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## **Fiduciary Duties of LLC Managers: Are They Subject to Prospective Waiver under the New York LLC Statute?**

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**FIDUCIARY DUTIES OF LLC MANAGERS:  
ARE THEY SUBJECT TO PROSPECTIVE WAIVER UNDER  
THE NEW YORK LLC STATUTE?**

*Jack Graves\**  
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**ABSTRACT:**

Fiduciary duties are imposed upon managers of New York LLCs under both the express provisions of the statute and the common law supplementing the statute. Less clear is whether such fiduciary duties may be waived, prospectively, in an LLC operating agreement under New York law. In *Pappas v. Tzolis*, the New York Supreme Court; the Appellate Division, First Department; and, ultimately, the Court of Appeals, faced a case potentially raising this question and provided four somewhat different analyses of the range of possible issues presented (the Appellate Division included both a majority and dissent). Of most significance for purposes of this article, some have suggested that the Court of Appeals answered the question raised herein by holding that fiduciary duties of managers are indeed subject to contractual waiver under New York law. This article reaches a contrary conclusion, suggesting that the Court of Appeals never reached the issue, and further suggesting the likelihood of a contrary result in the event it may do so in the future.

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**I. A BRIEF INTRODUCTION—DUTIES OF MANAGERS TO LIMITED LIABILITY COMPANIES**

A limited liability company (LLC) is generally run by “managers” for the benefit of its “member” owners. These managers may or may not also be members of the LLC. In either event, these managers, as such, will have certain duties to the LLC based on (1) contract; (2) statute; and (3) common law. The basic contours of these duties are generally similar under different state statutes, though some of the details will vary from state to state. This article will focus on fiduciary duties of managers under New York LLC Law and, more importantly, the potential prospective waiver of these duties.

This introductory Part I will very briefly lay out the basic duties under New York law. Part II will then address the potential waiver or elimination of such duties under both New York and Delaware law. Finally, Part III will analyze a recent New York case involving an attempted waiver of fiduciary duties and the potential effectiveness of that waiver under New York and Delaware law, respectively. This analysis will begin with a guided tour of the case, as it moved through the New York Supreme Court, Appellate Division, and Court of Appeals, and will conclude by addressing two key issues not addressed by the New York Court of Appeals. First, however, we begin with the basic duties of LLC managers.

**A. Contract Duties**

The basic duties of managers to an LLC are typically defined by contract (much as the basic duties of any agent are defined by contract with the principal). These “contract” duties are often found in the operating agreement,<sup>1</sup> though they may also be addressed in other contracts between the LLC and its managers. Each manager is obligated to comply with his or her contractual duties, unless contrary to mandatory law governing LLCs. To the extent that such duties are not defined by contract, they may be defined by reference to the default provisions of the governing law, as found in the LLC statute or supplemented by common law.

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<sup>1</sup> See N.Y. LTD. LIAB. CO. LAW § 417 (McKinney 1996).

## B. Statutory Duties and Limitations

Managers of an LLC are required to perform their duties, as such, “in good faith and with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances.”<sup>2</sup> This duty of care is often broken down into “substance” and “process,” with managers generally afforded the substantial deference of the “business judgment rule” in the absence of any defect in their decision-making process.

Moreover, transactions between the manager and the LLC in which the manager is deemed personally “interested” are statutorily “limited” in that they must be specially approved in accordance with the statute.<sup>3</sup> The statute thereby seeks a balance between concerns on one hand over transactions in which a manager may have split loyalties and potentially significant benefits to the LLC on the other that may arise from a transaction, even though a manager has potentially competing financial interests.

While a duty of “loyalty” is, to some degree, inherent in NYLLCL § 411, referenced in the previous paragraph, the statute does not expressly address any duty of loyalty in the context of potential competition with (as opposed to contracting with) the LLC. This aspect of the duty of loyalty might be “implied” from the language of NYLLC § 409(a) requiring “good faith,” but is more often said to be derived from the common law.

## C. Common Law Duties and Limitations

A common law fiduciary duty of loyalty is generally imposed on all corporate directors and LLC managers, even in the absence of any specific statutory provision addressing the issue. The roots of such duty are often traced to Judge Cardozo’s seminal opinion in *Meinhard v. Salmon*,<sup>4</sup> which describes the nature of this duty as follows:

[Partners] owe to one another, while the enterprise continues, the duty of the finest loyalty. . . . A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of

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<sup>2</sup> *Id.* § 409(a).

<sup>3</sup> *See id.* § 411.

<sup>4</sup> 164 N.E. 545 (N.Y. 1928).

an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the ‘disintegrating erosion’ of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.<sup>5</sup>

Judge Cardozo noted the potential for waiver of such a duty with proper notice of a specific opportunity at the time it arose, but declined to opine on the effectiveness of such a waiver.<sup>6</sup> It is hard to imagine that the court would have countenanced a prospective waiver of the fiduciary duty of loyalty—in effect, a “blank check” without limits on its nature or amount.

Strictly speaking, *Meinhard v. Salmon* was a partnership case. However, its language and logic have been extended beyond the partnership context<sup>7</sup> to stand for a fiduciary duty of loyalty to a common enterprise that generally precludes individual pursuit of financial opportunities reasonably related and available to the common enterprise. The general imposition of a duty of loyalty that restricts usurpation of a corporate opportunity or competition with the corporation is broadly accepted, though its precise contours may remain subject to some variation and debate. What is far less clear is whether such a duty may be waived prospectively, effectively allowing individuals managing a common enterprise to compete, simultaneously, with each other and with the enterprise itself, without breaching any duty to the common enterprise.

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<sup>5</sup> *Id.* at 546 (internal citation omitted).

<sup>6</sup> *Id.* at 547.

<sup>7</sup> *See, e.g.,* *Alexander & Alexander of N.Y., Inc. v. Fritzen*, 542 N.Y.S.2d 530, 534-35 (App. Div. 1st Dep’t 1989) (applied to a New York corporation); *cf. Tzolis v. Wolff*, 884 N.E.2d 1005 (N.Y. 2008) (relying on a breach of the fiduciary duty of loyalty of those in control of an LLC in implying the right of plaintiffs to bring a derivative action in response to such breach).

## II. WAIVER OR ELIMINATION OF LIABILITY OF DUTIES OF MANAGERS TO A LIMITED LIABILITY COMPANY

One might reasonably begin by asking why a group of individuals engaged in a common enterprise would ever wish to waive or eliminate duties of the individuals to act loyally for the benefit of that common enterprise. However, enterprises take many forms, and a group of individuals may be more interested, prospectively, in litigation avoidance than in imposing limitations or restrictions on the actions of those responsible for the common enterprise. Part II begins with two exemplary cases—one in a partnership context<sup>8</sup> (decided under Oklahoma law) and one in an LLC context<sup>9</sup> (decided under Ohio law) and then moves to examine the New York and Delaware statutes addressing the same basic issue in the context of an LLC. A thorough examination of the nature and extent of the applicable New York LLC statute further requires us to look more fully at its origin in the New York Business Corporation law. With this understanding of the relevant New York and Delaware statutes in hand, we can then be ready to move on to consider the case at issue in Part III.

### A. Prospective Contractual Waivers or Elimination of the Basic Fiduciary Duty of Loyalty—Two Exemplary Cases

An Oklahoma oil and gas partnership agreement expressly allowed partners to engage in competitive oil and gas transactions for their own individual accounts, even where such transactions might directly and negatively affect the financial interests of the partnership.<sup>10</sup> The contract clause allowing for such conduct provided as follows:

Each partner shall be free to enter into business and other transactions for his or her own separate individual account, even though such business or other transaction may be in conflict with and/or competition with the business of this partnership. Neither the partnership nor any individual member of this

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<sup>8</sup> See *infra* note 10.

<sup>9</sup> See *infra* note 16.

<sup>10</sup> *Singer v. Singer*, 634 P.2d 766, 768 (Okla. Civ. App. 1981).

partnership shall be entitled to claim or receive any part of or interest in such transactions, it being the intention and agreement that any partner will be free to deal on his or her own account to the same extent and with the same force and effect as if he or she were not and never had been members of this partnership.<sup>11</sup>

Two of the partners individually acquired oil and gas rights in which their broader partnership had also shown an interest in acquiring.<sup>12</sup> When the partnership sought to impose a constructive trust, the court rejected the claim by reference to the contractual provision quoted above.<sup>13</sup> The court noted and gave effect to the clear language allowing “spirited, if not outright predatory competition between the partners” even to the extent “as if there never had been a partnership.”<sup>14</sup> While noting typical fiduciary obligations arising in the context of a partnership, the court gave effect to the parties’ agreement in waiving liability for any actions short of individual partners stealing or otherwise misusing “existing” partnership assets.<sup>15</sup>

A group of investors hoping to secure and operate an NHL professional hockey franchise formed an LLC expressly for that purpose.<sup>16</sup> Within the same time frame, Hunt, a managing member of that LLC, sought and successfully secured for his own personal benefit the same franchise sought by the LLC.<sup>17</sup> In a legal action to determine whether Hunt’s actions had violated any fiduciary duty to his co-venturers in the LLC, the court ruled that he had not by relying on the following provision in the LLC operating agreement:

*Members May Compete.* Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company.<sup>18</sup>

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<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 768-69.

<sup>13</sup> *Id.* at 770.

<sup>14</sup> *Id.* at 772.

<sup>15</sup> *Singer*, 634 P.2d at 772-73.

<sup>16</sup> *McConnell v. Hunt Sports Enters.*, 725 N.E.2d 1193, 1200 (Ohio Ct. App. 1999).

<sup>17</sup> *Id.* at 1200-01.

<sup>18</sup> *Id.* at 1206.



In each of these two cases, a group of co-venturers sought to limit, and perhaps even eliminate, fiduciary obligations to their co-venturers, allowing for, as the *Singer* court expressed “spirited, if not outright predatory competition between the partners.”<sup>19</sup> Moreover, the seemingly broad and unequivocal language suggests a strong intent by the parties to avoid exactly the sort of litigation that ultimately transpired. The question is whether such a prospective waiver should be enforceable. The two courts above said yes.<sup>20</sup> However, individual state laws governing LLCs differ. In this article, we will initially examine the laws of both Delaware and New York, which provide for useful comparative analysis. However, we will ultimately focus on the law of New York, as applied to this question.

### **B. Statutory Provisions Addressing Waiver or Elimination of the Basic Fiduciary Duty of Loyalty under Delaware and New York Law**

The statutory duties of managers to an LLC are of course subject to waiver or elimination only to the extent allowed by statute.<sup>21</sup> Common law duties, such as the fiduciary duty of loyalty, might, at least in theory, be subject to waiver or elimination under the common law as well. However, there is little precedent allowing for prospective waiver of a common law fiduciary duty of loyalty (the Oklahoma case above being relatively unique), and the authors are aware of no such New York case. In fact, such a prospective waiver is arguably inconsistent with the very nature of the fiduciary relationship described by the New York Court of Appeals in *Meinhard v. Salmon*.<sup>22</sup> Thus, any right to waive or eliminate the basic fiduciary duty—including the common law duty of loyalty—must likely be found in an applicable statute. We now turn our attention to the relevant Delaware and New York statutes, which present a rather stark contrast.

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<sup>19</sup> *Singer*, 634 P.2d at 772.

<sup>20</sup> *See id.* at 772 (holding that the agreement was “designed to allow and was uniquely drafted to promote spirited, if not outright predatory competition between the partners”). *See also McConnell*, 725 N.E.2d at 1222 (finding that the partner’s actions “were in no way impermissible under the operating agreement”).

<sup>21</sup> *See supra* note 1. Some statutory duties may be mandatory, while others may be subject to waiver or modification by agreement, provided any statutory requirements for such waiver or modification are met.

<sup>22</sup> *See* discussion *supra* Part I.C.

### 1. *The Delaware Statute*

The Delaware statute is unique to Limited Liability Company law and expressly seeks “to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements,”<sup>23</sup> even where such freedom may go beyond traditional common law doctrine, such as that imposing a duty of loyalty on managers.<sup>24</sup> The statute expressly allows for contractual modification or elimination of the duties of an LLC member or manager (including any fiduciary duties), with the sole limitation “that the limited liability company agreement may not eliminate the implied *contractual* covenant of good faith and fair dealing.”<sup>25</sup> In short, the only limitation under the Delaware statute on the parties’ right to eliminate fiduciary duties by contract is, itself, grounded in the common law of contract. The duty of good faith, as a matter of *contract law*, is a mandatory rule and is not subject to waiver by the parties. The Delaware LLC statute merely reiterates that common law rule.<sup>26</sup> However, any fiduciary duty arising from the unique nature of a manager’s role in an LLC is fully subject to prospective waiver under Delaware law.<sup>27</sup>

### 2. *The New York Statute*

In contrast to Delaware’s use of a unique statutory provision crafted specifically for LLCs, the only New York LLC provision addressing waiver of duties of a manager to an LLC or its members is taken almost verbatim from the New York Business Corporation Law.<sup>28</sup> This statutory provision begins by broadly allowing for the inclusion within the LLC operating agreement of a contractual “provision eliminating or limiting the personal liability of managers to the limited liability company or its members for damages for any

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<sup>23</sup> DEL. CODE ANN. tit. 6, §18-1101(b) (West 2013).

<sup>24</sup> *Id.* § 18-1101(a).

<sup>25</sup> *Id.* § 18-1101(c) (emphasis added); *see also id.* § 18-1101(d)-(j) (further elaborating on the broad deference to contract under the statute).

<sup>26</sup> *See id.* § 18-1101(c).

<sup>27</sup> DEL. CODE ANN. tit. 6, §18-1101(c).

<sup>28</sup> *See generally* N.Y. LTD. LIAB. CO. LAW § 417(a)(1) (the LLC provision allowing for elimination or limitation of personal liability of managers) *and* N.Y. BUS. CORP. LAW § 402(b)(1) (McKinney 1998) (the provision in the Business Corporation Law allowing for elimination or limitation of personal liability of directors).

breach of duty in such capacity . . . .”<sup>29</sup> However, this broad grant is then substantially limited to preclude elimination or limitation of liability where, *inter alia*, the manager’s “acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law” or the manager “*personally gained in fact a financial profit or other advantage to which he or she was not legally entitled.*”<sup>30</sup> This substantial limiting language appears to provide for a far narrower range of application than the Delaware statute above, in effect, allowing the parties far less autonomy in limiting or eliminating the duties of managers or liability for any breach thereof.

In *Pappas v. Tzolis*,<sup>31</sup> addressed in Part III, none of the courts directly address NYLLCL § 417(a), even though the supreme court decision directly addresses the effectiveness of a prospective waiver of fiduciary duty, which would seem to fall directly within the scope of the statutory language. As further explained in Part III, the Court of Appeals avoided any decision as to the effectiveness of the prospective waiver. However, our own “hypothetical” exploration of this issue requires us to consider the statute and its history in some detail.

**a. The Genesis of NYBCL § 402(b)—*Smith v. Van Gorkom* and the Duty of Corporate Directors to Inform Themselves**

The evolutionary history of NYLLCL § 417(a) begins with a case involving the duties of corporate directors to take reasonable steps to inform themselves before taking action on behalf of the corporation. In New York, this duty is found in NYBCL § 717(a) and the duty of directors to act “with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances”—often called the “duty of care.”<sup>32</sup> Similar duties were historically imposed under most corporation laws, including Delaware. Significantly, the inquiry was typically very fact specific, with significant deference to the directors in balancing the need for prompt action with the need for more information, consistent with the

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<sup>29</sup> N.Y. LTD. LIAB. CO. LAW § 417(a).

<sup>30</sup> *Id.* § 417(a)(1) (emphasis added).

<sup>31</sup> 982 N.E.2d 576 (N.Y. 2012).

<sup>32</sup> N.Y. BUS. CORP. LAW § 717(a).

business judgment rule. That all changed when the Delaware Supreme Court handed down its controversial decision in *Smith v. Van Gorkom*.<sup>33</sup>

*i. The Basic Conundrum of  
Smith v. Van Gorkom*

In *Smith v. Van Gorkom*, the board of directors of Trans Union Corporation had made a decision to sell the business in its entirety.<sup>34</sup> The selling price was significantly higher than the market price at which the company's shares were trading at the time.<sup>35</sup> However, the negotiations occurred between a small group over a compressed period of time, and the board decision happened very quickly.<sup>36</sup> The case represented the classic challenge in which the directors were required to balance the need for prompt action with the potential that they might learn more with further analysis and deliberation.<sup>37</sup> The directors opted in favor of moving quickly (a view supported by counsel, who suggested they might get sued if they did not accept the offer then on the table), likely confident that their decision would be protected by the business judgment rule.<sup>38</sup> However, the Delaware Supreme Court thought otherwise.<sup>39</sup>

The Delaware Supreme Court held that the directors of Trans Union were not, in this case, entitled to the benefit of the business judgment rule, because they had failed to exercise due care in informing themselves.<sup>40</sup> Thus, all were exposed to personal liability to the extent of any determination that Trans Union had been sold for less than fair value.<sup>41</sup> The corporate response was swift and overwhelmingly critical. Insurance premiums for directors and officers skyrocketed, and boards became far more fearful of quick decision-making, without exhaustive analysis (which may or may not be a good thing, depending on the circumstances).<sup>42</sup> The legislative

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<sup>33</sup> 488 A.2d 858 (Del. 1985).

<sup>34</sup> *Id.* at 865.

<sup>35</sup> *Id.* at 865-68.

<sup>36</sup> *Id.* at 869.

<sup>37</sup> *Id.* at 880.

<sup>38</sup> *Van Gorkom*, 488 A.2d at 868.

<sup>39</sup> *Id.* at 874.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.* at 893.

<sup>42</sup> Lynn A. Howell, *Post Smith v. Van Gorkom Director Liability Legislation with a*

responses were also swift.

**ii. *The Common Statutory  
Solution to this Conundrum***

In Delaware, the legislature enacted and the Governor signed, on June 18, 1986, Title 8 §102(b)(7),<sup>43</sup> essentially allowing for limitation or elimination of liability arising from a director's duty of care, but precluding any such waiver of a director's duty of good faith, loyalty, or improper self-dealing.<sup>44</sup> The vast majority of Delaware corporations promptly took advantage of §102(b)(7). A majority of other states quickly followed suit,<sup>45</sup> including New York, which, in 1987, enacted New York Business Corporations Law § 402(b).<sup>46</sup>

Significantly, however, neither the Delaware nor the New York legislative response to *Smith v. Van Gorkom* in any way provided for prospective waiver of director liability for a breach of the fiduciary duty of loyalty or for improper self-dealing. As indicated in Part II.B.1 above, Delaware has independently taken this latter step with respect to LLC managers.<sup>47</sup> New York, however, has taken a very different approach.

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*Proactive Perspective*, 36 CLEV. ST. L. REV. 559, 564-68 (1988).

<sup>43</sup> DEL. CODE ANN. tit. 8, §102(b)(7) (West 2013).

<sup>44</sup> Howell, *supra* note 42, at 568-69.

<sup>45</sup> *Id.* at 569.

<sup>46</sup> N.Y. BUS. CORP. LAW § 402(b) (McKinney 2015):

The certificate of incorporation may set forth a provision eliminating or limiting the personal liability of directors to the corporation or its shareholders for damages for any breach of duty in such capacity, provided that no such provision shall eliminate or limit: (1) the liability of any director if a judgment or other final adjudication adverse to him establishes that his acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled or that his acts violated section 719, or (2) the liability of any director for any act or omission prior to the adoption of a provision authorized by this paragraph.

*Id.*

<sup>47</sup> *See supra* notes 24-28.

**b. Transporting the Statutory Response to *Smith v. Van Gorkom* to an LLC Statute**

In enacting its LLC statute in 1994 (post *Smith v. Van Gorkom*), the legislature largely copied and pasted the language of New York Business Corporations Law § 402(b)(1) into New York Limited Liability Company Law § 417(a)(1).<sup>48</sup> The statutory provisions (contained in footnotes below) are easily compared, and the changes are limited as follows: (1) corporation is changed to limited liability company; (2) directors are changed to managers; (3) shareholders are changed to members; (4) female pronouns are added to male pronouns; and (5) certain LLC statutory provisions are substituted for comparable New York Business Corporations Law statutory provisions regarding certain specific director liability.<sup>49</sup> None of the above changes address the basic effect of the statute, and none in any way change the effectiveness of any waiver of the fiduciary duty of loyalty of a director or manager, respectively. Thus, one can reasonably infer that the legislature's intent in transporting the language of New York Business Corporations 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.

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<sup>48</sup> N.Y. LTD. LIAB. CO. LAW § 417(a):

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.

*Id.*

<sup>49</sup> See *supra* notes 46 and 48.

### III. *PAPPAS V. TZOLIS*—WHAT THE NEW YORK COURT OF APPEALS DID AND DID NOT SAY

In *Pappas v. Tzolis*,<sup>50</sup> the Court of Appeals had an opportunity to discuss the issue of prospective waiver of fiduciary duties under New York law. Instead, however, the Court of Appeals grounded its decision entirely in a subsequent “Certificate” executed by the parties in which any existing claims for breach of any fiduciary duties were expressly released, and any then-existing fiduciary duties were expressly disclaimed.<sup>51</sup> The path of this litigation through the New York Supreme Court, the Appellate Division, and Court of Appeals is outlined below, after which we return to the questions that were not answered by the Court of Appeals—including the question of whether a prospective waiver is effective in limiting or eliminating the fiduciary duties of managers of an LLC under New York law.

#### A. The Facts of the Case

Steve Tzolis and plaintiffs formed Vrahos LLC for the purpose of leasing a building in Manhattan.<sup>52</sup> The lease commenced in January 2006 and required payment by the LLC of a security deposit of \$1,192,500, along with personal guarantees from Tzolis and plaintiff Steve Pappas as to payment of ongoing rent by the LLC.<sup>53</sup> The LLC operating agreement specified that Tzolis would personally advance the security deposit on behalf of the LLC and provided that, as consideration for advancing the security deposit, Tzolis would have certain specified rights to enter into a sublease of the property from the LLC.<sup>54</sup> Under such sublease, Tzolis would pay additional monies to the LLC above the rental payments that the LLC was required to pay directly to the landlord.<sup>55</sup> Tzolis soon exercised his right to sublease the building.<sup>56</sup>

By late 2006, however, a variety of issues had arisen between Tzolis and the others, leading Tzolis to suggest that he acquire their

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<sup>50</sup> 982 N.E.2d 576 (N.Y. 2012).

<sup>51</sup> *Id.* at 578-80.

<sup>52</sup> *Pappas v. Tzolis*, 932 N.Y.S.2d 439, 442 (App. Div. 1st Dep’t 2011).

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

interests in the LLC.<sup>57</sup> Plaintiffs agreed and negotiated buyouts of \$1,000,000 for plaintiff Pappas and \$500,000 for plaintiff Ifantopoulos (for which they had originally paid \$50,000 and \$25,000, respectively), which were completed by early 2007.<sup>58</sup> The agreements between plaintiffs and Tzolis were accompanied by a signed, handwritten “Certificate,” which provided, in pertinent part, that:

[E]ach of the undersigned Sellers, in connection with their respective assignments to Steve Tzolis of their membership interests in Vrahos LLC, has performed their own due diligence in connection with such assignments. Each of the undersigned Sellers has engaged its own legal counsel, and is not relying on any representation by Steve Tzolis or any of his agents or representatives, except as set forth in the assignments & other documents delivered to the undersigned Sellers today. Further, each of the undersigned Sellers agrees that Steve Tzolis has no fiduciary duty to the undersigned Sellers in connection with such assignments.<sup>59</sup>

Six months after the assignment of plaintiffs’ interest to Tzolis, Vrahos LLC, now wholly owned by Tzolis, assigned its lease to nonparty Charlton Soho LLC for \$17.5 million.<sup>60</sup> In the ensuing legal action, Pappas asserted that he later discovered (unbeknownst to plaintiffs at the time) that Tzolis had begun negotiating the assignment of the lease to nonparty Extell Development Company, Charlton’s owner, a number of months before plaintiffs assigned their interests in the LLC to Tzolis.<sup>61</sup>

The above referenced LLC Operating Agreement also contained the following potentially relevant provision:

Any Member may engage in business ventures and investments of any nature whatsoever, whether or not in competition with the LLC, without obligation of

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<sup>57</sup> *Pappas*, 932 N.Y.S.2d at 442.

<sup>58</sup> *Id.* at 442-43; *Pappas*, 982 N.E.2d at 578.

<sup>59</sup> *Pappas*, 932 N.Y.S.2d at 443.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*



any kind to the LLC or to the other Members.<sup>62</sup>

Vrahos LLC was organized as a Delaware limited liability company under Delaware LLC law. However, the Operating Agreement included a choice of law provision<sup>63</sup> expressly providing that the agreement was governed by New York law.<sup>64</sup>

In short, Tzolis had purchased the interests of his co-venturers in the LLC for an amount equal to roughly twenty times their original investment.<sup>65</sup> However, Tzolis had, a relatively short time later, resold those same interests (along with his own original interest) at an even greater profit (valuing the LLC at roughly seven times what Tzolis paid in buying out the other LLC members), to the exclusion of his original co-venturers.<sup>66</sup> Moreover, Tzolis had allegedly begun negotiating the ultimate sale while still engaged in the original co-venture with plaintiffs.<sup>67</sup> Assuming these facts to be true, Tzolis might have raised two potentially distinct defenses: (1) the Operating Agreement provision purporting to allow “competition with the LLC” (and perhaps waiving any fiduciary duty to his co-venturers in the LLC); and (2) the provision of the “Certificate” purporting to disclaim or waive any fiduciary duty in connection with the assignment to Tzolis of plaintiffs’ interests in the LLC. This distinction is important in considering the decisions of each of the New York courts addressing plaintiffs’ claims.

## B. The Decision of the Supreme Court

Plaintiffs brought various claims against Tzolis, including a claim for breach of fiduciary duty, and Tzolis moved to dismiss.<sup>68</sup> On the motion, the parties disagreed as to the governing law, with Tzolis arguing Delaware law and plaintiffs insisting on New York

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<sup>62</sup> See *infra* note 72.

<sup>63</sup> In most cases, the inclusion in any agreement of an express choice of law provision will add a degree of certainty to the resolution of any subsequent question or dispute. However, the inclusion in an LLC operating agreement of any such choice other than the state of organization would seemingly only inject uncertainty based on the inherent conflict between the near universally embraced “internal affairs doctrine,” and the parties’ express choice.

<sup>64</sup> *Pappas*, 932 N.Y.S.2d at 442.

<sup>65</sup> *Id.* at 447.

<sup>66</sup> *Id.* at 443.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

law.<sup>69</sup> The Supreme Court sided with Tzolis on the merits, but avoided the complex choice of law issue by deciding that both Delaware and New York law rendered the same result.<sup>70</sup>

In dismissing the breach of fiduciary claim, the Supreme Court relied on the above-referenced provision of the Operating Agreement that allowed members to “engage in business ventures and investments of any nature whatsoever, whether or not in competition with the LLC, without obligation of any kind to the LLC or to the other Members.”<sup>71</sup> The court held that this provision effectively eliminated the members’ respective fiduciary duties to each other under both New York and Delaware law “from the start of the LLC.”<sup>72</sup> The Delaware LLC statute,<sup>73</sup> as the Supreme Court explained, allowed such prospective waiver in LLC operating agreements, with the exception of the covenant of good faith and fair dealing implied as a matter of basic contract law.<sup>74</sup> The court further concluded that the parties’ contract to have no fiduciary duties to each other and to the LLC was lawful under New York law and did not violate its public policy.<sup>75</sup> As such, plaintiffs’ breach of fiduciary duty claim failed under both Delaware and New York law based on the prospective waiver of such duties in the Operating Agreement.<sup>76</sup>

Significantly, however, the court’s analysis of the Operating Agreement under New York law failed to cite any statutory authority or even mention § 417 of NYLLCL. Instead, the court grounded its conclusion upon the broad principle of freedom of contract, ignoring a potentially significant limitation imposed by the applicable New York LLC statute.

### C. The Decision of the Appellate Division

The Appellate Division took a different approach. Seemingly assuming that Delaware law governed,<sup>77</sup> the appellate court explained

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<sup>69</sup> *Pappas*, 932 N.Y.S.2d at 443.

<sup>70</sup> *Id.* at 444.

<sup>71</sup> *Id.* at 442.

<sup>72</sup> *Pappas v. Tzolis*, No. 601115/09, 2010 WL 8367478, at \*3 (N.Y. Sup. Ct. Mar. 3, 2010).

<sup>73</sup> DEL. CODE ANN. tit. 6, § 18-1101(c) (West 2013).

<sup>74</sup> *Pappas*, 2010 WL 8367478, at \*3.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Pappas*, 932 N.Y.S.2d at 445. While the case was in the Appellate Division, plaintiffs

that while permitting prospective waiver of fiduciary duties, Delaware law required such waiver to be “explicit.”<sup>78</sup> In the court’s view, Tzolis did not establish that the subject provision of the Operating Agreement “explicitly” waived all traditional fiduciary duties as required by Delaware law.<sup>79</sup> Hence, at the time of the buy-out transaction, Tzolis still owed some fiduciary duty to plaintiffs, and the Certificate, purportedly releasing him from any liability arising from his fiduciary duties, moved front and center as the focus of the court’s analysis.<sup>80</sup>

In the Certificate, executed as part of the New York buy-out transaction (and therefore governed by New York law), plaintiffs expressly acknowledged that Tzolis owed them no fiduciary duty. But, the court invalidated this purported disclaimer relying on New York law.<sup>81</sup> The Appellate Division held that Tzolis had “an overriding duty to disclose his dealings with Extell to plaintiffs before they assigned their interests in Vrahos to him”<sup>82</sup> because the relationship of trust still existed between the members at the time of the assignment of plaintiffs’ interest.<sup>83</sup>

The dissent seemingly agreed that the language of the Operating Agreement was insufficient to provide an effective prospective waiver of all fiduciary duties under Delaware law.<sup>84</sup> However, the dissenting judges concluded that under New York law<sup>85</sup> the Certificate discharged Tzolis from any liability arising from his

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continued to argue that New York law applied based on the choice of law clause in the Operating Agreement. The appellate court’s decision on Tzolis’ prospective waiver argument is based solely on Delaware law, with no choice of law analysis and no analysis of the New York LLC statute.

<sup>78</sup> *Id.* (citing *Kelly v. Blum*, No. 4516-VCP, 2010 WL 629850, at \*10 (Del. Ch. Feb. 24, 2010)).

<sup>79</sup> *Id.*

<sup>80</sup> Notably, Tzolis’ argument was based on the waiver provision in the Operating Agreement, rather than on the Certificate. As suggested by the decision of the Supreme Court, Tzolis contended that the Certificate merely corroborated the parties’ intent to disclaim all fiduciary duties. *Id.*

<sup>81</sup> *Id.* at 445 (relying primarily on *Blue Chip Emerald v. Allied Partners*, 750 N.Y.S.2d 291 (App. Div. 1st Dep’t 2002)).

<sup>82</sup> *Pappas*, 932 N.Y.S.2d at 446.

<sup>83</sup> *Id.* at 445.

<sup>84</sup> *Id.* at 449.

<sup>85</sup> *Id.* at 450 (Freedman, J., dissenting). The dissent relied on *Centro Empresarial Cempresa S.A. v. América Móvil, S.A.B. de C.V.*, 952 N.E.2d 995, 1001 (N.Y. 2011), a case that criticized the Appellate Division’s decision in *Blue Chip Emerald* and upheld the parties’ right to release each other from claims arising out of fiduciary duties.

fiduciary duties.<sup>86</sup> In effect, the dissent presented a new theory, which Tzolis had not argued either in the court below or on appeal, laying ground for the Court of Appeals' review. While the Appellate Division reinstated the plaintiffs' breach of fiduciary duty claim, it shifted the focus of the dispute from the validity of the prospective waiver provision in the Operating Agreement to the effect of the purported release in the Certificate.<sup>87</sup>

#### **D. A Rather Ordinary Decision by the Court of Appeals**

The decision of the Court of Appeals does not discuss the Operating Agreement or the parties' purported prospective waiver of fiduciary duties at all. Rather, it deals with one and only one issue with respect to plaintiffs' claim of breach of fiduciary duty—whether the Certificate effectively released Tzolis from any such claim.

The Court's prior precedent established that a principal could release its fiduciary from claims where "the fiduciary relationship is no longer one of unquestioning trust."<sup>88</sup> Applying this principle to the specific circumstances of this case, the Court of Appeals held that the release in the Certificate was valid because at the time of the buy-out the parties' relationship had already deteriorated and plaintiffs could not reasonably rely on Tzolis as their fiduciary.<sup>89</sup>

While Tzolis ultimately prevailed, his victory at the Court of Appeals rested on a different ground than at the trial court. The Supreme Court found that the parties prospectively waived their respective fiduciary duties to each other by means of the provision in the Operating Agreement.<sup>90</sup> The Appellate Division found that the Operating Agreement did not provide a valid prospective waiver of all traditional fiduciary duties and moved the inquiry to the Certificate.<sup>91</sup> The Court of Appeals did not even consider the Operating Agreement, but based its decision on the release of claims arising out of Tzolis' fiduciary duties provided at the time of the buy-out transaction by means of the Certificate.<sup>92</sup>

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<sup>86</sup> *Pappas*, 932 N.Y.S.2d at 446.

<sup>87</sup> *Id.* at 445.

<sup>88</sup> *Pappas*, 982 N.E.2d at 579 (citing *Centro*, 952 N.E.2d at 1001).

<sup>89</sup> *Id.*

<sup>90</sup> *Pappas*, 2010 WL 8367478.

<sup>91</sup> *Pappas*, 932 N.Y.S.2d at 445.

<sup>92</sup> *Pappas*, 982 N.E.2d at 580.

One might reasonably infer that the Court consciously avoided the Operating Agreement knowing that it required potentially challenging statutory interpretation. Even if the Court agreed with the Appellate Division, that the Operating Agreement did not effectively waive all traditional fiduciary duties, it could have still addressed the effectiveness of the waiver even if limited. A prospective waiver of any fiduciary duties would have further suggested the lack of such duties, generally, at the time the Certificate was executed.<sup>93</sup> The Certificate clearly presented an easier path to find for Tzolis and uphold the parties' choice to eliminate fiduciary duties. In taking this path, however, the Court chose to forego an opportunity to buttress its decision by pointing out that even a partial waiver in the Operating Agreement, as Tzolis argued, helped to further establish the effectiveness of the Certificate at the time of the buy-out transaction. While the Court's intent will ultimately remain unknown, the fact remains that the Court of Appeals never discussed: (1) which law governed this prospective attempt to waive fiduciary duties in the Operating Agreement, or (2) whether such a prospective waiver was valid.

### *1. Misinterpreting the Decision of the Court of Appeals*

Nonetheless, a number of commentators seemingly misinterpret *Pappas* to suggest that the case established LLC members' rights to prospectively waive fiduciary duties under New York law. For example, one commentator wrote that "[f]ollowing the decision in *Pappas*, it can be said with a high degree of certainty that New York indeed permits the complete waiver of LLC member fiduciary duty via contract (but still subject to the limitations of Section 417 of the NY LLC Law)."<sup>94</sup> Similarly, another commentator also discussed the decision in *Pappas* in connection with § 417 of New York LLC statute and stated that the Court

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<sup>93</sup> *Pappas*, 932 N.Y.S.2d at 450. Consistent with the dissenting opinion of the Appellate Division, the focus of Tzolis' argument at the Court of Appeals shifted from the Operating Agreement to the Certificate. Nevertheless, the questions presented to the Court of Appeals by Tzolis' brief invited the Court to weigh in on the effect of the waiver provision in the Operating Agreement, as it related to the effectiveness of the Certificate.

<sup>94</sup> *Limiting Fiduciary Duty in New York Entities for Private Placement Offerings*, RAISING CAPITAL (Nov. 24, 2014), <http://www.regd-ppm-lawyers.com/limiting-fiduciary-duty-new-york-entities-private-placement-offerings/>.

“enforced a contractual waiver of fiduciary duties among LLC members.”<sup>95</sup> Commentators further discussed *Pappas* in the context of prospective waivers of fiduciary duties, such as those allowed by § 18-1101 of the Delaware LLC statute.<sup>96</sup> Another author seemingly concluded that *Pappas* “permitted waivers of fiduciary duties owed to LLC members” based on multiple factors, including the antagonistic relationship of sophisticated LLC members, the LLC agreement permitting competing business ventures, and the Certificate releasing Tzolis from his fiduciary duties.<sup>97</sup>

The aforementioned comments on *Pappas* seem to conflate the notion of an *ex ante* prospective waiver of all fiduciary duties, governed by § 417 of NYLLCL, and an *ex post* release of an existing known right. While the Court of Appeals affirmed the validity of the latter under the circumstances presented in *Pappas*, it never even discussed the former under either Delaware or New York law. The distinction is important.

A prospective waiver is a decision by LLC co-venturers to do business owing no fiduciary duties to each other or the LLC from the very start of their business venture. Section 417 of NYLLCL affirms their right to waive certain duties in the LLC operating agreement, but imposes significant limitations on such waivers. The Certificate reviewed by the Court of Appeals in *Pappas* was not a blanket prospective waiver of fiduciary duties and, therefore, did not invoke § 417 of NYLLCL. Rather, it represented plaintiffs’ release of their known (or knowable) right to a claim against Tzolis in the context of a buy-out transaction. The validity of such a release depended, as the Court of Appeals explained, on the particular circumstances of the buy-out transaction and the nature of the parties’ relationship at the time of that transaction. Thus, contrary to the assertions of some commentators, *Pappas* provided no insights on the contours of New

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<sup>95</sup> Arina Shulga, *Part III: Fiduciary Duties of LLC Managers in New York, Delaware, and Other States*, BUS. LAW POST (Nov. 16, 2013), <http://www.businesslawpost.com/2013/11/part-iii-fiduciary-duties-of-llc.html>.

<sup>96</sup> Zachary G. Newman & Alison M.C. Schrag, *The Enforceability of Fiduciary Duty Waivers*, 14 COM. & BUS. LITIG. 3 (2013), available at: [http://www.hahnhausen.com/uploads/1065/doc/2013\\_06\\_zgn\\_amc\\_fiduciary\\_duty\\_waivers.pdf](http://www.hahnhausen.com/uploads/1065/doc/2013_06_zgn_amc_fiduciary_duty_waivers.pdf); Vincent Syracuse, Paul Sarkozi, Jamie Stecher & Zev Raben, *Litigation: Can LLC Members Effectively Waive Their Fiduciary Duties?*, INSIDE COUNSEL (Feb. 14, 2013), <http://www.insidecounsel.com/2013/02/14/litigation-can-llc-members-effectively-waive-their>.

<sup>97</sup> Helen (Wendy) J. Williamson & Andrew M. Walsh, *New Jersey Eases Fiduciary Duties for LLCs*, ANDERSON KILL & OLICK, P.C. (Jan. 2013), [http://www.andersonkill.com/webpdfext/publications/csu/pdf/New\\_Jersey\\_Eases\\_Fiduciary\\_Duties\\_For\\_LLCs.pdf](http://www.andersonkill.com/webpdfext/publications/csu/pdf/New_Jersey_Eases_Fiduciary_Duties_For_LLCs.pdf).

York law on the issue of prospective waiver of fiduciary duties in the context of an LLC. By focusing on the release in the Certificate the Court of Appeals avoided reviewing the Operating Agreement, a task that would probably require a choice of law analysis, and potentially commentary on § 417 of NYLLCL.

## 2. *The Issues Not Decided*

The Court of Appeals, in *Pappas*, re-iterated that LLC members may release claims arising out of their respective fiduciary duties.<sup>98</sup> But, the high Court did not address, arguably, the most interesting and challenging issues that the case presented at the outset of the litigation. First, the parties disagreed on the governing law, with respect to the Operating Agreement. Nonetheless, neither court engaged in a choice of law analysis, although the Appellate Division seemingly decided that Delaware law governed without any explanation. Second, the Court of Appeals never reviewed the validity of the waiver provision in the Operating Agreement under § 417 of NYLLCL. The discussion below focuses on these issues suggesting that the choice of law clause as well as a prospective waiver of a duty of loyalty clause is likely ineffective under the NYLLCL.

### a. **Choosing Law to Govern an LLC Operating Agreement**

While the Vrahos LLC was organized under the Delaware law, its members chose New York law in their Operating Agreement.<sup>99</sup> It is hard to fathom any rational basis for choosing to form an LLC in Delaware and then seeking to subject the Operating Agreement and internal affairs of that LLC to New York (or any state other than Delaware) law. At a minimum, such approach creates uncertainty as to the governing law. That said, it does present an interesting choice of law question.

A strict application of the relevant statute suggests that the choice of law provision in Vrahos's Operating Agreement was likely ineffective. Section 801(a) of NYLLCL provides:

Subject to the constitution of this state: (a) the laws of

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<sup>98</sup> *Pappas*, 982 N.E.2d at 580.

<sup>99</sup> *Pappas*, 932 N.Y.S.2d at 442.

the jurisdiction under which a foreign limited liability company is formed govern the organization and internal affairs and the liability of its members and managers; . . .<sup>100</sup>

Based on the statutory language, this provision appears to be a mandatory rather than a default rule. The default provisions of the NYLLCL allow the parties to contract for a different result by indicating that they are subject to the parties' Operating Agreement or the LLC's Articles of Organization.<sup>101</sup> Section 801, however, is subject only to the New York Constitution, without any suggestion of the parties' right to contract for a different result in the Operating Agreement or otherwise. Hence, unlike the default provisions of the NYLLCL, the legislature chose to limit the choice of law provided in § 801 only by the state's constitution—and not to provide the parties with a right to contract otherwise. The statutory language, when strictly applied, renders the parties' purported choice of New York law in Vrahos's Operating Agreement ineffective.

However, the Court of Appeals does not always engage in a strict application of the statutory language,<sup>102</sup> and we found no reported appellate decisions reviewing a choice of law clause vis-à-vis § 801. Given that an LLC, as a form of business organization, is supposed to provide the parties with the most freedom to define the governance of their business through contract, one might reasonably expect the Court of Appeals to imply the parties' right to deviate from the statute if and when it is faced with this issue.

#### **b. Prospective Waiver of a Manager's Duty of Loyalty to an LLC**

To the extent the parties' choice of New York law is upheld, the wisdom of such choice with respect to the parties' intent to prospectively waive a managers' duty of loyalty is questionable at best. A foreign LLC whose members for whatever reason effectively subjected the LLC Operating Agreement to New York law, as well as a domestic New York LLC, is subject to the limitations set forth in §

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<sup>100</sup> N.Y. LTD. LIAB. CO. LAW § 801(a).

<sup>101</sup> *See, e.g.*, N.Y. LTD. LIAB. CO. LAW §§ 406, 407, 414, 420, 603 etc.

<sup>102</sup> *See, e.g.*, *Tzolis v. Wolff*, 884 N.E.2d 1005 (N.Y. 2008) (in a four to three decision, finding a right to bring a derivative action where the legislature clearly did not provide for one in the statute).



417(a)(1) of NYLLCL.<sup>103</sup> The scope of these limitations, as currently written, most likely renders any waiver of the fiduciary duty of loyalty, such as the one attempted in Vrahos's Operating Agreement, ineffective.

While LLC members may limit or eliminate manager's personal liability to the members of the LLC under New York law,<sup>104</sup> section 417(a)(1) prohibits the managers, *inter alia*, from personally gaining "in fact a financial profit or other advantage to which he or she was not legally entitled."<sup>105</sup> In effect, this limitation excludes the duty of loyalty, and potentially other duties, from the universe of waivable duties. However, the question of whether Tzolis was "legally entitled" to the financial profit at issue presents a classic problem of circularity. One may argue that Tzolis was "legally entitled" to act as he did by virtue of the waiver provision in the Operating Agreement. But, such interpretation would effectively swallow the limitation in its entirety by "legalizing" any conduct through a contractual waiver.

The Court of Appeals has yet to explain its understanding of the statutory language. In the meantime it appears that the statutory limitations, absent some creative interpretation, invalidate any prospective attempt by the members to waive the managers' duty of loyalty.<sup>106</sup> Moreover, the legislative history of NYLLCL § 417(a)(1) strongly suggests that this statutory provision was never intended to be read so broadly as to allow the members of an LLC to limit or eliminate prospectively the fiduciary duty of loyalty.

New York's LLC statute vests members with the right to prospectively limit or eliminate managers' liability, but does not appear to provide any basis for upholding the members' attempt to prospectively waive any fiduciary duties. To the extent members of a Delaware LLC seek to prospectively eliminate all fiduciary duties, they would be ill-advised to attempt a choice of New York law in the LLC's operating agreement given these New York statutory limitations. At best, such choice, if valid, would leave them with uncertainty as to the effectiveness of their agreement to proceed

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<sup>103</sup> See N.Y. LTD. LIAB. CO. LAW § 417(a).

<sup>104</sup> N.Y. LTD. LIAB. CO. LAW § 417(a).

<sup>105</sup> *Id.* § 417(a)(1).

<sup>106</sup> As discussed above, in New York the duty of loyalty is established by common law rather than the statute. One may reasonably question whether the statute preempts common law on the issue of prospective waiver. This article, however, does not attempt to address this potentially complex question.

assuming no loyalty to each other or their enterprise.

#### **IV. CONCLUSION**

In this article, we take the position that a manager's fiduciary duty of loyalty to an LLC is not subject to prospective waiver under current New York law. However, this perhaps begs the more interesting question on this 20th anniversary of the enactment of New York's LLC law—*should* the law allow for and give full effect to such a waiver if clear and unequivocal? Should New York follow the approach of Delaware, or should it continue to hew closely to the path originally charted by Judge Cardozo in *Meinhard v. Salmon*? Should New York LLC law limit itself to basic contract rules, or are there more important regulatory issues at stake? Perhaps the time has come for the legislature to consider these questions more carefully in the specific context of an LLC.