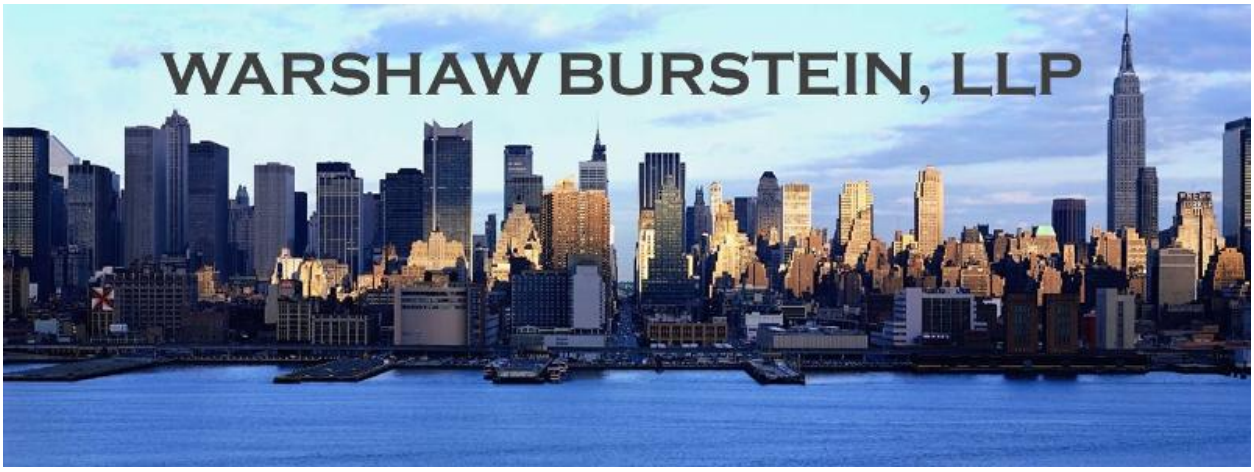

October 8, 2015

CLIENT ALERT

To Be (Dissolved) or Not to Be (Dissolved) – That is the Question To Be Addressed by an LLC Operating Agreement

The importance of having an operating agreement for a New York limited liability company (LLC) that addresses the basic business and legal issues that an LLC may face throughout its existence, is difficult to overstate. Despite the fact that the New York Limited Liability Company Law (LLCL)[1] states that members of an LLC "shall adopt a written operating agreement," there are some LLCs that neglect to do so and even those that do have an operating agreement, the provisions contained therein may not adequately address those basic business and legal issues. Without a well-constructed operating agreement, the rights, duties and obligations of an LLC's members are governed by the "default provisions" of the LLLC. However, those default provisions typically do not address every topic that might be important in a specific situation. For example, the LLCL does not address certain important rights, such as "ouster" of members and dissolution of the LLC. As the LLCL is silent as to the right to remove or "oust" members of an LLC for gross misconduct or breach of fiduciary duty, unless expressly set forth in an LLC's operating agreement, no such grounds for ouster or removal of members would be available.[2]

Similarly, the "default provisions" of the LLCL regarding dissolution are impracticably stringent. Even extreme cases of member or manager misconduct, such as improperly excluding a member from the LLC's business affairs, may not trigger dissolution if the LLC is able to function as intended, or if it is financially viable. Moreover, courts are very reluctant to order dissolution and thus, even when grounds exist, courts nonetheless, may permit a "buy out" of a member's interest, rather than dissolve an LLC. For this reason, an LLC not only should have an operating agreement as required by statute, but the agreement also should provide mechanisms for dealing with critical events in the lifespan of an LLC, including ouster of members and, as discussed in this Client Alert, dissolution of the LLC.

Dissolution of an LLC is a process that leads to termination of the legal existence of the entity. An LLC may be dissolved voluntarily (by vote or other action of its members) or by judicial decree (when authorized by statute). Following either a vote to dissolve the LLC or entry of a judicial decree of dissolution, the LLC continues to exist for a period of time for the purpose of "winding up" its affairs, including closing the business, disposing or selling its assets, discharging liabilities and distributing any remaining assets to its members.

In the absence of an operating agreement, or when the operating agreement lacks a provision for dissolution or such provision is found to be ambiguous, LLC members are left at the mercy of LLCL § 702 (the default dissolution provision) and court decisions interpreting that section.[3] Under LLCL § 702, on application by a member of the LLC, a court *may* decree "dissolution" of the entity "whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement."[4] However, because the statute does not define "reasonably practicable," it has been left to the courts to devise the legal standard under which an LLC may be dissolved, and that standard very well may differ from what an LLC's members intended or what they would have adopted had they addressed the issue in the LLC's operating agreement.

In Schindler v. Niche Media Holdings, LLC, an early case dealing with dissolution of an LLC, the trial court, after noting that this statutory standard "has never been construed in the case law," went on to "interpret[] it to mean that judicial dissolution will be ordered only where the complaining member can show that the business sought to be dissolved is unable to function as intended, or else that it is financially failing."[5] Since Schindler, the leading case on the standard for judicial dissolution of an LLC has been Matter of 1545 Ocean Ave., LLC.[6] There, the Second Department, after reviewing the legislative history of the LLCL (§ 702, in particular) and earlier court decisions (including Schindler), distinguished the LLC's dissolution provisions from those of the New York Business Corporation Law (BCL) and the New York Partnership Law.

Unlike the LLCL, the BCL and the Partnership Law set forth the following specific grounds for dissolving New York corporations and partnerships: "fraudulent or oppressive conduct" (BCL § 1104-a[a][1]); a "deadlock" between directors (BCL § 1104[a][1]); or the "expulsion of any partner from the business bona fide" (Partnership Law § 62[1][d]). These specific grounds, if satisfied, will compel a court to order dissolution of a corporation or a partnership (as the case may be), whereas an LLC is limited to the "not reasonably practicable" standard of LLCL § 702, even if such factors are present. While the reason for this anomaly is unclear, the court in 1545 Ocean Avenue observed that although various provisions of the LLCL were amended, the New York State Legislature declined to amend LLCL § 702 (the dissolution provision). The court reasoned that by declining to amend that provision, "the Legislature can only have intended the dissolution standard therein provided to remain the sole basis for judicial dissolution of a limited liability company."

As the Appellate Court held in 1545 Ocean Avenue, dissolution under LLCL § 702 requires that a member demonstrate either that: (i) "the management of the entity is unable or unwilling to reasonably permit or promote the stated purpose of the entity to be realized or achieved," *or* (ii) "continuing the entity is financially unfeasible."[7] This standard has been adopted by the First Department.[8]

Not surprisingly, most courts applying this rigid standard have denied requests for dissolution of LLCs.[9] For instance, in 1545 Ocean Avenue, the court found that a dispute between the two members of an LLC formed to purchase and rehabilitate a property was not shown to be "inimicable to achieving the purpose" of the LLC, as the work on the building was nearly complete when the dissolution proceeding was commenced and one member did not object to the quality of the work performed by the other member who owned the construction company doing the work. Similarly, in Doyle v. Icon,[10] the First Department found that allegations that a member had been "systematically excluded from the operation and affairs" of the LLC were insufficient to warrant dissolution. There, the Appellate Court found that the LLC was able to carry on its business even *after* the member's expulsion. Indeed, the court found that the other member's failure to pay him his share of profits and distributions actually showed that the LLC was "financially feasible,"[11] and therefore, did not provide grounds for dissolution.

Another case with similar results is Matter of Eight of Swords, LLC,[12] in which the Second Department held that dissolution was properly denied, as the purpose of the LLC was being achieved and the LLC remained financially viable. There, the Appellate Court found that the "primary purpose" of the LLC was to operate a tattoo shop, with one member serving as the primary tattoo artist, and rejected the complaining member's claim that the LLC's primary purpose was the allocation of management responsibilities between its two members.

Mizrahi v. Cohen[13] is notable because it is one of the few cases in which a court actually found that grounds existed to dissolve an LLC, but nevertheless, permitted one member to "buy out" the other's membership interest rather than dissolve the LLC. There, the LLC had an operating agreement that provided for dissolution upon certain specified events, not relevant to the particular facts at issue. The "dispute" between the two members (who initially made equal capital contributions to the LLC) arose after the contributions made by one member greatly exceeded those of the other. Unfortunately, the operating agreement did not specify how subsequent contributions were to be treated (i.e., either as loans or as capital contributions). The factor tipping this case toward dissolution appears to have been that the LLC suffered "net operating losses" for a number of years, and that the LLC would have failed but for the proceeds from a mortgage loan and the complaining member's "capital infusions." The court concluded that under these circumstances, it was "not reasonably practicable for the LLC to continue to operate, as continuing the LLC is financially unfeasible."[14] Even so, underscoring the disinclination toward judicial dissolution of LLCs, the court presented the parties with a buy-out option that would preempt dissolution, if exercised.

In view of these precedents, to avoid unintended consequences and promote commercial certainty, we strongly recommend that LLCs with more than one member adopt operating agreements that clearly set forth the specific events that may require the company's dissolution. In many instances, a good starting point could be the grounds for dissolution set forth in the BCL and the Partnership Law, which would include oppressive and fraudulent conduct, deadlock or expulsion of a member. Members of an LLC may provide for additional terms regarding dissolution, as long as those terms specifically are set forth in the operating agreement. For example, if members of an LLC wish to provide for dissolution by a vote of a majority, supermajority or unanimous vote of the members, they must provide specifically for that in the LLC's operating agreement. The particular grounds for dissolution and how the dissolution is to

be effected, of course, should be tailored to the specific needs and circumstances of the LLC's members, and best implemented with the advice of experienced and knowledgeable counsel.

* * *

Warshaw Burstein, LLP is a full-service law firm, with experienced business counsel who will assist you in forming an LLC, as well as drafting an appropriate operating agreement. Our Firm also has experienced litigation attorneys who have litigated these issues in the trial and appellate courts. Please contact the undersigned if you have any questions concerning these matters.

Maxwell Breed	mbreed@wbcsk.com	(212) 984-7747
Slava Hazin	shazin@wbcsk.com	(212) 984-7810
Bruce H. Wiener	bwiener@wbcsk.com	(212) 984-7878

[1]While LLCL § 417 provides that members of an LLC "shall" adopt a written operating agreement that contains provisions not inconsistent with law or its articles of organization, LLCs that fail to adopt such agreement are governed by the "default provisions" of the LLCL. See, e.g., Matter of Eight of Swords, LLC, 96 A.D.3d 839, 946 N.Y.S.2d 248 (2d Dep't 2012); Spires v. Lighthouse Solutions, LLC, 4 Misc.3d 428, 778 N.Y.S.2d 259 (Sup. Ct., Monroe Co. 2004); Matter of 1545 Ocean Ave., LLC, 72 A.D.3d 121, 893 N.Y.S.2d 590 (2d Dep't 2010).

[2] See Man Choi Chiu v. Chiu, 71 A.D.3d 646, 896 N.Y.S.2d 131 (2d Dep't 2010) (dismissing "ouster" claim where neither the LLC's articles of organization nor the alleged operating agreement provided for expulsion of a member).

[3] See Matter of Jeffrey Horning v. Horning Constr., LLC, 12 Misc.3d 402, 816 N.Y.S.2d 877 (Sup. Ct., Monroe Co. 2006) (noting that "dissolution in the absence of an operating agreement can only be had upon satisfaction of the standard set forth in LLCL § 702").

[4] Whether dissolution of an LLC should be granted is vested in the "sound discretion" of the court. See Molina v. Hong (In re Extreme Wireless, LLC), 299 A.D.2d 549, 750 N.Y.S.2d 520 (2d 2002). Moreover, even if grounds exist to dissolve an LLC, a court, nonetheless, may find that the "most equitable method of liquidation" is to permit a "buy out" of the interest of the member seeking dissolution, rather than dissolving the entity. See Matter of Superior Vending, LLC, 71 A.D.3d 1153, 898 N.Y.S.2d 191 (2d Dep't 2010).

[5] 1 Misc.3d 713, 716, 772 N.Y.S.2d 781, 785 (Sup. Ct., N.Y. Co. 2003) (holding that plaintiff failed to demonstrate that the LLC was unable to carry on its business in accordance with its governing documents or that there was a "deadlock" impeding its smooth operation).

[6] 72 A.D.3d 121, 893 N.Y.S.2d 590 (2d Dep't 2010).

[7] 72 A.D.3d at 131, 893 N.Y.S.2d at 598. Indeed, the "default" setting of the LLCL is the continuation, not the dissolution, of an LLC. Thus, LLCL § 701(b) provides that the "death, retirement, resignation, expulsion, bankruptcy or dissolution of any member or the occurrence of any other event that terminates the continued membership of any member shall not cause the limited liability company to be dissolved or its affairs to be wound up, and upon the occurrence of any such event, the limited liability company shall be continued without dissolution" (emphasis added), except in the event of a majority vote of its members.

[8] See Doyle v. Icon, LLC, 103 A.D.3d 440, 959 N.Y.S.2d 200 (1st Dep't 2013); Barone v. Sowers, 128 A.D.3d 484, 10 N.Y.S.3d 22 (1st Dep't 2015).

[9] Indeed, in Matter of 1545 Ocean Avenue, the court noted that, "[g]iven its extreme nature, judicial dissolution is a limited remedy" that should be granted "sparingly."

[10] 103 A.D.3d 440, 959 N.Y.S.2d 200 (1st Dep't 2013).

[11] 103 A.D.3d at 440, 959 N.Y.S.2d at 201.

[12] 96 A.D.3d 839, 946 N.Y.S.2d 248 (2d Dep't 2012).

[13] 104 A.D.3d 917, 961 N.Y.S.2d 538 (2d Dep't 2013), leave to appeal denied, 21 N.Y.3d 968, 970 N.Y.S.2d 493 (2013).

[14] Id. at 920, 961 N.Y.S.2d at 541.