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Business Divorce Cases of 2024

By Peter A. Mahler and Matthew D. Donovan

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Last year's installment of this column highlighted *Andris v. 1376 Forest Realty, LLC* (213 AD3d 923 [2d Dept 2023]), where the Second Department reinstated a petition for judicial dissolution of an LLC pursuant to LLC Law (LLCL) §702 brought by the estate representative of one of the LLC's deceased members.

The court's sparsely worded decision permitted the dissolution petition to proceed, relying on LLCL §608 which authorizes a deceased member's executor or other estate fiduciary to "exercise all of the member's rights for the purposes of settling his or her estate." *Andris* did not address how the executor's status fell within §702 which, by its plain terms, only permits application for judicial dissolution "by or for a member."

The member distinction is critical given the definitions of "member" and "membership interest" in LLCL Article 1 endowing members with voting, management, and economic rights, whereas under LLCL §603 a non-member transferee's rights are limited to "receiv[ing], to the extent assigned, the distributions and allocations of profits and losses to which the assignor would be entitled."

In what is perhaps 2024's most consequential business divorce decision, the Second Department de-enigmatized *Andris* in *Weinstein v. Wallace* (231 AD3d 1187 [2d Dept 2024]). *Weinstein* involved a family-owned funeral home business owned 50-50 by two brothers.

The company's operating agreement provided that one of the brothers was the sole manager. With

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Peter A. Mahler and Matthew D. Donovan

language mirroring §608, the agreement expressly granted a representative of a deceased member's estate "all or any part of [the deceased member's] Membership interest" for purposes of "settling or managing its estate."

Upon the managing member's death, his two daughters serving as estate representatives sought to transfer his ownership interest in the LLC to a trust, as directed by his will.

After the surviving brother did not consent to the transfer, the trustee of the trust and the managing-member's daughters entered into an agreement by which the estate assigned its economic interest to the trust while expressly retaining voting control of the assigned interest pending the Trust's future admission as a member in compliance with the operating agreement.

The surviving brother sued for declarations that he was the sole voting member of the LLC and as such became managing member based on his vote alone. The trial court ruled in his favor, finding that the Estate had no voting or other member rights and therefore the surviving brother as the only remaining member held sole voting power to appoint himself manager.

On appeal, the Second Department reversed in favor of the trust and the estate. The court interpreted LLCL §608 as not giving the estate representatives membership status but, rather, the power for indefinite duration to exercise membership rights, specifically including voting rights, for the purpose of settling or managing the estate.

The ruling, which *sub silentio* overrules lower court decisions dismissing derivative claims by estate representatives of deceased LLC members, likely will have a major impact on a significant segment of business divorce litigation involving estates.

> The trial court dismissed both claims against the bookkeeper for failure to allege fraud with particularity and reliance on conclusory allegations.

Partnership Agreement's Transfer Restrictions Trump Testamentary Bequest

The Bronx County Commercial Division last year also addressed an issue surrounding the disposition of a deceased business owner's interest in *Pappas v. B&G Holding Co* (83 Misc3d 1285(A) [Sup Ct, Bronx County 2024]).

There, the court held invalid a purported testamentary transfer of a deceased partner's interest because the will did not comport with the transfer requirements in the governing partnership agreement.

Pappas involved a two-partner realty-holding partnership governed by an agreement that contained a transfer-upon-death provision requiring the estate representative of the deceased partner to sell, and the surviving partner to buy, the decedent's partnership interest at a formula-based price.

The provision prohibited any sale or other transfer of a partnership interest "except in accordance with this agreement." Prior to his death in 2020, one partner executed a will bequeathing his partnership interest to a third party.

The surviving partner did not recognize the bequest's validity, after which the legatee brought suit contending that, while the partnership agreement "clearly proscribed the transfer, pledge, and/or assignment of a partner's shares," it did not prohibit testamentary transfers.

The court found the plaintiff's contention "absurd," reasoning that "[i]f bequeathing property in a will is not a pledge or assignment ... then nothing is." The court ultimately concluded that "because at the time of his death [the decedent] owned his shares of [the partnership] and his conveyance to [plaintiff] was a nullity, the shares did not pass outside the estate and instead, became [the Estate]'s property."

The court therefore ordered the decedent's estate to sell the interest to the surviving partner at the value determined by the formula in the partnership agreement – exactly what the surviving partner offered to pay prior to litigation.

Claims Against Company Accountant and Bookkeeper Go Forward

It's not unusual for accounting firms and employees to be caught in the cross-fire of disputes between co-owners of closely held business entities. Last year, the First and Second Departments issued important rulings addressing whether business owners can bring claims against outside accountants and in-house bookkeepers for aiding and abetting alleged fraud by fellow shareholders.

In *1650 Broadway Associates, Inc. v. Sturm* (228 AD3d 1 [1st Dept 2024]), the First Department revived claims against a company's outside accounting firm involving the Stardust Diner, the well-known theme restaurant in Manhattan's Theatre District owned by a mother-son duo.

The accounting firm provided the Diner with tax-preparation services and financial statements. When the mother switched accounting firms, the new firm

advised that her son had defrauded the Diner and its shareholders to the tune of almost $12 million, allegedly aided by the original accounting firm.

The mother alleged that her son took the money from the diner and disguised the spoils as "loans" to fund his own investments and real-estate development business. The original accounting firm allegedly never provided the mother with financial statements, instead sending the relevant documents only to her son. The mother also claimed that the accounting firm knew of the son's alleged chicanery but willfully ignored it.

The mother sued the accounting firm for professional malpractice and aiding and abetting her son's fraud. The lower court dismissed the mother's claims, holding that the loans were properly disclosed on the financial statements and that the mother did not sufficiently allege any deviation from the standard of care or how the original accounting firm aided and abetted her son's activities.

On appeal, the First Department reversed, holding that the original accounting firm could not be shielded from liability merely by pointing its finger at the son and his personal impropriety. The court reinstated the mother's claims "because an accountant must perform all services in accordance with the standard of a reasonable accountant under similar circumstances, which includes reporting fraud that is or should be apparent."

The Second Department in *Schiano v. Harsanyi* (230 AD3d 820 [2d Dept 2024]), also addressed claims for aiding and abetting fraud, this time against a company's in-house bookkeeper. *Schiano* centered on a vending-machine company, a cash-heavy operation seemingly ripe for potential fraud.

The relationship between the two partners was contentious from the start: the plaintiff alleged that although the defendant was the sole owner on paper, the plaintiff was a *de facto* partner because he had invested several hundred thousand dollars into the company for over a decade.

The defendant allegedly locked the plaintiff out of the business, which sparked the lawsuit, and later brought his own claims, including a third-party claim against the company's in-house bookkeeper for breach of fiduciary duty and aiding and abetting the plaintiff's alleged fraud.

According to the third-party complaint, the plaintiff seized large sums of cash from the business, and the bookkeeper, tasked with receiving the plaintiff's cash reports and recording the income for the company's books, identified the takings as loans or capital contributions. The trial court dismissed both claims against the bookkeeper for failure to allege fraud with particularity and reliance on conclusory allegations.

The First Department reversed on appeal, reviving both claims in defendant's third-party complaint. As to the claim for breach of fiduciary duty, the court held that the defendant "sufficiently alleged the existence of a fiduciary duty . . . based upon allegations that [the bookkeeper] had a duty to make truthful and complete disclosures to the company."

As to the claim for aiding and abetting fraud, the court held that the third-party complaint sufficiently alleged that the bookkeeper deceptively recorded the plaintiff's alleged cash takings as loans and purposefully withheld her internal records from defendant.

Books and Records Proceedings Involving Foreign Entities

The First Department's 2016 *Raharney Capital* decision (138 AD3d 83 [1st Dept 2016]), definitively resolved an inter-Departmental split on the question whether New York courts have subject matter jurisdiction over proceedings seeking judicial dissolution of foreign business entities, joining the Second and Third Departments in finding jurisdiction absent.

The related question whether New York court have jurisdiction over books and records proceedings involving foreign business entities has not attained the same certainty at the appellate level, which makes all the more significant last year's decision in *Mojtahedi v. Craddock* (2024 NY Slip Op 33452[U] [Sup Ct, New York County 2024]), where the court rejected a jurisdictional challenge to a books and records petition involving a Delaware corporation.

In *Mojtahedi*, the board of a New York-based Delaware corporation removed the defendant from his position as CEO and president of the company allegedly for withholding access to the company's books and records from the company, its directors, and its shareholders.

In response, the defendant revoked all employees' key-card access to the company's building and attempted to discharge the entire board.

The acting CEO-plaintiff petitioned for inspection of the company's books and records under §220 of the Delaware General Corporation Law. The defendant moved to dismiss the petition for lack of subject matter jurisdiction, arguing that Delaware courts had exclusive jurisdiction under both Delaware law and the forum-selection clause in the company's certificate of incorporation.

The court rejected the forum-selection argument because the clause allowed the company to consent to jurisdiction in a forum other than Delaware, which the plaintiff did by filing the petition in New York.

The court also found that "[t]he fact that the parties agree that Delaware law applies to the books and records request likewise does not defeat this court's jurisdiction over the issue."

Citing recent Court of Appeals precedent in *Eccles v. Shamrock Cap. Advisors, LLC* (42 NY3d 321 [2024]), on the ability of New York courts to hear cases involving foreign entities, the Manhattan Supreme Court opined generally that "New York courts have significant flexibility and discretion in deciding whether to take notice of that foreign law and apply it to the case at hand," and specifically that "this court is capable of applying Delaware law to the question of requests to books and records of [a Delaware] company."

In another significant lower court decision involving a New York-based Nevada corporation not involving a jurisdictional challenge, the court held that Business Corporation Law §1315, which authorizes a shareholder of a foreign corporation doing business in New York to require the corporation to produce shareholder information including names, addresses, number and class of shares held by each, and record ownership dates, does not give the petitioner the broader rights of inspection afforded under BCL §624 (*Goldman v. Icaro Media Group, Inc.*, 2024 NY Slip Op 33610(U) [Sup Ct, New York County 2024]).

Manager Discretion Regarding Distributions

The courts have seen a fair number of cases in which minority owners of closely held business entities sue controlling owners for failing to distribute profits. The complaints typically allege hoarding of cash while, at least in pass-through entities, requiring the plaintiffs to pay taxes on phantom income.

In *Schneider v Pine Mgt., Inc.* (2024 NY Slip Op 51030[U] [Sup Ct, New York County 2024], the court upheld the discretion of LLC managers to determine whether and when an LLC can and should make distributions.

The *Schneider* case involved 10 New York realty-holding LLCs owned equally by two factions consisting of the descendants of the original two founders. The plaintiffs held membership interests in the LLCs, but the defendants served as managers under the companies' operating agreements, which authorized them to "act ... on behalf of the compan[ies]."

The plaintiffs alleged that, for over a decade, the defendants withheld distributions to the LLCs' members to maintain "cash reserves" for "no specific reason." The defendants contended that the cash reserves were necessary for renovation and maintenance of the properties owned by the LLCs.

Irrespective of the purpose for withholding distributions, the court found that the plaintiffs failed to demonstrate that the defendants' distribution policy was outside the authority given them under the operating agreement. The court also noted that defendants were "authorized person[s]" under LLCL §102(c), which permitted them to act on behalf of the companies without court interference.

In so ruling, the court reinforced the general rule that when an operating agreement confers broad discretion on an LLC's managers to make decisions regarding distributions, courts will not second guess the managers' business judgment.

Peter A. Mahler *is a business divorce partner and* **Matthew D. Donovan** *is a commercial litigation partner at Farrell Fritz.*

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