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When Can LLCs Appoint A Special Litigation Committee?

By **Muhammad Faridi and Elizabeth Quirk**
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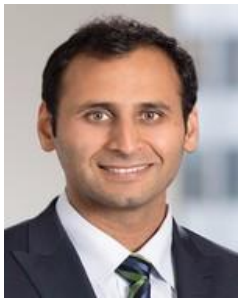

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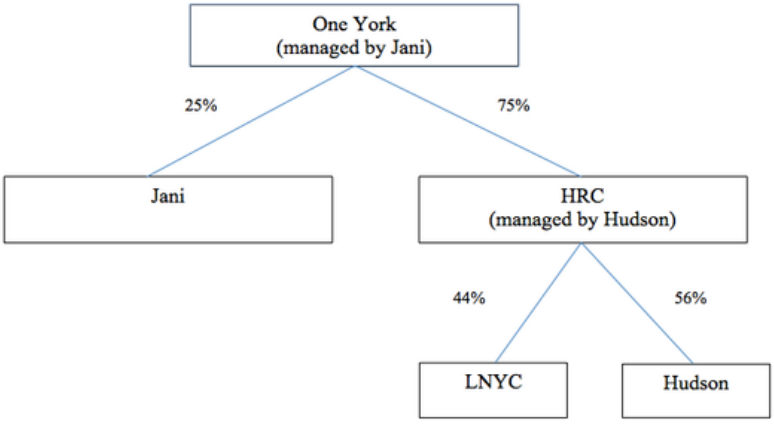
In a decision handed down on Aug. 15, 2017, the New York Appellate Division, First Department, endorsed the practice of the appointment of a special litigation committee (SLC) by a limited liability company (LLC) "at least where explicitly contemplated" by the LLC's operating agreement.[1] However, where the operating agreement does not explicitly provide for such an appointment or otherwise evince intent to delegate core governance functions to a nonmember, the LLC cannot appoint an SLC that has authority over a major decision of the LLC.[2]

Background

The underlying dispute involves several LLCs. Plaintiff LNYC Loft LLC brought derivative claims on behalf of two other New York LLCs — HRC-NYC Development LLC and One York Street Associates LLC — related to the parties' investment in a condominium building in lower Manhattan. The building is owned by One York, which, in turn, is owned by defendant Jani Development II LLC and HRC. Jani and HRC have a 25 percent and 75 percent interest in One York, respectively. HRC is owned by LNYC, which has a 44 percent interest in the entity, and Hudson Opportunity Fund I LLC, which has a 56 percent interest in the entity. Jani is One York's managing member, and Hudson is HRC's managing member.[3]



The One York operating agreement provides that Jani cannot make a "major decision" without the prior written consent of One York's co-owner, HRC. "Major decisions" in the One York operating agreement include a decision to amend the operating agreement and to prosecute or settle any material legal actions. HRC's operating agreement similarly provides that neither of its owners, Hudson and LNYC, can make a "major decision" without the prior written consent of the other owner. This operating agreement also defined a "major decision" to include an amendment to the agreement and the prosecution or settlement of any material legal action.[4]

According to LNYC, Hudson allegedly violated the HRC operating agreement in May 2010 by entering into an amendment to the One York operating agreement — i.e., making a "major decision" — without LNYC's prior written consent. The amendment modified One York's distributions in a manner that was allegedly detrimental to HRC's and LNYC's interests and beneficial to Jani's interests.[5]

LNYC brought this action in April 2011 and, in February 2016, amended the complaint to assert derivative claims on behalf of HRC and One York. The managing members of One York and HRC agreed to engage a third-party lawyer to act as an SLC. With respect to the derivative claims, the lawyer was given authority to "determine the positions and actions that the Companies should take," including by considering "whether the claims have merit, whether they are likely to prevail, and whether it is in the Companies['] best interest to pursue them."[6]

Plaintiff LNYC argued that, as a general matter, an LLC formed under New York law has no authority to appoint an SLC. The lower court disagreed, "holding that a New York LLC, like a New York corporation, may appoint an SLC to address derivative claims brought on the LLC's behalf."[7]

The Court's Decision

The First Department began its analysis by noting that its decision here builds on the New York Court of Appeals' decision in Tzolis v. Wolff, 10 N.Y.3d 100 (2008), which recognized the right of a member to sue derivatively on behalf of an LLC. The Court of Appeals left it to lower courts to further define "[w]hat limitations on the right of LLC members to sue derivatively may exist."[8]

The First Department noted that, since Tzolis, courts have relied on New York statutory and common law on partnerships and corporations to address questions in the LLC context that Tzolis left unanswered.[9] For instance, the First Department has drawn upon Section 626(c) of the Business Corporation Law to hold that it is "necessary for a plaintiff suing derivatively on behalf of an LLC to allege presuit demand or demand futility."[10] The First Department has also held that "notwithstanding the defendant's argument that the plaintiff was limited to the remedies set forth in the LLC Act," an LLC has the "right under the common law to seek an equitable accounting."[11] Further, in consideration of "the corporation-partnership hybrid nature of the LLC," at least one court has held that "the criminal acts of a managing member may be imputed to an LLC, notwithstanding the legislature's silence."[12]

The First Department noted that while "[i]t is true ... that Tzolis encouraged courts to fashion remedies to speak to the omissions in the LLC statute," it would decline "to uphold the appointment of an SLC where the relevant operating agreements do not delegate managerial authority to nonmembers or nonmanagers or otherwise provide for the appointment of an outsider to serve as an SLC."[13]

The court emphasized that LLCs are "creatures of contract."[14] It noted that "[o]ne attraction of the LLC form of entity is the statutory freedom granted to members to shape, by contract, their own approach

to common business relationship problems."[15] Further, "Article IV of the New York LLC Act makes clear that the operating agreement of an LLC governs the relationship among members and the powers and authority of the members and manager."[16]

The court found that the appointment of an SLC constituted a "major decision" under the One York and HRC operating agreements because the SLC was granted the authority to determine the position and actions of the companies with respect to the litigation. Because the One York and HRC operating agreements did not provide for delegation of decision-making authority to someone other than a member — e.g., an SLC — the court found the appointment of the SLC to be improper under both agreements.[17]

In doing so, the First Department explained "that the appointment of an SLC may serve an important purpose in the LLC context," and the court "endorse[d] the practice generally, at least where explicitly contemplated by the relevant governing documents."[18]

The First Department stressed that its decision does not mean "that the appointment of an SLC would in all cases be improper in the LLC context."[19] It noted that where an operating agreement allows for the appointment of an SLC, the court would enforce such an arrangement "in accordance with the same principles concerning the parties' freedom to contract."[20]

Implications for LLCs

The First Department's decision represents a departure in the trend of courts using statutory and common law on partnerships and corporations to address questions in the LLC context that are not directly addressed by the LLC operating agreement. As the decision notes, LLCs are "creatures of contract" and thus emphasis should be placed on an LLC's operating agreement to address issues related to an LLC's internal affairs.

The decision sends a clear message to LLCs: If they wish to have the option to appoint an independent SLC, they should expressly say so in their operating agreements. When this option is expressly agreed to by the parties in writing, LLCs can rest assured that the SLC appointment will be enforced pursuant to general principles of contract law.

On the other hand, where the operating agreement is similar to the One York and HRC operating agreements — in that it neither expressly allows for an SLC, nor otherwise indicates that the parties intended such an appointment — courts are likely to prohibit the appointment of an independent SLC.

The First Department conceived of yet another scenario — a middle ground — in which a contract does not expressly contemplate appointment of an independent SLC, but otherwise "delegate[s] managerial authority to nonmembers or nonmanagers."[21]

In short, an LLC should expressly state its intentions with respect to appointment of an SLC in the operating agreement. If courts are confronted with anything short of such an express statement, they will employ general principles of contract law to determine if the appointment is permitted under the contract.

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[1] LNYC Loft LLC v. Hudson Opportunity Fund I LLC, No. 650969/11, 4096, 2017 N.Y. App. Div. Lexis 6108, at *2 (1st Dep't Aug. 15, 2017).

[2] Id. at *1-2.

[3] Id. at *2-3.

[4] Id. at *2-4.

[5] Id. at *4.

[6] Id. at *5-6.

[7] Id. at *6.

[8] Id. at *1 (quoting Tzolis v. Wolff, 10 N.Y.3d 100, 109 (2008)).

[9] Id. at *7.

[10] Id. (citing Najjar Grp. LLC v. W. 56th Hotel LLC, 974 N.Y.S.2d 58 (1st Dep't 2013); Segal v. Cooper, 856 N.Y.S.2d 12 (1st Dep't 2008)).

[11] Id. at *8 (citing Gottlieb v. Northriver Trading Co. LLC, 872 N.Y.S.2d 46 (1st Dep't 2009)).

[12] Id. (citing JMM Props. LLC v. Erie Ins. Co., 5:08-CV-1382 (GTS/ATB), 2013 U.S. Dist. LEXIS 5080, at *17 (N.D.N.Y. 2013), aff'd 548 Fed. App'x 665 (2d Cir. 2013)).

[13] Id.

[14] Id. (citation omitted).

[15] Id. at *8-9.

[16] Id. at *9.

[17] Id. at *9-11.

[18] Id. at *2.

[19] Id. at *11.

[20] Id.

[21] Id. at *8.
