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NY Court Defines When LLCs Can Use Special Litigation Committees

Jason Grant, New York Law Journal

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A special litigation committee cannot be used to determine the fate or direction of derivative claims brought on behalf of a New York limited liability company, unless its use is expressly written into the operating agreement, a Manhattan appeals court has ruled in an important decision of first impression.

"Article IV of the New York LLC Act makes clear that the operating agreement of an LLC governs the relationships among members and [their] powers and authority," wrote a unanimous panel of the Appellate Division, First Department, [in a ruling](#) that has changed the course of a legal battle, begun in 2011, over revenues springing from a luxury condominium development found in Manhattan's opulent Tribeca neighborhood.

[manzanet-daniels-sallie-Square-201505071654.jpg]

"One attraction of the LLC form of entity is the statutory freedom granted to members to shape, by contract, their own approach to common business relationship problems," the panel wrote, quoting *Obeid v. Hogan*, a 2016 Delaware Court of Chancery opinion.

The ruling, penned by Justice Sallie Manzanet-Daniels, is important because it draws a line between how New York corporations, governed by the Business Corporation Law, may resolve derivative claims, and how LLCs may work through the same types of claims when an operating agreement is silent on special litigation committees.

At the same time, the opinion in *LNyC Loft LLC v. Hudson Opportunity Fund I LLC*, 650969/11, helps further define parameters surrounding the court-created right of New York LLC members to lodge derivative actions in the first place.

That right—set forth in state Business Corporation Law but conspicuously absent from the LLC Act—was created by the Court of Appeals in its 2008 *Tzolis v. Wolff* decision.

Since then, according to Manzanet-Daniels, "courts have looked to New York statutory and common law on partnerships and corporations in determining certain questions arising in the LLC context."

She added, "*Tzolis* encouraged courts to fashion remedies to speak to the omissions in the LLC

statute." But "nonetheless," she wrote, "we decline to uphold the appointment of an SLC [special litigation committee] where the relevant operating agreements do not delegate managerial authority to nonmembers or nonmanagers or otherwise provide for the appointment of an outsider to serve as an SLC."

Still, Manzanet-Daniels' Aug. 15 opinion could ultimately face scrutiny in the Court of Appeals.

[Steven Shore](#), of Ganfer & Shore in Manhattan, the defendants' counsel, said on Aug. 17 that he and his clients will seek leave to appeal.

"It's a case of first impression," he said in an interview, and "our view is that the Court of Appeals in *Tzolis* indicated that LLCs should be treated similar to corporations. We think if you're going to treat LLCs and corporations in a similar manner that LLCs should have an ability to have a special litigation committee."

Moreover, he said, "unless the decision is reversed by the high court, it will have an adverse impact on LLCs in New York. Also the result is going to be that our courts, which are already busy enough, are going to have to resolve all of these LLC cases, which are much better handled by special litigation committees."

How It Began

The dispute in the long-running case is complicated, involving entities and shareholder members that could be more cleanly described using a chart.

Plaintiff LNYC Loft LLC brought direct claims in the lawsuit. And later it was able to amend the suit to add derivative claims on behalf of two New York companies, HRC-NYC Development LLC and One York Street Associates LLC.

One York Street Associates LLC is the sole owner of a high-end residential and commercial condominium at 1 York Street in Tribeca. The fight over 1 York Street's revenues, fueled by sales of multimillion-dollar units, is at the heart of the struggle.

One York Street Associates LLC, meanwhile, is 75 percent owned by derivative plaintiff HRC-NYC Development LLC, and 25 percent owned by defendant Jani Development II LLC.

And HRC-NYC Development LLC is 56 owned by defendant Hudson Opportunity Fund I LLC (and affiliates), and 44 percent by the original, direct plaintiff, LNYC Loft LLC.

LNYC Loft contends in its suit that Hudson Opportunity Fund I, while acting as managing member of One York Street Associates in 2010, entered into an illegal amendment to reduce distributions by One York Street to members, including to LNYC.

It says Hudson Opportunity Fund I was induced to do so—against its own financial interest—by Jani, in a backdoor deal. Hudson Opportunity Fund's actions, LNYC contends, were a breach of HRC-NYC Development's operating agreement because, under that agreement, it needed LNYC's consent before it could make any such move.

After five years of motion practice and discovery, LNYC added the derivative claims on behalf of HRC-NYC Development and One York Street Associates in 2016.

Soon after, managing members of those two closely held LLCs decided to engage an independent person to serve as a special litigation committee (SLC). The SLC's role would be to determine whether the derivative claims should go forward and, if so, how.

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After some dispute with LYNC over who the SLC should be, the two LLCs' managing members decided to select a one-person, outside committee: Mark Zauderer, senior partner at the Manhattan litigation boutique Flemming Zulack Williamson Zauderer.

LYNC, in turn, objected, leading to more litigation. And in September 2016, Manhattan Supreme Court Justice Carol Edmead, the presiding judge in the lawsuit, declared as part of a 15-page ruling that Zauderer could remain in his role.

Edmead found in part that, despite LYNC's contentions otherwise, Article 6 of the HRC-NYC Development operating agreement did not bar appointment of an SLC.

She wrote that the agreement did require "operating members," including LYNC, to approve of any "major [company] decision"—but ruled that appointment of an SLC did not qualify as a major decision.

"The court finds that the retention of Mr. Zauderer, in and of itself, does not rise to the level of prosecuting or settling this legal action, so as to require plaintiff's [LYNC's] written consent," Edmead wrote.

The Reversal

On Aug. 15, Manzanet-Daniels, joined by Justices Rolando Acosta, Dianne Renwick, Angela Mazzarelli and Richard Andrias, disagreed, reversing Edmead.

"Neither operating agreement [for either derivative plaintiff HRC-NYC Development or derivative plaintiff One York Associates] provides for the delegation of decision-making authority to other than a member, or to an outsider like Mr. Zauderer to serve as SLC," Manzanet-Daniels wrote.

"The agreements are explicit that while day-to-day management is vested in the manager, 'major decisions' need the consent of the other members. We reject the argument that the appointment of the SLC (as opposed to the ultimate decision as to whether to proceed with the derivative litigation) was not a 'major decision' within the meaning of the agreements," she continued, writing, "The SLC [Zauderer] was specifically granted the authority to 'determine the positions and actions that the companies should take with respect to the claims, considering, among other things, whether the claims have merit, whether they are likely to prevail, and whether it is in the companies' best interests to pursue them.'"

However, the panel also made clear that if New York LLCs want to write special litigation committees and outsiders into their operating agreements, they can do so.

"That is not to say that the appointment of an SLC would in all cases be improper," Manzanet-Daniels said. "Indeed, the [LLC] members may so provide in the operating agreement, and such provision will be enforced in accordance with those same principles concerning the parties' freedom to contract."

[Steven Kaplan](#), of Rosenfeld & Kaplan in Manhattan and representing LNYC Loft, said on Aug. 17 that he believes the unanimous panel got it right. And he's prepared to oppose any motion by the defendants for leave to appeal, he said.

"This has clarified the law that, at least in the First Department, derivative claims on behalf of an LLC cannot be delegated to a committee, unless the operating agreement calls for it," Kaplan said.

Of the ongoing litigation, he added, "The ruling affords my client the opportunity to fully vindicate its rights." He did not specify how much money may be at issue.

[Marcel Kahan](#), a corporate law professor at New York University, said that he believed the First Department decision's was reasonable, and he pointed out that the parties to the two LLC operating agreements could have written into their agreements—before a dispute arose—an SLC who they both chose as neutral and independent.

In the case of Zauderer, Kahan said, while the panel made clear that "no one suggests [he] is in any way biased," he was still selected by only HRC-NYC Development and One York Street Associates, not by LNYC Loft.

"There is some question about who was chosen and why the defendants chose Zauderer," he said. "The defendants picked him. They selected him unilaterally."

The panel's opinion, while directed largely at reversing Edmead's September 2016 decision that included her approval using Zauderer, also had the effect of throwing out a 14-page decision issued by Edmead earlier this month. In part of that decision, Edmead had approved of Zauderer's settlement for the derivative claims, settlement terms that LNYC had opposed.

"The SLC's investigation was independent and sufficiently thorough, the SLC's determinations, including that the derivative claims should be dismissed pursuant to the terms of its recommended settlement are entitled to deference," the judge had written, adding, "To rule otherwise, would be to subject these companies to further litigation when they have already decided, through the mechanism of an SLC, to settle the derivative claims on terms that are fair and sensible."

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