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Minority Rights and Fiduciary Obligations

By Tim Lynn (September, 2007)

Fiduciary duties applicable to participants in a New York LLC are not nearly as clear and well-defined as in the corporate context. Default statutory language is similar to corporate provisions under the Business Corporation Law. However, because a New York LLC can be structured like a corporation or like a partnership, it is not clear how a court will interpret and apply the rules in various contexts. With the relative youth of LLCs as a business entity, there is very little caselaw interpreting the LLC Law, leaving practitioners to make educated guesses as to the outcome of questions.

Minority interest holders in a New York LLC have little protection. The statutory default is majority rule. With the termination of the withdrawal right by default in 1999, minority interest holders have little protection under the statute. The LLC Law does provide enormous flexibility to modify the default rules in ways which will protect the interest minority interest holders. However, other than simple rules calling for unanimous approval of all corporate actions, can be complicated and require a great deal of foresight.

This article provides a description of the default fiduciary duty rules and the manner in which they are commonly modified by the participants and how they may be interpreted by courts in the future. In the end, the LLC is a contractual relationship among the participants, requiring a meeting of the minds with respect to innumerable issues that may arise in the future.

I. Fiduciary Obligations.

The primary source creating fiduciary duties in managers of New York LLCs is section 409 of the LLC Law. This section, similar to provisions in the BCL, provides:

> *409. Duties of managers. (a) A manager shall perform his or her duties as a manager, including his or her duties as a member of any class of managers, in good faith and with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances.*

(b) In performing his or her duties, a manager shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

(1) one or more agents or employees of the limited liability company;

(2) counsel, public accountants or other persons as to matters that the manager believes to be within such person's professional or expert competence; or

(3) a class of managers of which he or she is not a member, duly designated in accordance with the operating agreement of the limited liability company, as to matters within its designated authority, which class the manager believes to merit confidence, so long as in so relying he or she shall be acting in good faith and with such degree of care, but he or she shall not be considered to be acting in good faith if he or she has knowledge concerning the matter in question that would cause such reliance to be unwarranted.

(c) A person who so performs his or her duties in accordance with this section shall have no liability by reason of being or having been a manager of the limited liability company.

In the corporate context, the fiduciary duties of directors and officers have been developed through decades of caselaw. Directors and officers are charged with a duty of loyalty to the corporation. This duty of loyalty includes the following: (1) a director may, under rare circumstances, be liable for unauthorized actions that cause harm to the corporation; (2) a director may be liable for fraud that harms the corporation; (3) there is a long line of caselaw dealing with a director privately benefiting from action taken as a director of a corporation (in the corporate context, private benefit is generally frowned upon by the courts); and (4) a director may be liable for directing a corporate opportunity for his or her own benefit or for the benefit of another (such as another corporation of which such person is a director or shareholder).

Directors and officers are also charged with a duty of care, generally formulated in the language of the statute – a director shall perform his or her duties "in good faith and with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances."

Because the language of section 409 of the LLC Law is so similar to provisions regarding directors under the BCL, one could reasonably suppose that managers of an LLC will likewise be charged with a duty of loyalty and a duty of care. The nature of the LLC under New York law may contravene that supposition.

The New York LLC law is exceptionally flexible. New York was one of the last to adopt LLCs as a form of business enterprise (in 1994). In crafting the New York LLC Law, the legislature was able to draw upon the best that other states had to offer. As such, the LLC Law provides the participants with exceptional flexibility in structuring the relationship of the participants.

It is quite possible under the LLC Law to structure an LLC that operates and is managed in the same fashion as a corporation. Membership interests can be certificated in the same fashion as shares of stock. The LLC can be managed by a Board of Managers subject to a one manager/one vote rule. Member voting can be restricted to limited matters such as the election of managers and extraordinary transactions such as a sale of substantially all of the business or mergers and consolidations. The LLC can have officers identical to those appointed in the corporate context. In sum, an LLC can not only be taxed as a corporation, it can be identical in structure and participant rights and obligations as in the corporate context.

On the other hand, the New York LLC Law permits the structuring of an LLC that is identical in operations and management to a partnership. Three key exceptions would be the limited liability of members, the termination of the right of withdrawal, and the continuing existence of the LLC upon the death or bankruptcy of a member. Management can be controlled by the members acting by majority in interest. Any member can by default bind the LLC.

Continuing this flexibility, many (if not most) LLCs formed in New York reflect elements of both the corporate and the partnership model. Centralized management is often vested in one or more managers (often denominated a board of managers). Many LLCs appoint a president, secretary and treasurer. Contrary to the corporate model, authorizing action is often voting by interest (ignoring the one director/one vote rule in the corporate context). Interests are rarely certificated, and the relative interests of the members in capital and profits are treated in the same fashion as a partnership. Many LLCs reserve a greater set of actions to the discretion of the members.

Because the actual structure of the relationship of managers and members may vary so greatly in an LLC, it may be a mistake to assume a corporate model will be imposed by the courts. The rights and responsibilities of managers and members in any given situation may vary so far from the corporate model that a court may not impose the same duties on some participants.

To date there is little caselaw interpreting section 409. One case has indicated that self-dealing by a controlling member may result in liability to minority members. However, a minority interest holder should be wary of relying on the courts to protect its position from a controlling member or manager.

Section 417(a) of the LLC Law provides:

> *The operating agreement may set forth a provision eliminating or limiting the personal liability of managers to the limited liability company or its members for damages for any breach of duty in such capacity, provided that no such provision shall eliminate or limit:*
>
> *(1) the liability of any manager if a judgment or other final adjudication adverse to him or her establishes that his or her acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law or that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled or that with respect to a distribution the subject of subdivision (a) of section five hundred eight of this chapter his or her acts were not performed in accordance with section four hundred nine of this article; or*

> *(2) the liability of any manager for any act or omission prior to the adoption of a provision authorized by this subdivision.*

This common clause in operating agreements largely eviscerates much of the duty of loyalty and duty of care. A minority interest holder should be cautious in agreeing to include this provision in the operating agreement. One solution is to separately and expressly define actions that are not permissible (such as making loans by the LLC to the manager without the consent of the minority interest holder).

A second clause commonly included in operating agreements comes from section 420 of the LLC Law:

> *Subject to the standards and restrictions, if any, set forth in its operating agreement, a limited liability company may, and shall have the power to, indemnify and hold harmless, and advance expenses to, any member, manager or other person, or any testator or intestate of such member, manager or other person, from and against any and all claims and demands whatsoever; provided, however, that no indemnification may be made to or on behalf of any member, manager or other person if a judgment or other final adjudication adverse to such member, manager or other person establishes (a) that his or her acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated or (b) that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled.*

This indemnification provision can eviscerate the ability of a minority interest holder to hold an incompetent manager liable or to hold a sly controlling member liable for self-dealing. A well crafted operating agreement and other agreements may be able to take advantage of the language "a financial profit or other advantage to which he or she was not legally entitled."

Because clauses adopting the permissive provisions of sections 417 and 420 are commonly included in operating agreements, a minority interest holder must be careful to prohibit specific actions that could cause harm.

II. Identifying and Protecting the Rights of Minority Interest Holders.

As a default rule, New York LLCs are governed by majority rule. This default rule can be eliminated for all or some issues in the management and operation of the LLC. The Articles of Organization of the LLC will determine whether the LLC will be member-managed or manager-managed. The parties have an almost unlimited power to customize the management provisions in the operating agreement.

A. Distributions. Likely the most important issue to minority interest holders will be the determination of when and how much of the LLC's net cash flow will be distributed to the members.

There are two concerns: How will profits and losses be allocated to the minority interest holders? Will cash be distributed reflecting these allocations? The starting point for examining allocations will be the limited liability company percentages of the members. Usually, these percentages will be a stated number for each member. Some agreements will provide that the LLC percentage is calculated based upon relative capital account balances.

In general, allocations will be made based upon these LLC percentages. However, allocation provisions in the operating agreement may vary from these percentages. First, there should be special regulatory allocations correcting for the lack of member liability for LLC debts. Without such provisions, it is possible the members may be agreeing to such liability. Second, profits may first be allocated based upon prior allocations of losses. This could be a concern to a minority interest holder where the majority is a guarantor of LLC debt. Third, there may be special allocations of certain items of income or deduction. For instance, special allocations may be made of items relating to specific property so that depreciation will be recognized by one member.

The primary concern is that these allocations match the business deal made by the parties. Tax allocations will be driven by these allocations of profits and losses. The value of each member's interest will also be determined by these allocations of profits and losses.

Assuming the allocation provisions agree with the business terms, the allocations may be meaningless until a liquidating event. The minority interest holder could be allocated income for tax purposes with no right to any distributions of cash equal to such allocations or even the tax on such allocations.

The minority interest holder can protect himself or herself in two ways. First, provisions can be included mandating that a tax distribution be made before April 15 of the following year. This cash distribution would be equal to the estimated federal and state tax on the income to be allocated to the members by the LLC.

Second, provisions can be included mandating when distributions of net cash flow will be made and how much will be distributed. The provision may provide that all net cash flow will be distributed before a certain date of the next fiscal year. For this purpose, it is important to review the definition of net cash flow. What items are excluded from net cash flow? Will the majority interest holder have the ability to establish reserves that are subtracted from net cash flow for distribution purposes?

B. Compensation. Where members are employed by the LLC, the relative compensation of members is often a key concern. The compensation of members is usually in the form of guaranteed payments (payments made to a member without regard to the profits or losses of the LLC that are ordinary income to the member and a deductible expense to the LLC).

The minority interest holder's concerns can be addressed within the operating agreement or externally in an employment agreement or other agreements.

If addressed in the operating agreement, a logical place to treat the issue is in the distributions section of the operating agreement. It is not uncommon to have a provision allowing the manager to establish and pay guaranteed payments to the members. Such a provision, however, provides little

comfort to the minority interest holder. Another method is to define the initial guaranteed payments to the individual members, and create a procedure for how such payments will change over time. Another, common with professional entities, is to provide a procedure for setting member compensation on an annual basis. This may provide for a compensation committee and standards to be applied in reviewing the individual performance of the members.

In the situation where the relationship between the LLC and the member is more like a traditional employer-employee relationship, it may be useful to adopt an employment agreement. Reference to the employment agreement should be made in the operating agreement (regarding treatment of any payments as a guaranteed payment – a recipient may be surprised if it is treated as a draw and the LLC will desire to ensure deductibility).

An employment agreement can be useful to both the employee and the LLC. The employment agreement provides for a specific relationship between the member/employee and the LLC separate and apart from the general management and affairs of the LLC (and the other members). It can provide for a term of employment that can be breached by either party. Non-competition, non-solicitation and confidentiality provisions can be included for the protection of the LLC and the other members (including minority interest holders, especially where the majority interest holder is subject to the employment agreement terms). The employment agreement is a more appropriate context for handling such issues as fringe benefits and employee benefits. The employment agreement also provides an opportunity to define a member/employee's duties and role without making such terms part of the broader operation and management of the company.

Restrictive covenants may be a benefit to either or both of the minority interest holder and the majority interest holder or other key individuals. Imposition of non-competition type provisions in an employment agreement is difficult. The courts are not always inclined to enforce the agreements, restricting the agreement to what the court deems reasonable in scope, geography and time. Many companies are also concerned with proprietary information, patents and trade secrets.

Although there does not appear to be any caselaw directly adopting the following rationale, it is possible that non-compete, non-solicitation, confidentiality and proprietary information clauses may be more enforceable if included in the operating agreement rather than in a mere employment agreement. The operating agreement of an operating business LLC governs the going concern and goodwill of the LLC. It is not merely a contract for services between an individual and the LLC. Because of the broader scope of the agreement between the members set forth in the operating agreement, courts may be inclined to enforce restrictive covenants more broadly. The participants have agreed to jointly conduct business, each sharing in profits and losses. As such, certain actions by members that harm the going concern and goodwill value of the LLC may be subject to restrictive covenants in this context that would be unenforceable in the employment context.

C. Self-Dealing and Fiduciary Duties. Self-dealing by managers (no mention of controlling members) is one area of management that the LLC Law does not allow the operating agreement to override the statutory provision. Section 411 of the LLC Law provides:

> *(a) No contract or other transaction between a limited liability company and one or more of its managers, or between a limited liability company and any other limited liability company or other business entity in which one or more of its managers are managers, directors or officers, or have a substantial financial interest, shall be either void or voidable for this reason alone or by reason alone that such manager or managers are present at the meeting of the managers, or of a class thereof, which approves such contract or transaction, or that his or her or their votes are counted for such purpose:*
>
> *(1) if the material facts as to such manager's interest in such contract or transaction and as to any such common managership, directorship, officership or financial interest are disclosed in good faith or known to the other managers or class of managers, and the managers or such class approve such contract or transaction by a vote sufficient for such purpose without counting the vote of such interested manager or, if the votes of the disinterested managers are insufficient to constitute an act of the*

managers pursuant to section four hundred eight of this article, by unanimous vote of the disinterested managers; or

(2) if the material facts as to such manager's interest in such con-tract or transaction and as to any such common managership, director-ship, officership or financial interest are disclosed in good faith or known to the members entitled to vote thereon, and such contract or transaction is approved by vote of such members.

(b) If such good faith disclosure of the material facts as to the manager's interest in the contract or transaction and as to any such common managership, directorship, officership or financial interest is made to the managers or members, or known to the managers or class of managers or members approving such contract or transaction, as provided in subdivision (a) of this section, the contract or transaction may not be avoided by the limited liability company for the reasons set forth in subdivision (a) of this section. If there was no such disclosure or knowledge, or if the vote of such interested manager was necessary for the approval of such contract or transaction at a meeting of the managers or class of managers at which it was approved, the limited liability company may avoid the contract or transaction unless the party or parties thereto shall establish affirmatively that the contract or transaction was fair and reasonable as to the limited liability company at the time it was approved by the managers, a class of managers or the members.

(c) Common or interested managers may be counted in determining the presence of a quorum at a meeting of the managers or of a class of managers that approves such contract or transaction.

(d) The operating agreement may contain additional restrictions on contracts or transactions between a limited liability company and its managers and may provide that contracts or transactions in violation of such restrictions shall be void or voidable by the limited liability company.

> *(e) Unless otherwise provided in the operating agreement, the managers shall have authority to fix the compensation of managers for services in any capacity.*

Generally, the LLC Law allows the participants to modify the statutory provisions by agreement of the members in the operating agreement. Section 411 is not waivable. There may be good reason for this exceptional treatment. In the context of self-dealing, the members are likely not able to agree in advance on the transaction with full knowledge of all relevant facts. Section 411 is structured to avoid actions where approval obtained without full disclosure of a manager's self-interest and approval is not by disinterested managers or members with full knowledge of all facts and circumstances. Because there could be no meeting of the minds ahead of time with respect to such transactions, the law requires there be agreement at the time of the approval of the action.

A statutory complication exists. Section 611 provides:

> *Except as may be provided in the operating agreement, a member may lend money to, borrow money from, act as a guarantor or surety for, provide collateral for the obligations of and transact other business with the limited liability company and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a member.*

What of the common situation where a member is also a manager? In what capacity is the member/manager dealing with the LLC? Is the transaction subject to section 411 or section 611? There does not appear to be any caselaw addressing this issue. In order to provide clarity, it may be wise to ensure that provisions are included in the operating agreement controlling the situation where a member is also a manager.

A side issue to self-dealing can be called other business ventures. Will a manager or member be allowed to participate in another business enterprise, including one that competes with the LLC. In the corporate context, it may be permissible for a director to do so, provided the director does not violate the duty of loyalty with respect to corporate opportunities. It may be wise to include provisions governing

participation in other business ventures, including those in competition with the LLC, in the operating agreement. An LLC may not desire that an employee/member have the same freedom as members may have to undertake such conduct.

D. Admission of Additional Members. Additional members can threaten the interests of the minority interest holder in a variety of ways.

- Will the minority interest holder be diluted with respect to future profits upon the admission of the additional member? In the corporate context, the rules are generally clear. If share capital is authorized, the board of directors has the power to issue the shares (whether such shares are unissued or treasury). Under the provisions of most operating agreements, what is the affect of the admission of a new member? Many agreements do not adequately describe the affect of the admission. This ambiguity may put minority interest holders at risk.

- When an additional member is admitted, the Internal Revenue Code and (likely) the operating agreement will require a fair market valuation of the capital of the company at the time of the admission of the new member, preserving that value to the capital accounts of the existing members. Who will have control over determining the fair market value of the company's capital? What procedures are in place to ensure the true fair market value of the minority interest holder's capital is protected? Will the information used to determine the fair market value be transparent and readily communicated to the minority interest holder? The minority interest holder can be deprived of his or her rightful interest in the LLC at any time that the fair market valuation of capital accounts is performed. It is not uncommon to include provisions making this process transparent and provide rules for the appraisal (such as an MAI appraiser for real estate).

- Who is the new member? Will the minority interest holder have the ability to reject the admission of an undesirable additional member? Does the new member have a unity of interest with the majority interest holder?

E. Company Actions. There are any number of company actions that may be of concern to the minority interest holders. A certainly incomplete list is:

- Capital Contributions. What capital contributions will be made by the members at the commencement of business? Will additional capital contributions be required in the future? Can the majority interest holder make additional capital contributions without the consent of the minority interest holders? What capital contributions will be required of future additional members?

- Employees. Who has the authority to hire and fire employees? Who determines employee compensation and employee benefits?

- Purpose. Will the LLC have narrow purposes or will management have broad authority to determine the purposes for which it continues to exist?

- Professional Advisors. Who determines the identity and scope of engagement of the LLC's attorneys and accountants?

- Banking. What bank will the LLC utilize? Who will have signatory authority over the accounts? What types of accounts will be maintained? What types of investment accounts are permitted?

- Competition. What other business ventures are the members permitted to participate in? Are members permitted to compete with the LLC? Will non-competition, non-solicitation and confidentiality provisions be included in the agreement?

- Management. Who chooses the manager? How can the manager be removed from office? How is a manager replaced? Is the LLC governed by a single manager or a Board of Managers? Do the minority interest holders have any representation in the management of the LLC? What actions are reserved to the vote of the members? Are there any actions requiring the unanimous consent of the members?

- Officers. Will the LLC have officers (e.g., president, secretary, treasurer)? Who appoints the officers? Who establishes the duties and powers of the officers? Because the officers may have broad authority to affect the conduct of the business of the LLC and its relationship with third-parties, it is both convenient to have officers and potentially a threat to the equity holders. The minority interest holder may protect himself or herself by requiring that he or she be appointed as an office of the company.

- Insurance. Who determines what liability, property/casualty, products liability, environmental liability, errors and omissions, or directors and officers insurance will be purchased? The person bearing the greatest risk of loss will be most likely to approve the additional expense of insurance.

- Loans. Who approves borrowing money from banks? Who approves loans made by members or affiliates?

- Litigation. Who controls the commencement of, defense of, settlement of contested matters with third-parties, employees, governmental agencies and others? Who has the authority to release any third-party?

- Reserves. Who has the authority to establish and invest reserves?

- Personal Property. Who has the authority to buy, sell or lease personal property? Is there a distinction between ordinary course of dealing and extraordinary transactions?

- Real Property. Who has the authority to buy, sell or lease personal property? If the real estate is an important asset of the LLC, these controls will obviously be important to the minority interest holders.

- Bankruptcy. Who has the authority to commence a bankruptcy case by filing a petition on behalf of the LLC? Who will have the authority to defend and try to obtain a dismissal of an involuntary bankruptcy filing?

- Conduct of Business. Who will be responsible for the conduct of business, performance of agreements, payment of expenses, relationships and dealings with suppliers and customers, etc.

- Tax Returns, Elections. Who will direct the preparation of the LLC's tax returns? Who determines the making of tax elections? Who is responsible for adjusting allocations in compliance with section 704(b)?

- Sale of Assets. Who must approve a sale of all or substantially all of the assets of the LLC?

- Merger. Who must approve a merger of the LLC with or into another business enterprise?

- Sale of Membership Interests. Who must approve a sale of all of the membership interests to a third-party?

- Business Acquisitions. Who has the power to negotiate, authorize and close the acquisition of another business or the assets of another business?

- Transactions with Members. Who must approve and authorize transactions with members or managers – loans, employment agreements, sales or purchases, etc.

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- Guaranteed Payments. Who has the authority to determine the guaranteed payments to be paid to the members?

- Admission of Additional Members. Who must consent to the admission of additional members?

- Transfer of a Membership Interest. Who must consent to the sale of a membership interest to another party, whether the acquirer is a member, a non-member or family member of the transferring member?

- Dissolution and Winding-Up. Who has the authority to approve and file a certificate of dissolution? Who will have control of the winding-up process?

If approval is reserved to the members, the LLC law provides a general default of majority approval. This default rule provides little comfort to the minority interest holder. The simple response is to provide for unanimous action with respect to important company actions. However, unanimity provides opportunities for a holdout to take advantage of the other members.

In each situation, one or more of the factors above (and other factors specific to the situation) will be more or less important to the minority interest holder. If the LLC is an operating business, it may be important to have professional management in place through a powerful manager (similar to a corporation's board of directors) and officers filling traditional corporate roles. If the minority interest holder is not risking any capital (such as an employee given a profits interest), there may be little reason to protect such employee minority interest holder outside the terms of an employment agreement. If the minority interest holder is risking significant capital, he or she may be more concerned with company sales and purchases, loans from banks, insurance and other issues affecting the capital structure of the company. In each situation, the minority interest holder's concerns will be different. The operating agreement can be crafted to provide reasonable protections to the minority interest holder, without unduly limiting the authority of the majority.