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THE NEW YORK LIMITED LIABILITY COMPANY LAW AT TWENTY: PAST, PRESENT & FUTURE

*Meredith R. Miller**

The New York Limited Liability Company Law (“LLC Law”) has turned 20. This occasion presents an opportunity to reflect on its past, present and future.

I. THE PAST

There was no debate in either the New York Assembly or Senate and, in April 1994, the LLC Law was unanimously passed in both chambers. Governor Mario Cuomo signed the bill into law on July 26, 1994; it took effect 90 days later.¹

Indeed, by 1994, enactment of the LLC Law was a foregone conclusion. Well over 40 states had adopted LLC statutes. New York City could not maintain its reputation as the business capital of the world without allowing formation of New York LLCs and recognizing out-of-state LLCs.² The LLC brought to the landscape an entity that combines both the tax advantages of a partnership and the limited liability of a corporation, as well as supreme flexibility in governance.

Based on the legislative record, the genesis of the actual language used in the LLC Law is elusive. On its face, much of the LLC Law appears to borrow largely from the language of either the New York Business Corporation Law (“BCL”) or the New York Partnership Law, in all events with alterations to maximize the principles of

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¹ N.Y. LTD. LIAB. CO. LAW § 1403 (McKinney 1994).

² N.Y. LEGISLATIVE SERV., LEGISLATIVE HISTORY ON THE LIMITED LIABILITIES COMPANY ACT 110 (1994). Senator John B. Daly remarks at the introduction of the bill: “Because of this, LLCs have been formed in over 44 States already, and it’s very important that New York State join with that growing list already.” *Id.*

flexibility and freedom of contract.

By 1994 nearly every state had enacted an LLC statute or was considering one. It is not clear which, if any, other state statutes the legislature looked to in drafting New York's LLC Law. At the time, there was tremendous variety among the state LLC statutes, most of which predated any efforts at uniformity. While a Committee of the American Bar Association had drafted a "Prototype Limited Liability Company Act" in 1992,³ there is scant evidence that the New York LLC Law drafters looked to it for guidance. Moreover, New York, like most states, rushed to enact legislation before the National Conference of Commissioners on Uniform State Laws ("NCCUSAL") finalized the Uniform Limited Liability Company Act ("ULLCA"), which NCCUSAL only first approved in July of 1996.⁴

A consequence of this history is that the LLC Law does not always work well as a unit—there are provisions that, when read together, are puzzling. In addition, as has been seen in decisional law since its enactment, there are "conspicuous gaps" from its content.⁵ Indeed, so mysterious is the origination of the statute that, when the New York Court of Appeals had occasion to address whether an LLC member had the right to bring a derivative suit, there was simply no explanation on record for the complete omission of a provision addressing the subject.⁶

II. THE PRESENT

The present state of LLC law in New York is a patchwork of the statutory language and decisional law interpreting the statute's significant ambiguities and omissions. To be certain, all statutes present some level of confusion that requires court interpretation. That

³ 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 1.7, at 13 (2d ed. 2011).

⁴ See REVISED LTD. UNIF. LIAB. CO. ACT (Preamble) (2006), available at http://www.uniformlaws.org/shared/docs/limited%20liability%20company/ullca_final_06rev.pdf

⁵ *Tzolis v. Wolff*, 884 N.E.2d 1005, 1008 (N.Y. 2008) ("The Legislature clearly did decide not to enact a statute governing derivative suits on behalf of LLCs. An Assembly-passed version of the bill that became the Limited Liability Company Law included an article IX, entitled 'Derivative Actions.' In the Senate-passed version, and the version finally adopted, the article was deleted, leaving a *conspicuous gap*; in the law as enacted, the article following article VIII is article X. *Nothing in the legislative history discusses the omission.*" (emphasis added)).

⁶ *Id.*

said, the New York LLC Law is silent or unclear on a number of very fundamental issues about the governance and operation of the LLC.

Some of the significant lingering issues are ably addressed in the articles in this symposium issue. For example, the article by Professor Jack Graves and Yelena Davydan discusses the fundamental question of whether fiduciary duties may be prospectively waived in a New York LLC.⁷ As they explain, against the backdrop of statutory silence, the New York Court of Appeals has not squarely addressed the issue. In contrast, the Delaware LLC statute expressly permits prospective waiver of fiduciary duty.⁸

Also in this issue, Professor Miriam Albert writes about piercing the LLC veil.⁹ As she notes, neither the LLC Law nor the legislative history address whether veil piercing is available in the New York LLC and, if so, what factors should be used to determine whether to pierce the veil. As Professor Albert discusses, since 2005, New York case law has specifically allowed veil piercing in an LLC; however, the courts have not meaningfully analyzed the issues left open by the statute.

These issues are not the only ones that remain open. For example, the LLC Law is silent on whether LLC members may petition for dissolution of the LLC based upon fraud, illegality or oppression, as permitted in a closely-held corporation pursuant to BCL § 1104-a. The New York Court of Appeals has yet to address this issue. In the absence of statutory guidance, at least one court has, without explanation, simply applied BCL § 1104-a to an LLC.¹⁰ Other courts have indicated that the LLC is distinct from the corporation and have refused to import corporate dissolution standards into the silence of the

⁷ Jack Graves & Yelena Davydan, *Fiduciary Duties of LLC Managers: Are They Subject to Prospective Waiver under the New York LLC Statute?*, 31 *TOURO L. REV.* 439 (2015).

⁸ DEL. CODE ANN. tit. 6, § 18-1101(c) (West 2013). In addition, the Revised Uniform Limited Liability Company Act (“RULLCA”) allows the operating agreement to eliminate “each specific aspect” of the duty of loyalty and allows the parties to alter the duty of care. Though, its provisions are in conflict. See REVISED LTD. UNIF. LIAB. CO. ACT § 110. Section 110(c)(4) of the RULLCA prohibits an operating agreement from eliminating the duty of loyalty, but Section 110(d)(1) provides that the parties may eliminate a specific aspect of the duty of loyalty. *Id.* § 110(d)(1), (3); see Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 *VA. L. & BUS. REV.* 35, 69-73 (2008).

⁹ Miriam R. Albert, *The New York LLC Act at Twenty: Is Piercing Still “Enveloped in the Midst of Metaphor”?*, 31 *TOURO L. REV.* 411 (2015).

¹⁰ *Scibelli v. Beacon Bldg. Grp., LLC*, N.Y. L.J. Aug. 14, 2014, at *1 (Sup. Ct. Queens County June 20, 2014).

LLC Law.¹¹ Meanwhile, outside of the dissolution context, in holding that an LLC member may bring a derivative suit, the New York Court of Appeals did extend rights to LLC members that are fundamental to the BCL but omitted from the LLC Law.¹²

The New York statute is notably silent on other fundamental issues, such as:

- Whether the operating agreement may vary the law applicable to the internal governance of the LLC;
- Whether there are consequences for failure to adopt a written operating agreement as required by the LLC Law;¹³
- Whether the LLC entity may be used to form a non-profit entity; and
- While the LLC law allows the court to issue a charging order, whether creditors may foreclose on a membership interest in the LLC.

The LLC Law also contains ambiguities. For example, § 402 addresses the voting rights of members, and provides that, unless the operating agreement states otherwise, certain extraordinary business decisions require the consent of a majority of the membership inter-

¹¹ *In re 1545 Ocean Ave., LLC*, 893 N.Y.S.2d 590 (App. Div. 2d Dep't 2010); *Horning v. Horning Constr., LLC*, 816 N.Y.S.2d 877 (Sup. Ct. Monroe County Mar. 21, 2006).

¹² *Tzolis*, 884 N.E.2d at 1019.

¹³ N.Y. LTD. LIAB. CO. LAW § 102(u) (“ ‘Operating agreement’ means any *written* agreement of the members concerning the business of a limited liability company and the conduct of its affairs and complying with section four hundred seventeen of this chapter.” (emphasis added)); *Id.* § 417(a).

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.

Id. (emphasis added)).

Despite the mandatory nature of the statutory language, in *Spires v. Casterline*, 778 N.Y.S.2d 259 (Sup. Ct., Monroe County 2004), the court held that the failure to adopt an operating agreement did not negate the existence the LLC. *Id.* at 266. The court also held that the LLC Law did not invoke a penalty for the failure to adopt an operating agreement. *Id.* at 262.

est. However, it is unclear why the following two subsections (c) and (d) are separately listed:

(c) Except as provided in the operating agreement, whether or not a limited liability company is managed by the members or by one or more managers, the vote of a majority in interest of the members entitled to vote thereon shall be required to:

(1) admit a person as a member and issue such person a membership interest in the limited liability company;

(2) approve the incurrence of indebtedness by the limited liability company other than in the ordinary course of its business; or

(3) adopt, amend, restate or revoke the articles of organization or operating agreement, subject to the provisions in subdivision (e) of this section, subdivision (b) of section six hundred nine of this chapter and subdivision (b) of section four hundred seventeen of this article.

(d) Except as provided in the operating agreement, whether or not a limited liability company is managed by the members or by one or more managers, the vote of at least a majority in interest of the members entitled to vote thereon shall be required to:

(1) approve the dissolution of the limited liability company in accordance with section seven hundred one of this chapter;

(2) approve the sale, exchange, lease, mortgage, pledge or other transfer of all or substantially all of the assets of the limited liability company; or

(3) approve a merger or consolidation of the limited liability company with or into another limited liability company or foreign limited liability company.

Likewise, the default voting rights of the members in a member-managed LLC are simply lacking clarity. The statute separately

provides for default management rights for managers¹⁴ and for members.¹⁵ The member voting default rules reference proportionate ownership share, while the manager voting default rules provide for one vote per manager. Section 401(a) provides for the default rule of management of the LLC by its members. Section 401(b) provides:

If management of a limited liability company is vested in its members, then (i) any such member exercising such management powers or responsibilities shall be deemed to be a manager for purposes of applying the provisions of this chapter, unless the context otherwise requires, and (ii) any such member shall have and be subject to all of the duties and liabilities of a manager provided in this chapter.

Does § 401(b)(i) mean that, in a member-managed LLC, manager voting rules are the default for all matters?¹⁶ Literally read, it could be taken to suggest as much. However, this would erode the distinction between manager-managed and member-managed LLCs.

Perhaps § 401(b)(i) is referring to the situation where the LLC has a board of managers and some of those managers are also members. In that connection, perhaps this subsection means that, when members are acting as owners, the member voting rules apply but, otherwise, when they are acting as managers, the manager voting rules apply? (Akin to asking whether a shareholder/director is serving at any moment in the capacity as shareholder or director and then applying applicable voting defaults accordingly).

The only strong conclusion to be drawn is that the voting provisions and other sections of the New York LLC Law are not a picture of clarity.

Given the omissions and uncertainties, the conventional advice is to clearly contract in a solid operating agreement for the optimal standard for the parties – essentially, leave nothing to the vagaries of statute. This solution is not a panacea given the practical reality: whether because of lack of knowledge or resources or a commitment to informality, so many small businesses form LLCs but never execute an operating agreement. The current proliferation of

¹⁴ N.Y. LTD. LIAB. CO. LAW § 408.

¹⁵ N.Y. LTD. LIAB. CO. LAW § 402.

¹⁶ Thanks to Professor Jack Graves for meaningful and engaging discussions on this issue.

do-it-yourself (“DIY”) forms often leaves the LLC members without a signed operating agreement that would override the uncertainties of the statute.

III. THE FUTURE

The LLC Law has not been significantly reformed since its enactment 20 years ago. The New York legislature should either amend the statute to clarify the numerous uncertainties or simply adopt the Revised Uniform Limited Liability Company Act, which represents a more careful study of the issues that arise in the LLC context.

One way or another, the legislature should address the uncertainties raised in this law review issue. In addition, as Matthew Moisan advocates in his contribution, the publication requirement for formation of an LLC should be eliminated.¹⁷

The LLC Law requires that the LLC announce its existence in two newspapers, one of weekly publication and one of daily publication in its county of formation, as designated by the county clerk, for a period of six weeks following formation.¹⁸ As Mr. Moisan explains, this requirement needlessly adds potentially significant costs to starting a business,¹⁹ and no convincing explanation has been proffered for the requirement. Indeed, no such requirement exists to form a corporation. Further, if jurisdictional competition was at least part of the impetus for joining other states in enacting an LLC statute, New York is at a disadvantage for filings because our neighboring and competitor states (namely, Delaware) do not have a publication requirement.²⁰

It certainly seems that there is currently the political will to spur entrepreneurship in New York. For example, “SUNY Tax-free Areas to Revitalize and Transform Upstate NY” (“Start-Up NY”) attempts to encourage startup activity in New York by providing tax-free status to new companies built around state universities through-

¹⁷ Matthew J. Moisan, *A Look at the Publication Requirement in New York Limited Liability Company Law*, 31 *TOURO L. REV.* 465 (2015).

¹⁸ N.Y. LTD. LIAB. CO. LAW § 203.

¹⁹ Angus Loten & Rhonda Colvin, *Entrepreneurs Push Back against Rising LLC Fees*, *WALL ST. J.* (Feb. 12, 2014, 7:48 PM), <http://www.wsj.com/articles/SB10001424052702304703804579378733962360294>.

²⁰ In fact, the RULLCA does not have such a requirement.

out the State.²¹ Start-Up NY, as well as already existing tax incentive programs such as Excelsior (a program that gives tax incentives to high-tech strategic businesses),²² is making use of tax incentives as a means to increase small business activity in New York. In line with these initiatives, the legislature must address the problematic state of the LLC statute, including the financial barrier to forming an LLC that is presented by the publication requirement.

In sum, the current LLC Law needs an overhaul. It does not function well as a system of default rules because of its fundamental omissions and uncertainties. Further, through the publication requirement, it introduces unnecessary costs for entrepreneurs. If New York wants to continue to proclaim itself the center of international commerce and attempt to attract startup companies through tax and other initiatives, the New York legislature should revise this system of statutory default rules to be clear and predictable and eliminate needless startup costs. The need for revising the statute is especially acute in this era of DIY entity formation. It is increasingly common that the members of an LLC form without the advice of counsel and, therefore, never adopt an operating agreement. This leaves them with significant uncertainties concerning basic governance issues.²³

²¹ START UP NY, <http://startup.ny.gov> (last visited Apr. 24, 2015).

²² *Excelsior Jobs Program*, EMPIRE STATE DEV., <http://www.esd.ny.gov/BusinessPrograms/Excelsior.html> (last visited Apr. 24, 2015).

²³ If the members of the LLC do not adopt an operating agreement, the default rules provided by the LLC Law apply. *Spires*, 778 N.Y.S.2d at 266.