January 2013

NEW YORK LIMITS FIDUCIARY OBLIGATIONS IN LIMITED LIABILITY COMPANIES

By: JOAN M. SECOFSKY | RICHARD I. JANVEY

On November 27, 2012, the New York Court of Appeals decided *Pappas v. Tzolis*, 2012 Slip Op 08053. *Tzolis* demarcates and limits the fiduciary duties of majority members of limited liability companies to minority members in the context of a buy-out, and reiterates the Court's June 2011 holding in *Centro Empresarial Cempresa S.A. v. America Movil, S.A.B. de C.V.,* 17 N.Y.3d 269, 278 (2011). These two cases make abundantly clear the Court's hostile attitude to these types of breach of fiduciary claims absent clear language in the relevant documents preserving them and its rejection of the more flexible approach of the First Department.

Tzolis and *Centro* provide a drafting roadmap to practitioners advising clients in buy-out situations how to either open or shut the doors to a fraud or breach of fiduciary duty claim if one party discovers information that allegedly would have changed its decision had that information been known at the time of the transaction. Woe to the draftsman who uses boilerplate language without thinking through the various scenarios and potential claims.

The Facts. Plaintiffs Steve Pappas ("Pappas") and Constantine Ifantopoulos ("Ifantopoulos"), along with defendant Steve Tzolis ("Tzolis") formed defendant Vrahos LLC ("Vrahos") as a Delaware limited liability company (with an operating agreement that provided that New York law would govern) for the purpose of entering into a long term lease in 2006 on a New York City commercial building.[1] The lease required payment of a $1,192,500 security deposit to the landlord and personal guarantees to the landlord from Tzolis and Pappas. The Vrahos operating agreement provided that Tzolis would advance the $1,192,500 security deposit in return for Tzolis's right to enter into a sublease with Vrahos, conditioned on Tzolis paying additional funds to Vrahos over and above the rent that Vrahos was required to pay the landlord.

Tzolis subleased the building from Vrahos, but failed to make the additional required payments. The members' relationship was generally fraught. To resolve the situation, the parties agreed that Pappas and Ifantopoulos would be bought out by assigning their interests in Vrahos to Tzolis so that Tzolis would take over the prime lease in consideration of payment of $1 million to Pappas, $500,000 to Ifantopoulos and release by the landlord of Pappas's personal guarantee. The agreements became effective in February 2007. During the summer of 2007, Vrahos, now wholly owned by Tzolis, assigned its lease to an unrelated third party for $17.5 million. Pappas alleged that he discovered that, unknown to him and Ifantopoulos at the time of their buy-out, Tzolis already was negotiating the assignment of the lease to a third party.

The Vrahos operating agreement provided in Paragraph 11 that any member of Vrahos "may engage in business ventures and investments of any nature whatsoever, whether or not in competition with [Vrahos] without obligation of any kind to [Vrahos] or to the other members." The assignment documents for the buy-out contained an executed Certificate that also purported to eliminate any fiduciary duty of Tzolis to the other two. The Certificate provided that the plaintiffs/sellers had "performed their own due diligence in connection with [the] assignments . . . engaged [their] own legal counsel, and [were] not relying on any representations by Steve Tzolis or any of his agents or representatives, except as set forth [in the documents] … and agrees that Steve Tzolis has no fiduciary duty to the undersigned Sellers in connection with such assignments."

The Complaint. Pappas and Ifantopoulos, individually and on behalf of Vrahos, commenced an action against Tzolis and Vrahos in Supreme Court New York County, Index No. 601115/09, in 2009.[2]

The complaint alleged ten causes of action against Tzolis: breach of fiduciary duty, misappropriation of a business opportunity of Vrahos, breach of contract and of the implied covenant of good faith and fair dealing, conversion, unjust enrichment, rescission and a declaratory judgment setting aside plaintiffs' assignments and forfeiting Tzolis interest in Vrahos, equitable accounting, imposition of a constructive trust, tortious interference and fraud and misrepresentation. The final claim was brought derivatively and asserted that Tzolis breached his fiduciary duty to Vrahos.

The Motion to Dismiss. Prior to answering, Tzolis moved to dismiss the complaint in its entirety. In a March 2010 decision, Judicial Hearing Officer Ira Gammerman held that Paragraph 11 of the operating agreement "eliminates the fiduciary relationship that would, otherwise, be owed by the members to each other and to [Vrahos] …" He granted the motion and dismissed the complaint.

The Intermediate Appeal. In a September 2011 three to two decision, the First Department reversed dismissal as to the breach of fiduciary duty, conversion, unjust enrichment and fraud and misrepresentation claims.[3] The Court held, whether under New York or Delaware law, that plaintiffs adequately alleged that Tzolis breached a fiduciary duty "to keep them informed of any and all opportunities" that he was pursuing on behalf of Vrahos:

> Paragraph 11 … may have permitted Tzolis to pursue a business opportunity unrelated to Vrahos, for his exclusive benefit, without having to disclose it to plaintiffs or otherwise present it first to Vrahos. However, we find that the provision does not "clearly" permit Tzolis to engage in behavior such as that alleged here, which was to surreptitiously engineer the lucrative sale of the *sole asset owned by Vrahos,* without informing his fellow owners of that entity. … we find that Tzolis failed to meet his burden of establishing that the provision extended that far.

As to the Certificate signed in connection with the buy-out acknowledging that Tzolis owed them no fiduciary duties, the court, relying on its earlier decision in *Blue Chip Emerald v. Allied Partners*, 299 A.D.2d 278 (1st Dep't 2002), held that it was "compelled to act with the same uncompromising rigidity" in finding that Tzolis "had an overriding duty to disclose his dealing with [the third party] to plaintiffs before they assigned their interests" to him.

The dissent argued that *Centro, supra,* required dismissal of the remaining claims. The disclaimer in the Certificate, according to the dissenters, "was tantamount to a release from all claims against Tzolis in connection with the assignment that were premised on his fiduciary duty to plaintiffs."

The Court of Appeals. The Appellate Division granted Tzolis leave to appeal to the Court of Appeals. The Court heard argument October 17 and reversed on November 27, 2012. The unanimous and relatively brief opinion relied extensively on its *Centro* decision. The Court held:

> Where a principal and fiduciary are sophisticated entities and their relationship is not one of trust, the principal cannot reasonably rely on the fiduciary without making additional inquiry. … The test, in essence, is whether, given the nature of the parties' relationship at the time of the release, the principal is aware of information about the fiduciary that would make reliance on the fiduciary unreasonable. … [P]laintiffs were in a position to make a reasoned judgment about whether to agree to the sale of their interests to Tzolis. The need to use care to reach an independent assessment of the value of the lease should have been obvious to plaintiffs, given that Tzolis offered to buy their interests for 20 times what they had paid for them just a year earlier.

Because plaintiffs were sophisticated businesspeople represented by counsel and were in a position to make a reasoned judgment about whether to sell to Tzolis, and the relationship among the members at the time of the buy-out was already antagonistic, reliance on Tzolis's representations as a fiduciary would not have been reasonable. Therefore, the Court held the release contained in the Certificate was valid and dismissed the breach of fiduciary duty claim.

The Court also dismissed the fraud and misrepresentation claim based on the Certificate: "[W]hile it is true that a party that releases a fraud claim may later challenge that release as fraudulently induced it if alleges a fraud separate from any contemplated by the release, plaintiffs do not allege that the release was itself induced by any action separate from the alleged fraud consisting of Tzolis's failure to disclose his negotiations to sell the lease."[4]

The *Centro* Decision. Because the Court in *Tzolis* essentially reiterated its decision in *Centro*, it is worthwhile to revisit that case. Plaintiffs were minority shareholders in a closely held telecommunications company indirectly owned by Mexican financier Carlos Slim. Essentially, plaintiffs claimed that they sold their minority interest for much less than it was worth because defendants failed to provide them with accurate tax and financial statements and were unwilling to negotiate with them in good faith. They sought damages in excess of $900 million.

The "Members Release" that plaintiffs in *Centro* executed in connection with the sale was extremely broad, releasing the buyers and their agents from all actions "arising out of, based upon, attributable to or resulting from the ownership of membership interests in [the entity] or having taken or failed to take any action in any capacity on behalf of [the entity or in connection with the entity's business]."[5] Based on the Release, defendants unsuccessfully moved to dismiss the complaint before answer.

On appeal, the First Department reversed in a three to two decision based on the Release and dismissed the case. Plaintiffs appealed to the Court of Appeals which affirmed.

Preliminarily, the Court held that the broad language of the Members Release "indicates an intent to release defendants from fraud claims, like this one, unknown at the time of contract." Therefore, plaintiffs were estopped from arguing that defendants fraudulently misled them regarding the value of their ownership interests "unless the release was itself induced by a separate fraud," which plaintiffs did not allege.

Although recognizing that the defendant majority shareholder owed a fiduciary duty to the plaintiff minority shareholders, "A sophisticated principal is able to release its fiduciary from claims—at least where, as here, the fiduciary relationship is no longer one of unquestioning trust—so long as the principal understands that the fiduciary is acting in its own interest and the release is knowingly entered into." The Court, referencing three earlier First Department decisions (including *Blue Chip*, *supra*, which the First Department relied on in *Tzolis*), wrote that to the extent those cases suggested that a fiduciary has an obligation to come forward and confess to all his wrongful acts to have a valid, enforceable settlement, those cases "misapprehend our case law." Plaintiffs, "as sophisticated entities, … negotiated and executed an extraordinary broad release with their eyes wide open. They cannot now invalidate that release by claiming ignorance of the depth of their fiduciary's misconduct."

In addition to failing to allege that the Members Release was induced by a separate fraud, the Court further held that plaintiffs' claims were properly dismissed because they failed to allege the standard fraud pleading requirement that they justifiably relied on defendants' fraudulent statements in executing the Members Release. While the Court agreed that in certain (not described) circumstances, a fiduciary's disclosure obligation might be the equivalent of a written representation that there were no undisclosed material facts, "Where a principal and fiduciary are sophisticated parties engaged in negotiations to terminate their relationship, however, the principal cannot blindly trust the fiduciary's assertions. This is particularly true where, as alleged here, the principal has actual knowledge that its fiduciary is not being entirely forthright."

The Take-Away. All New York courts—including federal courts interpreting parties' obligations in transactions subject to New York law—are constrained to follow the Court of Appeals' interpretation of fiduciary obligations as set forth in *Centro* and *Tzolis*. That means that the language in operating agreements regarding fiduciary duties and releases and the representations and warranties and release sections in purchase and sale agreements or assignments must clearly set forth exactly what are the fiduciary obligations, if any, between the parties, and what will be the effect if one of the parties allegedly discovers a breach after the fact. Since in the normal course, one side will want to close off all remedies upon closing, and the other will try to keep its options open, the scope of these clauses may be the subject of intense negotiation. But, it is no longer reasonable to assume—if it ever was—that ambiguity in the drafting combined with overreaching by the majority will be interpreted in favor of the minority.

[1] Interestingly, although the lower and intermediate courts stated that it was irrelevant to the decision whether Delaware or New York law applied, the Court of Appeals never referenced the choice of law issue.

[2] In an unrelated case involving Steve Tzolis and a different limited liability company, *Tzolis v. Wolff*, 10 N.Y.3d 100 (2008), the Court of Appeals held that limited liability company members have the right to bring derivative suits on behalf of the limited liability company, even though the applicable New York law did not specifically authorize such suits; "We base our 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 this remedy when it passed the Limited Liability Company Law in 2009."

[3] As to the derivative count, the court held that plaintiffs had standing to assert the claim because their assignments of their interests in Vrahos may be voidable, but the claim was correctly dismissed on the merits, "since it was contradicted both by other allegations in the complaint and by the documentary evidence, which shows that Vrahos received $17,500,000 from the assignment of its lease."

[4] The Court dismissed the remaining conversion and unjust enrichment claims because plaintiffs failed to allege the elements of these common law claims. Because Tzolis had purchased plaintiffs' interests in Vrahos, he could not have interfered with their property rights. Because the doctrine of unjust enrichment only applies in the absence of an actual agreement, and the sale of Vrahos was based on both the operating agreement and the documents relating to the sale, the unjust enrichment claim failed as a matter of law.

[5] The parties also signed a "Master Release" which provided that the "release shall not release any claims involving fraud," but the Court determined that the dispute at issue was governed by the Members Release.

Richard I. Janvey, Partner, is a business advisor, mediator and litigator involved in commercial, inter- and intra-company disputes and internal investigations. Richard has completed numerous mediation programs, including the Program on Negotiation at Harvard Law School's Mediation Workshop. Rjanvey@diamondmccarthy.com

Joan M. Secofsky, Senior Counsel, focuses on corporate and securities litigation, arbitration and mediation. Jsecofsky@diamondmccarthy.com

Both are based in the New York office:

DIAMOND MCCARTHY LLP

620 Eighth Avenue (between 40th & 41st Streets), 39th Floor, New York, NY 10018
Phone: (212) 430-5400 Fax: (212) 430-5499