FARRELLFRITZ ATTORNEYS

New York Business Divorce

Commentary on Dissolution and Other Disputes Among Co-Owners of Closely Held Business Entities

Groundbreaking Appellate Ruling Boosts LLC Cash-Out Mergers

By Peter Mahler on January 18, 2021

For law bloggers, if there's one thing more satisfying than writing about an important new court decision, it's writing about an important new court decision that you won for your client.

Last week, the Brooklyn-based Appellate Division, Second Department, unanimously ruled in favor of my clients, construing for the first time at the appellate level two sections of New York's LLC Law with profound effect on the ability of controlling members of LLCs to oust minority members by means of a cash-out merger.

First, reversing in part the lower court's order, the appellate panel held that under **§ 1002 (g) of New York's LLC Law**, an appraisal proceeding is the cashed-out, dissenting member's sole remedy and that, in contradistinction to the analogous statute applicable to dissenting

shareholders under the Business Corporation Law (BCL), no exception exists for alleged fraud or illegality in the procurement of the merger.

Second, affirming in part the lower court's order, the appellate panel held that **LLC Law § 1002 (c),** which requires member approval of the proposed merger agreement at a meeting called on at least 20-days notice, is trumped by **LLC Law § 407 (a)'s** default rule providing generally for member action by written consent in lieu of meeting.

Based on those unanimous rulings, the court in ***Farro v Schochet*, 190 AD3d 689, 2021 NY Slip Op 00150 [2d Dept Jan. 13, 2021]**, granted my clients' request to dismiss an action brought against them by a cashed-out minority member who sought to rescind the merger on grounds of alleged fraud and breach of fiduciary duty, and who also argued for rescission on the ground that he was not permitted to vote on the merger at a meeting of the members called on 20-days notice.

Background

The case involves a company called LMEG Wireless LLC formed in 2003 to refurbish and sell aftermarket cell phone accessories. From 2003 to 2011, it had two co-equal members, plaintiff Menachem Farro and defendant Levi Wilhelm. The business never had or could get conventional financing and relied for capital on loans from friends and family. LMEG had no written operating agreement.

Beginning in 2008, defendant Zalman Schochet made a series of loans to LMEG which, by 2010, resulted in a balance owed to him over $6 million. When the company was unable to make the required loan repayments, in late 2011, Schochet, Farro and Wilhelm entered into a written agreement under which, in consideration of forbearing from taking enforcement action under the loan agreement, reducing the interest rate, and loaning LMEG additional millions to pay off the friends and family loans, Schochet received a one-third interest in LMEG, its subsidiaries and affiliates.

In 2014, LMEG's three members agreed to market LMEG for sale through an investment banking firm. In early 2015, the first of two private equity firms gave a letter of intent to buy LMEG for a little over $100 million, which Farro refused to sign. Instead, he induced Schochet and Wilhelm to engage a team of prominent M&A lawyers to re-shop the business, promising that he would execute any deal the new team procured.

In late 2015, all three members signed a letter of intent with a second PE firm, also offering slightly over $100 million. In early 2016, however, Farro announced that he would not honor

the prior commitment unless the buyer valued LMEG at least $180 million — a manifestly unrealistic and unobtainable sum. Over the next eight months, the buyer, Wilhelm, and Schochet negotiated a workaround deal that would have cashed out Farro's interest while requiring Schochet and Wilhelm to roll a portion of their ownership stake over into the new equity capital structure put in place by the acquiring PE firm in lieu of receiving cash proceeds.

By September 2016, however, deteriorating market forces caused the PE firm to reduce its valuation of LMEG to approximately $50 million, but it agreed to gross-up the value to approximately $70 million if it received preferential returns on its investment.

Farro's Lawsuit Kills the PE Deal

In October 2016, as the PE deal was on the verge of closing, Farro filed a lawsuit asserting direct and derivative claims against Schochet and Wilhelm. Initially, Farro alleged that Schochet did not own a membership interest in LMEG. In a subsequent, amended pleading filed after the lower court rejected Farro's initial motion for injunctive relief, Farro conceded that Schochet was an owner of LMEG but that his ownership interest should be rescinded based on the allegation that Schochet fraudulently obtained his interest in 2011 by giving false, verbal assurance that the source of his loans was his "personal" funds, notwithstanding that the 2011 written agreement contains no such representation.

In the meantime, however, as a result of Farro's lawsuit alleging that Schochet was not a member of LMEG, the PE firm predictably terminated negotiations with LMEG, costing LMEG and its members millions of dollars.

The Cash-Out Merger

In mid-November 2016, following the collapse of the PE deal resulting from Farro's lawsuit, Schochet and Wilhelm as LMEG's majority members signed written consents in lieu of meeting, approving a merger of LMEG with and into LMEG Acquisition LLC. Under the Agreement and Plan of Merger, Farro did not receive any membership interest in the surviving entity and instead was offered the cash value of his interest and advised of his right to dissent and demand a judicial appraisal proceeding under **LLC Law § 1005**.

In response, Farro moved for a temporary restraining order (TRO) and preliminary injunction, restraining the defendants from interfering with his alleged rights as a member of LMEG or

taking any steps in furtherance of the merger. The lower court denied the TRO but granted Farro's request to toll his time to dissent from the merger.

The Lower Court Lets Stand Farro's Rescission Claim

The defendants moved to dismiss Farro's amended complaint, arguing principally that Farro's fraud-based rescission claim was barred by LLC Law § 1002 (g); that his exclusive remedy was an appraisal proceeding; that Farro failed to state a valid fraud claim in any event; and that as a former member of LMEG Farro lacked standing to assert derivative claims.

By **Decision and Order dated May 19, 2017**, the lower court denied defendants' dismissal motion, finding that Farro's amended complaint sufficiently pleaded a claim for fraud as grounds to rescind the merger, and also allowing Farro to add a new claim that the merger effectuated without a meeting of the voting members on 20-days notice violated LLC Law § 1002 (c).

At the same time, the court denied as "moot" Farro's motion to preliminarily enjoin defendants from consummating the merger and interfering with Farro's alleged rights as a member of LMEG. Shortly afterward, Farro served a notice of dissent and demand for an appraisal.

Both sides moved for reargument of the May 19 decision. By **Decision and Order dated August 18, 2017**, the court ruled in Farro's favor insofar as it adhered to its prior refusal to dismiss Farro's fraud-based rescission claim and issued a preliminarily injunction staying the appraisal proceedings triggered by Farro's notice of dissent "until the parties' interest in the Businesses is determined." In support, the court cited **BCL § 623 (k)** which provides an exception to the exclusive appraisal remedy allowing a dissenting shareholder to challenge a merger "on the ground that such corporate action will be or is unlawful or fraudulent as to him." The decision did not acknowledge defendants' argument that the exclusive appraisal remedy provided in LLC Law § 1002 (g) omits the exception found in BCL § 623 (k). It also ignored defendants' reliance on the Court of Appeals' 2008 ruling in ***Appleton Acquisition, LLC v National Housing Partnership***. In that case, the court construed the Revised Limited Partnership Act's dissenting-partner provision, which essentially is identical to LLC Law § 1002 (g), as precluding a cashed-out limited partner from challenging a merger on grounds of fraud or other illegality.

The August 18 decision wasn't all bad news for the defendants. First, it dismissed Farro's claim that the merger effectuated by written consent of the majority members in lieu of a meeting on 20-days notice to all members, was invalid under LLC Law § 1002 (c). The court agreed with the defendants that action by written consent was authorized under LLC Law § 407 (a). Second, it held that Farro's breach of contract claim against Schochet seeking to rescind the 2011 agreement and divest him of his one-third interest failed to state a viable cause of action because, even if Schochet allegedly misrepresented the source of his loans, he still provided valid consideration to obtain his one-third interest in LMEG.

The Second Department's Rulings

Both sides appealed from the August 18 decision.

Defendants appealed from the lower court's refusal to dismiss all of Farro's remaining claims including those challenging the merger and suing derivatively on LMEG's behalf.

Farro appealed from the lower court's denial of his preliminary injunction motion, the dismissal of his claim to invalidate the merger based on non-compliance with LLC Law § 1002 (c)'s meeting requirement, and the dismissal of his claim to rescind the 2011 agreement giving Schochet a one-third interest in LMEG.

The appellate panel's decision last week ruled across-the-board for the defendants.

First, it held that the language of LLC Law § 1002 (g) "makes clear that an appraisal proceeding is the member's 'sole remedy,' and that no exception exists for alleged fraud or illegality in the procurement of the merger," citing *Appleton Acquisition, LLC v National Housing Partnership*. This critical ruling effectively puts to rest certain lower court decisions, including the oft-cited ***SBE Wall, LLC v New 44 Wall Street, LLC* case**, which looked to BCL § 623 (k) instead of LLC Law § 1002 (g) in allowing cashed-out LLC members to challenge mergers on grounds of fraud or other illegality. The court accordingly denied as moot Farro's appeal from the denial of his preliminary injunction motion.

Second, consistent with a number of lower court precedents including former Justice Kornreich's decision in ***Slayton v Highline Stages, LLC***, it held that LLC Law § 407 (a)'s default rule authorizing action by written consent in lieu of meeting, by the section's plain terms, applies ""[w]henever under this chapter members of a limited liability company are required or permitted to take any action by vote" and, thus, supersedes § 1002 (c)'s requirement to call a member meeting on no less than 20-days notice to vote on a proposed merger.

Third, it dismissed all of Farro's derivative claims seeking declaratory relief and damages based on LLC Law § 1002 (f) which provides that, subsequent to a merger, a dissenting member possesses no interest in the surviving entity. Farro's exclusive remedy, the court wrote, "was appraisal and payment, and he was precluded from maintaining any derivative claims on behalf of the subject businesses."

Fourth, it dismissed Farro's direct claims for an accounting, for breach of fiduciary duty, and to remove Schochet as a manager of LMEG, based on the merger's divestiture of Farro's membership interest and the exclusive appraisal remedy afforded him under LLC Law §§ 1002 (f) and 1002 (g).

Fifth, further undermining the validity of Farro's basic theory of the case, it held that even assuming the truth of Farro's allegation that Schochet misrepresented the source of the funds he loaned to LMEG, "the source of funds used for a loan is not typically a factor in determining its validity," plus Farro "has not pointed to any contractual term [in the 2011 agreement] prohibiting Schochet from obtaining funds from any particular source."

The Decision's Impact

For New York LLCs like LMEG that have no written operating agreement and therefore are governed by the LLC Law's default rules, the Second Department's decision in *Farro v Schochet* provides the controllers of New York LLCs with virtually unbeatable power to consummate a cash-out merger of minority members without any prior notice, immediately relegating them to the status of former members with no voting rights, no right to pursue dissolution or derivative claims, no right to demand access to books and records, and no other rights they previously enjoyed as members. If not satisfied with the consideration offered for their former membership interest, their only remaining right is to dissent from the merger and demand payment of the fair value for their former interest or, if no agreement as to fair value is reached, ask a court to determine fair value in an appraisal proceeding.

The same holds true for LLCs that have a written operating agreement whose provisions neither require the members' unanimous consent for a merger nor opt out of the default rule permitting member action by written consent in lieu of meeting.

In my years of practice I've encountered many shareholder and LLC agreements that include mergers in a list of major decisions requiring supermajority or unanimous consent. If you or a client you represent are contemplating becoming a minority owner of a New York

closely held business entity — and now, in light of *Farro v Schochet*, especially if the entity is an LLC — it behooves you to demand that such a provision be included in the owners' agreement.

Finally, my crystal ball tells me that, as awareness of the *Farro v Schochet* decision spreads in the legal community, we're likely to see an uptick in the pace of LLC cash-out mergers.
