny and DeGrasse, JJ., concur.

Appeal from order, Supreme Court, New York County, entered May 3, 2010, deemed an appeal from a judgment, same court{**99 AD3d at 116} and Justice, entered August 30, 2010, and as so considered, affirmed, with costs.

Footnotes

Footnote *: One set of plaintiffs is Martin D. Yudell and Donald M. Spanton as trustees of the Julius Yudell Trust.

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66 N.Y.2d 951 (1985)

Harry Abrams, Appellant,
v.
Enrico Donati, Respondent, et al., Defendants.

Court of Appeals of the State of New York.

Decided December 17, 1985.

Emanuel Baetich for appellant.

Ronald J. Offenkrantz for respondent.

Concur: Chief Judge WACHTLER and Judges JASEN, MEYER, SIMONS, KAYE, ALEXANDER and TITONE concur.

953 *953MEMORANDUM.

The judgment appealed and the order of the Appellate Division brought up for review should be affirmed, with costs.

For a wrong against a corporation a shareholder has no individual cause of action, though he loses the value of his investment or incurs personal liability in an effort to maintain the solvency of the corporation (Citibank v Plapinger, 66 N.Y.2d 90, 93, n; General Motors Acceptance Corp. v Kalkstein, 101 AD2d 102, *appeal dismissed* 63 N.Y.2d 676; Fifty States Mgt. Corp. v Niagara Permanent Sav. & Loan Assn., 58 AD2d 177). Exceptions to that rule have been recognized when the wrongdoer has breached a duty owed to the shareholder independent of any duty owing to the corporation wronged (General Rubber Co. v Benedict, 215 N.Y. 18 [director of parent corporation who acquiesced in the misuse of funds of its subsidiary; action by parent maintainable]; Hammer v Werner, 239 App Div 38 [issuance of treasury stock to directors at an inadequate price and without affording plaintiff the right to purchase his proportionate part; individual action maintainable]). But allegations of mismanagement or diversion of assets by officers or directors to their own enrichment, without more, plead a wrong to the corporation only, for which a shareholder may sue derivatively but not individually (*see, e.g.*, Niles v New York Cent. & Hudson Riv. R. R. Co., 176 N.Y. 119; Carpenter v Sisti, 45 AD2d 529, 531). A complaint the allegations of which confuse a shareholder's derivative and individual rights will, therefore, be dismissed (Greenfield v Denner, 6 N.Y.2d 867, *revg on dissenting opn* of Breitel, J., 6 AD2d 263, 268; Brock v Poor, 216 N.Y. 387; *see*, Witherbee v Bowles, 201 N.Y. 427, 433), though leave to replead may be granted in an appropriate case (*Greenfield v Denner*, 6 AD2d, at p 271, *supra*).

Here plaintiff pleads a conspiracy to terminate his employment as president of Donrico, Inc., and to depress the value of its stock so that the stock could be acquired by the corporation under the shareholders' agreement at a greatly depreciated price, but mixes those allegations with

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charges of diversion of corporate assets by the padding of expenses and the fraudulent reduction of the price of Donrico's products to a corporate purchaser owned by one of the
954 conspirators. The wrongs thus *954 pleaded are to Donrico, Inc.; there is no claim that plaintiff sustained a loss disproportionate to that sustained by Donrico, or that defendants breached an independent duty owed plaintiff, or that if the corporation is made whole in a derivative action plaintiff will be unable to enforce his right under the employment agreement to damages for its breach and under the shareholders' agreement to the higher price he claims was due him for his stock. The more particularly is this so in light of the fact that plaintiff's second cause of action, since discontinued, sought damages for the claimed wrongful termination of the contract employing him as Donrico's president. His first cause of action was, therefore, properly dismissed. Moreover, the Appellate Division's failure to grant him leave to replead involved no abuse of discretion in light of the absence of any request on his part for such relief and the fact that his claim against defendant Houbigant, Inc., had been earlier dismissed on the ground that it alleged wrongs to Donrico resulting in a proportionate decrease in the value of plaintiff's stock which afforded him no right to individual relief.

On review of submissions pursuant to section 500.4 of the Rules of the Court of Appeals (22 NYCRR 500.4), judgment appealed from and order of the Appellate Division brought up for review affirmed, with costs, in a memorandum.

6 N.Y.2d 204 (1959)

Warren S. Tenney, Suing as a Director of New York Water Service Corporation, Respondent,
v.
Richard L. Rosenthal et al., Appellants, et al., Defendants.

Court of Appeals of the State of New York.

Argued May 12, 1959.
Decided July 8, 1959.

Jesse Climenko and *Martin I. Shelton* for corporate appellants.

Henry J. Friendly, *Leonard S. Sheriff* and *Sedgwick W. Green* for individual appellants.

Milton Pollack, *Warren S. Tenney* and *Samuel N. Greenspoon* for respondent.

Chief Judge CONWAY and Judges DESMOND, DYE, FROESSEL, VAN VOORHIS and BURKE concur.

207 *207FULD, J.

Certified questions call upon us to say whether a director of a corporation may continue to maintain an action, brought by him while a director on behalf of the corporation, pursuant to section 61 of the General Corporation Law, after he has been defeated for re-election to such office.

In May of 1957, Warren S. Tenney became a director of the New York Water Service Corporation and in December of that year commenced this suit, as director, pursuant to section 61 of the General Corporation Law, against fellow directors and a wholly-owned subsidiary of Water Service. The latter is also named as a nominal defendant.

On May 14, 1958, a day before the annual meeting of stockholders to elect directors, the corporate defendants moved to dismiss the complaint on the ground that the plaintiff "has not legal capacity to sue" (Rules Civ. Prac., rule 107, subd. 2) and, in support of the motion, the defendants asserted that the plaintiff, not included on the "slate of persons proposed by Management", would not be re-elected as a director at the election to be held on May 15 and that, consequently, the plaintiff would not be in office at the time of the hearing of the motion. The forecast was accurate; the plaintiff was not elected. Then, on May 16, the day following the election, and after their time to make motions had expired, the individual defendants moved, *nunc pro tunc* as of May 14, to dismiss the complaint on two grounds — (1) pursuant to section
208 82 of the Civil Practice Act, "because the action has abated" and (2) pursuant to rule 107, *208 on the ground, specified in the earlier motion, that the plaintiff "has not legal capacity to sue".

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The court at Special Term, ruling in favor of the defendants, dismissed the complaint. The Appellate Division, however, unanimously reversed and denied the defendants' motions. It granted leave to appeal, certifying two questions for our review.

It is sufficient, for present purposes, to observe that the four causes of action alleged in the complaint before us assert breaches by the defendant directors of the duties owed by them to their corporation. The first cause of action alleges that the defendant directors have exceeded their authority to manage the business of the corporation by making *ultra vires* investments of corporate funds; the second, third and fourth causes of action charge that the defendant directors severally named therein have failed to discharge their duties to the corporate defendant by wasting the corporate assets through excessive or unlawful payments to or for the benefit of certain individual defendants. These causes of action are unquestionably within the scope of section 60 of the General Corporation Law and were properly brought, pursuant to section 61, by the plaintiff as a director of the corporation. These causes, it is manifest, do not assert a right which is personal to the plaintiff or a right which belongs to him by virtue of his status as director. The right which he seeks to vindicate in each cause of action is the right of the corporation to the faithful services of its directors in the management of its corporate affairs and, quite obviously, this right of the corporation, as well as the causes of action for the alleged breaches of duty by the defendant directors, survive unaffected by the fact that the plaintiff is no longer a director.

Section 82 of the Civil Practice Act declares, in terms clear and unambiguous, that "An action does not abate by any event if the cause of action survives or continues", and since 1924 the courts of this State have consistently held that, while a director's right to bring the action does not exist after he has been defeated for re-election, the cause of action survives because it is brought for the benefit of the corporation; in other words, the action, once properly initiated, may not be defeated by the circumstance that the plaintiff loses, or is ousted from, his directorship. (See *Manix v. Fantl*, 209 App. Div. 756, 758-759; *Wangrow v. Wangrow*, 211 App. Div. 552,
209 557-558; *209 *Abberger v. Kulp*, 156 Misc. 210 [Erie County]; *Wyckoff v. Sagall*, 16 Misc 2d 630, 631 [New York County]; *Handler v. Belmare Light. Co.*, 8 Misc 2d 687, 691 [Kings County]; but see, contra, *Kehaya v. Axton*, 32 F.Supp. 266.) We agree with these views.

Matter of Cohen v. Cocoline Prods. (309 N.Y. 119), upon which the appellants rely, has nothing to do either with section 61 of the General Corporation Law or with the case before us. We simply held that, since a director's absolute, unqualified right to inspect books is a personal right and is merely a procedural adjunct of his duty to keep informed of corporate matters, his absolute right terminates and becomes but a qualified one when his duty as director ceases. The plaintiff is not here suing to enforce a personal right given to him at common law so that he may keep himself informed. Rather, he brought suit on behalf of his corporation to vindicate a status given by statute and pursuant to statutory authorization.

Having concluded that the action has not abated, we are brought to the second certified question, which we interpret as posing the issue whether the plaintiff has standing to continue to prosecute the action now that he is no longer a director. Concededly, he had the legal capacity

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to bring the action, when he did, by virtue of the provisions of the statute (General Corporation Law, § 61), and we see no basis for holding that he lost that capacity or suffered a disqualification when he failed to be re-elected as director.

The plaintiff, and there can be no doubt of this, is prosecuting this action, in the right and for the benefit of the corporation, in a fiduciary capacity which "may not inaptly be compared to that of a guardian *ad litem*". (*Whitten v. Dabney*, 171 Cal. 621, 625, 631-632; see, e.g., *Denicke v. Anglo California Nat. Bank*, 141 F.2d 285, 288, cert. denied 323 U. S. 739; *Goodwin v. Castleton*, 19 Wn. [2d] 748, 763.) The plaintiff is privileged to continue in such fiduciary capacity to prosecute the action for the benefit of the corporation so long as there is no compelling reason to remove him from his trust. To remove him, it is not enough that the corporation, controlled by the very directors accused of negligence or misconduct, request that some one else, an unnamed person, prosecute the action on its behalf; a persuasive case has to be made out to establish
210 that the proper *210 protection of the corporation's interest or the proper conduct of the litigation would be better served by the elimination or a change in the identity of the guardian ad litem. For example, following the analogy of *Ream v. Ream* (281 N.Y. 395), which held that a minor upon reaching majority is entitled to take control of an action on his behalf from his guardian ad litem, the corporation would be entitled to take control of an action if it could show that it was managed by a board of directors in no way involved in the misconduct alleged in the complaint. It may also be that, in a proper case, the plaintiff should be disqualified for conflict of interest or some other reason. In our opinion, however, the fact that the plaintiff has failed of re-election as a director does not automatically bar him from continuing to prosecute the action for the benefit of the corporation.

Strong reasons of policy dictate that, once he properly initiates an action on behalf of the corporation to vindicate its rights, a director should be privileged to see it through to conclusion. Other directors, themselves charged with fraud, misconduct or neglect, should not have the power to terminate the suit by effecting the ouster of the director-plaintiff. It is no answer to say that, if wrongs were committed, others are available to commence a new and appropriate action.

To support their position, the defendants urge the analogy of derivative suits brought by shareholders, wherein it has been held that the plaintiff loses his right to continue to prosecute the action if he ceases to be a shareholder. (See *Gleicher v. Times-Columbia Distrs.*, 283 App. Div. 709; *Smith v. Industrial Acceptance Corp.*, 265 App. Div. 931; *Johnson v. Baldwin*, 221 S. C. 141.) While there may be many similarities between the derivative action brought by a shareholder and one brought by a director — in both cases the action is prosecuted in the right and for the benefit of the corporation — there are important reasons why the rule of automatic disqualification upon loss of status should not be extended to the director's action.

In the first place, the shareholder's action was developed by the courts of equity in large measure to avoid a multiplicity of suits by shareholders similarly damaged by the negligence or
211 misconduct of corporate directors. (See Prunty, The Shareholders' *211 Derivative Suit: Notes on its Derivation, 32 N. Y. U. L. Rev. 980.) The shareholder is under no fiduciary duty to the corporation prior to the institution of the action. When he sues derivatively, he does so as a

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volunteer insofar as his fellow shareholders are concerned; he is authorized to proceed only because of his proprietary interest in the corporation. It is significant that in 1944, when the Legislature undertook to combat abuses of the shareholder's derivative action, the remedial legislation sought to strengthen the proprietary interest of the plaintiff in two ways: first, by requiring a showing that he was a shareholder at the time of the transaction of which he complained (L. 1944, ch. 667; General Corporation Law, § 61); and, second, by providing for his posting of security for litigation expenses unless his proprietary interest amounted to at least 5% of the outstanding shares of any class or was worth at least $50,000 (L. 1944, ch. 668; General Corporation Law, § 61-b). In a very real sense, in modern theory, the standing of the shareholder is based on the fact that, when he sues derivatively, he is defending his own interests as well as those of the corporation. If he disposes of his shares after initiating the derivative action, he destroys the technical foundation of his right to continue to prosecute the suit.

The situation is, obviously, quite different in the case of the director's derivative suit. His right to sue is based on the public policy declared by the Legislature upon enactment of the statute. We may assume that the right to bring suit has been granted in order to facilitate and improve the director's performance of the "stewardship obligation" which he owes to the corporation and its stockholders and to protect him from possible liability for failure to proceed against those responsible for improper management of the corporate affairs. (See *Matter of* Cohen v. Cocoline Prods., 309 N.Y. 119, 123, *supra*.) Consequently, the director is not a volunteer and there is no equitable ground for holding that he automatically forfeits his standing to continue to prosecute the action if he thereafter ceases to be a director. The analogy of the shareholder's action is not persuasive here because no proprietary interest is involved. The analogy must be sought elsewhere. We have suggested that of the guardian ad litem. Once he has been properly appointed, as the director has been in this action, his standing is in no way affected by the fact
212 that he is a stranger *212 to his ward. His fiduciary obligations as guardian ad litem are separate from those which he had prior to the commencement of the action and are in no way diminished by his loss of status as a director.

In the second place, it is logical to hold, in the case of the shareholder's derivative action, that, by the sale of his stock, the plaintiff forfeits his right to continue to prosecute the action for the benefit of the corporation. By the voluntary abandonment of his personal interest in the litigation, he has also by implication abandoned the cause of the corporation. However, no such abandonment of the corporate cause of action is inferable when the plaintiff director has failed of re-election as a director. For example, it may well be that a majority of the shareholders in a close corporation will vote against a director who properly insists that the corporation be managed for the benefit of all the shareholders, rather than only of the majority. Or, it may happen in a publicly held corporation that the proxies of quiescent shareholders will be voted against a director who has sought to expose wrongdoing by the same dominant directors who actually cast the votes. In such situations, it would hardly be argued that a director's loss of status implies a voluntary abandonment of the corporation's cause of action. If anything, the plaintiff's failure of re-election may be simply another aspect of the unhealthy corporate condition which he is intent upon correcting.

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In the present case, the record reveals that the plaintiff in 1957 had been elected a member, under the cumulative voting procedure, of a board of eight directors. After he instituted this action against the dominant directors, the latter exercised their power to reduce the membership of the board from eight to five. This made it mathematically more difficult for the plaintiff to be re-elected in 1958. Indeed, the record discloses that the dominant directors announced, prior to the election, that the plaintiff would be defeated. The defendants have pointed out that the plaintiff would have lost even if there had been no reduction in the number of directors. This, though, is not material; the pertinent fact is that the plaintiff did not voluntarily abandon his trust.

213 In the third place, the rule of automatic disqualification of the plaintiff shareholder in a derivative action, when he ceases *213 to be a shareholder, is but one of a group of related rules worked out by the courts to sustain such suits while avoiding some of their potential abuses. This effort is still in the process of development. (See Clarke v. Greenberg, 296 N.Y. 146; cf. Fed. Rules Prac., rule 23, subd. [c].)

The statutory authorization for suits by directors seeks to achieve the same end, of vindicating the corporation's rights by a method less subject to the risk of abuse. In the absence of legislative direction, we do not believe that we are warranted in extending to the director's derivative action the rule of automatic disqualification of the plaintiff to prosecute the action upon loss of his status. On the one hand, a faithless director might be induced to resign, and thereby betray his trust, perhaps upon inducements from the individual defendants. On the other hand, the individual defendants, by virtue of the power they hold in the corporation, and which it is alleged they have misused, may find it advantageous to defeat the plaintiff's bid for re-election rather than defend the suit. In either case, the corporation would be left defenseless even though it had — or, perhaps, particularly when it had — a meritorious case. This result can better be avoided by keeping the director as plaintiff so long as it is proper to do so and holding him to the strictest accountability as guardian ad litem for the corporation.

Finally, in view of the defendants' further argument, we have explored the record to ascertain whether there are any other compelling reasons to hold the plaintiff barred from going on with the litigation. We need but say that we find none. Even if we were to assume, as the defendants insist, that the plaintiff was motivated by personal gain in bringing this action as director, we perceive no conflict of interest or other ground requiring this court to hold as matter of law that the plaintiff is disqualified from continuing to prosecute the action for the benefit of the corporation.

In sum, then, the action, properly commenced by the plaintiff when he was a director, may not be defeated, either on the theory of abatement or of lack of capacity to sue, by effecting the plaintiff's ouster as director. The plaintiff's purpose and plan to bring to account those mismanaging the corporation may not be frustrated or interrupted by any such process. The
214 action *214 is for the benefit of the corporation and, to cull from the opinion in the *Manix* case (209 App. Div. 756, 759, *supra*), it should not be terminated "on account of the mere fact that other directors succeed, by trick or otherwise, in defeating the plaintiff director for re-election. Such a construction of the statute would often render it practically ineffectual."

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The order appealed from should be affirmed, with costs, and the two certified questions answered in the negative.

Order affirmed, etc.

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Matter of 1545 Ocean Ave., LLC
2010 NY Slip Op 00688 [72 AD3d 121]
January 26, 2010
Austin, J.
Appellate Division, Second Department
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, May 12, 2010

[*1]

In the Matter of the Dissolution of 1545 Ocean Avenue, LLC. Crown Royal Ventures, LLC, Respondent; Ocean Suffolk Properties, LLC, Appellant, and Walter T. Van Houten et al., Respondents.

Second Department, January 26, 2010

Matter of 1545 Ocean Ave. LLC v Ocean Suffolk Props. LLC, 2007 NY Slip Op 34451[U], reversed.

APPEARANCES OF COUNSEL

Rivkin Radler, LLP, Uniondale (*Joseph Buzzell* and *Cheryl Korman* of counsel [Oliver Hull former of counsel on the brief]), for appellant.

Barry V. Pittman, Bayshore, for Crown Royal Ventures, LLC, respondent.

{**72 AD3d at 122} OPINION OF THE COURT

Austin, J.

{**72 AD3d at 123}On this appeal, we are asked to determine whether the Supreme Court properly granted the petition of Crown Royal Ventures, LLC (hereinafter Crown Royal), to dissolve 1545 Ocean Avenue, LLC (hereinafter 1545 LLC). For the following reasons, we answer in the negative and reverse the order of the Supreme Court.

I

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1545 LLC was formed in November 2006 when its articles of organization were filed with the Department of State. On November 15, 2006 two membership certificates for 50 units each were issued respectively to Crown Royal and the appellant, Ocean Suffolk Properties, LLC (hereinafter Ocean Suffolk).

On the same date that the membership certificates were issued, an operating agreement was executed by Ocean Suffolk and Crown Royal. The operating agreement provided for two managers: Walter T. Van Houten (hereinafter Van Houten), who was a member of Ocean Suffolk, and John J. King, who was a member of Crown Royal. Each member of 1545 LLC contributed 50% of the capital which was used to purchase premises known as 1545 Ocean Avenue in Bohemia (hereinafter the property) on January 5, 2007. 1545 LLC was formed to purchase the property, rehabilitate an existing building, and build a second building for commercial rental (hereinafter buildings A and B, respectively).

It was agreed by Van Houten and King that they would solicit bids from third parties to perform the necessary demolition and construction work to complete the project. Van Houten, who owns his own construction company, Van Houten Construction (hereinafter VHC), was permitted to submit bids [*2]for the project, subject to the approval of the managers.

Ocean Suffolk alleges that when there were no bona fide bidders, the managers agreed to allow VHC to perform the work, while Crown Royal maintains that VHC began demolition and reconstruction on building A without King's consent. In rehabilitating the existing building, Van Houten claims that he discovered and remediated various structural flaws with the claimed knowledge and approval of King or another member of Crown Royal.

King wanted architect Gary Bruno to review the blueprints upon which VHC began demolition since it had been started without the necessary building permits. In addition. King claimed that VHC did not have the proper equipment to efficiently{**72 AD3d at 124} do the excavation and demolition work, causing the billing to be greater than necessary. VHC billed 1545 LLC the sum of $97,322.27 for this work. King claims that he agreed 1545 LLC would pay VHC's invoice on the condition that it would no longer

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unilaterally do work on the site. Notwithstanding King's demand, VHC continued working on the site. Despite his earlier protests, King did nothing to stop it.

Thereafter, Bruno applied to the Town of Islip for the necessary building permits. The Suffolk County Department of Health required an environmental review whereby a so-called "hot spot" was detected by an environmental engineering firm which proposed to remediate it for $6,500. F&E, the company recommended by Crown Royal to do the remediation work, estimated that the cost for the environmental remediation work would be about $6,675. King claims that Van Houten objected to F&E and had another firm do a separate evaluation without King's approval, while Van Houten asserts that although F&E eventually charged $8,229.63 for its work, payment to F&E by 1545 LLC was made with his approval. Moreover, Van Houten claimed that the separate evaluation was paid for by Ocean Suffolk out of its own account.

Following this incident, King contended that tensions between King and Van Houten escalated. King asserted that things could not continue as they were or else the project would not be finished in an economical or timely manner. King claimed that Van Houten refused to meet on a regular basis; that he proclaimed himself to be a "cowboy"; and that Van Houten stated he would "just get it done." Nevertheless, King acknowledged that the construction work undertaken by VHC was "awesome."

By April 2007, King announced that he wanted to withdraw his investment from 1545 LLC. He proposed to have all vendors so notified telling them that Van Houten was taking over the management of 1545 LLC. As a result, Van Houten viewed King as having resigned as a manager of 1545 LLC.

Ultimately, King sought to have Ocean Suffolk buy out Crown Royal's membership in 1545 LLC or, alternatively, to have Crown Royal buy out Ocean Suffolk. In the interim, King had his attorney send a "stop work" request to Van Houten.

There ensued discussions regarding competing proposals for the buyout of the interest of each member by the other. No satisfactory resolution was realized. Nevertheless, despite disagreement among the members during this difficult period, VHC {**72 AD3d at 125} continued to work unilaterally on the site so that the project was

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within weeks of completion when this proceeding was commenced whereby further work by Van Houten was enjoined.

II

Article 4.1 of the operating agreement provides that "[a]t any time when there is more than one Manager, any one Manager may take any action permitted under the Agreement, unless the approval of more than one of the Managers is expressly required pursuant to the [operating agreement] or the [Limited Liability Company Law]."

Article 4.12 of the operating agreement entitled, "Regular Meetings," does not require meetings of the managers with any particular regularity. Meetings may be called without notice as the managers may "from time to time determine."

Article 7.4 of the operating agreement provides, "any matter not specifically covered by a provision of the [operating agreement], including without limitation, dissolution of the Company, shall be governed by the applicable provisions of the Limited Liability Company Law." Accordingly, dissolution of 1545 LLC is governed by Limited Liability Company Law article VII.

III

This proceeding was commenced by order to show cause and verified petition seeking the dissolution of 1545 LLC and related relief. The sole ground for dissolution cited by Crown Royal is deadlock between the managing members arising from Van Houten's alleged violations of various provisions of article 4 of the operating agreement. There was no allegation of fraud or frustration of the purpose of 1545 LLC on the part of Ocean Suffolk, Van Houten, and VHC. [*3]

Answering the petition, Van Houten, on behalf of his company and Ocean Suffolk, denied the allegations in the petition and set forth their claim that they did business in accordance with the operating agreement. Van Houten alleged that the only significant dissension among the members arose from the inability of the parties to agree on a buyout of each other's interest in 1545 LLC. Significantly, Van Houten alleged, without dispute, that the renovation of building A was within three to four weeks of completion when this proceeding was commenced.

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Van Houten also contended that, as a result of King's resignation as a managing member, Crown Royal could not reasonably{**72 AD3d at 126} claim that a deadlock existed. Moreover, there is no evidence that King complied with article 4.8 of the operating agreement by submitting a written resignation. Nevertheless, by May 10, 2007, in anticipation of a buyout of the Crown Royal interest in the venture, the parties were operating as if Van Houten was the sole managing member of 1545 LLC. Indeed, throughout the negotiations for the buyout, the renovation work on building A continued.

IV

Limited Liability Company Law § 702 provides for judicial dissolution as follows:

> "On application by or for a member, the supreme court in the judicial district in which the office of the limited liability company is located may decree dissolution of a limited liability company *whenever it is not reasonably practicable to carry on the business* in conformity with the articles of organization or operating agreement" (emphasis added).

The Limited Liability Company Law came into being in 1994. Many of its provisions were amended in 1999 (L 1999, ch 420) to track changes in federal tax code treatment of such entities (*see* Peter A. Mahler, *When Limited Liability Companies Seek Judicial Dissolution, Will the Statute Be Up to the Task?*, 74 NY St BJ 8 [June 2002]). Such amendments included changes in how the withdrawal of a member was to be treated (Limited Liability Company Law § 606) and events of dissolution which relate back to the operating agreement (Limited Liability Company Law § 701).

Although various provisions of the Limited Liability Company Law were amended, Limited Liability Company Law § 702 was neither modified nor amended in 1999. In declining to amend Limited Liability Company Law § 702, the Legislature can only have intended the dissolution standard therein provided to remain the sole basis for judicial dissolution of a limited liability company (*see* McKinney's Cons Laws of NY, Book 1, Statutes §§ 74, 153, 191). Phrased differently, since the Legislature, in determining the criteria for dissolution of various business entities in New York, did not cross-reference such grounds from one type of entity to another, it would be inappropriate for this Court to import dissolution grounds from the Business Corporation Law or Partnership Law to the Limited Liability Company Law.{**72 AD3d at 127}

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Despite the standard for dissolution enunciated in Limited Liability Company Law § 702, there is no definition of "not reasonably practicable" in the context of the dissolution of a limited liability company. Most New York decisions involving limited liability company dissolution issues have avoided discussion of this standard altogether (*see e.g. Matter of Extreme Wireless*, 299 AD2d 549, 550 [2002]; *Matter of Horning v Horning Constr., LLC*, 12 Misc 3d 402 [2006]; *Matter of Spires v Lighthouse Solutions, LLC*, 4 Misc 3d 428 [2004]).

Such standard, however, is not to be confused with the standard for the judicial dissolution of corporations (*see* Business Corporation Law §§ 1104, 1104-a) or partnerships (*see* Partnership Law § 62; *see Widewaters Herkimer Co., LLC v Aiello*, 28 AD3d 1107, 1108 [2006] [Appellate Division, Fourth Department, held that the defendants did not plead the requisite grounds for dissolution of a limited liability company in pleading the corporate dissolution standard of "oppressive conduct"]; *see also Matter of Horning v Horning Constr., LLC,* 12 Misc 3d at 413 [holding that Limited Liability Company Law § 702 was "more stringent" than corporate or partnership dissolution standards]).

The Business Corporation Law applies to "every domestic corporation and to every foreign corporation which is authorized to do business in this state" and also to "a corporation of any type or kind, formed for profit under any other chapter of the laws of this state *except a chapter of the consolidated laws*" (Business Corporation Law § 103 [a] [emphasis added]). The grounds for judicial dissolution of a corporation are set forth in article 11 of the Business Corporation Law.

Partnership Law § 10 (2) states that "any association formed under any other statute of this state . . . is not a partnership under this chapter." The bases for dissolution of a partnership are clearly enumerated in Partnership Law §§ 62 and 63.

Limited liability companies thus fall within the ambit of neither the Business Corporation Law nor the Partnership Law.

The language of Limited Liability Company Law § 702 appears to be borrowed from Revised Limited Partnership Act (Partnership Law) § 121-802 (dissolution is authorized when it is "not reasonably practicable to carry on the business in conformity with the

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partnership agreement") and Partnership Law § 63 (1) (d), in which dissolution is permitted, inter [*4]alia, where a partner's conduct of the partnership business makes it "not reasonably practicable to carry on the business in partnership{**72 AD3d at 128} with him." While there are no New York cases which interpret and apply this standard in the context of limited partnerships, it has been held to mean that, without more, disagreements between the partners with regard to the accounting of the entity are insufficient to warrant dissolution (*see Red Sail Easter Ltd. Partners, L.P. v Radio City Music Hall Prods., Inc.*, 1992 WL 251380, *5-6, 1992 Del Ch LEXIS 203, *12-17 [1992]).

The Limited Liability Company Law also clarifies its scope by defining "limited liability company" as "an unincorporated organization of one or more persons having limited liability . . . other than a partnership or trust" (Limited Liability Company Law § 102 [m]). Thus, the existence and character of these various entities are statutorily dissimilar as are the laws relating to their dissolution (*compare* Business Corporation Law art 11; Partnership Law §§ 62, 63; Limited Liability Company Law § 702). Indeed, it was found to be improper to apply partnership dissolution standards to a cause for dissolution of a limited liability company (*see Matter of Spires v Lighthouse Solutions, LLC*, 4 Misc 3d at 431).

In the absence of applying Business Corporation Law or Partnership Law dissolution factors to the analysis of what is "not reasonably practicable," the standard for dissolution under Limited Liability Company Law § 702 remains unresolved in New York. However, Limited Liability Company Law § 702 is clear that unlike the judicial dissolution standards in the Business Corporation Law and the Partnership Law, the court must first examine the limited liability company's operating agreement (*see Matter of Spires v Lighthouse Solutions, LLC*, 4 Misc 3d at 432) to determine, in light of the circumstances presented, whether it is or is not "reasonably practicable" for the limited liability company to continue to carry on its business in conformity with the operating agreement (*id.* at 433). Thus, the dissolution of a limited liability company under Limited Liability Company Law § 702 is initially a contract-based analysis.

Section 102 (u) of the Limited Liability Company Law defines "operating agreement" as "any written agreement of the members concerning the business of a limited liability company and the conduct of its affairs." Limited Liability Company Law

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§ 417 (a) mandates that the operating agreement contain "provisions not inconsistent with law . . . relating to (i) the business of the limited liability company, (ii) the conduct of its affairs and (iii) the rights, powers, preferences, limitations or[**72 AD3d at 129] responsibilities of its members [and] managers." Where an operating agreement, such as that of 1545 LLC, does not address certain topics, a limited liability company is bound by the default requirements set forth in the Limited Liability Company Law (*see Matter of Spires v Lighthouse Solutions, LLC*, 4 Misc 3d at 436-437; 1545 LLC operating agreement art 7.4).

The operating agreement of 1545 LLC does not contain any specific provisions relating to dissolution. It provides only in article 1.5 that "[t]he Company's term is perpetual from the date of filing of the Articles of Organization . . . unless the Company is dissolved."

Crown Royal argues for dissolution based on the parties' failure to hold regular meetings, failure to achieve quorums, and deadlock. The operating agreement, however, does not require regular meetings or quorums (*see* 1545 LLC operating agreement arts 4.2, 4.13). It only provides, in article 4.12, for meetings to be held at such times as the managers may "from time to time determine." The record demonstrates that the managers, King and Van Houten, communicated with each other on a regular basis without the formality of a noticed meeting which appears to conform with the spirit and letter of the operating agreement and the continued ability of 1545 LLC to function in that context.

King and Van Houten did not always agree as to the construction work to be performed on the 1545 LLC property. King claims that this forced the parties into a "deadlock." "Deadlock" is a basis, in and of itself, for judicial dissolution under Business Corporation Law § 1104. However, no such independent ground for dissolution is available under Limited Liability Company Law § 702. Instead, the court must consider the managers' disagreement in light of the operating agreement and the continued ability of 1545 LLC to function in that context.

It has been suggested that judicial dissolution is only available when the petitioning member can show that the limited liability company is unable to function as intended or that it is failing financially (*see Schindler v Niche Media Holdings*, 1 Misc 3d 713, 716

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[2003]). Neither circumstance is demonstrated by the petitioner here. On the contrary, the purpose of 1545 LLC was feasibly and reasonably being met.

The "not reasonably practicable" standard for dissolution of limited liability companies and partnerships has been examined in other jurisdictions. In Delaware, the Chancery Court has observed, "Given its extreme nature, judicial dissolution is a{**72 AD3d at 130} limited remedy that this court grants sparingly" (*Matter of Arrow Inv. Advisors, LLC*, 2009 WL 1101682, *2, 2009 Del Ch LEXIS 66, *8 [2009]). In Virginia, dissolution is only available when the business cannot continue "in accord with its . . . operating agreement" (*Dunbar Group, LLC v Tignor*, 267 Va 361, 367, 593 SE2d 216, 219 [2004] [serious differences of opinion among the members and the managers and the comingling of funds was insufficient to warrant a finding that it was [*5]not reasonably practicable for the company to continue]). However, where the economic purpose of the limited liability company is not met, dissolution is appropriate (*see Kirksey v Grohmann*, 754 NW2d 825 [SD 2008]). Several courts take the view that the "not reasonably practicable" standard should be read as "capable of being done logically and in a reasonable, feasible manner" (*Taki v Hami*, 2001 WL 672399, *3, 2001 Mich App LEXIS 777, *8 [2001] [dissolution granted where the two partners had not spoken in years and there were allegations of violence and expulsion]), or as "one of reasonable practicability, not impossibility" (*PC Tower Ctr., Inc. v Tower Ctr. Dev. Assoc. L.P.*, 1989 WL 63901, *6, 1989 Del Ch LEXIS 72, *16 [1989]).

Here, a single manager's unilateral action in furtherance of the business of 1545 LLC is specifically contemplated and permitted. Article 4.1 of the 1545 LLC operating agreement states: "At any time when there is more than one Manager, *any one manager may take any action permitted under the Agreement*, unless the approval of more than one of the Managers is expressly required pursuant to the Agreement or the Act" (emphasis added). This provision does not require that the managers conduct the business of 1545 LLC by majority vote. It empowers each manager to act autonomously and to unilaterally bind the entity in furtherance of the business of the entity. The 1545 LLC operating agreement, however, is silent as to the issue of manager conflicts. Thus, the only basis for dissolution can be if 1545 LLC cannot effectively operate under the operating agreement to meet and achieve the purpose for which it was created. In this case, that is the development of the property which purpose, despite the disagreements between the

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managing members, was being met. As the Delaware Chancery Court noted in *Matter of Arrow Inv. Advisors, LLC*,

> "The court will not dissolve an LLC merely because the LLC has not experienced a smooth glide to profitability or because events have not turned out exactly as the LLC's owners originally envisioned;{**72 AD3d at 131} such events are, of course, common in the risk-laden process of birthing new entities in the hope that they will become mature, profitable ventures. In part because a hair-trigger dissolution standard would ignore this market reality and thwart the expectations of reasonable investors that entities will not be judicially terminated simply because of some market turbulence, dissolution is reserved for situations in which the LLC's management has become so dysfunctional or its business purpose so thwarted that it is no longer practicable to operate the business, such as in the case of a voting deadlock or where the defined purpose of the entity has become impossible to fulfill . . .
>
> "Dissolution of an entity chartered for a broad business purpose remains possible upon a strong showing that a confluence of situationally specific adverse financial, market, product, managerial, or corporate governance circumstances make it nihilistic for the entity to continue" (2009 WL 1101682, *2-3, 2009 Del Ch LEXIS 66, *9-14 [2009]).

Here, the operating agreement avoids the possibility of "deadlock" by permitting each managing member to operate unilaterally in furtherance of 1545 LLC's purpose.

<u>V</u>

After careful examination of the various factors considered in applying the "not reasonably practicable" standard, we hold that for dissolution of a limited liability company pursuant to Limited Liability Company Law § 702, the petitioning member must establish, in the context of the terms of the operating agreement or articles of incorporation, that (1) the management of the entity is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved, or (2) continuing the entity is financially unfeasible.

<u>VI</u>

Dissolution is a drastic remedy (*see Matter of Arrow Inv. Advisors, LLC*, 2009 WL 1101682, *2, 2009 Del Ch LEXIS 66, *9 [2009]). Although the petitioner has failed to meet the standard for dissolution enunciated here, there are numerous other factors which

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support the conclusion that dissolution of 1545 LLC is inappropriate under the circumstances of this case.{**72 AD3d at 132}

First, the dispute between King and Van Houten was not shown to be inimicable to achieving the purpose of 1545 LLC (*see e.g. Haley v Talcott,* 864 A2d 86, 94 [Del Ch 2004] [Delaware's "not reasonably practicable" standard "has the obvious purpose of providing an avenue of relief when an LLC cannot continue to function in accordance with its chartering agreement"]). Indeed, the test is "whether it is 'reasonably practicable' to carry on the business of the [LLC], and not whether it is 'impossible' " (*Fisk Ventures, LLC v Segal,* 2009 WL 73957, *3, 2009 Del Ch LEXIS 7, *9-10 [2009], *affd* 984 A2d [*6]124 [Del Super Ct 2009]).

King never objected to the quality of Van Houten's construction work, but only to its expense. The work on building A was all but complete when this proceeding was commenced. King approved and praised it. Further, the parties were operating in conformity with the operating agreement.

Second, there is a remedy available in the Limited Liability Company Law to regulate Van Houten's conduct. Limited Liability Company Law § 411 permits a limited liability company to avoid contracts entered into between it and an interested manager, or another limited liability company in which a manager has a substantial financial interest, unless the manager can prove the contract was fair and reasonable. Crown Royal took no action under Limited Liability Company Law § 411 here. Beyond complaining about the cost of VHC's work and seeking to withdraw from 1545 LLC, the record is clear that Crown Royal ratified, albeit grudgingly at times, Van Houten's unilateral efforts.

The notion that 1545 LLC could void the contract with VHC in its entirety may serve as a check on Van Houten's unilaterally hiring his own company for future construction work on the property, and may result in Van Houten being made to disgorge excess moneys paid in derogation of 1545 LLC's best interest at the time of the accounting of the members. In any event, a fair reading of Limited Liability Company Law § 702 demonstrates that an application to dissolve 1545 LLC does not flow from a claim under Limited Liability Company Law § 411.

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Finally, if Crown Royal is truly aggrieved by Van Houten's actions as manager, the Court of Appeals has found that a derivative claim is available (see Tzolis v Wolff, 10 NY3d 100 [2008]). Nevertheless, such remedy cannot serve as the basis for dissolution unless the wrongful acts of a managing member which give rise to the derivative claim are contrary to the contemplated functioning and purpose of the limited liability company. [**72 AD3d at 133]

VII

"The appropriateness of an order for dissolution of [the] limited liability company is vested in the sound discretion of the court hearing the petition" (*Matter of Extreme Wireless*, 299 AD2d 549, 550 [2002], citing Limited Liability Company Law § 702). However, in applying the standard for dissolution of a limited liability company, upon a review of the evidence submitted, we conclude that the Supreme Court did not providently exercise its discretion in granting the petition for dissolution. Thus, the order of the Supreme Court should be reversed, the petition denied, and the proceeding dismissed.

Fisher, J.P. (concurring in part and dissenting in part). A limited liability company may be judicially dissolved when the court, in the exercise of its discretion, finds that it is no longer reasonably practicable for the company to carry on its business in conformity with its articles of organization or operating agreement (*see Matter of Extreme Wireless*, 299 AD2d at 550; Limited Liability Company Law § 702). I have no serious quarrel with the standard the majority adopts based on its analysis of the authorities it cites. In my view, those authorities and the plain language of the statute suggest that, pursuant to Limited Liability Company Law § 702, it is "not reasonably practicable" for a limited liability company to carry on its business in conformity with its articles of organization or operating agreement when disagreement or conflict among the members regarding the means, methods, or finances of the company's operations is so fundamental and intractable as to make it unfeasible for the company to carry on its business as originally intended.

Here, 1545 Ocean Avenue, LLC (hereinafter 1545 LLC), was formed to purchase a certain piece of property, to rehabilitate a building that stood on it, and to build a second building on the property for commercial rental. The majority recounts the growing disputes between the managers of 1545 LLC, John King and Walter Van Houten, which

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ultimately led to King's withdrawal from management of 1545 LLC, amid claims, inter alia, that Van Houten had turned the project "into a construction job for [his] own company," that he did work at excessive cost without King's consent, that he violated the parties' agreement that all construction work was to be procured through a competitive bidding process, that he submitted invoices billing 1545 LLC on a time-and-materials basis which King believed was unacceptable for a commercial project, and that Van Houten had refused{**72 AD3d at 134} to fulfill his responsibility to pay real estate taxes and vendors. Many of those allegations were disputed by Van Houten, but the Supreme Court made no findings of fact.

In my view, without a factual finding, we cannot meaningfully decide whether the Supreme Court providently exercised its discretion in finding that the actions of the parties rendered it not reasonably practicable for 1545 LLC to carry on its business in conformity with its articles of organization or operating [*7]agreement. Accordingly, I would remit the matter to the Supreme Court, Suffolk County, for a fact-finding hearing and thereafter for a new determination on the petition (*cf.* Business Corporation Law § 1109; *Sobol v Les Pieds Nickels*, 262 AD2d 194, 196 [1999]; *Matter of Giordano v Stark*, 229 AD2d 493, 494-495 [1996]).

Dillon and Miller, JJ., concur with Austin, J.; Fisher, J.P., concurs in part and dissents in part in a separate opinion in which Chambers, J., concurs.

Ordered that the order is reversed, on the facts and in the exercise of discretion, with costs, the petition is denied, and the proceeding is dismissed.

[As amended, see 2012 NY Slip Op 60123(U).]

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Mace v Tunick
2017 NY Slip Op 06170 [153 AD3d 689]
August 16, 2017
Appellate Division, Second Department
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, September 27, 2017

[*1]

David J. Mace, Appellant,
v
Nicholas Tunick et al., Respondents.

McMillan, Constabile, Foster & Perone, LLP, Larchmont, NY (Gary Kyme of counsel), for appellant.

Tashlik Goldwyn Crandell Levy LLP, Great Neck, NY (Jeffrey N. Levy of counsel), for respondents.

In an action, inter alia, for the judicial dissolution of Pedani Realty Services, LLC, the plaintiff appeals (1) from so much of an order of the Supreme Court, Westchester County (Scheinkman, J.), dated May 23, 2016, as granted that branch of the defendants' motion which was pursuant to CPLR 3211 (a) to dismiss the first cause of action, seeking judicial dissolution, and (2) from so much of an order of the same court dated August 5, 2016, as denied that branch of his motion which was for leave to renew his opposition to the branch of the defendants' prior motion which was pursuant to CPLR 3211 (a) to dismiss the first cause of action.

Ordered that the order dated May 23, 2016, is reversed insofar as appealed from, on the law, and that branch of the defendants' motion which was pursuant to CPLR 3211 (a) to dismiss the first cause of action is denied; and it is further,

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Ordered that the appeal from the order dated August 5, 2016, is dismissed as academic in light of our determination on the appeal from the order dated May 23, 2016; and it is further,

Ordered that one bill of costs is awarded to the plaintiff.

The plaintiff, the defendant Nicholas Tunick (hereinafter Tunick), and Tunick's father each held ownership interests in Ceres Chemical Co., Inc. (hereinafter Ceres). In 2007, those individuals formed Pedani Realty Services, LLC (hereinafter Pedani), which, approximately two months later, obtained title to a parcel of real property (hereinafter the property). Pursuant to a lease, Ceres occupied the property from 2007 through 2014, at which time Tunick, then the sole owner of Ceres, relocated the company out of state.

In October 2015, the plaintiff commenced this action, inter alia, for the judicial dissolution of Pedani. The defendants moved pursuant to CPLR 3211 (a), inter alia, to dismiss the first cause of action, seeking judicial dissolution. The Supreme Court granted that branch of the motion. The plaintiff then moved, inter alia, for leave to renew his opposition to the branch of the [*2]prior motion seeking dismissal of the first cause of action. That motion was also denied. The plaintiff appeals.

On a motion to dismiss pursuant to CPLR 3211 (a) (7), the court must "accept the facts as alleged in the complaint as true, accord plaintiffs the benefit of every possible favorable inference, and determine only whether the facts as alleged fit within any cognizable legal theory" (*Leon v Martinez*, 84 NY2d 83, 87-88 [1994]; *see Sokol v Leader*, 74 AD3d 1180, 1181 [2010]). Although a court can consider evidentiary material submitted by a defendant in support of a motion to dismiss, the motion should not be granted unless it has been shown through this evidence "that a material fact as claimed by the [plaintiff] to be one is not a fact at all and unless it can be said that no significant dispute exists regarding it" (*Guggenheimer v Ginzburg*, 43 NY2d 268, 274-275 [1977]; *see Nilazra, Inc. v Karakus, Inc.*, 136 AD3d 994, 995 [2016]).

In order to demonstrate entitlement to dissolution of a limited liability company, the member seeking such relief "must establish, in the context of the terms of the operating agreement or articles of incorporation, that (1) the management of the entity is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or

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achieved, or (2) continuing the entity is financially unfeasible" (*Matter of 1545 Ocean Ave., LLC*, 72 AD3d 121, 131 [2010]; *see* Limited Liability Company Law § 702).

Here, the plaintiff alleged in the complaint that Pedani was formed for the purpose of acquiring title to and managing property to serve as Ceres' headquarters, and that it became impossible to fulfill that purpose once Ceres relocated to a different property, not owned by Pedani. Contrary to the defendants' contention and the Supreme Court's conclusion, the defendants did not show, through the operating agreement or any other evidence, that the material fact alleged by the plaintiff regarding Pedani's purpose "is not a fact at all" and that "no significant dispute exists regarding it" (*Guggenheimer v Ginzburg*, 43 NY2d at 275). In this respect, the operating agreement did not set forth any particular purpose for Pedani. The court's determination that Pedani's purpose was simply to acquire and manage property constituted an impermissible factual finding.

Moreover, the defendants were not entitled to dismissal of the first cause of action under CPLR 3211 (a) (1). Neither the operating agreement nor the leases of the property to Ceres and, upon Ceres' relocation, a third party, utterly refuted the plaintiff's allegation as to Pedani's purpose so as to conclusively establish a defense as a matter of law to the plaintiff's dissolution cause of action (*see* CPLR 3211 [a] [1]; *Goshen v Mutual Life Ins. Co. of N.Y.*, 98 NY2d 314, 326 [2002]; *Old Republic Natl. Tit. Ins. Co. v Junction Abstract, Inc.*, 150 AD3d 757, 758 [2017]).

Accordingly, that branch of the defendants' motion which was pursuant to CPLR 3211 (a) to dismiss the first cause of action should have been denied.

In light of our determination, we need not consider the plaintiff's remaining contention. Balkin, J.P., Sgroi, Cohen and Duffy, JJ., concur.

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Advanced 23, LLC v Chambers House Partners, LLC
2017 NY Slip Op 32662(U)
December 15, 2017
Supreme Court, New York County
Docket Number: 650025/2016
Judge: Saliann Scarpulla
Cases posted with a "30000" identifier, i.e., 2013 NY Slip Op 30001(U), are republished from various New York State and local government sources, including the New York State Unified Court System's eCourts Service.
This opinion is uncorrected and not selected for official publication.

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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION PART 39

---X

ADVANCED 23, LLC, DAVID SHUSTERMAN,

Petitioner,

- v -

CHAMBERS HOUSE PARTNERS, LLC, ANITA MARGRILL, HERBERT MARGRILL

Respondent.

---X

INDEX NO. 650025/2016

MOTION DATE ________

MOTION SEQ. NO. 001

DECISION AND ORDER

The following e-filed documents, listed by NYSCEF document number were read on this application to/for Dissolution

HON. SALIANN SCARPULLA:

Petitioners Advanced 23, LLC ("Advanced") and David Shusterman ("Shusterman") (collectively, "Petitioners") commenced this special proceeding by verified petition and order to show cause (motion seq. no. 001), seeking, *inter alia*, a judicial decree dissolving Chambers House Partners, LLC pursuant to NY Limited Liability Company Law ("LLCL") § 702 and directing that its real property be sold and that CHP be liquidated.

Background

Respondent Herbert Margrill ("Herbert") and Respondent Anita Margrill ("Anita") (collectively, "Respondents") and Ephraim Resnick and Hisako Resnick (collectively, "the Resnicks") purchased the land and building located at 154 Chambers Street, New

York, New York 10013 (hereinafter, "the Building") on January 18, 1982. The Building contains four residential units and one commercial unit. On that same date, Respondents and the Resnicks conveyed the Building by deed to Chambers House Partners, a general partnership. Respondents each held a 25% membership share in the Building and the Resnicks collectively held 50% of the membership shares. On November 8, 2007, the Chambers House Partners general partnership conveyed the Building by deed to Chambers House Partners, LLC ("CHP"); Respondents and the Resnicks maintained their membership shares. CHP is the current owner of the Building.

On February 1, 2013, Advanced[1] purchased the Resnicks' 50% membership share in CHP. Respondents and Advanced executed CHP's Amended and Restated Operating Agreement ("Operating Agreement"); Shusterman executed a personal guarantee which stated, in part, that he would be responsible for Advanced's obligations under the Operating Agreement as a Member of CHP. The parties also executed separate guarantees, each in favor of half of the $547,760.30 HSBC Bank mortgage on the Building, which was to become due and payable on December 1, 2015.

CHP's business purpose is "to own and operate the building known and located at 154 Chambers Street, New York, NY 10013 . . . ; to provide a residence for its Members; and to conduct any lawful business as the Members may from time to time determine." Operating Agreement ¶ 2.3. The Operating Agreement provides that the only method for

[1] Shusterman owns 100% of Advanced.

CHP's dissolution is by unanimous consent of CHP's Members. Operating Agreement ¶ 10.1.

Operating Agreement ¶ 3.10 provides a list of actions that require the Members' unanimous consent. Relevant actions requiring unanimous consent include "(a) amending or waiving any provision of [the Operating Agreement]" and "(h) any . . . refinance or extension of any existing mortgage." If the Members are unable to reach a unanimous agreement, Operating Agreement ¶ 3.11(a) provides that Members are to first hold a series of informal meetings to try to come to an agreement on the matters that require unanimous consent. If after these meetings, Members still have not come to a resolution on something that will "materially hinder the conduct of [CHP's] business," that the matter shall be resolved by the arbitration clause. Operating Agreement ¶ 3.11(b). The arbitration clause states, in part, that "[a]ny controversy or claim arising out of or relating to this Agreement, in excess of Twenty-Five Thousand ($25,000) Dollars, shall be finally resolved by arbitration . . . ." Operating Agreement ¶ 13.11. If a claim or controversy does not exceed $25,000, the Operating Agreement does not provide any alternate procedures to resolve these disagreements.

Under the terms of Article 4 of the Operating Agreement, the parties agreed that Shusterman and Herbert each have a material obligation to actively manage CHP as equal Co-Managers with equal voting rights. The Operating Agreement defines "actively managed" to

> mean that each Manager is available for management responsibilities in New York, at the Building, and shall meet with the other Manager no less than once per month to review management and operation matters or as may be

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needed to address and emergency impacting the physical or financial condition of the Building or any imminent danger to person or property.

Operating Agreement ¶ 4.1(d).

Operating Agreement ¶ 4.2(b) provides a non-exhaustive list of the Co-Managers' duties, which are to be performed "in good faith and with that decree that an ordinarily prudent person in a like position would use under similar circumstances." Operating Agreement ¶ 4.2(a). As Co-Managers, Shusterman and Herbert established a bank account at Capital One Bank, N.A. ("Capital One Account") in accordance with the Operating Agreement – they were both signatories, rent checks from the Building's tenants were to be deposited into this account, and payments of expenses were to be withdrawn from it. Operating Agreement ¶ 8.1.

If either Co-Manager refuses to serve as a manager or fails to fulfill their managerial duties in a manner "reasonably necessary to conduct [CHP's] business, then the ***remaining*** Manager" is entitled to receive a three percent fee of CHP's gross annual rental income for managing CHP's business. Operating Agreement ¶ 4.1(d) (emphasis added). This provision provides for the removal of a Manager in another context than provided in Operating Agreement ¶ 4.3.[2] If this were to occur, the Manager who was removed would "have the right to appoint a Manager to replace . . . himself, subject to the

[2] "A Manager may be removed only for intentional misconduct hereunder or a knowing violation of law which causes material damage to the assets of the Company (and by which such Manager personally gained a financial profit to which he or she was not legally entitled). Any vacancy occurring as a result of such removal from office shall be filled as set forth in Section 4.1(b)." Operating Agreement ¶ 4.3.

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unanimous approval of the remaining Managers, which shall not be unreasonably withheld . . . ." Operating Agreement ¶ 4.1(b).

Since Advanced purchased its interest in CHP in 2013, various disputes have arisen between the parties. Petitioners allege that in July 2015, Anita began to harass Shusterman's companion and entered his apartment without permission. Respondents submit a police report for harassment, which Anita filed against Shusterman on July 15, 2017 after an alleged physical altercation. Because of these disputes, Herbert appointed an attorney, Maurice A. Reichman, Esq. ("Mr. Reichman"), on September 17, 2015 to negotiate on his behalf with Shusterman regarding the mortgage[3] and Shusterman's obligations in the Operating Agreement.

On October 16, 2015, the parties and Mr. Reichman attended a meeting to discuss CHP business and the refinancing of the mortgage. Respondents allege that the meeting constituted a formal meeting of the Managers, that a quorum was present, and that Shusterman left the meeting without notice or explanation, which Petitioners deny. After Shusterman left the meeting, Respondents contend that Herbert held a vote to create a separate single-signature bank account for CHP, which he was allegedly entitled to do because a quorum was still present.

On October 19, 2015, Respondents created the separate bank account entitled "Anita & Herbert Margrill Trustees in Trust for Chambers House Partners LLC" at TD

[3] The parties were ultimately unable to agree to an extension or refinancing of the mortgage, and Respondents and Shusterman each paid half of the outstanding mortgage balance by the December 1, 2015 due date.

Bank ("TD Bank Account") and deposited the November rent checks from CHP without Shusterman's knowledge or consent. Respondents informed Shusterman that they created the TD Bank Account by letter dated November 24, 2015, justifying their actions as necessary "in order to ensure the timely and full payment of all [CHP] obligations" because his "conduct has seriously interfered with the operation of [CHP]." On December 3, 2015, Respondents transferred $75,000 from the Capital One Account into the TD Bank Account without Shusterman's authorization. On December 21, 2015, the TD Bank Account was frozen after Shusterman, acting through counsel, notified TD Bank that the account contained diverted rents and misappropriated funds.

In mid-December 2015, one of CHP's tenants wrote an email to the parties, requesting that they use a portion of her security deposit to pay for that month's rent. Respondents allegedly unilaterally consented to this request without consulting Shusterman, who later objected.

Petitioners commenced this special proceeding by verified petition and order to show cause seeking: (1) a judicial decree dissolving CHP pursuant to New York's Limited Liability Company Law ("LLCL") § 702, directing that its real property be sold, and that CHP be liquidated; (2) an accounting of all transactions from the TD Bank Account and any other transactions Respondents unilaterally entered into with CHP funds without Shusterman's authorization or consent; and (3) injunctive relief to maintain the status quo and to prevent irreparable harm to CHP's business during the pendency of this proceeding.

Respondents, by their verified amended answer, oppose the petition for dissolution. Respondents argue that any of Petitioners' allegations that it is no longer reasonably practicable to carry on CHP's business is a direct result of Shusterman's conduct. They argue that since Shusterman became Co-Manager of CHP, he has failed to fulfill his managerial duties, and Herbert has been the only one actively managing the Building such that he is entitled to the three percent manager's fee pursuant to Operating Agreement ¶ 4.1(d). They contend that Shusterman's sole actions as Manager were to negotiate a lease, propose house rules which were ultimately not adopted, and co-sign checks that Herbert provided to him; even though Shusterman's responsibilities were minimal, he would either refuse or significantly delay signing the checks to pay for CHP's expenses and operating costs and would routinely ignore Herbert's requests for managerial meetings. Therefore, Respondents allege, the creation of the TD Bank Account was not a breach of the Operating Agreement and their actions were necessary and justified because Shusterman's conduct was interfering in CHP's operation. Respondents submit evidence of all transactions made under the TD Bank Account, which they maintain were to pay for CHP expenses and monthly distributions.

Since the commencement of this proceeding, CHP has been functioning pursuant to a February 10, 2016 court stipulation – any noncompliance of which would subject the parties to a motion for contempt – which includes the following provisions: all funds in the TD Bank Account are to be deposited into the Capital One Account and all future rent deposits are to be deposited into the Capital One Account; monthly distributions and the Building's operation will continue during the pendency of this litigation; and all future checks for ordinary and necessary payments for CHP's obligations will be submitted by Herbert to Shusterman by presenting Shusterman with an invoice and a check with Herbert's signature, which Shusterman will countersign and return within seven days.

Discussion

The standard of review in a special proceeding is the same as that of a motion for summary judgment, *In re Bank of New York Mellon*, 42 Misc 3d 1237(A) (Sup Ct, NY County 2014), *affd as mod sub nom. In re Bank of New York Mellon*, 127 AD3d 120 (1st Dept 2015), and I must "make a summary determination upon the pleadings, papers and admissions to the extent that no triable issues of fact are raised." CPLR § 409(b).

A court may order the dissolution of a limited liability company "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." LLCL § 702 (McKinney 2017). "Judicial dissolution of a limited liability company is considered a drastic remedy," the appropriateness of which "is vested in the sound discretion of the court hearing the petition." *Goldstein v. Pikus*, 2015 WL 4627747 (Sup Ct, NY County 2015) (quoting *Matter of 1545 Ocean Ave., LLC*, 72 A.D.3d 121, 131 & 133 (2d Dept 2010)) (internal quotation marks omitted).

In determining whether a limited liability company should be dissolved pursuant to LLCL § 702, "the court must first examine the limited liability company's operating agreement to determine, in light of the circumstances presented, whether it is or is not 'reasonably practicable' for the limited liability company to continue to carry on its business in conformity with the operating agreement." *In re 1545 Ocean Ave., LLC*, 72

AD3d at 128 (internal citations omitted). The petitioner seeking judicial dissolution must either "show that the management of the entity is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved, or [that] continuing the entity is financially unfeasible." *Doyle v Icon, LLC*, 103 AD3d 440, 440 (1st Dept 2013) (quoting *In re 1545 Ocean Ave., LLC*, 72 A.D.3d at 131) (internal citations and quotation marks omitted).

Here, Petitioners have made a *prima facie* showing that it is no longer reasonably practicable for CHP to continue functioning in accordance with its Operating Agreement to achieve its stated business purpose. The Operating Agreement provides that virtually any material business decision requires the unanimous consent or the majority vote of either its Members or Co-Managers, however the relationship between the parties has degraded to such an extent that they are no longer on speaking terms (Respondents retained an attorney to deal with Shusterman directly) and they have been unable to cooperate to make business decisions regarding a tenant's inability to pay rent or refinancing their mortgage. *See Matter of 47th Rd. LLC*, 54 Misc 3d 1217[A], 2017 NY Slip Op 50196[U], *3 (Sup Ct, Queens County 2017); *Fakiris v Gusmar Enters., LLC*, 53 Misc 3d 1215[A], 2016 NY Slip Op 51665[U], *3 (Sup Ct, Queens County 2016).

Additionally, Petitioners maintain that CHP can no longer operate in accordance with the Operating Agreement – which requires that CHP be co-managed by Shusterman and Herbert – because Respondents have breached the Operating Agreement numerous times and undermined Shusterman's rights as a Co-Manager; the most significant example of this was when Herbert acted unilaterally to create the TD Bank Account, deposit rents into that account, and transfer funds into it from the Capital One Account, all of which "are contrary to the contemplated functioning and purpose of [CHP]." *Goldstein*, 2015 WL 4627747, 16 (citing *In re 1545 Ocean Ave., LLC*, 72 AD3d at 132). Regardless of whether there was a quorum at the October 16, 2015 meeting and whether that quorum continued after Shusterman left, as Respondents claim, these actions taken by Herbert would not be in accordance with the Operating Agreement because any amendment to the Operating Agreement, such as changing the banking requirements of Operating Agreement ¶ 8.1, would require the unanimous consent of the Members. Operating Agreement ¶¶ 3.10(a) & 13.1.

Based on the above disputes, Petitioners contend that Respondents' actions have rendered it impossible to cooperate with Herbert equally in managing CHP, as required by the Operating Agreement. While deadlock between managers is not an independent basis for judicial dissolution under LLCL§702, "the court must consider the managers' disagreement in light of the operating agreement and the continued ability of [CHP] to function in that context." *In re 1545 Ocean Ave., LLC*, 72 AD3d at 129. However, courts will not order dissolution despite disagreements between managers when the limited liability company can continue to operate in furtherance of achieving its stated business purpose. *See, e.g., Belardi-Ostroy, Ltd. v. American List Counsel, Inc.*, 2016 WL 1558850 (Sup Ct, NY County 2016), 6 ("the Operating Agreement provides a straightforward means of avoiding deadlock - having a tie-breaking fifth member on the Board."); *Goldstein*, 2015 WL 4627747 (Sup Ct, NY County 2015), 17 (finding that dissolution was not warranted despite the parties being deadlocked over whether to sell or convert the property because the property was being managed and operated by an independent managing agent); *In re 1545 Ocean Ave., LLC*, 72 AD3d at 129 (finding that deadlock is not possible because "the operating agreement permit[s] each managing member to operate unilaterally in furtherance of [the limited liability company's] purpose").

Here, there is evidence showing that CHP cannot continue to function because of the disagreements and inability of the parties to cooperate. Even though Operating Agreement ¶ 13.11 authorizes and requires that any dispute arising out of the Operating Agreement and exceeding $25,000 to be resolved through arbitration, neither party has availed themselves of this provision to resolve any of their disputes. Further, the Operating Agreement does not provide any means to resolve disputes that do not meet the amount in controversy requirement of the arbitration clause.

However, Respondents have raised issues of fact to preclude a summary determination on the issue of judicial dissolution. Respondents allege that any ineffectiveness in CHP's management and operation is due to the intentional acts of Shusterman in his attempt to force dissolution and gain control of the Building. Respondents argue that Shusterman breached his material obligation to manage CHP and that he was significantly interfering with CHP's operation by either refusing or causing a significant delay signing the checks to pay for CHP's expenses and operating costs and routinely ignoring Herbert's requests for managerial meetings.

The Respondents' allegations regarding Shusterman's conduct raise triable issues of fact, and if the trier of fact credits Respondents' allegations, judicial dissolution may not be warranted. *Ward Sales, Inc. v. Millennium Falcon Corp.*, 2005 WL 6313474 (Sup Ct, Nassau County 2005) ("[J]udicial dissolution, which is discretionary, will not be granted to a member who claims to have been cut out of the day-to-day operations of the Company when it is found he is responsible for his own 'freeze out' and is the perpetrator rather than the victim of abuse.").

Based on the parties' submissions, I find that a material issue of fact exists as to whether Shusterman breached his duties and obligations under the Operating Agreement to force dissolution. Accordingly, I order an evidentiary hearing to resolve this material issue of fact. CPLR § 410.

In accordance with the foregoing, it is

ORDERED that an evidentiary hearing is directed to be conducted before a Special Referee to determine whether Shusterman breached his duties and obligations under the Operating Agreement to force dissolution. The Special Referee is to report to this Court with all convenient and deliberate speed, except that, in the event of and upon the filing of a stipulation of the parties, as permitted by CPLR § 4317, the Special Referee, or another person designated by the parties to serve as referee, shall determine the aforesaid issue; and it is further

ORDERED that Petitioners' petition for judicial dissolution and for a court order directing that CHP's real property be sold and that CHP be liquidated (motion seq. no. 001) is held in abeyance pending receipt of the report and recommendations of the Special Referee and a motion pursuant to CPLR § 4403 or receipt of the determination of the Special Referee or the designated referee; and it is further

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ORDERED that counsel for the Petitioners shall, within 30 days from the date of this order, serve a copy of the order with notice of entry, together with a completed Information Sheet, upon the Special Referee Clerk in the Motion Support Office in Room 119 at 60 Centre Street, who is directed to place this matter on the calendar of the Special Referee's Part (Part 50R) for the earliest convenient date; and it is further

ORDERED that upon receipt of the Special Referee's report, Petitioners petition for judicial dissolution and for a court order directing that CHP's real property be sold and that CHP be liquidated shall be disposed of in accordance with the results of the Special Referee's report as to service and this decision.

This constitutes the decision and order of the Court.

12/15/17
DATE

Saliann Scarpulla
SALIANN SCARPULLA, J.S.C.

CHECK ONE:	☐ CASE DISPOSED		☒ NON-FINAL DISPOSITION	
APPLICATION:	☐ GRANTED	☐ DENIED	☐ GRANTED IN PART	☒ OTHER
	☐ SETTLE ORDER		☐ SUBMIT ORDER	
CHECK IF APPROPRIATE:	☐ DO NOT POST		☐ FIDUCIARY APPOINTMENT	☐ REFERENCE

Doyle v Icon, LLC
2013 NY Slip Op 00797 [103 AD3d 440]
February 7, 2013
Appellate Division, First Department
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, March 27, 2013

Keith Doyle, Respondent, **v** **Icon, LLC, Doing Business as R Bar, et al., Appellants.**

—[*1]

Bracewell & Giuliani LLP, New York (Kelly Koscuiszka of counsel), for appellants.

Cooper & McCann, LLP, New Rochelle (Gary G. Cooper and Jared A. Cooper of counsel), for respondent.

Order, Supreme Court, New York County (Joan A. Madden, J.), entered April 13, 2011, which, to the extent appealed from as limited by the briefs, denied defendants' motion to dismiss the causes of action seeking judicial dissolution and appointment of a receiver, unanimously reversed, on the law, without costs, and the motion granted.

Plaintiff's allegations that he has been systematically excluded from the operation and affairs of the company by defendants are insufficient to establish that it is no longer "reasonably practicable" for the company to carry on its business, as required for judicial dissolution under Limited Liability Company Law § 702. The allegations do not show that "the management of the entity is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved, or [that] continuing the entity is financially unfeasible" (*see Matter of 1545 Ocean Ave., LLC*, 72 AD3d 121, 131 [2d Dept 2010]; *Schindler v Niche Media Holdings*, 1 Misc 3d 713, 716 [Sup Ct, NY County 2003]). Indeed, the allegations show that the company has been able to carry on its business since the alleged expulsion of plaintiff in 2007; the allegation that defendants

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failed to pay plaintiff his share of the profits and award him distributions shows that the company is financially feasible.

In view of the foregoing, there is no occasion for the appointment of a receiver (*see* [*2]Limited Liability Company Law § 703). We note that plaintiff admits that he can seek appointment of a temporary receiver under CPLR 6401 (a), given his remaining causes of action. Concur—Mazzarelli, J.P., Acosta, Saxe, Renwick and Clark, JJ.

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Mizrahi v Cohen
2013 NY Slip Op 02056 [104 AD3d 917]
March 27, 2013
Appellate Division, Second Department
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, April 24, 2013

Ronald Mizrahi, Appellant-Respondent, v Ezra Cohen, Respondent-Appellant.

—[*1] Edward B. Safran, New York, N.Y., for appellant-respondent.

Solomon E. Antar, P.C., Brooklyn, N.Y. (Leopold Gross of counsel), for respondent-appellant.

In an action, inter alia, to recover damages for breach of fiduciary duty and breach of contract, and for the judicial dissolution of the subject limited liability company, the plaintiff appeals from so much of an order of the Supreme Court, Kings County (Demarest, J.), dated January 12, 2012, as, after a nonjury trial, directed dismissal of the causes of action to recover damages for breach of fiduciary duty and breach of contract, and denied, in effect, his application for an order authorizing him to purchase the defendant's interest in the limited liability company upon its dissolution, and the defendant cross-appeals, as limited by his brief, from so much of the same order as granted, in effect, the plaintiff's application for judicial dissolution of the limited liability company and directed that, upon dissolution, certain contributions of the plaintiff to the limited liability company are to be treated as loans to the limited liability company.

Ordered that on the Court's own motion, the notices of appeal and cross appeal are treated as applications for leave to appeal and cross-appeal, and leave to appeal and cross-appeal is granted (*see* CPLR 5701 [c]); and it is further,

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Ordered that the order is modified, on the law and the facts, by deleting the provision thereof denying, in effect, the plaintiff's application for an order authorizing him to purchase the defendant's interest in the limited liability company upon its dissolution, and substituting therefor a provision directing that the plaintiff may purchase such interest within 60 days after a determination by the Supreme Court as to the value of such interest; as so modified, the order is affirmed insofar as appealed and cross-appealed from, without costs or disbursements, and the matter is remitted to the Supreme Court, Kings County, for further proceedings and for a determination thereafter as to the value of the defendant's interest in the limited liability company.

The plaintiff and the defendant are the sole members of a limited liability company (hereinafter LLC). The plaintiff is a dentist and the defendant is an optometrist. The LLC was formed for the purpose of the construction and operation of a mixed-use commercial/residential building. The parties did not initially execute an LLC operating agreement (hereinafter LLC agreement). In 2000, several months after the LLC was formed, the parties purchased a parcel of real [*2]property, upon which they intended to construct the building. At the closing of title, the property seller or lender required an LLC agreement. The attorney who represented both the plaintiff and defendant at the closing then drafted an LLC agreement.

The LLC agreement provided that the parties each own a 50% membership interest in the company. However, the LLC agreement did not set forth the amount of the parties' initial capital contributions. The LLC agreement also provided that, after the "initial capital contributions" by the parties, no member would be required to contribute additional capital unless required by a vote of all of the members of the company. The LLC agreement provided that no member "shall have the right to receive any return of any Capital Contribution," subject to certain exceptions that are not relevant here. The LLC agreement provided that the LLC may be dissolved only upon the happening of certain specified events. Upon dissolution, the assets were to be distributed first to creditors of the LLC, and then to the members, in proportion to their respective ownership shares.

The parties contributed approximately equal funds toward the down payment on the parcel of real property. The construction of the building was largely financed by a construction loan. At some point, the parties refinanced that loan and obtained a mortgage loan. In 2006, the construction was completed, and both parties moved their professional offices into the building.

Through approximately 2003, the parties made approximately equal capital contributions to the LLC. After that, however, the contributions by the plaintiff greatly exceeded those of the defendant. It is undisputed that, over time, the plaintiff contributed approximately $1.4 million in capital to the company, while the defendant contributed approximately $317,000 in capital to the company. At a hearing, an accountant for the LLC testified that the LLC experienced net operating losses in each year from 2006 through 2010, and through the first half of 2011, when the hearing was held. The accountant testified, inter alia, that the LLC would have failed, if not for the use of proceeds of the mortgage loan and capital infusions by the plaintiff, which were used to cover its operating expenses.

The plaintiff commenced this action, inter alia, to recover damages for breach of fiduciary duty and breach of contract, and for the judicial dissolution of the LLC. The plaintiff also sought an order authorizing him to purchase the defendant's interest in the LLC upon its dissolution.

The Supreme Court did not err in directing dismissal of the cause of action to recover damages for breach of fiduciary duty. Contrary to the plaintiff's contention, that cause of action was not properly brought in the plaintiff's individual capacity (*see Abrams v Donati*, 66 NY2d 951, 952 [1985]; *Yudell v Gilbert*, 99 AD3d 108, 113-114 [2012]; *Hahn v Stewart*, 5 AD3d 285, 286 [2004]; *see also Tzolis v Wolff*, 10 NY3d 100 [2008]).

Contrary to the defendant's contention, the LLC agreement is ambiguous and, therefore, parol evidence of the parties' course of dealing is admissible to supplement and interpret the terms of that agreement (*see Goldman Sachs Group, Inc. v Almah LLC*, 85 AD3d 424, 426-427 [2011]; *White Plains Equities Assoc., Inc. v Vista Devs. Corp.*, 82 AD3d 569 [2011]; *Foot Locker, Inc. v Omni Funding Corp. of Am.*, 78 AD3d 513, 515 [2010]). Further, the evidence of the parties' conduct with respect to capital contributions did not constitute a prior oral agreement or an impermissible oral modification of the contract.

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Nevertheless, the Supreme Court did not err in directing dismissal of the cause of action to recover damages for breach of contract. Even considering the evidence of the parties' conduct regarding capital contributions, the plaintiff failed to establish the existence of a binding agreement as to the parties' responsibility for such contributions. Therefore, the plaintiff failed to show a breach of any such agreement (*see Schaffe v SimmsParris*, 82 AD3d 867, 867-868 [2011]; *Mode Contempo, Inc. v Raymours Furniture Co., Inc.*, 80 AD3d 464 [2011]; *Wild v Hayes*, 68 AD3d 1412, 1414 [2009]).

The Supreme Court did not err in granting, in effect, the plaintiff's application for judicial dissolution of the LLC. Under the circumstances presented, it is not reasonably practicable for the LLC to continue to operate, as continuing the LLC is financially unfeasible (*see* Limited Liability Company Law § 702; *see also Matter of 1545 Ocean Ave., LLC*, 72 AD3d 121, 131 [2010]). [*3]

Contrary to the defendant's contention, the Supreme Court did not err in determining that if the assets of the company are to be liquidated, then the capital contributions of the plaintiff are to be treated as loans to the LLC to the extent that those contributions exceeded those made by the defendant. Although the LLC agreement provided that a member does not have the right to receive any return of capital contributions, the LLC agreement also provided for the repayment of debts of the LLC upon dissolution. The record, including an affidavit submitted by the defendant, establishes that the parties intended that the capital contributions by the plaintiff were to be treated as loans to the LLC to the extent that those contributions exceeded those made by the defendant. In addition, the LLC agreement is silent as to the issue of equalization of capital contributions. Under these circumstances, the Supreme Court did not err in directing that such contributions are to be treated as loans to the LLC (*see* Limited Liability Company Law §§ 702, 704 [c]; *Matter of KSI Rockville v Eichengrun*, 305 AD2d 681 [2003]).

The Supreme Court should have granted, in effect, the plaintiff's application for an order authorizing him to purchase the defendant's interest in the LLC upon its dissolution. The Limited Liability Company Law "does not expressly authorize a buyout in a dissolution proceeding" (*Matter of Superior Vending, LLC [Tal—Plotkin]*, 71 AD3d 1153, 1154 [2010]). Nonetheless, in certain circumstances, a buyout may be an appropriate equitable remedy upon the dissolution of an LLC (*see id.*). Under the facts of this case, the remedy of a buyout by the plaintiff is appropriate (*see id.*). Contrary to the defendant's

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contention, the provisions of the LLC agreement regarding dissolution of the LLC do not preclude an order authorizing a buyout upon the judicial dissolution of the LLC pursuant to Limited Liability Company Law § 702 (*see* Limited Liability Company Law § 702; *see also Matter of Superior Vending, LLC [Tal—Plotkin]*, 71 AD3d at 1154). Accordingly, the matter must be remitted to the Supreme Court, Kings County, for further proceedings and for a determination thereafter as to the value of the defendant's interest in the LLC. Eng, P.J., Rivera, Lott and Miller, JJ., concur. **[Prior Case History: 34 Misc 3d 1210(A), 2012 NY Slip Op 50030(U).]**

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Matter of Jacobs v Cartalemi

2017 NY Slip Op 08521 [156 AD3d 635]

December 6, 2017

Appellate Division, Second Department

Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.

As corrected through Wednesday, February 7, 2018

[*1]

In the Matter of William Jacobs, Appellant,
v
Charles Cartalemi et al., Respondents.

DelBello Donnellan Weingarten Wise & Wiederkehr, LLP, White Plains, NY (Lee S. Wiederkehr, Michael J. Schwarz, and Eric J. Mandell of counsel), for appellant.

Farrell Fritz, P.C., New York, NY (Peter A. Mahler and Michael A.H. Schoenberg of counsel), for respondents.

Appeal from an order and judgment (one paper) of the Supreme Court, Westchester County (Linda S. Jamieson, J.), dated April 21, 2016. The order and judgment granted that branch of the motion of Charles Cartalemi and Westchester Industrial Complex, LLC, which was, in effect, pursuant to CPLR 3211 (a) to dismiss the action, and, in effect, dismissed the action.

Ordered that the order and judgment is modified, on the law, (1) by deleting the provision thereof, in effect, dismissing the action, (2) by deleting the provision thereof granting that branch of the motion of Charles Cartalemi and Westchester Industrial Complex, LLC, which was, in effect, pursuant to CPLR 3211 (a) to dismiss the action, and substituting therefor a provision denying that branch of the motion, and (3) by adding thereto a provision declaring that William Jacobs has withdrawn as a member of Westchester Industrial Complex, LLC, effective December 1, 2015, and that in order to receive the value of his membership interest, he is obligated to follow the procedures set

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forth in the operating agreement of Westchester Industrial Complex, LLC; as so modified, the order and judgment is affirmed, without costs or disbursements.

In June 1995, William Jacobs and Charles Cartalemi entered into an operating agreement for the formation of a limited liability company, Westchester Industrial Complex, LLC (hereinafter WIC). On March 26, 2015, Jacobs served Cartalemi and WIC with a notice of withdrawal (hereinafter the notice), which indicated that he was exercising his right to withdraw as a member of WIC, in accordance with Limited Liability Company Law former § 606. At that time, Jacobs allegedly owned a 20% membership interest in WIC, and Cartalemi owned the remaining 80% interest. The notice asked Cartalemi to consent to Jacobs's withdrawal, and to make arrangements for the payment of the value of his membership interest in accordance with Limited Liability Company Law § 509. The notice stated that, if Cartalemi did not consent to Jacobs's withdrawal, the notice would serve as formal notice that his withdrawal would be automatically effective on December 1, 2015. Cartalemi did not consent to Jacobs's withdrawal.

On July 30, 2015, Jacobs commenced this action, denominated a "special proceeding," asserting two causes of action. The first sought a judgment declaring that, pursuant to Limited Liability Company Law former § 606, Jacobs was entitled to withdraw as a member of WIC, effective December 1, 2015. The second cause of action sought a declaration that, upon his withdrawal from WIC, Jacobs was entitled to be paid, within a reasonable time, the fair value of his membership interest in accordance with Limited Liability Company Law § 509, together with [*2]interest at nine percent per annum, without the application of any discount factor. By notice of motion dated December 18, 2015, WIC and Cartalemi moved, in effect, to dismiss the action pursuant to CPLR 3211 (a), or, alternatively, to convert the "special proceeding" to an action pursuant to CPLR 103. They argued that Jacobs withdrew from WIC effective December 1, 2015, and that therefore, his first cause of action should be dismissed as academic. As to the second cause of action, they argued that Jacobs was not entitled to a judgment declaring that he was entitled to be paid the fair value of his membership interest pursuant to Limited Liability Company Law § 509, because WIC's operating agreement provided otherwise and Jacobs was obligated to follow the procedures in the operating agreement. In an order and judgment dated April 21, 2016, the Supreme Court granted that branch of

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the motion which was, in effect, to dismiss the action, and, in effect, dismissed the action. Jacobs appeals.

"The supreme court may render a declaratory judgment . . . as to the rights and other legal relations of the parties to a justiciable controversy" (CPLR 3001). "[T]he demand for relief in the complaint shall specify the rights and other legal relations on which a declaration is requested" (CPLR 3017 [b]). Generally, a motion to dismiss the complaint in an action for a declaratory judgment "presents for consideration only the issue of whether a cause of action for declaratory relief is set forth, not the question of whether the plaintiff is entitled to a favorable declaration" (*Staver Co. v Skrobisch*, 144 AD2d 449, 450 [1988]; *see Rockland Light& Power Co. v City of New York*, 289 NY 45, 51 [1942]; *North Oyster Bay Baymen's Assn. v Town of Oyster Bay*, 130 AD3d 885, 890 [2015]; *Bregman v East Ramapo Cent. Sch. Dist.*, 122 AD3d 656, 657 [2014]). Further, "a complaint praying for judgment declaring the 'rights and legal relations' of the parties should not be dismissed as insufficient merely because the facts alleged in the complaint show that the plaintiff is not entitled to a declaration of rights as the plaintiff claims them to be. The court should, in proper case[s], retain jurisdiction of the action and should exercise its power to declare the rights and legal relations of the parties whatever they may be" (*Rockland Light & Power Co. v City of New York*, 289 NY at 51 [emphasis omitted]; *see Cahill v Regan*, 5 NY2d 292, 298 [1959]). "Accordingly, where a cause of action is sufficient to invoke the court's power to 'render a declaratory judgment . . . as to the rights and other legal relations of the parties to a justiciable controversy' (CPLR 3001; *see* CPLR 3017 [b]), a motion to dismiss that cause of action should be denied" (*Matter of Tilcon N.Y., Inc. v Town of Poughkeepsie*, 87 AD3d 1148, 1150 [2011]; *see North Oyster Bay Baymen's Assn. v Town of Oyster Bay*, 130 AD3d at 890; *Bregman v East Ramapo Cent. Sch. Dist.*, 122 AD3d at 657; *Minovici v Belkin BV*, 109 AD3d 520, 524 [2013]; *DiGiorgio v 1109-1113 Manhattan Ave. Partners, LLC*, 102 AD3d 725, 728 [2013]).

Furthermore, upon a motion to dismiss for failure to state a cause of action, where "the material allegations of the complaint are constructively admitted [and] there is no issue of fact," a court may reach the merits of a properly pleaded cause of action for a declaratory judgment (*German Masonic Temple Assn. v City of New York*, 279 NY 452, 457 [1939]; *see St. Lawrence Univ. v Trustees of Theol. School of St. Lawrence Univ.*, 20 NY2d 317, 325 [1967]; *Lanza v Wagner*, 11 NY2d 317, 334 [1962]; *Hoffman v City of*

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Syracuse, 2 NY2d 484, 487 [1957]; *Rockland Light & Power Co. v City of New York*, 289 NY at 53; *North Oyster Bay Baymen's Assn. v Town of Oyster Bay*, 130 AD3d at 890). "Under such circumstances, the motion to dismiss for failure to state a cause of action should be taken as a motion for a declaration in the defendant's favor and treated accordingly" (*Matter of Tilcon N.Y., Inc. v Town of Poughkeepsie*, 87 AD3d at 1150 [internal quotation marks and brackets omitted]; *see North Oyster Bay Baymen's Assn. v Town of Oyster Bay*, 130 AD3d at 890; *Minovici v Belkin BV*, 109 AD3d at 524; *DiGiorgio v 1109-1113 Manhattan Ave. Partners, LLC*, 102 AD3d at 728).

Here, the parties are in agreement that the issue of withdrawal is governed by Limited Liability Company Law former § 606 (*see* Limited Liability Company Law § 606 [b]). As relevant, Limited Liability Company Law former § 606 provided that, unless otherwise provided in the operating agreement, a member may withdraw as a member of a limited liability company with the vote or written consent of at least "two-thirds in interest" of the remaining members. If such consent is not given, unless otherwise provided for or prohibited by the operating agreement, the member may withdraw "upon not less than six months' prior written notice to the limited liability company" (Limited Liability Company Law former § 606). The uncontested facts set forth in the pleadings, to which were appended WIC's operating agreement, Jacobs's notice of withdrawal, and the refusal to consent to the withdrawal, establish that Jacobs's withdrawal as a member of WIC was effective December 1, 2015.

However, contrary to Jacobs's contention, the pleadings, and the exhibits appended [*3]thereto, also established that the issue of valuation of his membership interest upon withdrawal is not governed by Limited Liability Company Law § 509, because WIC's operating agreement includes a controlling provision. Limited Liability Company Law § 509 provides that, upon withdrawal as a member of a limited liability company, any withdrawing member is entitled to receive any distribution to which he or she is entitled under the operating agreement and, "*if not otherwise provided in the operating agreement*, he or she is entitled to receive, within a reasonable time after withdrawal, the fair value of his or her membership interest in the limited liability company as of the date of withdrawal" (emphasis added).

WIC's operating agreement includes an article setting forth the procedures to be followed when a member "desires to sell his, her or its Membership Interest." Where a

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"selling member" has received a prior offer from a bona fide purchaser for value, the selling member is obligated to offer the membership interest first to the other WIC members upon the terms and conditions offered to the third party. Where there is no prior offer to purchase the membership interest, the operating agreement directs that the selling member must make an offer of sale to the other WIC members, who may accept or reject the same, or make a counteroffer. In the event of a rejection of the offer and a rejection of the counteroffer, if any, the selling member then becomes free to offer the membership interest to any other party, provided that the terms are no less favorable to the selling member than the terms offered to WIC's members. It is undisputed that Jacobs has not engaged in this procedure.

Jacobs's contention that these provisions of the operating agreement control only the "sale" of a membership interest and not the valuation of a membership interest upon a member's withdrawal from WIC is unavailing. "The fundamental, neutral precept of contract interpretation is that agreements are construed in accord with the parties' intent" (*Greenfield v Philles Records*, 98 NY2d 562, 569 [2002]; *see Marin v Constitution Realty, LLC*, 28 NY3d 666, 673 [2017]). "The best evidence of what parties to a written agreement intend is what they say in their writing" (*Slamow v Del Col*, 79 NY2d 1016, 1018 [1992]; *see Greenfield v Philles Records*, 98 NY2d at 569). "[A] contract should be 'read as a whole; . . . and if possible it will be so interpreted as to give effect to its general purpose' " (*Beal Sav. Bank v Sommer*, 8 NY3d 318, 324-325 [2007], quoting *Matter of Westmoreland Coal Co. v Entech, Inc.*, 100 NY2d 352, 358 [2003]; *see Marin v Constitution Realty, LLC*, 28 NY3d at 673). "[A] written agreement that is complete, clear and unambiguous on its face must be enforced according to the plain meaning of its terms" (*Greenfield v Philles Records*, 98 NY2d at 569; *see Marin v Constitution Realty, LLC*, 28 NY3d at 673).

Here, the operating agreement is unambiguous on its face. It establishes procedures to be used where a member has not received an offer of sale, but nonetheless wishes to relinquish her, his, or its membership interest and to be compensated for the same. Thus, regardless of whether the "selling member" has withdrawn as a member of WIC, the operating agreement provides the manner in which the member might receive value for the membership interest (*cf. Bellwether Community Credit Union v CUSO Dev. Co., LLC*, 566 Fed Appx 398 [6th Cir 2014]). Accordingly, the Supreme Court properly determined

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that Jacobs was not entitled to a judgment declaring that, upon his withdrawal from WIC, he is entitled to be paid, within a reasonable time, the fair value of his membership interest in accordance with Limited Liability Company Law § 509, together with interest at nine percent per annum, without the application of any discount factor.

However, because this is an action for declaratory relief, instead of dismissing the action on the ground that Jacobs was not entitled to the relief he sought, "the proper procedure for the court is to deny the motion to dismiss the complaint (thereby retaining jurisdiction of the controversy) and then to declare the rights of the parties, whatever they may be" (*St. Lawrence Univ. v Trustees of Theol. School of St. Lawrence Univ.*, 20 NY2d at 325; *see Cahill v Regan*, 5 NY2d at 298; *Rockland Light & Power Co. v City of New York*, 289 NY at 51). Accordingly, the Supreme Court should have denied that branch of the motion which was, in effect, to dismiss the action, and declared that Jacobs has withdrawn as a member of WIC, effective December 1, 2015, and that in order to receive the value of his membership interest, he is obligated to follow the procedures set forth in WIC's operating agreement.

Jacobs's remaining contentions are without merit. Mastro, J.P., Chambers, LaSalle and Brathwaite Nelson, JJ., concur.

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Stulman v John Dory LLC
2010 NY Slip Op 33911(U)
September 10, 2010
Supreme Court, New York County
Docket Number: 602365/09
Judge: Charles E. Ramos
Cases posted with a "30000" identifier, i.e., 2013 NY Slip Op 30001(U), are republished from various state and local government websites. These include the New York State Unified Court System's E-Courts Service, and the Bronx County Clerk's office.
This opinion is uncorrected and not selected for official publication.

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FILED: NEW YORK COUNTY CLERK 09/14/2010 INDEX NO. 602365/2009
NYSCEF DOC. NO. 27 RECEIVED NYSCEF: 09/14/2010

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY E-FILE

PRESENT: CC Ramos PART 53

Index Number : 602365/2009
STULMAN, GABRIEL
vs
JOHN DORY LLC,
Sequence Number : 002
PARTIEL SUMMARY JUDGMENT

INDEX NO. ______
MOTION DATE ______
MOTION SEQ. NO. ______
MOTION CAL. NO. ______

The following papers, numbered 1 to ______ were read on this motion to/for ______

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that this motion

NYS SUPREME COURT
RECEIVED
SEP 14 2010
MOTION SUPPORT OFFICE

is decided in accordance with accompanying memorandum decision and order.

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE
FOR THE FOLLOWING REASON(S):

Dated: 9/10/2010

CHARLES E. RAMOS J.S.C.

Check one: ☐ FINAL DISPOSITION ☑ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

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[* 1]

E-FILE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK:COMMERCIAL DIVISION
--X
GABRIEL STULMAN,

Plaintiff, Index No. 602365/09

-against-

JOHN DORY LLC, JOSEPH CAMPANARO, personally, and ROBERT M. PRICE JR., personally,

Defendants.
--X

Charles Edward Ramos, J.S.C.:

In motion sequence 002, the defendants John Dory LLC ("John Dory"), Joseph Campanaro, and Robert M. Price, Jr. (collectively, the "Defendants") move pursuant to CPLR 3212 for partial summary judgment: (1) dismissing all or part of the first cause of action for breach of contract, the second cause of action for conversion, the third cause of action for declaratory judgment, and the fourth cause of action for rescission of the plaintiff Gabriel Stulman's complaint, and (2) dismissing the complaint in its entirety as against Campanaro and Price.

Background

In February 2007, Stulman, Campanaro, and Price formed John Dory, to develop and manage Market Table, a restaurant located in New York City (Complaint, ¶ 4). As equal managing members, each held a 20% interest with voting rights in John Dory, with the remaining 40% divided amongst non-voting investors. Campanaro and Price were responsible for the preparation of the food, while Stulman was responsible for overseeing the day-to-day operations at the restaurant.

After a dispute in March 31, 2008, Stulman resigned as a managing member of John Dory and relinquished his voting rights in exchange for $25,000, but retained a 20% interest in John Dory.

On May 1, 2009, Stulman received a letter from John Dory's counsel advising him that a merger had been effectuated between John Dory and John Dory Merger LLC ("JD Merger"), which resulted in the termination of his interest in John Dory[1] (Complaint, ¶ 7). The letter further offered Stulman $102,299.70, purportedly representing the fair market value for his interest in John Dory (Complaint, ¶ 12).

Stulman rejected the offer and thereafter, commenced this action alleging causes of action for breach of contract, conversion, declaratory judgment, rescission, and valuation on the basis that the merger was ineffective and that the offer in the letter did not represent the fair market value of his interest in John Dory.

Discussion

At issue in this action is the freeze-out merger[2] between John Dory and JD Merger effectuated by the written consent of Campanaro and Price, as the two voting members of John Dory (Dunne Aff., Exhibit D). The John Dory operating agreement (the

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[1] JD Merger was merged into John Dory, the surviving limited liability company.

[2] A freeze-out merger is defined as a merger by the majority, which forces the minority interest to give up its equity in the entity in exchange for cash or securities, while allowing the controlling interest to retain its equity (*Alpert v 28 Williams St. Corp.*, 63 NY2d 557, 563 n. 2 [1984]).

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"Operating Agreement") does not expressly prohibit a merger (*id.*, Exhibit H).

Pursuant to the Agreement of Merger (the "Merger Agreement"), Campanaro, Price, and the nine non-voting members of John Dory, excluding Stulman, would receive one unit of the surviving entity, also named John Dory, for each unit of their interest in the John Dory (*id.*, Exhibit E). Pursuant to the Merger Agreement, Stulman is only entitled to receive cash in exchange for his interest in John Dory.

Merger

The Defendants move for partial judgment arguing that the merger was properly executed pursuant to LLCL §§ 407(a) and is valid as a matter of law.

Stulman counters that the merger was invalid because notice of the merger was required and not provided. Stulman further alleges the merger was tainted by fraud, illegality, and self-dealing between Campanaro and Price. Finally, Stulman contends that the merger was inequitable because there was no legitimate purpose for the merger besides his removal as a member and he was not provided a fair price for his interest.

The relevant section of the Limited Liability Company Law states:

> "Whenever under this chapter members of a limited liability company are required or permitted to take any action by vote, except as provided in the operating agreement, such action may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing, setting forth the action so taken shall be signed by the

> members who hold the voting interests having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all of the members entitled to vote therein were present and voted..." (LLCL § 407 [a])

The Defendants argue that their merger was in compliance with the procedures set forth in the Limited Liability Company Law. This Court agrees. In fact, the record reflects that the Defendants went beyond the requirements of LLCL § 407(a), by obtaining the consent of all of the voting members and a majority of the equity interest in effectuating the merger (Transcript, June 15, 2010, 7:14-8:5).

Notice Requirement

Additionally, the Defendants argue that the plain language of LLCL § 407(a) does not require notice to members before any action is taken.

LLCL § 407(a) clearly provides that no notice is required if the consent of all the voting members is obtained. Furthermore, this Court has previously ruled that "[m]embers of a limited liability corporation may provide written consent in order to take action in lieu of an actual vote, unless the operating agreement provides otherwise (*Madison Hudson Assoc., LLC v Neumann*, 8 Misc. 3d 1025A [Sup Ct, NY County 2005, Ramos, J.]). Stulman has not alleged that any provision of the Operating Agreement limits the members' ability to act with written consent in lieu of an actual vote.

Stulman's arguments that notice of the merger was required are based only on the Business Corporation Law and the

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Partnership Law, neither of which applies to John Dory, a limited liability company. (Stulman Memo, ¶ 8-9).

The record demonstrates that the majority voting interests obtained the written consent, as required by LLCL § 407(a), and thus, John Dory was under no obligation thereunder, to provide notice to Stulman prior to the merger (*see* Dunne Aff., ¶ 32, Exhibit D). Furthermore, Stulman fails to cite any support for his argument that the absence of a notice requirement prior to a merger in the Limited Liability Company Law is merely an inadvertent omission.

Limited Liability Company Law

The merger of John Dory is clearly within the scope of the Limited Liability Company Law, which provides default procedures for limited liability companies that apply in limited liability company proceedings, unless the operating agreement applies otherwise (*Overhoff v Scarp, Inc.*, 12 Misc 3d 350, 359 [Sup Ct, Erie County, 2005]).

Stulman is barred in law and equity from challenging the validity of the merger or seeking rescission of the merger, pursuant to LLCL § 1002, because the merger was approved by more than a majority of members,(LLCL § 1002 [c], [g]).

Furthermore, LLCL § 1005(b) provides that if a former member disputes the surviving limited liability company's calculation of the fair market value of the former member's interest, then a special proceeding must be commenced to fix its value pursuant to BCL § 623.

Stulman's papers fail to address LLCL § 407(a), and instead rely almost exclusively on *Alpert v 28 Williams St. Corp.*, which predates the enactment of the Limited Liability Company Law (*Alpert v 28 Williams St. Corp.*, 63 NY2d 557 [1984]).

Alpert involved a freeze-out merger that was contested on the grounds that the merger was for the personal benefit of the majority and that there was no legitimate business purpose for the merger (*id.* at 564). The Supreme Court ruled that the majority had breached their fiduciary duty owed to the minority by effectuating a merger without establishing a strong and compelling legitimate business purpose (*id.* at 565).

The Appellate Division then reversed, holding that "[c]ourts will not interfere with the proper business judgment of directors in the absence of a showing of fraud, illegality, or self-dealing, so long as there is some proper corporate purpose for the merger other than the forced buy-out of the minority shares" and remanded the action to the Supreme Court (*Alpert v 28 Williams St. Corp.*, 91 AD2d 530, 531 [1st Dept 1982][internal citations omitted]).

Thereafter, the Supreme Court concluded that, as a whole, the transaction was fair and not tainted by fraud, illegality, or self-dealing and denied rescission of the merger (*Alpert*, 63 NY2d at 566). The Supreme Court's decision was affirmed by the Appellate Division.

Subsequently, the Appellate Division's decision was affirmed by the Court of Appeals, which held that "the majority's exclusion of the minority interests through a two-step merger does not violate the former's fiduciary obligations so long as the transaction viewed as a whole is fair to the minority shareholders and is justified by an independent corporate business purpose" and set forth the definition of an independent corporate purpose (*id.* at 566-567, 569-574).

In reconciling *Alpert* and the Limited Liability Company Law, it is clear that LLCL § 1005(b) codifies the remedies set forth in *Alpert*. The holding in *Alpert*, reflected in LLCL § 1005(b), provides that a former member is entitled to receive payment for its interest, but in the event the parties cannot agree on the fair market value of the interest, both *Alpert* and LLCL § 1005(b), reference the procedures set forth in BCL § 623 to fix the value (BCL § 623 [h] [i], [j], [k]). Furthermore, BCL § 623(k) provides that an action may be commenced if the merger is tainted by fraud, illegality, or self-dealing.

Stulman argues that he should be allowed to commence a plenary action for damages as opposed to a special proceeding merely to fix the value of Stulman's interest in John Dory because the merger lacked a valid business purpose and was tainted by fraud, illegality, and self-dealing.

Valid Business Purpose

The removal of members qualifies as an independent corporate purpose when the "removal of the minority shareholders, furthers the objective of conferring some general gain upon the corporation"(*Alpert* at 573).

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In opposing Stulman's assertions, Price submits an affidavit detailing Stulman's breaches of his fiduciary duty and the Operating Agreement.

Price testifies that Stulman breached his fiduciary duty and the Operating Agreement by attempting to open a competing restaurant while he was still a managing member of John Dory, including locating spaces, raising money, and meeting with potential investors (Price Aff., ¶ 6). Price asserts his attempt to open a competing restaurant also breached Section 17.15 of the Operating Agreement because he failed to present this opportunity to the members of John Dory first (*id.* at ¶ 7; Dunne Aff., Exhibit H, § 17.15). Furthermore, Stulman deleted the beverage program from John Dory's computer before his resignation as a managing member and thereafter, he solicited John Dory employees for his new venture that opened in 2009 (Price Aff., ¶ 5, 8, 9).

While Stulman has asserted that the merger was only to remove him as a member of John Dory, Price's affidavit, which is unchallenged by any sworn testimony by Stulman, clearly demonstrates that the managing members were acting in the best interests of John Dory by removing Stulman as a member because he was attempting to compete against John Dory.

Fraud, Illegality, Self-Dealing

Stulman's allegations that the merger was tainted by fraud, illegality, and self-dealing are vague and not supported by any evidence that would allow this Court to conclude there was any wrongdoing in effectuating the merger (*e.g.* Dunne Aff., Exhibits

A, C; Stulman Memo, ¶ 16). Furthermore, as stated above, the Defendants have established that there was a valid business purpose in removing Stulman as a member.

Campanaro and Price

Stulman argues that Campanaro and Price are personally liable for the acts of fraud, illegality, and self-dealing they committed in effectuating the merger between John Dory and JD Merger because the business judgment rule does not shield members from such conduct.

The Defendants argue that the complaint should be dismissed as against Campanaro and Price because they were acting in their capacity as managing members of John Dory, and therefore, cannot be held personally liable for the effect of the merger.

As stated above, Stulman fails to substantiate any of his allegations of fraud, illegality, or self-dealing with testimony or documentary evidence. Therefore, the complaint is dismissed against Campanaro and Price, individually.

Article 18

Stulman argues that John Dory was required to use Article 18 of the Operating Agreement in determining the fair market value of his interest in John Dory.

However, Article 18 of the Operating Agreement does not apply to a merger, but rather it applies to "an arm's length transaction between an informed and willing buyer (under no compulsion to purchase) and an informed and willing seller (under no compulsion to sell)" (Dunne Aff., Exhibit H, p. 24).

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Therefore, Article 18 of the Operating Agreement is applicable only between members seeking to purchase or sell their interests in John Dory and not in fixing the value of a member's interest after a merger.

Conclusion

Stulman has failed to establish that the merger of John Dory and JD Merger was improper or tainted with fraud, illegality, or self-dealing. Therefore, the merger was successful and Stulman ceased being a member of John Dory once the merger was effectuated. Consequently, Stulman's only remedy is to enforce his right to receive the fair market value of his interest, which shall be determined in a hearing before a referee.

Accordingly, it is

ORDERED and ADJUDGED that Gabriel Stulman is not entitled to a declaration that he is still currently a member in good standing of John Dory LLC, and it is further

ORDERED that the Defendants' motion for partial summary judgment is granted thereby dismissing the first, second, third, and fourth causes of action in complaint as against John Dory LLC and dismissing the complaint in its entirety as against Joseph Campanaro, and Robert M. Price, Jr., and it is further

ORDERED that the issue of the fair market value of Gabriel Stulman's interest in John Dory LLC is referred to Special Referee to hear and report with recommendations, except that, in event of and upon the filing of a stipulation of the parties, as permitted by CPLR 4317, the Special Referee, or another person

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designated by the parties to serve as referee, shall determine the aforesaid issue, and it is further

ORDERED that the plaintiffs' counsel shall, within 30 days from the date of this order, serve a copy of this order with notice of entry, upon the Special Referee Clerk in the Motion Support Office in Room 119 at 60 Centre Street, who is directed to placed this matter on the calendar of the Special Referee's Part for the earliest convenient date.

This constitutes the decision and order of this Court.

Dated: September 10, 2010

J.S.C.

CHARLES E. RAMOS

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87 N.Y.2d 161 (1995)
661 N.E.2d 972
638 N.Y.S.2d 399

In the Matter of Selma K. Friedman et al., Respondents,
v.
Beway Realty Corp. et al., Appellants.

Court of Appeals of the State of New York.

Argued October 18, 1995
Decided December 7, 1995.

Kirkpatrick & Lockhart LLP, New York City (*Gerald A. Novack* and *Alan S. Brodherson* of counsel), for appellants.

LeBoeuf, Lamb, Greene & MacRae, L.L.P., New York City (*Milton S. Gould* and *Steven E. Levitsky* of counsel), for respondents.

Judges SIMONS, TITONE, BELLACOSA, SMITH and CIPARICK concur; Chief Judge KAYE taking no part.

164 *164LEVINE, J.

Petitioners are minority stockholders in nine family owned close corporations, each of which had as its sole asset a parcel of income-producing office, commercial or residential real estate in New York City. In 1986, the board of directors and the requisite majority of stockholders of each corporation voted to transfer all of its property to a newly formed partnership. Petitioners voted their shares against the transfers and, pursuant to Business Corporation Law § 623, timely elected to exercise their appraisal rights and receive the "fair value" of their shares in each corporation. When the corporations failed to offer to purchase their shares, petitioners commenced this proceeding to have a judicial determination of the fair value of the shares (*see*, Business Corporation Law § 623 [h]).

In the first phase of a bifurcated valuation trial, Supreme Court determined the net value of the leasehold interest in an office building held by one of the family corporations, a decision not now
165 disputed. The parties then stipulated to the net *165 asset values of the remaining corporations. It is undisputed that, based on the percentages of each petitioner's stockholdings in the nine corporations, her proportionate share of the aggregate net asset values of all nine corporations was $15,200,833.

The second phase of the trial was devoted to a determination of the fair value of petitioners' shares in the nine corporations, given the net asset values previously fixed. At the conclusion of the trial, Supreme Court rejected the testimony of petitioners' expert, who had essentially arrived at his opinion of fair value by simply applying petitioners' fractional corporate stock ownership to

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the aggregate corporate net asset values. The court reasoned that this approach ignored the effect of the lack of marketability of the corporate stock and "valued these shares as if petitioners were co-tenants in the real estate rather than corporate shareholders".

Instead, Supreme Court adopted the net asset-based valuation methodology employed by Kenneth McGraw, the corporations' expert. McGraw's technique was, first, to ascertain what petitioners' shares hypothetically would sell for, relative to the net asset values of the corporations, if the corporate stocks were marketable and publicly traded; and second, to apply a discount to that hypothetical price per share in order to reflect the stocks' actual lack of marketability. As to the first step in this valuation process, Supreme Court accepted the comparability of one group of publicly traded shares suggested by McGraw, that is, of real estate investment trusts (REITs). McGraw suggested that REITs shares traded primarily in direct relation to each REIT's net asset value and, hence, the mean discount between REIT net asset values per share and REIT stock prices (which McGraw found was 9.8%) could be applied to determine what petitioners' stocks were worth if they were marketable. Thus, McGraw opined that the hypothetical value of the dissenters' shares here, if marketable and publicly traded, would be 9.8% less than their net asset value per share.

For the second step in McGraw's valuation process he applied a discount to reflect the illiquidity of petitioners' shares, i.e., that a potential investor would pay less for shares in a close corporation because they could not readily be liquidated for cash (*see*, *Matter of Seagroatt Floral Co. [Riccardi]*, 78 N.Y.2d 439, 445-446). The primary unmarketability discount recommended by McGraw was 30.4%. According to McGraw, that figure represented the mean reduction in price
166 per share when ordinarily publicly traded shares in "comparative" corporations *166 became unregistered and thus, restricted shares, which could only be sold in private placements. The corporations' expert then exacted an additional 14.6% discount in the value of the shares, which he based upon the existence of restrictions on transfer contained in stockholder agreements covering the shares of all nine corporations.

Although Supreme Court approved of the net asset valuation methodology of the corporations' expert as a generally valid approach to determining the fair value of petitioners' shares, it found various flaws in McGraw's evaluation and modified the values accordingly. First, the court eliminated the initial 9.8% discount from each petitioners' share in the aggregate net asset value of the corporations. The court based this upon McGraw's testimonial concession that the discrepancy between net asset value per share and price per share in REITs actually represented for the most part the minority status of the REIT shares traded. Thus, the court reasoned, to reduce petitioners' share of net asset value by 9.8% would in effect impose a discount based upon petitioners' status as minority stockholders, a result the court concluded violated New York precedents (citing *Matter of Raskin v Walter Karl, Inc.*, 129 AD2d 642; *Matter of Blake v Blake Agency*, 107 AD2d 139, *lv denied* 65 N.Y.2d 609).

Second, Supreme Court rejected McGraw's rationale for the imposition of a second unmarketability discount of 14.6% based upon stockholder agreement restrictions, as factually "unpersuasive". Finally, the court found that McGraw's 30.4% unmarketability discount actually

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included "a minority interest factor which is implicit in any minority stock holding". Consequently, the court considered it necessary to eliminate that factor from the value equation. It did so by reducing the 30.4% discount by 9.4%, which the court regarded as the discount McGraw had testified reflected the minority status of the shares traded in comparable REITs.[1] Thus, Supreme Court only applied a 21% discount for unmarketability against each petitioner's proportionate share of the aggregate net asset value of the corporations, resulting in a fair value determination of each petitioner's total stock interests of $2,008,682.

The Appellate Division affirmed for the reasons stated by Supreme Court.

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The corporations' primary argument for reversal is that Supreme Court erred as a matter of law in refusing to take into account in its fair value determination the financial reality that minority shares in a close corporation are worth less because they represent only a minority, rather than a controlling interest. Although the corporations' argument may have validity when corporate stock is valued for other purposes, it overlooks the statutory objective here of achieving a *fair* appraisal remedy for dissenting minority shareholders. Mandating the imposition of a "minority discount" in fixing the fair value of the stockholdings of dissenting minority shareholders in a close corporation is inconsistent with the equitable principles developed in New York decisional law on dissenting stockholder statutory appraisal rights (a position shared by the courts in most other jurisdictions), and the policies underlying the statutory reforms giving minority stockholders the right to withdraw from a corporation and be compensated for the value of their interests when the corporate majority takes significant action deemed inimical to the position of the minority.

Several principles have emerged from our cases involving appraisal rights of dissenting shareholders under Business Corporation Law § 623 or its predecessor statute. (1) The fair value of a dissenter's shares is to be determined on their worth in a going concern, not in liquidation, and fair value is not necessarily tied to market value as reflected in actual stock trading (*Matter of Fulton*, 257 N.Y. 487, 492). "The purpose of the statute being to save the dissenting stockholder from loss by reason of the change in the nature of the business, he [or she] is entitled to receive the value of his [or her] stock for sale *or its value for investment*" (*id.*, at 494 [emphasis supplied]). (2) The three major elements of fair value are net asset value, investment value and market value. The particular facts and circumstances will dictate which element predominates, and not all three elements must influence the result (*Matter of Endicott Johnson Corp. v Bade*, 37 N.Y.2d 585, 587-588). (3) Fair value requires that the dissenting stockholder be paid for his or her *proportionate* interest in a going concern, that is, the intrinsic value of the shareholder's economic interest in the corporate enterprise (*Matter of Cawley v SCM Corp.*, 72 N.Y.2d 465, 474). (4) By virtue of the 1982 amendment to Business Corporation Law § 623 (h) (4) (L 1982, ch 202, § 9), fair value determinations should take into account the
168 subsequent economic impact on value of the very transaction giving rise to *168 appraisal rights, as supplemental to the three basic value factors (net asset, investment and market values). (5)

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Determinations of the fair value of a dissenter's shares are governed by the statutory provisions of the Business Corporation Law that require equal treatment of all shares of the same class of stock (*Matter of* Cawley, *supra*, at 473).

Further, contrary to the corporations' contention here, there is no difference in analysis between stock fair value determinations under Business Corporation Law § 623, and fair value determinations under Business Corporation Law § 1118. The latter provision governs the rights of minority stockholders when the corporation has elected to purchase their interests, also at "fair value", following their petition for corporate dissolution under Business Corporation Law § 1104-a for oppressive majority conduct. The corporations' opposing argument is that considerations of the oppressive conduct of the majority stockholders enter into fair value considerations conducted under Business Corporation Law § 1118; therefore, the cases decided under that section are distinguishable and not authoritative for fair value considerations under Business Corporation Law § 623. The corporations' position in this regard is untenable because their basic underlying assumption — that oppressive majority conduct enters into the court's fair value equation under section 1118 — is in error. As we stated in *Matter of Pace Photographers (Rosen)* (71 N.Y.2d 737), once the corporation has elected to buy the petitioning stockholders' shares at fair value, "the issue of [majority] wrongdoing [is] superfluous * * * [f]ixing blame is material under [Business Corporation Law] § 1104-a, but not under [Business Corporation Law §] 1118" (*id.*, at 746; *see also*, *Matter of Seagroatt Floral Co.*, 78 NY2d, at 445, *supra*).

Thus, we apply to stock fair value determinations under section 623 the principle we enunciated for such determinations under section 1118 that, in fixing fair value, courts should determine the minority shareholder's proportionate interest in the going concern value of the corporation as a whole, that is, "'what a willing purchaser, in an arm's length transaction, would offer for the *corporation* as an operating business'" (*Matter of Pace Photographers [Rosen]*, 71 NY2d, at 748, *supra*, quoting *Matter of Blake v Blake Agency*, 107 AD2d, at 146, *supra* [emphasis supplied]).

Consistent with that approach, we have approved a methodology for fixing the fair value of
169 minority shares in a close corporation under which the investment value of the entire *169
enterprise was ascertained through a capitalization of earnings (taking into account the unmarketability of the corporate stock) and then fair value was calculated on the basis of the petitioners' proportionate share of all outstanding corporate stock (*Matter of Seagroatt Floral Co.*, 78 NY2d, at 442, 446, *supra*).

Imposing a discount for the minority status of the dissenting shares here, as argued by the corporations, would in our view conflict with two central equitable principles of corporate governance we have developed for fair value adjudications of minority shareholder interests under Business Corporation Law §§ 623 and 1118. A minority discount would necessarily deprive minority shareholders of their proportionate interest in a going concern, as guaranteed by our decisions previously discussed. Likewise, imposing a minority discount on the compensation payable to dissenting stockholders for their shares in a proceeding under Business Corporation Law §§ 623 or 1118 would result in minority shares being valued below

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that of majority shares, thus violating our mandate of equal treatment of all shares of the same class in minority stockholder buyouts.

A minority discount on the value of dissenters' shares would also significantly undermine one of the major policies behind the appraisal legislation embodied now in Business Corporation Law § 623, the remedial goal of the statute to "protect[] minority shareholders 'from being forced to sell at unfair values imposed by those dominating the corporation while allowing the majority to proceed with its desired [corporate action]'" (*Matter of Cawley v SCM Corp.*, 72 NY2d, at 471, *supra*, quoting *Alpert v 28 William St. Corp.*, 61 N.Y.2d 557, 567-568). This protective purpose of the statute prevents the shifting of proportionate economic value of the corporation as a going concern from minority to majority stockholders. As stated by the Delaware Supreme Court, "to fail to accord to a minority shareholder the full proportionate value of his [or her] shares imposes a penalty for lack of control, and unfairly enriches the majority stockholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder" (*Cavalier Oil Corp. v Harnett*, 564 A2d 137, 1145 [Del]).

Furthermore, a mandatory reduction in the fair value of minority shares to reflect their owners' lack of power in the administration of the corporation will inevitably encourage oppressive majority conduct, thereby further driving down the compensation necessary to pay for the value
170 of minority shares. *170 "Thus, the greater the misconduct by the majority, the less they need to pay for the minority's shares" (Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Evaluation of Minority Shares*, 65 Notre Dame L Rev 425, 487).

We also note that a minority discount has been rejected in a substantial majority of other jurisdictions.[2] "Thus, statistically, minority discounts are almost uniformly viewed with disfavor by State courts" (*id.*, at 481). The imposition of a minority discount in derogation of minority stockholder appraisal remedies has been rejected as well by the American Law Institute in its Principles of Corporate Governance (*see*, 2 ALI, Principles of Corporate Governance § 7.22, at 314-315; comment *e* to § 7.22, at 324 [1994]).

II

We likewise find no basis to disturb the trial court's discretion in failing to assign any additional diminution in value of petitioners' shares here because they were subject to contractual restrictions on voluntary transfer. As we noted in *Matter of Pace Photographers (Rosen)* (*supra*), a statutory acquisition of minority shares by a corporation pursuant to the Business Corporation Law is not a voluntary sale of corporate shares as contemplated by a restrictive stockholder agreement and, therefore, "the express covenant is literally inapplicable" (71 NY2d, at 749). Nor is there any reason to disturb Supreme Court's award of prejudgment interest.

III

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While we have concluded that Supreme Court correctly applied the legal doctrines respecting fair value determinations of dissenting minority stockholders' shares in the instant case, we find error in the court's calculation of the unmarketability discount which must be applied here. As previously explained, Supreme Court generally adopted the net asset valuation approach of McGraw, the corporations' expert, and his two-step evaluation process. However, the court
171 added back the 9.8% discount McGraw took in the first step of that process *171 because the court concluded that it actually represented a minority discount. Then, when it reached the second step of the evaluation process, the court removed what it regarded as the same minority discount from the 30.4% unmarketability discount McGraw applied at that stage. Thus, Supreme Court added back McGraw's minority discount twice, once in each of the stages of the process. Apparently, this was based upon the court's erroneous finding that McGraw arrived at the 30.4% discount by analyzing privately transacted sales of stock "with restrictive sale provisions and [McGraw] found that they exhibited a median discount of 30.4 percent *relative to net asset value*" (emphasis supplied). Supreme Court further reasoned that, because the sales McGraw analyzed were of minority shares, his unmarketability discount also must have contained an element of reduced value because of their minority status. The evidence in the record does not support the foregoing conclusions. In actuality, McGraw did not arrive at the 30.4% discount by comparing shares with "restrictive sale provisions" to their net asset values. He calculated the unmarketability factor by comparing the purchase prices of registered, publicly traded *minority* shares in comparative corporations, to the purchase prices of *the same class of minority shares* in the same corporations that were unregistered and, therefore, not publicly traded but purchased under trading restrictions in private placements. Because McGraw in his calculations always compared the prices of a marketable set of minority shares to the prices of a set of minority shares when the same stock was unmarketable, the difference in prices of the shares did not contain any additional minority discount element, and the discount was solely attributable to the difference in the marketability of the shares in the same stock.

Thus, Supreme Court erred in removing a nonexistent minority discount element from the reduction in value of petitioners' shares McGraw attributed to their lack of marketability. It is unclear, however, as to whether Supreme Court would have accepted in full McGraw's 30.4% discount as a proper reflection of diminution in value due to unmarketability had the court been aware that it did not also reflect a reduction in value due to the shares' minority status. Because of this uncertainty, the matter must be remitted to Supreme Court for a new determination of the appropriate discount for unmarketability of petitioners' shares and a recalculation of fair value when that discount is applied to the proportionate net asset value of petitioners' stockholdings in the nine corporations.

172 *172Accordingly, the order should be reversed, without costs, and the matter remitted to Supreme Court for further proceedings in accordance with this opinion.

Order reversed, etc.

[1] As earlier described, the actual mean minority discount McGraw derived from his REIT study was 9.8%, not the 9.4% the court applied to reduce McGraw's recommended unmarketability discount. None of the parties to this appeal has raised any objection based upon this discrepancy.

[2] *E.g.*, *Brown v Allied Corrugated Box Co.*, 91 Cal App 3d 477, 486, 154 Cal Rptr 170; *Cavalier Oil Corp. v Harnett*, *supra*, at 1144 (Del); *Hickory Cr. Nursery v Johnston*, 167 Ill App 3d 449, 521 NE2d 236, 239-240; *Eyler v Eyler*, 492 NE2d 1071 (Ind); *Woodward v Quigley*, 257 Iowa 1077, 133 NW2d 38, 43, *mod* 257 Iowa 1104, 136 NW2d 280; *Matter of McLoon Oil Co.*, 565 A2d 997, 1004-1005 (Me); *Rigel Corp. v Cutchall*, 245 Neb 118, 511 NW2d 519.

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Tzolis v Wolff
2008 NY Slip Op 01260 [10 NY3d 100]
February 14, 2008
Smith, J.
Court of Appeals
Published by New York State Law Reporting Bureau pursuant to Judiciary Law § 431.
As corrected through Wednesday, April 16, 2008

[*1]

Soterios (Steve) Tzolis et al., Individually and in the Right and on Behalf of Pennington Property Co. and Another, et al., Respondents, v Herbert Wolff et al., Defendants, and Parkway LLC et al., Appellants.

Argued January 3, 2008; decided February 14, 2008

Tzolis v Wolff, 39 AD3d 138, affirmed.

{**10 NY3d at 102} OPINION OF THE COURT

Smith, J.

We hold that members of a limited liability company (LLC) may bring derivative [*2]suits on the LLC's behalf, even though there are no provisions governing such suits in the Limited Liability Company Law.

Facts and Procedural History

Pennington Property Co. LLC was the owner of a Manhattan apartment building. Plaintiffs, who own 25% of the membership interests in the LLC, bring this action "individually and in the{**10 NY3d at 103} right and on behalf of" the company. Plaintiffs claim that those in control of the LLC, and others acting in concert with them, arranged first to lease and then to sell the LLC's principal asset for sums below market value; that the lease was unlawfully assigned; and that company fiduciaries benefitted

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personally from the sale. Plaintiffs assert several causes of action, of which only the first two are in issue here: The first cause of action seeks to declare the sale void, and the second seeks termination of the lease.

Supreme Court dismissed these causes of action. It held that they could not be brought by plaintiffs individually, because they were "to redress wrongs suffered by the corporation" (12 Misc 3d 1151[A], 2006 NY Slip Op 50851[U], *4). It also held, following Hoffman v Unterberg (9 AD3d 386 [2d Dept 2004]), that "New York law does not permit members to bring derivative actions on behalf of a limited liability company" (*id.* at *5). The Appellate Division, concluding that derivative suits on behalf of LLCs are permitted, reversed (39 AD3d 138 [1st Dept 2007]), and granted two defendants permission to appeal on a certified question. We now affirm the Appellate Division's order.

Discussion

The issue is whether derivative suits on behalf of LLCs are allowed. The basis for appellants' argument that they are not is the Legislature's decision, when the Limited Liability Company Law was enacted in 1994, to omit all reference to such suits. We hold that this omission does not imply such suits are prohibited. We base our holding on the long-recognized importance of the derivative suit in corporate law, and on the absence of evidence that the Legislature decided to abolish this remedy when it passed the Limited Liability Company Law in 1994.

I

The derivative suit has been part of the general corporate law of this state at least since 1832. It was not created by statute, but by case law. Chancellor Walworth recognized the remedy in *Robinson v Smith* (3 Paige Ch 222 [1832]), because he thought it essential for shareholders to have recourse when those in control of a corporation betrayed their duty. Chancellor Walworth applied to a joint stock corporation—then a fairly new kind of entity—a familiar principle of the law of trusts: that a beneficiary (or "cestui que trust") could bring suit on behalf of a trust when a faithless trustee refused to do so. Ruling that{**10 NY3d at 104} shareholders could sue on behalf of a corporation under similar circumstances, the Chancellor explained:

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> "The directors are the trustees or managing partners, and the stockholders are the cestui que trusts, and have a joint interest in all the property and effects of the corporation. . . . And no injury the stockholders may sustain by a fraudulent breach of trust, can, upon the general principles of equity, be suffered to pass without a remedy. In the language of Lord Hardwicke, in a similar case [*Charitable Corp. v Sutton*, 2 Atk 400, 406 (Ch 1742)], 'I will never determine that a court of equity cannot lay hold of every such breach of trust. I will never determine that frauds of this kind are out of the reach of courts of law or equity; [*3]for an intolerable grievance would follow from such a determination.' " (3 Paige Ch at 232.)

Eventually, the rule that derivative suits could be brought on behalf of ordinary business corporations was codified by statute (*see* Business Corporation Law § 626 [a]). But until relatively recently, no similar statutory provision was made for another kind of entity, the limited partnership; again, the absence of a statute did not prevent courts from recognizing the remedy. In *Klebanow v New York Produce Exch.* (344 F2d 294 [2d Cir 1965, Friendly, J.]), the Second Circuit Court of Appeals held that limited partners could sue on a partnership's behalf. For the Second Circuit, the absence of a statutory provision was not decisive because the court found no "clear mandate *against* limited partners' capacity to bring an action like this" (*id.* at 298 [emphasis added]). We agreed with the holding of *Klebanow* in *Riviera Congress Assoc. v Yassky* (18 NY2d 540, 547 [1966, Fuld, J.]), relying, as had Chancellor Walworth long before, on an analogy with the law of trusts:

> "There can be no question that a managing or general partner of a limited partnership is bound in a fiduciary relationship with the limited partners . . . and the latter are, therefore, *cestuis que trustent*. . . . It is fundamental to the law of trusts that *cestuis* have the right, 'upon the general principles of equity' (*Robinson v. Smith*, 3 Paige Ch. 222, 232) and 'independently of [statutory] provisions' (*Brinckerhoff v. Bostwick*, 88 N. Y. 52, 59), to sue for the benefit of the trust on a cause of action which[**10 NY3d at 105] belongs to the trust if 'the trustees refuse to perform their duty in that respect'. (*Western R. R. Co. v. Nolan*, 48 N. Y. 513, 518 . . . .)"

After *Klebanow* and *Riviera* were decided, the Partnership Law was amended to provide for derivative actions by limited partners (*see* Partnership Law § 115-a [1]).

We now consider whether to recognize derivative actions on behalf of a third kind of entity, the LLC, as to which no statutory provision for such an action exists. In addressing

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the question, we continue to heed the realization that influenced Chancellor Walworth in 1832, and Lord Hardwicke 90 years earlier: When fiduciaries are faithless to their trust, the victims must not be left wholly without a remedy. As Lord Hardwicke put it, to "determine that frauds of this kind are out of the reach of courts of law or equity" would lead to "an intolerable grievance" (*Charitable Corp. v Sutton*, 2 Atk at 406).

To hold that there is no remedy when corporate fiduciaries use corporate assets to enrich themselves was unacceptable in 1742 and in 1832, and it is still unacceptable today. Derivative suits are not the only possible remedy, but they are the one that has been recognized for most of two centuries, and to abolish them in the LLC context would be a radical step.

Some of the problems such an abolition would create may be seen in the development of New York law since the Limited Liability Company Law, omitting all reference to derivative suits, was passed in 1994. Several courts have held that there is no derivative remedy for LLC members (*see Hoffman v Unterberg*, 9 AD3d 386 [2d Dept 2004]; *Lio v Mingyi Zhong*, 10 Misc 3d 1068[A], 2006 NY Slip Op 50016[U] [Sup Ct, NY County 2006]; *Schindler v Niche Media Holdings*, 1 Misc 3d 713, 716 [Sup Ct, NY County 2003]). But since the Legislature obviously did not intend to give corporate fiduciaries a license to steal, a substitute remedy must be devised. Perhaps responding to this need, some courts have held that members of an LLC have their own, direct claims against fiduciaries for conduct that injured the LLC—[*4]blurring, if not erasing, the traditional line between direct and derivative claims (*see Matter of Marciano [Champion Motor Group, Inc.]*, 2007 NY Slip Op 34071[U], *4 [Sup Ct, Nassau County 2007]; *Out of the Box Promotions LLC v Koschitzki*, 15 Misc 3d 1134[A], 2007 NY Slip Op 50973 [U], *7 [Sup Ct, Kings County 2007]; *Lio*, 2006 NY Slip Op 50016[U], at *4). Similarly, Supreme Court's decision in this case upheld several of plaintiffs' claims that are not in issue here, characterizing{**10 NY3d at 106} the claims as direct, though they might well be derivative under traditional analysis (*see generally*, Kleinberger, *Direct Versus Derivative and The Law of Limited Liability Companies*, 58 Baylor L Rev 63 [2006]).

Substituting direct remedies of LLC members for the old-fashioned derivative suit—a substitution not suggested by anything in the language of the Limited Liability Company Law—raises unanswered questions. Suppose, for example, a corporate fiduciary steals a hundred dollars from the treasury of an LLC. Unquestionably he or she is liable to

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the LLC for a hundred dollars, a liability which could be enforced in a suit by the LLC itself. Is the same fiduciary also liable to each injured LLC member in a direct suit for the member's share of the same money? What, if anything, is to be done to prevent double liability? No doubt, if the Legislature had indeed abolished the derivative suit as far as LLCs are concerned, we could and would answer these questions and others like them. But we will not readily conclude that the Legislature intended to set us on this uncharted path.

II

As shown above, courts have repeatedly recognized derivative suits in the absence of express statutory authorization (*Robinson v Smith*, 3 Paige Ch 222 [1832]; *Klebanow v New York Produce Exch.*, 344 F2d 294 [2d Cir 1965]; *Riviera Congress Assoc. v Yassky*, 18 NY2d 540 [1966]). In light of this, it could hardly be argued that the mere absence of authorizing language in the Limited Liability Company Law bars the courts from entertaining derivative suits by LLC members. It is argued, however, by appellants and by our dissenting colleagues, that here we face not just legislative silence, but a considered legislative decision not to permit the remedy. The dissent finds, in the legislative history of the Limited Liability Company Law, a "legislative bargain" to the effect that derivative suits on behalf of LLCs should not exist (dissenting op at 113). We find no such thing. For us, the most salient feature of the legislative history is that no one, in or out of the Legislature, ever expressed a wish to *eliminate*, rather than limit or reform, derivative suits.

The Legislature clearly did decide not to enact a statute governing derivative suits on behalf of LLCs. An Assembly-passed version of the bill that became the Limited Liability Company Law included an article IX, entitled "Derivative Actions." In the Senate-passed version, and the version finally{**10 NY3d at 107} adopted, the article was deleted, leaving a conspicuous gap; in the law as enacted, the article following article VIII is article X. Nothing in the legislative history discusses the omission. Our only source of information on the reason for it is a sentence written by the author of the Practice Commentaries on the Limited Liability Company Law: "Because some legislators had raised questions about the derivative rights provisions, to avoid jeopardizing passage of the balance of the entire law, Article IX was dropped" (Rich, Practice Commentaries, McKinney's Cons Laws of NY, Book 32/32A, Limited Liability Company Law, at 181

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[2007]). Nothing tells us what the "questions" were, or why they would have jeopardized the bill's passage.

The dissent attempts to fill this gap by reviewing some other events preceding the [*5]passage of the legislation. The dissent points out that New York politicians in 1993 and 1994 wanted to improve "New York's overall business climate" (dissenting op at 110), and that among the proposed means of doing so were "bills . . . to *modify the treatment of* derivative lawsuits and authorize limited liability companies" (*id.*, quoting Blackman, Corporate Update, *Move Over Delaware! Making New York Incorporation-Friendly*, NYLJ, Dec. 16, 1993, at 5, col 2 [emphasis added]). But the dissent cites no evidence, and we know of none, that anyone ever suggested doing away with derivative suits entirely—a radical step, as we have already pointed out, and one that might be expected to harm the "business climate" more than help it.

In fact, the reforms of derivative suits that were under discussion in 1993-1994 came nowhere near to abolition. They were, in substance, proposals to codify and expand on our decision in *Auerbach v Bennett* (47 NY2d 619 [1979]), holding that a decision by disinterested directors to terminate a derivative suit would be honored by the courts (*see* Blackman, NYLJ, Dec. 16, 1993, at 5, col 2). All three of the bills introduced to reform derivative suits began with an endorsement of such suits in principle:

> "The legislature finds and declares it to be the public policy of the state of New York to maintain the shareholder derivative suit proceeding as a remedy for shareholders on behalf of New York corporations because such suits, when meritorious, serve as an important deterrent against breaches of fiduciary duties by directors of such corporations." (*See* NY{**10 NY3d at 108} Senate Bill S6222 [introduced Dec. 15, 1993]; NY Senate Bill S6222-A [amended Dec. 17, 1993]; NY Assembly Bill A8938 [Dec. 17, 1993]).

The connection, if any, between the proposed reforms of derivative suits and the fate of proposed article IX of the Limited Liability Company Law is obscure. It seems to be true that the Senate favored a bill from which article IX was absent, and that the Assembly acquiesced in the Senate's preference. But this does not prove that any legislator, much less the Legislature as a whole, thought that the absence of article IX would render derivative suits nonexistent—an extreme result that no legislator is known to have favored. We simply do not know what consequences the legislators expected to follow from the omission. It is possible that some legislators did expect—though no one

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expressed the expectation—that there would be no derivative suits. It is possible that some legislators expected the courts to follow the established case law, and to recognize derivative suits in the absence of a "clear mandate against" doing so (*Klebanow*, 344 F2d at 298); one witness at a legislative public hearing did express that expectation (statement of Howard N. Lefkowitz, chair of Committee on Corporation Law, Association of Bar of City of NY, Transcript of Assembly Public Hearing on Limited Liability Company Legislation, June 11, 1992, at 133). It is possible that the Senate expected one thing, and the Assembly the other. It is even possible that neither expected anything, except that the problem would cease to be the Legislature's and become the courts'. The legislative history is, in short, far too ambiguous to permit us to infer that the Legislature intended wholly to eliminate, in the LLC context, a basic, centuries-old protection for shareholders, leaving the courts to devise some new substitute remedy.

The dissent says that, in upholding the right of LLC members to sue derivatively, we leave that right "unfettered by the prudential safeguards against abuse that the Legislature has adopted . . . in other contexts" (dissenting op at 121). But the right to sue derivatively has never [*6]been "unfettered," and the limitations on it are not all of legislative origin. The case in which derivative suits originated, *Robinson v Smith*, held that such a suit could be brought only on "a sufficient excuse"—i.e., a showing that those in control of the corporation "refused to prosecute" because they were themselves the wrongdoers, or were in "collusion with" them (3 Paige Ch at 232, 233). Later cases reaffirmed the rule that a derivative action could not be{**10 NY3d at 109} brought "unless it is necessary because of the neglect and refusal of the corporate body to act" (*see e.g. Continental Sec. Co. v Belmont*, 206 NY 7, 15 [1912]). The statutes governing ordinary business corporations and limited partnerships now reflect the existence of that rule, requiring the complaint in a derivative suit to allege "the efforts of the plaintiff to secure the initiation of such action . . . or the reasons for not making such effort" (Business Corporation Law § 626 [c]; Partnership Law § 115-a [3]). Other statutory provisions impose other limitations (*see* Business Corporation Law § 626 [b]; Partnership Law § 115-a [2] [contemporaneous ownership of plaintiff's interest]; Business Corporation Law § 627; Partnership Law § 115-b [posting security for expenses]). What limitations on the right of LLC members to sue derivatively may exist is a question not before us today. We do not, however, hold or suggest that there are none.

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Finding no clear legislative mandate to the contrary, we follow *Robinson, Klebanow* and *Riviera* in concluding that derivative suits should be recognized even though no statute provides for them. We therefore hold that members of LLCs may sue derivatively (*accord Bischoff v Boar's Head Provisions Co. Inc.*, 436 F Supp 2d 626 [SD NY 2006]; *Weber v King*, 110 F Supp 2d 124 [ED NY 2000]; *contra Pennacchio ex rel. Old World Brewing Co., Inc. v Powers*, 2007 WL 446355, 2007 US Dist LEXIS 8051 [ED NY 2007]).

Accordingly, the order of the Appellate Division, insofar as appealed from, should be affirmed with costs and the certified question answered in the affirmative.

Read, J. (dissenting). The result in this case is unique in the annals of the Court of Appeals. Never before has a majority of the Court read into a statute provisions or policy choices that the enacting Legislature unquestionably considered and rejected. I respectfully dissent.

<u>Background and Legislative History</u>

The limited liability company (LLC) first appeared in Wyoming in 1977, followed by Florida, which adopted an LLC act similar to Wyoming's in 1982. "As in Wyoming, the Florida statute was enacted to lure capital into the state," but "[a]s a result of the lingering uncertainty as to both tax treatment and the protection of the entity's members from personal liability," other states did not immediately follow suit (Keatinge et al., {**10 NY3d at 110} *The Limited Liability Company: A Study of the Emerging Entity*, 47 Bus Law 375, 383-384 [1992]). After the Internal Revenue Service's public ruling in 1988 that it would treat a Wyoming LLC as a partnership for tax purposes, however, many states and drafting commissions began to consider, or experiment with, LLC laws (*id.* at 384).

While all of this was happening, New York's Business Corporation Law was increasingly viewed as unfriendly to fledgling businesses. Indeed, in late 1993 a corporate lawyer in a major New York City law firm suggested that "[t]here are many cases where a lawyer who uses New York as the state of incorporation without discussing it in advance with his client is probably guilty of malpractice because of the many disadvantageous aspects of the New York law" (Peter Blackman, Corporate Update, *Move over Delaware!*

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Making New York Incorporation-Friendly, NYLJ, Dec. 16, 1993, at 5, col 2 [statement of Richard R. Howe]).

By the early 1990s, New York legislators and Governor Cuomo had advanced improving New York's overall business climate to the forefront of the political agenda in Albany (*see id.* ["In an effort to make New York a more attractive state in which to incorporate, several legislators have moved to even the imbalance between (New York and Delaware)"]). Although this pro-business agenda manifested itself in various ways—for example, it was in 1994 that Governor Cuomo and Chief Judge Kaye first sought to establish the Commercial Division of the Supreme Court (*see* Gary Spencer, *Cuomo Seeks State Commercial Court, Other Bills Aimed at Improvement of Business Climate*, NYLJ, Jan. 6, 1994, at 1, col 3)—two of the highest-profile pro-business initiatives were "bills pending in Albany to modify the treatment of derivative lawsuits and to authorize limited liability companies" (Blackman, NYLJ, Dec. 16, 1993, at 5, col 2). They were often cited together in reports of the legislative and gubernatorial agenda in 1993 and 1994 (*see id.*; *see also* Spencer, NYLJ, Jan. 6, 1994, at 1, col 3 ["pro-business proposals include bills that would: (d)iscourage shareholder derivative lawsuits . . . and (a) llow the formation of limited liability companies"]; Dao, New York Times, June 30, 1994, at B7 ["(Governor Cuomo) has lobbied for legislation to limit a type of lawsuit, known as derivatives, brought by shareholders against corporate boards for wrongdoing. . . . He has advocated creating a hybrid business entity—a limited liability company—that would possess the liability protections of corporations but have the lower tax rates of partnerships"]).[**10 NY3d at 111]

By mid-1992, "18 states . . . permit[ted] the formation of LLCs[,] . . . two states [recognized] LLCs formed in other states[,] LLC statutes [we]re pending or [we]re being considered in approximately 28 other states, and the National Conference of Commissioners on Uniform State Laws [wa]s drafting a uniform LLC statute" (Brian L. Schorr, *Limited Liability Companies: Features and Uses*, 62 CPA J [Issue 12] 26 [Dec. 1992], reprinted in 805 PLI/Corp 191, 193). On March 19, 1992, a Joint Drafting Committee of the Association of the Bar [*7]of the City of New York and the New York State Bar Association submitted a proposed limited liability company act for the New York Legislature's consideration; by early May 1992, LLC bills had been introduced in

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both houses of the New York State Legislature (New York Limited Liability Company Law Update, 805 PLI/Corp at 211-212).

A limited liability company bill was introduced in the New York State Assembly as A11016 on March 31, 1992, less than two weeks after receipt of the Joint Drafting Committee's draft. A11016 was, for purposes of this case, substantially identical to the finally enacted Limited Liability Company Law with two related exceptions: article IX of the bill authorized members to bring derivative actions;[FN1] and section 610, which set out the general rule that a member may not initiate an action by or against the company, included a derivative suit under article IX{**10 NY3d at 112} as an exception to this rule.[FN2] A11016 was referred to committee after its introduction; the Assembly took no further action on this bill in 1992. [*8]

On May 12, 1992, a limited liability company bill was introduced in the New York State Senate as S8180. This bill was substantially identical to the Assembly bill except for the notable absence of any language authorizing derivative actions. S8180 was amended and reprinted three times between May 12 and June 25 of 1992, at which point S8180-C—which still did not contain any provisions relating to derivative actions—was referred to committee and left for a subsequent session.

On June 11, 1992, public hearings were held on the Assembly bill. Testifying at these hearings on behalf of the Bar Association of the City of New York and the Joint Drafting Committee were Brian Schorr[FN3] and Howard Lefkowitz. At the Assembly hearings, Mr. Schorr observed that "[t]he Assembly bill does contain provisions concerning the right of a member to bring a derivative action. These provisions are adapted from the [Partnership Law] . . . [T]he Senate bill contains no comparable provisions" (testimony of Brian L. Schorr, Transcript of Assembly Public Hearing on Limited Liability Company Legislation, June 11, 1992, at 27). At those same hearings, Mr. Lefkowitz, who was the chair of City Bar's Committee on Corporation Law, spoke extensively in favor of derivative actions on behalf of LLCs. Before the Senate, however, the only reference to derivative rights in any testimony was the following statement by Mr. Schorr:{**10 NY3d at 113}

> "The Senate bills are based in large part on the proposed limited liability company law prepared by the Joint Drafting Committee, with changes that

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> have been agreed to with other proponents of a limited liability company law. Subject to two exceptions, [City Bar] enthusiastically supports the Senate bills . . . The two exceptions are the inclusion of a publication requirement and the lack of derivative action provisions" (testimony of Brian L. Schorr, Senate Public Hearing on Limited Liability Company Legislation, Dec. 4, 1992, at 2).

As the subsequent legislative history of the Limited Liability Company Law confirms, the omission of provisions authorizing derivative actions was a material—if not *the* material—term in the legislative bargain struck by the Senate and the Assembly.

As noted earlier, LLC bills were introduced, in substantially complete form, in both chambers of the Legislature in the spring of 1992. The Assembly bill (A11016) authorized derivative actions; the Senate bill (S8180) did not. After both chambers failed to pass an LLC bill in 1992, efforts to negotiate a mutually agreeable statute resumed in 1993. On January 6, 1993, an LLC bill, S27, was introduced in the Senate; neither S27 nor any of its three reprints in 1993 contained any provision authorizing derivative actions. On March 30, 1993, an LLC bill containing article IX and the accompanying language in section 610 was again introduced in the Assembly as A7127. This bill was referred to committee, and no further action was ever taken on it. On June 25, 1993, the Assembly Rules Committee introduced A8676, another LLC bill containing these same provisions authorizing derivative actions. On July 7, 1993, the Assembly passed the "B" print of this bill—which still allowed for derivative actions—and delivered it to the Senate. The Senate, which had never [*9]introduced any LLC bill sanctioning derivative actions, did not act on A8676-B, thus delaying the passage of any LLC law until at least 1994.

On March 8, 1994, S27 was reintroduced. On April 5, 1994, the Assembly Rules Committee introduced A11317, a companion to S7511, which was introduced in the Senate the same day. Unlike all prior Assembly bills, A11317 did *not* authorize derivative actions; as was the case with every prior Senate bill, S7511 likewise did not authorize derivative actions. On June 30, 1994, S7511 passed the Senate and was delivered to the Assembly. That same day, the Assembly substituted S7511 for A11317, and [**10 NY3d at 114] on July 1, 1994, the Assembly passed S7511 and returned it to the Senate. The adopted bill was delivered to the Governor on July 15, 1994, and was signed into law on July 26, 1994, as chapter 576 of the Laws of 1994.

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The deletion from the adopted LLC legislation of provisions authorizing derivative actions manifests a legislative bargain: the Senate refused to pass an LLC statute if it allowed for derivative suits. Nearly finalized LLC bills appeared in the Legislature as early as spring of 1992, and the Assembly actually passed a bill in mid-1993. Yet the Senate was unbending: at a time when serious consideration was being given to legislation cutting back on the derivative actions authorized by existing laws, the Senate refused to endorse any legislation allowing members of this new form of business entity, the LLC, to sue derivatively. It is this compromise—excision of provisions authorizing derivative actions from the Assembly bill in exchange for the Senate's agreement to the balance of the law—to which Mr. Rich, a participant in the drafting of the proposed Limited Liability Company Law, no doubt refers when he states that "[t]he absence of an Article IX from the LLCL was a conscious omission, not a typographical error, as the decision to omit derivative rights occurred late in the legislative session" (Practice Commentaries, McKinney's Cons Laws of NY, Book 32/32A, Limited Liability Company Law, at 181 [2007 ed]). The rejection of language authorizing derivative actions "strongly militates against a judgment that [the Legislature] intended a result that it expressly declined to enact" (*Gulf Oil Corp. v Copp Paving Co.*, 419 US 186, 200 [1974] [conference committee deleting House language]; *see also Pacific Gas & Elec. Co. v State Energy Resources Conservation & Development Comm'n*, 461 US 190, 220 [1983] [House bill deleting Senate language]; Posner, *Statutory Interpretation—in the Classroom and in the Courtroom*, 50 U Chi L Rev 800, 820 [1983] ["(W)here the lines of (legislative) compromise are discernible, the judge's duty is to follow them, to implement not the purposes of one group of legislators, but the compromise itself"]).[FN4]

The majority contends, however, that the Legislature's deletion of language authorizing derivative actions does not necessarily{**10 NY3d at 115} bespeak compromise, and is, in any event, essentially unimportant because the language was superfluous. This is so because derivative rights are so well-entrenched in existing law that the Legislature might have reasonably expected the courts to do what the majority has now done: extend the right to commence a derivative action to an LLC member based on analogy to either a cestui que trust or a shareholder, both of [*10]whom historically enjoyed standing to sue derivatively, as a matter of equity in the former case and common law in the latter. To support this proposition, the majority relies on the Second Circuit's decision in *Klebanow v New York Produce Exch.* (344 F2d 294 [2d Cir 1965, Friendly,

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J.]) (*see* majority op at 104-105, 106), and an oblique reference to *Klebanow* and *Riviera Congress Assoc. v Yassky* (18 NY2d 540 [1966]) (without referring to either case by name) made by Mr. Lefkowitz in his testimony at Assembly (not Senate) hearings in 1992 (*see* majority op at 108).

In *Klebanow*, the United States Court of Appeals for the Second Circuit held that, even in the absence of statutory authorization, a limited partner in a dissolved firm had capacity to sue on behalf of the partnership (i.e., derivatively) for injury arising out of conduct proscribed by the antitrust laws where the partnership and the liquidating partner had disabled themselves or had a conflict of interest, rendering futile any demand for the partnership to sue. The court reasoned that this was so because a limited partner was more like a shareholder (especially a preferred holder), or perhaps a cestui que trust, than a creditor.[FN5]

But this case is not *Klebanow*. First, as Judge Friendly acknowledged, there was no suggestion "that the framers of the Uniform Limited Partnership Act or the legislature of 1922 had focused on the problem . . . at issue" (344 F2d at 298); i.e., whether to authorize limited partners to bring derivative suits. In this case, we know that the Legislature did indeed "focus[ ] on the problem . . . at issue"—whether to authorize members of LLCs to bring derivative suits—and decided not to do it. Second, section 118 of the Partnership Law, captioned "Rules for cases not covered," specifies that "[i]n any case not provided for in this article the rules of law and equity, *including the law{**10 NY3d at 116} merchant*, shall govern" (emphasis added). This provision lends support for the view implicitly taken by the courts in *Klebanow* and *Riviera* that the Legislature intended judges to interpret the Partnership Law with the freedom with which they would construe and apply principles of the common law or equity to fill in perceived legislative blanks, and—without doubt—at common law a shareholder could maintain a derivative suit, which is a remedial invention of equity.[FN6] There is no provision comparable to section 118 in the Limited [*11]Liability Company Law. Although one federal judge has expressed the view that "[h]ad the legislature intended to preclude derivative claims by LLC{**10 NY3d at 117} members, it easily could have written an explicit prohibition into the law" (*Bischoff v Boar's Head Provisions Co., Inc.*, 436 F Supp 2d 626, 632 [SD NY 2006]), the Legislature does not customarily write zipper clauses into its statutes, or explicitly prohibit the courts from implying rights or liabilities that it did not choose to

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include. Rather, the modern Legislature reasonably expects the judiciary to respect its policy choices (*see e.g. Sherman v Robinson*, 80 NY2d 483, 489 [1992] [where the legal duty owed to a third party by a store selling alcoholic beverages is limited by General Obligations Law § 11-101 and does not include a duty to investigate possible indirect sales, "(g)iven the Legislature's choice not to provide liability for (indirect sales), we decline to expand the common law to impose such liability"]).

Next, Mr. Lefkowitz, who testified in favor of the right of LLC members to bring derivative suits, observed that "[s]tate and federal courts in New York have permitted derivative actions by a limited partner on behalf of limited partnerships without express statutory authority" and opined that

> "*if and to the extent that* members of a limited liability company are analogous to a minority shareholder or a limited partner . . . such member would, as a matter of common law precedent, have the right to bring a derivative action on behalf of a limited liability company whether or not the statute contains such an express right" (testimony of Howard Lefkowitz, Assembly Transcript, June 11, 1992, at 132, 133 [emphasis added]).

This testimony has been cited to support the proposition that the absence of an explicit provision in the Limited Liability Company Law authorizing derivative actions does not matter because the Legislature was aware that, under settled law, these [*12] provisions were unnecessary (*see Bischoff*, 436 F Supp 2d at 632-633; majority op at 108).

Courts have on occasion taken the position that "disappearance" of a provision from a statute "during the legislative travel" may not be significant "when settled law indicates that the omitted provision would have been surplusage" (*Diamond Crystal Salt Co. v P.J. Ritter Co.*, 419 F2d 147, 148 [1st Cir 1969] [in light of "the overwhelming weight of judicial authority favor(ing) retrospective construction," the Massachusetts long-arm statute applied retroactively notwithstanding that, in the year the law was enacted, four bills were filed, two of which expressly provided for retroactivity, and the Legislature enacted{**10 NY3d at 118} a bill omitting this language]). But here, there is no settled law in New York, or elsewhere for that matter, respecting LLCs and derivative suits (*see* Walker, New York Limited Liability Companies and Partnerships: A Guide to Law and Practice § 3:22, at 67 [1 West's NY Prac Series 2002] [while "(t)here is well-established case law for the treatment of C corporations, S corporations, limited partnerships and

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general partnerships" on many questions, "(n)o such extensive body of law yet exists for LLCs, although all of the states and the District of Columbia have enacted LLC statutes"]).

This vacuum no doubt exists because LLCs are a fairly recent statutory innovation, unknown to the common law; a new business form combining corporate-type limited liability with partnership tax advantages and organizational characteristics. On the matter of derivative suits in particular, there are divergent views throughout the country. The Uniform Limited Liability Company Act developed by the National Conference of Commissioners on Uniform State Laws provides for derivative suits modeled on the provisions of the Revised Uniform Limited Partnership Act. Many states have adopted laws along similar lines. By contrast, other states, preferring the American Bar Association's (ABA) Prototype Limited Liability Company Act, require disinterested members or managers to authorize litigation. The co-author of the major treatise on limited liability companies—who (unlike the majority) questions the utility of derivative suits in the LLC context—advocates the ABA's approach as "a reasonable compromise" (*see* Ribstein, *The Emergence of the Limited Liability Company*, 51 Bus Law 1, 23 [1995-1996] ["If the (derivative suit) remedy is justified . . . , it is only because requiring plaintiffs to seek authorization from the thousands of shareholders of publicly held firms could prevent some legitimate suits," but "(t)he same point does not apply . . . to closely held firms. Moreover, LLC members generally have other means of self-protection at their disposal that corporate shareholders may lack, including a default right to sell their interests back to the firm and substantial veto and removal powers"]).

In short, there is no settled law in New York or elsewhere on the subject of derivative rights for LLC members. Certainly, a third-party advocate's prediction that the courts might ignore the Legislature's policy choice (which, after years of contrary Supreme Court and Appellate Division holdings, is today made prescient) does not express or create settled law. Essentially, the [**10 NY3d at 119] majority simply disagrees with the Legislature, calling a decision not to authorize derivative suits in the context of LLCs a "radical step . . . that might be expected to harm the 'business climate' more than help it" (majority op at 107). But whether or not to vest LLC members with the right to sue derivatively is the Legislature's choice to make, not ours. Moreover, although the majority argues that *failing* to recognize a derivative right under the statute is an "extreme

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result" (*id.* at 108), creating an "uncharted path" upon which "we will not readily conclude that the Legislature intended to set us" (*id.* at 106), the "uncharted path" is the one taken by the majority: judicially legislating a cause of action that was rejected by the Legislature, [*13]and, for more than a decade after the Limited Liability Company Law's enactment, was not recognized by any New York court.

Our Precedents

The majority does not cite a single case where we have read into a statute a provision or policy choice that we know the enacting Legislature rejected. Indeed, we have never done such a thing before. We have, in fact, consistently deferred to the Legislature in cases where the facts are far less compelling than they are here. For example, in *Majewski v Broadalbin-Perth Cent. School Dist.* (91 NY2d 577, 581 [1998]), we were asked "whether certain amendments to the Workers' Compensation Law should be construed as retroactively applicable to pending actions." We noted "[i]mportantly," that the statute's initial draft included language providing for retroactive application, which "[did] not appear in the enacted version. A court may examine changes made in proposed legislation to determine intent" (*id.* at 587). Further, we quoted *People v Korkala* (99 AD2d 161, 166 [1st Dept 1984]) to the effect that "rejection of a specific statutory provision is a significant consideration when divining legislative intent" (*Majewski*, 91 NY2d at 587). Noting that the deletion of the provision was consistent with settled law presumptively favoring prospective application, we held that the statute "should be applied prospectively to actions filed postenactment" (*id.* at 581).

In *Matter of Grand Jury Subpoena Duces Tecum Served on Museum of Modern Art* (93 NY2d 729, 732 [1999]), we were called upon to decide "whether Arts and Cultural Affairs Law § 12.03, which protects the artwork of nonresident lenders from any kind of seizure while on exhibit in New York State, encompasses a subpoena duces tecum requiring production of two{**10 NY3d at 120} paintings . . . on loan to the Museum of Modern Art in New York" from a museum in Vienna (internal quotation marks omitted). The statute's predecessor's Bill Jacket included a letter from a City Bar committee questioning whether the legislation, as drafted, might prevent a rightful owner from recovering stolen art, and proposing a distinction to prevent this from happening. The Bill Jacket also, however, included a memorandum from the Attorney General, cautioning against creating any such "loopholes" in the statute, which "would force potential good-

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faith lenders to seek legal advice before lending artwork to museums, thus defeating the bill's purpose" (*id.* at 737). The Legislature did not adopt the change recommended by City Bar; as a result, the statute did not include any language embodying City's Bar's proposed exemption. Citing *Majewski*, we stated that

> "[i]t is well settled that legislative intent may be inferred from *the omission of proposed substantive changes in the final legislative enactment*. Thus, this history, coupled with the language of the statute, demonstrate a clear mandate from the Legislature. The statute's 'no loopholes' approach compels our holding that Arts and Cultural Affairs Law § 12.03 is not limited to civil process" (*id.* at 738 [citation omitted and emphasis added]).

In a related vein, just this past year in *People v Bratton* (8 NY3d 637 [2007]) we rejected a plea to read into article 12-B of the Executive Law an exception to the warrant requirement for violations taking place in a parole officer's presence. Acknowledging that this "would make sense" and that CPL 410.50 (4) authorizes a *probation* officer to take a probationer into custody without a warrant in such circumstances, we observed that "[t]he Legislature . . . did not include language comparable to CPL 410.50 (4) in the provisions of the Executive Law [*14]governing violation of parole. Nor can there be any doubt that this was a considered legislative choice" (*Bratton*, 8 NY3d at 641-642). For the latter proposition, we relied on legislative history showing that when the Legislature enacted article 12-B, it omitted the language found in predecessor statutes authorizing warrantless arrests for violations in a parole officer's presence. In short, we declined the invitation to read into a statute a provision that we knew the enacting Legislature chose not to include. We did not look to common law or to provisions in related statutes for license to second-guess the Legislature's policy choice. [**10 NY3d at 121]

Conclusion

The enacting (not a subsequent) Legislature considered and explicitly rejected language authorizing the very result that plaintiffs have successfully sought from the judiciary in this case. Fourteen years after the fact the majority has unwound the legislative bargain. The proponents of derivative rights for LLC members—who were unable to muster a majority in the Senate—have now obtained from the courts what they were unable to achieve democratically. Thanks to judicial fiat, LLC members now enjoy the right to bring a derivative suit. And because created by the courts, this right is unfettered by the prudential safeguards against abuse that the Legislature has adopted

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when opting to authorize this remedy in other contexts (*see* Business Corporation Law §§ 626, 627; Partnership Law §§ 115-a, 115-b).

Presumably, those businesses electing to organize as LLCs relied on what the Limited Liability Company Law says, and counted on the New York judiciary to interpret the statute as written. Instead, the majority has effectively rewritten the law to add a right that the Legislature deliberately chose to omit. For a Court that prides itself on resisting any temptation to usurp legislative prerogative, the outcome of this appeal is curious. I respectfully dissent.

Chief Judge Kaye and Judges Ciparick and Pigott concur with Judge Smith; Judge Read dissents in a separate opinion in which Judges Graffeo and Jones concur.

Order, insofar as appealed from, affirmed, with costs, and certified question answered in the affirmative.

Footnotes

Footnote 1: Article IX, as proposed in A11016 and the LLC bills introduced in the Assembly in 1993 (discussed infra at 113), authorized a member of an LLC to bring a derivative action; required at least one plaintiff to be a member at the time the action was commenced and at the time of the challenged transaction; required the complaint to set forth with particularity the plaintiff's or plaintiffs' efforts to secure the initiation of the action by the LLC's managers or those members who would otherwise have the authority to cause the LLC to sue in its own right; required court approval for the discontinuance, compromise or settlement of an action, and vested the court with discretion to require prior notice thereof by publication or otherwise to potentially affected members, and to assess the costs of this notice on one or more of the parties to the action; vested the court with discretion to award reasonable expenses, including reasonable attorneys' fees, to a successful plaintiff or plaintiffs; gave the LLC the right to security for expenses, including attorneys' fees, incurred in connection with the action unless the plaintiff's or plaintiffs' contributions or allocations amounted to 5% or more of the contributions or allocations of all members, or had a fair market value in excess of $50,000; and vested the court with discretion to determine the amount of any security even where the 5% or $50,000 test had been met, based upon the LLC's showing of need. These provisions were substantially the same as sections 115-a and 115-b of the Partnership Law, which were, in turn, patterned after sections 626 and 627 of the Business Corporation Law respectively.

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Footnote 2: Section 610, as proposed in A11016 and LLC bills introduced in the Assembly in 1993 (discussed infra at 113), read as follows:

"A member of a limited liability company is not a proper party to proceedings by or against a limited liability company, except where the object is to enforce a member's right against or liability to the limited liability company *and except in cases provided for in section nine hundred one of this chapter*" (emphasis added).

This provision mimics section 115 of the Partnership Law. Notably, the Legislature amended section 115 in 1968 to add the language excepting "cases provided for in section [115-a]" when it added the latter provision, which authorizes and regulates derivative suits commenced by limited partners (*see* L 1968, ch 496, § 2).

Footnote 3: Mr. Schorr, then a partner at a major New York City law firm, was co-chair of the Joint Drafting Committee. Another participant in the drafting of the proposed Limited Liability Company Law was Bruce A. Rich, author of the oft-cited McKinney's Practice Commentaries (*see* McKinney's Cons Laws of NY, Book 32/32A, Limited Liability Company Law, Preface, at III [2007 ed]; *see* infra at 114).

Footnote 4: In 1999, the Limited Liability Company Law was amended to update various provisions. The original Senate bill included article IX (member's derivative actions), but was revised in committee to remove these provisions (compare 1997 NY Senate Bill S7331 with 1997 NY Senate Bill S7331-A, which is, as relevant here, identical to 1999 NY Senate-Assembly Bill S1640A, A2844A, enacted as chapter 420 of the Laws of 1999).

Footnote 5: The District Court Judge had dismissed the complaint principally on the ground that a limited partner was a creditor rather than an owner, and that the antitrust laws do not allow a creditor to bring a treble damages suit against third parties who have allegedly injured the firm (*see* 232 F Supp 965 [SD NY 1964]).

Footnote 6: Even so, *Klebanow* was a controversial decision. A majority of a distinguished panel of the First Department flatly rejected its holding in *Millard v Newmark & Co.* (24 AD2d 333 [1st Dept 1966]). *Millard* was authored by Justice Harold Stevens, who was subsequently an Associate Judge on this Court as well as Presiding

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Justice of the First Department. He was joined in the three-judge majority by Justice Charles Breitel, subsequently the Chief Judge of this Court. In *Millard*, the Court held that because limited partnerships "are solely creatures of statute," limited partners "have only such rights, duties, obligations, etc., as the statute may provide" (*id.* at 335), and therefore no derivative action should be implied where the Legislature failed to create one. Further, the Court observed that the Second Circuit in *Klebanow* "seem[ed] to have gone on the basis of policy considerations and to have overlooked the fact that the New York Legislature has not so extended the law as to limited partnerships" (*id.* at 339-340). In his writing for the two-judge partial dissent, Justice Benjamin Rabin generally subscribed to the Second Circuit's reasoning in *Klebanow*, stating at the outset that he "dissent[ed] because [he] believe[d] that unless such right be given there will be a failure of an adequate remedy for the wrongs alleged to have been done" (*id.* at 340). In light of the unsettled nature of the law in the wake of *Klebanow* and *Millard*, the Law Revision Commission undertook a study "examin[ing] the power of a limited or special partner to commence a derivative action in the right of the limited partnership, . . . [a] problem [that presumptively] arises because the general partners are unable, or wrongfully have refused, to maintain the action on behalf of the firm" (Act, Recommendation and Study relating to Derivative Actions by Limited Partners, 1967 NY Legis Doc No. 65[B], at 13). The study, which recommended legislation to authorize derivative actions by limited partners, was completed (but not issued) before we handed down our decision in *Riviera*, which held that limited partners are analogous to cestuis que trustent, and are "authorized to sue as limited partners on behalf of the partnership entity to enforce a partnership claim when those in control of the business wrongfully decline to do so" (18 NY2d at 547). Although *Riviera* resolved the conflict prompting its study and recommendations, the Commission nonetheless took the position that legislation remained "appropriate . . . to clarify and regulate the right and obligations resulting from the [*Riviera*] decision . . . rather than to allow rules to be formulated on a case-by-case basis" (1967 NY Legis Doc No. 65[B], at 9). The Legislature adopted the Commission's proposed bill in 1968 (*see* L 1968, ch 496, amending Partnership Law § 115 and adding Partnership Law §§ 115-a, 115-b, 115-c).

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