When It Comes to Oppression, Corporations and LLCs Are Not Created Equal

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The limited liability company (LLC) is often touted as the ideal form of entity for a closely-held business. After all, an LLC provides its owners the benefits of limited liability, pass-through taxation and the flexibility to structure management and distributions as they see fit. But is an LLC the ideal form of business entity in the event of internal strife among the business owners? Closely-held businesses are especially prone to internal problems because owners generally participate in the management of the business. Although an LLC’s operating agreement should contain provisions that address the rights and remedies of members in the event of in-fighting, experience shows that the vast majority of LLC operating agreements are ill-equipped to address many of the most common catalysts for dissension among the owners, such as a member's lack of work effort, refusal to participate in a capital call, use of company funds for personal expenses, acting outside the scope of the member's authority, self-dealing and oppressive acts at the hand of the majority owner.

In the event of such a circumstance, whether the business operates as a traditional corporation or an LLC may have a significant impact on the rights and remedies to which the equity holders may be entitled. When internal strife arises, the LLC structure may offer less protection for mistreated members than the protections afforded to shareholders of a corporation. The myriad state corporation laws and their broad judicial interpretations provide redress for innocent shareholders seeking to enjoin fellow shareholders from acting contrary to the corporation's best interest or breaching the well-established fiduciary duties owed among shareholders of a closely-held corporation.

Statutory Protection for Corporate Shareholders

Most advisors to closely-held businesses have a level of familiarity with the statutes that protect minority shareholders. For example, in our home state, New Jersey, the Oppressed Minority Shareholder Act (OMS Act) provides shareholders of corporations having 25 or fewer shareholders with a wide variety of protections and remedies when faced with misconduct by fellow shareholders, including the drastic remedy of dissolution, the
appointment of a corporate "tie-breaker" or "watchdog," or a forced buy-out. Although not all states have enacted a statute specifically protecting the interests of shareholders in closely-held corporations, most state courts have extended similar protections to shareholders of close corporations who are victims of wrongdoing by their fellow shareholders. While the scope of the protections offered in both statutes and common law vary by state — with New Jersey standing out as one of the most protective of the rights of shareholders in closely-held corporations — if a shareholder can prove oppression or some other significant wrongdoing, generally a court will fashion a remedy.

Statutory Protection for Members of LLCs

LLCs, like corporations, are created by state statutes. Unlike statutes governing corporations, however, the statutes that gave birth to LLCs were enacted in the mid-1990s. Due to the relative newness of LLC statutes, they suffer from a lack of judicial interpretation. Although there are some differences in the various LLC statutes, virtually all lack protections for minority interest holders in a manner similar to the OMS Act or its sister statutes in other states. This is particularly interesting since the vast majority of the corporate anti-oppression statutes and many of their expansive judicial interpretations pre-date the LLC statutes. As a result, members of an LLC with a less-than-thorough or no operating agreement and without the default protections of anti-oppression statutes may find themselves without a remedy when faced with oppressive acts by their fellow members.

To resolve disputes among members of an LLC, the only remedy provided by the vast majority of LLC statutes is either dissolution or disassociation, either by consent of a majority of the members or by court order where it is "not reasonably practicable" to carry on the business. Some recent case law suggests that a court may hold an unhappy member captive and refuse to dissolve an LLC, even in the face of great animosity among the members, so long as the business is profitable and can continue to be effectively run by majority rule.

Recognizing that it makes little sense for oppressed minority members in an LLC to have fewer protections than those afforded to their corporate brethren, some states have adopted Section 801 of the Uniform Limited Liability Company Act, which aims to bring the commonly accepted corporate protections against majority oppression to members of an LLC. More specifically, Section 801 permits judicial dissolution whenever "the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner." Interestingly, only a handful of states have incorporated Section 801 into their LLC statutes. California has
adopted a somewhat different revision to its LLC statute that permits judicial dissolution whenever it is "reasonably necessary for the protection of the rights or interests of the complaining members" or when the controlling members "knowingly countenanced persistent and pervasive fraud, mismanagement, or abuse of authority." 

Since the vast majority of states have yet to adopt Section 801 or otherwise revise their LLC statutes in a manner similar to California, questions arise as to what remedies exist for oppressed minority members in LLCs. Some legal commentators are calling for more states to adopt Section 801. Alternatively, some practitioners feel that a broad adoption of Section 801 is not necessary and encourage state legislatures to adopt standards for LLC dissolution which mirror the thresholds for the dissolution of a corporation. Other practitioners feel that courts will be quick to apply the commonly accepted anti-oppression concepts in corporate law to LLCs. An attorney representing a majority member accused of oppressive conduct can present a number of arguments to defeat a claim for judicial dissolution as a remedy for alleged oppression, including: (i) that if the legislature intended the applicable LLC statute to include an oppression remedy, it would have incorporated those well accepted and judicially supported protections when the state's LLC statute was enacted; (ii) that the state legislature failed to adopt Section 801; (iii) that there is a moral hazard attached to providing a member with protection that he failed to bargain for in the LLC's operating agreement prior to becoming a member; or (iv) that judicial dissolution is an extreme remedy that should require a showing of significant malfeasance before being awarded.

In fact, a very recent New York appellate case involving a petition to dissolve an LLC, Matter of 1545 Ocean Avenue, LLC, demonstrates that courts are not so readily willing to apply corporate concepts in the LLC context. The Court found that the dissolution standards for corporations do not apply to the determination of whether it is "not reasonably practicable" to carry on the business of an LLC, because the legislature chose not to adopt the corporate standard when it enacted the LLC statute in 1994 and left the standard unchanged when certain amendments to the LLC statute were enacted in 1999. Instead, the Court held that dissolution of an LLC requires a showing of either a failed purpose or financial unfeasibility. The primary focus in this analysis is the LLC's operating agreement.

Judicial Guidance on Current Remedies for Oppressed Minority Members

The complexities of attempting to apply the corporate oppression concepts to an LLC are highlighted in In re Horning v. Horning Construction, LLC. In Horning, Jeffrey M. Horning sought the dissolution of the construction company that bore his name due to the in-fighting
between him and his two equal partners. Horning found himself in the unfortunate position of having transferred the business operations of his wholly-owned corporation, Horning Construction Company, Inc., to a newly formed LLC that he co-owned with two of his key employees. In doing so, Mr. Horning's intent was to effect both a succession and a retirement plan, with his key employees succeeding him as executives in charge of the business, and the profits of the business funding his retirement as he ceded control. Unfortunately for Horning, he leapt before he looked when he transferred the business from the corporation to the LLC by failing to document his succession/retirement plan in the LLC's operating agreement. In a familiar tale, the members were never able to agree on the terms of an operating agreement, so they never signed an operating agreement, and eventually the disagreement between the parties led to resentment, animosity and litigation.

In seeking the dissolution of the LLC, Horning alleged that the level of animosity between the members precluded the company from submitting competitive bids, and, as a result, profits suffered. Horning also alleged that the other members were committed to making the environment at the office difficult for Horning so that he would simply retire and sell his interest at a fraction of fair value. In assessing Horning's position, the Court looked at the different standards to be met and remedies available to members of an LLC seeking to separate from their fellow members, as compared to shareholders in a corporation. The Court commented that "dissolution under the [New York] Limited Liability Company Law is not as easy as dissolution under the Business Corporation Law." The Court aptly stated that "[d]issolution in the absence of an operating agreement can only be had . . . 'whenever it is not reasonably practicable to carry on the business.'" Since the Court found that the animosity between the members did not impair the company's ability to operate — after all, the company remained profitable — the Court dismissed Horning's lawsuit, finding it was reasonably practicable to carry on the business, and dissolution, therefore, was not warranted.

Perhaps the most interesting aspect of Horning is the length to which the Court went to identify the differences between how business divorces are addressed in the LLC context as opposed to the corporate context. Rather than attempt to borrow concepts and ideas from corporate law precedent, the Court focused on the differences between the two and limited its analysis to the remedies specifically provided by the applicable LLC act. The more recent appellate decision in 1545 Ocean Avenue, LLC marks a similar distinction.

In contrast to the Horning decision, New York's highest court has extended minority shareholder protection concepts to members of the LLC despite a lack of statutory authority.
In *Tzolis v. Wolff*, 21 the New York Court of Appeals held that a member of an LLC may bring a derivative action on the LLC's behalf — irrespective of the fact that the New York Limited Liability Company Law (LLCL) does not provide for same. The court noted, "[C]ourts have repeatedly recognized derivative suits in the absence of express statutory authorization. . . In light of this, it could hardly be argued that the mere absence of authorizing language in the Limited Liability Company Law bars the courts from entertaining derivative suits by LLC members." 22 In 2009, following the logic of *Tzolis*, a New York appellate court held in *Gottlieb v. Northriver Trading Co., LLC* 23 that an LLC member may seek an equitable accounting — again, irrespective of the fact that the LLCL does not provide for this remedy.

Only time will tell if decisions such as *Tzolis* and *Gottlieb* will be the start of a trend in which courts extend the protections provided to shareholders by corporate statutes to members otherwise unprotected by LLC statutes. The most recent guidance, provided by *1545 Ocean Avenue, LLC*, however, suggests that it may not.

*The Ultimate Lesson: the Need for a Sufficient Operating Agreement*

The main theme of the recent *1545 Ocean Avenue, LLC* decision is that in the LLC context, the first and most important place to look in performing any analysis is the parties' operating agreement. 24 Therefore, members of an LLC should focus their attention on drafting a comprehensive operating agreement that clearly defines the rights and remedies of members and covers all the bases if internal dissension arises, especially until the law in this area becomes better developed. The vast majority of "standard" or "form" operating agreements commonly used by practitioners fail to do this and, due to the complexities involved in addressing these issues, practitioners and clients alike tend to balk at spending the time and money necessary to properly document appropriate provisions. Doing nothing, however, is rarely, if ever, the correct course of action.

At a minimum, consideration should be given to the inclusion of provisions in the operating agreement which provide for mediation, arbitration or some other form of cost-effective alternative dispute resolution in the event of internal strife. Further, the members should discuss one of a number of so-called "pull the plug" provisions which provide a member the right to liquidate his membership interests, sometimes without cause and sometimes only with good cause. Such a provision has the dual effect of providing a remedy to a disenfranchised member as well providing a motivation to all of the members to promote harmony in the organization rather than be forced to buy-out a member. Short of including provisions such as the ones mentioned above in an operating agreement, if a member of an LLC finds himself embroiled in a dispute with his co-owners, his only remedy may be to

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convince a court that the complained-of conduct is so significant that dissolution is appropriate or that the court should make new law and create a protection for him that is not expressly provided for in the applicable LLC statute. Both of these options are risky and costly endeavors.

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10. Id.
11. Id.
12. See Horning, supra note 3.
13. Id. at 878.
14. Id.
15. Id. at 878–79.
16. Id. at 881.
17 Id. at 882–83.
18 Id. at 882.
19 Id. at 881.
20 Id. at 884–85.
21 10 N.Y.3d 100, 103, 2008 BL 29317 (N.Y. 2008).
22 Id. at 106 (internal citations omitted).
24 See In re 1545 Ocean Avenue, LLC, supra note 9.