Personal Injury/Workers Compensation Law

Using Cash-Out Mergers to Resolve LLC Member Disputes

When shareholders of a New York corporation are fighting with one another thoughts often turn to judicial dissolution. The standards applicable to judicial dissolution of business corporations are well known: deadlock in the case of 50/50 owners under Section 1104 of the Business Corporation Law, and oppressive conduct in the case of shareholders owning at least 20% under BCL § 1104-a. Such shareholder disputes lend themselves to resolution by means of a buyout, particularly in light of the election provided in BCL § 1118 to buy out the minority shareholder for fair value.

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Dissolution of LLC Often an Unachievable Remedy

Section 702 of the LLC Law permits a court to order dissolution when "it is not reasonably practicable to carry on the business in conformity with articles of organization or operating agreement." In *Matter of 1545 Ocean Avenue, LLC*, a decision written by former Commercial Division Justice Leonard B. Austin, the Second Department held that in order to obtain dissolution under Section 702, "the petitioning member must establish, in the context of the terms of the operating agreement or articles of incorporation, that (i) 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 (ii) continuing the entity is financially unfeasible."[1]

Since then the focus in limited liability dissolution cases has been upon the contractual language in the operating agreement, rather than the standards of the Business Corporation Law. In *1545 Ocean Avenue* the two 50/50 members were at deadlock with regard to various construction issues in their single asset real estate entity. The court pointed out, however, that the operating agreement did not require the unanimous agreement of the two member managers. Rather, either member was authorized to act unilaterally as a managing member. Dissolution is a drastic remedy, said the court, and the petitioner had not shown that it was not reasonably practicable to carry on the business of the company in accordance with the articles of organization or operating agreement.

The strict interpretation of Section 702 with respect to the standards for dissolution enunciated in *1545 Ocean Avenue* continue to be followed. For example, in *Goldstein v. Pikus* Justice Ramos denied dissolution, notwithstanding allegations of deadlock and breach of fiduciary duty with respect to the renting of apartments in the building owned by the LLC by one of the

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members to family members at below market rates.[2] Justice Ramos pointed out that such conduct might give rise to grounds for commencement of a derivative action for breach of fiduciary duty, but that did not mean that the company was unable to operate and manage the property in accordance with the operating agreement.

In *Matter of Ross* one of three brothers, each of whom owned one-third of the membership interests of a limited liability company, sought dissolution after the sale of the sole piece of property owned by the LLC.[3] The operating agreement contained a very broad purposes clause which recited that the purpose for which the company was formed was to "engage in any lawful act or activities for which limited liability companies may be formed" under New York law. Petitioner's two brothers did not want to dissolve and distribute the proceeds of the sale, but wanted to reinvest the proceeds in additional properties. Citing the broad purposes clause and the fact that the LLC was very profitable, Justice Driscoll dismissed the dissolution petition, finding that petitioner had not demonstrated it was not reasonably practicable to carry on business in conformance with the stated purposes of the company as provided in the operating agreement.

Accordingly, broad "purposes" clauses are often found to be obstacles to obtaining dissolution in cases involving limited liability companies. This, together with the absence of a statutory election to buy out the minority owner,[4] often make judicial dissolution an impractical remedy in limited liability company disputes.

The Advantages of Cash-Out Merger

In view of the obstacles to judicial dissolution and absence of statutory buy-outs in the case of limited liability companies, the cash out (also referred to as "freeze-out") merger of a minority member's interest in an LLC may be considered as an alternative remedy.

Section 1002 of the LLC Law provides the procedure for merger of limited liability companies. Unless a greater percentage is required under the operating agreement, the majority members may vote to merge with a limited liability company of which the minority owners are not members. Section 1002(c) provides that such a merger may be approved at a meeting of the members called for such purpose on 20 days' notice. Section 407(a) of the LLC Law provides, however, that unless otherwise provided in the operating agreement, whenever action may be taken by vote, it may be taken by written consents instead.

In *Stulman v. John Dory LLC*, Justice Ramos considered the interplay of these two sections and held that the provision in Section 407 permitting action to be taken by written consents without a meeting trumped the provision in Section 1002(b) requiring votes at a meeting.[5] Similarly, in *Slayton v. High Line Stages, LLC*, Justice Kornreich came to the same conclusion that a cash out merger could be effected by means of written consents in lieu of a meeting for that purpose.[6]

Section 1002(g) provides that a member of the limited liability company shall not have any right at law or in equity to attack the validity of the merger or have it set aside or rescinded, except in an action contesting either compliance with the operating agreement, or the procedures set forth in Section 1002 itself.

Note that the merger provisions of the Limited Liability Company Law are generally patterned after those contained in the Revised Limited Partnership Act. In *Appleton Acquisition, LLC v. National Housing Partnership* the Court of Appeals held that RLPA § 121-1102(d) barred a limited partner from seeking to set aside a merger based upon alleged fraud.[7] The court noted that the language contained in BCL § 623(k) permitting an exception to challenge mergers based upon common law fraud or illegality does not appear in the Revised Limited Partnership Law. Nor does it appear in the LLC Law. Of course, having a valid business purpose for the merger never hurts.

The Right to Dissent and to An Appraisal

A member of a limited liability company who is being cashed or frozen does not lack a remedy. As pointed out by Justice Ramos in *Stulman*, a former member who disputes the calculation of the value to be paid for his or her membership interest has the right to dissent pursuant to LLC Law § 1005, and have the fair value determined in an appraisal proceeding. The LLC Law largely adopts the procedures set forth in BCL § 623 for appraisal proceedings when a shareholder of a corporation dissents with respect to a merger.[8]

In determining fair value New York law does not permit a "minority discount," for lack of control, but does permit a discount for lack of marketability.[9] However, in an appropriate case, a zero discount for lack of marketability has been upheld.[10]

Conclusion

The "cash-out" or "freeze-out" merger should not be overlooked by counsel working on resolving member disputes in limited liability companies. Often it is a more efficient technique than a dissolution.

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1. 72 A.D.3d 121 (2d Dept. 2010).
2. 2015 N.Y. Slip Op 31455(U) (Sup. Ct., N.Y. Co. July 20, 2015).
3. Index No. 605338/2015 (Sup. Ct., Nassau Co. Dec. 10, 2015). The decision is available from the court's Decision Search page, *available at* https://goo.gl/85iDUM.
4. BCL §1118.
5. 2010 NY Slip Op 33911(U) (Sup. Ct., N.Y. Co. Sept. 10, 2010).
6. 46 Misc.3d 450 (Sup. Ct., N.Y. Co. 2014).
7. 10 N.Y.3d 250 (2008).
8. LLC Law §1005(b).
9. *See, e.g., Giamo v. Vitale*, 101 A.D.3d 523 (1st Dept. 2012); *Murphy v. U.S. Dredging Corp.*, 74 A.D.3d 815 (2d Dept. 2010).
10. *See, e.g., Chiu v. Chiu*, 125 A.D.3d 824 (2d Dept. 2015).