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Civil LITIGATION

The Fourth Department clarifies LLC indemnification rights

High legal fees are an unavoidable fact of life for many commercial litigants. A client's ability to commence, and successfully litigate, even a highly meritorious case often hinges on whether he or she can afford the inherent cost. This is particularly true in a "business divorce" case involving a limited liability company, where a client who is a minority member of an LLC has suffered financial harm at the hands of one or more members who control the LLC.

For this reason, minority members involved in a dispute against majority members almost always ask whether they can recover the legal fees they are forced to incur to protect themselves from their adversaries' wrongful conduct. The answer is almost always no, unless the operating agreement provides that remedy. To make things worse for minority members, the Limited Liability Company Law provides that under certain circumstances, the controlling member or members may be entitled to indemnification, and even advancement, of legal fees by the LLC, while the minority member is forced to fund his or her lawsuit out of his or her own pocket. LLCL §420 states:

"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 other 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



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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."

There is a lot to unpack in that long sentence, but the key points are: (1) the party entitled to indemnification (or advancement) is the party who is the target of a claim or demand; (2) the LLC's operating agreement may modify, restrict or even eliminate the right to indemnification (or advancement) of legal fees; and (3) a party seeking indemnification will be denied that remedy where it is finally determined that he or she committed the wrongful acts which gave rise to the claim or demand.

The case law reveals that the terms of LLC indemnification/advancement clauses vary. Some operating agreements require the prospective recipient of advanced legal fees to give an affirmation of his or her good faith belief that he or she did not engage in the misconduct alleged, and to give an undertaking for the repayment of any legal fees advanced if it is determined that the recipient did in fact commit wrongful

acts. Other operating agreements limit the availability of indemnification or advancement to potential liability based on actions performed by the prospective recipient within the scope of the authority conferred by the operating agreement. The case law also makes a distinction between *indemnification* for legal fees at the conclusion of the litigation and advancement of legal fees during the course of the litigation.

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The Fourth Department ruled conclusively on that distinction in its August 22, 2019 decision in *Mangovski v. DiMarco*. In that case, plaintiff brought direct and derivative claims against Stephen DiMarco, individually and as the trustee of a family trust, and a number of related companies. Among other claims, plaintiff alleged that DiMarco breached a contract with plaintiff and otherwise breached his fiduciary duties to plaintiff. Plaintiff also asserted that the defendant companies should be barred from paying DiMarco's legal fees. Supreme Court granted plaintiff's motion for a preliminary injunction barring the advancement of those fees. Defendants appealed, but the Fourth Department refused to vacate the order enjoining the defendant companies from advancing DiMarco's defense costs.

In rejecting defendants' arguments, the Fourth Department first noted that although LLCL §420 *permits* the advancement of legal fees to a member, "the statutory language is permissive and does not per se create a legal duty to indemnify." Second, the Court stated that it had to review the language of the subject operating agreements to determine whether

DiMarco was entitled to the advancement of his legal fees, because the statute clearly subjects the availability of indemnification (or advancement) to the “standards and restrictions” of the operating agreement in issue. Third, after reviewing the subject operating agreements, the Fourth Department found that they did not provide for advancement of legal fees, but only for indemnification *provided* that DiMarco was not ultimately found to be in breach of any of his duties. Lastly, the Court held that even if the operating agreements had permitted the advancement of legal fees before a determination on the merits rather than indemnification, it would

nevertheless affirm that part of the order enjoining the defendant companies from paying DiMarco’s defense costs, because plaintiff submitted evidence raising significant concerns that DiMarco was engaging in acts that threatened to render any final judgment ineffectual.

Mangovski is an important decision for minority members seeking some semblance of a level playing field in LLC litigation. The potential availability of indemnification may give comfort to a majority member sued for wrongful conduct. But the ability to have his or her legal fees advanced in real time by the LLC, while knowing the minority member has to use

his or her own money to keep the lawsuit going, emboldens the majority member to litigate with impunity – multiple motions, unreasonable objections to discovery requests, burdensome discovery demands – and try to bury the minority member in legal fees. The distinction between indemnification and advancement must be enforced in LLC disputes to avoid the surrender of meritorious claims in the face of improper financial advantage.

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