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BURGER

LLC derivative actions

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My best client, call her Anne, is an international spy and part time venture capitalist.

OK, I made up the spy part, but it makes this essay a little more interesting.

One of Anne's investments involved a New York State limited liability company (LLC) that manufactured small arms and high tech surveillance equipment. In return for her investment of funds, Anne received a minority equity position in the company. Unfortunately, the other members held a majority, controlling interest, and had been mismanaging its affairs. Anne wanted to explore her legal options.

We started to discuss a derivative action on behalf of the LLC against the other members to halt their mismanagement and recover the damages they caused. The derivative action allows one who holds an equity position in an entity to sue on behalf of such entity when its managers wrongly re-fuse to do so (such as when they are the putative defendants), see e.g., Business Corporation Law (BCL) § 626. The plaintiff equity-holder, therefore, derives her right to sue from and on behalf of her entity.

This is where our discussion stalled. State law expressly affords this right to shareholders in a corporation but, at least for the moment, the law is unsettled with respect to such rights for an LLC member. Our recommendation to Anne de-pended on the answer to this unsettled question.

When we described to Anne the uncertainty in this area of the law, she was initially inclined to simply assassinate her co-members and forge their names on documents assigning their membership interests to her. We talked over the pros and cons of her approach — under the auspices of the attorney-client privilege, of course — and persuaded her that a lawsuit, albeit uncertain, would at least not involve any additional dry cleaning of the beautiful cinnamon-colored dress she wore to our conference.

We asked Anne to leave this problem with us for a couple of days so we could analyze this issue before recommending a course of action. Anne reluctantly called off the dawn missile strikes on the other members' homes, tied her long brown hair in a bun and stealthily jet packed off the roof. Our analysis follows.

'Hoffman v. Unterberg'

The first appellate court in New York to examine whether an LLC member may sue derivatively on behalf of the LLC was the Second Department case of *Hoffman v. Unterberg*, 9 AD3d 386, 388-89 (Second Dept. 2004) (Altman, Miller, Townes, Fisher, JJ.). *Hoffman* held, without elaboration, that an LLC member could not sue derivatively absent specific statutory authority. Several trial courts subsequently adopted this holding.

Hoffman cites only the *McKinney's* practice commentaries regarding the New York LLC Law that notes that the Legislature deliberately removed language from an earlier draft of the statute that provided for derivative claims. *Hoffman* (and some trial courts), find the Legislature's deliberate omission of the right to sue derivatively from the LLC Law to be tantamount to the Legislature's explicit proscription of such a right, see *Lio v. Mingyi Zhong*, 814 NYS2d 562 (Sup. Ct. 2006) ("there is no such right" of an LLC member to maintain a derivative action "and this court concurs with this analysis"); *Schindler v. Niche Media Holdings, LLC*, 772 NYS2d 781, 785 (Sup. Ct. 2003) (LLCL "legislation provides no right to bring a derivative action").

Both *Lio* and *Schindler* were decided by New York County Supreme Courts within the First Department and have, therefore, tacitly been overruled by the First Department's subsequent decision in *Tzolis v. Wolff*, 829 NYS2d 488, 491 (First Dept., Feb. 8). Accordingly, at the very least, an LLC member's right to sue derivatively may depend on where the aggrieved minority member lives. Anne lives in the Fourth Department, which had not yet ruled on the issue.

A separate panel in the Second Department has reported this holding with less favor (albeit in *obiter dictum*), *Caprer v. Nussbaum*, 825 NYS2d 55, 67 (Second Dept. 2006) ("we have held, without elaboration, that a member of a limited liability company has no right to bring a derivative action on behalf of the company") (Florio, Krausman, Spolzino, Lifson, JJ.).

Before noting that LLCs "seem to be the one exception thus far to judicial recognition of the authority to bring a

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derivative action," the *Caprer* court engages in a careful review of this common law right, *Id.* The *Caprer* rationale ultimately finds favor in the First Department's *Tzolis* decision, *infra*. The reader detects some skepticism in the *Caprer* panel's description of *Hoffman's* rationale as supported solely by the deletion of "a provision permitting derivative actions ... by the Legislature during its consideration of the statute," *Id.*

Before *Tzolis*, the trial courts from other appellate departments that followed the Second Department's ruling in *Hoffman* may have been bound to do so because no other appellate division had addressed the issue, *see People v. Shakur*, 215 AD2d 184 (First Dept. 1995) ("Trial courts within this department must follow the determination of the Appellate Division in another department until such time as this court or the Court of Appeals passes on the question").

Fortunately for Anne, the First Department now persuasively holds that an LLC member may sue derivatively.

'*Tzolis v. Wolff*'

The *Tzolis* court ruled that a minority member of a New York LLC may bring a derivative action: "We respectfully decline to follow the Second Department given 1) the historic judicial recognition of the common-law right to bring a derivative action on behalf of a corporation or a limited partnership, both of which share many of a limited liability company's characteristics; 2) the principles of statutory construction, which provide that only a clear statement of legislative intent may override the common law; 3) the fact that most states provide a statutory right to bring a derivative claim and 4) the unpersuasive rationale of those decisions which have rejected derivative claims for limited liability company members," *Id.* at 491.

Tzolis' legal analysis thoughtfully and logically explored the common law roots of the derivative action, adopting the Southern District's view of this issue, *Bischoff v. Boar's Head Provisions Co., Inc.*, 436 FSupp2d 626, 631-32 (SDNY 2006) ("New York LLC members may bring derivative actions under New York law"); but, *see Pennacchio ex rel. Old World Brewing Co., Inc. v. Powers*, 2007 WL 446355, *6 (EDNY Feb. 5) ("Accordingly, consistent with these state decisions, this court finds that there is no right to bring a derivative action on behalf of a limited liability company under New York law").

A holding that prevents an LLC member from suing

derivatively would defeat the notion that "'origin of the derivative suit, as indeed of any other non-statutory type of action, lies in judicial recognition of a new wrong or maladjustment for which pre-existing legal procedures proved more or less inadequate,'" *Caprer*, 825 NYS2d at 66 (citing *Prunty, The Shareholder's Derivative Suit: Notes on its Derivation*, 32 N.Y.U. L. REV. 980, 992 [1957]).

The derivative action is not exclusively a creature of statute and, therefore, the Legislature's decision to drop the statutory language conferring this right does not affect its common law underpinnings. The Legislature's decision to drop the derivative language was simply "a strategic compromise to increase the likelihood of the passage of the 'balance of the law,'" *Tzolis*, 829 NYS2d at 492; *Weber v. King*, 110 FSupp2d 124, 131 (EDNY 2000) ("We do not believe that the legislature's failure to include a derivative action provision in the LLCL prevents us from recognizing such a right at common law").

This view is analogously supported by precedent permitting derivative actions by a limited partner, although the statute governing such entity did not expressly create such a right, *Klebanow v. New York Produce Exchange*, 344 F2d 294, 298-99 (Second Cir. 1965).

Also, *Hoffman's* purported reliance on legislative history is misleading in the absence of the complete legislative record: Testimony adduced before the Assembly indicated that an LLC member would have the common law right to bring a derivative suit on behalf of the LLC "whether or not the statute contains such an express right," *Bischoff*, 436 FSupp2d at 632-33 (citing Public Hearing on Limited Liability Company Legislation, N.Y. Ass. 133 (1992) [statement of Howard N. Lefkowitz, chairman of the Committee on Corporation Law, The Association of the Bar of the City of New York]).

A converse holding in *Hoffman* might just have easily relied on the Legislature's deliberate failure to write an explicit prohibition against derivative claims into the New York LLC law.

We ultimately predicted Anne's derivative action would prevail, but perhaps not without intrigue. This issue is still unsettled in the Fourth Department and Anne's case very well may be bound for a ruling by the Court of Appeals.

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