

CORPORATE COUNSEL

An Operating Agreement Is Essential Under RULLCA

What corporate attorneys need to know about N.J.'s revised statute

By Gianfranco A. Pietrafesa

The New Jersey Revised Uniform Limited Liability Company Act (RULLCA) was enacted on Sept. 19. This act will impact every New Jersey limited liability company (LLC). It will apply to new LLCs formed after March 18, 2013, and then to all LLCs in 18 months, in March 2014. The act is codified at N.J.S.A. 42:2C-1 et seq. For a general summary of the act, see Ira B Marcus and Denise Walsh, "Introducing the New Jersey Revised Uniform Limited Liability Company Act," *New Jersey Law Journal* (Oct. 8, 2012); Gianfranco A. Pietrafesa, "New Jersey Adopts the Revised Uniform Limited Liability Company Act," available at <http://www.archerlaw.com/news-resources/5791>.

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RULLCA updates and, on the whole, improves New Jersey's LLC law. Like New Jersey's existing LLC law, RULLCA governs any matter not addressed in an LLC's operating agreement. There are at least four matters that should be addressed in an operating agreement to avoid application of the default provisions under RULLCA. This article examines the default provisions of these matters under RULLCA and compares them to the default provisions under current law, which law has been in existence since 1993.

Distributions

Under existing law, each member is entitled to share profits or losses based on the agreed value of each member's capital contribution to the LLC. By contrast, under RULLCA, each member is entitled to an equal share of the profits or losses, regardless of capital contributions. The foregoing applies to both regular distributions, RULLCA, § 34(a), and liquidating distributions (after the payment of unreturned capital contributions). RULLCA, § 55(b).

By way of example, assume Laura contributes \$75,000 and Lisa contributes \$25,000 to an LLC. Under existing law, Laura would receive 75 percent and Lisa would receive 25 percent of the profits. Under RULLCA, Laura and Lisa will each receive 50 percent of the profits,

regardless of their unequal capital contributions.

These default provisions can be changed by the majority vote of the members each time a distribution is made, or by distribution provisions set forth in an LLC operating agreement. Therefore, if Laura and Lisa do not want to share distributions equally (because, for example, their capital contributions are not equal), they should enter into a written operating agreement that states how regular and liquidating distributions will be made by the LLC. They may decide, for example, to make distributions based on the agreed value of their capital contributions to the LLC.

Voting

Under existing law, most matters, including mergers, are decided by a majority of the members' current profit percentages. Under RULLCA, ordinary matters are decided by a majority of the members, with each member having one vote ("per capita"), and extraordinary matters, including mergers, are decided unanimously by the members. RULLCA, § 37(b). The admission of new members, the expulsion of existing members and the dissolution of the LLC still require the consent of all members. RULLCA, §§ 31(c), 46(d) and 48(a).

By way of example, assume Laura, Marc and Lisa are the three members of an LLC, with Marc receiving 51 percent of the profits. Under existing law, Marc has 51 percent of the vote based on his profit percentage and makes most decisions for the LLC. Under RULLCA, each member has an equal vote. Therefore, in the prior example, Laura and Lisa,

together receiving only 49 percent of the profits, can outvote Marc, 2-1, and make decisions on ordinary matters for the LLC even though together they own a minority interest in the LLC.

This default provision can be changed by an LLC operating agreement. The members would enter into an agreement that specifically sets forth the voting requirements on ordinary matters. Marc, for example, might insist that decisions be made based on the members' current profit percentages. They may also consider changing the required vote for approving mergers and dissolution from a unanimous to a majority vote.

Fiduciary Duty of Loyalty

New Jersey's existing LLC statute does not address fiduciary duties, and there are no state court decisions discussing such duties with respect to New Jersey LLCs. Under RULLCA, members (and managers) of New Jersey LLCs have newly defined fiduciary duties of care and loyalty and a "contractual" covenant of good faith and fair dealing that applies to rights and duties under an LLC's operating agreement and under the act.

Under RULLCA, members of a member-managed LLC owe a duty of loyalty to the LLC and to the other members. RULLCA, § 39(a). (In a manager-managed LLC, the members do not have a duty of loyalty.) The duty of loyalty includes refraining from competing with the LLC and accounting to the LLC for any profits or benefits derived by a member from misappropriating an opportunity belonging to the LLC. RULLCA, § 39(b).

The duty of loyalty may create problems for LLCs and their members. For example, assume an LLC is formed by three members to operate a fast-food restaurant. If one member is interested in opening another fast-food restaurant, alone or with others, the duty of loyalty may require her to first present the opportunity to the existing LLC. Or worse, she may be

precluded from operating another fast-food restaurant because doing so constitutes competition with the existing LLC.

Although RULLCA imposes a statutory duty of loyalty, it permits the members to eliminate the duty through their operating agreement. RULLCA, § 11(d)(1). If the members do not eliminate the duty of loyalty, they can restrict it by, for example, identifying specific acts that do not violate the duty. RULLCA, § 11(d)(2). For example, allowing a member to own other fast-food restaurants that are located a specific distance away from the restaurant owned and operated by the LLC.

As an alternative, the operating agreement may include a mechanism for a disinterested and independent person, after full disclosure of all material facts, to authorize or ratify an act that violates the duty of loyalty. RULLCA, § 11(e). If the operating agreement does not restrict or eliminate the duty of loyalty, then the members must unanimously authorize or ratify a member's act that violates the duty. RULLCA, § 39(f). Therefore, to avoid the requirement of a unanimous vote, it would be wise for the members to eliminate or restrict the duty of loyalty in their operating agreement.

Resignation

Under existing law, a member may resign from an LLC and have his equity purchased by the LLC for fair value, less applicable discounts. Under RULLCA, a resigning member continues to own his equity interest as a dissociated member. RULLCA, § 45(a). As such, he continues to receive distributions, if any, made by the LLC, but has no management or voting rights. RULLCA, §§ 34(a), 47(a) and 56(b)(2). He is, in essence, an assignee who has an economic interest in the LLC.

For example, a member resigns from an LLC. Under existing law, the LLC must use its cash flow to buy the resigning member's equity interest in the LLC instead of using it to operate the business of the LLC,

which may include hiring and paying an employee to provide the services to the LLC previously performed by the resigning member. The payment to the resigning member, alone or in combination with its operational cash needs, may cripple the LLC, which could cause a succession of resignations and, eventually, a dissolution and liquidation of the LLC. By contrast, under RULLCA, the resigning member becomes a dissociated member and is entitled to receive distributions from the LLC, if any. If the LLC does not make distributions, and will have little liquidation value in the future, the resigning member will never receive fair value for his interest, or may receive fair value when the LLC is liquidated years later. While the result under existing law can be harsh to the LLC and the remaining members, the result under RULLCA can be just as harsh to the resigning member.

Under the above circumstances, a member with thoughts of a possible resignation will not want to be a dissociated member. Therefore, members should address the matter of resignation in the LLC's operating agreement. The agreement should include provisions to establish a valuation for the LLC and purchase rights for a resigning member's equity interest, based on terms that they believe will be fair to both the resigning member and the LLC and its remaining members. For example, the LLC can pay the resigning member fair value for his equity interest over a period of time, giving the resigning member liquidity over time and leaving the LLC with sufficient cash to fund its operations and continue its existence.

Conclusion

As noted, RULLCA makes some significant changes to New Jersey's LLC law. As a result, it is important for new and existing LLCs to have written operating agreements to address the matters outlined in this article to avoid the default provisions under the act. ■