LLCL OVERHAUL PROJECT

REPORTS ON RECOMMENDATIONS FOR CHANGES TO PORTIONS OF THE NEW YORK LIMITED LIABILITY COMPANY LAW

AD HOC GROUP OF
BUSINESS LAW SECTION OF
NEW YORK STATE BAR ASSOCIATION

JANUARY 2019

Opinions expressed are those of the Committee preparing this report and do not represent those of the New York State Bar Association unless and until they have been adopted by its House of Delegates or Executive Committee. Opinions expressed further do not represent those of the Business Law Section until approved by the Section's Executive Committee.

Introduction

This booklet contains 16 short reports covering various sections of the New York Limited Liability Company Law [LLCL]. Each report identifies a statutory issue, describes the background and then suggests possible modification, amendment or enlargement of the particular LLCL section. The purpose of the reports is to initiate a wide dialogue by practitioners, business persons and academics about these areas and possibly other LLCL areas based upon their experiences with the LLCL and LLCs over the almost 25 since enactment of the LLCL. During this period, as word became known about the ease of formation, freedom of contract principles and flexibility of use, together with possible tax advantages and limited personal liability, LLCs have become the preferred form of business entity in New York and other jurisdictions. Our hope is that the dialogue will result in extensive recommendations to the State legislature for clarification and updating of the LLCL in order to enhance the use of LLCs in New York over the next decade.

The booklet is a product of what we call the "LLCL Overhaul Project," an ad hoc group within the Business Law Section of the NYS Bar Association. In the summer of 2017, we had prepared the material for the Section's email survey of its members asking them ten questions about the LLCL. The survey results were quite interesting and the accompanying comments were enlightening and pointed, compelling the next step of more comprehensive research and discussion of the issues, and then suggesting ways to deal with these issues. The survey result are Exhibit A to this booklet.

Our group consists of twelve attorneys who write, teach or work extensively with New York LLCs. Over a period of months the 10 survey issues grew to 16 topics. We assigned the topics among ourselves for preparation of initial reports that were presented for discussion before the group, and then sought to revise and conform them, resulting in this booklet.

In drafting the reports we looked at various articles and commentaries on LLCs, with an emphasis on New York, judicial decisions, recent updates in the LLC statutes of several other states, NCCUSL's Revised Uniform Limited Liability Company Act (2006) and the ABA Section of Business Law's Revised Prototype Limited Liability Company Act (2011). The reports should not be considered definitive expositions of the issues. We sought to provide information sufficient to gain an understanding of the issues and the reasons for the recommendations and conclusions. The positions taken in the reports are those of the members of the Project, and have not been reviewed by nor reflect the positions of the Business Law Committee or the NYSBA.

Over the course of our research and drafting we revised several of our initial recommendations. Also, some of the issues have alternative recommendations. This shows that the deeper one digs and the more voices heard from, many of the topics, and especially the possible recommended changes to the LLCL, are viewable from different points. Our goal is get a consensus on the issues. Further, the recommendations are subject to review from applicable state agencies, such as the Department of State, the Attorney General Charities Bureau, the Department of Education and the NYSBA.

We hope that many of the discussions, questions and recommendations in the reports encourage readers to send comments and changes, including dissenting views to us. One expectation is to use your input on the reports and other areas of concern under the LLCL to prepare an expanded version of this booklet. Another expectation is some will join the Project in its future steps.

A complete overhaul of the LLCL was beyond our scope. Also, an overhaul did not seem necessary as the New York statutory approach and the Department of State administration for LLCs function fairly well, subject perhaps to the issues we raised, and businesspersons and practitioners seem to have become accustomed to working under the statute.

The members of our Project group are:

Bruce A. Rich	Carter, Ledyard & Milburn LLP
Miriam R. Albert	Hofstra Law School
Terrence M. Bennett	Bennett & Samios LLP
Everett S. Carbajal	The Carbajal Law Firm, P.C.
Christine Sgarlata Chung	Albany Law School
Rachel B. Coan	Carter Ledyard & Milburn LLP
Nicholas G. Karambelas	Sfikas & Karambelas, LLP
Emma Lee	Thomson Reuters Corporation
Peter Mahler	Farrell Fritz LLP
Meredith R. Miller	Touro Law Center
Matthew J. Moisan	Moisan Legal P.C.
Thomas M. Pitegoff	LeClair Ryan PLLC

We welcome your comments and suggestions. Please send them to rich@clm.com.

TABLE OF CONTENTS

Page

Topic #1 – Operating Agreements 1
Topic #2 –Creation of Series LLCs 7
Topic #3 –Shelf Formations 19
Topic #4 –Publication 23
Topic #5 –Derivative Actions 34
Topic #6 –Designation of Type of Management/Authority to Bind an LLC 42
Topic #7 –Fiduciary Duties 46
Topic #8 –Piercing the LLC Veil 50
Topic #9 –Judicial Dissolutions of LLCs 54
Topic #10 –Activities Excluded from "Doing Business" for Foreign Qualification 60
Topic #11 –Profit Purpose 64
Topic #12 –Wage Claim Liability 65
Topic #13 –Charging Orders 71
Topic #14 –Professional Service LLCs 77
Topic #15 –Conversion of Other Business Entities into a NY LLC 85
Topic #16 –Waiver of Creditor Status of Members for Distributions 91

Exhibit A 2017 NYSBA Section of Business Law Survey of LLCL Issues

Topic #1 – Operating Agreements

Issues

(1) Should the mandatory word "shall" in New York Limited Liability Company Law ("LLCL") Section 417(a) be revised?

(2) Should LLCL Sections 102(u) and 417 be revised to allow for oral operating agreements?

(3) Should LLCL Sections 417 and 402(c)(3) be revised to require unanimous initial adoption of an operating agreement?

(4) Should LLCL Sections 417 and 402(c)(3) be revised to specify that, by default, amendments to the operating agreement require consent of all members and, where the operating agreement is in writing, by default, the amendment must be in writing?

(5) Should a provision be added to the LLCL to clarify that operating agreements are not subject to the statute of frauds?

Recommendations

(1) Yes. The only consequence of failing to adopt a written operating agreement is that, to the extent no other agreement of the parties addresses a specific issue, the default rules of the LLCL apply. Thus, the law does not actually require adoption of a written operating agreement (it is not actually a mandatory "shall" but, more appropriately a precatory "may" or "should"). The statute does not impose a penalty for failure to adopt a written operating agreement, and case law holds that there is no penalty for such failure. The courts have taken the optimal approach, it is just a mismatch with the mandatory language "shall."

(2) Yes. The LLCL should be amended to broadly define an "operating agreement" to include unwritten terms. This position is informed by two realities. First, many LLCs are formed without the benefit of counsel (often with "do-it-yourself" online sites) and the parties are not likely to adopt a written document or, if they do, to understand its import. They are, however, very likely to discuss and agree on certain basic terms (e.g., percentage of ownership, share of profits). Second, for those sophisticated LLCs with access to counsel – those most likely to have written operating agreements and understand their importance – they may use the operating agreement to contract for a writing requirement by using common contract provisions such as a no oral modification clause and a merger clause.

(3) Yes, LLCL Sections 417 and 402(c)(3) should be revised to clarify that *all* members must adopt the initial operating agreement.

(4) Yes, LLCL Sections 417 and 402(c)(3) should be revised to, by default, require *all* members to consent to amendments of the operating agreement. This is a much simpler default rule that is consistent with other states and would eliminate the need for Section 417(b). Further, to the extent there is concern that allowing oral operating agreements opens up the operating agreement

to arguments that it was orally amended, by default, where an operating agreement is in writing, the statute should require that it be amended in writing. This essentially makes a no oral modification clause the default rule where the parties have a written operating agreement and thereby eliminates much of the concern that recognizing oral operating agreements opens up writing agreements to “swearing matches.”

(5) Yes, to be consistent with the above-mentioned proposed changes, a provision be added to the LLCL to clarify that operating agreements are not subject to the statute of frauds.

Existing NY LLCL Operating Agreement Provisions

LLCL Section 417(a) provides:

> Subject to the provisions of this chapter, the members of a limited liability company *shall* adopt a written operating agreement that contains any provisions not inconsistent with law or its articles of organization relating to (i) the business of the limited liability company, (ii) the conduct of its affairs and (iii) the rights, powers, preferences, limitations or responsibilities of its members, managers, employees or agents, as the case may be.

(emphasis added).

LLCL Section 102(u) defines an “operating agreement” as “any written agreement of the members concerning the business of a limited liability company and the conduct of its affairs and complying with [Section 417].”

The LLCL defines “operating agreement” as a “written agreement” concerning the conduct of the LLC’s affairs, suggesting that any oral agreements about the LLC’s affairs are not an operating agreement or part of an operating agreement.

Concerning amendment of the operating agreement, LLCL Section 417(b) provides:

> The operating agreement of a limited liability company may be amended from time to time as provided therein; provided, however, that, except as otherwise provided in the operating agreement or the articles of organization, without the written consent of each member adversely affected thereby, (i) no amendment of the operating agreement or (ii) to the extent any provision concerning (A) the obligations of any member to make contributions, (B) the allocation for tax purposes of any items of income, gain, loss, deduction or credit, (C) the manner of computing the distributions of any member or (D) the compromise of an obligation of a member to make a contribution is contained in the articles of organization, no amendment of such provision in the articles of organization, shall be made that (i) increases the obligations of any member to make contributions, (ii) alters the allocation for tax purposes of any items of income, gain, loss, deduction or credit, (iii) alters the manner of computing the distributions of any member or (iv) allows the obligation of a member to make a contribution to be compromised by consent of less than all the members.

Other Jurisdictions Allow Oral Operating Agreements

Only a handful of other states define an LLC operating agreement as a written agreement. *See* Ark. Code Ann. Section 4-32-102(11); Alaska Stat. Section 10.50.990(15); Mich. Comp. Laws Ann. Section 450.4102(r)(same); New Mexico Stat. Ann. Section 53-19-2(O); Wis. Stat. Ann. Section 183.0102(16). Nevada's statute appears to contemplate a writing or other record by defining "operating agreement" as "any valid agreement of the members as to the affairs of a limited-liability company and the conduct of its business, *whether in any tangible or electronic format.*" Nev. Rev. Stat. Section 86.101 (emphasis added).

Most other states, including Delaware, allow for oral operating agreements. The Delaware statute defines "operating agreement" as "any agreement (whether referred to as a limited liability company agreement, operating agreement or otherwise), written, oral or implied, of the member or members as to the affairs of a limited liability company and the conduct of its business." Del. Gen. Corp. Law Section 18-101(7).

Similarly, the Revised Uniform Limited Liability Company Act ("RULLCA") Section 102(13) very broadly defines the operating agreement as the "agreement, whether or not referred to as an operating agreement and whether oral, in a record, implied, or in any combination thereof, of all the members of a limited liability company." This contemplates not only oral agreement, but that a number of separate documents or records could, together, constitute the operating agreement. Both RULLCA and Delaware also contemplate "implied in fact" agreements (i.e., those established based solely on the conduct of the parties).

Under RULLCA, to eliminate uncertainty about what exactly constitutes the operating agreement, the parties may include a provision in the agreement governing the "means and conditions for amending the operating agreement." RULLCA Section 110(a)(4). The comments to RULLCA state that this provision is intended to address the concern that "[o]ral and implied agreements invite memory problems and 'swearing matches.'" RULLCA Section 102 comments.

Effect of Failure to Adopt a Written Operating Agreement

In New York, where the members of the LLC have entirely failed to adopt a written operating agreement or have adopted a written agreement that does not address an issue in dispute, the courts have applied the default rules under the LLCL. *See Shapiro v. Ettenson,* 146 A.D.3d 650, 650 (1st Dep't 2017); *Doyle v. Icon, LLC,* 135 A.D.3d 642 (1st Dep't 2016); *Matter of Eight of Swords, LLC*, 96 A.D.3d 839, 839 (2d Dep't 2012); *Matter of 1545 Ocean Ave, LLC*, 72 A.D.3d 121, 129 (2d Dep't 2010); *Manitaras v. Beusman*, 56 A.D.3d 735, 736 (2d Dep't 2008); *Matter of Spires v. Lighthouse Solutions, LLC*, 4 Misc. 3d 428, 433 (Sup. Ct. Monroe Cty. 2004). Where an LLC member claims the parties had an oral agreement, or amended an existing agreement orally, courts have refused to consider the argument because the statute requires a writing. *See, e.g., Shapiro,* 146 A.D.3d at 650.

Manner of Adopting or Amending Operating Agreement

It should be noted that, while LLCL Section 417 requires "the members" to adopt a written operating agreement, LLCL Section 402(c)(3) states that the default vote required to "adopt, amend, restate or revoke" the operating agreement is a "vote of a majority in interest." Even though the language in Section 417 could be interpreted as requiring a unanimous vote of members, at least one court has held that, unless the operating agreement says otherwise, because of Section 402(c)(3), unanimity is not required to adopt or amend the operating agreement. *Shapiro,* 146 A.D.3d at 650.

Initial Adoption of Operating Agreement

If the statute is revised to contemplate oral operating agreements, a majority in interest is not an appropriate requirement for members to initially adopt an operating agreement, and probably is not the optimal rule even if the statute continues to require that operating agreements be in writing. The statute should be revised to clarify that initial adoption of the operating agreement requires a unanimous vote of all members. This would be consistent with RULLCA, which more clearly defines an operating agreement as an agreement "of all the members" of the LLC.

Further, LLCL Section 417(c) provides in part: "An operating agreement *may* be entered into before, at the time of or within ninety days after the filing of the articles of organization." (emphasis added). Given the precatory "may" (especially when combined with the mandatory "shall" in Section 417(a)), it is not clear what this provision implies for operating agreements adopted after ninety days from the filing of the articles of organization. This sentence should simply be changed to read: "An operating agreement may be entered into before, at the time of or ~~within ninety days~~ after the filing of the articles of organization." (emphasis added).

Amending an Operating Agreement

If the statute is revise to contemplate oral operating agreements, it becomes imperative to to clarify the default vote required to amend an operating agreement.

While the statute has been interpreted to allow amendment of the operating by a "majority in interest," LLCL Section 417(b)(i) prevents amendment of the operating agreement "without the written consent of each member adversely affected thereby." Further, LLCL Section 417(b)(ii) prevents amendment of certain provisions without unanimity. Rather than itemize which provisions require a unanimous vote of members, as a default rule, New York should simply require a unanimous vote of all members to amend an operating agreement. This would be consistent with Delaware, which provides a default requirement of a unanimous vote of all members to amend the operating agreement. Del. Gen. Corp. Law Section 18-302(f).

Further, to the extent LLCL Section 417(b)(i) requires "written consent" of adversely affected members to adopt an amendment, this rule would be inconsistent with permitting oral operating agreements. Instead, the default rule should simply be unanimous agreement of all members to change any provision of an operating agreement. If the members have a written operating agreement, the default rule should be that further amendments must be in writing (essentially a

default no oral modification clause). If the members do not have a written operating agreement, amendments may be made orally by unanimous consent (unless agreed otherwise).

Of course, members of a New York LLC are free to specify in their operating agreement the requirements to amend their agreement.

Statute of Frauds

The LLCL does not state whether, in requiring a written operating agreement, it intends for the statute of frauds to apply. It is noted that, as the law currently stands, the statute of frauds might apply if the LLC has a term exceeding one year. The default is a perpetual term, see LLCL Sectin 203(e)(3).However, it may not come within the statute of frauds if it is terminable at-will within a year. Moreover, even if the agreement comes within in the statute of frauds, the article of organization constitute a writing that may serve to satisfy the statute of frauds. *See* Daniel S. Kleinberger, *Like Great Britain, a Limited Liability Company May Have an Unwritten Constitution*, https://www.americanbar.org/groups/business_law/publications/blt/2017/09/ulc.html.

To eliminate this confusion, a provision should be added to the LLCL specifying that the statute of frauds does not apply to LLC operating agreements. For example, the Illinois LLC statute (805 ILCS 180/1-46) provides:

> Applicability of statute of frauds. An operating agreement is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought, even if the agreement is not capable of performance within one year of its making.

As an alternative, Florida specifies that the operating agreement is not subject to the statute of frauds, but does require that a promise by a person to contribute to the LLC be in writing. Florida Revised Limited Liability Company Act Sections 605.0106 and 605.0403.

Conclusion

The benefit of requiring a written operating agreement is more certainty about what the parties have agreed and avoidance of "memory problems" and "swearing matches." However, a drawback is that adherence to a writing requirement could, in a given situation, serve to substantially frustrate the reasonable expectations of the parties.

New York should follow Delaware, RULLCA and the majority of other jurisdictions that allow the operating agreement to include unwritten terms. This approach potentially prevents frustration of the reasonable expectations of members of an LLC that operates more informally and has not adopted a written agreement. It also allows those LLCs that adopt written agreements to opt in to the certainty that a writing provides, and to use that writing to preclude oral amendment.

Of course, best practice is that the members of the LLC adopt an operating agreement in writing

and specify how that agreement may be amended. However, the statute needs to reflect the practical reality that, all too often, LLC members do not adopt a written operating agreement.

For these reasons, New York should adopt the approach taken by RULLCA. To the extent that there may be concern about members making claims that their written agreement had been amended orally, the default rule in the revised statute could provide that, where there is a written operating agreement that addresses a specific issue, the written agreement may only be amended by a further writing. In addition, an LLC with a writing operating agreement may, by the agreement's terms, prevent oral modification. *See* NY General Obligations Law Section 15-301. Further, to address these concerns, default voting rules for adoption and amendment of the operating agreement should require a unanimous vote of members.

Topic #2 – Creation of Series LLCs

Background

The concept of the "Series LLC" or "Protected Series LLC" in which a limited liability company ("LLC") is formed contemplating multiple series with separate members, managers, LLC interests or assets, has gained popularity in recent years, with 13 states and two U.S. territories[1] authorizing such entities. New York's Limited Liability Company Law ("LLCL") does not currently authorize the creation of series LLCs. Persons desiring to establish a family of LLCs in New York with separate assets and liabilities with a single or related objectives must, therefore, organize separate LLCs with the attendant duplicative costs of making filings with the Department of State and satisfying the State's publication requirement.

Issue

Should the LLCL be amended to permit the creation of Series LLCs?

Recommendation

The LLCL should be amended to expressly authorize the organization of Series LLCs, borrowing certain provisions from the limited liability company laws of other states to permit the greater flexibility and efficiencies that they offer to businesses and to make New York a more hospitable jurisdiction in which to conduct business for Series LLCs formed in other states.

DISCUSSION

Existing LLCL and Concept of Series LLCs

Under current LLCL Section 418, persons desiring to form a LLC may do so establishing different classes of members having different rights, powers, preferences and limitations as set forth in the company's operating agreement. These differences may include different voting rights, based on capital accounts, capital contributions or other criteria. However, members of the different classes of the LLC would all share in the assets, liabilities, obligations and expenses of the company over all, would be subject to the same management and would have a common business purpose or investment objective.

By contrast, in the states and territories that permit the creation of Series LLCs, members of a particular series may not only have different voting rights and other powers within the

[1] As of May 11, 2016, according to the National Conference of Commissioners on Uniform State Laws in its Draft Uniform Protected Series Act prepared in June 2017 for its meeting July 14-20, 2017, the following states and territories provided for protected series within a LLC: Alabama (Ala. Code §§ 10-A-5A-11.01-.16 (2015)); Delaware (Del. Code Ann., tit. 6, § 18-215 (West 2015)); the District of Columbia (D.C. Code § 29-802.06 (2015)); Illinois (805 Ill. Comp. Stat. Ann. 180/37-40 (West 2014)); Indiana (2016 Ind. Legis. Serv. P.L. 170-2016 (H.E.A. 1336) (West)); Iowa (Iowa Code Ann. §§ 489.1201-12-6); Kansas (Kan. Stat. Ann. § 17-76,143 (West 2014)); Missouri (Mo. Rev. Stat. § 347-186.1 (2014)); Montana (Montana Code Ann. § 35-8-304 (West 2013)); Nevada (Nev. Rev. Stat. Ann. § 86.296 (West 2014)); Oklahoma (Okla. Stat. Ann., tit. 18, §§ 2005(B), 2054.4 (West 2014); Tennessee (Tenn. Code § 48-249-309 (West 2014)); Texas (Tex. Bus. Orgs. Code Ann. §§ 101.601-622 (West 2013)); Utah (Utah Code Ann. § 48-3a-1201-1209 (West 2014)); and Puerto Rico (P.R. Laws Ann., tit. 14, § 3967 (2011)).

series, but a separate manager, separate assets and separate liabilities from those of each other series and the LLC as a whole. The profits and losses of any series may be allocated only to the members associated with that series, and not to members of other series or to the LLC itself. Each series in a Series LLC can be empowered to, in its own name, enter into contracts, hold title to assets, grant security interests, sue and be sued, and otherwise conduct business and exercise the powers of a LLC under the relevant Series LLC act. Different series may be granted different rights and priorities with respect to the receipt of distributions, and classes within a series may also have different rights as to distributions. The flexibility afforded by the LLC structure is therefore potentially expanded in the Series LLC to give a member of a designated series the greater protection of being a member of a "company within a company" in which not only is that member personally insulated from liability for the obligations of the LLC, but such member's interest in the assets of the specified series is shielded from the claims of creditors of other series as well as claims of creditors of the LLC itself.

The concept of the Series LLC has been accepted for a number of years, having been developed to facilitate the formation of offshore mutual funds and captive insurance companies in locations such as the Cayman Islands, the British Virgin Islands, Bermuda, Guernsey and Mauritius.[2] In 1996, Delaware became the first state to enact a Series LLC act, but rather than creating a stand-alone statute, Delaware added the Series LLC provision, 6 Del. Code Ann. § 18-215, to the Delaware Limited Liability Company Act (the "Delaware Series LLC Act"). The other states that have authorized the creation of Series LLCs have largely followed this pattern or simply inserted additional series-related provisions into the existing text of their LLC laws. Since their adoption in the various U.S. jurisdictions, Series LLCs have been used predominantly for the establishment of investment funds, mutual funds and real estate companies. While it is hard to find any precise figures as to the numbers of Series LLCs organized to date, a Practical Law article from 2012 states: "In Delaware, the number of Series LLCs formed each year has grown from 725 in 2008 to 2,087 in 2011." [3] The National Conference of Commissioners on Uniform State Laws, in its draft of a Uniform Protected Series Act published in July 2017, states that: "As of January 26, 2016, more than 26,000 protective series were active under Illinois law."[4]

This memorandum addresses certain significant features of Series LLC laws in Delaware, Illinois, Texas and other jurisdictions, but does not attempt to cover all the relevant statutes or every legal issue associated with Series LLCs. It tries to compare and contrast some of these laws, to identify those that more thoroughly consider the numerous questions raised by the Series LLC structure, and to make recommendations for New York based on this analysis.

As with LLCs generally, the Series LLC provisions in the relevant state statutes qualify almost all of the requirements by the phrase "unless the operating agreement provides otherwise," thereby preserving the fundamental freedom of contract built into the LLC structure. Thus, the Series LLC statutes typically provide that the company will be presumed to be

---

[2] Gattuso, Dominick T., "Series LLCs: Let's Give the Frog a Little Love," *Business Law Today*, Vol. 17, No. 6 (July-Aug. 2008).
[3] Hering, L.G. and Russell, R.J., "Series LLCs", *Practical Law*, Vol. 4, Issue 3 (April 2012).
[4] National Conference of Commissioners on Uniform State Laws, Draft Uniform Protected Series Act (2017), Prefatory Note, p. 3 (authority not provided).

managed by its members, as will each series,[5] with the Delaware Series LLC Act adding the presumption that this means "in proportion to the then current percentage or other interest of members in the profits of the series owned by all of the members associated with each series, the decision of members owning more than 50 percent of the said percentage or other interest in the profits controlling; . . ."[6] but that the operating agreement may establish "classes or groups of members or managers associated with a series having such relative rights, powers and duties as the limited liability company agreement may provide,"[7] including the authority to "make provision for the future creation . . . of additional classes or groups of members or managers associated with the series . . . including rights, powers and duties senior to existing classes and groups of members or manager associated with the series."[8] Such power extends to action by the Series LLC to create "a class or group of the series of limited liability company interests that was not previously outstanding."[9]

In the jurisdictions that authorize the formation of Series LLCs, any one or more series may generally be terminated without causing the dissolution of the LLC.[10] Furthermore, some statutes also provide that an event that causes a member to cease to be associated with a series will not, in itself, cause the member to cease to be associated with any other series or terminate the member's interest in the LLC, and will not cause the termination of the series, even if the member was the last remaining member associated with the series.[11]

Limitation on Liability

In order for the Series LLC to achieve legal segregation among the series and between each series and the LLC, and to ensure that the liabilities of one series are limited to the assets of that series, the Series LLC statutes generally impose certain requirements on the company at the time of its formation. These requirements usually demand (i) the inclusion of language in the articles of organization (or comparable charter document) limiting the liabilities of each series solely to assets of that series; (ii) that the limited liability company agreement must specifically authorize the creation of one or more series; and (iii) that the operating agreement provide for the maintenance of records for each series and the assets associated therewith so that these assets are accounted for separately from the assets of each other series and from those of the company.

The record-keeping requirement is critical to the separation of the series both to provide for the smooth operation of the Series LLC generally and in a situation where the LLC or one or more series become insolvent. While there is not much case law addressing Series LLCs, most of the actions brought to date involve claims of creditors seeking to attach assets of one or more solvent series or the LLC itself when those of the subject series were insufficient.[12]

---

[5] *See, e.g.*, Del. Code Ann., tit. 6, § 18-215(g) (West 2015).
[6] Ibid.
[7] Del. Code Ann., tit. 6, § 18-215(e) (West 2015).
[8] Ibid; s*ee also, e.g.,* Tex. Bus. Orgs. Code Ann., § 101.607(2) (West 2013).
[9] Ibid.; *see also*, Tex. Bus. Orgs. Code Ann. § 101.607(a) and (b) (West 2013); 805 Ill. Comp. Stat. Ann. 180/37-40(g) (West 2014).
[10] *See, e.g.*, 805 Ill. Comp. Stat. Ann. 180/37-40(m) (West 2014); Del. Code Ann., tit. 6, § 18-215(k) (West 2015).
[11] *See, e.g.*, 805 Ill. Comp. Stat. Ann. 180/37-40(l) (West 2014); Kan. Stat. Ann. § 76,143(l) (West 2014); Del. Code Ann., tit. 6, § 18-215(j) (West 2015).
[12] Whether a single series can file a bankruptcy petition independent of the Series LLC or whether the company can

However, the statutory language differs among the various jurisdictions as to what will satisfy this recordkeeping requirement. In Texas, for example, the assets of any series must be

> . . . reasonably identified by specific listing, category, type, quantity or computational or allocational formula or procedure, including a percentage or share of any assets, or by any other method in which the identity of the assets can be objectively determined . . . .[13]

The text of the Delaware Series LLC Act is virtually identical.[14] By contrast, the operative Series LLC provisions in Illinois, the District of Columbia, Nevada, Kansas and Iowa do not include the "reasonably identified by specific listing . . ." or "objectively determined" criteria but require that "separate and distinct" records be maintained for any such series and ". . . the assets associated with any such series [must be] held. . . and accounted for separately from the other assets of the limited liability company or any series thereof."[15]

Separate Names for Each Series and Filing of Certificates of Designation

The Series LLC laws also differ regarding the naming of individual series and whether, in order to create a series, the company's articles of organization, LLC agreement or another document must be filed with the Secretary of State (or comparable official) identifying the series and/or enumerating specific rights of that series. For example, the Illinois and Kansas statutes require that to establish a new series, the Series LLC must file with the Secretary of State a certificate of designation (in Illinois, a single page, pre-printed form) setting forth the name of such series.[16] In these two states and Iowa, the name of any individual series with limited liability must commence with the entire name of the limited liability company, as set forth in its articles of organization, and be distinguishable from the names of the other series set forth in the articles of organization.[17] In addition, to secure the limitation on liability for a particular series, Illinois and Kansas require that the certificate of designation must contain the name and address of the manager of the series or the managing member of the series (in each case, if different from the manager or managing member of the LLC).[18]

The District of Columbia's Series LLC law similarly requires that for the creation of a new series and to obtain recognition of the limitation on liability of a series, the company must

---

file independently of any one or more series appears to be an open question. *See generally*, M. Harner, J. Ivey-Crickenberger, T. Kim, "What Happens When One Series Fails? Key Considerations and Issues," *Business Law Today* (Feb. 2013). The Series LLC statutes that permit recognition of the separate entity status of a series and require each series to have a separate name, as described below, would appear to contemplate the ability of an individual series to file for bankruptcy relief on its own behalf.

[13] Tex. Bus. Orgs. Code Ann., § 101.603(b) (West 2013).

[14] Del. Code Ann.§ 18-215(b) (West 2015).

[15] 805 Ill. Comp. Stat. Ann. 180/37-40(b) (West 2014); D.C. Code § 29-802.06(b)(i) (2015); Nevada Rev. Stat. Ann. § 86.296. 3(a) (West 2014).

[16] 805 Ill. Comp. Stat. Ann. 180/37-40(b) (West 2014); Kan. Stat. Ann. § 17-76,143(c) (West 2014).

[17] 805 Ill. Comp. Stat. Ann. 180/37-40(c) (West 2013); Kan. Stat. Ann. § 17-76,143(c) (West 2014); Iowa Code Ann. § 489.1201.1 (West 2014).

[18] 805 Ill. Comp. Stat. Ann. 180/37-40(d) (West 2014); Kan. Stat. Ann. § 17-76, 143(d) (West 2014). In Illinois, a certificate of designation (LLC 37.40) would also need to be filed upon a change of name for a series, the termination of a series or a change in the name or address of the manager.

deliver to the Mayor for filing "a certificate of series designation … for each series so designated whose debts, obligations and other liabilities are limited under this subsection."[19] The certificate of designation needs to include the name of the relevant series, which must be different from the name of each other series and contain the entire name of the limited liability company.[20]

Nevada's Series LLC law contains a variation on this concept; it does not expressly require the filing of a certificate of designation for establishment of a series but specifies that:

> (e) if the company is to have one or more series of members and the debts or liabilities of any series are to be enforceable against the assets of that series only and not against the assets of another series or the company generally, [the articles of organization must set forth] a statement to that effect and a statement:
>
> (1) Setting forth the relative rights, powers and duties of the series; or
>
> (2) Indicating that the relative rights, powers and duties of the series will be set forth in the operating agreement or established as provided in the operating agreement . . . .[21]

The requirement that the rights, powers and duties of a series must be spelled out in the articles or the operating agreement "or specified by one or more members or managers or other persons as provided in the articles of organization or operating agreement" is further emphasized in the Nevada statute's definition of "Series" and "series of members."[22] Neither the Delaware nor Texas Series LLC acts incorporate requirements for the distinct naming or the filing of a certificate of designation for creation of a new series.

In our view, the absence of such requirements is bound to lead to confusion for third parties dealing with the LLC or any one or more series. We therefore believe that if the New York LLCL were amended to authorize the formation of Series LLCs, the law should incorporate a filing requirement and a separate series naming requirement, and without any publication requirement for each additional series, see Topic 4-Publication.

Legal Entity Status for Series; Separate Tax Status; Interstate Recognition

Illinois and certain other states appear to have gone further in spelling out requirements for Series LLCs and anticipating related issues than most other jurisdictions in several other respects, in particular, interstate recognition, separate entity status and tax treatment. First, the Illinois statute addresses the question of qualification to do business in the state of any one or more series of a non-domiciliary Series LLC and the steps required for recognition of the limitation on liabilities of any such series from those of other series or those of the relevant

[19] D.C. Code Ann. § 29-802.06(b)(4) and (e) (2015).
[20] D.C. Code Ann. § 29-802.06(d) (2015).
[21] Nev. Rev. Stat. Ann., § 86.161(e) (West 2014).
[22] Nev. Rev. Stat. Ann., § 86.1255 (West 2014).

Series LLC. Thus, as with a series of an Illinois Series LLC, the series of a non-Illinois Series LLC seeking qualification must include in its application a statement regarding the limitation on liability of the series *and* a certificate of designation identifying such series.[23] The Illinois statute also specifies that registration by one or more series of an Illinois Series LLC to do business in another jurisdiction shall be governed by the laws of that jurisdiction.[24]

Illinois is also in the minority of jurisdictions that confront the potential issues for Series LLCs as to the separate entity status and tax treatment of individual series, as well as the impact of tax consolidation between a series and the LLC on the limitation on liability of the series. Under the Illinois law, "[a] series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization."[25] The D.C. Series LLC law contains a similar provision,[26] as do the Series LLC acts of Kansas and Iowa,[27] but none of the Series LLC laws of Delaware, Texas, Nevada or most of the other states with Series LLC acts include such a term.[28] Consistent with Illinois' willingness to treat a series as a separate legal entity, its Series LLC act seems to permit a series to claim that its tax status should also be separate from that of the LLC. The statute states:

> The limited liability company and any of its series may elect to consolidate their operations as a single taxpayer to the extent permitted under applicable law, elect to work cooperatively, elect to contract jointly or elect to be treated as a single business for purposes of qualification to do business in this or any other state. Such elections shall not affect the limitation of liability set forth in this Section except to the extent that the series have specifically accepted joint liability by contract.[29]

The IRS does not officially recognize a series within a Series LLC as a separate taxpayer. But in its January 2008 private letter ruling (P.L.R. 2008 WL 163064 (Jan. 18, 2008)), the IRS ruled that Series LLCs would be treated as separate taxable entities based on the similar treatment of series trusts. Furthermore, in its proposed regulations issued in 2010, the IRS indicated that if the law of the jurisdiction of organization of a Series LLC recognizes a series as an independent juridical entity, then such series may be treated as a separate entity for federal tax purposes.[30]

Thus, in the handful of states whose Series LLC laws expressly permit a Series LLC to elect, in its articles of organization, to treat each series as a separate entity, the tax status of an

---

[23] 805 Ill. Comp. Stat. Ann. 180/37-40(o) (West 2014); *see also*, Kan. Stat. Ann. § 76,143(o) (West 2014).
[24] 805 Ill. Comp. Stat. Ann. 180/37-40(n) (West 2014); *see also*, , Kan. Stat. Ann. § 76,143(n) (West 2014).
[25] 805 Ill. Comp. Stat. Ann. 180/37-40(b) (West 2014).
[26] D.C. Code Ann. § 29-802.06(h) (2015).
[27] Kan. Stat. Ann. § 76,143(b) (West 2014); 489 Iowa Code Ann. § 489.1201(3) (West 2014).
[28] Indeed, in *GxG Management LLC v. Young Bros. and Co., Inc.,* 2007 WL 551761, *7-8 (D. Me. Feb. 21, 2007), involving a tort and contract dispute between a Delaware Series LLC and a third party, the court noted the absence of such language in the Delaware statute. The court stated that the "unique relationship between a Delaware LLC and its series does not create a truly separate legal entity capable of independently pursuing its own legal claims … but merely [creates] a 'series of interest' maintained by the LLC …." Cited in Gattuso, *supra*., note 2.
[29] 85 Ill. Comp. Stat. Ann. § 180/37-40(b); *see also*, 17 Kan. Stat. Ann. § 76,143(b) (West 2014).
[30] Proposed Reg § 30.7701-1; 75 Fed. Reg. 55,699 (2010).

individual series should be more transparent and easier to determine than in other jurisdictions authorizing the creation of Series LLCs, assuming the proper steps have been taken to establish the limitations on liability of each series. Such laws also align more closely with the IRS's position, which should generally benefit members of a series and the relevant Series LLC. We recommend that any amendments to the New York LLCL to permit creation of Series LLCs incorporate such a "separate entity" provision.

Uniform Protected Series Act

In its 2015, 2016 and 2017 annual meetings, the National Conference of Commissioners on Uniform State Laws considered the proposed form of a draft Uniform Limited Liability Company Protected Series Act (hereafter, the "UPSA"). In the prefatory note to the draft published in 2017, the drafting committee stated, "In comparison with existing statutes, this act provides far greater transparency to the public and far greater clarity as to the myriad legal questions raised by the protected series concept.[31]

The note then sets forth a chart identifying 21 key issues related to series LLCs that the draft act expressly addresses, as compared with the existing Series LLC statutes of Delaware, Illinois and Texas. Of the 21 issues so identified, according to the chart, the Illinois law deals with six, the Delaware law deals with one and the Texas law deals with three.

The draft UPSA attempts to more clearly and completely confront a number of questions related to the segregation and insulation of assets of each series from those of other series and those of the LLC and to more specifically define the rights of members of each series with the goals of "protect[ing] the public in general and creditors in particular,"[32] as well as "provid[ing] certainty".[33]

The draft contains numerous thoughtful provisions that, if adopted, would indeed create clearer and stronger guidelines for the formation, operations and dissolution of Series LLCs, including the rights of members of a particular series vis-à-vis members of other series, the manager(s) of the series, the company and potential transferees of an interest in a series, as well as creditors. The draft UPSA would also impose restrictions on transactions between a series and the company and afford members and managers greater access to information regarding the protected series with which they are, or were, associated. It would dramatically raise the bar for Series LLCs by more definitively addressing various issues on which state law is now silent and represents a major advance from current law.

However, the prefatory note, as well as the commentary by the drafters on the various provisions of the UPSA, is sometimes highly technical and theoretical, and the proposed UPSA itself is lengthy and detailed. We are concerned that New York legislators could find it daunting and, rather than taking the time to weigh and analyze its terms to evaluate those that might, at least in the short run, best provide a framework for a new Series LLC law in the state, simply reject it out of hand as being too complicated.

---

[31] National Conference of Commissioners on Uniform State Laws, Draft Uniform Protected Series Act (2017), Prefatory Note, p. 11.
[32] *Ibid.*, at p. 5.
[33] *Ibid.*, see chart on at pp. 11-17.

Conclusion

Accordingly, while the Illinois Series LLC act is not ideal and does not address a number of questions relating to Series LLCs, we recommend that New York adopt a similar law since, to date, the Illinois statute incorporates more of the concepts sought to be addressed by the draft UPSA than the law of any other state. Specifically, while more onerous than the Series LLC statutes in Delaware and Texas, its provisions (i) requiring the separate and distinct naming of each series; (ii) requiring the public filing of a separate certificate of designation to give effect to each series; (iii) authorizing the grant of separate legal entity status of a series (if provided for in the operating agreement); and (iv) providing for recognition of series of a non-Illinois Series LLC seeking qualification to do business in the state and establishing the law of the foreign state as the law controlling qualification of a series of an Illinois LLC, furnish much greater clarity and transparency than those of Delaware, Texas or most of the other jurisdictions with Series LLC laws. Adoption by New York of the Illinois model would appear to strike a compromise between the open-ended and ambiguous statutes of Delaware and Texas and the stricter and more far-reaching but more complex draft UPSA, while still assuring greater protection to members and managers of the LLC and each series, as well as the public and potential creditors. We believe it could offer a practical and economical solution to the question of how to implement a Series LLC statute. A New York Series LLC act based on the Illinois model could be expanded in time to include some or all of the additional provisions contained in the UPSA as New York gains more experience with Series LLCs and identifies particular issues requiring more specific statutory guidance. In the interim, it would grant increased flexibility over the existing LLC Act to persons desiring to establish several related business units within a single but compartmentalized and legally segregated structure while imposing reasonable public notice and record-keeping directives to minimize confusion, disputes and abuse. Amending the LLCL to authorize the creation of Series LLCs would also make New York more competitive with Delaware for persons desiring or considering establishment of a new business and would make it a more hospitable state in which Series LLCs organized in other jurisdictions could operate by providing for the recognition of these entities and establishing rules for their operation.

A copy of the Illinois Series LLC Act is attached for reference.

Finally, we believe that by enacting a more fulsome Series LLC act rather than a "bare bones" model such as the Delaware statute, the New York State legislature would be taking a position consistent with that taken in several different statutes adopted or amended in the past few years in which New York has sought to set a new standard for thoroughness and transparency. For example, in its 2013 revisions to the Not-For-Profit Corporation Act, New York both simplified the administrative burdens on NFP organizations and tightened the corporate governance standards for boards of directors and managers to increase accountability and implement best practices. Similarly, in the new cybersecurity regulations of the New York Department of Financial Services that became effective in March 2017, New York implemented a far-reaching set of requirements that put it in the vanguard of states addressing the issues of cybersecurity and protection of private data by businesses in the financial services industry and their counterparts.

Exhibit to Topic #2

ILLINOIS LIMITED LIABILITY COMPANY ACT

SECTION 180/37-40. Series of members, managers or limited liability company interests.

(805 ILCS 180/37-40)

Sec. 37-40. Series of members, managers or limited liability company interests.

(a) An operating agreement may establish or provide for the establishment of designated series of members, managers or limited liability company interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and to the extent provided in the operating agreement, any such series may have a separate business purpose or investment objective.

(b) Notwithstanding anything to the contrary set forth in this Section or under other applicable law, in the event that an operating agreement creates one or more series, and if separate and distinct records are maintained for any such series and the assets associated with any such series are held (directly or indirectly, including through a nominee or otherwise) and accounted for separately from the other assets of the limited liability company, or any other series thereof, and if the operating agreement so provides, and notice of the limitation on liabilities of a series as referenced in this subsection is set forth in the articles of organization of the limited liability company and if the limited liability company has filed a certificate of designation for each series which is to have limited liability under this Section, then the debts, liabilities and obligations incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof, and unless otherwise provided in the operating agreement, none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability company generally or any other series thereof shall be enforceable against the assets of such series. The fact that the articles of organization contain the foregoing notice of the limitation on liabilities of a series and a certificate of designation for a series is on file in the Office of the Secretary of State shall constitute notice of such limitation on liabilities of a series. A series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization. Each series with limited liability may, in its own name, contract, hold title to assets, grant security interests, sue and be sued and otherwise conduct business and exercise the powers of a limited liability company under this Act. The limited liability company and any of its series may elect to consolidate their operations as a single taxpayer to the extent permitted under applicable law, elect to work cooperatively, elect to contract jointly or elect to be treated as a single business for purposes of qualification to do business in this or any other state. Such elections shall not affect the limitation of liability set forth in this Section except to the extent that the series have specifically accepted joint liability by contract.

(c) Except in the case of a foreign limited liability company that has adopted an assumed name pursuant to Section 45-15, the name of the series with limited liability must commence with the entire name of the limited liability company, as set forth in its articles of organization,

and be distinguishable from the names of the other series set forth in the articles of organization. In the case of a foreign limited liability company that has adopted an assumed name pursuant to Section 45-15, the name of the series with limited liability must commence with the entire name, as set forth in the foreign limited liability company's assumed name application, under which the foreign limited liability company has been admitted to transact business in this State.

(d) Upon the filing of the certificate of designation with the Secretary of State setting forth the name of each series with limited liability, the series' existence shall begin, and each of the duplicate copies stamped "Filed" and marked with the filing date shall be conclusive evidence, except as against the State, that all conditions precedent required to be performed have been complied with and that the series has been or shall be legally organized and formed under this Act. If different from the limited liability company, the certificate of designation for each series shall list the name and business address of all of the managers and any member having the authority of a manager. The name of a series with limited liability under subsection (b) of this Section may be changed by filing with the Secretary of State a certificate of designation identifying the series whose name is being changed and the new name of such series. If not the same as the limited liability company, the name and business address of all of the managers and any member having the authority of a manager may be changed by filing a new certificate of designation with the Secretary of State. A series with limited liability under subsection (b) of this Section may be dissolved by filing with the Secretary of State a certificate of designation identifying the series being dissolved or by the dissolution of the limited liability company as provided in subsection (m) of this Section. Certificates of designation may be executed by the limited liability company or any manager, person or entity designated in the operating agreement for the limited liability company.

(e) A series of a limited liability company will be deemed to be in good standing as long as the limited liability company is in good standing.

(f) The registered agent and registered office for the limited liability company in Illinois shall serve as the agent and office for service of process in Illinois for each series.

(g) An operating agreement may provide for classes or groups of members or managers associated with a series having such relative rights, powers and duties as the operating agreement may provide, and may make provision for the future creation of additional classes or groups of members or managers associated with the series having such relative rights, powers and duties as may from time to time be established, including rights, powers and duties senior to existing classes and groups of members or managers associated with the series.

(h) A series may be managed by either the member or members associated with the series or by a manager or managers chosen by the members of such series, as provided in the operating agreement. Unless otherwise provided in an operating agreement, the management of a series shall be vested in the members associated with such series.

(i) An operating agreement may grant to all or certain identified members or managers or a specified class or group of the members or managers associated with a series the right to vote separately or with all or any class or group of the members or managers associated with the series, on any matter. An operating agreement may provide that any member or class or group of members associated with a series shall have no voting rights.

(j) Except to the extent modified in this Section, the provisions of this Act which are

generally applicable to limited liability companies, their managers, members and transferees shall be applicable to each particular series with respect to the operation of such series.

(k) Except as otherwise provided in an operating agreement, any event under this Act or in an operating agreement that causes a manager to cease to be a manager with respect to a series shall not, in itself, cause such manager to cease to be a manager of the limited liability company or with respect to any other series thereof.

(l) Except as otherwise provided in an operating agreement, any event under this Act or an operating agreement that causes a member to cease to be associated with a series shall not, in itself, cause such member to cease to be associated with any other series or terminate the continued membership of a member in the limited liability company or cause the termination of the series, regardless of whether such member was the last remaining member associated with such series.

(m) Except to the extent otherwise provided in the operating agreement, a series may be dissolved and its affairs wound up without causing the dissolution of the limited liability company. The dissolution of a series established in accordance with subsection (b) of this Section shall not affect the limitation on liabilities of such series provided by subsection (b) of this Section. A series is terminated and its affairs shall be wound up upon the dissolution of the limited liability company under Article 35 of this Act.

(n) If a limited liability company with the ability to establish series does not register to do business in a foreign jurisdiction for itself and certain of its series, a series of a limited liability company may itself register to do business as a limited liability company in the foreign jurisdiction in accordance with the laws of the foreign jurisdiction.

(o) If a foreign limited liability company, as permitted in the jurisdiction of its organization, has established a series having separate rights, powers or duties and has limited the liabilities of such series so that the debts, liabilities and obligations incurred, contracted for or otherwise existing with respect to a particular series are enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof, or so that the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability company generally or any other series thereof are not enforceable against the assets of such series, then the limited liability company, on behalf of itself or any of its series, or any of its series on their own behalf may register to do business in the State in accordance with Section 45-5 of this Act. The limitation of liability shall be so stated on the application for admission as a foreign limited liability company and a certificate of designation shall be filed for each series being registered to do business in the State by the limited liability company. Unless otherwise provided in the operating agreement, the debts, liabilities and obligations incurred, contracted for or otherwise existing with respect to a particular series of such a foreign limited liability company shall be enforceable against the assets of such series only, and not against the assets of the foreign limited liability company generally or any other series thereof and none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to such a foreign limited liability company generally or any other series thereof shall be enforceable against the assets of such series.

(Source: P.A. 98-720, eff. 7-16-14; 99-608, eff. 7-22-16; 99-637, eff. 7-1-17.)

Topic #3 – Shelf Formations

Issues

(1) Should "Shelf LLCs" be subject to special formation requirements under the New York Limited Liability Company Law ("LLCL")?
(2) Should LLCL Section 203(c), which requires a limited liability company ("LLC") to have at least one member at time of formation, be repealed because it raises unwarranted confusion with other sections governing LLC formation in New York and is not observed in practice?

Recommendations

(1) No. The ease and almost instantaneous formation of LLCs in New York has basically terminated the need for practitioners to form and inventory Shelf LLCs in New York. Further, the procedures adopted under the Revised Uniform Limited Liability Company Act ("RULLCA") and states, such as Florida, to regulate formation of Shelf LLCs have created cumbersome additional filing requirements and could cause significant problems with their users if the requirements are not strictly observed.

(2) Yes. LLCL Section 203(c) is unnecessary as Section 203(d) provides that an LLC is formed when its initial articles of organization are filed with the Department of State, or a later date within 60 days of the filing as specified in the articles of organization, and Section 602 outlines when members are first admitted to an LLC. The interplay of these Sections, and subject to any applicable provisions in the operating agreement, regulate LLC formation in New York. Moreover, Section 203(c) is silent as to the consequences on an LLC in the event there is no member upon its formation. It is assumed that a substantial number of LLCs did not have a formal member at the time their articles of organization were filed.

Shelf LLCs

A Shelf LLC is an LLC formed without having at least one member at the time of formation. LLCL Section 203[c] provides that "[A]t the time of its formation, a limited liability company must have at least one member."

We are not aware of any study showing the degree of compliance with Section 203(c). Our guess is that many regular domestic LLCs do not have a formal member at time of formation, but subsequently admit their initial members and treat the admission *ab initio* in accordance with LLCL Section 403. It is noted that professional service LLCs covered by LLCL Article XII would by definition have at least one member at time of formation. Further, although there is no statutory consequence to an LLC if it does not have at least one member at time of formation, an LLC without members could be cause for dissolution under Section 701(a)(4). Thus, notwithstanding Section 203(c), many newly formed LLCs could be characterized as Shelf LLCs for whatever short periods until there is a record of a formal member.

Years ago there were concerns about use of “shelf or shell corporations” as the vehicle for transactions with questionable bona fides through backdating of business events or seeking to memorialize events that may not have then occurred. Another reason for “shelf corporations” was certain formalities had been required for formation as well as time delays in completing the filing process. That type of corporation probably comprised a very small fraction of the active corporations. In addition, sometimes a business entity was formed for a specific transaction and upon the transaction not going forward, the entity would go on the “shelf” for use in a future transaction, with a saving in cost and time upon the occurrence of the subsequent transaction.

The BCL does not prevent or regulate a New York corporation from becoming or being used as a “shelf corporation.” A domestic corporation’s existence begins upon the filing of its certificate of incorporation by the Department of State, which can be delayed up to 90 days. [BCL Section 403] After the corporate existence has begun, the incorporator would hold the organization meeting to elect directors and adopt by-laws, and then the board of directors would, among other things, authorize the issuance of securities to persons who would become shareholders. [BCL Section 404]

RULLCA Section 201 and some state LLC statutes, such as Florida Section 605.0201(4), seek to restrict LLCs from being “Shelf LLCs” by requiring an LLC being formed without members to state in its certificate of formation, and then obtaining members within the prescribed time period and filing a notice with the state setting forth that the LLC has at least one member and the date on person(s) became the initial member(s); otherwise the certificate of formation lapses at the end of the prescribed time period. [RULLCA Section 201(e)] The lapsing of the certificate of formation at the end of the time period could be a substantial trap for LLCs that for whatever reason were unable to designate a member and unwittingly lost their statutory existence.

The first draftsmen’s comment to RULLCA Section 201 expresses that “no topic received more attention or generated more debate in the drafting process for this Act than the question of “shelf LLC”- i.e., an LLC formed without have at least one member upon formation. Reasonable minds differed (occasionally intensely) as to whether the “shelf” approach (i) is necessary to accommodate current business practices; and (ii) somehow does conceptual violence to the partnership antecedents of the limited liability company.”

Now, the simplicity and the speed of formation of LLCs, and even corporations and limited partnerships, in New York has virtually eliminated the need to set up and maintain a “shelf” entity, and thus the need to deal with “shelf LLCs” in the LLCL.

<u>Confusion about when an LLC is Formed/Effective</u>

There can be confusion about when is the formation of an LLC. LLCL Section 203(d) states that an LLC “…is formed at the time of the filing of the initial articles of organization with the department of state or at any later time specified in the articles of organization, not to exceed sixty days from the date of such filing. The filing of the articles of organization shall, in the absence of actual fraud, be conclusive evidence of the formation of the limited liability company as of the time of filing or effective date if later,…” Based upon a literal reading of Section 203(d), a domestic LLC can have an effective date different from its formation date.

Section 203(c) would have some utility if the name(s) of the initial member(s) had to be listed in the articles of organization. Fortunately, neither the members nor the managers are required to be so listed, and we are not recommending that requirement.

It is unclear how the Section 203(c) requirement of the newly-formed LLC have at least one member affects the time of formation under Section 203(d) as there is no link between these two subsections. LLCL Section 602 provides a clear understanding regarding the entry of the initial members on the newly-formed LLC. Under Section 602(a), a person becomes a member of an LLC on the later of: (1) the effective date of the LLC's initial articles of organization or (2) the date as of which the person becomes a member pursuant to Section 602 or the operating agreement; provided, however, that if such date is not ascertainable, the date stated in the records of the LLC.

The common practice of admitting initial members follows the options spelled out in Section 602(a), especially with respect to the reference to the date stated in the LLC's records, such as its operating agreement.

The LLC formation provisions under Section 18-201(b) of the Delaware Limited Liability Company Act are basically identical to those in LLCL Sections 203(d) and 602(a), and without any provision similar to LLCL Section 203(c) requiring the presence of a member at the time of formation.

Conclusion

Because "Shelf LCCs" do not appear to raise statutory or regulatory concerns in New York, there is no compelling legal or practical need to deal with them in the LLCL. One fundamental concept of the LLCL is to give the members and managers freedom of contract in dealing with their LLCs, such as providing in their operating agreements the conditions and the timing of the effective date of the operations and the admission of members. In the event of future abusive practices through formation and acting through "Shelf LLCs," the formation may be nullified as Section 203(d) presumption that the filing of the initial articles of organization is conclusive is conditioned upon "the absence of actual fraud." Moreover, at that future time, this subject could be revisited for possible legislative change.

The repeal of Section 203(c) should not affect the statutory scheme for the admission of the initial members and should end the confusion caused by that Section. This would give practitioners confidence to continue their practices in starting up LLCs without lingering worries about compliance with Section 203(c).

This recommendation should be discussed with the Department of State ("DOS"). Our understanding is the DOS is aware of the confusion stemming from the presence of Section 203(c). The repeal should not affect the provisions dealing with the articles of organization or the filing process. We believe that the DOS would be reluctant for New York to adopt the RULLCA and Florida approach to "Shelf LLCs" of having the newly-formed LLC which stated in its articles of formation that it did not have members to subsequently file a notice within the

prescribed time period that it had obtained members, otherwise its formation would lapse. This regimen would create a new filing document with the DOS and also might require the DOS to monitor whether the formation has lapsed because of the failure to file have filed the notice of a member within the prescribed time period and then to maintain a list of the lapsed LLCs.

Topic #4 – Publication

Issues

(1) Should newly formed New York limited liability companies ("LLCs"), professional service LLCs, qualifying foreign LLCs and converted LLC continue to be required to publish their formation in local print publications?

(2) What alternative approaches might replace the current publication requirement?

Recommendations

We recommend repealing the publication requirement altogether.[1] The specific sections of the New York Limited Liability Company Law ("LLCL") that would be affected are stated under the heading "The Publication Requirement" below. The purpose of the publication requirement is apparently to put the public on notice that a limited liability company has been formed. Corporations have no comparable publication requirement. The absence of a publication requirement for corporations has had no apparent adverse consequences.

A June 2009 report of the Corporation Law Committee of the New York City Bar Association (NYCBA) on the Revised Uniform Limited Liability Company Act ("RULLCA") pointed out that RULLCA has no publication requirement for LCs. The NYCBA wrote the following:

> The publication requirements in the NYLLCL have been the subject of almost universal criticism. They are generally viewed as having no legitimate purpose. The cost of publication can be significant and, in certain instances, prohibitive to small businesses. It is estimated that these costs range from $1,300 to $2,500 for businesses whose offices are located in New York County. This is a cost that is not imposed by any other state and serves as a deterrent to new businesses that might otherwise organize or do business in New York.[2]

The New York Department of State provides better notice in the form of a searchable database of entities listing corporations as well as limited liability companies along with their addresses.[3] That website is freely available to the public and costs the organizers of a company nothing more than the standard filing fee. The online listing is superior to the newspaper listings, which are costly for entrepreneurs and which are likely ignored.

If LLC founders are no longer required to publish, the LLCL might affirmatively require the New York Department of State to maintain electronic records of LLC filings in a searchable

[1] *See* Moisan, A Look at the Publication Requirement in New York Limited Liability Company Law, 31 Touro L. Rev. 465, 474-75 (2015), available at http://digitalcommons.tourolaw.edu/cgi/viewcontent.cgi?article=2660&context=lawreview

[2] Report by the Corporation Law Committee Recommending Adoption by New York State of the Revised Uniform Limited Liability Company Act, www.nycbar.org/pdf/report/RULLCA_Corporation_Report%20PACKET061109.pdf

[3] https://appext20.dos.ny.gov/corp_public/corpsearch.entity_search_entry

format that is available to the public, and might designate a portion of the filing fee to maintaining this database.

There have been multiple legislative attempts to repeal LLCL Section 206, though none have yet succeeded. Former assemblyman Micah Kellner was particularly active in this push, introducing four bills in the past 10 years. Senator Liz Krueger is also a supporter of repeal. She currently sponsors a bill that would eliminate this and other publication requirements. The bill is in committee review.[4] We recommend voicing our support for this legislation.

The only benefit of the publication requirement is that it supports many newspapers around the state. Removal of the publication requirement would adversely affect many print publications and might cause some to close their businesses. On the other hand, removal of the publication requirement would likely increase business activity in New York and add to the Department of State revenues.

Secondary Fixes

Presumably, the only obstacle to abolishing the publication requirement is the political clout of the newspaper lobby, which has successfully blocked all attempts so far to abolish this requirement.

If the newspaper lobby continues to pose a real threat to the elimination of the publication requirement, we see a few alternative approaches that would reduce the negative effects of this requirement. We do not recommend any change that does not include repeal of the publication requirement. Nevertheless, here are a few alternative ideas that some have suggested:

- Allow the LLC's founders to select the newspaper in which the notice will appear rather than relying on the directives of the county clerk. This would likely lead to price competition thereby reducing the cost of publication for the organizers of LLCs.

- Reduce the publication period from six weeks to two and/or limit to one newspaper. Again, this would reduce the cost to the company founders.

- Clarify the "suspension" sanction for failing to file a certificate of publication by saying that this filing can be done at any time and that the only consequence of failure to make this filing is the inability to bring a lawsuit in New York until publication is completed and the certificate is filed.

We see merit in reducing the publication period from six weeks to two, simply because this would reduce the cost to the organizers of the company. We also see merit in clarifying the "suspension" sanction for failing to file a certificate of publication by saying that this filing can be done at any time and that the only consequence of failure to make this filing is the inability to bring a lawsuit in New York.

---

[4] See bills S3360 and A08125 (2017), available at https://nysenate.gov/legislation/bills/2017/S3360

Another way to reduce the cost to the organizers short of abolishing the requirement is to give LLC organizers the ability to select publications from a list made available by the county clerk. The county clerks might be required to make the list of acceptable publications easily accessible online. Then the organizers would be able to make selections from the list. Leaving this choice to entrepreneurs and new business owners would allow them to choose low-cost publications. This may result in price competition among newspapers, which would benefit businesses. At the same time, it would maintain some revenue for print publications from LLC formations and qualifications.

But rather than reducing the burden of publication, we question the need for any print notice whatsoever.

The Publication Requirement

LLCL Section 206 provides as follows:

> Within one hundred twenty days after the effectiveness of the initial articles of organization …, a copy of the same or a notice containing the substance thereof shall be published once in each week for six successive weeks, in two newspapers of the county in which the office of the limited liability company is located, one newspaper to be printed weekly and one newspaper to be printed daily, to be designated by the county clerk.

LLC founders commonly engage lawyers and law firms to handle the LLC formation. Law firms will typically use a service company to manage the publication and to file the required affidavit of publication with the state. Service companies know which newspapers the relevant county clerk has designated.[5]

Some LLC founders use Legal Zoom or other service companies that deal directly with consumers rather than attorneys. The likelihood is that at least some of these founders do not bother to comply with the publication requirement.

For those who do comply, the obligation applies only to the formation of the entity. If there is a change to any of the information published after the first weekly publication, the LLC may complete the remaining publication of the original notice and it is not required to publish any amended notice. Should the change be material, the publication will contain out-dated information.

LLCL Section 802(a) requires out-of-state LLCs to qualify to do business in New York. Section 802(b) imposes on companies qualifying to do business in New York the same publication requirement that domestic LLCs must meet under Section 206.

LLCL Section 1006(e) also requires publication under LLCL Section 206 when a partnership or a limited partnership converts to an LLC.

---

[5] If the county clerk has not designated two newspapers in the county, the publication may be made in any newspaper that meets the other requirements of Section 206.

Professional service limited liability companies are subject to the same publication requirement as other LLCs pursuant to LLCL Section 1203(c)(2). Foreign professional service LLCs qualifying to do business in New York are subject to the publication requirement pursuant to LLCL Section 1306(d). In addition, Partnership Law Section 81 provides that when a partnership or business name is continued to be used, as provided in Partnership Law Section 80 which sets forth the provisions for continuing the name, the persons using the name must file a certificate about the use of the name and then publish such certificate once a week for four consecutive weeks in a newspaper of the city or town in which the partnership's principal place of business is located.

LLCL Section 1101(s) states that there is a $50 fee for filing a certificate of publication under each of these sections.

We recommend repealing all of these LLC publication and fee requirements, namely LLCL Sections 206, 802(a), 1006(e), 1101(s), 1203(c)(2) and 1306(d). Moreover, New York limited partnerships and registered limited liability partnerships are subject to identical publication requirements. We believe these other entities also should not be subject to any publication requirement for the reasons given in this report for LLCs. However, this booklet is limited to the LLCL. Should this recommendation be pushed, we would seek similar statutory treatment for limited partnership and LLC publication requirement.

Other Jurisdictions

New York stands out among the fifty states as having a significantly lower number of LLCs formed in the state. This is most likely due to burdensome cost associated with forming a new LLC. A statistical analysis of LLC formations[6], New York was ranked #49 in LLC "popularity" by state (measured as the ratio of LLCs v. other entity types). We have found that high cost of forming an LLC is the primary reason founders choose not adopt an LLC structure in New York.

New York is one of just three states that have an LLC publication requirement. The other two states are Arizona and Nebraska. Nebraska requires a newly formed LLC to publish once a week for three weeks in two periodicals. The average cost for a metropolitan area like Omaha is around $200. Arizona requires an LLC to publish three times in one periodical. The average cost in Yuma is around $120-$160. Though similar in requirement, the fee in New York remains substantially higher. A notable example of burdensome costs associated is the requirement in New York County to publish in the *New York Law Journal* for a price of $723.[7] Today, the cost of publication in two newspapers over a six week period in Manhattan is roughly twice that amount.

---

[6] Daniel M. Häusermann, *For a Few Dollars Less: Explaining State to State Variation in Limited Liability Company Popularity*, SSRN Electronic Journal (2011).

[7] Amy E. D'Agostino, Practical Considerations for Forming LLCs in New York and Delaware, chadbourne.com (July 8, 2009), http://www.chadbourne.com/files/Publication/7544b5f5-276b-4e41-ba34c2c398823e9c/Presentation/PublicationAttachment/bca2f303-8819-4791-980f-cb57790b0ba5/July2009_Law.comArticle.pdf

Where New York stands as a leader in many other verticals, it is failing in comparison to other parts of the country in providing a fair and reasonable point of access for new business founders

Effect of Failure to Comply

Failure to comply with LLCL Section 206, in theory, results in the company's forfeiture of the right to conduct business. This sounds severe. But the wording of the law completely removes any adverse effects of failing to publish. Section 206(a) states that if an LLC fails to file proof of publication within 120 days after its formation, "the authority of such limited liability company to carry on, conduct or transact any business in this state shall be suspended …." The same subsection goes on to say that the failure to publish and to file proof of publication:

> shall not limit or impair the validity of any contract or act of such limited liability company, or any right or remedy of any other party under or by virtue of any contract, act or omission of such limited liability company, or the right of any other party to maintain any action or special proceeding on any such contract, act or omission, or right of such limited liability company to defend any action or special proceeding in this state, or result in any member, manager or agent of such limited liability company becoming liable for the contractual obligations or other liabilities of the limited liability company.

The law is internally contradictory. On the one hand, the failure to publish and file the required affidavit will result in a suspension of the authority of the LLC to transact any business in the state. On the other hand, such failure will not "limit or impair" the validity of any contract or any other rights of the company. In other words, there appears to be no adverse consequence to a limited liability company's failure to comply with the stated requirement to publish. Yet the requirement remains.

Although later overturned, the decision in *Barklee Realty Co. LLC v Pataki* [8] offers perspective on LLC Section 206 and internal contradictions. Barbara Kraebel, a small business owner, declined to comply with publication requirement when forming her LLC. Kraebel brought an action contesting the constitutionality of the requirement, arguing that the punishment prescribed infringed on her fundamental rights of due process and equal protection. The trial court saw merit in Kraebel's argument and granted her summary judgment, ruling that LLCL Section 206 was unconstitutional. New York State quickly announced its intention to appeal the decision.

Following the announcement to appeal, an amicus curiae brief was filed on behalf of a collective group of small business organizations interested in preserving the lower court's ruling. Contained in the brief were detailed accounts of long-standing criticism of the provision, as well as supporting quotes from the then State Attorney General and the New York City Bar. Although the court overturned the lower court's decision, this case is important in evidencing the breadth of support there is for eliminating this requirement.

---

[8] No. 120546/99, 2001 WL 36384022 (Sup. Ct. N.Y. County Nov. 16, 2001), *rev'd* 765 N.Y.S.2d 599 (App. Div. 1st Dep't 2003).

At the time Barklee was decided, the statute contained this sentence, which was removed from the statute in a 2006 amendment[9]:

> "Failure to cause such notice to be published and to file such proof within one hundred twenty days of the effective date of the articles shall prohibit the limited liability company from maintaining any action or special proceeding in this state unless and until such limited liability company files such proof of publication."

But even before the statute was amended, an LLC that failed to comply with the publication requirement was able to restore its good status retroactively through publication. This allowed a non-compliant LLC, when wishing to enforce a contract, to bring suit without waiting until publication as it can cure its own failure to publish at any time after bringing the suit.

In a 2010 decision[10], the United States Bankruptcy Court for the Southern District of New York rejected a debtor's challenge to the enforceability of an option agreement. The debtor sought the return of its deposit under the agreement on the basis that the debtor lacked authority to enter into the agreement because it failed to satisfy the publication requirement. The court rejected the claim, pointing out that the LLCL was amended in 2006 so that "the consequences of a failure to publish changed from the former prohibition on foreign LLC's ability to maintain 'any action or special proceeding in this state' to the current suspension of a foreign LLC's ability 'to carry on, conduct or transact business in this state.'" The court noted that the statute also states that the failure of an LLC to publish "shall not limit or impair the validity of any contract or act of such foreign limited liability company, or any right or remedy of any other party under or by virtue of any contract, act or omission of such foreign limited liability company…."

A federal district court held in 2013 that an LLC's failure to comply with the New York publication requirement does not prevent the LLC from litigating in federal court.[11]

Reasons to End the Publication Requirement

The failure of an LLC to publish can cause problems at the time it is selling its assets or entering into a bank loan agreement or some other significant agreement. The buyer or lender may require the LLC to represent and warrant that it is "duly formed and validly existing". The company's lawyer may be asked to write a legal opinion to this effect, which may be impossible to do or qualified if the LLC has not completed the publication process within the 120 day period.

Publication is required only when the LLC is formed. No further notice is required if any of the published information changes. Any possible benefit of publication is therefore fleeting. The state's online system, on the other hand, is continually updated and remains accurate and easily searchable at all times without charge to users. It is highly likely that no one actually reads any notice in the print publications. Further, there is no index of the statewide publications.

---

[9] 2005 Sess. Law News of N.Y. Ch. 767 (S. 85–A) (McKinney's)
[10] In re Empire Equities Capital Corp., No. 09-12751, 2010 WL 1849391 (Bankr. S.D.N.Y. May 6, 2010).
[11] Dual Groupe, LLC v. Gans-Mex LLC, 932 F.Supp. 2d 569 (SDNY 2013).

The cost of publication in New York discourages some entrepreneurs from forming LLCs in the state. Conversely, the removal of this requirement may increase revenue to the state in the form of more filing fees and tax revenues from entities that avoided New York registration due to the publication requirement. More companies might actually want to be located in the state, which would also benefit New York's economy.

The publication requirement can be characterized as a requirement that organizers of LLCs support local newspapers specified by the county clerk thereby using business formation to subsidize many newspapers. The requirement does not serve any other purpose. Expressed in this way, the requirement does not reflect any worthwhile public policy.

The only reason for *not* completely eliminating the publication requirement is that it brings significant revenue to newspapers and other print publications. This, in any case, is the real reason that newspapers vigorously support the requirement. There is no other justifiable reason given the burden it imposes on LLC organizers and the lack of need for the published information.

While abolishing the publication requirement would adversely affect the revenue of newspapers, it would significantly reduce the cost of LLC formation for entrepreneurs. LLCs would become significantly more desirable in New York and would likely be the most popular form of entity. The number of corporations formed in the state may decline while the number of LLCs formed would increase. The effect may be a wash in terms of revenue to the state in filing fees, or it may increase state revenue from filing fees. It is also possible that removing the publication requirement would result in more entrepreneurs locating their businesses in New York. It would be easier to promote New York as a business-friendly state. More companies with offices in New York would likely result in a greater number of employed New Yorkers and more tax revenue to the state.

NYSBA Survey

In a 2017 survey of lawyers in the Business Law Section of the New York State Bar Association on various potential changes in the LLCL. More than 97% of the respondents wrote that they wanted the publication requirement abolished. More respondents wrote comments about this requirement than about any other subject, and 100% of the comments were in favor of abolishing the requirement. The complete survey is Exhibit A to this booklet. Here are just a few of the many comments from respondents:

- … an absolute must. I have had numerous clients choose separate jurisdictions simply because of the publication costs, especially in New York County. Publication is antiquated in light of publicly available DOS information.
- It's expensive, burdensome and serves no public benefit. It also encourages companies to not form/qualify LLCs in NY or at least not with an office in NY county.
- Absolutely. The publication requirement is the main reason why I recommend against LLCs for start up businesses doing business in NY.
- Abolition of the publication requirement must be a Top Priority.

- Absurd!!!
- The publication process serves NO purpose other than to payoff newspapers and periodicals. It does not provide the public with any additional information that they can easily find with the NY Sec of State.
- Yes! LLCs are underused in NY because of publication costs.
- This should be a very high priority.
- It serves no legitimate purpose except to benefit local newspapers.
- ABSURD, RIDICULOUS, USELESS, ANTIQUATED--am I making myself clear?
- It serves no practical purpose other than to have businesses find ways to not form in NYS
- I discourage clients from forming LLCs in New York because of the publication requirement.
- publication requirement is really outrageous and is the number one thing that needs to get addressed
- Expensive and unnecessary. A boon only to the newspaper lobby.
- Completely unnecessary.
- 1. It serves NO purpose other than to enrich the newspaper lobby. 2. Inadequate info is required and no need to update which makes the publication useless. 3. Change would be in keeping with statute in other states which do not require publication
- Dying newspaper lobby should not make unique policy with in NY. Makes us non-competitive with other jurisdictions.
- I could not feel more strongly that the publication requirement should be abolished for NY LLCs and LLCs formed in other states doing business in New York. It is a $2,000 expense that is unnecessarily burdensome, especially for emerging companies and there is no legitimate business purpose. If we want to encourage job building in NY, we should find ways to do it other than by legislating support of small periodicals that publish these notices that no one reads anyway. This expense drives small, new companies out of the State.
- Yes!!! It's completely unnecessary and nothing but a boondoggle to the newspaper industry.

The NYSBA survey went on to ask about two possible alternatives to the current publication requirement if it cannot be abolished. One idea was to reduce the publication period from six weeks to two weeks. The other was to clarify the "suspension" sanction for failure to timely file the certificate of publication. Here are a few of the comments from respondents:

Reduce the publication period from six weeks to two weeks: More than 92% of respondents were in favor of this suggestion, with the remainder evenly divided between "no" and "no opinion". Here are a few of the comments from respondents with respect to this suggestion:

- Less bad is good.
- A 2-week period is even stupider than the present requirement, and must be seen as a sop to the publishers.
- Just abolish it.
- There is no reason not to abolish this requirement.
- Only as a last resort compromise.

- But why 2? A single publication would be as effective, since the publication requirement is not effective for any purpose anyway.
- Also, remove the requirement of two newspapers, or at least the requirement that one newspaper be a daily paper.

Clarify the "suspension" sanction for failure to timely file the certificate of publication: 89% of respondents were in favor of this suggestion. Here are a few of the comments from respondents regarding this suggestion:

- The clarification could be worse than what we have now.
- It is far better that the penalty remains uncertain.
- There is no reason not to abolish this requirement.
- This is a poorly written law and is unenforceable in its current form. It is a disgrace.
- Many of my clients are in limbo because they did not publish right after they formed the LLC.
- Also, clarify that failure to file can be cured at any time.
- Anything to make the publication requirement less onerous.
- I like the fact there is no real penalty, but the banks don't always know that and insist on publishing before they will grant a loan. They should be prohibited from forcing publication in return for a loan. That is wrong.
- Have no idea what clarify means. Discontinue suspension, or just have suspension mean that they can't institute litigation in NY until they publish. I am so opposed to the publication requirement to begin with that merely modifying it is unacceptable.
- Yes. This is a difficult issue to explain to clients when they ask about the real consequences of not publishing.
- It depends on what it means to clarify. If the clarification would make the LLC more susceptible to issues/problems if it does not comply, then I would prefer to leave the language as is.

At the end of the survey, respondents were asked whether they had additional comments. Some of these comments again criticized the publication requirement. Here are a few examples:

- Get rid of the publication requirement, which is an embarrassing and out of date subsidy for a particular industry and discourages entity formation in NY
- Number one priority is to abolish the publication requirement.
- I was on the original task force that wrote the LLCL (before the check the box rules came into effect). We drafted the statute given the IRS position on partnership taxation. There was no publication required in the draft statute. It was added on the last reading in Albany because of pressure from the newspaper lobby.

<u>Conclusion</u>

New York's LLC publication requirement does not serve any legitimate public policy. Certain publications are profiting, but no one actually reads the published notices. The letter of the law is often avoided because failure to comply is not punishable. Meanwhile, entrepreneurs are

suffering due to burdensome costs. For these reasons, we recommend repeal of the publication requirement.

Topic #5 – Derivative Actions

Issues

(1) Should the Limited Liability Company Law ("LCLL") be amended to authorize derivative actions?

(2) If so, what conditions and limitations, if any, should the LLCL impose on a member's right to file derivative actions?

Recommendations

(1) Yes, the LLCL should be amended to allow the members of a limited liability company ("LLC") to bring derivative actions on behalf of the LLC. The LLCL currently does not address derivative actions. Members of a New York LLC nonetheless may bring a derivative action on an LLC's behalf because New York courts recognize this right, notwithstanding the lack of statutory authority. Codifying this common law right would provide certainty to this right in New York. Also, the New York Business Corporation Law ("BCL"), Delaware Limited Liability Company Act (the "DE LLC Act") and the Revised Uniform Limited Liability Company Act ("RULLCA") all recognize the statutory right of LLC members to bring a derivative action.

(2) Yes. Not only should the LLCL authorize derivative actions but it should include provisions addressing standing, pre-suit demands, required pleadings, settlement, recovery of expenses and giving of security for expenses. In the statutory vacuum, courts have had to define the limitations on and the elements for bringing a derivative action. Establishing statutory conditions and requirements would ensure more uniformity in the procedural process. Attached as Appendix A are the proposed amendments to the LLCL.

Existing LLCL Provisions

As mentioned above, the LLCL does not address derivative actions. Earlier drafts of the LLCL before its adoption had included an Article IX, which contained provisions addressing derivative actions. However, Article IX was omitted in its entirety from the final version of the LLCL but the remaining Articles were not renumbered. As a result, the LLCL does not have an Article IX so the new recommended provisions regarding derivative actions could be inserted as Article IX.

New York Case Law

After the enactment of the LLCL in 1994, the omission of Article IX initially led to some confusion regarding derivative actions. Courts were split on whether members could bring derivative suits, with those against it pointing to the deliberate omission in the LLCL as the legislature's decision that members should not have this right. Then, in 2008, the New York Court of Appeals, in *Tzolis v. Wolff*, 855 N.Y.S.2d 6 (2008), held that a member of an LLC may bring a derivative action on behalf of the LLC. The court in *Tzolis* based its decision on the fact

that shareholder derivative suits have long been recognized in New York, even before the enactment of the BCL, and because it did not find any evidence that the legislature meant to abolish a member's derivative right. The court also noted that derivative rights had been recognized by courts for limited partners of limited partnerships before being expressly authorized by statute.

Following *Tzolis*, courts dealing with derivative suits established limitations and conditions on the right to bring this action. In general, courts borrowed from the BCL and corporate law when imposing requirements. For example, in *Najjar Group, LLC v. West 56th Hotel LLC*, 974 N.Y.S.2d 85 (1st Dep't 2013), the Appellate Court held that, similar to the pre-suit demand required by BCL Section 626, members cannot file a derivative action unless the complaint sets forth with particularity either the efforts made to secure the initiation of that action by management or reasons for not making the efforts. Also similar to the BCL, plaintiffs must have contemporaneous ownership, such that plaintiffs must be members at the time of the offending conduct and when the action is commenced (see *Billings v. Bridgepoint Partners, LLC*, 863 N.Y.S.2d 591 (Sup. Ct. Erie Co. 2008)).

Courts have also examined the question of whether a claim is direct or derivative and based the analysis on which party is suffering the harm and receiving the benefit. If the plaintiff suffered the harm individually and would receive the benefit, the claim is direct (*Maldonado v. DiBrie*, 35 N.Y.S.3d 731 (3rd Dep't 2016).) As this issue is usually addressed in case law and not in LLC statutes though, we are not recommending that it be included in Article IX.

The authorization of derivative rights established in *Tzolis* and the standards and conditions developed by *Najjar* and *Billings* should, however, be codified and included in Article IX of the LLCL. This would provide more certainty on these issues and avoid courts developing conflicting standards for filing derivative actions.

BCL

BCL Sections 626 and 627 authorize derivative actions and address standing, pleading requirements, settlement, expenses and providing security for expenses. For the sake of consistency within the state regarding derivative claims and because many New York courts have relied on the BCL for guidance when establishing rules for bringing derivative claims, we are recommending that the new provisions generally follow the language of Sections 626 and 627 of the BCL. Where modifications are necessary to apply the provisions to LLCs and members, we recommend the language be amended to utilize the language from the DE LLC Act or the omitted Article IX, which is similar to the derivative action provisions found in the DE LLC Act and RULLCA.

Delaware LLC Act and RULLCA

Many states' LLC laws, including Delaware, and RULLCA authorize derivative actions. These laws and RULLCA also address many of the same issues we are recommending be included in the LLCL, such as pre-suit demands, standing, pleading requirements and expenses, and impose similar conditions.

The DE LLC Act authorizes members (or an assignee of an LLC interest) to file derivative actions provided demand has been made on the managers or members with authority to file suits unless demand would be futile. The DE LLC Act also requires that the plaintiff be a member (or assignee) (i) when filing the suit and (ii) at the time of the transaction complained of or a successor to one by law or the under the terms of an operating agreement. In addition, the complaint must set out with particularity the pre-suit demand or the reasons it is futile and successful plaintiffs may recover reasonable expenses from the LLC. (DE LLC Act Sections 18-1001 to 18-1003) Our recommended provisions maintain these requirements but differ from the DE LLC Act in that they do not authorize assignees to file and the DE LLC Act does not provide for the posting of security for expenses.

RULLCA allows a member to maintain a derivative action if a pre-suit demand was made or would be futile. It also requires a plaintiff to be (i) a member when commencing the action and (ii) a member when "the conduct giving rise to the action occurred" or a successor to such a member by operation of law or pursuant to an operating agreement. In addition, the complaint must meet pleading requirements similar to the BCL and the DE LLC Act, successful plaintiffs can recover reasonable expenses and courts must approve any voluntary dismissal or settlement. Unlike the BCL, RULLCA does not allow LLCs to require plaintiffs to give security for expenses. (RULLCA Sections 802 to 804)

RULLCA also authorizes the appointment of special litigation committees ("SLC") (RULLCA § 805), which the BCL and DE LLC Act do not. Recently, the court in *LNYC Loft, LLC v. Hudson Opportunity Fund I, LLC*, 57 N.Y.S.3d 479 (1st Dep't 2017), rejected an LLC's appointment of an SLC consisting of only one member that was a nonmember of the LLC because the operating agreement neither provided for it nor "evince[d] an intent to delegate core governance functions to nonmembers". However, the court did recognize that SLCs could "serve an important purpose in the LLC context" and that, if provided for in the operating agreement, they would be enforced. We note that SLCs in the corporate field are recognized by courts and are more common but are not addressed in the BCL (see *Auerbach v. Bennet*, 393 N.Y.S.2d 920 (1979)). We therefore recommend that the proposed Article IX not address SLCs and instead allow members the flexibility to decide in the operating agreement whether to authorize SLCs and the terms of appointing SLCs, if any.

<u>Proposed Amendments</u>

Specifically, we are recommending that (i) only plaintiffs that are members at the time of filing and at the time of the transaction complained of (unless the plaintiff became a member by operation of law) be permitted to file, (ii) the complaint must plead that a pre-suit demand on management or members with authority to file suit was made and denied or that the demand would be futile, (iii) courts approve any discontinuance, compromise or settlement of the action, (iv) successful plaintiffs or those that receive anything in connection with a judgment, compromise or settlement be allowed to recover reasonable expenses, and (v) LLCs be allowed to require plaintiffs to give security for the expenses of the LLC and any other defendants to which the LLC may become liable.

Attached as Appendix A is the proposed Article IX and attached as Appendix B are redlined changes of the proposed Article IX against Sections 626 and 627 of the BCL.

Conclusion

New York recognizes a common law right for members of an LLC to file derivative actions. The lack of statutory authority or guidance on filing requirements though creates uncertainty and may result in inconsistent court rulings involving procedural issues. Amending the LLCL to include our proposed provisions regarding derivative claims would resolve many of these issues. Addressing derivative actions in the LLCL would also bring New York in line the BCL and the LLCL as well as other state LLC laws, such as Delaware, that explicitly authorize derivative actions and set out the filing requirements.

We recommend that the new provisions relating to derivative claims mirror the corresponding BCL sections except where they must be revised to account for LLCs and members. In those instances, language from the DE LLC Act and omitted Article IX (which for those clauses is similar to the DE LLC Act and RULLCA) should be incorporated. Since New York courts are already imposing the conditions and limitations from the BCL on members' rights to bring derivative actions, enacting our recommended provisions would not be a departure from current practice in New York.

APPENDIX A

Article IX – Derivative Actions

§ 901. Right to bring action

An action may be brought in the right of a domestic or foreign limited liability company to procure a judgment in its favor by a member of the limited liability company if (i) managers or members with authority to do so have refused to bring the action within a reasonable time after demand by such member; or (ii) a demand under clause (i) would be futile.

§ 902. Proper plaintiff

In any such action, the plaintiff shall be (a) such a member at the time of bringing the action and (b) such a member at the time of the transaction of which he complains or that his status as a member of the limited liability company devolved upon him by operation of law or pursuant to the terms of the operating agreement from a person who was a member at the time of such transaction.

§ 903. Pleading

In any such action, the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the managers or members with the authority to cause the limited liability company to sue in its own right or the reasons for not making such effort.

§ 904. Approval of court

Such action shall not be discontinued, compromised or settled, without the approval of the court having jurisdiction of the action. If the court shall determine that the interests of the members will be substantially affected by such discontinuance, compromise, or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to the members whose interest it determines will be so affected; if notice is so directed to be given, the court may determine which one or more of the parties to the action shall bear the expense of giving the same, in such amount as the court shall determine and find to be reasonable in the circumstances, and the amount of such expense shall be awarded as special costs of the action and recoverable in the same manner as statutory taxable costs.

§ 905. Expenses

If the action on behalf of the limited liability company was successful, in whole or in part, or if anything was received by the plaintiff or plaintiffs or a claimant or claimants as the result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff or plaintiffs, claimant or claimants, reasonable expenses, including reasonable attorney's fees, and shall direct him or them to account to the limited liability company for the remainder of the proceeds so received by him or them. This paragraph shall not apply to any judgment rendered for the benefit of injured members only and limited to a recovery of the loss or damage sustained by them.

§ 906. Security

In any action specified in section 901, unless the plaintiff or plaintiffs hold five percent or more of the membership interests, or the membership interests of such plaintiff or plaintiffs have a fair value in excess of fifty thousand dollars, the limited liability company in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the

plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which the limited liability company may become liable under this chapter, under any contract or otherwise under law, to which the limited liability company shall have recourse in such amount as the court having jurisdiction of such action shall determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or excessive.

APPENDIX B

Article IX – Derivative Actions

§ 901. Right to bring action

An action may be brought in the right of a domestic or foreign limited liability company to procure a judgment in its favor by a member of the limited liability company if (i) managers or members with authority to do so have refused to bring the action within a reasonable time after demand by such member; or (ii) a demand under clause (i) would be futile.

§ 902. Proper plaintiff

In any such action, the plaintiff shall be (a) such a member at the time of bringing the action and (b) such a member at the time of the transaction of which he complains or that his status as a member of the limited liability company devolved upon him by operation of law or pursuant to the terms of the operating agreement from a person who was a member at the time of such transaction.

§ 903. Pleading

In any such action, the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the managers or members with the authority to cause the limited liability company to sue in its own right or the reasons for not making such effort.

§ 904. Approval of court

Such action shall not be discontinued, compromised or settled, without the approval of the court having jurisdiction of the action. If the court shall determine that the interests of the members will be substantially affected by such discontinuance, compromise, or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to the members whose interest it determines will be so affected; if notice is so directed to be given, the court may determine which one or more of the parties to the action shall bear the expense of giving the same, in such amount as the court shall determine and find to be reasonable in the circumstances, and the amount of such expense shall be awarded as special costs of the action and recoverable in the same manner as statutory taxable costs.

§ 905. Expenses

If the action on behalf of the limited liability company was successful, in whole or in part, or if anything was received by the plaintiff or plaintiffs or a claimant or claimants as the result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff or plaintiffs, claimant or claimants, reasonable expenses, including reasonable attorney's fees, and shall direct him or them to account to the limited liability company for the remainder of the proceeds so received by him or them. This paragraph shall not apply to any judgment rendered for the benefit of injured members only and limited to a recovery of the loss or damage sustained by them.

§ 906. Security

In any action specified in section 901, unless the plaintiff or plaintiffs hold five percent or more of the membership interests, or the membership interests of such plaintiff or plaintiffs have a fair

value in excess of fifty thousand dollars, the limited liability company in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which the limited liability company may become liable under this chapter, under any contract or otherwise under law, to which the limited liability company shall have recourse in such amount as the court having jurisdiction of such action shall determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or excessive.

Topic #6 – Designation of Type of Management/Authority to Bind an LLC

A. Designation in Articles of Organization of Type of New York LLC Management

1. **Background**. Section 401(a) of the New York Limited Liability Company Law ("LLCL") provides that a New York limited liability company ("LLC") will be member-managed unless its articles of organization provide that it will be manager-managed. By contrast, while both the Delaware Limited Liability Company Act ("Del. LLCA") in Sections 18-401 and 18-402 and the Uniform Limited Liability Company Law ("RULLCA") in Section 407(a) also provide that if no choice of management type is reflected in an LLC's filed formation instrument, member management will be deemed to have been selected, both also provide that manager management may be chosen in an LLC's operating agreement and need not be provided for in its filed formation instrument.

2. **Issue.** Should the LLCL continue to provide for default selection regarding the type of management that an LLC will have or should the LLCL be amended to provide that persons forming an LLC will in all cases be required to make an affirmative selection in the articles of organization of the LLC's management type?

3. **Recommendations**. Our recommendation is that persons forming an LLC should be required in all cases to make an affirmative selection of the LLC's type of management. In view of the fact that an LLC manager – including a managing member - assumes significant due care and fiduciary duties under the LLCL and applicable case law, the decision to make all members of an LLC managing members should not be made without careful consideration. Our thinking is that requiring in all cases an affirmative selection of the type of LLC management will help focus the attention of an LLC's members on that selection and its consequences. Particularly in the current era of "do it yourself" limited liability company formation, when there may well be no lawyer to call the attention of persons forming an LLC to the fact that they are (if only by default) selecting a particular type of LLC management, we think that it is important that the LLCL be employed to try to call the attention of such persons to that fact. We seek additional input on the issue whether the selection of type of LLC management be made in an LLC's articles of organization as opposed to in its operating agreement. We acknowledge that requiring the designation be in the articles of organization could hamper future flexibility in the nature of the management and would welcome opposing views.

4. **Proposed Amendments to the LLCL to Implement Recommendations**. In order to implement our recommendations, two sections of the LLCL Law would need to be amended.

   (i) LLCL Section 203(e) would be amended as follows: the word "and" at the end of subsection (e)(6) would be deleted, subsection (e)(7) would be renumbered as subsection (e)(8), and the following would be inserted as subsection (e)(7): <u>(7) a statement indicating whether the limited liability company is to be managed</u>

(i) by its members or (ii) by a manager or managers or a class or classes of managers; and.

(ii) LLCL Section 401 would be amended as follows: ~~Unless the articles of organization provides for management of the limited liability company by a manager or managers or a class or classes of managers~~ If the articles of organization provides[1] for management of the limited liability company by its members, management of the limited liability company shall be vested in its members who shall manage the limited liability company in accordance with this chapter, subject to any provisions in the articles of organization or the operating agreement and section four hundred eighteen of this article granting or withholding the management powers or responsibilities of one or more members or classes of members.

B. Authority to Bind a New York LLC

1. **Background.** LLCL Section 412(a) provides that each member of a member-managed LLC may bind the LLC and LLCL Section 412(b) provides that each manager of a manager-managed LLC may do so, in each case subject to any restrictions or limitations on such authority set forth in the LLC's articles of organization (*see* LLCL Section 203(e)(7)(B), Section 401(a) and Section 408(a)) or operating agreement (*see* LLCL Section 401(a) and Section 408(a)). Del. LLCA Section 18-402 provides that unless otherwise provided in an LLC's operating agreement, each member and each manager of an LLC may bind it. Taking a different approach from that taken by either the LLCL or the Del. LLCA, Section 302 of the Uniform Law provides that an LLC may file with a state's public corporate records office a statement of authority conferring authority to bind the LLC on (a) persons holding specific positions within the LLC or (b) specific named individuals.

2. Issues

(a) Acknowledging that all managers of a manager-managed LLC should be able to bind the LLC absent a contrary provision in the LLC's articles of organization or operating agreement (as the LLCL currently provides), should the LLCL continue to provide that all members of a member-managed LLC will have authority to bind the LLC absent such a contrary provision?

(b) Should the LLCL be amended to provide for a certificate of authority like that provided for in RULLCA Section 302?

---

[1] Note – As the words "articles of organization" are currently treated as a singular (as opposed to a plural) noun in both LLCL Section 401(a) and in LLCL Section 408(a) (regarding manager management), we would, for the sake of consistency, propose treating them as a singular noun in revised Section 401(a).

3. **Recommendations**

(a) Regarding the question referred to in subsection 2(a) above, we acknowledge that providing by default that all members of a member-managed LLC will have authority to bind the LLC can lead to management problems. However, as a practical matter, we see no real alternative to so providing. We would hope that the changes that we recommend in Sections A.3 and A.4 above with regard to choice of LLC management type might go at least some distance toward addressing this issue. If persons forming an LLC are directed to focus on whether the LLC will be member-managed or manager-managed, they might also focus on the attributes of each type of management and, having done so, might consider who should be permitted to bind the LLC.

(b) Regarding the question referred to in subsection 2(b) above, we do not recommend that the LLC be amended to provide for certificates of authority like those provided for RULLCA Section 302. When an LLC enters into a transaction of such significance that the counterparty enquires into the authority of the LLC's signatories (a real estate transaction would be a classic example of such a transaction), any filed certificate of authority that sets out only the authority inherent in a particular position within an LLC will still need to be supported by a manager's or officer's certificate that indicates who holds that position, meaning that nothing would really have been gained by way of efficiency from the filing of the certificate of authority. While a certificate of authority that sets out the names of specific individuals who can bind the LLC would appear to solve that problem, (a) filing such a certificate would cause LLC members to give up a measure of the privacy afforded by an LLC and (b) any certificate that names specific individuals who may bind the LLC runs the risk of becoming incorrect on account of a named individual's death or separation from the LLC and thereafter causing confusion. The other danger of certificates of authority is that if members or managers of an LLC have a dispute, there could be a battle of certificate of authority filings, with various members or managers seeking to revoke, or at least call into question, the authority of other individuals to bind the LLC. We acknowledge that our recommendation against providing in the LLCL for certificates of authority might appear to be at variance with our recommendation in Section A.3 above that the choice of an LLC's type of management should be specified in its articles of organization. However, we would note that (a) not only does setting out an LLC's type of management in its articles of organization not implicate privacy, it is in our estimation far less likely that an LLC's overall type of management will change (requiring the filing of an amendment to the LLC's articles of organization) than that information regarding who may bind an LLC (whether indicated categorically or by naming individuals) will change (requiring an amendment to an LLC's certificate of authority) and (b) articles of organization must be filed in all cases, so including choice of management type in articles of organization (unlike specifying information regarding who may bind an LLC in a certificate of authority) does not require an additional filing. In addition, we asked some real estate title people in New York if a certificate of authority would be beneficial in closings, and they felt they already had procedures to deal with manager authority.

4. **No Amendments to LLCL required to Implement Recommendations.** Our recommendations regarding the authority of individuals to bind an LLC do not require any amendments to the LLCL.

Topic #7 – Fiduciary Duties

Issues

(1) Should Section 417(a) of the Limited Liability Company Law ("LLCL") be amended to specifically permit prospective limitation or elimination of managers' (including member-managers') fiduciary duties?

(2) If the answer to the issue above is "yes," should the LLCL be amended to replace the specific exceptions to permitted limitations or eliminations of fiduciary duties set forth in Section 417(a)(1) with a general exception like that found in the Delaware statute?

Background

Sources of Fiduciary Duties:

There are various sources of the fiduciary duties imposed on managers and, in some cases, members of LLCs.

First, there may be fiduciary duties based in contract, such as those arising under the operating agreement or under other contracts between the LLC's managers and/or members.

Second, there are statutory fiduciary duties. In New York, those duties arise under LLCL Section 409. Section 409(a) provides that LLC managers must perform their duties "in good faith and with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances." (This is the same fiduciary standard of care and loyalty applied to corporate directors.) Under Section 409(b), managers are entitled to rely on "information, opinions, reports or statements, including financial statements and other financial data" prepared by the usual types of persons (this is along the lines of Delaware General Corporation Law Section 141(e) and BCL Section 717). Under LLCL Section 409(c), any manager who complies with the requirements of Sectin 409 "shall have no liability by reason of being or having been a manager of the limited liability company."[1]

Finally, there are fiduciary duties set out in the relevant case law, stemming from cases like the seminal case of *Meinhard v. Salmon*[2], a decision by Judge Cardozo in which he made it clear that "coadventurers" (just like partners in a partnership) owe fiduciary duties to each other and

[1] LLCL Section 411 provides generally that a contract in which a manager has a "substantial financial interest" is voidable by the LLC unless the manager has disclosed the material facts of his or her interest to the managers or members who are entitled to vote on the contract. However, the statute does not impose an affirmative duty on the manager to make such disclosure. LLCL Section 411(d) provides that an LLC's operating agreement may provide for restrictions on interested manager contracts and transactions in addition to what is referred to above in this note.
[2] 249 N.Y. 458 (N.Y. 1928)

that a managing coadventurer owes a particularly high level of fiduciary duty to the other coadventurers.

Duties imposed on Managing Members in a Member-Managed LLC are the same as those imposed upon Managers of a Manager-Managed LLC:

In the case of a member-managed LLC, pursuant to LLCL Section 401(b)(i), each member "exercising…management powers or responsibilities shall be deemed to be a manager," and under Section 401(b)(ii) each such member has all of the "duties and liabilities of a manager" provided for in the LLCL (making Sections 409 and 411 applicable to member-managers).[3]

We found nothing in the statute or, looking beyond it, the case law to support any difference in the scope of fiduciary duties owed by managers of a manager-managed LLC and managing members of a member-managed LLC.

Limitations on and Disclaimers of Fiduciary Duties:

LLCL Section 417(a) (borrowing heavily from BCL Section 402(b)) permits members to limit or eliminate the personal liability of managers for "any breach of duty in such capacity" except for those breaches adjudicated (a) to have constituted acts or omissions made in bad faith or which involved intentional misconduct or a knowing violation of law, (b) to have resulted in financial profit or other advantage to the manager to which he or she was not entitled, or (c) to have resulted in a distribution violative of LLCL Section 508(a) without compliance with the due care provisions of LLCL Section 409.[4] The LLCL, then, allows for the limitation or elimination of (a) the Section 409 due care duties (except in the case of distributions made in violation of law) and (b) in its authorization of the limitation or elimination of liability for "any breach of duty," arguably, although not certainly, the affirmative duties of fidelity and candor normally thought to be part of fiduciary duties[5], but specifically prohibits the elimination or limitation of liability for adjudicated acts and omissions that might be considered, broadly speaking, to be wrongful.

---

[3] RULLCA Section 201(b) sets forth the required items for a certificate of organization, but does not require management designation. The comment to this section states that "this act does not require that the certificate of organization state whether the limited liability company is manager-managed or member-managed. Placing that information in a public record pertains primarily to "statutory apparent authority," which this act has eschewed. See the comment to Section 301(a). Under this act, the manager-managed and member-managed characterizations pertain principally to inter se relations, and the act therefore looks to the operating agreement to make the characterization. See Sections 102(10) and (12); Section 407(a)."

[4] These exceptions are set out in LLCL Sec. 417(a)(1).

[5] However, according to one commentator:

> "… one can reasonably infer that the legislature's intent in transporting the language of the New York Business Corporation Law ¶ 402(b)(1) into New York Limited Liability Company Law § 417(a)(1) was simply to allow the members of an LLC to address the concerns raised by *Smith v. Van Gorkom* and limit or eliminate any liability for failing to inform themselves adequately before making a decision --- but certainly not to allow for a waiver of a manager's fiduciary duty of loyalty.

Jack Graves and Yelena Davydan, "Fiduciary Duties of LLC Managers: Are They Subject to Prospective Waiver under the New York LLC Statute?" 31 TOURO L. REV. 439, 451 (2015).

Looking beyond the statute, however, certain recent cases have suggested that New York courts might, under certain circumstances, permit the prospective elimination of an even broader range of duties (including the interest disclosure requirement of LLC Sec 411) (see *Pappas v. Tzolis* (Court of Appeals, 2012)[6], in which the court approved a waiver of all fiduciary duties provided for in a membership interest buy-out agreement in a situation in which the purchasing member possessed clearly material information not known to the other members that allowed him to realize a large profit from the sale of the LLCs assets once he had acquired all of the membership interests), and *Gilbert v. Weintraub* (Nassau County Supreme Court, 2015)[7], in which the court allowed member-manager Weintraub to continue to receive member benefits (including distributions) after having disclaimed his managerial duties and while operating a business competitive with that of the LLC (although under circumstances (including a letter from managing-member Gilbert's lawyer to the LLC's customers advising them that Weintraub was not acting as a manager) that are unlikely to be duplicated); but see also *Fiduciary Duties of LLC Managers: Are They Subject to Prospective Waiver under the New York LLC Statute?* (Touro Law Review, Vol. 31, No. 3 (2015)), taking the view that *Pappas* does not permit broad prospective waivers of fiduciary duties).

Delaware specifically permits the limitation or elimination of a broad class of duties. Under the Delaware LLC Act, members may in their operating agreement limit or eliminate "any and all liabilities for breach of contract and breach of duties (including fiduciary duties)" of a manager or member, except for "the implied contractual covenant of good faith and fair dealing."[8]

Recommendations

We recommend that to avoid doubt, New York should amend LLCL Section 417 to replace the reference to liability for "any breach of duty" as a manager as being subject to limitation or elimination with a reference to liability for "any breach of any duty (including any fiduciary liability) owing by any manager or member." This will allow sophisticated persons who wish to be involved in various similar businesses (such as might be contemplated by the use of series LLCs [see Topic #2]) to do so without fear of violating any managing member or co-member fiduciary duty. However, we would also suggest that the statute might be amended to make it plain that in those cases in which fiduciary duties have not been waived, they will indeed apply to all managers (including all member-managers who had actual managerial authority), so that LLC members do not need to be concerned about something like competition from a member-manger (who would be in a particularly good position to compete with the LLC that he or she had managed). We think that these change would both clarify which manager duties may be limited or eliminated and clarify which manager duties will obtain absent such limitation or elimination.

In our view, the provisions of Section 417(a)(1) should be maintained. We believe that those specific exceptions to the right to limit manager duties provide a commonsense floor for those

---

[6] 982 N.E.2d 576 (N.Y. 2012). According to the court, "the test, in essence, is whether, given the nature of the parties' relationship at the time of the release, the principal is aware of information about the fiduciary that would make reliance on the fiduciary unreasonable." *Id.,* at 233.
[7] Index No: 602290-15
[8] Del. LLC Act, Secs. 18-1101(e). *See also* Sec. 18-1101(c).

duties and also provide clarity for LLC members that the general exception in the Delaware statute does not.

Topic #8 – Piercing the LLC Veil

Background

The doctrine concerning veil piercing of corporations is well-established in New York. However, the New York's Limited Liability Company Law ('LLCL') does not provide statutory guidance on veil piercing in the limited liability company ("LLC") context. Courts instead conduct their LLC piercing analyses through application of the corporate piercing doctrine, often with inconsistent results that lack clarity[1].

Issue

Should the LLCL law in the LLC veil piercing context be revised or left unchanged?

Recommendation

The LLCL should be ***revised*** to provide a statutory basis for the judicial application of the corporate piercing doctrine to LLCs. Moreover, the LLCL revision should also include guidance acknowledging the major difference between LLCs and corporations, namely, the LLC's lack of certain "formalities" that are more applicable in the corporate context.

DISCUSSION

Lack of a Statutory Basis

The present discussion concerns the lack of a statutory basis in the LLCL for LLC veil piercing, but it is also worth noting that the Business Corporation Law ("BCL") governing corporations likewise makes no mention of veil piercing in the corporate context[2]. It has thus been up to the New York state and federal courts to establish the corporate veil piercing doctrine over many decades.

With respect to LLC veil piercing, not only does the LLCL lack guidance in that regard, but the law's legislative history also provides no clues or direction in that connection or with respect to whether and how courts are to apply the corporate veil piercing doctrine to LLCs[3]. An

---

[1] *See* Miriam R. Albert, The New York LLC Act at Twenty: Is Piercing Still "Enveloped in the Midst of Metaphor"? 31 Touro Law Review 410, 428 (2015) ("Since 2005, New York case law has explicitly provided that its LLCs are subject to piercing. What is unclear, and somewhat inconsistent, is both the approaches courts take when evaluating LLC piercing claims, and in some cases, the elements required to pierce an LLC."); *See also* Stuart B. Newman and Tyler Silvey "Piercing the LLC Veil Under New York Law" Vol. 19 No. 1 NYSBA Business Law Journal (2015) 9, 10. In describing a range of New York LLC veil piercing decisions, the authors note that "where the facts become difficult, the lack of a meaningful piercing analysis becomes more apparent".

[2] *See* Newman and Silvey at 10. The authors note that "[p]iercing the veil is not referenced under New York's Business Corporation statues."

[3] *See* Albert at 416 ("Neither the language of §609(a) itself or its legislative history offers any guidance on what factors a court should use to determine whether to pierce an LLC").

unfortunate consequence of judges applying New York's corporate piercing doctrine to LLCs in a framework lacking a statutory basis is that those applications sometimes rely on mere assumptions regarding the corporate piercing doctrine's applicability to LLCs, with some courts misapplying precedent or otherwise engaging in judicial gymnastics to support their reasoning[4]. Indeed, the comment section of the Revised Uniform Limited Liability Company Act ('RULLCA') includes a notation that many state courts simply act "reflexively" when applying the corporate piercing doctrine to LLCs[5].

It is thus recommended that the "reflexive" judicial approach and reasoning that is based on mere assumptions be remedied by providing an express statutory basis for the application of the corporate veil doctrine to LLCs in New York.

Lack of Formalities with LLCs

While establishing a statutory foundation for the application of the corporate veil piercing doctrine to LLCs is necessary, more is needed than just a foundation when one considers that in many LLC piercing cases, LLCs are frequently analogized to corporations, sometimes to the level of being fully equated with them.[6] While corporations and LLCs do share many characteristics, they are indeed different in certain key respects.

Arguably a significant difference between LLCs and corporations relates to the lack of required LLC "formalities." For example, unless the LLC Operating Agreement provides otherwise, LLCs are generally not required to have annual meetings, and members typically need not elect directors or officers; nor do minutes of meetings need to be maintained.

To be sure, some states have recognized the differences between corporations and LLCs in regard to formalities and have accordingly revised their LLC laws to expressly exclude as an LLC piercing factor the failure to observe formalities. For example, the California LLC law expressly excludes "the failure to observe formalities pertaining to the calling or conduct of meetings" as a veil piercing factor. The full version of California's provision follows:

> *"A member of a limited liability company shall be subject to liability under the common law governing alter ego liability…except that the failure to hold meetings of members or*

---

[4] *Id*. at 438. ("Twenty years after the enactment of the NYLLCL, the doctrine of LLC piercing is cobbled together based on corporate law principles . . . The doctrine advances through a judicial affinity for parentheticals and misapplications of precedent. At both the state and federal level, courts have not been careful with their language . . .").

[5] Rev. Unif. Ltd. Liab. Co. Act (2006) (comment on §304 Subsection (b)) ("This subsection pertains to the equitable doctrine of 'piercing the veil' – i.e., conflating an entity and its owners to hold one liable for the obligations of the other. The doctrine of "piercing the corporate veil" is well-established, and courts regularly (and <u>sometimes almost reflexively</u>) apply that doctrine to limited liability companies. In the corporate realm, "disregard of corporate formalities" is a key factor in the piercing analysis. In the realm of LLCs, that factor is inappropriate, because informality of organization and operation is both common and desired." (*emphasis added*).

[6] *See* Albert at 429. ("The word choice of [some] courts seemingly blended LLCs into some variation of a corporation by incorrectly using corporate law terminology when evaluating LLCs piercing claims. While these distinctions are arguably a matter of semantics, they are illustrative of at least an underlying failure to facially see LLCs as an entity separate and apart from corporations.")

> *managers or the **failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor** tending to establish that a member or the members have alter ego or personal liability." (emphasis added)*(California Corporations Code § 17703.04).

On the issue of the lack of formalities in the LLC context, RULLCA Section 304(b) similarly provides that:

> *(b) **The failure of a limited liability company to observe any particular formalities** relating to the exercise of its powers or management of its activities **is not a ground** for imposing liability on the members or managers for the debts, obligations, or other liabilities of the company." (emphasis added)* (RULLCA Section 304).

Colorado's more plenary clause provides as follows:

> *"(1) In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, **the court shall apply the case law** which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law. (2) For purposes of this section, the **failure of a limited liability company to observe the formalities** or requirements relating to the management of its business and affairs **is not in itself** a ground for imposing personal liability on the members for liabilities of the limited liability company." (emphasis added)* (Colorado Revised Statutes, Corporations and Associations § 7-80-107).

The Colorado clause is distinct from other clauses that cover LLC veil piercing in several respects. For example, when comparing it to the RULLCA clause, while there might not at first appear to be a material difference between RULLCA's language that "the failure to observe any particular formalities . . . **is not a ground** for liability", and Colorado's language that "the failure . . . to observe the formalities . . . **is not *in itself* a ground** for imposing liability," Colorado's clause arguably provides a bit more nuance with its inclusion of the words "**in itself**."

What is also significant about the Colorado provision is the fact that not only does it address the issue concerning the LLC's lack of corporate formalities, but it begins by expressly instructing that courts "**shall apply**" corporate veil piercing case law to LLC piercing fact patterns.

Recommendations

The LLCL be revised to provide a statutory basis for the judicial application of the corporate piercing doctrine to LLCs, and the revision should also include guidance acknowledging the major difference between LLCs and corporations, namely, the lack of certain "formalities" in the LLC context.

Of the states and other bodies (including RULLCA) that have crafted LLC statutes to address the LLC veil piercing issue, Colorado strikes the appropriate balance in the following respects: (i) unlike other jurisdictions that have for whatever reason elected not to do so, Colorado expressly provides that reference can and should be made to corporate veil piercing jurisprudence when an LLC piercing analysis is undertaken; and (ii) Colorado's language also

expressly acknowledges that LLCs are different from corporations in regard to LLCs lacking the same formalities as corporations.

One area that Colorado does not address is whether its provision applies to single member LLCs. Thus, one recommended modification to Colorado's language for use in New York would involve the inclusion of a reference that the revised LLCL veil piercing provision also applies to single member LLCs.

Proposed Language

Following is the proposed section for inclusion in the LLCL, substantially in the form of Colorado's section, with the addition of a reference to the section's applicability to single-member LLCs. The clause would be placed at the end of the existing Section 609 of the LLCL (becoming Section 609(e).).

> ***"[§609(e)] In any case in which a party seeks to hold the members of a limited liability company (or member of a single-member limited liability company) personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under New York law. (2) For purposes of this section, the failure of a limited liability company to observe the formalities or requirements relating to the management of its business and affairs is not in itself a ground for imposing personal liability on the members for liabilities of the limited liability company."***

Topic #9 – Judicial Dissolutions of LLCs

Issues

Judicial and non-judicial dissolution of limited liability companies ("LLCs") is addressed in Article 7 of the Limited Liability Company Law ("LLCL") which, with certain exceptions, has not been amended since its enactment in 1994. Motivated at the time by now-passé tax concerns over the avoidance of corporate characteristics, Article 7 was patterned largely on the dissolution provisions governing New York limited partnerships. That helps explain why, compared to the more expansive and robust provisions of Article 11 of the Business Corporation Law ("BCL") governing dissolution of close corporations, Article 7's sparse dissolution provisions continue to generate significant controversy and uncertainty almost 25 years after the LLCL's enactment.

Consideration of Article 7's reformation raises a number of issues of which the following are most pressing, in our view:

(1) Should LLCL Section 702 governing judicial dissolution of LLCs be broadened to include the grounds specified in BCL Sections 1104 (deadlock; internal dissension) and 1104-a (oppression, fraud, illegality, looting, waste and diversion of assets)?

(2) Should standing to seek judicial dissolution under some or all circumstances be restricted to members holding a minimum ownership level?

(3) To what extent, if any, should an amended Section 702 be mandatory or subject to displacement by the operating agreement?

(4) Should Article 7 include an elective buy-out akin to BCL Section 1118 and/or authorize the court to order a remedy other than dissolution including compulsory buy-out of any party by any party?

(5) Should Article 7 authorize the court to grant interim remedies such as appointment of a temporary receiver and injunctive relief as provided in BCL Sections 1113 and 1115.

Recommendations

(1) LLCL 702 should be amended to expand the available grounds for judicial dissolution comparable to, if not precisely tracking, those provided in BCL Sections 1104 and 1104-a.

(2) (3) Standing to seek dissolution should not be subject to a minimum-ownership requirement nor should the operating agreement be permitted to waive judicial dissolution.

(4) (5) Article 7 also should be amended to include new provisions expressly broadening the court's remedial powers and, in particular, authorizing buy-out in lieu of dissolution upon

request of the petitioning or non-petitioning party, as well as any other equitable remedy. Courts also should be afforded more effective case control by authorizing interim remedies such as those found in BCL 1113 and 1115 for injunctive relief and appointment of a temporary receiver.

Existing Law

The Statute

Sections 701 through 705 of Article 7 of the LLCL in the main deal with voluntary dissolution of LLCs. The sole provision in Article 7 addressing involuntary dissolution is Section 702, authorizing a "member" to apply for judicial dissolution of an LLC "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." The only other requirement is that the applicant file a certified copy of the dissolution decree with the Department of State within 30 days of its issuance.

Case Law

LLCL 702's Dissolution Standard. There was no authoritative construction of LLCL 702's "not reasonably practicable" standard prior to the Second Department's decision in *Matter of 1545 Ocean Avenue, LLC*, 72 AD3d 121 [2d Dept 2010], in which the court, drawing upon Delaware case law applying that state's essentially identical statute, formulated a contract-centric, two-prong test requiring the petitioner to

> establish, in the context of the terms of the operating agreement or articles of incorporation, that (1) the management of the entity is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved, or (2) continuing the entity is financially unfeasible.

1545 Ocean Avenue and later cases, such as the First Department's decision in *Doyle v Icon, LLC*, 103 AD3d 440 [1st Dept 2013], establish that LLCs are not subject to the dissolution standards found in the BCL and Partnership Law and that, accordingly, neither deadlock between 50/50 members of an LLC nor oppression of a minority member are grounds *per se* for dissolution under LLCL 702. More recently, in *Mace v Tunick*, 153 AD3d 689 [2d Dept 2017], the Second Department held that a standard purpose clause using the "any lawful business" formulation found in countless operating agreements "did not set forth any particular purpose," thereby raising questions yet to be answered about the efficacy of the first prong of the dissolution standard articulated in *1545 Ocean Avenue*, focusing on whether the LLC's "stated purpose" is being achieved.

Standing. As noted above, LLCL Section 702 confers standing to seek judicial dissolution on any member. In that respect it differs from BCL Section 1104-a, which restricts standing to seek judicial dissolution based on oppressive conduct, among other grounds, to shareholders holding at least 20% of the corporation's voting shares. The Section 702 conferral of standing on members precludes judicial dissolution of an LLC at the behest of an assignee of a membership

interest who has not been admitted as a member (*see Matter of Cline v Donovan*, 72 AD3d 471[1st Dept 2010]), in accord with case law holding that non-member assignees lack standing to assert derivative claims on the LLC's behalf (*e.g., Herman v Herman*, 122 AD3d 506 [1st Dept 2014]).

Dissolution Waiver. LLCL 702 lacks the standard default-rule phraseology, "unless otherwise provided in the operating agreement." We are not aware of any court decision specifically holding that Section 702 is mandatory, however, in *Matter of Youngwall*, Short Form Order, Index No. 22266/07 [Sup Ct Nassau County July 28, 2008], the court held that a provision in an operating agreement waiving the right to seek judicial dissolution of a New York LLC is void and unenforceable as against public policy.

Buy-Out. In contrast to dissolution petitions for close corporations under BCL Sections 1104-a and 1118, the LLCL has no provision authorizing the LLC or any of its members to avoid dissolution by electing to purchase for fair value the interest of the member seeking judicial dissolution. In a handful of appellate rulings, even while recognizing the absence of a statutory buy-out remedy, courts have given life to the "equitable buy-out" under special circumstances, but only after the petitioner has established grounds for judicial dissolution See *Lyons v Salamone*, 32 AD3d 757 [1st Dept 2006]; *Matter of Superior Vending, LLC*, 71 AD3d 1153 [2d Dept 2010]; *Mizrahi v Cohen*, 104 AD3d 917 [2d Dept 2013]); *Kassab v Kasab*, 137 AD3d 1138 [2d Dept 2016]).

Interim Remedies. Article 7 does not include any provision empowering the court to grant interim remedies such as those found in BCL Section 1113 (appointment of temporary receiver) and BCL Section 1115 (interim injunction against corporation's officers, directors, and creditors). In *At the Airport, LLC v Isata, LLC*, 15 Misc 3d 1145(A) [Sup Ct Nassau Co. 2007], the court held that LLCL Section 703 provision authorizing appointment of a receiver or liquidating trustee only applies post-dissolution. Litigants seeking interim remedies in LLC dissolution cases therefore must satisfy the rigorous standards for injunctive relief and appointment of a temporary receiver under CPLR Articles 63 and 64, respectively.

Discussion

Dissolution Standard. In the great majority of states, the first-generation LLC laws adopted in the 1980s and 1990s limited judicial dissolution to a showing that it was no longer reasonably practicable to carry on the business in conformity with the LLC's governing documents. Since then, a still-growing number of states, of which there are at least 24 presently, now include in their second-generation LLC laws – many of which are based on the Revised Uniform LLC Act ('RULLCA') – conduct that is oppressive or unfairly prejudicial to the petitioner as additional ground for judicial dissolution, akin to dissolution statutes governing close corporations. This enlargement of the grounds for judicial dissolution recognizes, as LLC authority Professor Douglas Moll has written, that the principle of majority rule and the lack of a market exit make minority members of LLCs no less vulnerable to abuse at the hands of LLC controllers than minority shareholders at the hands of close corporation controllers. *See* D. Moll, Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History, 40 Wake Forest Law Review 883 (2005).

The LLC has become the preferred entity for newly formed businesses, big and small. Experience tells us that the many small, thinly capitalized businesses with two or more owners that utilize the LLC form rarely invest in negotiated, customized operating agreements or have no operating agreement, leaving minority members subject to the LLCL's default rules offering them minimal protection against the majority's whim. It is a safe bet that most business owners without legal acumen, or without access to experienced legal counsel, are clueless as to the relatively minimal protection afforded them by the LLCL's default rules versus the more robust, mandatory rules and remedies available to minority shareholders of close corporations.

It has been almost 40 years since New York enacted BCL Section 1104-a, giving minority shareholders the right to seek judicial dissolution for oppressive conduct by those in control. A rich body of case law has developed since then, applying the "reasonable expectations" test for oppression articulated by the Court of Appeals in *Matter of Kemp & Beatley*, 64 NY2d 63 [1984]. Incorporation of the BCL's oppression standard in LLCL Section 702 would provide LLC members, their counsel, and the courts with a ready-made set of known governance rules – rules that provide minority members with needed protection against overreaching and inequitable conduct by the majority.

BCL Section 1104-a (a) (1) includes oppressive conduct alongside "illegal" and "fraudulent" actions toward the complaining shareholders. The same trio of actionable conduct appears in RULLCA Section 701. Consideration should be given to including this "trio" in a revised LLCL Section 702.

LLCL Section 702 should also be amended to include member or manager deadlock as an additional ground for judicial dissolution. At least five states by statute, and a significant number of states by case law including Delaware, recognize deadlock as ground for judicial dissolution of LLCs. Disputes between two 50% co-managing members of LLCs have become one of the most common type of "business divorce" case in New York courts, often involving income producing, singe-asset realty companies where it may be difficult to satisfy the "not reasonably practicable" standard.

Finally, and notwithstanding the recent uncertainty concerning "stated purpose" recently introduced by *Mace v Tunick* (*supra*), there is no need to revise LLCL Section 702 existing "not reasonably practicable" standard for LLC dissolution as interpreted in *1545 Ocean Avenue*, which should be left to further refinement by the courts on a case-by-case basis.

Standing. New York courts have hosted numerous LLC dissolution cases brought by members holding interests less than 20%, and even less than 10%. The issues raised in these cases generally are no different than the cases brought by members with larger interests. The question is if there is to be any amendment of standing requirements in dissolution cases, should there be elimination of the 20% minimum under BCL Section 1104-a, not the introduction of a matching or other minimum in LLCL 702. However, the contrary view is that without some minimum a small minority owner can use threat of dissolution of a viable business to sabotage the desire of the majority. In addition, any attempt to legislate a minimum ownership level could generate satellite litigation over its quantification, given the various economic and voting metrics

associated with LLC interests. It is noted that BCL Section 1104-a does not apply to companies whose shares are listed on a national securities exchange or regularly quoted in the over-the-counter market. This exception may not be of much value to LLCs which infrequently are public companies, however, it would be important to the few public LLCs. However, further discussion may be needed to determine if there should be any ownership percentage and, if so, what percentage.

RULLCA and most LLC statutes nationwide limit to the LLC's members the right to petition for judicial dissolution of the LLC, thereby excluding non-member assignees (and creditors). Giving assignees the right to seek dissolution would be inconsistent with the LLCL's default rules, freely permitting assignment but relegating the assignee to the status of economic interest holder with no management or voting rights (unless admitted as a member by the other members), and also would undermine the pick-your-partner principle that is central to the LLC's genetics.

Dissolution Waiver. At this point, Delaware may be the only state whose courts will enforce a provision in the operating agreement of an LLC whereby members waive the right to seek judicial dissolution. *See Huatuco v Satellite Healthcare*, 2013 WL 6460898 [Del. Ch. Dec. 9, 2013], *aff'd w/o opinion*, 93 A.3d 654 [Del. 2014]. The pro-waiver argument rests on freedom-of-contract and enhancement of managerial efficiencies – an argument perhaps better suited to the more sophisticated types of LLCs formed in Delaware, involving more highly capitalized businesses with relatively large numbers of sophisticated, passive investors. While such entities exist in New York as well, this does not describe the small, owner-operated LLCs that constitute the vast majority of LLCs formed in New York by individuals without adequate (or any) legal counsel and without appreciation of the built-in exit barriers. The public policy argument against enforcement of a dissolution waiver, as recognized in *Matter of Youngwall* (*supra*) retains its cogency. In moving forward, further consideration will be given to the pro-waiver v. non-wavier debate.

Buy-Out. The elective buy-out remedy provided in BCL Section 1118, triggered whenever a shareholder petitions for dissolution under BCL Section 1104-a, has proven to be a highly effective mechanism for separating business co-owners who otherwise would remain captive to prolonged litigation over the alleged grounds for dissolution. In many if not most cases, conversion of the dissolution litigation to a fair value proceeding, and the consequential involvement of valuation professionals, spurs a buy-out settlement agreement, thereby allowing the parties to structure the buy-out in ways that might not otherwise be available through judicial means, and also conserving judicial resources.

There is no reason a statutory buy-out remedy could not be equally effective in LLC dissolution cases. Nor is there any justification – other than the absence of statutory authorization – to limit buy-outs in LLC dissolution cases to exceptional ones meriting an "equitable" buy-out as under existing case law that, if anything, incentivizes each side to prove the other's inequitable conduct. Consideration should be given to making a statutory buy-out remedy a "default" provision permitting the members to establish a buy-out mechanism in their operating agreement.

Section 701 (b) of RULLCA authorizes the court in dissolution proceedings based on illegal,

fraudulent, or oppressive conduct by the managers or members in control of the LLC to "order a remedy other than dissolution." The section's Official Comment states that it "can be overridden by the operating agreement," thereby restricting or eliminating the court's power to craft a lesser remedy. When New Jersey adopted RULLCA, it adopted a more explicit version of Section 701 (b) by providing that the court "may order the sale of all interests held by a member who is a party to the proceeding to either the [LLC] or any other member who is a party to the proceeding."

New York likewise should enact a buy-out provision that gives the court broad authority to fashion remedies short of dissolution, including a buy-out of any member by the LLC or another member regardless of the member's status as petitioner or respondent, subject to being overridden by the operating agreement.

Interim Remedies. Article 7 should be amended to empower the court, upon application by a party, to appoint a temporary receiver and to grant interim injunctive relief to preserve the LLC's assets and to carry on its business, as provided in BCL Sections 1113 and 1115. Cloning these provisions into the LLCL will enable courts and litigants to apply a well-developed body of case law that, in general, requires a less rigorous showing and gives the courts broader latitude in fashioning receivership and injunctive remedies that meet the specific needs of the business at a time when it is under maximum stress due to owner conflicts.

Conclusion

Over the years, as LLCs gained in popularity and been operating for a wide variety of businesses, the cases have tended toward resolving disputes among the members and efforts to dissolve the LLC. The LLCL dissolution provisions have worked well for sophisticated parties with negotiating leverage and access to legal expertise, but not for the bulk of small-business owners who lack the sophistication and finances to negotiate and document adequate protection against majority overreach, or who find themselves in irreconcilable deadlock with their co-owner. The contractarian model also does not meet the needs of the many family-owned businesses that, by the second or third generation, fall victim to dysfunction and divergence of interests and talents, and the dispute may relate to family or other non-business factors, notwithstanding the soundness of the LLC's operations and finances.

There is need to facilitate a court-supervised buy-out for fair value and on equitable terms, if adopted will lead to more efficient resolutions of disputes between LLC members. As mentioned, attention would need to be given to seeking to balance the rights and effect of the recommended changes in judicial dissolution in on all the other members, rather than just focusing on the member claiming oppression.

Topic #10 – Activities Excluded from "Doing Business" for Foreign Qualification

Issue

Should the Limited Liability Company Law ("LLCL") Section 803(a) list of prescribed activities by foreign LLCs ("FLLCs") considered as not "doing business in New York" for purposes of exclusion from qualification in New York be expanded to reflect current business activities and to conform with recent changes in the limited liability company ("LLC") statutes in other states?

Recommendation

Yes. For greater certainty in advising FLLCs and to follow the trend of other states in recognizing the wider reach and nature of business activities conducted nationally and internationally, the current list of four activities that do not constitute "doing business in New York" by a FLLC should be expanded by adding all or some of the suggested activities set forth in "Discussion" below.

Current Law

LLCL Section 803(a) provides that without excluding other activities that may not constitute doing business in New York, a FLLC shall not be considered to be doing business in New York for purposes of the LLCL by reason of carrying on in New York any one or more of the following activities:

(1) maintaining or defending any action or proceeding, whether judicial, administrative, arbitrative or otherwise or effecting settlement thereof or the settlement of claims or disputes;

(2) holding meetings of its members or managers;

(3) maintaining bank accounts; or

(4) maintaining offices or agencies only for the transfer, exchange and registration of its membership interests or appointing and maintaining depositaries with relation to its membership interests.

LLCL Section 803(a) was taken from and is identical to Section 1301(b) of the Business Corporation Law ("BCL"), Section 1301(b) of the Not-for-Profit Corporation Law, Section 121-902(b) of the Revised Limited Partnership Act ("RLPA") and Sectin 121-1502(b) of the Partnership Law for foreign limited liability partnerships. The sameness of those Sections under the laws governing the principal business entities in the State may evidence a public policy that the concept of a foreign entity doing business in New York should not vary by reason of the nature of the entity- whether a corporation, not-for-profit corporation, limited partnership, LLP or LLC. The reasons set out herein for examining and perhaps expanding the prescribed activities to exclude a foreign entity from qualification apply equally to all these types of entities; however, the LLCL is the sole focus of our project. Assuming a change to LLCL Section 803(b) as contemplated herein, we believe corresponding changes should be made to those other statutes to maintain parity among the business entity statutes.

The consequence to a FLLC which does business in New York without having qualified is that it may not maintain any action, suit or special proceeding in any New York court unless and until it shall have received a certificate of authority. The failure to have qualified does not impair the validity of any contract or act nor prevent the FLLC from defending any action or special proceeding in New York. Courts have stayed, rather than dismissed, proceedings instituted by non-qualified FLLCs pending completion of their qualifications. *RMS Residential Properties LLC v. Naaze,* 28 Misc.3d 843 (Dist. Ct. Nassau Co., 1st Dist. 2010) Also, no member, manager or agent of such FLLC becomes liable for any of the FLLC's liabilities solely by reason of the FLLC not having been qualified. [Section 808] A practical consequence is representing about or opining on the non-qualified FLLC's status in New York.

Discussion

One perplexing question when forming or dealing with a FLLC which may have some form of business activity in or other association with New York is whether any of the activities or associations would constitute "doing business," thereby subjecting it seek authority as a qualified FLLC. The greater ease of communication, money transfers, travel and other developments since the adoption of the LLCL resulting in business entities extending their geographic reach and business scope has led to uncovering new interpretations of the qualification question.

It is noted that this qualification question is separate from what activities may subject a foreign business entity to state and local sales and other taxes or to jurisdiction in a proceeding in New York.

As part of revising and updating their LLC laws, and to deal with business realities, several states have considered what specific activities engaged in by a FLLC should exclude it from qualification, thereby simplifying the qualification question in their jurisdictions. The four prescribed excluded activities in the New York laws (see "Current Law" above) have been expanded to more than 12 activities in other states. The following list is a composite of excluded activities taken from the LLC statutes in Connecticut, Delaware and Florida and the Revised Uniform Limited Liability Company Act ("RULLCA").

(1) selling through independent contractors;

(2) soliciting or obtaining orders by any means [whether by mail or electronic means or through employees or agents or otherwise], if the orders require acceptance outside New York before they become contracts;

(3) creating as borrower or lender, or acquiring indebtedness with or without a mortgage, or other security interest in real or personal property;

(4) securing or collecting debts, or enforcing mortgages or security interests in property securing the debts, and foreclosing on, holding, protecting or maintaining any such property so acquired;

(5) conducting an isolated transaction (that is completed within ____ days and) that is not one in the course of similar transactions;

(6) owning, without more, real or personal property [although RULLCA Section 803(b) provides that the ownership in New York of income-producing real property or tangible personal property, other than property excluding in this list, constitutes transacting business in this state];

(7) voting securities or other equity ownership interests owned by the FLLC; and

(8) transacting business in interstate commerce.

Moreover, based upon the review of these other statutes, the scope of two of the existing New York exclusions in Section 803(a) should be revised. First, add the lead-in "carrying on any activity concerning its internal affairs, including" to (2). Second, change (3) to read: "maintaining accounts in financial institutions."

The exclusion list is solely for determining whether a FLLC needs to file for a certificate of authority, and should not be used for other purposes. For avoidance of doubt, some jurisdictions have included a separate subsection in the excluded activities section to the effect that: "this section does not apply in determining the contacts or activities that may subject a foreign limited liability company to service of process, taxation or regulation under the laws of this state other than Chapter VIII."

Conclusion

Modification and expansion of the current four statutory business activities exclusions from qualification of a FLLC in New York would reflect current business practices and provide certainty to businesspeople and their advisors when engaging in or planning to engage in some business activities in New York. The additional activities mentioned herein are suggestions for consideration by various users of LLCs in New York, and their attorneys and advisors, in New York, especially those in the real estate and financing sectors. After consensus about possible changes to LLCL Section 803(a), proposed statutory language will be prepared.

In conjunction with possible adoption of changes to LLCL Section 803(a), we will suggest that similar changes to the companion sections under the BCL, the Not-for-Profit Corporation Law, the RLPA and Article 8-B of the Partnership Law for consistency when a foreign enterprise considers the nature of consequences of its activities in New York.

Topic #11 – Profit Purpose

The ad hoc committee has examined this topic and is working with the Business Law Section's Not-for-Profit Corporations Law Committee for further study and recommendations.

Topic #12 – Wage Claim Liability*

Issue

Should Subsections (c) and (d) of Section 609 of the NY Limited Liability Company Law ("LLCL"), which makes the ten members of a NY limited liability company ("LLC") with the largest percentage ownership interest personally liable for wages and salaries of employees, be removed from the LLCL?

Recommendation

Subsections (c) and (d) of LLCL Section 609 should be repealed.

Existing Law — LLCL Section 609

In 2014, the New York legislature passed and the Governor signed into law a bill extending personal liability for wages to members of LLC in New York State. This law amended LLCL Section 609 by adding subsections (c) and (d), making the ten members with the largest percentage ownership interest personally liable for wages and salaries of employees. Subsections (c) and (d) were modeled after a provision in Section 630 of the New York Business Corporation Law ("BCL") making the ten largest shareholders of a corporation personally liable for wages.

An employee seeking recovery under LLCL Section 609(c) must first give written notice to the member or members that he intends to hold them liable under that section. The notice must be giving within 180 days after the employee's services terminate. The employee must first bring a successful action against the corporation that is unsatisfied. An action to enforce liability under Section 609(c) must be commenced within 90 days after "the return of an execution unsatisfied against the LLC upon a judgment recovered against it for such services." A member who has paid more than his pro rata share under Section 609(c) is entitled to contribution pro rata from the other members liable under Section 609(c).

Personal liability for wages does not yet extend to members of foreign LLCs doing business in New York. But bills are pending in the State Assembly and Senate that would extend this liability to foreign limited liability company members for unpaid services performed in New York.[1] Personal liability for wages was similarly extended in 2015 to shareholders of closely held corporations formed in other states for unpaid services performed in New York State.[2] A January 2016 report of the New York City Bar Association ("NYCBA") raised the question of whether applying wage liability to shareholders or members of foreign entities doing business in New York violates the "dormant Commerce Clause" doctrine, which invalidates state laws that

---

* Prior request by the Business Law Section to the NYSBA Executive Committee to pursue repeal of BCL 630/LLCL 609 on wage liability was rejected.

[1] A5131 and S5966, 2017-2018 Leg., Reg. Session (N.Y.)

[2] A.B. A737, 2015-2016 Leg., Reg. Session (N.Y.); S.B. 4476, 2015-2016 Leg., Reg. Session (N.Y.).

place impermissible burdens on interstate commerce, as well as the Due Process Clause of the U.S. Constitution.[3]

Reasons for Repeal

We recommend repeal of subsections (c) and (d) of LLCL Section 609 for the following reasons:

- Subsections (c) and (d) discourage businesses from forming an LLC in New York State and from locating in the state. They act as an impediment to business and employment in the state. No other state makes limited liability company members personally liable for wages in this way.

- These subsections are unfair. They create strict liability for the ten largest owners. Passive owners are liable jointly and severally and regardless of knowledge or fault.

- Workers are adequately protected by veil piercing principles, which allow personal liability for members at fault (Topic #8 above), and by labor and bankruptcy laws. To the extent that other laws fall short in protecting wages, the remedy should be in a change in the labor laws, not the LLCL. The changes should target owners who bear responsibility for the failure to pay wages. Passive owners and investors should not be the ones required to bear the burden.

Limited Liability Serves a Positive Purpose

Personal liability for wages based on nothing more than an ownership interest flies in the face of accepted law in all other states. It also undermines the reason to form a limited liability company in the first place. It is contrary to even the name "limited liability company", making its name misleading for most entrepreneurs.

Limited liability is a bedrock principle of business law for a reason.

- Limited liability encourages investors to take entrepreneurial risks. This promotes the formation and growth of new business entities, which is socially desirable.

- Limited liability allows investors to diversify. Normally, diversification reduces risk. But the possibility of any one company yielding a catastrophic liability discourages diversification.[4]

---

[3] See Note 15 *infra*.

[4] "In an economic analysis, limited liability is seen as a condition for diversification. Without limited liability, investing in one more corporations does not reduce risk. Catastrophic liability in any company within an investor's portfolio would eliminate the investors personal wealth. Adding a corporation to a portfolio causes an increased probability of financial destruction. Rather than investing being analogous to many small gambles, unlimited liability restores to each investment the possibility of being a huge disaster. Limited liability is necessary for diversification and reduction of the financial risk it entails" Phillip I. Blumberg et al., Blumberg on Corporate Groups, § 5.03[B][2] (2d ed. 2005).

- With more risk, an investor would want a higher return on his or her investment, which limits the company's ability to reinvest profits or to compensate management and employees. Higher risk increases the cost of capital. Limited liability facilitates investment, making more capital available at a lower cost.

Removing Limited Liability Discourages Investment and Limits Employment

Most entrepreneurs and angel investors assume that when they invest capital in a corporation or limited liability company, they will incur no personal liability at all. They may need to sign a personal guaranty to obtain a bank loan or sign a lease. But that is a separate undertaking that is generally well understood.

Personal liability for wages is largely unknown and would likely come as a shock to many if not most New York entrepreneurs and angel investors. It is likely that this law has already reduced or at least hindered business formation and new employment in the State of New York.

Imposing Personal Liability on Passive Owners for Wage Liability is Unfair

In addition to discouraging investment and employment in New York State, the imposition of strict liability for employee wages on the largest investors is unfair. Also, the term "largest % ownership interest" is unclear as LLC's can have different forms of ownership interest, such as by allocation of profits and losses, on distributions, on voting and on dissolution.

The members sued may have had no role in the decisions that led to liability. Why should a few passive investors be liable specifically for wages when the reasons for the company's failure to pay are attributable to decisions made or actions taken by others without their knowledge or participation?

Subsections (c) and (d) do not distinguish among the ten largest members based on culpability. The ten largest members are liable without regard to whether they are active or passive owners, or whether they caused or were even aware of events that resulted in non-payment of employees.

The law also poses a dilemma when more than 10 members make equal investments in the company. When twelve or twenty investors invest equal amounts, which ones are the ten largest? Even when the investment amounts differ, an investor may not know whether he or she is one of the ten largest equity owners.

Commonly Known Exceptions to Limited Liability Protection

Aside from wage liability, LLC members can face personal liability for the traditional reasons that corporate shareholders can be liable. LLC members can be personally liable for their company's obligations in three ways: (i) they may sign a personal guaranty, which is commonly done when a small company leases premises or takes out a bank loan; (ii) they may have acted in a way that allows the claimant to "pierce the corporate veil" or (iii) they may fall within the scope of a sanction under a specific statute. For example, the Securities Exchange Act, the Internal Revenue Code and the Comprehensive Environmental Response, Compensation, and

Liability Act (CERCLA), impose liability on individuals at fault regardless of the entity's limited liability protection.

In New York and throughout the U.S., courts have used the doctrine of piercing the corporate veil to hold shareholders and limited liability company members personally liable for their own wrongdoing in appropriate cases, notwithstanding the general principle of limited liability. Veil-piercing typically requires fraud on the part of the defendant as well as a disregard of LLC formalities, inadequate capitalization, commingling of assets or the personal use of the entity's funds. Veil-piercing is a well-known doctrine that targets wrongdoers.[5]

Some History

The historic trend for corporations has been away from personal liability of shareholders.[6] Today, only Massachusetts[7] and New York impose personal liability on the largest corporate shareholders for wages. The courts of Massachusetts have also held that managers of an LLC can be held individually liable under the Massachusetts Wage Act for unpaid wages. But to be personally liable, the manager must be one who "controls, directs, and participates to a substantial degree in formulating and determining the financial policy" of the entity.[8] Personal liability under LLCL Section 609 is far broader. Liability under Section 609 is absolute and does not depend on control or direction. It applies to members, not managers. Moreover, the Massachusetts law is a "wage" act. It is not a part of the state's limited liability company law.

Personal liability of investors for wages dates back to the mid-19th Century. New York first specifically protected employee wages in the Manufacturing Corporations Act of 1848, which made all shareholders of companies organized under the act "jointly and severally individually liable for all debts that may be due and owing to all their laborers, servants and apprentices, for services performed for such corporation."[9] Joint and several shareholder liability for wages was then embodied in Section 71 of the New York Stock Corporation Law, the predecessor of the Business Corporation Law.[10]

Eventually, personal liability for wages became part of New York corporate law as Section 630 of the Business Corporation Law. The BCL was enacted in 1961 and became effective in 1963.[11] Section 630 was added for the first time in the final draft of the BCL which was introduced shortly before it was enacted. Section 630 is a revised version of Section 71 of the

---

[5] *See* Stuart B. Newman & Tyler Silvey, *Piercing the LLC Veil Under New York Low,* 19 N.Y. Bus. Law Journal 9 (Summer 2015) note 15, at 21. *See also* Miriam **R.** Albert, "The New York LLC Act at Twenty: Is Piercing Still 'Enveloped in the Midst of Metaphor'?" Touro Law Review, Vol 31, No. 3 (2015).

[6] Broadening Low-Wage Workers' Access to Justice: Guaranteeing Unpaid Wages in Targeted Industries, 28 Hofstra Lab. & Emp. L.J., 15 (2010); Blumberg on Corporate Groups § 3.04[A].

[7] Massachusetts law imposes liability on corporate shareholders for services an employee renders up to six months before the demand for payment. Mass. Gen. Laws ch. 156, § 35.

[8] Cook v. Patient Edu LLC, 465 Mass 548 (Supreme Judicial Court of Mass., June 2013), available at https://scholar.google.com.co/scholar case?case=830407315138960736

[9] N.Y. Sess. Laws 1848, ch. 40, § 18.

[10] See Rogers & McManus, Sharehoklers' Booby-Trap: Partnership Liability of Shareholders under Section 71, New York Stock Corporation Law, 28 N.Y.U. L. Rev. 1148 (1953).

[11] N.Y. Bus. Corp. Law § 630 (1961); See Robert S. Stevens, New York Business Corporation Law of 1961, 47 Cornell L. Rev. 141 (1962).

prior law.[12] The time within which an employee must notify the shareholders of a wage claim under Section 630 was increased from 90 days to 180 days in 1984.

In November 2015, BCL Section 630 was amended to extend personal liability for wages to shareholders of closely held corporations formed in other states and qualified to do business in New York State. The ten largest shareholders were made personally liable for unpaid services performed in New York State.[13]

This change was unsuccessfully opposed by a joint legislative committee of the NYSBA's Business Law Section and International Law Section, which also sought to repeal BCL Section 630 and LLCL Sections 609(c) and (d).[14] The NYCBA issued a separate report supporting this unsuccessful effort, saying in part that

> "despite attractive tax breaks and cash incentives offered to New York incorporated and located businesses, companies will avoid New York to protect their investors from a legal regime of unlimited liability. An unknown amount of unlimited liability is simply a non-starter for sophisticated business investors."[15]

The NYCBA report called New York's wage liability position an "anachronism" that is "completely at odds with well-settled principles of New York corporation law."

Limited liability companies were introduced in the U.S. in 1977. In that year, Wyoming was the first state to enact a limited liability company law. The New York LLCL was enacted in 1994. By 1997, ail fifty states in the U.S. had limited liability company laws. Today, the number of new limited liability companies far exceeds the number of new corporations being formed across the country each year.

As noted above, the LLCL was amended in 2014 to make the ten members with the largest percentage ownership interest personally liable for wages and salaries of employees.[16] In 2016, the Executive Committee of the NYSBA opposed a proposal by its Business Law Section to repeal the 2014 amendments to LLCL 609. Any new recommendation by the Section for the repeal of those amendments would be brought before the NYSBA Executive Committee.

We wonder how effective BCL Section 630 and its predecessor sections have been ove rhte years n protecting employee wage claims in New York against the effect of the notoriety of the provision.

---

[12] See Shareholder Liability for Wages: Section 630 of the New York Business Corporation Law, 30 Fordham **L.** Rev. 471, 476 (1962).

[13] A.B. A737, 2015-2016 Leg., Reg. Session (N.Y. 2015); 5.6. 4476, 2015-2016 Leg., Reg. Session (N.Y. 2015).

[14] www.ieclairryan.com/files/Uploads/Documents/Owner%20Liability%2Ofor%20Wages%2Oin%2ONY,pdf.

[15] BCL Section 630 and LLCL Sections 609(b) and (c) result in "real dollars lost to New York, in the form of lost corporate filing fees, taxes, unclaimed property, professional service fees and other losses to New York coffers from corporations that have incorporated elsewhere" to avoid these laws. https://www2.nycbar.org/pdf/report/uploads/20073032-VeilPiercingRepealNYSBACorporationsReportFINAL11516.pdf

[16] Assembly Bill A8106.C; Senate Bill S5885B, 2013-2014 Leg., Reg. Session (N.Y.).

Other Laws Protecting Employees

The need for wage protection was far greater in 1848, when New York first specifically enacted legislation to protect employee wages, than it is today. In 1848, lawmakers could not have imagined the range of federal and state labor laws that protect workers today. The Fair Labor Standards Act of 1938 (FLSA) establishes the minimum wage, overtime pay, recordkeeping requirements, and youth employment standards. The FLSA defines "employer" broadly, often imposing personal liability where an individual has operational control of the day-to-day management. The Employee Retirement Income Security Act of 1974 ("ERISA") sets minimum standards for worker pension and health plans. The Bankruptcy Act gives employees a priority claim in bankruptcy proceedings for up to $10,000 in wages earned within 180 days of the bankruptcy filing.

New York State law also aggressively protects workers' wages. In one case, an employee missed the short time period in which to make a claim under BCL Section 630 but succeeded in a claim under New York Labor Law Section 190(3), which broadly defines an "employer"[17]

In addition, New York's Wage Theft Prevention Act, which became effective in 2011, added remedies such as the ability to collect double damages for wage violations. The legislation enacted in 2014 that amended LLCL Section 609 to make the ten members with the largest percentage ownership interest personally liable for wages and salaries of employees also included changes in New York labor law. One of those changes was to create successor liability that makes it more difficult for a company to restructure or to dissolve and create a new entity in order to avoid wage liability. The problem with the 2014 legislation was that it went one step too far by adding subsections (c) and (d) to LLCL Section 609.

Conclusion

No members of an LLC should be personally liable for debts, wages or salaries owed to employees, simply by virtue of their status as members. LLCL Sections 609(c) and (d) violate a bedrock principle of limited liability company laws throughout the United States that the liability of members is limited to the amount of money they invest in the business and create a detriment to business formation in New York.

---

[17] Wing Wong v. King Sim Yee, 693 N.Y.5.2c1536 (1st Dep't 1999).

Topic #13 – Charging Orders

Issues

(1) Should the NY Limited Liability Company Law ("LLCL") expressly state that the charging order is the exclusive remedy of judgment creditors of LLC members' transferable interests?

(2) Should the LLCL provide that court may foreclose the lien and order the sale of a member's transferable interest in a limited liability company ("LLC")?

(3) Should the LLCL expand the concept of a charging order to refer to appointment of receivers?

Brief Background

LLCL Section 607 provides that a creditor may obtain a charging order against a judgment debtor's transferable interest in a LLC.[1] Under Section 607, the rights of the judgment creditor are those of an assignee of the membership interest. The creditor does not have the right to "obtain possession or, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company."[2] ULLCA Section 503 likewise provides that a judgment creditor may seek a charging order.[3] Under both the LLCL and Revised Uniform

---

[1] NY LLCL Section 607(a) ("On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the membership interest of the member with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the membership interest. This chapter does not deprive any member of the benefit of any exemption laws applicable to his or her membership interest.")

[2] NY LLCL Section 607(b) ("No creditor of a member shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company."). Note, however, a creditor may have rights against an LLC that makes a wrongful distribution to a member as set forth in Section 508(a) of the Act, and against that member under Section 508(b) of the Act. *See* NY LLCL SectionSection 508(a) and (b). NY LLC Section 508(a) provides, in pertinent part, that "[a] limited liability company shall not make a distribution to a member to the extent that, at the time of the distribution, after giving effect to the distribution, all liabilities of the limited liability company, other than liabilities to members on account of their membership interests and liabilities for which recourse of creditors is limited to specified property of the limited liability company, exceed the fair market value of the assets of the limited liability company, except that the fair market value of property that is subject to a liability for which the recourse of creditors is limited shall be included in the assets of the limited liability company only to the extent that the fair value of such property exceeds such liability." A member who receives such a distribution is liable to the LLC to repay it if the member knew at the time of the distribution that it violated Section 508(a) of the Act.

[3] ULLCA Section 503(a) ("On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount

Limited Liability Company Act ("RULLCA"),a charging order is a lien on the transferable interest and is not a transfer or assignment of the charged interest.[4]

Is a Charging Order the Exclusive Remedy of Judgment Creditors?

The LLCL does not expressly say that a charging order is the exclusive remedy of the judgment creditor.[5] Some commentators have suggested that the non-exclusive nature of the NY charging order statute means that judgment creditors may seek alternative methods of enforcement in certain circumstances. For example, some commentators have argued that judgment creditors should be able to seek the entry of an order requiring the member/owner of a single-member LLC to turn over his entire interest in the LLC in cases where distributions will not satisfy a judgment in reasonable time. The theory being that the sole member of a single-member LLC has control over when and if future distributions will be made. Other commentators have argued that the language of Section 607 is unclear, and that it therefore is an open question whether charging orders are the exclusive remedy for judgment creditors.

In contrast to the LLCL, the RULLCA commentary states that Section 503 (the charging order statute) "provides the exclusive remedy by which a person seeking in the capacity of judgment creditor to enforce a judgment against a member or transferee may satisfy the judgment from the judgment debtor's transferable interest." Section 503(a) provides that "[o]n application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment." Sections 503(b) and (c) of the RULLCA provides for the entry of "all orders necessary" to give effect to a charging order, including the appointment of a receiver or, upon a showing that distributions under a charging order will not pay a judgment debt within a reasonable time, a

---

of the judgment.") *See also* Del LLCA Section18-703(a) ("On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the limited liability company interest of the judgment debtor to satisfy the judgment. To the extent so charged, the judgment creditor has only the right to receive any distribution or distributions to which the judgment debtor would otherwise have been entitled in respect of such limited liability company interest.")

[4] ULLCA Section 503(a) (Except as otherwise provided in subsection (f), a charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that otherwise would be paid to the judgment debtor.")

[5] Compare LLCL Section 607 with RULLCA Section503(h) ("This section provides the exclusive remedy by which a person seeking in the capacity of judgment creditor to enforce a judgment against a member or transferee may satisfy the judgment from the judgment debtor's transferable interest.") and Del LLCA Section18-703(d) ("The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or a member's assignee may satisfy a judgment out of the judgment debtor's limited liability company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member.").

court order foreclosing the lien and ordering the sale of the member's transferable interest. [6]

Apart from the RULLCA, several non-NY jurisdictions have considered whether charging orders are, or ought to be, the exclusive remedy for judgment creditors, especially in cases involving single-member LLCs. In *Olmstead v. FTC*, 44 So.3d 76 (Fla. 2010), for example, the Florida Supreme Court held that charging orders were "*nonexclusive* remedial mechanism[s]" in such cases, and further held that a court "may order a judgment debtor to surrender all right, title, and interest in the debtor's single-member LLC to satisfy an outstanding judgment." *Id.* at 81, 83 (emphasis in original). In response to *Olmstead* (and a vigorous dissent in that case), the Florida legislature amended its LLC law specifically to state that the charging order is not the exclusive remedy if distributions will not satisfy a judgment against the owner of a single-member LLC within a reasonable time.[7] The legislature also amended the statute to provide that a creditor can foreclose on a single-member LLC interest in such cases, with the purchaser becoming the owner of the single-member LLC following foreclosure.[8] The amended statute makes it clear that these remedies are available only with respect to single-member LLCs.[9]

---

[6] *See* ULLCA Section 503(b) ("To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subsection (a), the court may: (1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and (2) make all other orders necessary to give effect to the charging order.") *See also* ULLCA Section 503(c) (c) ("Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. Except as otherwise provided in subsection (f), the purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a member, and is subject to Section 502.").

[7] The Florida LLC statute generally provides that the charging order is an exclusive remedy. *See* FL LLCA 605.0503 (3) ("Except as provided in subsections (4) and (5), a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member's transferee may satisfy a judgment from the judgment debtor's interest in a limited liability company or rights to distributions from the limited liability company."). The Florida LLC charging order statute also makes it clear, however, that other options may be available if distributions under a charging order will not satisfy a judgment within a reasonable time. *See* 605.0503(4) ("In the case of a limited liability company that has only one member, if a judgment creditor of a member or member's transferee establishes to the satisfaction of a court of competent jurisdiction that distributions under a charging order will not satisfy the judgment within a reasonable time, a charging order is not the sole and exclusive remedy by which the judgment creditor may satisfy the judgment against a judgment debtor who is the sole member of a limited liability company or the transferee of the sole member, and upon such showing, the court may order the sale of that interest in the limited liability company pursuant to a foreclosure sale. A judgment creditor may make a showing to the court that distributions under a charging order will not satisfy the judgment within a reasonable time at any time after the entry of the judgment and may do so at the same time that the judgment creditor applies for the entry of a charging order.")

[8] *See* FL LLCA 605.0503(5) ("If a limited liability company has only one member and the court orders a foreclosure sale of a judgment debtor's interest in the limited liability company or of a charging order lien against the sole member of the limited liability company pursuant to subsection (4):

(a) The purchaser at the court-ordered foreclosure sale obtains the member's entire limited liability company interest, not merely the rights of a transferee;

(b) The purchaser at the sale becomes the member of the limited liability company; and

(c) The person whose limited liability company interest is sold pursuant to the foreclosure sale

Other jurisdictions – notably Delaware – take a different approach. The Delaware LLC statute makes it clear that the charging order is the exclusive remedy for judgment creditors, even in cases involving single-member LLCs. *See* DEL. LLCA Section 18-703(d) ("The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or a member's assignee may satisfy a judgment out of the judgment debtor's limited liability company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member.")

Other Considerations

Although an in-depth review of the interplay between LLC law and the bankruptcy code is beyond the scope of this report, there is some evidence suggesting that creditors may have an easier time recovering in bankruptcy. In *In re Albright,* 291 B.R. 538, 541 (Bankr. D. Colo 2003), for example, the court held that bankruptcy trustee succeeded to all rights of the debtor (the sole owner of a single-member LLC), including voting and management rights. The court also held that no written unanimous approval of transfer was necessary under a Colorado LLC statute that required "other members" to permit an assignee to participate in management of the LLC, because the LLC had only one member/owner. *Id*. (citing Colorado LLC law). *See also In re First Protection*, 440 B.R. 821, 828 (B.A.P. 9th Cir. 2010) (holding Section 541(c)(1) of the Bankruptcy Code "overrides both contract and state law restrictions" on the transfer of a debtor's membership interest in an LLC, and further holding that bankruptcy trustee "was not a mere assignee, but stepped into [the] debtors' shoes, succeeding to all of their rights, including the right to control" the LLC).

Also note that the equitable doctrine of piercing the veil of limited liability *may* be available in certain jurisdictions as an additional mechanism for enforcement/ recovery. See Topic #8.

Recommendations

We recommend amending the LLCL expressly to state whether and under what circumstances a charging order is the exclusive remedy for judgment creditors. Clear and consistent rules regarding the availability (or lack of availability) of other methods of enforcement would allow parties such as voluntary creditors to perform due diligence, or to engage in private ordering (e.g., require security for transactions), or both, before entering into transactions with LLCs or LLC members. Clear rules and opportunities for diligence and planning have the potential to

---

or is the subject of the foreclosed charging order ceases to be a member of the limited liability company."

[9] FL LLCA 605.0503(6) "(In the case of a limited liability company that has more than one member, the remedy of foreclosure on a judgment debtor's interest in the limited liability company or against rights to distribution from the limited liability company is not available to a judgment creditor attempting to satisfy the judgment and may not be ordered by a court.")

reduce risk and costs.

We also recommend amending the statute to make charging orders the exclusive method of enforcement in the manner set forth in RULLCA Section 503. Arguments for making the charging order the exclusive remedy of judgments creditors are particularly strong for voluntary creditors such as contractual counterparties. Voluntary creditors are in a position to engage in planning, self-protection and private ordering prior to entering into transactions with LLCs or their owners. Voluntary creditors also have the opportunity to walk away if they are not comfortable with deal terms or risks. Making the charging order the exclusive remedy of the judgment creditor recognizes that we allow people to contract with whom they wish, including businesses and individuals who operate through forms of organization that provide for limited liability for owners. Routinely opening up enforcement mechanisms other than the charging order risks undermining incentives for planning and self-help, and the strength of the LLC liability shield.

We do have some concerns about impact of this proposed rule on involuntary creditors – e.g., tort victims. Involuntary creditors do not have the opportunity to engage in pre-judgment research, self-protection, or private ordering, and there is a risk that tort-based judgments may be left unsatisfied, especially in situations involving thinly-capitalized single-member LLCs or in situations when a tortfeasor's major asset is an interest in an LLC. More generally, as to both voluntary and involuntary creditors, there is always the risk that an LLC or its owners might seek to evade a lien, or use the LLC's liability shield (and the language of the charging order statute) in a wrongful or fraudulent manner, so as to deprive judgment creditors of any recovery. An overly strict exclusivity rule runs the risk of cutting off equitable avenues for recovery in such cases.

With these concerns in mind, the approach taken by RULLCA Section 503 makes sense. Section 503(h) states that the charging order is the "exclusive remedy" by which a person seeking in the capacity of judgment creditor to enforce a judgment against a member or transferee may satisfy the judgment from the judgment debtor's transferable interest, but the statute empowers the court to make all orders necessary to give effect to the charging order, including the appointment of a receiver and, in limited circumstances, a foreclosure sale. In this way, Section 503 empowers courts to deal with any efforts to evade a lien associated with a charging order. A Section 503 receiver has the power to make all inquiries the judgment debtor might have made. The court's power under Section 503 does not, however, extend to interfering in the legitimate activities of an LLC. Relatedly, the purchaser at a foreclosure sale does not become a member under subsection (c), thereby preserving the "pick your partner/LLC member" principle reflected in the LLCL. In this way, the RULLCA balances the judgment creditor's interest in enforcement with the LLC and LLC member's interest preserving the LLC liability shield. For this reason, we recommend amending the LLCL charging order statute along the lines of the approach taken in RULLCA Section 503.

Topic #14 – Professional Service LLCs

Issues

(1) Should licensed professionals must use the professional service limited liability company ("PSLLC") form if they choose to form a limited liability company in New York ("LLC")?

(2) Should the NY Limited Liability Company Law ("LLCL") expressly state that LLCs formed to engage in activities subject to state licensing authority must form under Article XII (PSLLC) or XIII (Foreign PLLC), and not Article II (LLC)?

Background

LLCL Article XII sets forth the rules and requirements relevant to forming and operating domestic PSLLCs in New York:

- Section 1201(b) defines "profession" to include any practice as an attorney and counselor-at-law, or as a licensed physician, and those professions designed in Title 8 of the Education Law.

- Section 1203 provides that "one or more professionals each of whom is authorized by law to render a professional service . . . **may** form or cause to be formed, a professional services limited liability company."[1] *Id.* (emphasis added).

- Section 1204 provides that " [n]o professional service limited liability company may render a professional service except through individuals authorized by law to render such professional service, as individuals . . ."

- And, relatedly, Section 1205 provides that licensed professionals remain liable for their own wrongful acts or other misconduct, along with the wrongful acts or other misconduct of those acting under their direct supervision or control, even when providing services through a PLLC. *See* Section 1205(a).[2]

---

[1] *See* Section 1203 Formation.

> (a) Notwithstanding the education law or any other provision of law, one or more professionals each of whom is authorized by law to render a professional service within the state, or one or more professionals, at least one of whom is authorized by law to render a professional service within the state, may form, or cause to be formed, a professional service limited liability company for pecuniary profit under this article for the purpose of rendering the professional service or services as such professionals are authorized to practice.")

[2] "Each member, manager, employee or agent of a professional service limited liability company shall be personally and fully liable and accountable for any negligent or wrongful act or misconduct committed by him or her or by any person under his or her direct supervision and control while rendering professional services on behalf of such limited liability company."

Article XIII speaks to requirements for foreign PSLLCs. The limited liability partnership (LLP) [3] and professional service corporation (PC) forms[4] are subject to similar rules and restrictions in New York.

The **may** language of Section 1203 has led to confusion about whether domestic professional services firms – and law firms, in particular -- **must** form under Article XII of the LLCL if they wish to use the LLC form; or, alternatively whether they may choose to form under either Article

---

[3] *See* Section 121-1500 Registered limited liability partnership.

> (a)(I) Notwithstanding the education law or any other provision of law, (i) a partnership without limited partners each of whose partners is a professional authorized by law to render a professional service within this state and who is or has been engaged in the practice of such profession in such partnership or a predecessor entity, or will engage in the practice of such profession in the registered limited liability partnership within thirty days of the date of the effectiveness of the registration provided for in this subdivision or a partnership without limited partners each of whose partners is a professional, at least one of whom is authorized by law to render a professional service within this state and who is or has been engaged in the practice of such profession in such partnership or a predecessor entity, or will engage in the practice of such profession in the registered limited liability partnership within thirty days of the date of the effectiveness of the registration provided for in this subdivision, (ii) a partnership without limited partners authorized by, or holding a license, certificate, registration or permit issued by the licensing authority pursuant to the education law to render a professional service within this state, which renders or intends to render professional services within this state, or (iii) a related limited liability partnership may register as a registered limited liability partnership".)

[4] *See* Section 1501. Definitions, Business Corporation Law

> (b) "Profession" includes any practice as an attorney and counselor-at-law, or as a licensed physician, and those occupations designated in title eight of the education law.

See Section 1503. Organization. Business Corporation Law

> (a) Notwithstanding any other provision of law, one or more individuals duly authorized by law to render the same professional service within the state may organize, or cause to be organized, a professional service corporation for pecuniary profit under this article for the purpose of rendering the same professional service, except that one or more individuals duly authorized by law to practice professional engineering, architecture, landscape architecture, land surveying or geology within the state may organize, or cause to be organized, a professional service corporation or a design professional service corporation for pecuniary profit under this article for the purpose of rendering such professional services as such individuals are authorized to practice.

See Section 1504. Rendering of professional service. Business Corporation Law

> (a) No professional service corporation, including a design professional service corporation, may render professional services except through individuals authorized by law to render such professional services as individuals.

II or Article XII. It is noted that the BCL and Partnership Law Article 8-B both provide that the professional may form a PC or a LLP. This question is addressed below, focusing on lawyers and law firms.

<u>What is a Profession?</u>

In 1974, the New York Court of Appeals defined a "profession" as having certain distinguishing characteristics, including the following: (1) requirements for formal training and learning, (2) admission to practice by qualifying licensing, (3) a code of ethics beyond that generally established in the marketplace, (4) a system to discipline its members for violation of the code of ethics, and (5) duties of members to conduct themselves honorably. *See Hospital Computer Sys. Inc. v. Staten Island Hosp.*, 788 F. Supp. 1351, 1361 (D.N.J. 1992) (quoting *In re Estate of Freeman*, 311 N.E.2d 480 (N.Y. 1974))[5]. Historically, definitions such as the one used by the Court of Appeals in *Hospital Computer Sys. Inc.* encompassed only the traditional professions such as law, accounting, and medicine. By the 1980's, however, courts had extended professional malpractice liability to pharmacists, architects, and engineers. *See, e.g.,* John W. Wade, *An Overview of Professional Negligence,* 17 Memphis St. U. L. Rev. 465, 477 (1987).

Today, a wide range of occupations are subject state licensure, registration, and regulation. For the traditional professions of law, medicine, and accounting, licensure, registration, and regulation is handled by domain-specific bodies (e.g., for lawyers, through the Office of Court Administration). Other professions in New York are subject to licensure under Title 8 of the Education Law. *See* https://www.dos.ny.gov/licensing/.

<u>Background</u>

<u>Law Firm Organization</u>

Traditionally, lawyers had two options with respect to entity selection – sole proprietorships or general partnerships. Lawyers were restricted to these two forms for a variety of reasons, including lawyers' fiduciary duties to their clients and client protection. The absence of a liability shield in sole proprietorships and general partnerships meant that the owners suffered the burden of unlimited personal liability for enterprise debts and obligations, allowing clients harmed by attorney malpractice, for example, to recover from individual partners in cases where the firm's assets were insufficient to satisfy a judgment.

Things began to change in 1961, when the ABA Committee on Ethics and Professional Responsibility issued Opinion No. 303. At that time, lawyers were interested in using the

---

[5] *In re Estate of Freeman*, 311 N.E.2d at 483 ("A profession is not a business. It is distinguished by the requirements of extensive formal training and learning, admission to practice by a qualifying licensure, a code of ethics imposing standards qualitatively and extensively beyond those that prevail or are tolerated in the marketplace, a system for discipline of its members for violation of the code of ethics, a duty to subordinate financial reward to social responsibility, and, notably, an obligation on its members, even in non professional matters, to conduct themselves as members of a learned, disciplined, and honorable occupation.")

corporate form to take advantage of certain tax benefits (e.g., higher pension contributions) associated with the corporate form. Opinion No. 303 stated that lawyers could practice through corporations provided certain safeguards were satisfied, including the following: (i) the lawyer remains personally responsible to the client for services rendered; (ii) restrictions on liability of other lawyers in the firm are made apparent to the client; (iii) none of the stockholders are non-lawyers; (iv) there is no sharing of profits with employees who are not lawyers; and (v) only lawyers may participate in the management of the firm.

Different Approaches to Professional Services Firms

As the first alternative to the sole proprietorship and general partnership, the professional corporations authorized by Opinion No. 303 opened the door for other limited liability entity forms now available, including the LLP and LLC.[6] Today, lawyers and other professional services firms are taking advantage of the opportunity to use these newer forms of organization. *See*, *e.g.*, Allison Martin-Rhodes, Robert W. Hillman & Peter Tran, *Law Firm Entity Choices Reflect Appeal of New Business Forms*, Business Entities, at pp.16-23 (July/August 2014); Conrad S. Ciccotello & C. Terry Grant, *Professions as Commercial Institutions: An Analysis of Evolving Professional Forms*, 7 J. Legal Stud. Bus. 1, 16 (2000).

Requirements for and Approaches to Limited Liability Forms of Organization

It is important to note that in many jurisdictions – including New York – professional services firms must comply with rules and requirements not applicable to other types of businesses: [7]

- States (including New York) that offer the PSLLC form typically say that only state-licensed professionals can provide services through a PSLLC. This means that non-licensed individuals may not form or provide services through a PSLLC.

- "[S]tates almost universally require some form of professional malpractice insurance for [law firms that choose to form and operate via] liability limiting entities," including (where available) LLCs and LLC variants, where available. *See* Allison Martin-Rhodes, Robert W. Hillman & Peter Tran, *Law Firm Entity Choices Reflect Appeal of New Business Forms*, Business Entities, at 21 (July/August 2014).

- State statutes (including New York's LLCL) also generally provide that professionals will remain liable for their own misconduct, and potentially the misconduct of those whom they directly supervise or control, even when using a

[6] LLPs originated in Texas as a response to lawyers (and accountants) arising out of the collapse of the real estate and energy markets in the 1980s. *See* Conrad S. Ciccotello & C. Terry Grant, *Professions as Commercial Institutions: An Analysis of Evolving Professional Forms*, 7 J. Legal Stud. Bus. 1, 16 (2000).

[7] For example, Alabama allows lawyers to form LLCs, but the statute contains special rules and requirements for LLCs providing professional services. These rules and requirements track those applicable to professional corporations in Alabama, and track those set forth in Article XII of the NY LLCA. *See* https://www.alabar.org/resources/office-of-general-counsel/formal-opinions/1993-16/

PLLC. In other words, the liability shield available to professional services firms using the PLLC form may not be absolute.

- A number of jurisdictions allow licensed professionals to use any form of organization or business entity, including an LLC, ***unless*** the relevant professional licensing authority or professional code expressly prohibits it. (In some jurisdictions, this approach is accomplished via rules which state that a professional services firm may use the LLC form if specifically authorized to do so via statute.) In California, for example, LLCs may not provide legal services because relevant provisions of the Business & Professions Code do not authorize LLCs to do so. *See* Cal. Corp. Code Section 17701.04(b).[8]

- Finally, some jurisdictions provide for some liability limiting forms of organization for professional services forms (typically, PCs), but do not provide for PLLCs in their LLCAs.

The Jacoby & Meyers Case

Although the New York courts have not directly addressed the question of whether professional services firms – and law firms, in particular – must form under Article XII of the LLCA, the Jacoby & Meyers case discussed below offers some insight into how a court might approach this question.

In 2011, the New York-based law firm Jacoby & Meyers LLP (J&M) filed a lawsuit challenging the constitutionality of Rule 5.4 of the Model Code of Professional Responsibility, as adopted in New York. *See Jacoby & Meyers, LLP et al v. Presiding Justices of the First, Second, Third and Fourth Departments, Appellate Division of the Supreme Court of the State of New York*, 847 F. Supp. 2d 590 (S.D.N.Y. 2012). Rule 5.4 embodies the rule that lawyers may not obtain equity investments in their practices from non-lawyers. J&M argued that the ban on equity investment by non-lawyers violated the First and Fourteenth Amendments and the dormant Commerce Clause of the U.S. Constitution by imposing unfairly high capital costs on the firm. The firm argued that high capital costs were impairing the firm's ability to expand what it characterized as

---

[8] *See Cal. Corp. Code Section 17701.04.*

> (a) A limited liability company is an entity distinct from its members.
>
> (b) A limited liability company may have any lawful purpose, regardless of whether for profit, except the banking business, the business of issuing policies of insurance and assuming insurance risks, or the trust company business. A domestic or foreign limited liability company may render services that may be lawfully rendered only pursuant to a license, certificate, or registration authorized by the Business and Professions Code, the Chiropractic Act, the Osteopathic Act, or the Yacht and Ship Brokers Act, if the applicable provisions of the Business and Professions Code, the Chiropractic Act, the Osteopathic Act, or the Yacht and Ship Brokers Act authorize a limited liability company or foreign limited liability company to hold that license, certificate, or registration.

its mission – i.e., to provide lower cost legal services to those who cannot afford more traditional lawyers.

After a motion to dismiss J&M's complaint on standing grounds, Jacoby amended its complaint to include an additional plaintiff -- Jacoby & Meyers USA, LLC ("J & M LLC"). J & M LLC allegedly was formed for the purpose of allowing non-lawyers to own an interest in the entity through which J & M practiced law. J&M represented that it was prepared to transfer all of its assets to J & M LLC in order to obtain non-lawyer investment if Rule 5.4's suppression of non-lawyer ownership was declared unconstitutional and its enforcement enjoined.

In a 2012 ruling, Judge Kaplan of the Southern District of New York dismissed J&M's amended complaint, holding that because New York law prohibits law firms from using LLCs regardless of the nature or identity of investors, J&M's newly-formed LLC lacked standing to challenge Rule 5.4. Judge Kaplan cited two bases for this holding: N.Y. Jud. Law Section 495(1), which prohibits "corporations and voluntary associations from practicing law," and Section 1203 of the LLCL and related provisions of the LLCL.

With respect to Section 495, Judge Kaplan cited two cases as grounds for his conclusion that an LLC is a "corporation or voluntary association" for purposes of Section 495 – *Garas* and *In Co-Operative Law Co*. In *Garas*, a lawyer who had subcontracted real estate closing services to an LLC that was owned and staffed by non-lawyers was charged with aiding and abetting non-lawyers in the practice of law. In *Co-Operative Law Co.*, the entity at issue was created to provide legal services to shareholders, and it was structured so that it "might not have a lawyer among its stockholders, directors or officers." Although both of these cases arguably are distinguishable from J&M – where the LLC was formed and controlled by lawyers – Judge Kaplan held that LLCs formed under Article II of the LLCA fall within Section 495's prohibitions.

With respect to the LLCL, Judge Kaplan cited the "very existence" of the PSLLC form (together with the requirement that only state-licensed professionals may use the PSLLC form) as grounds for his holding. Judge Kaplan noted that PLLCs are subject to more restrictions that LLCs, have greater potential liabilities for owners, and offer "no meaningful benefits" over an LLC formed under Article II, and he commented that there would be little reason for having the PSLLC form, given these additional risks and burdens, if law firms were not required to form under Article XII.[9]

In 2017, the Second Circuit issued an opinion which affirmed Judge Kaplan's decision. *Jacoby & Meyers, LLP et al v. Presiding Justices of the First, Second, Third and Fourth Departments, Appellate Division of the Supreme Court of the State of New York*, 852 F.3d 178. The Court's discussion of the LLC/ PSLLC issue was brief: In a footnote, the Court stated that an LLC created to accept outside investments "would have run afoul of certain New York laws that bar

---

[9] *Id.* at 597 ("Finally, the very existence of PSLLCs undermines plaintiffs' argument that any limited liability company is permitted to practice law. If law firms could organize themselves and practice law as limited liability companies generally, they never would organize themselves as PSLLCs because PSLLCs are subject to greater restrictions, have great potential liabilities, and receive no meaningful benefits.") (internal citations omitted).

the practice of law by LLCs regardless of the nature of their investors." *Id.* at 182 n.1. Perhaps because J&M had replaced its LLC with a PSLLC by the time the case was before the Second Circuit, the court did not delve further into the issue.

Recommendations

Although Judge Kaplan's opinion is not dispositive, his argument has force – namely, why would the LLCL provide for PSLLCs (given the rules and obligations associated with this form of organization) if professional services providers could simply "opt out" of Article XII's burdens by forming under Article II. This argument, coupled with parallel requirements that exist for LLPs and PCs in New York, suggest that the "may" language in Section 1203 reflects a legislative intent to make liability limiting forms of organization available to professional services firms, but subject to certain restrictions and requirements having to do with client/ customer protection. (In other words, the use of "may" in Section 1203 does not mean that professional services firms can choose between Article II and Article XII as they see fit: Rather, it means that professional services firms "may" form a PSLLC (as opposed to a general partnership, for example) – something that was not possible in the past (at least for law firms) – provided the firm complies with the requirements of Article XII.

With this context in mind, we recommend adding a statement that LLCs formed to engage in activities subject to state licensing authority must form under Article XII (PSLLC) or XIII (Foreign PSLLC), and not Article II (LLC) – at least with respect to the "traditional" professions of law and medicine. We take this position with respect to lawyers because lawyers owe fiduciary duties to their clients. Allowing lawyers to insulate themselves from liability for their own malpractice or misconduct (or the malpractice or misconduct of those whom they supervise) via a simple LLC strikes me as contrary to our ethical obligations. We are comforted by the fact that lawyers have access to malpractice insurance. We also believe that the Article XII requirements for PSLLCs strike a reasonable balance between the desire of lawyers to limit liability for actions and events beyond their knowledge or control and lawyers' professional obligations to their clients. We come out the same way as to the other traditional professions (e.g., medicine), especially given LLCL's statutory definition of "profession," and because practitioners from the traditional professions stand in a relationship of trust and confidence with, and generally owe fiduciary or other similar obligations to, their patients and clients.

We have reached out to the Department of Education with respect to professions currently subject to licensure under Title 8 of the Education Law, but have not yet heard back. In the interim, I recommend maintaining consistency in the approach taken under the LLCL, NY Business Corporation Law, and New York Partnership Law, given definitional and other similarities between Section 1201(b) of the LLCL, Section 1501(b) of the Business Corporation Law, and Section 121-1500 of the Partnership Law.

Topic #15 – Conversion of Other Business Entities into a NY LLC

Issue

(1) Should LLCL Section 1006 be amended to enable a corporation and other business entities to convert to an LLC?

(2) Should LLCL Article X be expanded to permit non-U.S. entities to re-domesticate with LLCs and also to add a form of an Entity Transactions Act covering LLCs and other business entities?

Recommendation

(1) Yes- the amendment would be a logical and overdue addition by reason of prior amendments to the LLCL and tax laws, and would streamline current practices.

(2) Qualified Yes, subject to separate comprehensive studies as these issues raise significant and complex statutory and policy questions, including the feasibility in coordinating similar changes to the restructuring provisions in other New York business entities statutes, although foreign domestication should be considered in light of New York being a leading international financial center.

The Concept of Conversion and Domestication

Traditionally, there were only two methods by which a business entity could change from one form of business entity into another form of business entity: either dissolve, wind up and then file the appropriate other business entity documents or merge/consolidate with an existing business entity that is in the desired form. Each method involved substantial legal issues, tax matters, costs and business disruptions, with the dissolution route requiring the conveyancing of assets and assumptions of liabilities which could be a cumbersome, sometimes uncertain, time consuming and expensive process. Rather than having to go through that multi-step process, states have been adopting simple one-step statutory procedures for conversions and domestications as an efficient and inexpensive means of achieving the same result.

The conversion concept developed to enable interest holders to change the organizational form of their business entity in the same state, known as an "entity conversion." The domestication concept was to change (or convert) the entity's place of formation. Moreover, an entity in a single transaction could both change its place of formation and type of entity, blurring the definitional distinction between the two terms. Domestication also refers to permitting any non-U.S. entity to become "domesticated" as an LLC in the permitting state while continuing the existence of the entity in its foreign place of formation. See Sections 18-212 and 18-213 of Delaware Limited Liability Company Act ("DLLCA") covering foreign domestication of Delaware LLCs. For purposes of this report, "foreign domestication" shall be the type of domestication permitted by those Sections of the DLLCA.

These transactions take effect simply by filing the appropriate documents of conversion or domestication under the appropriate statutory regimes. The resulting entity is the same entity as the converted/domesticated entity. The debts, liabilities, obligations, titles to assets and licenses are the same in the resulting entity as they were in the original entity. Without more, as of the date of conversion or domestication, the resulting entity is subject to the business entity laws of the form of business entity into which it has converted and the new place of formation.

Nature of Conversion/Domestication

The trend in other jurisdictions has to include some form of expansive conversion and domestication provisions in their updated LLC statutes. In many of these statutes, conversion covers both change of form of entity and change of state of formation, while a foregin domestication covers a non-U.S. entity which could become an LLC under the laws of its chosen state and also retain its status and existence in the non-U.S. jurisdiction in which it existed before the domestication. The concept followed by these states is there are four basic entity transactions ("restructuring transactions"): merger, interest or share exchange, conversion and domestication. There are several forms of business entity, such as corporation, LLC, limited partnership or business trust, which depending on applicable state statutes, can engage in restructuring transactions with other domestic or foreign business entities. The transaction process may take two or more indirect steps to fit the different statutory requirement pieces together.

While variations exist in the details and processes among the recent expansive state statutes covering restructuring transactions, the statutes follow two different models known as "self-contained" and "junction-box (also referred to as "hub-and-spoke"). The "self-contained" model (which has been the traditional model) is inclusion in the provisions governing each type of business entity how that entity may effect a restructuring transaction with another entity, either domestic or foreign. The expectation is for each entity statute to be internally complete and for consistency among the different entity statutes. For example, all provisions covering a restructuring transactions by an LLC are in Article X of the LLCL and those for a corporation are in Article 9 of the Business Corporation Law ("BCL"). A restructuring transaction between an LCC and a corporation requires reference to both statutues. The "junction-box" model puts the restructuring transaction for all business entities, such as LLCs, corporations and other business entities, into a single statute. This would assure consistency and facilitate in planning the transaction. The "junction-box" model comes from the Model Entity Transactions Act ("META"), adopted by the NCCUSL in 2007 and last amended in 2013.

Entity Conversion in New York

LLCL Section 1006 limits entity conversions to conversions into LLCs by limited partnerships formed in New York and to general partnerships (which should include limited liability partnerships) meeting the concept in Article 2 of the Partnership Law. The LLLC does not enable a corporation or any other business entity (other than domestic limited partnerships and general partnerships) to convert to an LLC, nor vice versa. The regular domestication and foreign domestication concepts are not in the LLCL.

Currently, New York is one of only a few other states which still limit LLC conversions to

general and limited partnerships. The evolution toward broader conversion provisions is seen by the change in the uniform laws. Section 902(a) of ULLCA (1996) sets forth a partnership or limited partnership may be converted to an LLC pursuant to that Section. Section 1006(a) of the 2006 revision of ULLCA provided an organization may convert to an LLC and an LLC may convert to an organization. "Organization" was defined in Section 1001(a) as a general partnership, limited partnership, corporation or any other person having a governing statute. See Appendix 11-12 in *Ribstein and Keatinge on Limited Liability Companies,* Second Edition (Nov. 2017).

Domestic LLCs have always been free to merge or consolidate with other LLCs or other business entities without restriction. [LLCL Section 1001] "Other business entities" comprise most for entities, see LLCL Sections 102(v) aand (W). A practical problem was the lack of parallel statutory provisions covering the other entity. The LLCL merger provisions have amended several times to clarify and expand the procedures for mergers and consolidations between LLCs and other business entities, with corresponding amendments to the merger provisions in the BCL. See L.1997 C.470 and L.1998 C.374. No corresponding changes were ever made to Section 1006.

A possible reason for the New York limitation on conversions is LLCs were then a new form of entity but in many ways similar to partnerships, especially with respect to desired tax classification, and their partners may consider operating their entity under the LLC structure, such as for limited partnerships to let the general partners take advantage of the limited liability umbrella for members and broader exculpation for managers in LLCs. The statutory conversion provision would provide a simple method for changing the limited partnership form.

Also, prior to 1997, the Internal Revenue Service had applied the Kintner Regulations to determine how LLCs were to be taxed- as a "corporation" or a "partnership." LLCs which desired partnership classification had to be structured to meet the Kintner tests. When adopted in 1994, the LLCL, similar to other first generation LLC statutes, contained provisions intended to permit a domestic LLC to meet the Kintner Regulations. Since 1997, after the IRS ceased applying the Kintner Regulations, an LLC simply "checks the box" in selecting its tax status either as a "corporation" or a "partnership." In 1999, amendments to the LLCL removed those tax structured provisions. L. 1999 Ch. 420, NYS Sponsor's Memorandum. Under the prior tax regime, it was impractical for a corporation to convert into an LLC. There is no longer a practical impediment to converting a corporation into an LLC. Unfortunately, LLCL was not changed to reflect the changed tax considerations.

Section 121-1106 of the New York Revised Limited Partnership Act ("RLPA") allows mergers between limited partnerships and LLCs as well as other business entities, but does not contain a conversion provision similar to LLCL Section 1006. Until the LLCL was enacted in 1994, limited partnerships could merge or consolidate only with other domestic or foreign limited partnerships. Section 121-1106 was added as part of the changes made upon enactment of the LLCL to permit limited partnerships to merge or consolidate with LLCs. That Section was amended in 1994 to extend the ability of limited partnerships to merge with "other business entities." RLPA does not a contain a conversion provision mirroring LLCL Section 1006.

Recommendation for Inclusion of Other Business Entities for LLC Conversions

The inclusion of other business entities into LLCL Section 1006 would facilitate a change in formation from the current form to LLC form through a single direct transaction. Currently, under the merger sections of Article X, and companion sections under the BCL, a corporation and other business entities can change their form to an LLC by going through an extensive merger process (or even through a dissolution/re-formation process). That process is too complicated and expensive when the entity is just changing its form, and not its business, owners, assets or liabilities. Over the years the tax aspects for an LLC-corporation conversion have been better understood leading to more interest for such a transaction. We are recommending expanding LLCs conversions to other business entities as has been done under many of the second generation state LLC statutes and is consistent with existing New York merger/consolidation provisions.

Foreign Domestication

Foreign domestication is a process by which a non-U.S. entity moves its domicile from a foreign jurisdiction to the United States while continuing the existence of the entity in its original place of organization. For a variety of reasons, foreign domestication has been desired by entities existing in offshore financial centers where their countries' legislation permits such transaction without the local entity having to dissolve. After the foreign domestication, the existence of the U.S, entity remains intact and it is not required to wind up its affairs or pay its liabilities and distribute its assets. For purposes of the DLLCA, the domestic LLC (or corporation) and the pre-existing non-U.S. entity are considered a single entity formed and existing under the laws of Delaware and the laws of the foreign jurisdiction. The rights, privileges and powers of the domesticated non-U.S. entity and also all of its property (real, personal and mixed) and all debts due to it, shall remain vested in the domestic entity and the non-U.S. entity. Further, the rights of creditors and all liens on property of the non-U.S. entity are preserved and unimpaired. The concept of foreign domestication may be deemed a radical change from the usual New York restructuring transaction, thereby leading to determining its effect on against domestic public policy against providing an additional option to enhance certain types of international finance transactions by New York businesses.

Conversion/Domestication Statutory Schemes in Other Jurisdictions

States have some form of conversion/domestication provision in their LLC statutes, ranging from the very limited approach of New York to either expanding their "self-contained" provisions to more major overhauls through some version of the "junction-box" approach or grafting META. A study of whether New York should consider adding broad conversion/domestication provisions to the LLCL and the governing laws of other business entities and, if so, the nature of the additions should examine the experiences of other states in deciding these questions. The following is a brief summary as to where a few states ended up when updating the restructuring transaction provisions in their LLC statutes.

Mississippi took a hybrid position of in adopting the "junction-box META approach to conversion and domestication and leaving the "self-contained" approach for merger. In 2012, the

Mississippi Secretary of State prepared a study of domestication and conversion of business entities as part of the State considering the authorization of these transactions through a single-step process. The study analyzed conversion statutes in the other states, finding 41 states had some form of statute. New York was not listed among the 41 states. See Applewhite, *Ushering in Entity Change: The Development and Advantages of Entity Domestication and Conversion Statutes,* www.sos.ms.gov/Documents. Title 79 of the Mississippi Code covers corporations, associations and partnerships. In 2016, Title 79 was expanded by the addition of Chapter 37- Mississippi Entity Conversion and Domestication Act. That Act does not cover transactions by an entity that are already covered in the chapter governing that entity, such as mergers which for LLCs remain under the Revised Mississippi LLC Act.

The Florida Revised Limited Liability Company Act uses the "self-contained" model with separate sections for merger (Sections 605.1021-26), interest exchange (Sections 605.1031-36), conversion (Sections 605.1041-46) and domestication (Sections 605.1051-56). The Florida provisions and even format follow Article 10 of RULLCA. It is noted that Article 10 of the ABA Revised Prototype LLCA covers merger and entity conversion, but not domestication nor share exchange.

A possible reason for choosing the "self-contained" model is to avoid the possible statutory hassle of simultaneously enacting similar provisions in the statutes governing the other business entities. For example, the revised Florida law was the product of several sections of the Florida Bar which sought a complete revision of the Florida LLC Act. The District of Columbia took a different hybrid approach through a comprehensive revision of its business law by enacting a new Title 29 entitled Business Organizations Code. This is a unified entity code covering all existing entities. Chapter 2 of the new Code incorporates META and applies it to all business entities under Title 29.

META is a "junction-box" statute intended to be separate from any other state business organization statutes but applicable to all domestic entities, and it also is separate from RULLCA. Eight states (Alaska, Arizona, Connecticut, District of Columbia, Idaho, Indiana, Kansas and Pennsylvania) has adopted portions of META. Uniform Law Commission, Acts, Entity Transactions Act, Model (2007) (Last Amended 2013).

Conclusion

We acknowledge there are benefits of broad conversion and domestication provisions for New York LLCs, as well as for other types of business entities in New York. The various approaches taken by other states in providing for some form of those provisions in their business statutes is quite instructive and compelling as guidance for New York. However, our Project is focused on several discrete statutory portions of the LLCL. As mentioned, the Delaware foreign domestication should be examined closely from a policy consideration. META-type provisions raise many threshold issues. We believe the better approach is to analyze the advantages and disadvantages of the business entity concept to all New York business laws, and if the concept is feasible to have a coordinated amendment to all those laws at the same time. This analysis would be separate from the issues being considered by this Project as such analysis should involve a wide representation of interested persons and probably take considerable time to

complete.

Topic #16 – Waiver of Creditor Status of Members for Distributions

Issue

Should a member who is entitled to a distribution must, as a matter of law, have the status of a creditor of the LLC?

Recommendation

No. The Limited Liability Company Law ("LLCL") existing mandatory creditor status provision should be changed to a default provision like under the Delaware Limited Liability Company Act ("DLLCA") permitting the members to determine in their operating agreement how to treat the distribution, following the freedom of contract principles under other portions of the LLCL.

Distributions in Concept

A distribution is a transfer of cash or other property from a LLC to a person who is a member or to a person who, though not a member, is entitled to the right of a member to receive a distribution. See LLCL Section 102(i). The purpose of the transfer can be for:

1. payment from profits in the nature of a dividend or interim distributions,
2. purchase of the membership interest of a member by the LLC, or
3. return of a contribution of a member.

A profits distribution can be automatic based upon triggering events set forth in the operating agreement, such as from net income, or be authorized in conjunction with an event, such as upon an asset sale.

New York Mandatory Provision

LLCL Section 506 mandates that at the time a member becomes entitled to a distribution, that member has the status of, and is entitled to all remedies available to, a creditor of the LLC with respect to the distribution, subject to LLCL Sections 508 (limitations on distributions) and 704 (distribution of assets on winding up the LLC). There is usually a time gap between the declaration or the event causing the distribution and the payment of the distribution amount. The LLC would then record a liability for the amount of the declared distribution until it is paid or otherwise settled or discharged.

LLCL Section 506 is virtually identical to RULLCA Section 404(d) and to Section 404(b)(4) of the Revised Prototype LLCA which refers to members associated with a series having the rights of a creditor of the series. See Topic 2 of this Booklet.

Delaware Default Provision

The DLLCA has a default provision which states that a member who is entitled to a distribution becomes a creditor of the LLC unless the members otherwise agree. [Section 18-606] It is a

default provision so that the members can agree as to whether or not a member has creditor status for that distribution.

Analysis

Fundamental to the concept of LLCs is the principle of freedom of contract. Since 1977, when the first LLC statute was enacted in Wyoming, LLC statutes have to varying degrees, implemented this principle. Certainly since 1995, when the Internal Revenue Service abolished the Kintner Regulations, the trend has been to minimize the number of mandatory provisions and maximize the number of default provisions in an LLC statute. Members are and should be accorded as much discretion as possible in ordering the internal affairs of the LLC. Mandatory provisions should be specially scrutinized to assure that they implement a significant policy choice.

Whether or not a member should be accorded creditor status with respect to a distribution typifies a matter that should be within the discretion of the members. The members can have reasons for being able to waive creditor status for the members, among them is to enhance the legal position of the LLC as a bankrupt remote entity. It is difficult to articulate a significant policy objective that is served by continuing the mandatory creditor status.