New Remedies for Oppression in LLCs

by Gianfranco A. Pietrafesa

In New Jersey, an oppressed member of a limited liability company (LLC) may resign and receive fair value for his or her equity interest, less applicable valuation discounts. N.J.S.A. 42:2B-38 provides that "a member may resign upon not less than 6 months' prior written notice to the limited liability company." N.J.S.A. 42:2B-39(a) provides that a member "is entitled to receive, within a reasonable time after resignation, the fair value of his limited liability company interest as of the date of resignation, less all applicable valuation discounts." Valuation discounts include "discounts for lack of liquidity, relative size of holding, absence of any trading market and comparable factors."[1]

However, an LLC operating agreement may provide for an alternate valuation method. As stated above, N.J.S.A. 42:2B-39(a) provides for the receipt of fair value "unless the operating agreement provides for another distribution formula." For example, an operating agreement may require a resigning member to sell his or her equity interest to the LLC or to the other members for a purchase price equal to book value. Therefore, a resigning member may receive little value, and certainly not fair value, for his or her equity interest.

An operating agreement may also prohibit a member from resigning. Pursuant to N.J.S.A. 42:2B-38, "an operating agreement may provide that a member may not resign from a limited liability company." If a member attempts to resign in violation of the operating agreement, he or she may be liable to the LLC for damages. Under N.J.S.A. 42:2B-39(a), "If the resignation of a member violates an operating agreement,...a limited liability company may recover from the resigning member damages for breach of the operating agreement..."

Unless provided in the operating agreement, an oppressed member cannot force the other members to buy his or her equity interest at a fair price, or force the other members to sell their equity interests to him or her at any price. An oppressed member can try to sell his or her equity interest to a third party. However, unless the other members accept the third party as a member, the third party will be a mere assignee entitled to receive distributions, if any, but will not have a vote or any say in the management of the LLC. N.J.S.A. 42:2B-44(a) provides that "assignee ... shall have no right to participate in the management of the business and affairs of a limited liability company." N.J.S.A. 42:2B-44(b)(1) provides that an "assignment entitles the assignee to receive...distributions." As a result, a sale by an oppressed member to a third party is unlikely. Moreover, an operating agreement may also prohibit the assignment or transfer of an equity interest to a third party.

Under these circumstances, an oppressed member can seek judicial dissolution.[2] However, a court will dissolve an LLC only "when it is not reasonably practicable to carry on the business in conformity with an operating agreement."[3] It is possible that a court may find that an LLC can carry on its business notwithstanding the allegations of the oppressed member and, therefore, the LLC will not be dissolved.

Moreover, judicial dissolution is a drastic remedy that the courts do not favor. As a result of not having a means to exit an LLC, oppressed LLC members have asked the courts to grant them the relief available to oppressed shareholders under the corporate statute. For example, compelling the other members to buy their equity interests or compelling the other members to sell their equity interests to the oppressed members at fair value.[4] Oppressed members have also sought the appointment of custodial receivers and provisional managers to deal with oppression in an LLC.

In this regard, the corporate statute provides in part:

> The Superior Court...may appoint a custodian, appoint a provisional director, order a sale of the corporation's stock..., or enter a judgment dissolving the corporation, upon proof that...In the case of a corporation having 25 or less shareholders, the directors or those in control have acted fraudulently or illegally, mismanaged the corporation, or abused their authority as officers or directors or have acted oppressively or unfairly toward one or more minority shareholders in their capacities as shareholders, directors, officers, or employees.[5]

Such relief is not mentioned in the LLC statute. As a result, some courts have been reluctant to enter orders granting such relief in light of the absence of specific statutory authorization. In *Actives Int'l LLC v. Reitz*[6] the court noted that a party's request for the appointment of a custodial receiver under the corporate statute was "somewhat obscure" when dealing with an LLC. (*See also Flores v. Murray*,[7] where a trial court decision awarding legal fees pursuant to the corporate statute was reversed because the company was an LLC and the LLC statute did not provide for an award of legal fees under the facts of the case.) In

Grand View Developers LLC v. Celentano,[8] the definition of deadlock in the corporate statute was inapplicable to an LLC.

The courts have been reluctant to grant relief available to oppressed shareholders of a corporation even though, when dealing with the LLC statute, they may analogize to the corporate statute.[9] Moreover, aside from the statute, the courts have "the authority to appoint a receiver or a fiscal agent in appropriate circumstances."[10]

As a result of the foregoing, there is general agreement that the LLC statute needs to be amended to expressly authorize the courts to grant to LLCs and their members the relief available to corporations and their shareholders in cases of oppression. The relevant provision from the new LLC statute being proposed by the Business Law Section expressly provides oppressed members with the remedies now available to oppressed shareholders of corporations. These remedies are found in Section 701 of the Revised Uniform Limited Liability Company Act (RULLCA), which deals with events of dissolution.

Proposed Sections 701(a)(1) to (4) of RULLCA provide:

> (a) A limited liability company is dissolved, and its activities must be wound up, upon the occurrence of any of the following:
> (1) an event or circumstance that the operating agreement states causes dissolution;
> (2) the consent of all the members;
> (3) the passage of 90 consecutive days during which the company has no members;
> (4) on application by a member, the entry by the Superior Court of an order dissolving the company on the grounds that:
> (A) the conduct of all or substantially all of the company's activities is unlawful; or
> (B) it is not reasonably practicable to carry on the company's activities in conformity with the certificate of organization and the operating agreement; ...

The above provisions are virtually identical to the existing New Jersey Limited Liability Company Act, which provides:

> A limited liability company is dissolved and its affairs shall be wound up upon the first to occur of the following:
> b. Upon the happening of events specified in an operating agreement;
> c. The written consent of all members, which includes written consent of the sole member of a limited liability company with only one member;
> d. Ninety days after the date on which the limited liability company no longer has at least one member, unless at least one new member is admitted within that 90 day period; or
> e. The entry of a decree of judicial dissolution under section 49 of this act.[11]

N.J.S.A. 42:2B-49 provides that "On application by or for a member or manager the Superior Court may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with an operating agreement."

The Business Entities Committee of the Business Law Section modified RULLCA Section 701 by adopting aspects of the New Jersey corporate statute dealing with oppression and other egregious conduct. Therefore, Section 701(a)(5) (A) and (B) of the amended version of RULLCA developed by the Business Entities Committee allows a court to judicially dissolve an LLC if its managers or controlling members have acted, are acting or will act in a manner that is illegal or fraudulent or have acted or are acting in a manner that is oppressive and was, is or will be directly harmful to the non-controlling member.

Specifically, proposed Section 701(a)(5) provides:

> (a) A limited liability company is dissolved, and its activities must be wound up, upon the occurrence of any of the following: ...
> (5) on application by a member, the entry by the Superior Court of an order dissolving the company on the grounds that the managers or those members in control of the company:
> (A) have acted, are acting, or will act in a manner that is illegal or fraudulent; or
> (B) have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant.

Proposed Section 701(a)(5) is similar, but not identical, to N.J.S.A. 14A:12-7(c), quoted above.

In addition to dissolution, Sections 701(b)(1) and 701(b)(2) of the proposed LLC statute allow a court to appoint a custodian or a provisional manager, and to order the sale of a member's equity interest to the LLC or to another member who is a party to the lawsuit. In this regard, proposed Section 701(b) provides:

> (b) In a proceeding brought under subsection (a)(4) or subsection (a)(5), the court may order a remedy other than dissolution.
> (1) By way of example, the court may appoint a custodian or one or more provisional managers if it appears to the court that such an appointment may be in the best interests of the limited liability company and its members. In any proceeding under this section, the court shall allow reasonable compensation to any custodian or provisional manager for his or her services and reimbursement or direct payment of all his or her reasonable costs and expenses, which amounts shall be paid by the limited liability company.
> (2) By way of further example, the court may order the sale of all interests held by a member who is a party to the proceeding to either the limited liability company or any other member who is a party to the proceeding, if the court determines in its discretion that

such an order would be fair and equitable to all parties under all of the circumstances of the case.

As noted, these provisions in the proposed LLC statute are derived from the New Jersey corporate statute, which provides:

(3) One or more provisional directors may be appointed if it appears to the court that such an appointment may be in the best interests of the corporation and its shareholders, notwithstanding any provisions in the corporation's by-laws, certificate of incorporation, or any resolutions adopted by the board or shareholders. A provisional director shall have all the rights and powers of a duly elected director of the corporation, including the right to notice of and to vote at meetings of directors, until such time as he shall be removed by order of the court or, unless otherwise ordered by the court, by a vote or written consent of a majority of the votes entitled to be cast by the holders of shares entitled to vote to elect directors.

(4) A custodian may be appointed if it appears to the court that such an appointment may be in the best interests of the corporation and its shareholders, notwithstanding any provisions in the corporation's by-laws, certificate of incorporation, or any resolutions adopted by the shareholders or the board. Subject to any limitations which the court imposes, a custodian shall be entitled to exercise all of the powers of the corporation's board and officers to the extent necessary to manage the affairs of the corporation in the best interests of its shareholders and creditors, until such time as he shall be removed by order of the court or, unless otherwise ordered by the court, by the vote or written consent of a majority of the votes entitled to be cast by the holders of shares entitled to vote to elect directors. Such powers may be exercised directly or through, or in conjunction with, the corporation's board or officers, in the discretion of the custodian or as the court may order. If so provided in the order appointing him, a custodian shall have the fact-determining powers of a receiver as provided in subsections 14A:14-5(e) and (f).

(7) In any proceeding under this section, the court shall allow reasonable compensation to the custodian or provisional director for his services and reimbursement or direct payment of his reasonable costs and expenses which amounts shall be paid by the corporation.

(8) Upon motion of the corporation or any shareholder who is a party to the proceeding, the court may order the sale of all shares of the corporation's stock held by any other shareholder who is a party to the proceeding to either the corporation or the moving shareholder or shareholders, whichever is specified in the motion, if the court determines in its discretion that such an order would be fair and equitable to all parties under all of the circumstances of the case.[12]

The proposed LLC statute also allows a court to award reasonable expenses, including counsel fees. Proposed Section 701(c) provides:

(c) If the court determines that any party to a proceeding brought under subsection (a)(4) or subsection (a)(5) has acted vexatiously, or otherwise not in good faith, it may in its discretion award reasonable expenses, including counsel fees incurred in connection with the action, to the injured party or parties.

The foregoing provision is virtually identical to the corporate statute, which provides:

If the court determines that any party to an action brought under this section has acted arbitrarily, vexatiously, or otherwise not in good faith, it may in its discretion award reasonable expenses, including counsel fees incurred in connection with the action, to the injured party or parties.[13]

The committee believes that proposed Section 701 of RULLCA, as amended, will greatly benefit New Jersey limited liability companies and their members by expressly authorizing the courts to grant remedies and relief to oppressed members of LLCs that are now available only to oppressed shareholders of corporations. ■

ENDNOTES

1. N.J.S.A. 42:2B-39(b).
2. N.J.S.A. 42:2B-48(e).
3. N.J.S.A. 42:2B-49.
4. *See* N.J.S.A. 14A:12-7(8).
5. N.J.S.A. 14A:7-12(1)(c).
6. 2005 WL 1861939 at *4 (Ch. Div. Aug. 5, 2005).
7. 2007 WL 3034512 at *15 (App. Div. Oct. 19, 2007).
8. 2006 WL 163502 at *5 (Ch. Div. Jan. 20, 2006).
9. *See, e.g., Percontino v. Camporeale*, 2005 WL 730234 at *3 (Ch. Div. March 24, 2005).
10. *Id.* (*citing* N.J.S.A. 42:2B-67, which states that "In any case not provided for in this act, the rules of law and equity...shall govern").
11. N.J.S.A. 42:2B-48(b) to -48(e) and -49.
12. N.J.S.A. 14A:12-7(3), (4), (7) and (8).
13. N.J.S.A. 14A:12-7(10).

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