Nassau Lawyer

APRIL 2011 | VOL. 60 | NO. 8 | WWW.NASSAUBAR.ORG

The LLC: Beware of Statutory Defaults

The New York Limited Liability Company Law ("LLCL") was enacted to create a form of business entity, the limited liability company ("LLC"), which would provide partnership tax status under the Internal Revenue Code while affording its owners ("members") some of the protections comparable to those of a shareholder of a corporation. In order to accomplish these results, the LLCL granted the members of a limited liability company wide latitude to modify the statutory scheme through the use of an operating agreement. Numerous sections of the LLCL begin with or contain the phrase "except as provided in the Operating Agreement." The corollary to this is that, if the operating agreement does not provide for a specific result, the LLCL provides a "statutory default." The adoption of an operating agreement was considered so important to the functioning of a limited liability company that the LLCL requires every limited liability company to have a written operating agreement.[1] While the statute mandates the adoption of a written operating agreement, it does not provide a penalty for the failure to adopt one. The consequences for failing to adopt an operating agreement were a key issue in *Spires v. Casterline*.[2] The court in *Spires* held that the lack of an operating agreement did not permit an LLC member to negate the existence of the limited liability company so as to create a general partnership. The *Spires* court further noted that the LLCL did not provide for a penalty for failing to have an operating agreement.

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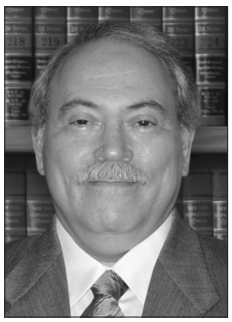
The statutory defaults in regard to the sharing of profits and losses, management of the LLC and distributions on dissolution may create a result not intended by the members of the LLC. The following example will aid in the analysis of this aspect of the LLCL.

Member 1 and Member 2 established a limited liability company. The Articles of Organization contained the statutory minimum requirements.[3] This entity was therefore a member-managed LLC, which is the statutory default if the Articles of Organization do not state that it is to be manager-managed.[4] The members never adopted an operating agreement. Each of the two members contributed $100,000 to the LLC. The LLC purchased a vacant parcel of real property with the intent to obtain zoning approval for the construction of a commercial building on the property. Two and a half years later, after the expenditure of considerable time and talent, the parcel was ready for development. In order to obtain capital to continue the project, the LLC took in Member 3, who contributed $300,000 to the LLC. The three LLC members signed a one page agreement stating that they were equal (1/3) owners of the LLC. Members 1 and 2 assumed that distribution of profits, distribution upon dissolution, and control of the LLC would be based on ownership, *i.e.*, each Member with an equal share.



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When the construction of the commercial building was halted due to the economy, reality set in. Member 3 advised the other members that he had sought the advice of counsel and was advised that his $300,000 contribution to the LLC – compared to the combined $200,000 in contributions from the other two Members – entitled him to sixty percent (60%) of the voting power and sixty percent (60%) of the distributions of profits and sixty percent (60%) of any residuary distributions upon dissolution of the LLC. To everyone's chagrin (except perhaps Member 3), he may be right. The rights of the members are far from clear. This lack of clarity is due to the permissive language of the LLCL, its default provisions and the dearth of court opinions interpreting these aspects of the LLCL.

Under LLCL §503, except as provided in the operating agreement, profits and losses are allocated on the basis of the value of the contributions (not necessarily the capital account) of each member to the LLC (as reflected in the records of the LLC if so stated). Identical language is used for the apportionment of distributions under LLCL §504.

LLCL §704 provides for the order of distribution of assets upon liquidation of an LLC. Pursuant to this statute, except as set forth in the operating agreement, distributions will first be made to creditors of the LLC other than members, then to members of the LLC in satisfaction of certain liabilities and the balance is to then be distributed among the members first to return unreturned

capital contributions and then in proportion to their distributions, as determined in LLCL §504. Finally, according to LLCL §402, the voting rights of the members in a member-managed LLC are exercised in proportion to each member's share of the current profits of the LLC, as set forth in §503, unless the operating agreement provides otherwise.

The result of these statutory defaults is that voting rights, profits (and losses), and distributions are all based on the proportion of each member's contributions, as stated in the records of the LLC, if so stated. The statutory defaults are not based on a member's ownership percentage. LLCL §102(f) defines "Contribution" as "any cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to render services that a member contributes to a limited liability company in his or her capacity as a member." Of further interest is LLCL §501, which states "the contribution of a member to the capital of a limited liability company may be in cash, property or services rendered …." While these provisions authorizing services to be included as a contribution suggest that Members 1 and 2 may have a valid claim that the services they provided in finding and purchasing the property and shepherding the parcel through the zoning process should be valued as contributions such that each of their contributions to the company is greater than the cash contributed, the reality is that unless the contribution is valued and is so stated in LLC's records, there is no clear answer whether this argument will be successful. The LLCL does not provide any guidance (or penalty) if the contributions to the LLC are not stated on LLC's records as required by LLCL §1102(a) (2).[5] If the LLC's current records only reflect contributions in terms of cash and not the value of prior services, the position of Members 1 and 2 may be significantly weakened. The members have "bought" litigation.

There are no current cases dealing with this specific issue, *i.e.*, the interpretation of "contributions" as set forth in LLCL §§ 503, 504, and 102(f) in the absence of an operating agreement. The one case which decided somewhat similar issues is *KSI Rockville, Inc. v. Eichengrun*.[6] In *KSI Rockville*, the managing member of an LLC argued that because he was entitled to payment for his services on behalf of the LLC, a portion of what would be due to him for his services fulfilled his initial capital contribution requirements (which were required to be in cash) such that he should be entitled to distributions under LLCL §704 upon the dissolution of the company. The company at issue in KSI Rockville had an operating agreement, but it was unclear as to whether services were an acceptable way to fulfill the contribution requirements. The court found that the operating agreement was ambiguous: one section stated that contributions could be made in the form of cash, property and/or services while another section stated that only cash and/or the fair market value of property was acceptable as his initial capital contribution. The court noted that the record contained no evidence that the members had consented to the payment for the services, or that such a potential payment could be used to satisfy his contribution requirement. Since the managing member had drafted the agreement, the court construed the ambiguity against him, and held that the services he provided did not constitute a contribution.

While this case is not directly on point with the situation facing Members 1 and 2, the decision does help to define what a court will look to in determining the contributions of members of an LLC. In *KSI Rockville*, the managing member had assumed that the payment for his services would be credited to his capital account, yet the records of the limited liability company did not reflect that the services provided by the managing member constituted a contribution of the member to the LLC. Using *KSI Rockville* as a cautionary tale, if members intend that services are to be included in the determination of contributions or capital, it is crucial that the operating agreement be clear on this point and the value of such services be memorialized on the records of the LLC. If an LLC does not have an operating agreement or the operating agreement is such that the LLCL statutory default provisions are applicable so that services rendered could be one of the measures of contributions to the LLC, it is strongly recommended that any such services be valued and recorded in the records of the LLC. It is in this way that the records of the LLC will accurately reflect the contributions of the various members and the results intended will be the results.

If the statutory default provision in regard to any of the sections of the LLCL referred to above is not to govern an LLC's operations, then the operating agreement must clearly provide otherwise. If the operating agreement provides that management, distribution of profits and losses and/or distribution in liquidation are to be governed by the members' percentage of ownership of the LLC, then that language will govern the operation of the LLC since it overrides the statutory default.

One lesson to be learned from this all too common business arrangement is that Members 1 and 2 will be forced to litigate to determine their rights, the result of which is uncertain. By forming an LLC and failing to adopt a written operating agreement which could have overridden the statutory defaults, they may be in a position where Member 3 will be entitled to sixty percent (60%) of the profits, sixty percent (60%) of any distributions upon dissolution and, perhaps more importantly, sixty percent (60%) of the voting rights. This result was never envisioned by Members 1 and 2.

The drafting of an operating agreement is extremely important and requires more care than many practitioners give to it. The practitioner must understand the statutory defaults contained in the LLCL and, in particular, those defaults that his clients do not intend to govern their limited liability company. A carefully constructed operating agreement is the cornerstone for carrying out the intent of the members establishing the LLC.

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1. N.Y. LLCL §417.
2. *Spires v. Casterline*, 4 Misc. 3d 428 (Sup. Ct., N.Y. Co. 2004).
3. N.Y. LLCL §203(e).
4. N.Y. LLCL 401(a)
5. LLCL 1102 (a)(2) a current list of the full name set forth in alphabetical order and last known mailing address of each member together with the contribution and the share of profits and losses of each member or information from which such share can be readily derived;
6. *KSI Rockville, Inc. v. Eichengrun*, 305 A.D.2d 681 (2d Dept. 2003).

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