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Commercial division update

Judicial dissolution of New York limited liability companies

Thomas J. Hall and Judith A. Archer, *New York Law Journal – October 27, 2018*

New York courts are frequently called upon to resolve disputes over whether a limited liability corporation ("LLC") should be dissolved. The dissolution of New York LLCs is governed by Article 7 of the New York Limited Liability Company Law ("LLCL"). Section 702 thereof provides that, as one ground, judicial dissolution may be decreed "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." Two primary questions drive the determination of whether dissolution is proper under the provision. First, does the petitioner seeking judicial dissolution have standing to request that relief? And, second, is it "reasonably practicable" for the LLC to continue fulfilling its organizational purpose?

Standing to seek dissolution

Section 702 limits standing to seek judicial dissolution to those applications brought "by or for a member." Justice Shirley W. Kornreich of the New York County Commercial Division has held that non-members lack standing to seek judicial dissolution. *JG Club Holdings, LLC v. Jacaranda Holdings, LLC*, 35 Misc. 3d 1217(A), 951 N.Y.S.2d 86 (N.Y. Co. 2012); see also *762 Park Place Realty, LLC v. Lehrer*, 161 A.D.3d 1135, 1137, 78 N.Y.S.3d 719, 721 (2d Dep't 2018) (application must be made either by a member or "on behalf of a member of the LLC"); *Matter of Cline v. Donovan*, 72 A.D.3d 471, 472–73, 901 N.Y.S.2d 2, 3-4 (1st Dep't 2010) (dissolution should not have been granted summarily due to question of fact as to whether petitioner was member of LLC). No New York decisions have been found analyzing the circumstances under which a petition for judicial dissolution might be brought "for a member" or "on behalf of a member" rather than by the member themselves.

Legal standard

As to the second requirement, the Second Department was called upon to interpret the meaning of "not reasonably practicable" as it relates to continuation of an LLP under Section 702 in its 2010 decision *In re 1545 Ocean Ave., LLC*, 72 A.D.3d 121, 893 N.Y.S.2d 590 (2d Dep't 2010). The Second Department initially observed that New York law contained "no definition of 'not reasonably practicable' in the context of the dissolution of a limited liability company" and that "[m]ost New York decisions involving limited liability company dissolution issues have avoided discussion of this standard altogether." It also noted that the standard for judicial dissolution of an LLC "is not to be confused with the standard for the judicial dissolution of corporations or partnerships."

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Before enunciating a standard, the Second Department cautioned that "[d]issolution is a drastic remedy" and that, for example "disagreements between the partners with regard to the accounting of the entity" are insufficient grounds to warrant dissolution. Instead, the court held that "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." The First Department adopted this test in *Doyle v. Icon, LLC*, 103 A.D.3d 440, 440, 959 N.Y.S.2d 200 (1st Dep't 2013).

In both *1545 Ocean Ave.* and *Doyle*, the Appellate Division found this standard unmet. In *1545 Ocean Ave.*, the LLC had been formed to purchase property, rehabilitate the existing building, and add an additional building for commercial rental. The LLC had two members, both with 50% interests, and both of whom appointed managers. When the managers could not find bidders for the demolition and rehabilitation work, one of the managers used his own company to perform the work, allegedly without the consent of the other. The other manager resigned. The member whose manager had resigned brought the dissolution action, alleging as grounds the "failure to hold regular meetings, failure to achieve quorums, and deadlock." The Second Department found, however, that none of these issues frustrated the purpose of the LLC, which was "feasibly and reasonably being met." The operating agreement "specifically contemplated and permitted" that a single manager could take "unilateral action in furtherance of the business" of the LLC and thus "avoid[ed] the possibility of 'deadlock.'"

Doyle similarly held an allegation that the plaintiff had been "excluded from the operation and affairs of the company" insufficient to warrant dissolution. In addition, the plaintiff's allegation "that defendants failed to pay plaintiff his share of the profits and award him distributions" showed the company to be profitable and therefore "financially feasible."

Commercial division application

The Commercial Division has consistently applied the test set forth in *1545 Ocean Ave*. Thus, under recent Commercial Division jurisprudence, dissolution is granted where the LLC is not financially feasible or where its purpose has been frustrated. Dissolution has been denied where the corporation is able to continue to fulfill its purpose in a profitable manner. Other grievances with regard to the operation of the LLC that do not address these criteria have been found irrelevant.

An example of a case granting dissolution of an LLC based on financial infeasibility is *Mizrahi v. Cohen*, 34 Misc. 3d 1210(A), 943 N.Y.S.2d 792 (Kings Co. 2012), *aff'd as modified*, 104 A.D.3d 917, 961 N.Y.S.2d 538 (2d Dep't 2013). In *Mizrahi*, Justice Carolyn E. Demarest of the Kings County Commercial Division judicially dissolved a real estate holding company even though the contractual grounds for dissolution laid out in the operating agreement were not satisfied. Justice Demarest found that "the LLC has consistently operated at a loss from its beginning," noting losses in all five years of its existence. Because the building, which was the sole asset of the LLC, did "not support the costs of its maintenance," the plaintiff "established that continuing the LLC [was] financially unfeasible and that the LLC should be dissolved."

The frustration of purpose criteria is satisfied by demonstrating, either via an operating agreement or otherwise, the founding purpose of the LLC and then by showing that it cannot be satisfied. For example, in *Natanel v. Cohen*, 43 Misc. 3d 1217(A), 988 N.Y.S.2d 524 (Kings Co. 2014), Justice Demarest held that the subject LLC had been created "exclusively in order to continue to house" the petitioner's and respondent's partnership business by serving as a holding company for the building. While the LLC remained financially viable, the court found that because the former partners had ceased to operate that business and instead formed competing businesses, that purpose "no longer exist[ed]," thereby warranting dissolution.

Intractable deadlock that prevents operation of the LLC also demonstrates frustration of purpose. For example, in *Fakiris v. Gusmar Enterprises, LLC*, 53 Misc. 3d 1215(A), 48 N.Y.S.3d 265 (Queens Co. 2016), Justice Martin E. Ritholtz of the Queens County Commercial Division held that judicial dissolution was appropriate where the conflict between the brother and sister members of the LLC (both 50% members) was sufficiently acrimonious that the individual originally designated to function as the tie-breaking vote resigned and no replacement could be appointed because the members could not agree on such a replacement. The members' deadlock also prevented the LLC from refinancing its mortgage at more favorable rates, resulting in the LLC defaulting on the foreclosure and preventing the release of insurance moneys related to the sinking of a boat owned by the LLC. The court granted dissolution on summary judgment based on the fact that management of the LLC was dysfunctional in that the members could not agree on "fundamental matters." The inability of the LLC to operate distinguished the case from *1545 Ocean Ave.*, wherein the operating agreement prevented the possibility of true deadlock.

While the above cases exemplify the circumstances where judicial dissolution has been found to be appropriate, dissolution remains "a drastic remedy." *1545 Ocean Ave.*, 72 A.D.3d at 131. Thus, even in circumstances where a member alleged that an LLC was being used for an oppressive purpose, or was otherwise seeking to harm the interests of the petitioning member, dissolution was not warranted since the *1545 Ocean Ave.* test had not been satisfied. *Yu v. Guard Hill Estates, LLC*, No. 656535/2016, 2018 N.Y. Slip Op. 32008(U) (N.Y. Co. Aug. 17, 2018). In *Yu*, Justice Saliann Scarpulla of the New York County Commercial Division dismissed the claim for dissolution because the operating agreements provided for a broad purpose, including "engaging in any other lawful act or activity . . . and engaging in any and all activities necessary or incidental to the foregoing." There was no evidence, however, that purpose was not being satisfied and it was not asserted that the subject LLCs were not financially feasible.

Conclusion

1545 Ocean Ave. and its progeny have clarified the requirements for satisfying the "not reasonably practicable" standard of Section 702. While prior caselaw had typically avoided analysis of the meaning of this standard, the Commercial Division now applies consistent criteria to applications for judicial dissolution of LLCs, providing greater certainty to members who seek dissolution. A member seeking judicial dissolution of an LLC must show that either the LLC is not profitable to operate or that its founding purpose can no longer be fulfilled. Other disagreements between members have not justified judicial dissolution.

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