The Manifestly Unreasonable Standard under NJ-RULLCA

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The New Jersey Revised Uniform Limited Liability Company Act (NJRULLCA) imposes a duty of loyalty and a duty of care on managers of manager-managed limited liability companies (LLCs) or members of member-managed LLCs, and a contractual obligation of good faith and fair dealing on both managers and members.[1] If not manifestly unreasonable, an LLC operating agreement may do any of the following: eliminate or restrict the duty of loyalty, identify activities that do not violate the duty of loyalty, alter the duty of care, and prescribe standards to measure performance of the contractual obligation of good faith and fair dealing.[2]

Whether such a term in an operating agreement is manifestly unreasonable is a legal issue for the court. Under NJ-RULLCA:

> The court shall decide any claim under subsection d. of this section that a term of an operating agreement is manifestly unreasonable. The court:
>
> (1) shall make its determination as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time; and
>
> (2) may invalidate the term only if, in light of the purposes and activities of the limited liability company, it is readily apparent that:
>
> (a) the objective of the term is unreasonable; or
>
> (b) the term is an unreasonable means to achieve the provision's objective.[3]

There is no case law in New Jersey, and very little case law in other jurisdictions, discussing the manifestly unreasonable standard in the context of an LLC operating agreement.[4] This article attempts to explain the manifestly unreasonable standard.

NCCUSL Commentary

It should be noted that NJ-RULLCA is based on the Revised Uniform Limited Liability Company Act (RULLCA) promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL). Therefore, NCCUSL's commentary should be used by practitioners and the courts to understand NJ-RULLCA. As part of its effort to harmonize the language of its uniform unincorporated entity acts (*i.e.,* harmonization of business entity acts), NCCUSL amended RULLCA (now designated as 'ULLCA' as part of the harmonization) and added more comments.[5]

NCCUSL believed it was important to describe the manifestly unreasonable standard in the uniform act to give courts guidance on the application of the standard. NCCUSL's commentary describes the standard as being fundamental to the uniform act because the act defers to the parties' operating agreement and the manifestly unreasonable standard safeguards an operating agreement in several ways:

- Determining manifest unreasonableness [among the members of an LLC] is a different task than doing so in a commercial context, where concepts like 'usages of trade' are available to inform the analysis. Each business organization must be understood in its own terms and context.[6]
- If loosely applied, the concept of 'manifestly unreasonable' would permit a court to rewrite the members' agreement, which would destroy the balance [the] act seeks to establish between freedom of contract and fiduciary duty.[7]
- Case law has not adequately delineated the [manifestly unreasonable] concept.[8]
- In the context of statutes permitting stock transfer restrictions unless manifestly unreasonable, courts have often ignored the meaning or role of 'manifestly.'[9]

Relevant Time under the Standard

The statute states that the court "shall make its determination [whether a term is manifestly unreasonable] as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time."[10] NCCUSL's comment explains this provision with an example:

> An LLC's operating agreement as initially adopted includes a provision subjecting a matter to "the manager's sole, reasonable discretion." A year later, the agreement is amended to delete the word "reasonable." Later, a member claims that, without the word "reasonable," the provision is manifestly unreasonable. *The relevant time* under subsection (h) (1) *is when the agreement was amended, not when the agreement was initially adopted*.[11]

Manifestly Unreasonable

NCCUSL notes that the burden of proof is on the person claiming the term is manifestly unreasonable.[12] A court may invalidate the challenged term "only if, in light of the purposes and activities of the [LLC], it is *readily apparent* that (a) the objective of the term is unreasonable or (b) the term is an unreasonable means to achieve the provision's objective."[13] One set of commentators has described the standard as follows:

> The manifestly unreasonable standard will act as a limitation on the parties' ability to bargain away aspects of fiduciary duties and the contractual obligation of good faith and fair dealing in an LLC operating agreement.... [C]ourts will likely weigh the sophistication of the parties, the overall bargain, and the parties' expectations when interpreting the manifestly unreasonable standard [under the statute]. Any LLC operating agreement that results in oppressive conduct from unfair dealing or the appearance of a situation outside of the reasonable expectations of the parties in regard to fiduciary duties will likely be subject to court-imposed limitations on contractual freedom and will thus subject the parties to the default fiduciary duties provided in the [statute].[14]

The application of the manifestly unreasonable standard can be demonstrated through an example:

> When a particular manager-managed LLC comes into existence, its business plan is quite unusual and its success depends on the willingness of a particular individual to serve as the LLC's sole manager.…In order to induce the individual to accept the position of sole manager, the members are willing to have the operating agreement significantly limit the manager's fiduciary duties. Several years later, when the LLC's operations have [stabilized] and the manager [is] not nearly so crucial, a member challenges the fiduciary duty limitations as manifestly unreasonable.…[15]

Based on the specific circumstances at the time the operating agreement was entered into, and in light of the LLC's purpose and business, it is not readily apparent that the objective of the term—inducing a person to serve as the manager of the LLC—is unreasonable, or that the term is an unreasonable means to achieve its objective—limiting a manager's fiduciary duties.

Sample Contract Language

When an operating agreement eliminates or restricts the duty of loyalty, identifies activities that do not violate the duty of loyalty, alters the duty of care, and/or prescribes standards by which to measure performance of the contractual obligation of good faith and fair dealing, practitioners may want to add the following provision:

> *Each Member acknowledges and agrees that the provisions of this Section x.xx are reasonable. If any portion of this Section x.xx should be adjudged to be manifestly unreasonable in any proceeding, such provision shall be appropriately modified by such court so that such provision may be enforced to the extent adjudged not to be manifestly unreasonable.*[16]

Conclusion

To summarize, a court may invalidate a term as manifestly (*i.e.*, clearly or obviously) unreasonable only if it is readily apparent that the objective of the term is

unreasonable or the term is an unreasonable means to achieve its objective. This determination is made as of the date the term was added to the operating agreement, based on the specific facts and circumstances of the LLC existing at that time, and in light of the LLC's purpose and business. ■

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Endnotes

1. N.J.S.A. 42:2C-39.
2. N.J.S.A. 42:2C-11(d).
3. N.J.S.A. 42:2C-11(h).
4. *See* Matthew D. Maser and Joseph R. Hefflinger, Nebraska's New Limited Liability Company Act: A Welcome Improvement for Legal Guidance Concerning Limited Liability Companies, 89 *Nebraska L. Rev.* 470, 479 (2011) [hereinafter Maser & Hefflinger]. *See also* Mark J. Loewenstein, Fiduciary Duties and Unincorporated Business Entities: In Defense of the 'Manifestly Unreasonable' Standard, 41 *Tulsa L. Rev.* 411 (2006).
5. For reference, N.J.S.A. 42:2C-11 is based on RULLCA §110, which is now designated as ULLCA §105. *See* NCCUSL Comment to RULLCA §110(h) and NCCUSL Comment to ULLCA §105(e), both available at www.uniformlaws.org.
6. NCCUSL Comment (dated Jan. 14, 2013) to ULLCA §105(e).
7. *Id.*
8. *Id.*, *citing In re Brobeck, Phleger & Harrison LLP*, 408 B.R. 318, 335 (Bankr. N.D. Cal. 2009) ("RUPA does not define what is 'manifestly unreasonable' and the parties have not cited, nor can the court locate, a decision that defines the term. Absent case law or even a dictionary definition, the court must rely on its common sense to recognize something as manifestly unreasonable.").
9. *Id.*, *citing Brandt v. Somerville*, 692 N.W.2d 144, 152 (N.D. 2005) (stating that "in close corporations, a majority of courts have sustained restrictions that are determined to be reasonable in light of the relevant circumstances"); *Roof Depot, Inc. v. Ohman*, 638 N.W.2d 782, 786 (Minn. Ct. App. 2002) (stating that "the restrictions [on share transfer] are not 'manifestly unreasonable' because they are reasonable means to ensure that the management and control of the business remains in the group of investors or with people well known to them"); *Castriota v. Castriota*, 268 N.J. Super. 417, 423-24 (App. Div. 1993) ("We are obliged to apply the statute in a manner consonant with its essential purpose to permit reasonable restrictions upon alienation.").
10. N.J.S.A. 42:2C-11(h)(1).
11. NCCUSL Comment to RULLCA §110(h)(1) (emphasis added).
12. *See* NCCUSL Comment to RULLCA §110(h) and Comment to ULLCA §105(e).
13. N.J.S.A. 42:2C-11(h)(2) (emphasis added).
14. Maser & Hefflinger at 482.
15. NCCUSL Comment to RULLCA §110(h)(1).
16. This proposed contract provision was drafted by Jeffrey M. Shapiro of Lowenstein Sandler LLP, and presented at the Institute for Continuing Legal Education's 2014 Business Law & Corporate Counsel Symposium.