Liability for the limited liability company (LLC): New York court of appeals addresses the issue

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Under what circumstances can management of a limited liability company be held liable for decisions made on behalf of the company? Recently the New York court of appeals addressed the issue with some surprising results. We will take a look at the case, examine the nature of a derivative claim, discuss the defenses to a derivative claim, and also examine the fiduciary nature of the relationship of management to minority members.

The Derivative Claim. In Tzolis v. Wolff, a February 14 decision of the New York court of appeals, the plaintiffs owned a 25% membership interest in an LLC, which owned a Manhattan apartment building. The plaintiffs (minority members) argued that the management of the LLC sold the building for below market value and that the company fiduciaries (management) benefited personally from the sale. The plaintiffs sought, in the name of the corporation, to set aside the sale as void. This aspect of the claim is termed a "derivative claim" in which a minority member seeks to sue in the name of the company. Several courts in New York had previously held that there was no derivative remedy for an LLC member.

The court's decision. However, the court of appeals ruled that a derivative claim is an ancient common law remedy in New York and, as such, would require an express act of the legislature to overrule this equitable remedy. As the court said, "To hold that there is no remedy when corporate fiduciaries use corporate assets to enrich themselves was unacceptable in 1742 and in 1832, and is still unacceptable today. Derivative suits are not the only possible remedy, but they are the one that has been recognized for most of two centuries, and to abolish them in the LLC context would be a radical step."

What is a "derivative claim?" The derivative action is an equitable device available to equity holders (members) to vindicate a company claim and to protect their interest in the company in the event of a breach of trust, or carelessness, by management. Typical derivative claims involve the right to sue to recover damages in instances on mismanagement, waste of assets and misappropriation. A member may bring the action in the name of the company, and the consequential remedies adhere to the company, not to the member personally. The member may also bring an individual action where such separate claim (such as a fiduciary claim) constitutes an independent wrong to the member. In the derivative action, relief is usually awarded to the company, not to the member, and the member must sue the company in order to force the company to act in its own behalf. Prior to a lawsuit, the member must make a demand on management to correct the wrong. If the company is in bankruptcy, a derivative action is not stayed by the automatic stay since a derivative action is not brought against the corporation but to procure a judgment in its favor.

Defenses to a derivative claim. A board's decision not to assert the company's action should be protected under the "business judgment rule" when a board has acted in good faith and on an

informed basis in either (1) a majority of the board members voting on the issue are disinterested, or (2) a special litigation committee comprised of disinterested management has been granted authority to act on behalf of the board.

The fiduciary obligation of management. Unlike a derivative claim, which is sued on behalf of the company, a minority member may also have a separate fiduciary claim against management. In Salm v. Feldstein, a 2005 decision from Nassau County, the LLC owned an auto dealership. The buyer was the managing member of the LLC and purchased the seller's interest for $3.75 million, plus $1.35 million payable under a consulting contract. Two days later the buyer (managing member) sold the dealership for $16 million. The seller (minority member) alleged that the buyer misrepresented the value of the dealership as being valued between $5 million and $6 million and failed to disclose that the non-party purchaser had made a firm offer to buy it for $16 million before the buyer acquired the seller's interest. The Appellate Court ruled that the buyer, as a managing member of the LLC, owed the seller a fiduciary duty to fully disclose all of the material facts. Since the buyer had a fiduciary relationship with the seller, the disclaimers in the contract did not relieve the buyer of the obligation of full disclosure. Additional cases on point include Kramer v. Schloss, a 2004 Northern District case, and Blue Chip Emerald LLC v. Allied Partners, a 2002 New York County case.

The court of appeals decision in the Tzolis case is a worthwhile reminder that management of limited liability companies will be held accountable for management decisions. On the other hand, if those decisions are supported by complete documentation and prudent business practices, they are likely to be upheld.

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