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Expert Analysis

Scope of Indemnification Rights Under LLC Law Limited

By **Richard I. Janvey** And **Joan M. Secofsky**

Here is a plausible scenario. You are one of several members in a New York LLC, and you are sued for something for which you claim the LLC is obligated to indemnify you. But you and the other members are at odds, and they dispute this interpretation. You sue the LLC and establish that the operating agreement requires the LLC to indemnify you. But those many thousands of dollars in legal fees incurred to establish the LLC's obligation to you—those may be yours to pay. That is because absent an express provision in the LLC operating agreement to reimburse for legal expenses incurred in moving for indemnification when the LLC does not voluntarily indemnify, also known as "fees on fees," the LLC is not required to reimburse you.

Ambiguity favors the LLC. That is the takeaway from a recent decision in *546-552 West 146th Street v. Arfa*, 603041-06 (1st Dept. Aug. 10, 2012), in which the Appellate Division, First Department, limited the scope of indemnification rights under the LLC Law. The court rejected payment of "fees on fees" unless expressly required under the applicable operating agreement.

146th Street counsels promptly revising and clarifying indemnification language in LLC operating agreements if the intention is that the indemnified party is entitled to recover fees on fees. Indeed, it is important to review operating agreements regularly—and amend if necessary—to insure that the agreement continues to reflect the parties' interests and intentions. The *146th Street* holding applies, unless overruled, to all New York LLC agreements being interpreted by courts in New York City and the Bronx (the geographic reach of the First Department) and is likely to be followed by all courts in the state.

In addition to the indemnification holding, *146 Street* also is interesting as an example of a closely held company gone bad and tied up in long-running, expensive and not fruitful litigation. Minority investors allege that they were defrauded by the promoters when they made their investments during the years 2002 through 2005. The litigation trail is complex and involves two separate lawsuits pending in Supreme Court, New York County, both before Justice Charles Ramos, and multiple appeals in each. Ten years after their first investments, there is no trial, let alone recovery, in sight. And, the LLCs in which the investors are minority members have already been held liable to reimburse those same promoters for more than $132,000 in legal fees the promoters spent in defending against the minorities' claims. Here are the highlights.

Plaintiffs in *146th Street* are several real estate LLCs that purchased various residential properties in New York and the Bronx. The purchase agreements and related documents for the properties were entered into prior to formation of the LLCs. After their formation, the LLCs were assigned the purchasers' rights and obligations with respect to the specific property.

When the LLCs were formed, defendants Arfa, Shpigel and Zamir were their sole members and, with a related entity, their sole managers. Outside investors in Israel were solicited by the promoters to purchase interests in the LLCs and the amounts the investors paid for their interests were used to fund the closings of the properties.

The *146th Street* complaint alleged that the promoters/defendants received secret commissions on the purchases of the properties, and that they and their counsel, also defendants, were liable for the failure to disclose. The complaint demanded an accounting, claimed breach of fiduciary duty, actual and constructive fraud and malpractice against the attorneys. On defendants' motion to dismiss the complaint, Ramos concluded that plaintiffs lacked standing to bring the action, dismissed the complaint and denied plaintiffs' motion for leave to serve an amended complaint.

Those many thousands of dollars in legal fees incurred to establish the LLC's obligation to you—those may be yours to pay.

Appeals and Actions

On the first appeal, 54 A.D.3d 543 (1st Dept.), motion for leave to appeal denied, 12 N.Y.3d 840 (2009), the First Department affirmed Ramos. "The alleged malefactors were the only members and managers of the LLCs at the time the agreements for the payment of the undisclosed commissions

RICHARD I. JANVEY *is a partner at Diamond McCarthy and can be reached at Rjanvey@diamondmccarthy.com.* JOAN M. SECOFSKY *is senior counsel at the firm and can be reached at Jsecofsky@diamondmccarthy.com. Both are based in the New York office.*

were entered into, and, therefore their acts and knowledge are imputed to the LLCs."

While the first appeal in *146th Street* was pending, approximately 25 entities, original Israeli investors and assignees of some of the investors, filed *Roni, LLC v. Arfa*, Index No. 601224-07. In brief summary, the *Roni* complaint demands an accounting and asserts claims for waste, breach of fiduciary duty and common law and constructive fraud. It alleges that the Israeli investors were solicited to invest in the acquisition of residential buildings in Harlem and the Bronx, but the defendants/promoters, their counsel and various sellers failed to disclose secret commissions the promoters received, which inflated the purchase price of the properties.

The '146th Street' court held that the language "any and all claims and demands whatsoever" in Section 420 does not explicitly provide for an award of fees on fees and that the operating agreement did not contain unambiguous language providing for the recovery of fees on fees.

There was extensive motion and appellate practice in *Roni*. The attorney/defendants were dismissed, several claims were dismissed and assignors were joined as parties. Plaintiffs recently filed papers that they were ready for trial and were seeking a minimum of $4.5 million in damages and other equitable relief. Shortly thereafter, defendants' counsel was permitted to withdraw and the case was stayed to allow defendants time to retain new counsel. *Roni* is unlikely to be tried in the near future.

After the affirmance on the first appeal in *146th Street*, Ramos denied defendants' motion for indemnification in that case. In the second appeal in *146th Street*, the Appellate Division reversed, 70 A.D.3d 512 (1st Dept. 2010), holding that the fact that claims for the same alleged wrongdoing remain pending in the parallel *Roni* action did not impair defendants' entitlement to indemnification. "To make defendants wait until all of the related claims against them are resolved would eviscerate the right to indemnification." In its 2010 decision, the court declined to address whether indemnified legal expenses should include costs incurred in filing the motion or prosecuting the appeal, because the issue was not fully briefed.

On remand, Ramos denied defendants' request for legal fees incurred in the litigation seeking indemnification and referred the issue of the reasonableness of the remaining fees to a judicial hearing officer (JHO) to hear and report. The JHO found that $132,176.88 of the expenses sought was reasonable. Thereafter, Ramos reduced the award by $34,608.15, confirming $94,051.23 as the award, and denied prejudgment interest. Enforcement of the order was stayed, and another appeal followed.

Third Appeal

However, in the third *146th Street* appeal decided this August, after examining the language of New York LLC Law §420[1] and the applicable indemnification provision in the operating agreement,[2] the First Department agreed that Ramos properly denied fees on fees. The court rejected the Delaware practice, which interprets statutory language similar to Section 420 as authorizing an award of fees on fees in indemnification proceedings.

Noting the New York rule that an award of fees on fees must be based on a statute or on an agreement, the court held that the language "any and all claims and demands whatsoever" in Section 420 does not explicitly provide for an award of fees on fees and that the operating agreement did not contain unambiguous language providing for the recovery of fees on fees.

The indemnification language in LLC Law §420 is broader than the indemnification language in the law applicable to New York corporations, Business Corporation Law (BCL) §722(a) (indemnification for "attorneys' fees actually and necessarily incurred as a result of such action"). However, the result in *146th Street* was the same as in *Baker v. Health Management Systems*, 98 N.Y.2d 80, 745 N.Y.S.2d 741 (2002), where New York's highest court, the Court of Appeals, rejected fees on fees under the BCL unless there is an express agreement requiring payment of fees on fees.[3] Relying on *Baker* and other cases, the First Department held in *146th Street*: "When a party is under no legal duty to indemnify, a contract assuming that obligation must be strictly construed to avoid reading into it a duty which the parties did not intend to be assumed."[4]

The holding is a clear instruction to members of LLCs and their counsel—if you expect to be indemnified for fees on fees, say it loud and clear in the operating agreement.

1. *"Subject to the standards and restrictions, if any, set forth in its operating agreement, a limited liability company may, and shall have the power to, indemnify and hold harmless, and advance expenses to, any member, manager or other person, or any testator or intestate of such member, manager or other person, from and against any and all claims and demands whatsoever; provided, however, that no indemnification may be made to or on behalf of any member, manager or other person if a judgment or other final adjudication adverse to such member, manager or other person establishes (a) that his or her acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated or (b) that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled."*

2. *"The Company shall indemnify and hold harmless each Manager and its or his direct or indirect agents…from and against all claims and demands to the maximum extent permitted under [§420], except to the extent that such claims or demands result from the willful misconduct or gross negligence of the Manager seeking such indemnification."*

3. *In Baker, the Court of Appeals noted that the indemnification provision in the BCL is not an exclusive remedy, and corporations remain free to provide indemnification of fees on fees in bylaws, employment contracts or through insurance.*

4. *In addition, the Appellate Division (i) agreed that the lower court properly directed a reference as to the reasonable amount of attorney fees to be indemnified; (ii) affirmed denial of prejudgment interest on the fee award; and (iii) held that the court should have confirmed the JHO's report and not reduced the amount because block billing did not render the invoiced amounts per se unreasonable and the allocation of work among related cases was adequately explained.*

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