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BUSINESS ENTITIES

New LLC Law Became Effective on March 1st

Some may be surprised by the changes

By Gianfranco A. Pietrafesa

The New Jersey Revised Uniform Limited Liability Company Act (RULLCA) became effective, and the New Jersey Limited Liability Company Act was repealed, on March 1. RULLCA makes some significant changes in New Jersey LLC law, which will require practitioners to revise their form of operating agreement. Among the changes are the following.

- *Distributions.* Each member of an LLC is entitled to an equal share of the profits or losses. This is the default rule provided in the statute, which can be modified in the LLC's operating agreement. Under the old law, each member shared the profits or losses based on the agreed value of their capital contributions to the LLC.

- *Voting on Ordinary Matters.* Each member has an equal vote, regardless of his ownership percentage interest, and a majority of the mem-

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bers decide matters in the ordinary course of business. Again, this is the default rule, which can be modified in the operating agreement. Under the old law, such ordinary matters were decided by a majority of the percentage interests.

- *Voting on Extraordinary Matters.* Matters outside the ordinary course of business, such as a merger or sale of all LLC assets, are decided by the unanimous vote of the members. This default rule can be modified in the operating agreement (for example, to a simple majority or supermajority). Under the old law, such extraordinary matters were decided by a majority of the percentage interests.

- *Fiduciary Duty of Loyalty.* The persons managing the LLC, whether members or managers, have a newly defined fiduciary duty of loyalty, which prohibits them from competing with the LLC and self-dealing with the LLC, such as lending money or leasing property to the LLC. This duty of loyalty can be altered or even eliminated in the operating agreement. The old law did not mention a fiduciary duty of loyalty.

- *Contractual Obligation of Good*

Faith and Fair Dealing. Members and any managers must exercise their rights and perform their duties under a standard of good faith and fair dealing. The old law did not include such a standard, but every agreement included and continues to include an implied covenant of good faith and fair dealing. RULLCA imposes this obligation of good faith and fair dealing not only on rights and duties in an operating agreement, but extends it to rights and duties under the statute. The obligation cannot be eliminated, but an operating agreement can prescribe how to measure whether a member or manager has complied with the obligation.

- *Manifestly Unreasonable Standard.* As noted, RULLCA allows an operating agreement to alter or eliminate certain fiduciary duties, but only if doing so is not manifestly unreasonable. This is an issue of law determined by the court as of the time the parties entered into the operating agreement by taking into considering the circumstances existing at that time. The court may invalidate a provision only if, in light of the purposes and activities of the LLC, it is readily apparent that the objective of the provision is unreasonable or an unreasonable means to achieve its objective.

- *Authority to Bind.* Under RULLCA, the authority to bind an LLC depends on the type of management. In a manager-managed LLC, the managers have the exclusive authority to decide matters in the ordinary course of business, but the members have the

authority to decide extraordinary matters (e.g., mergers and sale of assets). In a member-managed LLC, the members obviously decide all matters since there are no managers. However, a person's status as a member by itself does not make him an agent of, or establish his authority to bind, the LLC. Instead, agency law will determine whether a member had the authority to bind the LLC. Under the old law, in a member-managed LLC, a person's status as a member gave him the authority to bind the LLC. In a manager-managed LLC, the manager's authority was set forth in the operating agreement. At a minimum, under RULLCA, an operating agreement should identify the management of the LLC as member-managed or manager-managed.

• *Oppression.* RULLCA provides protection for oppressed members of an LLC by providing them with rights and remedies previously unavailable to them under the old law. These rights and remedies are similar to those available to oppressed minority shareholders of corporations under the New Jersey Business Corporation Act (BCA). In cases of oppression, a court may order a remedy other than dissolution, such as appointing a custodian or provisional manager or requiring the LLC to purchase the interest of the oppressed member.

• *Indemnification.* Indemnification is mandatory for members, managers, employees and agents of an LLC under certain circumstances, similar to the BCA. The operating agreement may alter or even eliminate this mandatory indemnification. By comparison, the old law merely provided discretionary indemnification for members and managers.

• *No Buyout on Resignation.* A member who resigns or withdraws from an LLC is not entitled to a pay-

ment of fair value for his interest in the LLC. Instead, he remains a dissociated member entitled to distributions, but loses the right to vote and manage the LLC. Under the old law, a resigning member was entitled to have his interest purchased by the LLC for fair value. If desired, an operating agreement can address this issue by requiring adequate notice of resignation, a method to determine fair value for his interest, and a buyout paid over time.

• *Conversion and Domestication.* RULLCA allows a corporation or other form of entity to convert to an LLC in a straightforward manner and an out-of-state LLC to easily domesticate into a New Jersey LLC. The old law did not include any provision for conversion or domestication. Instead, to convert, practitioners were required to form an LLC and then merge the corporation or other entity into the LLC, a two-step process. To domesticate, practitioners were required to form a New Jersey LLC and then file papers in New Jersey and the other state to merge the out-of-state LLC into the New Jersey LLC, a three-step process. Unfortunately, conversion is unavailable until legislation is enacted amending the BCA and partnership statutes to authorize it.

• *Right to Information.* The old law identified specific categories of documents and information available for inspection by the members, and a member had the right, subject to reasonable standards, to obtain the documents and information upon reasonable demand for any purpose reasonably related to the member's interest as member of the LLC. RULLCA does not include such categories of documents and information, and it allows a member to inspect and copy any record maintained by the LLC, or any other member, regarding the LLC's business and financial condition to the extent mate-

rial to the member's rights and duties. In addition, when a member is required to vote on a matter, the LLC must provide all information that is material to the member's decision to vote. The operating agreement can alter, but may not unreasonably restrict, a member's right to obtain LLC records.

• *Oral and Implied Operating Agreements.* RULLCA allows oral and implied operating agreements. As noted, if an issue is not addressed in an operating agreement, the default provisions of RULLCA will apply. For that reason, practitioners should continue to counsel clients to have a written operating agreement, which can address and modify the default provisions of RULLCA and minimize or eliminate the necessity to prove their oral or implied agreements in court. By comparison, under the old law, an operating agreement had to be written, although an agreement was not required.

• *Perpetual Duration.* Under the old law, an LLC had a 30-year life unless the certificate of formation stated that it had a perpetual life. Under RULLCA, all LLCs, including those formed under the old law, have perpetual life. However, if a certificate of formation included a termination date for the LLC, the certificate must be amended to give it perpetual life.

Members and managers of LLCs may be surprised by the changes in the law and the default provisions, such as equal voting, equal distributions, fiduciary duty of loyalty prohibiting competition and self dealing, and resigning members remaining as dissociated members. In light of these significant changes in the law, practitioners should alert clients about the new LLC law and advise them that operating agreements should be reviewed and, if necessary, amended to avoid the default provisions in RULLCA. ■