

THREE RECENT SIGNIFICANT N.Y. COURT OF APPEALS DECISIONS

By: *Michael A. Bamberger*
Sonnenschein Nath & Rosenthal LLP
New York, N.Y.

In a period of three months, the N.Y. Court of Appeals (the state's highest court) recently issued decisions in three significant cases involving unincorporated entity law. The first case decided an issue of LLP law; the second, one of LLC law; and the third, one of limited partnership law. In all three cases there were strenuous dissents.

The first case was *Ederer v. Gursky*.¹ Ederer and Gursky were "partners" in a law firm named Gursky & Ederer, P.C. Ederer started as a non-equity "partner" in the PC. He subsequently purchased a 30% interest for \$600,000, to be paid \$150,000 per year out of Ederer's share of profits. It was also agreed that, as new partners were added, Gursky's 70% would be diluted to 25% before there was any dilution of Ederer's 30%.

The firm is converted to an LLP in 2001, although no written partnership agreement was created. (Once again highlighting how an agreement can usually limit problems.) Shortly thereafter three new partners were admitted, with an aggregate of 15% equity, reducing Gursky's interest to 55%. In July 2002, Ederer's compensation was increased by about 28% (it is not clear from the opinion how this affected his equity interest), and the remaining \$300,000 owed by Ederer was forgiven. In June 2003, Ederer advised Gursky that he was withdrawing as a partner in the LLP and a shareholder in the LP. The reason for the withdrawal is disputed. Later that month Ederer entered into a withdrawal agreement with the PC and the LLP, which Gursky signed as president of the PC and a partner in the LLP. Under this agreement, Ederer agreed to remain a partner in the LLP in order as to serve as lead counsel for a trial scheduled to commence in Georgia on June 30, 2003, although he was not obligated to delay his withdrawal from the LLP beyond July 8, 2003. In exchange, the LLP agreed to "continue to pay [Ederer his] regular draw and other compensation through the date of [his] withdrawal from the [the LLP]"; to have files on which he was working transferred to his new firm upon the client's request; to give him the opportunity to review his client's bills before the LLP asked for payment; and to allow him and/or his representatives (including accountants) access to

the LLP's and PC's books and records after his withdrawal from the LLP.

The PC was dissolved on June 30, 2003. Ederer withdrew from the LLP on or about July 4, 2003 after having helped secure a \$2 million verdict in the Georgia trial, which generated a \$600,000 contingency fee for the LLP.

In December 2003, Ederer commenced an action against the PC, the LLP, and the individual partners of the LLP seeking an accounting as to both the PC and LLP, and asserting breach of the withdrawal agreement. Defendants moved to dismiss the complaint as to individual partner defendants Gursky, Stern, Feinberg and Levine on the ground that N.Y. Partnership Law § 26(b) shielded them from any personal liability as partners of an LLP. The trial court determined that Ederer was entitled to an accounting against all defendants, because Partnership Law § 26, which places limits on the personal liability of partners in an LLP, applies "to debts of the partnership or the partners to third parties" and "has nothing to do with a partner's fiduciary obligation to account to his partners for the assets of the partnership." The Appellate Division (NY's intermediate appellate court) affirmed the trial court's order, concluding that "Partnership Law § 26(b), limiting the liability of partners of a limited liability partnership, does not exempt . . . partners from their individual obligations to account to a withdrawing partner under the earlier enacted and unamended Partnership Law § 74" and does not exempt the individual defendants from liability to plaintiff for breaches of firm-related agreements between them.

The Court of Appeals affirmed (5-2), holding that § 26(b) limits a partner's liability only for debts owed to a third party, not to the partnership or to each other. The opinion points out that § 26 generally deals with liability to third parties and is in article 3 entitled "Relations of Partners to Persons Dealing with the Partnership" rather than article 4, "Relations of Partners to One Another." It also finds that the statutory right to an accounting would be of little value in an LLP if a partner called to account would not have to pay the amount determined.

There was a brief but vigorous dissent by Judge Smith (joined by Chief Judge Kaye). The dissent relies on the language of § 26(b) that partners in an LLP are not "liable for any debts, obligations or

¹ 9 N.Y.3d 514, 851 N.Y.S.2d 108 (2007).

liabilities of . . . the registered limited liability partnership . . . whether arising in tort, contract otherwise...solely by reason of being such a partner,” pointing out there is no exception for liabilities to former partners claiming a share of the firm’s net assets. The dissent argues that Ederer, as a withdrawn partner, is a third party, and therefore should not recover. Judge Smith posits the following hypothetical in support of his position.

Suppose there are three partners, two with a 49% interest each and one with a 2% interest. One of the 49% partners withdraws, and is entitled to 49% of the firm’s assets. Before he can be paid, however, it is found that the other 40% partner has stolen all of those assets, lost them at a casino and gone bankrupt. Why should the innocent 2% partner have to make good the former partner’s large loss?

New York has not yet adopted RUPA. Thus, the Partnership Act into which the LLP provisions were added is UPA-based and includes a provision for the right of a partner to an accounting “in the absence of agreement to the contrary.” Partnership L. § 74, which was emphasized by plaintiffs.

The issue is compounded by the fact that, under New York law, as is equally true with the RUPA LLP provision, there is nothing similar to RULPA §§ 607-608 or ULPA (2001) §§ 508-509, which would impose liability on a partner for taking distributions from an LLP so that the LLP was unable to pay that which is owed to a withdrawn partner and other creditors. In my view it is illogical not to have such a provision in an LLP statute.

The second decision, *Tzolis v. Wolff*,² deals with whether members of a NY LLC may bring a derivative suit on the LLC’s behalf, even though the LLC law does not specifically provide for such relief. The situation prior to the *Tzolis* case was unsettled, to understate it. As part of a compromise of a dispute between Senate and Assembly in the NY legislature, which had held up enactment of an LLC law, an LLC law was passed which had no Article IX, which had been a provision authorizing derivative suits. Subsequently, in *Cabrini Dev. Council v. LCA-Vision, Inc.*,³ *Weber v. King*⁴ and *Bischoff v. Boar’s Head Provisions Co., Inc.*,⁵ the federal courts held that, contrary to some lower

N.Y. state courts’ holdings, NY law did provide for a common law right of an LLC member to sue derivatively on behalf of the LLC. (This holding, in the *Bischoff* case, defeated diversity jurisdiction, causing the case to be remanded to the state courts which at that time did not recognize LLC derivative jurisdiction.) At the same time, in 2004, the Appellate Division for the Second Department did not follow the federal courts.⁶ Three years later, in *Tzolis v. Wolff*,⁷ the Appellate Division for the First Department held for the availability of common law derivative LLC jurisdiction. Thus, after the 2007 decision in *Tzolis*, an LLC derivative claim could be pursued in two of New York City’s counties (Manhattan and the Bronx) and would be dismissed in the other three (Queens, Brooklyn and Staten Island). This was obviously intolerable. The Court of Appeals accepted jurisdiction of an appeal in the *Tzolis* case.

By a vote of 4 to 3, the Court of Appeals held that members of a limited liability company may bring derivative suits on the LLC’s behalf, even though there are no provisions authorizing such suits in the Limited Liability Company Law. Finding that the omission of the remedy from the LLC Act as passed was not determinative, the majority based its holding on the long-recognized importance of the derivative suit in corporate law, and on the absence of evidence that the Legislature decided to abolish the common law remedy when it passed the Limited Liability Company Law in 1994.

The dissenting judges, viewing the legislative history differently, were outraged. The dissent begins:

The result in the case is unique in the annals of the Court of Appeals, Never before has a majority of the Court read into a statute provisions or policy choices that the enacting Legislature unquestionably considered and rejected.

These words resonate when considering the final case, which involves the interpretation of NY Partnership Law § 121-1102, which sets for the procedure for a merger involving a limited partnership. It grants a dissenting limited partner the right to provide a notice of dissent, which provides the partner with an entitlement to receive the “fair value of his interest in the limited partnership” as of the date prior to the effectiveness of the merger. If the parties do not agree as to the fair market value, there is an appraisal. In *Appleton*

² 10 N.Y.3d 100, 855 N.Y.S.2d 6 (2008).

³ 197 F.R.D. 90 (S.D.N.Y. 2000); vacated in part 292 F.3d 134, 139-40 (2d Cir. 2002).

⁴ 110 F. Supp.2d 124 (E.D.N.Y. 2002).

⁵ 436 F. Supp.2d 626 (S.D.N.Y. 2006).

⁶ *Hoffman v. Unterberg*, 9 A.D.3d 386, 780 N.Y.2d 617 (2d Dept. 2004).

⁷ 39 A.D.3d 138, 829 N.Y.S.2d 488 (1st Dept. 2007).

Acquisition, LLC v. National Housing Partnership,⁸ a limited partnership merged with an affiliate of its general partner. Limited partners, who had not sought an appraisal under § 121-1102, brought an action for recession or money damages on the grounds that the transaction was premised on fraudulent or illegal acts by the general partner. The Court stated that plaintiffs asked the Court to engraft a common-law exception onto Partnership Law § 121-1102(d) for situations where a merger is alleged to be permeated with fraud or illegality, noting that the common law allowed shareholders to corporations to initiate a civil action based on these grounds. (New York Bus. Corp. Law § 623(h)(2) codifies such an exception in the corporate context) Looking at the legislative history, the majority found such a provision was purposely not included in the limited partnership statute. Therefore the majority refused incorporate such a provision as a matter of common law. (It is interesting that two of the four-judge majority in *Appleton* where the legislative exclusion was upheld were also in the four-judge majority in *Tzolis* where the legislative exclusion was overridden.)

The dissent, signed onto by three judges, argues that, as to two of the causes of action, looking at the language of § 121-1102, the claims should not be barred because the claims do not fall within the language of the statute. Section § 121-1102(d) bars “attacks on the validity of the merger” or to have the merger “set aside or rescinded.” Pointing out that the two claims of action for breach of contract and for aiding the abetting that breach do neither of the proscribed things, the dissent argues quite persuasively. The majority discussed the dissent’s argument, arguing these claims are merely “veiled attacks on the validity of the merger.”

In summary, these three decisions, while some may disagree with the results (and I do), clarified and decided three significant issues under the New York State unincorporated business entity law.

⁸ 10 N.Y.3d 250, 856 N.Y. Supp.2d 522 (2008).