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Outside Counsel

Business Divorce and Judicial Dissolution Cases of 2022

One normally does not associate business divorce and judicial dissolution litigation with an organization with over five million members. Last year witnessed a major departure from the norm when a Commercial Division Justice of the Supreme Court rejected the New York Attorney General's controversial bid to dissolve the National Rifle Association under the Not-for-Profit Corporation Law's involuntary dissolution provisions based on allegations of financial impropriety by some of its top executives.

In addition to the NRA case, this column highlights a pair of noteworthy appellate decisions in cases brought under Section 1104-a of the Business Corporation Law complaining of minority shareholder oppression, and a trial court's decision denying dismissal of a complaint seeking judicial dissolution of a limited liability company whose Caribbean real estate development project stalled for over a decade.

By **Peter A. Mahler**

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NRA Spared 'Corporate Death Penalty'

Cases for judicial dissolution of not-for-profit corporations under Article 11 of the New York Not-For-Profit Corporation Law (N-PCL) are few and far between. N-PCL Article 11's provisions in large part resemble those in Business Corporation Law (BCL) Article 11 governing dissolution of regular business corporations, but also contain important differences. One of those differences, namely, the paramount importance of the public interest, seemingly made all the difference in a high-profile case decided last year in which Attorney General Letitia James sued to dissolve the not-for-profit National Rifle Association.

The NRA was incorporated in New York in 1871 for the quaint-sounding purpose of "the improvement of its members in marksmanship, and to promote the introduction of a system of army drill and rifle practice…and for those purposes to provide a suitable range in the vicinity of the City of New York." In *People v. National Rifle Assn. of Am., Inc.* (74 Misc 3d 998 [NY County, 2022]) the Attorney General sought to dissolve the NRA under N-PCL §§1101 and 1102 based on "a grim story of greed, self-dealing, and lax financial oversight at the highest levels."

Under N-PCL §1101 (a) (2), the Attorney General is expressly authorized to seek dissolution of a not-for-profit corporation when "the corporation has exceeded the authority conferred upon it by law…or carried on, conducted or transacted its business in a persistently fraudulent or illegal manner, or by the abuse of its powers contrary to public policy of the state."

Under N-PCL §1102 (a) (2) (D), which tracks almost *verbatim* the grounds for corporate dissolution based on minority shareholder "oppression" under BCL §1104-a, the Attorney General, exercising her deemed status as a member, director or officer under N-PCL

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§112 (a) (7), also has the authority to seek dissolution when "[t]he directors or members in control of the corporation have looted or wasted the corporate assets, have perpetuated the corporation for their personal benefit, or have otherwise acted in an illegal, oppressive or fraudulent manner."

The Attorney General backed her claim for dissolution with allegations that the NRA's leadership "advance[d] insiders' personal interests" and "instituted a culture of self-dealing, mismanagement, and negligent oversight" by, among other misconduct, use of NRA funds to support outlandish expensing habits, including "private jet travel…; trips to the Bahamas to vacation on a yacht…; costly black car services; gifts for favored friend and vendors; lucrative consulting contracts…; and excessive security costs."

The NRA and two members of its leadership team named in the action moved to dismiss, arguing that the Attorney General's complaint failed to allege board misconduct in accordance with the statute, and that her allegations otherwise did not warrant the drastic remedy of dissolution.

The Manhattan Commercial Division sided with the NRA, emphasizing the public nature of the harm that must accompany the kind of corporate malfeasance warranting the relief sought in government-initiated dissolution proceedings. Unlike dissolution proceedings brought by members or directors where the benefit to the members is of paramount importance, the court wrote, under N-PCL §1109(b)(1) "the interest of the *public* is of paramount importance" when the action is brought by the attorney general.

While acknowledging that the malfeasance alleged was "undoubtedly troubling," the court found that the Attorney General's "boldest claims target the NRA itself," and as such, "concern primarily private harm to the NRA and its members and donors, which if proven can be addressed by the targeted, less intrusive relief she seeks through other claims." The court therefore concluded that the Attorney General's dissolution claim "d[id] not allege the type of public harm that is the legal linchpin for imposing the 'corporate death penalty.'"

Last year the Commercial Division rejected the New York Attorney General's bid to dissolve the National Rifle Association based on allegations of financial impropriety by some of its top executives. In addition this case, this column highlights several appellate decisions in cases brought under Section 1104-a of the BCL complaining of minority shareholder oppression, and a trial court's decision denying dismissal of a complaint seeking judicial dissolution of a limited liability company whose real estate development project stalled for over a decade.

Reasonable-Expectations Test

The Appellate Division, Second Department, last year in *Matter of Hoffman v. S.T.H.M. Realty Corp.* (207 AD3d 722 [2d Dept. 2022]), addressed the subject of judicial dissolution concerning a family-owned business based on allegations by an "outside" minority shareholder of "oppressive" conduct by the "inside" majority shareholders.

Under BCL §1104-a, shareholders owning 20% or more of a corporation's outstanding voting stock may petition the court for dissolution when "[t]he directors or those in control of the corporation have been guilty of illegal, fraudulent or oppressive actions toward the complaining shareholders," or when "[t]he 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." The Court of Appeals defined "oppressive" conduct nearly 40 years ago in *Matter of Kemp & Beatley* as "aris[ing] only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner's decision to join the venture" (64 NY2d 62, 73 [1984]).

Outside, minority shareholders in successful businesses or companies holding valuable assets, who have no voice in company management and no access to company revenue streams in the form of compensation or other distributions, often seek recourse under the BCL's oppression

statute in an effort to convert their otherwise dormant ownership interests into a substantial payday, particularly when there is no corresponding shareholder agreement with buyout provisions or other exit mechanisms at their disposal.

But in *Hoffman*, which involved an outside minority owner's efforts under BCL §1104-a to force a liquidity event concerning her 25% interest in three family-owned companies holding increasingly valuable real estate, a valid and enforceable shareholder agreement was in play—namely, a 2/3-majority-approval provision for matters of employee compensation, as well as a right-of-first-offer provision allowing a shareholder to sell her interest to her fellow shareholders at "book value."

Presumably seeking a higher price tag for her shares, the outside minority petitioned for dissolution—or, more likely, a judicially-compelled buyout of her interest as a valid, discretionary alternative under the statute—by alleging that the controlling shareholders were guilty of oppression over the years by freezing her out of company management, particularly on matters of compensation and distributions, and by blocking her entitlement to her share of the ever-increasing value of the companies.

Following a bench trial, the Kings County Commercial Division sided with the majority owners and dismissed the petitions, finding "no significant evidence that the entities have been run in anything other than an honest and straightforward manner or that compensation was anything other than reasonable and modest"; that the "petitioner's expectations have been frustrated only in the sense that she desires the corporate entities, which now possess a great deal of equity in real property, to liquidate some or all of that wealth and distribute it to the shareholders"; and that [t]his is decidedly not the frustration needed for liquidation under BCL §1104-a."

The petitioner appealed, and the Appellate Division, Second Department affirmed, holding that she "did not evince a reasonable expectation of actively participating in the management of the corporations, and that, while the petitioner might now disagree with the manner in which the corporations' assets are being managed, the conduct of the majority shareholders was not oppressive."

Moribund Condo Project

The Kings County Commercial Division also addressed dissolution in the LLC context in *Chernomordik v. Ocean Sand Dev., LLC* (2022 NY Slip Op 33846[U] [Sup Ct, Kings County 2022]), which involved the fate of a beach-resort development project in the Dominican Republic that literally never got off the ground.

The New York Legislature defined the statutory standard for judicial dissolution under §702 of the Limited Liability Company Law (LLCL) as requiring the member seeking such relief to show that "it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." Some 15 years later, the Second Department interpreted that standard in *Matter of 1545 Ocean Avenue* (893 NYS2d 590 [2d Dept. 2010]), as requiring the petitioning member to show "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."

Chernomordik centered on the first of the two *1545 Ocean Avenue* prongs dealing with the entity's purpose. The plaintiff, a 5% non-managing member, sought dissolution of a single-asset, real-estate holding company that had been holding beachfront property in the Dominican Republic for well over a decade without any prospect of developing the planned resort due to repeated regulatory permitting issues.

The plaintiff focused on the portion of the purpose clause in the entity's operating agreement providing that the company was formed to "own, lease, develop, manage, and operate the premises located at Caberette, Dominican Republic" and alleged that dissolution was proper because "no development has taken place at all" due to the fact that "the government of the Dominican Republic has rejected plans to develop the property three times."

The company and its control-owner moved to dismiss the complaint, pointing instead to the portion of the operating

agreement's purpose clause that permitted the company to "engage in any lawful act or activity for which Limited Liability companies may be formed in New York," and arguing that "the Operating Agreement does not even require [the company] to do any development at all." According to the control-owner, "the best option going forward is to continue to hold the Property with the expectation that its value will skyrocket if and which the regulatory environment changes, as it tends to do from time to time in the Dominican Republic."

The argument for dismissal, however, was too "speculative,… abstract and…theoretical" for the court, particularly given that "there can be no question the goal of the entity was not to hold the undeveloped property for such a long period of time."

And while the court acknowledged that the extended holding period may be "due to conditions beyond its control, [t]hat does not mean the entity is legitimately pursuing the goals of the operating agreement." The court therefore denied the defendants' motion and directed the parties to conduct "further discovery and an eventual trial…to evaluate the ability to sell the property, the advantages that may be gained from owning the adjoining properties and the harsh reality the property may never be developed."

Shareholder Oppression

Our final case on the subject is perhaps better characterized as *quasi*-dissolution, as the Appellate Division, First Department in *Stile v. C-Air Customhouse Brokers-Forwards, Inc.* (204 AD3d 429 [1st Dept. 2022]), addressed the enforceability of a contractual anti-dissolution provision and considered whether oppressive conduct toward a minority shareholder by the control-owners of a closely-held corporation constitutes a stand-alone, valid cause of action outside the framework of BCL §1104-a.

Stile involved a three-owner logistics business in which, as a result of the settlement of a prior lawsuit between them, one of the owners agreed as part of a broad release to not "seek dividends or dissolution"; "commence any derivative action in the name of the companies"; "assert any of his rights as a shareholder"; or "make any request or demand to inspect the records of the companies"—all in exchange for the receipt of certain lifetime "payments and benefits provided for in the settlement."

Following the settling owner's death, his estate brought suit and asserted multiple claims for damages and equitable relief, including claims for dissolution under BCL §1104-a and the common law, as well as a claim for damages based on "shareholder oppression" due to the control-owners' refusal to acknowledge any rights of the estate as shareholder, including the right to inspect the companies' books and records. The control-owners moved to dismiss based on the settlement agreement and release, but the motion court allowed the estate to proceed with its claims, and the control-owners appealed.

The First Department modified the motion court's order and granted dismissal of the estate's common-law and statutory dissolution claims because "in the settlement agreement, [the settling owner] agreed to not seek…dissolution," but otherwise affirmed with respect to the estate's "shareholder oppression" claim for damages "to the extent the claim is based on [the control owners'] refusal to recognize [the estate] as a shareholder."

Stile arguably is a case of first impression because it (i) enforced a contractual anti-dissolution provision in the face of existing appellate authority holding that such provisions violate public policy protecting the rights of shareholders (*see, e.g., Schimel v. Berkun* (264 AD2d 725 [2d Dept. 1999]), and (ii) for the first time permitted a stand-alone damages claim for "shareholder oppression" to proceed outside the statutory framework of a dissolution claim under BCL §1104-a.

Practitioners will have to wait and see whether the case ultimately takes on broader role in the world of business divorce litigation, or whether it will be limited to its facts concerning the refusal to recognize the plaintiff's status as an owner.