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Business Divorce in New York State: The Pitfalls of Relying on Judicial Dissolution Under LLCL §702



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The limited liability company (LLC) has blossomed into the most widely-used business entity in New York and many other states in recent years because of the many perks it affords members and managers. It is a flexible model that allows companies to structure their business in a manner that best suits their wants and needs, while still providing them with the same limited liability protection afforded by limited partnerships. While the malleability of the LLC is attractive to sole proprietors and companies alike, members should not blindly rely on New York's Limited Liability Company Law (LLCL) to govern the activities of the LLC, resolve all conflicts within the LLC or to compensate for a poorly drafted or non-existent operating agreement.

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Case in point: Post-1999, it is notoriously difficult to withdraw from or dissolve an LLC in New York State without a carefully worded operating agreement that provides withdrawing members with a clear exit strategy, either in the form of an unambiguous withdrawal provision and/or an explicit clause providing a dissolution option. Where an LLC's operating agreement fails to provide such clear-cut provisions—or where the LLC was formed without a written agreement altogether—members are left with no choice but to petition for judicial dissolution of the LLC under §702 of the LLCL, and more often than not, those petitions are unsuccessful.

The bar for judicial dissolution of a New York LLC is extremely high. Under §702 of the LLCL, a court may dissolve an LLC "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." LLCL §702. Unfortunately, where the LLC lacks any such written agreement setting forth the purpose of the business, or where the articles of organization fail to provide a description with adequate detail, it can be nearly impossible

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to determine whether judicial dissolution is justified. Indeed, in such a situation departing LLC members often find themselves unable to meet the rigorous standard of establishing that "it is not reasonably practical to carry on the business in conformity with the articles of organization or operating agreement." Not surprisingly, where the members fail to clearly define the purpose of the business, courts encounter great difficulty determining whether the above standard has been met. In these situations, determining whether the stated purpose of the entity is being fulfilled may depend on the affidavits and trial testimony of the LLC's members.

1545 Ocean Avenue, LLC is the seminal New York case concerning the interpretation and application of §702 of the LLCL. In *1545 Ocean Avenue*, the Appellate Division, Second Department, enumerated two factors that courts should assess when faced with a withdrawing LLC member's petition for judicial dissolution. The petitioning member must show that: (1) the management of the company is unable or unwilling to reasonably permit or promote the stated purpose of the company to be realized or achieved; or (2) continuing the company is financially unfeasible. *1545 Ocean Avenue, LLC v. Crown Royal Ventures, LLC*, 72 A.D.3d 121 (2d Dep't 2010). In applying the aforementioned two-factor standard, the Appellate Division ultimately determined that the allegations underlying the withdrawing member's petition—i.e., that the LLC failed to hold regular meetings, achieve quorums, and was essentially deadlocked—did not warrant judicial dissolution under LLCL §702.

Since *1545 Ocean Avenue* was decided, a handful of other decisions—usually from the Commercial Division of the Supreme Court of New York—have weighed in on the issue of judicial dissolution under §702 and have affirmed that petitioning members face an uphill battle in the absence of withdrawal or dissolution protocols in an operating agreement. For example, in *Yu v. Guard Hill Estates, LLC*, Justice Saliann Scarpulla of the New York County Commercial Division dismissed a petition to dissolve a family-owned LLC under LLCL §702 where the member seeking dissolution was only able to point to family discord as grounds for the dissolution. In her decision, Justice Scarpulla noted: "While [the petitioner] complains that his family members have engaged in certain activities to further their personal 'vendetta' against him, his unflattering characterization of his family's actions is not sufficient to support a cause of action that his family has abandoned the purpose of the LLC." *Yu v. Guard Hill Estates, LLC*, 2018 WL 3953795, at *3 (N.Y. Sup. Ct, N.Y. County Aug. 17, 2018).

In *Kassab v. Kasab*, Justice Timothy Dufficy of the Queens County Commercial Division arrived at a similar conclusion in denying a petition to dissolve under LLCL §702 on the basis that the "exile" of a member from participating in the operation of the business failed to satisfy either prong of *1545 Ocean Avenue's* analysis. See *Kassab v. Kasab*, 2018 WL 3069782 (N.Y. Sup. Ct., Queens County June 11, 2018).

While member exile and modest personal vendettas fall short of the LLCL §702 threshold, in *Matter of 47th Rd. LLC*, Justice Dufficy *did* find that personal vendettas that lead to physical violence and ultimately drive the business into the ground *may* warrant judicial dissolution. In that case, two feuding brothers who were members of an LLC that owned and managed an apartment building engaged in a physical altercation over the business, allowed the building to fall into a state of disrepair, and did nothing to prevent the LLC's finances from collapsing. As the court summarized: "[T]he dissension among the parties has driven the company's only asset [the apartment building] into foreclosure. There are numerous violations on the property, and the respondent has collected the rents without making repairs, paying the violations, or the mortgage … Due to the violent relationship between the two managers, the company will be unable to achieve its purpose of operating an apartment building." *In re 47th Rd. LLC*, 2017 WL 653096, at *5 (N.Y. Sup. Ct. Feb. 16, 2017); see also *Cortazar v. Cortazar*, 2019 WL 2554627, at *5 (N.Y. Sup. Ct., Queens County June 7, 2019).

A similar result was reached in *Matter of D'Errico* by the Nassau County Commercial Division last summer, albeit on different facts. In *D'Errico*, the LLC members owned and operated a gymnastics training center called Epic Gymnastics, LLC. See *Matter of D'Errico*, Nassau County Index No. 610084/2016 (N.Y. Sup. Ct., Nassau County Aug. 21, 2018). The business was formed without a formal written operating agreement, with the minority members owning a collective 42 percent interest in the business. The relationship between the minority members and the majority members turned sour approximately two years after the business's inception when the gym generated only meager profits and the minority members were accused of starting a "side" gym to compete with Epic. After the feud erupted, Epic's majority members banished the minority members from the business's premises and locked them out of all of the business's accounts. To complete the lockout process, the majority members went so far as to form an entirely new LLC, "BeyondEpic," to which they funneled all of Epic's profits, and proceeded to use BeyondEpic's bank account as the business's primary account and deposited funds into Epic's account only on occasion. The new entity—BeyondEpic—had, essentially, eclipsed Epic to the point that Epic's stated business purpose was no longer achievable. As the court framed it, "BeyondEpic … reduced Epic to an entity which operates solely at BeyondEpic's sufferance." The court further compared Epic to a "marionette to be manipulated at will by BeyondEpic." Accordingly, the court found that judicial dissolution of Epic under LLCL §702 was warranted.

The dissolution ordered in *D'Errico* was—without question—colored by the oppression and inequity created by the majority members and their bad faith conduct in forming the new entity to intentionally shutout the minority members. While a plethora of §702 cases tell us that the mistreatment or even exile of LLC members may not be enough to clear §702's high bar for judicial dissolution (see, e.g., *Yu v. Guard Hill Estates, LLC*, supra; *Kassab v. Kasab*, supra), the creation of an entirely *new* entity to usurp control over the existing entity's business operations such that the existing entity becomes obsolete *is likely* enough as *D'Errico* demonstrates. It also is worth emphasizing that in *D'Errico*, the parties seeking dissolution were the minority LLC members who were the victims of the "lockout" and the "oppressive" actions of the majority members. If it were not for the majority members' decision to render the original business entity virtually defunct, the minority members very well could have been trapped in the LLC in perpetuity.

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As the contours of the law interpreting LLCL §702 continues to develop, and the grounds for judicial dissolution of an LLC in New York evolve, the significance of clearly-written, unambiguous withdrawal and dissolution provisions in LLC operating agreements becomes more and more apparent. While burgeoning businesses often do not want to think about the possibility of their eventual demise or dissolution, the aforementioned cases underscore the importance of having an operating agreement that provides members with an unambiguous exit strategy. In light of the obstacles that withdrawing members face under New York's default dissolution rules, reliance on LLCL §702 is a risk that LLC members simply cannot afford to take.