To Be Submitted By:
LARRY E. RIBSTEIN, ESQ.

Court of Appeals

STATE OF NEW YORK

RONI LLC, ESHEL PROPERTIES, LLC, GILI HOLDINGS, LLC, and KRR INVESTMENTS, LLC, Assignees, and A.G. DOR INVESTMENTS, LLC, BANAGA LLC, MORDECHAI GOLDENBERG, ELORY LLC, ELUNGER, INC., HOD INTERNATIONAL EQUITES LLC, JOSSIFOFF LLC, KALINA & SONS LLC, KARSH N. DYAZ LLC, LYDGAT, LLC, MAZELDIK LLC, RISING STAR, LLC, ROKCOM LLC, S.I. DAR LLC, SBGR LLC, SINTRA REAL-ESTATE LLC, TAMR LLC, TATIVA FINANCE LTD., WASTED DREAMS, LLC, YALI, LLC, YORAM BAUMANN, LLC, ELI UNGER, JEOSHUA DOR, EREZ ZENOV, NIR KRIEL, EYAL SCHIFF, OVED SASON, AZARIA JOSSIFOFF, URI KALINA, ZVI KARSH, RON BAHAT, YEHUDA KEREN, JACOB PERRY, SHALOM PAPIR, RAFI RACHMAN, AMOS LASKER, ELI MOR, YORAM DAR, SHLOMO MASHAIACH, EYTAN STIBBE, RON GUTTMAN, PNINA GOLDBERG, SHUKI WEISS, ILAN CALIC, and YORAM BAUMANN, as Assignors,

Plaintiffs-Respondents,

-against-

RACHEL L. ARFA, ALEXANDER SHPIGEL, AMERICAN ELITE PROPERTIES, INC., and LAWRENCE A. MANDELKER, in his Official capacity as Court-Appointed Temporary Receiver, pursuant to CPLR Art. 64 of HARLEM HOLDINGS, LLC,

Defendants-Appellants,

GADI ZAMIR, HARLEM ACQUISITION LLC, MINTZ LEVIN COHN FERRIS GLOVSKY & POPEO, P.C., JEFFREY A. MOERDLER, EDWARD LUKASHOK, AUBREY REALTY CO., AUBREY REALTY, LLC, 42ND STREET REALTY, LLC, TAMMAZ REALTY, LLC, and ELUL ACQUISITION, LLC,

Defendants.

BRIEF FOR *AMICUS CURIAE*

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I submit this Amicus Curiae Brief in support of the appeal of Defendants-Appellants Rachel L. Arfa, Alexander Shpigel, and American Elite Properties, Inc. (collectively, "Appellants").

INTERESTS OF PROFESSOR RIBSTEIN

I am the Mildred van Voorhis Jones Chair and Associate Dean for Research at the University of Illinois College of Law. I have written approximately 170 articles and 10 books on a wide range of scholarly and practice-oriented subjects. My background is as an expert in business law generally and the law of unincorporated business associations in particular gives me a unique level of knowledge and expertise that is useful in analyzing a case of first impression such as the one before the Court. My writings have been widely recognized by courts and scholars. *Ribstein & Keatinge on Limited Liability Companies* and *Bromberg & Ribstein on Partnerships* have been cited in more than 240 cases, including by the highest courts in more than half the states, eight federal appeals courts and the U.S. Supreme Court. *Bromberg & Ribstein* has been cited three times by this Court. *See Eurycleia Partners, LP v. Seward & Kissel, LLP,* 12 N.Y.3d 553, 910 N.E.2d 976, 883 N.Y.S.2d 147 (2009), *Dawson v. White & Case,* 88 N.Y.2d 666, 672 N.E.2d 589, 649 N.Y.S.2d 364 (1996); *People v. Zinke,* 76 N.Y.2d 8, 555 N.E.2d 263, 556 N.Y.S.2d 11 (1990). In *Tzolis v. Wolff*, 10 N.Y.3d 100, 855 N.Y.S.2d 6 (2008), three members of this Court referred to me as "[t]he co-author

of the major treatise on limited liability companies." According to a widely recognized scholarly impact study published in 2010,[1] I am third among all U.S. corporate and securities law professors in citations in law journals.

I have also been actively involved in law drafting and reform in the area of unincorporated business entities. I am a past Chair of the Association of American Law Schools Section on Agency, Partnership and LLCs, a member of the Institute of Illinois Business Law, the American Bar Association, Section on Business Law, Committee on Partnerships and Unincorporated Business Organizations, and Ad Hoc Subcommittees on Revised Uniform Partnership Act and Limited Liability Companies, and Working Groups on Prototype LLC Act and Prototype Registered Limited Liability Partnership Statute. I was the Reporter for the original Prototype LLC Act. I also participated in the drafting of the Revised Uniform Partnership Act as an Official Advisor to the Drafting Committee to Revise the Uniform Partnership Act, National Conference of Commissioners on Uniform State Laws.

Thus, I am uniquely qualified to identify law or arguments that might otherwise escape the Court's consideration and to be of assistance to the Court in its consideration of the issue of first impression being addressed in this appeal relating to the fiduciary duties, if any, owed by organizers of New York limited liability companies to the prospective investors they solicit.

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[1] http://www.leiterrankings.com/new/2010_scholarlyimpact.shtml.

ARGUMENT

ORGANIZERS OF AN LLC OWE NO FIDUCIARY DUTIES OF DISCLOSURE TO INVESTORS THEY SOLICIT TO BE MEMBERS OF THE LLC

The Appellate Division held in this case that Appellants, in connection with the sale of membership interests in real estate LLCs, had an affirmative duty as the LLCs' organizers to disclose that they received commissions from the sellers in acquiring these buildings. This holding is unprecedented in the law of LLCs, is not supported by other law, and is contrary to sound policy. This brief does not address other issues in this case, including whether a fiduciary duty of disclosure might be supported on some other theory or preempted by the Martin Act.

I. The New York LLC Law Does Not Support a Pre-Formation Fiduciary Duty of Disclosure by Organizers of LLCs.

The Appellate Division's holding in favor of a fiduciary duty of disclosure of organizers of LLCs is unprecedented in the law of LLCs.

It is important to note at the outset that there is no general duty affirmatively to disclose all material facts to parties with whom one is dealing. *See generally* Keeton, *Fraud-Concealment and Nondisclosur*e, 15 Tex. L. Rev. 1. (1936). Liability generally is limited to affirmative misrepresentations. The traditional rule is stated by Lord Cairns in *Peek v. Gurney*, (1893) L.R. 6 H.L. 377, 403: "[t]here must, in my opinion, be some active misstatement of fact, or, at all events, such a partial and fragmentary statement of fact that the withholding of that which is not

stated makes that which is stated absolutely false." In other words, in the general run of transactions, parties have only the duty not to lie. As discussed further below, this rule is based on sound policy considerations based on the need to define the scope of any duty of affirmative disclosure.

An important exception to the rule against liability for failure to make affirmative disclosures is the existence of a fiduciary relationship. The fiduciary duty of unselfish conduct, which differs sharply from standards prevailing in ordinary arms'-length transactions, arises only in certain situations where a party delegates to another the power to act on his or her behalf. *See generally* Larry E. Ribstein, *Are Partners Fiduciaries?* 2005 Illinois L. Rev. 209. In this situation, it is reasonable to require the fiduciary to share information acquired on behalf of the beneficiary, and to provide facts that would enable the beneficiary to evaluate the quality of the fiduciary's management.

In the present case, any duty to disclose must be based on the existence of a fiduciary relationship. The Appellate Division here held that no fiduciary duty could be based on the parties' business or personal relationship. The sole basis of the Appellate Division's imposition of a fiduciary duty to disclose was its conclusion that "the organizer of a limited liability company is a fiduciary of the investors it solicits to become members." *Roni LLC v. Arfa*, 74 A.D. 3d 442, 445, 903 N.Y.S.2d 352, 355 (1st Dep't 2010).

The Appellate Division relied on Section 203 of the New York Limited Liability Company Law as the source of organizers' fiduciary duties. However, this section provides no authority for fiduciary duties of organizers. The purpose of this section's reference to "organizers" is to clarify who may perform the technical act of filing necessary to bring an LLC into formal existence under the Limited Liability Company Law, and specifically that these people need not be members. *See id.* §203(b). The organizer has no statutory function in establishing or organizing the *business* of the LLC. Not only does this section itself not provide for fiduciary duties, but the functions that the section provides for organizers do not include the delegation of control over the business, or indeed any other functions, necessary for the existence of fiduciary duties.

The Limited Liability Company Law provides other reasons for refusing to recognize fiduciary duties of organizers. Section 409 provides only for duties of Managers, including Managing Members. Section 401 provides for management by members unless the articles of organization provide for management by Managers. Section 102(p) defines a "Manager" as "a person designated by the members to manage the limited liability company as provided in the operating agreement." Section 102(u) defines the "operating agreement" as a written agreement complying with Section 417. Under Section 417(c), an operating agreement is not effective prior to formation, an event which does not occur

pursuant to Section 203(d), at least until filing of the initial articles of organization. In short, the sole persons having fiduciary duties under the Limited Liability Company Law are Managers or Managing Members who may or may not also serve as organizers. This focus on people with management power is consistent with the basis of fiduciary duties discussed above.

There is accordingly no basis in the Limited Liability Company Law for fiduciary duties of organizers or for any pre-formation fiduciary duties. This makes sense, since an LLC that has not even been formed obviously can provide no basis for a contractual or other form of legal relationship that could give rise to a fiduciary duty. If a fiduciary duty exists during this period it must be on the basis of some other relationship between the parties. Yet the Appellate Division found no such relationship.

Not only does the New York statute fail to recognize a pre-formation duty of organizers, but I am unaware of *any* case anywhere in the country other than the Appellate Division's decision in this case recognizing such a duty in limited liability companies based on my exhaustive research for my LLC treatise over almost two decades. *See Ribstein & Keatinge on Limited Liability Companies* §9:5 n.42.

II. Partnership Law Does Not Support Pre-Formation Fiduciary Duties.

If courts are to recognize any pre-formation fiduciary duty to disclose it would have to be by analogy from business entities other than LLCs. These analogies should be drawn carefully because, as discussed further below, the LLC has evolved as a unique entity, sharing some features of but ultimately distinct from all other business entities. *See generally*, Larry E. Ribstein, *Rise of the Uncorporation* ch. 6 (2010).

One possible analogy to LLCs is the law of partnership. However, New York Partnership Law Section 42 (Uniform Partnership Act Section 20) does not support a pre-formation duty to disclose since it provides only for duties of "partners" to render information of matters "affecting the partnership." Section 43 of the Partnership Law 43 (U.P.A. §21) does refer to a *duty to account* in partnerships that have been brought into existence for profits derived from transactions "connected with the *formation*, conduct, or liquidation of the partnership" (emphasis added). However, this section provides no basis for a pre-formation duty to disclose. Rather, it provides only for a *duty to account* in partnerships that *have* been formed. The Colorado version of the Revised Uniform Partnership Act clarifies this point by providing that "[i]f a partnership is formed, the duties a partner owes to the partnership and the other partners pertain to all

transactions connected with the formation, conduct, or liquidation of the partnership." Colo. Stat. § 7-64-404.

The case law under the U.P.A. does not support a general partnership-based fiduciary duty of disclosure prior to the formation of the *partnership* (as distinguished from a duty that may arise after the formation of the partnership relationship while the business is being set up). *See* A. Bromberg & L. Ribstein, *Bromberg & Ribstein on Partnership*, §§ 6.06 & 6.07(a)(7). As noted above, prior to the existence of a fiduciary relationship the parties normally deal with each other at arms' length, subject only to the duty not to lie. Several cases have clearly held against an affirmative disclosure duty prior to formation of a partnership relationship. *See Jordan v. McDonald*, 803 F. Supp. 493 (D. Mass. 1992) (no duty to person purchasing a partnership interest); *Lagen v. Balcor Co.*, 274 Ill. App. 3d 11, 653 N.E.2d 968 (1995) (no pre-partnership fiduciary duty to disclose where plaintiff reposed no special trust or confidence in defendant); *Waite ex rel. Bretton Woods Acquisition Co. v. Sylvester*, 560 A.2d 619, 624-26 (N.H. 1989) (UPA § 21 does not impose fiduciary duty among prospective partners dealing at arms' length during formation negotiations).

Courts have imposed liability for non-disclosures on grounds other than fiduciary duty. One such type of case is where defendant has made affirmative statements that omitted facts necessary to make them true. See *R.C. Gluck & Co.*

v. Tankel, 24 Misc. 2d 841, 842-46, 199 N.Y.S.2d 12, 14-17 (Sup. Ct. N.Y. Co. 1960), *aff'd*, 12 A.D.2d 339, 199 N.Y.S.2d 602 (1st Dep't 1961). Another is where the defendant made a promise or statement prior to formation of the partnership and then later engaged in conduct inconsistent with the promise or statement. *See Tobias v. First City Nat'l Bank & Trust Co.*, 709 F. Supp. 1266, 1277-78 (S.D.N.Y. 1989). There also may be liability for breach of a disclosure duty that arises other than from the existence of a partnership. But none of these cases supports liability for breach of a partnership-based fiduciary duty to disclose arising prior to the formation of the partnership relationship.

The Revised Uniform Partnership Act, now in effect in the vast majority of jurisdictions, provides that there is no fiduciary disclosure duty prior to the creation of the partnership relationship. *See* R.U.P.A. § 403(c) (providing for disclosure by "[e]ach partner and the partnership" to "a partner"), § 404 (providing for duties of loyalty and care only in the conduct and winding up of the partnership and not in "formation"). Although New York has not yet adopted R.U.P.A., these provisions are relevant to the present case as a clarification of the existing law of partnership. Even if partnership cases *did* support a pre-formation fiduciary duty to disclose, these cases would not support such a duty in LLCs. As noted above, although there are some similarities between various business entities, each is distinct in many respects. These distinctions mean that courts must be careful when making

analogies between different types of business entities. As discussed in Part I above, LLCs are based on a distinct set of statutory provisions which provide, among other things, that the firm is formed in a particular way and comes into being at a particular time—that is, on or after organizers' filing of the articles of organization. By contrast, partnerships require no formalities and come into being based on the parties' intent. *See Bromberg & Ribstein, supra,* § 2.05. The haziness concerning formation that is inherent in partnerships does not apply to LLCs. There may be some uncertainty concerning when the parties have crossed the formation line in partnerships, and therefore possibly some ambiguity in the cases as to whether duties have arisen before or after formation of the relationship. There is no such uncertainty in LLCs, and therefore even less basis in LLCs than in partnerships for recognizing duties based on a non-existent relationship.

In short, neither partnership nor LLC cases have recognized the fiduciary disclosure duty of organizers on which the Appellate Division relies. None of the hodgepodge of cases cited by Respondents on fiduciary duties in a variety of entities holds in favor of a rule requiring pre-formation disclosure. Rather, these cases stand for basic principles of fiduciary in already established firms that are not at issue in this case.

III. The Corporate Promoter Cases Should Not Be Applied to Establish Pre-Formation Duties in LLCs.

The lone source of authority for a fiduciary duty to disclose arising out of a business entity prior to the formation of that entity cited by either Respondents or the Appellate Division is based on duties of promoters of corporations-to-be to those being solicited as investors in those firms.

In analyzing these cases it is important to distinguish between two theories of recovery. Under the first theory, the court may find a fiduciary duty based on an *existing relationship* in which the investors have delegated power and therefore trusted in the promoter even prior to the technical formation of the corporation. *See, e.g.*, *Gates v. Megargel,* 266 F. 811 (2d Cir. 1920); *Brewster v. Hatch*, 122 N.Y. 349, 25 N.E. 505 (1890). In these cases, the promoters had undertaken to perform certain acts on behalf of the investors prior to formation which provided the basis of a fiduciary relationship. By contrast, in the present case the Appellate Division imposed a duty solely on the basis of the fact that the defendants were organizers of the LLC, which the court analogized to a promoter relationship.

The closest thing in the case law to the concept relied on by the Appellate Division is the legal theory that a promoter may breach a duty to an *existing* corporation even though the transaction was approved by all of the shareholders as of the time of issuance of the stock. *See Old Dominion Copper Mining & Smelting Co. v. Bigelow,* 203 Mass. 159, 89 N.E. 193 (1909), *aff'd*, 225 U.S. 111 (1911).

This extraordinary theory can be rationalized, if at all, as a way to address abuses in large capital-raising ventures prior to the adoption of the federal securities laws. Not surprisingly, these cases became a dead letter even in this setting following the adoption of the federal securities laws, which provided extensive rules and regulations to guide organizers of businesses regarding the disclosures they had to make to investors.

Even if the promoter liability were still good law in corporations, it would be inappropriate to apply these century-old cases to a form of business that came to prominence only in the last twenty years. "Uncorporations," such as partnerships and LLCs do not present a potential for abuse comparable to that of large business entities seeking capital from hundreds or thousands of small investors. Accordingly, as I discussed in *The Rise of the Uncorporation*, courts and commentators traditionally have viewed unincorporated firms as basically creatures of contract. Early in the 20th century concerns about limited liability impeded extending this contractual approach to limited liability unincorporated firms. However, the explosive development of the limited liability company in the late 20th century made widely available the "hybrid" of the contractual nature of the unincorporated firm and corporate-type limited liability. Promoter liability is a distinctly corporate theory which recognizes liability that is imposed on the parties as a matter of public policy rather than deriving from their consensual relationship.

Respondents' Brief (at 27-29) cites an assortment of authorities for the proposition that LLCs should be treated the same as corporations in some respects. However, none of these authorities suggests that LLCs and corporations should be treated the same in all respects regarding the enforcement of the parties' agreement.[2] Many of these cases are not even relevant to the issues in this case. To the extent the cases deal with fiduciary duties at all, they either concern analogies between LLCs and *partnership* law, *see Blue Chip Emerald LLC v. Allied Partners Inc.,* 299 A.D.2d 278, 750 N.Y.S.2d 291 (1st Dep't 2002), or with default duties that apply in the absence of contrary agreement rather than to the application of the parties' agreement, *see Credentials Plus, LLC v. Calderone*, 230 F. Supp. 2d 890 (N.D. Ind. 2002); *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451 (Del. Ch. Ct. Apr. 20, 2009).

Much closer to the issue at hand are cases Respondents did not cite. For example, in *In re 1545 Ocean Avenue, LLC*, 72 A.D.3d 121, 126-27, 893 N.Y.S.2d 590, 594-95 (2d Dep't 2010), the Appellate Division refused to apply to LLCs the statutory standard for dissolving a close corporation, noting that "it would be

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[2] Instead of citing cases and authorities relevant to my arguments, including my distinction between LLCs and corporations, Respondents attack my reputation by falsely labeling me as an extremist (p. 26 n.25). My national reputation discussed above should amply refute this characterization. In any event, Respondents' culling of thousands of blog posts and hundreds of articles produces three pieces of evidence that are not only irrelevant to the issues in this case but do not support Respondents' characterization of my positions. One cited post takes a position on market efficiency supported by mainstream finance experts, another aligns with the position of a majority of the U.S. Supreme Court, and the only article cited is completely mischaracterized in a way that suggests that Appellant was misled by its ironic title and did not actually read it.

inappropriate for this Court to import dissolution grounds from the Business Corporation Law or partnership Law to the [Limited Liability Company Law]" and that "[l]imited liability companies . . . fall within the ambit of neither the Business Corporation Law nor the Partnership Law." A notable difference between the two standards is that the LLC standard explicitly refers to the parties' agreement while the corporate standard does not. *See* Larry E. Ribstein, *Close Corporation Remedies and the Evolution of the Closely Held Firm,* 33 West. N.E. L. Rev. __ (2011).

Also, in *CML V, LLC v. Bax,* 6 A.3d 238, 249 (Del. Ch. Ct. 2010), Vice Chancellor Laster denied a creditor standing to sue derivatively for an LLC under Delaware law, carefully and elaborately distinguishing LLCs and corporations (including citations to both of my treatises). The Vice Chancellor noted: "'Because the conceptual underpinnings of the corporation law and Delaware's [alternative entity] law are different, courts should be wary of uncritically importing requirements from the DGCL into the [alternative entity] context.' *Twin Bridges Ltd. P'ship v. Draper*, 2007 WL 2744609, at *19 (Del. Ch. Ct. Sept. 14, 2007)." *See also* Joshua Fershee, *LLCs and Corporations: A Fork in the Road in Delaware?*, Harvard Business Law Review Online (June 6, 2011), http://www.hblr.org/2011/06/llcs-and-corporations-a-fork-in-the-road-in-delaware/ (approving the result in this case). As Professor Fershee states:

> Where legislatures have decided that distinctly corporate concepts should apply to LLCs–such as allowing piercing the veil or derivative lawsuits – those wishes (obviously) should be honored by the courts. But where state LLC laws are silent, courts should carefully consider the legislative context and history, as well as the policy implications of the possible answers to the questions presented. In making such decisions, courts should put forth cogent reasons for their decisions, rather than blindly applying corporate law principles in what are seemingly analogous situations between LLCs and corporations.

In light of the specific provisions of the New York LLC law discussed above regarding the functions of organizers, courts should not import into this concept cases arising out of the very different context of turn-of-the-century promoters of publicly held corporations.

IV. Policy Does Not Support Imposing Pre-Formation Duties.

In addition to lacking any basis in statutory language and judicial precedent, pre-formation fiduciary duties of organizers of LLCs are contrary to sound policy. One problem is that prior to formation of the business association the parties have not necessarily determined the precise form their relationship will take, and therefore the nature of the substantive and disclosure duties that are appropriate to this relationship. Accordingly, a fiduciary duty in this situation would be potentially open-ended. *See* Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 Washington & Lee L. Rev. 537, 584-87 (1997).

A second problem is that the parties cannot effectively contract regarding their duties if these duties are imposed prior to formation of their contractual

relationship. Respondents concede that the parties may "be able to contractually limit, supplement or expand [their fiduciary] duties" but note that there was no such contract in this case (Resp. Br. at 26 n.24). Yet Appellants cannot contract to waive duties imposed in connection with a contract that has not yet been formed. Respondents' suggested contract language merely acknowledges that certain conduct has occurred without purporting to disclaim liability for this conduct. Moreover, any breach of this pre-existing duty might vitiate the contract, and therefore any limitation of duties in the contract. By contrast, duties arising out of LLC law or the parties' contract would be subject to the limitations in this law or contract. Thus, in two recent cases in which this Court held that parties effectively disclaimed liability for unknown frauds, the Court examined closely the language of the contracts to determine whether they applied to the claims in the cases. *See Centro Empresarial Cempresa S.A. v. America Movil, S.A.B. de C.V.,* 2011 N.Y. Slip Op. 04720, at 4-5, 2011 WL 2183293 (Ct. App. June 7, 2011) (release of "all manner of actions ... whatsoever ... whether past, present or future, actual or contingent, arising under or in connection with the Agreement Among Members and/or arising out of ... the ownership of membership interests in [TWE]"); *Arfa v. Zamir*, 2011 NY Slip Op 04719, at 2, 2011 WL 2183280 (Ct. App. June 7, 2011) (release of "any and all claims, demands, actions, rights, suits, liabilities, interests and causes of action, known and unknown, which they have ever had, have or may

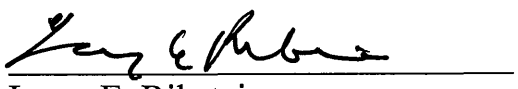
now have, which in any way pertain to or arise from any matters, facts, occurrences, actions or omissions which occurred prior to" the date of the contract). The parties accordingly effectively disclaimed liabilities they otherwise might have incurred on entering into the contract. It is not clear how parties could contract to disclaim or limit duties and liabilities created *prior to* the formation of any contract. Imposing promoter liability accordingly would be inconsistent with this Court's recognition in the above cases of the primacy of the parties' contract.

CONCLUSION

Neither LLC law, law borrowed from other types of business entities, nor policy considerations support imposing an affirmative pre-formation fiduciary duty to disclose on organizers of LLCs. Affirmance of the Appellate Division's unprecedented holding would introduce burdensome uncertainty to the law of LLCs. This Court should instead follow established fiduciary principles and impose an affirmative duty to disclose only if the parties have entered into a relationship that provides the basis for this duty. One does not enter into such a relationship merely by virtue of serving as the organizer of a New York LLC.

Dated: September 9, 2011
Champaign, Illinois

Respectfully submitted,



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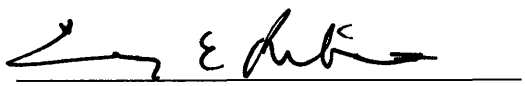
Respectfully submitted,



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