



NEW YORK STATE BAR ASSOCIATION

JUNE 2002 | VOL. 74 | NO. 5

Journal

BREAKING UP LLCs

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When Limited Liability Companies Seek Judicial Dissolution, Will The Statute Be Up to the Task?

BY PETER A. MAHLER

In the years since New York authorized limited liability companies in 1994, the statistics on new business entity filings demonstrate a growing recognition of the significant tax and organizational advantages that limited liability companies (LLCs) offer when compared with other available corporate or partnership options for closely held business entities. The trend has led some to predict that "before too long the LLC may largely render the partnership, limited partnership and closely held corporation obsolete."¹

Now that many thousands of LLCs have been formed and the natural life cycles are running their course, the question arises whether New York's statute governing proceedings for judicial dissolution of LLCs is up to the task.

This article examines New York law concerning LLC dissolution and concludes that the governing statute does not adequately empower the courts to resolve LLC "business divorce" litigation. The statute's provisions for member dissociation and dissolution were drafted to assure that LLCs would receive favorable tax treatment as partnerships under then-existing IRS regulations, which were subsequently scrapped. The legislature responded with amendments establishing corporation-style default rules for dissociation and dissolution, but without revising the judicial dissolution provision. This article recommends amending the statute to assimilate the statutory scheme for judicial dissolution of closely held business corporations under the Business Corporation Law (BCL).

Tax Policy and the LLC Movement

The approach of the Limited Liability Company Law (LLCL) to dissolution has its roots in federal tax policy, as do many other key features of LLCs.

The modern tax era began in 1913 with ratification of the 16th Amendment authorizing the income tax.² Under the first Revenue Act passed that same year, Congress imposed taxes on the net income of every corporation or "association . . . not including partnerships." This dual classification scheme—entity-level taxation of corporations and unincorporated organizations classi-

fied as "associations," and pass-through taxation of partnerships—remains in place and plays a critical role in entity selection.

For almost 50 years after the adoption of the federal income tax, regulations generally classified and taxed unincorporated entities as non-partnership "associations" whenever they shared the corporate trait of limited liability. In 1960, the IRS adopted new regulations making it harder for unincorporated entities to be treated as associations.³ Under the 1960 regulations, an unincorporated organization is classified for tax purposes as a partnership if it lacks at least two of four corporate characteristics: (1) continuity of life, (2) centralization of management, (3) limited liability and (4) free transferability of interests.⁴

Over the following two decades, shifts in the relative tax rates for individuals and corporations, together with a surge of independent oil producers and other partnership syndications needing to pass through tax losses to investors, made conditions ripe for the invention of a new business form that combined limited liability and pass-through tax benefits, but without the constraints of the subchapter S corporation.⁵

The breakthrough came in 1977 when Wyoming enacted the first domestic LLC statute at the request of the Hamilton Brothers Oil Company. In 1980, Hamilton obtained from the IRS a private letter ruling confirming that the LLC qualified for federal tax treatment as a partnership. About the same time, however, the IRS proposed new, contrary partnership classification rules that would treat the LLC as a corporation for tax purposes.



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Under heavy criticism, the IRS withdrew the proposed regulations in 1983 and embarked on a five-year study of the issue. In the interim, Congress passed major tax reform that severely curtailed partnership syndications and raised corporate tax rates, thereby generating even greater interest in business and legal circles for partnership tax treatment for LLCs.⁶

By 1988, due to the tax uncertainty only one other state (Florida) had adopted LLC legislation and less than 100 businesses had organized as domestic LLCs.⁷ That all changed in 1988 with Revenue Ruling 88-76, in which the IRS recognized partnership tax classification for the Wyoming LLC. The ruling established that limited liability alone would not require corporate taxation for unincorporated organizations, and that the four corporate characteristics would be weighed equally.⁸

Revenue Ruling 88-76 triggered an avalanche of LLC legislation. Between 1990 and 1996, the remaining 48 states and the District of Columbia all enacted LLC legislation, some of it modeled on a prototype LLC act sponsored by the American Bar Association.⁹ From 1988 through the end of 1995, more than 200,000 new LLCs were organized nationwide.¹⁰

In New York, by 1991 various bar association drafting committees organized to take up the LLC cause. LLC legislation was introduced in the 1992 and 1993 legislative sessions without success, apparently due to concern over loss of corporate tax revenues. In the end, fear of losing business to surrounding states with LLC statutes overcame revenue concerns, and in July 1994 Governor Cuomo signed the LLCL, made effective October 24, 1994.¹¹

Dissociation and Dissolution in New York

Revenue Ruling 88-76 essentially dictated the original dissociation and dissolution provisions of the LLCL by requiring drafters to establish default rules that would cause the LLC to fail the test for continuity of life. They achieved that objective by mimicking the dissociation and dissolution provisions for limited partnerships. The supporting memorandum submitted by one of the proposed legislation's sponsors, Senator John Daly, declared that many of its dissolution and winding-up provisions would be adapted, with minor modifications, directly from the Revised Limited Partnership Act (RLPA).¹²

New Business Corporations and LLCs 1994–2001

<u>Year</u>	<u>New Business Corporations</u>	<u>New LLCs</u>	<u>Conversions to LLCs</u>
1994	70,691	1,133*	124*
1995	72,433	7,063	824
1996	73,866	9,427	858
1997	74,397	12,238	771
1998	72,568	15,149	608
1999	75,276	18,007	510
2000	75,992	20,818	364
2001	<u>73,410</u>	<u>21,913</u>	<u>377</u>
<i>Totals</i>	588,633	105,748	4,436

*LLC filings became effective on 10/24/94

Source: New York Department of State

The provisions of the law for member dissociation and dissolution are contained in three sections: LLCL § 606, governing member withdrawal; § 701, setting forth events of dissolution; and § 702, authorizing actions for judicial dissolution.

LLCL § 606 The original version of § 606 permitted a member to withdraw from the LLC upon the happening of any events specified in the operating agreement, or in accordance with the operating agreement or, unless otherwise provided in the operating agreement, with the consent of two-thirds of the other members. Unless prohibited by the operating agreement, a member could still withdraw even without the other members' consent upon six months' prior written notice. A withdrawal in violation of the operating agreement, however, entitled the LLC to recover any damages for breach that could be offset against any distributions due the withdrawing member. Under LLCL § 509, a withdrawing member is entitled to receive, within a reasonable time after withdrawal, the fair value of his or her membership interest.

LLCL § 701 As originally enacted, LLCL § 701 mandated dissolution of LLCs upon the first to occur of five enumerated events, including a decree of judicial dissolution under § 702. The other dissolution events fell into two general categories: (1) contractual or other consensual events expressly contemplated in the articles of organization and operating agreement, or (2) non-consensual events including the bankruptcy, death, dissolution, expulsion, incapacity or withdrawal of a member, subject to the remaining members' right to continue the LLC within 180 days pursuant to vote or a right to continue stated in the operating agreement.

LLCL § 702 This section authorizes a member to apply for a decree of judicial dissolution of an LLC “whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement.” The quoted language is borrowed from RLPA 121-802, which authorizes dissolution of a limited partnership whenever it is “not reasonably practicable to carry on the business in conformity with the partnership agreement.” The latter section, in turn, is a truncated version of Partnership Law § 63(d) which, among other grounds, permits dissolution of a general partnership when a partner “wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him.”

LLCL § 702 also closely tracks the language in § 902 of the ABA Prototype LLC Act, the 1992 commentary to which states that the “‘not reasonably practicable’ language probably includes at least some of the causes of dissolution provided for in partnership law, particularly partner misconduct.”¹³ The same commentary also suggests a deliberate avoidance of the typical grounds for dissolution found in corporate dissolution statutes, on the ground that “disgruntled members” of an LLC “would be encouraged to make this sort of allegation in limited liability company breakups.”¹⁴

“Check-the-Box”

Shortly after New York’s LLCL went into effect, the IRS gave notice that it was considering the adoption of radically simplified regulations that would allow unincorporated business organizations, including LLCs, to elect either partnership or association tax treatment without regard to application of the four-factor test for corporate characteristics.¹⁵ Under the so-called “check-the-box” regulations, which went into effect in 1997, a new unincorporated entity with two or more members automatically is classified as a partnership unless it elects a different status, and a new one-member entity is disregarded for tax purposes absent an election otherwise.¹⁶

Prior to check-the-box, the default provisions of LLC statutes were carefully drawn to avoid the corporate characteristic of continuity of life. The new regulations rendered non-continuity of life essentially meaningless for tax purposes. For business purposes, continuity of life is more attractive to LLC investors, third-party lenders and contract partners because it removes the uncertainty associated with events of dissolution and simplifies the operating agreement. Accordingly, states including New York responded to the new regulations by reversing the default rules governing member withdrawal and dissolution.

The 1999 LLCL Amendments

Chapter 420 of the Laws of 1999, which went into effect August 31, 1999, included important amendments to LLCL § 606 and § 701. The previous default rights of members to withdraw upon consent of the other members or, absent consent, unilaterally upon six months’ notice, were eliminated from § 606 and replaced with a default prohibition barring withdrawal prior to dissolution except as otherwise provided in the operating agreement.¹⁷

The default rules for dissolution under § 701 were amended to provide the LLC with “perpetual existence” absent a limited-duration provision in the articles of organization and operating agreement.¹⁸ The previous default rule under § 701, requiring dissolution of the LLC upon the death, retirement, resignation, expulsion, bankruptcy or dissolution of any member unless the remaining members vote to continue, also was eliminated. In its place, the amended section states that such dissolution events shall not cause the LLC to be dissolved unless within 180 days a majority of the remaining members agree to dissolve.¹⁹

Senator John Marchi’s memorandum in support of the proposed amendments explained that the changes in the default rules for withdrawal were designed to codify “the likely expectations of the parties forming” the LLC “to have rights similar to those of a shareholder of a business corporation.” It went on to note that shareholders would “not have a right of withdrawal or redemption absent an express agreement” and that it would therefore be “appropriate” to treat LLCs “similarly to corporations in this area.” The memorandum also commented that “the dissolution provisions of the LLCL that were designed to meet [previous] IRS regulations may be changed to conform with the likely expectations and preference of LLC members.”²⁰

Partnership vs. Corporate Exit Rules

The 1999 amendments to LLCL § 606 and § 701 jettisoned the partnership model in favor of the corporate model, but left LLCL § 702 untouched. Can a partnership-modeled judicial dissolution statute adequately address membership disputes of the type found in closed corporations?

Over the last several decades, a vast body of literature and case precedent has grown around the problem of squeeze-out and other forms of minority shareholder oppression in closed corporations.²¹ Historically, partnership squeeze-out cases are rare not only because of the partners’ equal management rights, but also because of the relative ease of exit under partnership law.²² In the absence of any agreement to the contrary, a partner can dissolve the partnership at any time and receive his or

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Dissolution Provisions Of Limited Liability Companies Law

§ 701. Dissolution.

(a) A limited liability company is dissolved and its affairs shall be wound up upon the first to occur of the following:

(1) the latest date on which the limited liability company is to dissolve, if any, provided in the articles of organization, or the time specified in the operating agreement, but if no such date is provided in the articles of organization and if no such time is specified in the operating agreement, then the limited liability company shall have a perpetual existence;

(2) the happening of events specified in the operating agreement;

(3) subject to any requirement in the operating agreement requiring approval by any greater or lesser percentage in interest of the members or class or classes or group or groups of members, the vote or written consent of at least a majority in interest of the members or, if there is more than one class or group of members, then by at least a majority in interest of each class or group of members;

(4) at any time there are no members, provided that, unless otherwise provided in the operating agreement, the limited liability company is not dissolved and is not required to be wound up if, within one hundred eighty days or such other period as is provided for in the operating agreement after the occurrence of the event that terminated the continued membership of the last remaining member, the legal representative of the last remaining member agrees in writing to continue the limited liability company and to the admission of the legal representative of such member or its assignee to the limited liability company as a member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member; or

(5) the entry of a decree of judicial dissolution under section seven hundred two of this article.

(b) Unless otherwise provided in the operating agreement, the death, retirement, resignation, expulsion, bankruptcy or dissolution of any member or the occurrence of any other event that terminates the continued membership of any member shall not cause the limited liability company to be dissolved or its affairs to be wound up, and upon the occurrence of any such event, the limited liability company shall be continued without dissolution, unless within one hundred eighty days following the occurrence of such event, a majority in interest of all of the remaining members of the limited liability company or, if there is more than one class or group of members, then by a majority in interest of all the remaining members of each class or group of members, vote or agree in writing to dissolve the limited liability company.

(c) A limited liability company whose original articles of organization were filed with the secretary of state and effective prior to the effective date of this subdivision shall continue to be governed by this section as in effect on such date and shall not be governed by this section, unless otherwise provided in the operating agreement.

§ 702. Judicial dissolution.

On application by or for a member, the supreme court in the judicial district in which the office of the limited liability company is located may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement. A certified copy of the order of dissolution shall be filed by the applicant with the department of state within thirty days of its issuance.

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her rightful share of the liquidation proceeds. If the business as a going concern is worth more than its liquidation value, the partners are highly motivated to negotiate a buyout. The Revised Uniform Limited Partnership Act also contains liberal exit rules, permitting general partners to cash out for fair value so long as their departure does not trigger dissolution, and per-

mitting limited partners to receive fair value upon six months' notice.²³

In contrast, "[c]orporate law norms are conducive to minority squeeze-outs in a closely held firm."²⁴ Majority shareholders exercising control of the board of directors have any number of ways to impair minority shareholder interests, e.g., barring participation in management decisions, reducing salary, terminating employ-

ment, removing a shareholder from the board of directors, altering dividend policy, or paying the controlling shareholders excessive salaries.

At the same time, unlike partnership default rules, corporate law does not provide non-controlling shareholders of closed corporations with any easy means of egress that would permit them to recoup their investment. For this reason most states, including New York in 1979, enacted laws giving minority shareholders the right to seek judicial dissolution for oppressive actions or other misconduct by controlling shareholders. These laws typically also provide for a statutory buyout of the minority shareholder's stock and empower the courts to fashion other forms of relief short of dissolution.²⁵

Time will tell whether the LLCL's 1999 amendments will lead to increased litigation of disputes between LLC members. The most likely candidates are post-amendment LLCs without operating agreements and therefore governed by the LLCL's new default rules.²⁶ A member of such an LLC has no right to withdraw and no right to receive fair value for his or her interest. An action for judicial dissolution may be the only way out.

The Developing Case Law

To date, only a handful of court decisions have involved judicial dissolution of New York LLCs. The decisions are striking in two respects. First, they make no meaningful attempt to construe or apply the specific language of LLCL § 702. Second, almost all of them either explicitly or implicitly treat LLCs as business corporations subject to the same dissolution standards and remedies available under BCL Article 11, without any acknowledgment of the statutory differences and without offering any rationale for doing so.

The one officially reported New York decision thus far to address LLC dissolution in anything approaching a substantive fashion is *In re Roller (W.R.S.B. Development Co., LLC)*,²⁷ in which the Fourth Department affirmed the denial of a motion to dismiss the petition. Practitioners should not expect much guidance from the *Roller* opinion's meager four sentences. The court merely states that the petitioners' ownership of membership interests in the two subject LLCs on the date the proceeding was commenced gives them standing to bring the proceeding, and that "the petition adequately states a cause of action for judicial dissolution" under LLCL § 702.²⁸

What allegations in *Roller* sufficed to state a § 702 claim? A look at the *Roller* petition shows that there were two subject LLCs organized by four members to develop shopping centers.²⁹ The three petitioning members owned 75% of one LLC and 45% of the other. The petition alleges that the respondent member "excluded" them from the companies' business affairs; that there is

"internal dissension" and "irreconcilable conflict" such that dissolution "would be beneficial to the membership"; that the respondent breached his fiduciary duty by denying petitioners access to company records and by managing the businesses to his sole benefit; that dissolution would not injure the public; and that all of the foregoing renders it "no longer reasonably practicable to carry on the business of the companies in conformity with the operating agreement of each."

Veterans of corporation business divorce litigation recognize the *Roller* allegations as classic grounds for dissolution under BCL §§ 1104 and 1104-a, for deadlock and oppression. While such grounds may indeed point to the need for dissolution of an LLC, by its express terms § 702 requires something else: a showing that "it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." Conspicuously missing from the *Roller* petition is any reference to the provisions of the operating agreement or articles of organization which, in light of the conduct alleged, make it impracticable for the business to carry on in conformity therewith.

The unspoken reliance on BCL dissolution standards in *Roller* comes out into the open in an unreported lower court ruling in *RRA Limited Partnership v. A Space Place, Centereach, LLC*.³⁰ The case involved four related LLCs formed to acquire and improve real property for use as self-storage space. The petitioner was the majority owner of two of the LLCs and 50% owner of the other two. Both sides agreed that the companies were operating successfully and that they intended to sell all the assets.

The petitioner sought dissolution after the failure of a proposed sale to a third party. The petitioner explicitly relied on BCL § 1104(a)(3) in support of dissolution, based on "numerous incidents of divisiveness between the parties" such that dissolution "may be beneficial to the shareholders [sic]."³¹ The court's determination to deny the respondent's dismissal motion likewise paraphrases the standards for dissolution under BCL §§ 1104 and 1104-a, several subsections of which the court cites along with several case precedents under those statutes. As in *Roller*, the specific prerequisite for dissolution stated in LLCL § 702 is given nominal regard.

Several other unreported trial court decisions likewise apply BCL Article 11 to LLC dissolutions without any discussion of the basis for, or implications of, doing so. In *In re O'Brien (Academe Paving, Inc.)*,³² the petitioner sought to dissolve two related entities—one a business corporation and the other an LLC—under BCL § 1104-a for minority shareholder oppression. The respondents served an election under BCL § 1118 to purchase the petitioners' "shares" in both entities for fair value, after

Provisions of Operating Agreement Can Minimize Dissolution Contests

The freedom that limited liability companies have to form the agreements that govern their operation allows the founders to include provisions that would, in effect, constitute a kind of prenuptial agreement to avoid a messy business divorce when the LLC members wish to break up.

With few exceptions, LLCL § 417(a) permits members to adopt a written operating agreement that contains "any provisions not inconsistent with law or its articles of organization" relating to the LLC's business affairs and the rights and duties of LLC members and managers. The LLCL's articles dealing with membership, management, contributions and distributions, function as default rules that govern only when the operating agreement is silent on the issue. As the Delaware Chancery Court put it, "LLC members' rights begin with and typically end with the Operating Agreement."¹

So, too, with member dissociation and dissolution. In this regard, LLC operating agreements and shareholder agreements for business corporations can serve the same purpose. Courts routinely deny petitions for judicial dissolution of closely held corporations based on provisions in shareholder agreements that, for example, require surrender of stock with or without consideration upon any termination of the shareholder's employment,² or deem the commencement of a dissolution proceeding as an offer to sell at a fixed price or under a predetermined formula.³ Courts also can be relied on to deflect LLC dissolution petitions based on mandatory arbitration clauses in operating agreements, just as they do with arbitration clauses in shareholder agreements.⁴

The inclusion of such provisions in an operating agreement will depend on many factors. These include the nature of the business and its capital structure; the number of members and the resources or talents each contributes; whether the LLC is family-owned; the magnitude of any possible threat to the LLC's liquidity posed by a member buyout; and the relative bargaining power of the parties to the operating agreement. So long as the particular mechanism adopted reflects the parties' voluntary agreement to avoid dissolution and to carry on the business notwithstanding the alleged detriment to the complaining LLC member, an application for judicial dissolution under LLCL § 702 is not likely to succeed.

1. *Walker v. Resource Dev. Co., LLC*, 791 A.2d 799 (Del. Ch. 2000).
2. See *In re Apple (Apple Rubber Prod., Inc.)*, 224 A.D.2d 1016, 637 N.Y.S.2d 534 (4th Dep't 1996).
3. See *Doniger v. Rye Psychiatric Hosp. Ctr., Inc.*, 122 A.D.2d 873, 505 N.Y.S.2d 920 (2d Dep't 1986).
4. See *Alleman v. Sunrest Health Facilities, Inc.*, 176 A.D.2d 287, 574 N.Y.S.2d 216 (2d Dep't 1991).

which the court stayed the dissolution and ordered a valuation hearing.

At first blush, nothing about O'Brien's enforcement of the respondents' § 1118 election seems amiss, especially if the petitioner's consent to the election is assumed. Upon closer examination, however, the incorporation of BCL buyout rights is highly problematic. BCL § 1118(a) specifically limits the statute's application to proceedings for shareholder oppression and other misconduct under BCL § 1104-a. This express statutory limitation has led courts repeatedly to preclude § 1118 buyouts in deadlock proceedings under BCL § 1104.³³

The LLCL does not authorize a buyout of the interest of the member seeking dissolution. If BCL § 1118 cannot reach across the small gap between BCL §§ 1104 and 1104-a, certainly it cannot bridge the chasm separating BCL § 1104-a and LLCL § 702.

Other recent examples of courts applying BCL Article 11 to LLC dissolutions include *In re Rodriguez (Zoros Limited)*³⁴ and *In re Honig (JM Marketing, LLC)*.³⁵ In Rodriguez, the court denied a motion to dismiss a dissolution proceeding involving a foreign LLC on the ground that BCL § 1104 empowered the court, if not to actually dissolve the LLC, to declare the parties' rights of ownership, order a winding up and, if called for, order the parties to file dissolution papers in the foreign jurisdiction. In Honig, the court ordered a hearing on the petition to dissolve an LLC after acknowledging the dearth of reported decisions interpreting LLCL § 702. The Honig court concluded on the basis of BCL Article 11 case law that the proper focus is "assurance to the petitioner seeking dissolution that a fair return on his investment in company securities can be obtained whether through a buy-out option, if available, or by the sale of the shares to other share holders."³⁶ It is impossible to locate any basis in LLCL § 702 for this BCL-derived standard.

At least one unreported LLC dissolution decision, *In re Quinn (David Rose Perennials, LLC)*,³⁷ is more attuned to the statutory constraints of LLCL § 702. Quinn involved a two-member LLC. The petitioner was the managing member who ran the retail business while the respondent member and majority owner was responsible for the business plan and finances. The petitioner left

the business and formed a new business after the respondent refused to increase her compensation.

The court denied the petitioner's motion for a preliminary injunction on the ground that the operating agreement gave the respondent a controlling voting interest in the company. As viewed by the court, the petitioner's departure resulted from "a disagreement as to the apparently proper exercise of discretion" in determining her compensation and not from any wrongdoing by respondent.

Quinn's focus on whether the complained-of conduct conforms to the operating agreement is consistent with the language of LLCL § 702. At the same time, it highlights § 702's inherent limitations as a remedial statute. LLC members wielding majority control under the operating agreement will almost always be able to use their control to the disadvantage of the minority owners for whom employment with the LLC may be the primary if not sole source of return on their investment. Majority curtailment of the minority's employment benefits is a classic squeeze-out technique which can often occur without appreciable impact on the business, and therefore without running afoul of LLCL § 702. As one commentator succinctly noted, "it is often possible to carry on the business while freezing a minority interest out of any return."³⁸

So long as the language of the statute forces courts to focus primarily on the inability of the LLC to carry on its business in conformity with the operating agreement or articles of organization, and only secondarily on the conduct of the members or the effect on a particular membership interest, there are bound to be cases in which LLC members will be denied relief under circumstances where a similarly situated corporation shareholder would succeed.³⁹

A contrary argument could be made based on the notion that the BCL is a statute of general application to all species of business entities, including LLCs. However, BCL § 103 expressly limits the application of the statute to domestic "corporations" and foreign "corporations" authorized or doing business in New York. LLCL § 102(m) defines an LLC as an "unincorporated organization . . . other than a partnership or trust." The statutory schemes governing business corporations and LLCs, and their authorized business and ownership structures, are like day and night.

In addition, the Court of Appeals has observed that, historically, New York courts were considered divested

of equity jurisdiction to order dissolution of corporations, as statutory prescriptions were deemed "exclusive."⁴⁰ There is no more reason to conclude that courts have a general, non-statutory power to augment the LLCL's prescriptions for dissolution by incorporating what are essentially alien BCL provisions.

A Proposal to Amend LLCL § 702

It is possible that in years to come, a stand-alone jurisprudence for judicial dissolution of LLCs will take root, flourish and mature into a well-developed body of law from which the business and legal communities can draw guidance. So far the signs are not promising. The LLCL's narrow standard for exercise of the dissolution power, based on outdated partnership exit rules, does not seem adequate to the task. In the meantime, the uncertainty resulting from the absence of authoritative case law can only serve as a deterrent to greater use of the LLC as one among several competing business entities.

A number of other states have taken the lead in adopting the "modern, liberal corporate model" for judicial dissolution of LLCs.⁴¹ Section 801 of the Uniform Limited Liability Company Act (1996) (ULLCA), which so far has been enacted by eight states and one territory,⁴² 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."⁴³ California permits judicial dissolution of LLCs whenever it is "reasonably necessary for the protection of the rights or interests of the complaining members" or when controlling members "knowingly countenanced persistent and pervasive fraud, mismanagement, or abuse of authority."⁴⁴ The ULLCA and California standards are more liberal than those governing dissolution of closely held New York business corporations, and have been criticized as "creat[ing] too many opportunities for oppression of the majority by the minority."⁴⁵

Amendment of LLCL § 702 need not go as far as the ULLCA and California law. Rather, the legislature should amend § 702 by incorporating the existing, more modest standards for dissolution under BCL §§ 1104-a and 1104. Since its enactment in 1979, BCL § 1104-a has permitted a 20%⁴⁶ or more shareholder to seek dissolution where the directors or those in control of the corporation engage in "illegal, fraudulent or oppressive actions" or where corporate property and assets are being "looted,"

wasted, or diverted for non-corporate purposes." An extensive body of interpretive case law has grown around these provisions, with "oppressive actions" garnering the overwhelming share of judicial attention.⁴⁷

BCL § 1104 and its predecessor statutes, in place for more than 70 years, authorize a 50% shareholder to petition for dissolution based on management or ownership deadlock and dissension.⁴⁸ These provisions likewise have been construed in numerous cases, giving clarity and predictability to deadlock-based disputes.⁴⁹

As a matter of public policy, there seems little reason to distinguish between LLCs and closely held business corporations when it comes to the grounds for business divorce. The reliance of New York courts on BCL statutory and decisional law in the early LLC dissolution cases discussed above underscores the similarity of the internal forces that contribute to dissension and oppression among co-owners of both LLCs and business corporations. Amending LLCL § 702 to incorporate the grounds for dissolution in BCL §§ 1104 and 1104-a will place these respective proceedings on a par where they belong, and will provide LLC members and their counsel with a ready-made, extensive body of decisional law from which to draw guidance in designing operating agreements and in regulating member conduct.

LLCL § 702 also should be amended to incorporate buyout rights akin to those found in BCL § 1118.⁵⁰ The latter provision gives the respondent shareholders or the corporation the right to elect, within 90 days of the petition, to purchase the petitioner's shares for fair value. If the parties are unable to agree on fair value, upon application the court will stay the dissolution and determine the fair value as of the day prior to the date on which the petition was filed.

There is every reason to expect that granting respondent LLC members the right to stay dissolution in favor of a buyout will have the same salutary effect the proceedings under BCL Article 11. It will also likely induce organizers of LLCs to include mandatory buyout provisions in an operating agreement, which will promote two important goals. First, parties entering into an LLC venture will be encouraged to enter into consensual arrangements that fix their rights and financial expectations in the event of dissociation. Second, by doing so, LLC members will be far less likely to burden the courts with business divorce litigation.

1. F. Gevurtz, *Squeeze-Outs and Freeze-Outs in Limited Liability Companies*, 73 Wash. U. L.Q. 497, 497 (1995) ("Gevurtz, *Squeeze-Outs*"). A former IRS commissioner recently noted that "[n]o rational, reasonably well-informed tax professional would deliberately choose subchapter S [corporation] status over an LLC when there is a choice, and 99% of the time there is a choice." D. Alexander, *Tax Prac-*

tice, July 17, 2000, quoted in 1 Ribstein and Keatinge on Limited Liability Companies § 2.01 (2001).

2. See S. Hamill, *The Origins Behind the Limited Liability Company*, 59 Ohio St. L.J. 1459, 1478–1504 (1998) ("Hamill, *Origins*").
3. The 1960 regulations were adopted in response to the decision six years earlier in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), where the court sided with a medical partnership that purposefully structured itself with certain corporate characteristics to gain tax treatment as an association and thereby to obtain pension benefits not then available to partnerships. See S. Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 Wash. U. L.Q. 565, 573 (1995).
4. Former Treas. Reg. § 301.7701-2. The factors are drawn from the decision in *Morrissey v. Commissioner*, 296 U.S. 344 (1935), where the Supreme Court held that a business trust with corporate characteristics could be taxed as a corporation. See C. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 Syracuse L. Rev. 1193, 1200 (1995) ("Goforth, *Rise of LLC*").
5. See 1 Ribstein and Keatinge on Limited Liability Companies § 16.02; Hamill, *Origins*, *supra* note 2, at 1509–16.
6. See Hamill, *Origins*, *supra* note 2, at 1516–18; Goforth, *Rise of LLC*, *supra* note 4, at 1199–1201.
7. See Hamill, *Origins*, *supra* note 2, at 1469.
8. *Id.* at 1469–70.
9. See Goforth, *Rise of LLC*, *supra* note 4, at 1206, 1222–62.
10. See Hamill, *Origins*, *supra* note 2, at 1477–78.
11. See K. Walker, *New York Limited Liability Companies and Partnerships* § 1.1.1 (2002) ("Walker, NY LLCs").
12. Senate Introducer Mem. in Support, Bill Jacket, 1994 N.Y. Laws ch. 576, at 8.
13. ABA Prototype LLC Act § 902, commentary at 64.
14. *Id.*
15. Notice 95-14, 1995-14 CB 297; see 1 Ribstein and Keatinge on Limited Liability Companies § 16.02.
16. Treas. Reg. § 301.7701-2(c). See Walker, NY LLCs, *supra* note 11, §§ 2.2–2.3. The new regulations replaced Treas. Reg. §§ 301.7701-1, 301.7701-2, 301.7701-3.
17. Under LLCL § 606(b) as amended, an LLC whose original articles of organization were filed prior to August 31, 1999, shall continue to be governed by the pre-amendment version of the statute unless otherwise provided in the operating agreement.
18. LLCL § 701(a)(1).
19. LLCL § 701(b).
20. Senate Introducer Mem. in Support, Bill Jacket, 1999 N.Y. Laws ch. 420, at 5–6.
21. The leading treatise on the subject is F. O'Neal & R. Thompson, *O'Neal's Oppression of Minority Shareholders* (2d ed. 1999).
22. Gevurtz, *Squeeze-Outs*, *supra* note 1, at 501–502; see D. Karjala, *Planning Problems in the Limited Liability Company*, 73 Wash. U. L.Q. 455, 471 (1995) ("Karjala, *Planning Problems*").
23. Gevurtz, *Squeeze-Outs*, *supra* note 1, at 501–504.
24. *Id.* at 501.

25. *Id.* at 498–501; see 1 Ribstein and Keatinge on Limited Liability Companies § 2.06.
26. LLCL § 417(a) states that every LLC “shall adopt a written operating agreement” but does not address the consequences (if any) of failure to do so and does not require the operating agreement to be filed. LLCL § 417(c) states that the operating agreement “may” be entered into before, at the time of or within 90 days after the filing of the articles of organization. For an example of the litigation complexities that can arise in the absence of an operating agreement, see *Child Care of Irvine, LLC v. Facchino*, 1998 Del. Ch. LEXIS 114 (Del. Ch. July 15, 1998) (denying plaintiffs’ motion for summary judgment in action to uphold termination of defendant member as LLC’s general manager where factual issues arose from the parties’ failure to execute an operating agreement).
27. 259 A.D.2d 1012, 689 N.Y.S.2d 897 (4th Dep’t 1999). In *Roller* and all of the unreported LLC dissolution cases discussed in this article, dissolution was sought by way of petition in a special proceeding notwithstanding the absence of any authorization in LLCL § 702. CPLR 103(b) mandates that “[a]ll civil judicial proceedings shall be prosecuted in the form of an action, except where prosecution in the form of a special proceeding is authorized.” The use by counsel of the special proceeding form in LLC dissolutions is yet another manifestation of the prevailing treatment of LLC dissolutions as governed by BCL Article 11 which mandates a special proceeding for dissolution proceedings under that article.
28. *Roller*, 259 A.D.2d at 1012.
29. Petition, *In re Roller (W.R.S.B. Development Co., LLC)*, Index No. 10012/97 (Sup. Ct., Erie Co. Nov. 25, 1997) (on file with author, courtesy of Melissa Hancock Nickson, Esq.).
30. Index No. 00-26634 (Sup. Ct., Suffolk Co., June 8, 2001).
31. *Id.*, slip op. at 2.
32. Index No. 99-2594 (Sup. Ct., Broome Co., Aug. 24, 2000).
33. See *In re Sternberg (Osman)*, 181 A.D.2d 897, 582 N.Y.S.2d 206 (2d Dep’t 1992). In *In re Cristo Brothers, Inc.*, 64 N.Y.2d 975, 976, 489 N.Y.S.2d 35, 36 (1985), the Court of Appeals commented that “the legislative history of Business Corporation Law § 1118 contains nothing to indicate why it accorded a buy-out privilege in any proceeding brought pursuant to section 1104-a but not with respect to a dissolution proceeding under Business Corporation Law § 1104.”
34. N.Y.L.J., Jan. 18, 2001, p. 29, col. 5 (Sup. Ct., N.Y. Co.).
35. Index No. 6405/00 (Sup. Ct., Nassau Co. Oct. 19, 2000).
36. *Id.*, slip op. at 5 (citations omitted).
37. N.Y.L.J., Apr. 20, 2000, p. 32, col. 6 (Sup. Ct., Nassau Co.).
38. Karjala, *Planning Problems*, *supra* note 22, at 471.
39. See *McConnell v. Hunt Sports Enterprises*, 132 Ohio App. 3d 657, 694, 725 N.E.2d 1193, 1220 (Ohio Ct. App. 1999) (where the court held that while it is not “necessary” under Ohio’s LLC dissolution statute to find wrongful conduct, it is “possible that wrongful conduct is the underlying reason for it no longer being practicable to carry on the business of a company” in conformity with the articles of organization and operating agreement).
40. *In re Kemp & Beatley, Inc. (Gardstein)*, 64 N.Y.2d 63, 69, 484 N.Y.S.2d 799 (1984).
41. Karjala, *Planning Problems*, *supra* note 22, at 472.
42. The ULLCA jurisdictions are Alabama, Hawaii, Illinois, Montana, South Carolina, South Dakota, U.S. Virgin Islands, Vermont and West Virginia.
43. ULLCA § 801(a)(4)(v). Section 801 also authorizes judicial dissolution whenever (i) the economic purpose of the company is likely to be unreasonably frustrated; (ii) another member has engaged in conduct relating to the company’s business that makes it not reasonably practicable to carry on the company’s business with that member; (iii) it is not otherwise reasonably practicable to carry on the company’s business in conformity with the articles of organization and the operating agreement; and (iv) the company failed to purchase the petitioner’s distributional interest under § 701, which requires the LLC to purchase a dissociated member’s distributional interest for its fair value under certain circumstances.
44. Cal. Corp. Code § 17351(a)(2), (5).
45. R. Keatinge & J. Reynolds, *Advisors’ Report on the Uniform Limited Liability Company Act* § 4, submitted Mar. 13, 1995, to the Committee on Partnerships and Unincorporated Business Organizations of the Business Law Section of the American Bar Association.
46. New York is in the minority of states that condition standing to seek dissolution for oppressive or other misconduct on a minimum stock ownership percentage. Given that LLCL § 702 at present contains no similar requirement, it would make little sense to include this feature of BCL dissolution in any amendment of § 702.
47. See *In re Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 484 N.Y.S.2d 799 (1984) (adopting a “reasonable expectations” standard under which oppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner’s decision to join the venture). For a comprehensive review of judicial dissolution proceedings under BCL § 1104-a, see Peter A. Mahler, *Twenty Years of Court Decisions Have Clarified Shareholder Rights Under BCL §§ 1104-a & 1118*, N.Y. St. B.J., Vol. 71, No. 5 at 28 (1999); Peter A. Mahler, *Decisions Have Set Parameters for Establishing “Fair-Value” of Frozen-Out Shareholder Interests*, N.Y. St. B.J. Vol. 71, No. 6 at 71 (1999); Peter A. Mahler, *Reviewing Shareholder “Freeze-Out” Cases of 2001*, N.Y.L.J., Feb. 8, 2002, p. 1; Peter A. Mahler, *Reviewing Shareholder “Freeze-Out” Cases of 2002*, N.Y.L.J., Jan. 3, 2001, p. 1; Peter A. Mahler, *Annual Review of Shareholder “Freeze-Out” Cases*, N.Y.L.J., Feb. 25, 2000, p. 1.
48. The grounds for dissolution under BCL § 1104 are:
- (1) that the directors are so divided respecting the management of the corporation’s affairs that the votes required for action by the board cannot be obtained;
 - (2) that the shareholders are so divided that the votes required for the election of directors cannot be obtained; or
 - (3) that there is internal dissension and two or more factions of shareholders are so divided that dissolution would be beneficial to the shareholders.
49. See *In re Radom & Neidorff*, 307 N.Y. 1, 119 N.E.2d 563 (1954); *In re Seamerlin Operating Co.*, 307 N.Y. 407, 121 N.E.2d 392 (1954); *In re Gordon & Weiss, Inc.*, 32 A.D.2d 279, 301 N.Y.S.2d 839 (1st Dep’t 1969).
50. See S. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 Mont. L. Rev. 43, 84–90 (1994) (arguing in favor of buyout remedy in LLC dissolution proceedings).