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Tzolis v. Wolff, N.Y. Slip Op. No. 01260 (N.Y. February 14, 2008)

On February 14, 2008, a sharply divided New York Court of Appeals decided *Tzolis v. Wolff*,¹ which held that members of a limited liability company (“LLC”) may bring derivative suits on the LLC’s behalf, even though there are no provisions governing such suits in the Limited Liability Company Law (“LLC Law”).

I. BACKGROUND

The LLC is a hybrid legal entity that has attributes of both a corporation and partnership, with a corporation’s limitation on personal liability and a partnership’s operating flexibility.² Although similar to corporations and partnerships, New York statutes treat LLCs differently than these entities, especially with respect to derivative suits.³ New York’s corporation and partnership statutes expressly authorize derivative claims.⁴ New York’s LLC Law, on the other hand, contains no provision allowing for derivative suits by members of the LLC.

Until recently, New York Courts did not recognize a common law right to assert a derivative action on behalf of an LLC. The Appellate Division, Second Department held that there is no derivative remedy for LLC members.⁵ In *Caprer v. Nussbaum*, the court reaffirmed this principle, noting that “[l]imited liability companies seem to be the one exception thus far to judicial recognition of the authority to bring a derivative action . . . a member of a limited liability company has no right to bring a derivative

¹ N.Y. Slip Op. No. 01260 (N.Y. February 14, 2008).

² See Am. Jur. 2d *Limited Liability Companies* § 1 (2007).

³ Shareholder derivative suits are brought by an existing shareholder on behalf of the company to seek legal redress against the officers and directors of the company for breaches of fiduciary duty. See Am. Jur. 2d *Limited Liability Companies* § 7 (2007).

⁴ See N.Y. Bus. Corp. § 626 (allowing derivative actions to be brought on behalf of the corporation); N.Y. P’ship § 121-1002 (allowing derivative actions to be brought on behalf of the limited partnership).

⁵ See *Hoffman v. Unterberg*, 9 A.D.3d 386, 388-89, 780 N.Y.S.2d 617, 620 (2d Dep’t 2004).

action on behalf of the company.”⁶ The Appellate Division, First Department, however, adopted the opposite view in 2007 and held that LLC members have standing to seek legal redress for wrongs committed to the LLC.⁷ Similarly, some federal courts, applying New York law, have recognized the right of LLC members to bring derivative suits.⁸

New York case law was split on the issue of an LLC member’s right to bring derivative claims on behalf of the LLC. In *Tzolis v. Wolff*, the New York Court of Appeals addressed and resolved this controversy, finding that members of an LLC may bring derivative suits on behalf of the LLC.

II. FACTS AND PROCEDURAL HISTORY

Pennington Property Co. LLC was the owner of a Manhattan apartment building. The plaintiffs owned twenty-five percent of the membership interests in the LLC. The plaintiffs claimed that the directors of the LLC, and others acting in concert with them, arranged first to lease and then to sell the LLC’s principal asset for sums below market value, that the lease was unlawfully assigned, and that company fiduciaries personally benefited from the sale. Plaintiffs brought an action individually and on behalf of their LLC seeking, *inter alia*, to declare the sale void, and to terminate the lease.

The Supreme Court dismissed these causes of action. It held that plaintiffs could not bring the suit individually because the causes of action were “to redress wrongs suffered by the corporation.”⁹ The court relied on Second Department precedent¹⁰ for the proposition that “New York Law does not permit members to bring derivative actions on behalf of a limited liability company.” The First Department reversed, concluding that derivative suits on behalf of LLCs are permitted.¹¹ It granted two defendants permission to appeal on a certified claim to the New York Court of Appeals.

III. RATIONALE OF THE COURT

A. The Opinion of the Court (per Smith, J.)

The 4-3 decision resolved the issue of whether members of LLCs may file derivative suits. The Court held that English and American precedents demand that LLC members receive the same recourse that is available to corporate shareholders or members of limited partnerships. In upholding the right of LLC members to bring derivative suits, the Court highlighted the importance of such suits in cor-

⁶ N.Y. Slip Op. No. 7443, at *7, 825 N.Y.S.2d 55, 67 (2d Dep’t 2006).

⁷ *Tzolis v. Wolff*, 39 A.D.3d 138, 829 N.Y.S.2d 488 (1st Dep’t 2007).

⁸ *See Bischoff v. Boar’s Head Provisions Co., Inc.*, 436 F. Supp. 2d 626 (S.D.N.Y. 2006); *Weber v. King*, 110 F. Supp. 2d 124 (E.D.N.Y. 2000).

⁹ N.Y. Slip Op. No. 01260, at *2 (N.Y. February 14, 2008).

¹⁰ *Hoffman v. Unterberg*, 9 A.D.3d 386, 780 N.Y.S.2d 617 (2d Dep’t 2004).

¹¹ N.Y. Slip Op. No. 01260, at *2 (N.Y. February 14, 2008).

porate law. It noted that derivative suits had been a long recognized remedy for corporate malfeasance. The Court stated, “[t]o hold that there is no remedy when corporate fiduciaries use corporate assets to enrich themselves was unacceptable in 1742 and in 1832, and it is still unacceptable today. Derivative suits are not the only possible remedy, but they are the one that has been recognized for most of two centuries, and to abolish them in the LLC context would be a radical step.”¹²

The majority relied on a long history of jurisprudence allowing derivative suits in other contexts, especially with respect to corporations and partnerships. Moreover, the majority noted that “courts have repeatedly recognized derivative suits in the absence of express statutory authorization.”¹³ The derivative suit was a well recognized part of the general corporate law of the state since 1832, even though it was not codified until much later in Business Corporation Law § 626 [a].¹⁴ In addition, the Court of Appeals recognized the Second Circuit’s holding that members of a limited liability partnership were able to pursue such a claim before the partnership law was amended to recognize such suits.¹⁵ The Court concluded that despite the absence of statutory authority, derivative causes of action for LLCs should also be recognized.

In upholding the right of LLC members to bring derivative suits, the majority focused on the legislative history of the LLC Law. Justice Smith argued that, while the New York Legislature had often decided to regulate derivative suits, it had not rejected the legitimacy of derivative suits. The Court stated “the most salient feature of the legislative history is that no one, in or out of the Legislature, ever expressed a wish to eliminate, rather than limit or reform, derivative suits.”¹⁶ The Court thus concluded that even though the LLC Law did not expressly provide for such derivative suits, it could find no clear mandate in the legislative history barring derivative suits.

B. The Dissenting Opinion of the Court (per Read, J.)

The dissent interpreted the legislative history of the LLC Law in a different manner. The dissent argued that the failure of the New York LLC Law to expressly permit derivative suits meant that the Legislature had implicitly prohibited such suits. Moreover, the dissent argued that the Legislature intentionally deleted provisions regarding derivative suits from the 1994 statute that became LLC Law.

The dissent criticized the majority for violating the separation of powers. The dissent maintained that the majority exceeded its authority by engaging in impermissible judicial legislation. It noted, “whether or not to vest LLC members with the right to sue derivatively is the Legislature’s choice

¹² *Id.* at *5-6

¹³ *Id.* at *7.

¹⁴ *See Robinson v. Smith*, 3 Paige Ch 222 (Ch 1832) (holding that shareholders could sue on behalf of a corporation).

¹⁵ *See Klebanow v. N.Y. Produce Exch.*, 344 F.2d 294 (2d Cir. 1965) (holding that limited partners could sue on a partnership’s behalf); *see also Riviera Congress Assoc. v. Yassky*, 18 N.Y.2d 540, 223 N.E.2d 876 (1966) (agreeing with the holding of *Klebanow*).

¹⁶ N.Y. Slip Op. No. 01260, at *8 (N.Y. February 14, 2008).

to make, not ours.”¹⁷ “[T]he majority has effectively rewritten the law to add a right that the Legislature deliberately chose to omit. For a Court that prides itself on resisting any temptation to usurp legislative prerogative, the outcome of this appeal is curious.”¹⁸

III. SIGNIFICANCE OF DECISION

The right to sue LLCs derivatively has been a matter of debate and confusion as evidenced by the split of authority among New York courts. In *Tzolis*, New York’s highest court makes clear that members of LLCs may sue derivatively. The decision affects some 372,800 LLCs in New York State.¹⁹ While the Legislature could amend New York’s LLC Law, this is an important decision for LLCs.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jon Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com.

¹⁷ *Id.* at *17 (Read, J., dissenting).

¹⁸ *Id.* at *20 (Read, J., dissenting).

¹⁹ Joel Stashenko, *N.Y. High Court Approves Derivative Lawsuits for LLCs*, N.Y. LAW JOURNAL, February 15, 2008.