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CivilLITIGATION

Developing remedies for LLC members

Limited liability companies appeared in New York state in 1994, when the New York Limited Liability Company Law (LLCL) went into effect. An LLC is an unincorporated organization (but not a partnership or a trust) of one or more persons having limited liability for the contractual obligations and other liabilities of the business.

The LLC combines aspects of the corporate form and the partnership form. An LLC can be used to limit the personal liability of its owners (called members) like a corporation, and offers flexibility in management and operations, capital formation, and the allocation and distribution of benefits like a partnership. Last, but certainly not least in the minds of business owners who use the LLC form, the LLC may provide significant tax advantages to those owners.

LLCL §417 requires the LLC's members to adopt an operating agreement addressing the business of the LLC, the conduct of its affairs, and the rights, powers, preferences, limitations or responsibilities of its members, managers, employees or agents.

A well-considered operating agreement should address, among other things, decision-making procedures, access to the business' books and records and exit strategies such as buyout provisions. In the absence of an operating agreement, and in the event of legal action, a court will enforce the rights and obligations in issue by reference to the "default" provisions of the LLCL.

Business owners may choose the LLC form without much thought (and sometimes without an operating agreement), or they may elect to form an LLC in consultation with lawyers experienced in business formation and tax law. Either way, the members hope common goals and the LLC form will lead to financial success.

However, sometimes members may encounter irreconcilable differences even when dealing with one another in good faith, and sometimes one member's intentional misconduct, such as fraud, misappropriation, and misuse of LLC assets for personal gain, will cause harm to the LLC, and the other member or members will be forced to go to court to protect the LLC and their ownership interests, or to obtain a remedy that will extricate them from an untenable situation.

While the LLCL provides for judicial dissolution under certain limited circumstances, it does not expressly provide an aggrieved member with remedies such as the right to bring a derivative action, the right to an accounting or the right to a buyout of her ownership

interest. Therefore, given the hybrid nature of the LLC form, lawyers who handle "business divorce" cases have advocated, and the courts have evaluated, an LLC member's potential remedies by analogy, using the Business Corporation Law (BCL), the Partnership Law, and the common law.

At the threshold level, the courts have recognized that members of LLCs owe fiduciary duties to one another, see, e.g., *McGuire Children LLC v. Huntress*, 24 Misc.3d 1202A (Erie Sup. Ct. 2009), aff'd 83 A.D.3d 1418 (4th Dept. 2011); *Willoughby Rehabilitation and Health Care Center LLC v. Webster*, 13 Misc.3d 1230A (N.Y. Sup. Ct. 2006), aff'd 46 A.D.3d 801 (2nd Dept. 2007). These decisions, which analogize a member's duties to other members to a partner's duties to other partners, provide a foundation for the advocacy of a member's rights and remedies in the face of misconduct by other members.

In *Tzolis v. Wolff*, 10 N.Y.3d 100 (2008), the Court of Appeals held that LLC members may sue derivatively, even though the LLCL does not expressly authorize such actions. The court, after reviewing the development of the law authorizing derivative actions on behalf of trusts, corporations and limited partnerships, found that an LLC member had the right to bring a derivative action, stating that "to hold that there is no remedy when corporate fiduciaries use corporate assets to enrich themselves" was unacceptable.

In *Gottlieb v. Northriver Trading Co., LLC*, 58 A.D.3d 550 (1st Dept. 2009), a minority member of an LLC sued the LLC and the majority member for an accounting. Supreme Court dismissed the complaint, holding, among other things, that the LLCL did not give the plaintiff member the right to an accounting; the court refused to apply the cases cited by the member plaintiff, which addressed the right to an accounting in business entities other than LLCs.

The First Department reversed, holding that "members of a limited liability company may seek an equitable accounting under common law", and rejecting any assertion that LLC members "are limited to statutory remedies with respect to potential fraud" as inconsistent with the reasoning of *Tzolis*.

Although the LLCL provides for the judicial dissolution of an LLC, unlike the BCL, which includes provisions authorizing the buyout of a complaining shareholder as a means of resolving a dissolution action brought by that shareholder, the LLCL does not con-



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tain any provision which authorizes a buyout as a means of avoiding dissolution.

Notwithstanding this absence of statutory authority, in *Matter of the Dissolution of Superior Vending, LLC*, 71 A.D.3d 1153 (2nd Dept. 2010), an action in which the members consented to the dissolution of their LLC, the Second Department approved Supreme Court's order that one member buy out the other member's ownership interests as "the most equitable method of liquidation."

Also, in *Matter of Gold* (Cosmo Holdings, LLC) (Nassau County Index No. 6722/11), the court denied an LLC member's application for judicial dissolution but ordered an appraisal proceeding for the buyout of that member's ownership interest, holding that the member "has the common law right to an appraisal proceeding for the purpose of determining the fair market value of her membership

interest in the limited liability company."

As authority for this proposition, the court cited *Appleton Acquisition, LLC v. National Housing Partnership*, 10 N.Y.3d 250, 256 (2008), a case in which the Court of Appeals addressed a limited partner's remedies under the New York Revised Limited Partnership Law.

Each of the decisions discussed above is worthy of analysis, but the takeaway for practitioners is that the courts will likely continue to follow the Court of Appeals' lead in *Tzolis* and look, where appropriate, to the New York law on corporations and partnerships for guidance in the development of remedies for LLC members.

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