To Be Argued By:
JAMES M. FELIX

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New York Supreme Court

APPELLATE DIVISION—FIRST DEPARTMENT

ROBERT SHAPIRO,

Plaintiff-Appellant,

—against—

GABRIEL ETTENSON and DAVID NEWMAN,

Defendants-Respondents.

REPLY BRIEF FOR PLAINTIFF-APPELLANT

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PRELIMINARY STATEMENT

Plaintiff-Appellant Robert Shapiro ("Shapiro") submits this Reply Brief in further support of his appeal from the Decision, Order and Judgment dated August 16, 2015 and entered September 2, 2015 granting summary judgment to Defendants-Respondents David Newman ("Newman") and Gabriel Ettenson ("Ettenson") (RA 9), and in response to the Brief for Defendants-Respondents ("Resp. Br.").

Under Respondents' reasoning, immediately upon the filing of articles of organization for a limited liability company ("LLC") without the parties having first signed a written operating agreement, (1) a mere majority in interest of the owners can adopt an operating agreement binding upon all owners without ever discussing, presenting or negotiating it with the other owners and (2) the verbal agreement pursuant to which all of the owners joined together in the LLC, and purportedly acquired their interests, is entirely irrelevant and unenforceable so that the operating agreement adopted by the majority does not need to be consistent with that agreement. In this case of first impression, that cannot be the law.

LEGAL ARGUMENT

I. IN THE ABSENCE OF AN OPERATING AGREEMENT, THE FORMATIVE AGREEMENT FOR THE LLC REMAINS RELEVANT. THE TERMS OF THAT AGREEMENT WERE DISPUTED AND SUMMARY JUDGMENT SHOULD HAVE BEEN DENIED

For all of its 45 pages, Respondents' Brief does not address the central issue that the provisions of the New York Limited Liability Company Law ("LLC Law") are predicted upon and assume the existence of an operating agreement and compliance with the statutory mandate to have an operating agreement. In the absence of an operating agreement, the relevant agreement must remain the formative agreement pursuant to which the individuals claiming to be members joined together to form the LLC. If not for that agreement, how do any of the individuals have the right to claim an ownership interest in the LLC?

Here, Respondents claim that they and Appellant "have been the only members of the Company, and each has been an equal one-third member of the Company, with equal one-third management rights and rights to one-third of the profits of the Company." (Resp. Br. at 6). Pursuant to what agreement? It can only be the verbal agreement between them prior to formation.

Similarly, Respondents argue that they became "members" when ENS Health was formed by the filing of the original articles of organization (Resp. Br. at 29).

But, the only person mentioned in the articles of organization is Appellant. What was the agreement pursuant to which Respondents allegedly became "members"? It can only be the parties' verbal agreement.

According to Appellant, the parties agreed to form an LLC, with each of them as equal owners acting unanimously on all material decisions and member-managed. Respondents, incongruously, claim the benefit of half of that agreement (to make them equal owners) but claim the other half of that agreement (acting unanimously, member-managed, which they dispute) is irrelevant and unenforceable. Respondents cannot have it both ways.[1]

In disregarding the disputed terms of this verbal agreement, the lower court held that this verbal agreement was an "unenforceable oral agreement" citing but one case, Harris v. Seward Park Hous. Corp. 79 A.D. 3d 425 (1st Dept. 2010), a non-LLC case where there was no agreement reached (RA 23). Here, there is no dispute that an agreement was reached; it is just that the lower court did not give a reason why the parties' verbal agreement here was unenforceable.

[1] Respondents erroneously assert that Appellant has abandoned his challenge to their amendment of the articles of organization changing ENS Health from member-managed to manager-managed (Resp. Br. at 1 n.1). The change is contrary to the parties' formative agreement and this appeal challenges their act by majority decision. Appellants' Brief challenges the change in the challenged Operating Agreement. (App. Br. at 16).

Respondents suggest that the parties' formative agreement is not enforceable because it "was never reduced to writing." (Resp. Br. at 19). However, Respondents' Answer (RA 67) does not assert the Statute of Frauds as a defense. Further, if the verbal agreement is not enforceable, what is the basis for the Respondents' claim that they are equal owners with equal management rights and entitlement to two-thirds of the profits?

Respondents also suggest that the verbal formative agreement is not enforceable as an operating agreement because an operating agreement must be in writing (Resp. Br. at 19). But, Appellant does not claim that the parties' verbal agreement is an operating agreement.[2]

The case of Bobrow v. Liebman, 839 N.Y.S. 2d 431, 2007 WL 1139417 (Sup. Ct. N.Y. Co. 2007), cited by Respondents at page 27 fn. 13 of their Brief, demonstrates the continued relevance of the parties' verbal agreement upon which they joined together to form the LLC. There, the court held that the plaintiff could not be required to sign an operating agreement which did not reflect the agreement pursuant to which she joined, invested her money in the LLC, and was promised a 10% interest. Otherwise, the court noted "employing Defendants' reasoning, they

[2] In other jurisdictions, and under the Revised Uniform Limited Liability Company Act (Section 102(13)) an LLC operating agreement may be oral.

could have drafted an agreement stating that Plaintiff has a 2% interest, and Plaintiff would not have recourse for refusal to sign." 2007 WL 1139417 at *14 n. 6.

Respondents have the temerity to assert that Appellant "chose to become a member of a Company formed under the LLC Laws, and he chose to do so without bargaining for rights different than the default, majority-rules provisions of the LLC Law." (Resp. Br. at 27 n. 14). See also Resp. Br. at 36 ("a member is free to negotiate the terms of his participation in an LLC at the time of his decision to enter into it"). First, Appellant was the sole organizer of ENS Health, and, therefore, its sole member according to the articles of organization, LLC Law, §203 (b) and (c). It is the parties' verbal agreement that made Respondents owners. Second, Appellant did bargain for his rights and negotiate the terms of his participation in ENS. That bargain is the parties' verbal agreement, the terms of which are disputed and which necessitated the denial of Respondents' motion for summary judgment.

II. THE INITIAL OPERATING AGREEMENT CANNOT BE VALIDLY ADOPTED BY A MERE MAJORITY IN INTERESTS

The lower court opinion, and Respondents' Brief, are premised entirely upon the erroneous assertion that, in the absence of any written operating agreement, the default provisions of the LLC Law apply. Respondents' Brief claims that there is a "legion of case law" so holding. (Resp. Br. at 30). In fact, neither the lower court nor the Respondents cited any.

Appellant's Brief pointed out that the only two LLC cases cited by the lower court (Matter of 1545 Ocean Ave., LLC, 72 A.D. 3d 121 (2d Dept. 2010) and Matter of Spires v. Lighthouse Solutions, LLC, 4 Misc. 3d 428 (Sup. Ct. Monroe Co. 2004)) both involved situations where there was an operating agreement, the operating agreement did not address a certain topic and the relevant LLC Law provision applied by default. These two cases are examples of the numerous holdings that the default provisions of the LLC Law apply when the operating agreement already adopted by the parties does not address the topic.

Every one of the cases cited by Respondents in support of their assertion that the default provisions of the LLC Law apply in the absence of any written operating agreement, actually all involved situations where there was an operating agreement. (See Resp. Br. at 20-21, 28). In Spires, there was an operating agreement. In Ross v. Nelson, 54 A.D. 3d 258 (1st Dept. 2008), there was an operating agreement. In In re 1545 Ocean Ave., there was an operating agreement. In Manitares v. Beusman, 56 A.D. 3d 735 (2d Dept. 2008), there was an operating agreement. In Man Choi Chiu v. Chiu, 71 A.D. 3d 646 (2d Dept. 2010), there was an operating agreement. In Overhoff v. Scarp, Inc., 812 N.Y.S.2d 809 (Sup. Ct. Erie Co. 2015), there was an operating agreement.

Thus, no court has held that in the absence of any written operating agreement, Section 402 (c)(3) of the LLC Law operates by default and allows a mere majority

of ownership interests to adopt the initial operating agreement binding upon all owners. This, too, is an issue of first impression.

For the purposes of the LLC Law, and for Section 402(c)(3), a "member" is defined as:

> a person who has been admitted as a member of a limited liability company in accordance with the terms and provisions of this chapter and the operating agreement and has a membership interest in a limited liability company with the rights, obligations, preferences and limitations specified under this chapter and the operating agreement

LLC Law, §102 (q.) (emphasis added).

Thus, to be a "majority in interest of the members" under the meaning of LLC Law, §402 (c) (3), the persons must already have been admitted in accordance with "the operating agreement." (emphasis added). Section 402 (c)(3) assumes that an initial operating agreement has already been adopted (as required by Section 417 (a)). To read Section 402 (c)(3) as applying to the initial operating agreement means ignoring the very definition of "member" in Section 102 (q) for the purposes of the statutory provisions.[3]

[3] Respondents erroneously assert that Appellant is seeking to re-write the statute. Not so. This Court must apply well-settled principles of statutory construction to interpreting the statute, including that "a court must consider a statute as a whole, reading and construing all parts of an act together to determine legislative intent" and "where possible, should harmonize all parts of a statute with each other…" See McKinney's Consolidated Laws of N.Y., Book 1, Statutes §§97 and 98; Lewis Family Farm, Inc. v. Adirondack Park Agency, 22 Misc. 3d 568 (Sup. Ct. Essex Co. 2008).

Appellant's Brief noted that because Section 402 (c) starts off with the phrase "Except as otherwise provided in the operating agreement," it clearly assumes the existence of the initial operating agreement. It is specific to "the operating agreement" for the LLC. Respondents first argue that Section 402 (c) cannot be interpreted to assume the existence of an operating agreement because of the "legion of case law holding that the default provisions of the LLC law apply in the absence of a written operating agreement." Resp. Br. at 30. However, as shown above, this simply is not true. Respondents have not cited any case so holding. In addition, Respondents assert that this interpretation "contradicts the definition of "except" which includes "other than." Resp. Br. at 30. But, this is of no help to them, as the phrase would then simply read "Other than as provided in the operating agreement."

If Respondents' reasoning was adopted, the LLC Law majority default rules would apply as soon as the ENS Health articles of organization were filed and there was no operating agreement in place, so that immediately after formation Newman and Ettenson could have adopted the Operating Agreement here without even the need to consult with or present it to Appellant.

For example, the statute specifically contemplates that the operating agreement will be entered into before, at or "within ninety days after the filing of the

articles of organization". LLC Law Section 417 (c).[4] Under Respondents' analysis, during this 90 day period, the majority in interest of persons purporting to be members can adopt the initial operating agreement binding upon everyone, with no further discussions. That cannot be the result. Under this analysis, since the default majority-rules "kicks in" as soon as the articles of organization were filed, why would the majority ever relinquish their control to a unanimous vote? It can only be that the initial operating agreement must be adopted by all initial members and that it is they who, in the operating agreement, provide for unanimity, majority or some other governing rule.

Respondents do not dispute that:

1. The Operating Agreement they adopted was never presented to or discussed with Appellant, and was materially different and more onerous than the version they had been negotiating and had last sent to Appellant for his review;

2. In their December 2, 2013 re-draft (the only draft of an operating agreement they sent to Appellant), they had agreed that unanimous approval

[4] Respondents assert that this means that if the operating agreement is adopted within the window of 90 days, then it may be deemed effective as of the formation date of the company. (Resp. Br. at 25-26). However, Section 417 (c) provides that "Regardless of whether such agreement was entered into before, at the time of or after such filing, such agreement may be effective upon the formation of the limited liability company…" The "after" filing is not limited to the 90 day period.

would be required for a litany of actions, including additional capital calls and salary decisions. Respondents simply state they decided not to sign that agreement; and

3. They did not wait for Appellant to return from vacation the following week to retain independent counsel to review and advise him on their December 2, 2013 re-draft.

Without disputing the detailed negotiating history and that there was a "meeting of the minds" on the matters requiring a unanimous vote, Respondents simply contend that "whatever was discussed" or even agreed to prior to their adoption of materially different and more onerous operating agreement on December 13, 2013 "is ultimately irrelevant." (Resp. Br. at 9-10 n.5).

But, these facts are not irrelevant to this Court's consideration of whether to adopt Respondents' interpretation of the statute so as to allow a mere majority of ownership interests in an LLC to adopt an initial operating agreement immediately upon the filing of the articles of organization. These facts are not irrelevant to the Court's determination of whether to adopt as law Respondents' position that this majority of ownership interests has no obligation whatsoever to present, discuss or negotiate the terms of the initial operating agreement with the other owners.

These facts are not irrelevant in determining whether, by their conduct, Newman and Ettenson breached their fiduciary duty to Appellant. Contrary to

Respondents' Brief at 44 n. 17, Ettenson and Newman each owed Appellant a fiduciary duty. Jones v. Voskresenskaya, 125 A.D. 3d 532 (1st Dept. 2015). Since Appellant argues that Respondents breached their fiduciary duty by "impos[ing] upon Shapiro an initial Operating Agreement which was materially different from the one they had last prepared and were negotiating, and to do so in response to Shapiro's notice that he would obtain independent counsel" (App. Br. at 23), Appellant does not understand Respondents' assertion that he has not identified "any actual breaches of fiduciary duties." Resp. Br. at 44.

Just one example will suffice of the danger of adopting Respondents' position. The Operating Agreement they adopted contained provisions for the expulsion of a member (Sections 13.03 and 13.04), when the LLC Law does not provide for expulsion. Thus, they argue that immediately after the formation of ENS, they could adopt provisions expelling Appellant and confiscating his capital contribution, even though he never agreed to that.

III. THE CAPITAL CALL PROVISION OF THE OPERATING AGREEMENT WAS NOT VALIDLY ADOPTED, AS IT INCREASED SHAPIRO'S OBLIGATION TO MAKE A CONTRIBUTION WITHOUT HIS CONSENT, AND THE OCTOBER 2014 CAPITAL CALL REQUIRING SHAPIRO TO MAKE AN ADDITIONAL CONTRIBUTION OR SUFFER DILUTION WAS IN CONTRAVENTION OF SECTION 7.01 OF THE OPERATING AGREMENT

The lower court found that the Capital Call was authorized by Section 7.01 of the Operating Agreement adopted by Respondents on December 13, 2013 (RA 21). But, if the Operating Agreement was not validly adopted, then there was no basis for the Capital Call. The LLC Law does not authorize additional capital calls without consent.

Respondents repeat the lower court's observation that the Capital Call was not obligatory or required, but merely voluntary (Resp. Br. at 34). However, the Capital Call itself threatened Appellant with dilution of his interest if he did not make the contribution. It declared that "upon the failure of any Member to provide all or part of his proportionate share of such additional Capital Contribution," his participation interest shall be reduced proportionally (RA 232, 233). This threat demonstrates that the Capital Call was required, violating Section 7.01 itself ("No Member shall be required to make Capital Contributions to the Company…)

Finally, Respondents do not dispute that in the only draft of an Operating Agreement they presented to Appellant (their December 2, 2013 draft) they agreed that additional capital calls would require a unanimous vote.

Respondents do not dispute that Section 417(b) of the LLC Law does not permit an amendment to the operating agreement requiring a member to make additional capital contributions unless the member assents to such an amendment. They merely argue that Section 417(b) only applies to amendments. But, that is because Section 417(b) already assumes the existence of an operating agreement. In light of Section 417(b), it makes no sense to allow Respondents, immediately upon ENS' formation by the filing of its articles of organization, to adopt an Operating Agreement requiring Appellant to make additional capital contributions to which he never assented.

IV. THE OCTOBER 2014 SALARY ACTION BY NEWMAN AND ETTENSON VIOLATED SECTION 9.01 OF THE OPERATING AGREEMENT AND SECTION 411 OF THE LLC LAW

The lower court found that the October 2014 salary action by Respondents as managers, whereby they cancelled Appellant's salary and continued to pay themselves salary, was permitted by Section 411(e) of the LLC Law, which states

that "Unless otherwise provided in the operating agreement, the managers shall have authority to fix the compensation of manager for services in any capacity."[5]

But, the Operating Agreement adopted by Respondents (if valid) does provide otherwise. It states in Section 9.01 that "No compensation shall be paid to the Managers for their services in arranging transactions contemplated by the Company and managing the Company." That "compensation" includes salary and there is nothing in the record to refute that. The lower court simply and erroneously interpreted the word "compensation" to not include salary. Although Section 9.01 is captioned "Management Fees," it prohibits any "compensation" for "managing the Company." There is, likewise, nothing in the record upon which the lower court could discern what was meant by the caption "management fees" or whether it was intended to be narrower than all "compensation." There was simply no factual basis for the lower court to interpret the word "compensation" as not including salary.

Also, Respondents do not dispute that in the only draft of an Operating Agreement to Appellant (their December 2, 2013 draft) they agreed that the salary decisions would require a unanimous vote.

Finally, Respondents became managers when no agreement existed to pay managers a salary. Accordingly, each of the Respondents were interested parties on

[5] Appellant does not understand Respondents' assertion that salary decisions do not "fall within the ambit of §411." (Resp. Br. at 39). See §411(e).

the vote to pay themselves salaries as managers and could not receive a majority vote of disinterested managers, in violation of Section 411 of the LLC Law.

CONCLUSION

For all of the reasons set forth above, the Decision, Order and Judgment granting summary judgment to Defendants-Respondents should be reversed and vacated.

Dated: October 20, 2016

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