

New Jersey Limited Liability Companies— Some Keys to Drafting Operating Agreements That Work

by Ira B. Marcus and Denise Walsh

Limited liability companies (LLCs) and corporations have a lot in common. To the business person forming (or having his or her lawyer form) an entity with which to conduct a business, the primary similarity, and the one of overriding importance, is the limited liability each affords its owners. Given this (and the ease with which each can be formed—the filing of a short certificate with the state of formation), it is easy for people to fall into the trap of thinking LLCs and corporations are the same. Lawyers and judges are not immune; even today, some cases refer to LLCs as limited liability corporations.¹

It is important, however, for lawyers representing clients forming LLCs to have more insight and sensitivity to the differences between these entities. A lawyer organizing an LLC must keep in mind that an LLC, unlike a corporation (even an S corporation) can choose to be governed by Subchapter K of the Internal Revenue Code.² One of the major advantages of an LLC is the ability that it affords its members to obtain the limited liability of a corporation, while enjoying tax classification as a partnership under Subchapter K. The lawyer also must recognize that, unlike corporations, the basic premise of statutes governing LLCs is that such entities will be governed internally by way of the contractual arrangements of the members.³ Unlike New Jersey's corporate statute, the New Jersey Limited Liability Company Act⁴ contains few statutory norms that deal with governance issues if the business owners do not do so by way of agreement. In those limited instances where the act does provide a statutory norm, it is almost always coupled with the phrase "unless otherwise provided in an operating agreement." Finally, unlike the New Jersey Business Corporation Act (NJBCA),⁵ the act is a relative newcomer that has neither been the subject of significant revision and refinement nor interpretive case law.

Although the act does not require that the members of an

LLC enter into an operating agreement, failure to do so means their relationship will be governed by the default provisions of the act, which may lead to unexpected and disappointing results if they do not reflect the intentions of the members. Thus, the authors consider a carefully crafted operating agreement to be essential. Set forth below are some important issues that should be addressed in an operating agreement, but are often overlooked.

Issue No. 1: Explicate the rights and obligations of those managing the LLC.

Unlike the well-established duties of care and loyalty owed by a director to a corporation and its shareholders, the fiduciary obligations owed by those managing an LLC are unclear in many states, including New Jersey. For instance, the act is virtually silent regarding the extent and nature of the fiduciary duties imposed upon those managing the LLC.⁶ The act merely provides that, unless a different standard of care is set forth in the operating agreement, those managing an LLC are not personally liable unless their actions constitute gross negligence or willful misconduct.⁷

Regarding indemnification, the act provides that an LLC can indemnify its members and managers to the extent provided in the operating agreement. Would a court enforce an

operating agreement that required an LLC to indemnify a member against his or her own willful misconduct? Does the right to indemnify set forth in the act imply the right to advance expenses, a right explicitly granted corporations in the NJBCA? The rights of members and managers to indemnification should be carefully crafted in an LLC's operating agreement.

Finally, the operating agreement should address under what circumstances those managing the LLC can contract with or transact business with the LLC, despite any applicable duty of loyalty. In the corporate context, the duty of loyalty prohibits directors from self-dealing, usurping corporate opportunities and receiving improper personal benefits. Most corporate statutes, including the NJBCA,⁸ set forth the requirements for these interested party transactions not to be deemed voidable solely because of the conflict presented.

In the context of LLCs, the act expressly permits both members and managers to contract with and transact business with an LLC, unless otherwise provided in the operating agreement.⁹ In contrast to the NJBCA, the act provides no guidance on how those governing an LLC can protect contracts between them and the LLC from successful attack.

Although an extensive body of case law has developed on the fiduciary obligations owed by directors to a corporation and its shareholders, only some states apply this case law directly to LLCs.¹⁰ Due to the lack of case law in New Jersey on this subject, it is unclear how, and if, New Jersey courts would apply the law of corporate fiduciary duties to LLCs. A recent New Jersey case, *D.R. Horton Inc. v. Dynastar Dev., L.L.C.*,¹¹ further clouds the issue. In that case, a New Jersey court for the first time addressed whether to apply the corporate veil-piercing doctrine, without change, to an LLC. Because of an LLC's special attributes, the court held that

the traditional corporate veil-piercing standard must be modified to afford lesser weight to factors such as adherence to corporate formalities, dominion and control by the owner, and undercapitalization.¹² Thus, although New Jersey courts may apply longstanding corporate fiduciary law in the context of an LLC, it also may modify the law to account for the differences between an LLC and a corporation.

Issue No. 2: Take into account the esoteric tax allocation rules, and include revaluation or book-up provisions if appropriate.

A lawyer forming an LLC must understand the economic concepts underlying such an entity's operation. Ignoring these economic concepts or relying solely upon the LLC's accountant, without any independent understanding of the concepts, is a disservice to the lawyer's clients. The LLC's economic structure controls the LLC's taxes and how the owners share in the economic results of the LLC.

As a general rule, neither the LLC nor any of its members recognizes gain or loss upon a member's contribution of property to the LLC in exchange for an interest in the LLC. Regardless of the fair market value of the property at the time of contribution, the LLC's basis in the contributed property is equal to the contributing member's basis in that property. In exchange for contributing the property, the member's capital account is credited with the fair market value of the property at the time of contribution. If the LLC later sells the property for fair market value, the taxable gain or loss on the sale of the property is allocated back to the member who originally contributed the property. Notwithstanding this result, the member's capital account is not affected by the sale because the fair market value of the property, rather than its tax basis, was credited to the member's capital

account in the first instance.

Similar rules apply when members' capital accounts are revalued or booked up immediately before the admission of a new member to the LLC.

If members contribute cash to an LLC, the members' capital accounts are credited with the cash contributed by each respective member. When the LLC later uses the cash to purchase property that increases in value, the members' capital accounts will not be affected by the increase in value unless and until the LLC sells the property and recognizes a gain. Upon sale of the property by the LLC, the profits are allocated to the members' capital accounts. Under the default rules, if the LLC admits a new member prior to selling the property, the new member also shares in the profits from the sale.

For example, A and B each contribute \$10,000 to form an LLC, with the operating agreement providing that each shares equally in profits and losses. Immediately after their contribution, each has a capital account of \$10,000. The LLC uses the \$20,000 to purchase securities. The securities appreciate in value to \$35,000 in the three years following the formation of the LLC. The \$15,000 gain has not yet been recognized and, therefore, no profits allocated to A and B. Both A and B each still have a capital account of \$10,000 (assuming, that the LLC has no other assets or income, and makes no distributions).

After this three-year period, A and B admit C as a one-third member under the operating agreement. C should pay \$17,500 for the membership interest (in order to account for one third of the total value of the capital of the LLC, or \$52,500, which consists of the \$35,000 value the LLC had before C's admission and C's contribution of \$17,500). After C's contribution, the capital accounts in the LLC are \$10,000 for A, \$10,000 for B and \$17,500 for C.

Soon after admitting C, the LLC sells the securities for \$35,000. The LLC allocates the gain equally among A, B and C. As a result, the capital accounts of A and B now equal \$15,000 (\$10,000 original capital account plus one third of the \$15,000 gain) and C's capital account now equals \$22,500 (\$17,500 original capital account plus one third of the \$15,000 gain).

Under the above scenario, C receives \$22,500 upon liquidation, but A and B receive only \$15,000.¹³ A and B likely did not anticipate this result when forming the LLC or when admitting C as a one-third member. Instead, they likely expected, and reasonably so, that each member's capital account would reflect a one-third interest in the LLC and that each member would receive \$17,500 upon liquidation.

In order to meet the reasonable expectations of the members, the operating agreement should provide for the booking up or revaluation of members' capital accounts at the time of a new member's admission. In other words, the operating agreement should allow for the revaluation of the LLC's property to fair market value, and the allocation of profits and losses to the members' capital accounts, immediately before a new member's admission.

In the above example, if the operating agreement of the LLC permitted the book up of the members' capital accounts, the securities would be revalued to fair market value immediately before the admission of C as a new member. As a result, the capital accounts of A, B and C would equal \$17,500 upon C's admission. Upon the later sale of the securities, the members' capital accounts each remain at \$17,500 because the LLC previously credited the accounts with the fair market value of the securities.

Issue No. 3: Detail the LLC's governance structure.

A crucial aspect of forming an LLC involves deciding on the LLC's governance structure. A lawyer forming an LLC should discuss with his or her client the different management options available and provide for the client's choices in the operating agreement.

First, those forming an LLC must decide whether the LLC will be managed by its members or one or more managers, who may or may not be members. Under the act's default rules, the members manage the LLC and each has the power to bind the LLC.¹⁴ Thus, each member, even a passive member, has apparent authority to bind the LLC. If the members desire otherwise, the operating agreement must indicate that the LLC shall be managed in whole or in part by one or more managers and must set forth the method of choosing the managers.

Another consideration is whether the members of the LLC or the managers, if any, should appoint officers. Most business people are familiar with the corporate structure and the traditional officer titles associated with a corporation (*i.e.*, president, vice president, etc.) and, thus, may feel more comfortable if their LLC's structure conforms to the corporate model. Traditionally, many lawyers avoided use of the corporate model if they wanted to prevent the LLC from having centralized management, an attribute that could cause the Internal Revenue Service to classify the LLC as a corporation. Since the adoption of the check-the-box regulations, however, nothing stands in the way of an operating agreement designating officers and providing how the officers are appointed and removed. Having a president, a treasurer, and so on can reduce uncertainty regarding the actual authority of persons purporting to act on behalf of the LLC in transactions with third parties.

Regardless of the agreed-upon structure, the operating agreement should

specify the powers and obligations of the members, managers and officers, as applicable. The operating agreement also should set forth the percentage of approval needed for various acts of the LLC. In a New Jersey member-managed LLC, most actions require majority approval. A draftsman should consider whether certain actions warrant a higher approval percentage. Further, for manager-managed LLCs, the operating agreement should specifically identify the actions of the managers that require member approval, and the required percentage for approval of each action.

For instance, the act states that, unless otherwise provided in an operating agreement, any member in a member-managed LLC can file for insolvency or reorganization of the LLC upon approval of a majority of the membership interests.¹⁵ In the case of a manager-managed LLC, the act permits a manager to file for insolvency or reorganization without receiving the approval of any of the members. The members may not intend for anyone to file for insolvency or reorganization except upon a supermajority vote, or upon the unanimous consent of the members. In addition, the act states that an LLC shall dissolve upon the written consent of all members. Perhaps the members intend for the LLC's dissolution upon the consent of less than all members.

The operating agreement also should identify the method of voting. Pursuant to the act, if an action requires the affirmative vote of either the managers or members, the operating agreement may provide for action by consent without a meeting.¹⁶ Presumably, action requiring an affirmative vote may not be taken by written consent unless stated in the operating agreement.¹⁷ In addition, unlike the Delaware LLC statute, which by default allows electronic transmission of consent, the act is silent in this respect. In light of the technological age

in which we live, an operating agreement should expressly allow for written consent via electronic transmission.

The operating agreement should recite whether managers or officers can delegate their authority to others within or outside of the LLC. Under Delaware law, a member or manager may delegate his or her rights to manage and control the business and affairs of the LLC to others including, without limitation, agents, officers or employees of the LLC.¹⁸ The act is silent regarding delegation, and it is uncertain whether third parties dealing with a delegatee in New Jersey would recognize the delegation absent, at the very least, a provision in the operating agreement permitting the delegation. The authority to delegate one's management rights may prove extremely useful to LLCs, especially those with a limited number of managers.

Finally, the operating agreement should include any rights of members akin to appraisal rights. Corporate statutes typically give shareholders who do not consent to certain major actions (e.g., a dispositional merger or certain amendments to the certificate of incorporation) the right to force the corporation to purchase his or her shares for fair value.¹⁹ The act provides no corresponding rights to members of LLCs. Suppose that an LLC that owns land is acquired by merger by a privately held strip club that wants to use the land to build another club. Should a member of the acquired LLC be forced to remain an owner against his or her will, despite ethical and religious concerns? Although the authors believe it is unlikely that the courts will impute the corporate-style appraisal rights mechanisms (which were legislatively, not judicially, created), it is possible the courts could do so under egregious circumstances. The best course of action is either to affirmatively provide for these rights in the operating agreement,

describe why they are not being granted to the members, or provide protections for non-assenting members that would make judicial intervention less likely.

Generally, the authors believe it is best to avoid the requirement of unanimous approval, even for amendments to the certificate of formation and the operating agreement. Requiring unanimous approval can create a deadlock situation. The authors believe it is important, however, that if the relative rights or preferences of a member or class of members are adversely affected, that member or class should have the benefit of contractual appraisal rights.

Issue No. 4: Incorporate an exit strategy.

An operating agreement should include appropriate buy-sell provisions, such as those that are common in agreements among the shareholders of corporations. For example, a buy-out might be triggered on a member's death, disability, or scheduled retirement. The buy-out price need not be the same for each triggering event. For example, the buy-out price on death might well be higher than the buy-out price resulting from an involuntary transfer. A shotgun-style buy-sell provision should be considered in the event the members are deadlocked on a major issue.

Another subject an operating agreement should address is the resignation of members. Specifically, an operating agreement should set forth the circumstances under which a member may resign, as well as the distributions the member should receive upon resignation.

Unless the operating agreement states otherwise, any member of a New Jersey LLC may resign at any time and for any reason, as long as the member provides not less than six months notice to the LLC, its managers and other members.²⁰ In addition, unless otherwise stated in the operating agreement, a resigning member is entitled to receive, in consid-

eration of his or her membership interest, the fair value of the interest as of the date of resignation, minus any applicable valuation discounts.²¹

Under the above default provisions, the resignation of several members in a short period of time, along with the accompanying fair value payout to each, may lead to disastrous results for the LLC. Instead of permitting such unfettered resignation, the owners should consider in the operating agreement the circumstances under which a member may resign. For instance, perhaps a member may resign only after he or she reaches a certain age or only upon the approval of the managers or a certain percentage of the members. As provided in the Delaware LLC Act,²² perhaps members should not be permitted to resign from the LLC prior to its dissolution and winding up.

Regardless of when a member resigns, the remaining owners should retain control over what the resigning member receives in distributions. The only way the owners of an LLC can retain this control is by setting forth in the LLC's operating agreement either a specific dollar amount to be paid to a member upon resignation or a formula for determining a dollar amount. Any valuation formula should make sense based on the business of the LLC. Further, the members should plug into the formula prospective figures so no one is later surprised by what a member receives upon resignation. Finally, the valuation formula should be determined in conjunction with the LLC's accountant, who can evaluate the pros and cons of utilizing the proposed formula.

Finally, it might be appropriate to include provisions that restrict the majority member of an LLC from improperly benefiting from the sale of control of an LLC to the detriment of the minority members. In the corporate context, there is a body of case law

regarding the obligations of majority shareholders to minority shareholders in this context. Not so in the LLC context. Likewise, the lawyer may want to limit the ability of minority members to thwart the ability of the majority members to sell the LLC. Both of these issues can be dealt with by the inclusion of so-called drag along/tag along provisions in the operating agreement.²³

Issue No. 5: Describe the circumstances under which a member can assign the member's interest in the LLC.

A thorough practitioner should discuss with his or her client, and include in the operating agreement, whether, and under what circumstances, a member may assign his or her interest in the LLC. Some issues to consider include, without limitation: 1) whether a member can assign his or her interest prior to the dissolution and winding up of the LLC; 2) whether an assignment requires member and/or manager approval; 3) whether the assigning member must sell his or her interest to the remaining members and/or the LLC or offer them a right of first refusal; 4) regardless of the restrictions placed on assignment, whether a member can assign his or her interest to relatives during life and/or upon death; and 5) the rights of an assignee including, without limitation, whether an assignment of a member's interest entitles the assignee to any rights of a member, other than economic rights.

Under the default rules of the act, a member may assign his or her interest in the LLC, in whole or in part.²⁴ However, upon assignment, an assignee only receives the economic benefits of membership, such as the right to receive distributions and share in the profits and losses of the LLC.²⁵ The assignee does not, for instance, receive any voting rights previously held by the assigning member. The authors have seen operat-

ing agreements that were not clear regarding the ramifications vis-à-vis voting when a member assigned his or her interests. Suppose an LLC has two equal members, one of which assigns 10 percent of that member's membership interests to a relative. Are the voting rights regarding this 10 percent assigned interest lost? Does the non-transferring member now own more than 50 percent of the membership interests entitled to vote, thus giving the non-transferring member control of the entity?

A recent amendment to Delaware's LLC statute expressly confirms that all members, managers and assignees of LLC interests are bound by the operating agreement (referred to as a limited liability company agreement in Delaware), regardless of whether they execute it.²⁶ Unfortunately, the act does not include an identical provision. Rather, the act states that an operating agreement may provide that a member or assignee: 1) shall be bound by the operating agreement upon its execution of the operating agreement or another writing evidencing an intention to be bound, or 2) without execution, upon fulfillment of the conditions for becoming a member or an assignee under the operating agreement and a request that the records of the LLC reflect this membership or assignment.²⁷

Thus, arguably, if an operating agreement is silent on this issue and the assignee of an LLC interest fails to execute either the operating agreement or a writing whereby the assignee agrees to be bound by its terms, the assignee may escape the contractual provisions of the operating agreement. A lawyer forming an LLC must be cognizant of the specific rules provided under the act regarding execution of the operating agreement.

Issue No. 6: Describe the remedies provided to a member of an LLC for mismanagement or wrongful acts.

As with a shareholder of a corpora-

tion, the act permits a member to bring a derivative action on behalf of the LLC under certain circumstances.²⁸ However, a member also has the common law right to bring an action against the LLC. Those forming the LLC may wish to limit the forum in which members may bring an action against the LLC, a manager or even another member. A common method of limiting the forum for contractual disputes is through an arbitration provision. Courts enforce arbitration provisions in operating agreements in the same manner as any other type of contract.²⁹ A practitioner should discuss with his or her client the advantages and disadvantages of including an arbitration provision in the LLC's operating agreement.

Further, the act, like the NJBCA, provides for the possible appointment of a receiver by the court upon liquidation.³⁰ However, unlike the NJBCA,³¹ and the case law interpreting it, the act does not provide for the possible appointment of a custodian or fiscal agent. As a result, a careful draftsman should consider inclusion of a provision in the operating agreement permitting a member to seek the appointment of a custodian or fiscal agent under certain circumstances.

A recent New Jersey case illustrates the potential importance of this type of provision. In *Actives International, L.L.C. v. Reitz*,³² a member, facing expulsion from the LLC, requested that the court appoint a receiver. The court denied the member's request, finding that the appointment of a receiver was a drastic remedy to be avoided whenever possible. A provision in the operating agreement permitting the appointment of a custodian or fiscal agent may be the type of less drastic remedy a court would enforce.

Conclusion

This article necessarily deals with only a small fraction of the issues that must be considered when organizing an

LLC and drafting an operating agreement. How will additional capital be raised? Must members guarantee the LLC's obligations to lenders or other parties? If so, what are the consequences to a member who fails to provide his or her guaranty? Can the LLC expel a disruptive or non-productive member? There is extensive case law in the corporate context dealing with cash-out and freeze-out mergers. Its applicability to LLCs is unknown, but the authors believe the courts will enforce operating agreement provisions dealing with these issues if they pass a baseline test of fairness and reasonableness.

Nothing that lawyers prepare should ever be treated as a form document, to be spit out from the word processor and used thoughtlessly. This is especially true with LLC operating agreements, given the lack of statutory norms, the absence of interpretive case law, and the wide latitude given the draftsperson. The specific context in which the operating agreement will be used must be considered. For instance, the management structure of an LLC owning passive real estate would surely be inappropriate for a manufacturing enterprise.

The flexibility provided by the LLC format offers many planning opportunities for people organizing businesses, but only if care is taken in crafting the operating agreement. ☞

Endnotes

1. See, e.g., *Freedman v. Freedman*, 834 N.E.2d 251, 252 (Mass. 2005) ("The settlor's family operates a residential real estate business that is organized in two limited liability corporations (LLCs)."); *Moyer v. Moyer*, 2005 WL 1991813, *1 (Tex. App., Aug. 17, 2005) (referring to an LLC as a limited liability corporation); *Holdeman v. Epperson*, 2005 WL 1714210, *1, 5 (Ohio App., July 22, 2005) (referring to LLCs inter-

changeably as "limited liability companies" and "limited liability corporations"). See also *Merovich v. Huzenman*, 911 So.2d 125, 126-27 (Fla. Dist. Ct. App. 2005); *Strouch v. 72 Degrees Heating and Air Conditioning, LLC*, 2004 WL 2397279, *6 (Conn. Super. Ct., Sept. 24, 2004).

2. I.R.C. § 701 *et seq.*
3. States differ on the name designated to the contract among LLC members. For purposes of this article, the authors refer to this contract as an operating agreement. New Jersey likewise refers to the contract among members as an operating agreement.
4. N.J.S.A. 42:2B-1 *et seq.*
5. N.J.S.A. 14A:1-1 *et seq.*
6. Cf. N.Y. Limited Liability Company Law § 409(a) (declaring that a manager has a statutory duty to perform his or her duties "in good faith and with that degree of care that an ordinarily prudent person would use under similar circumstances"); *Fla. Sta. Ann.* § 608.4225 (Florida's LLC statute specifically defines the duty of care and the duty of loyalty, and applies them to managers and managing members).
7. N.J.S.A. 42:2B-30.
8. See N.J.S.A. 14A:6-8.
9. N.J.S.A. 42:2B-9. Cf. *Mo. Stat. Ann.* § 347.088.3 (unless the operating agreement provides otherwise, no member or manager may enter into a transaction with the LLC without obtaining the approval of a majority of the LLC's members).
10. See, e.g., *In re Holcomb Health Care Servs., LLC*, 329 B.R. 622 (Bankr. M.D. Tenn. 2004) (relied exclusively upon corporate case law and the Tennessee corporate statute in analyzing an LLC officer's fiduciary duties); *Cimarron Feeders v. Bolle*, 17 P.3d 957 (Kan. App. 2001) (upholding use of fiduciary duty language from partnership statute in jury

instruction regarding duties of members of LLC).

11. 2005 WL 1939778 (N.J. Law Div., Aug. 10, 2005).
12. *Id.* at 31.
13. Liquidating distributions due to any member are equal to the member's capital account plus the member's share of unrealized profits, minus the member's share of unrealized losses.
14. N.J.S.A. 42:2B-27(a)(b).
15. N.J.S.A. 42:2B-27(b)(1).
16. N.J.S.A. 42:2B-22.
17. Cf. 6 Del. C. § 18-404 (the default rule is that any action that can be taken by vote can be taken by the written consent of the minimum number needed to approve the action).
18. 6 Del. C. § 18-407.
19. The NJBCA provides dissenting shareholders with the right to force a corporation to redeem the shareholder's shares for fair value. N.J.S.A. 14A:11-2.
20. N.J.S.A. 42:2B-38.
21. N.J.S.A. 42:2B-39(a).
22. 6 Del. C. § 18-603.
23. A drag along is a right that allows a majority owner selling his or her ownership interest to compel a minority owner to also sell his or her ownership interest in the same transaction and on the same terms. A tag along is a right that allows a minority owner to sell his or her ownership interest in the same transaction and on the same terms as when the majority owner sells his or her ownership interest.
24. N.J.S.A. 42:2B-44.
25. *Id.*
26. 6 Del. C. § 18-101(7).
27. N.J.S.A. 42:2B-21.
28. N.J.S.A. 42:2B-60.
29. See, e.g., *Palaio v. Letson*, 611 S.E.2d 787 (Ga. App. 2005) (holding LLC member implicitly agreed to arbitrate issue of arbitrator's jurisdiction and affirming dismissal of declaratory judgment

action requesting declaration that certain claims were not subject to arbitration under operating agreement). See also *CAPROC Manager, Inc. v. The Policemen's & Firemen's Retirement Sys. of the City of Pontiac*, 2005 WL 937613 (Del. Ch. March 18, 2005).

30. N.J.S.A. 42:2B-49.1.

31. N.J.S.A. 14A:12-7.

32. 2005 WL 1861939 (N.J. Ch. Div., Aug. 5, 2005).

Ira B. Marcus is a member of Marcus, Brody, Ford, Kessler & Sahnner, L.L.C., in Roseland. He is a director of the Business Law Section and the chair of its Business Entities Committee, and teaches a course in corporate finance at Rutgers Law School-Newark. **Denise Walsh** is an associate with Marcus, Brody, Ford, Kessler & Sahnner, L.L.C., and a member of the Business Entities Committee.