



**STATE OF NEW JERSEY**

NEW JERSEY LAW REVISION COMMISSION

**Final Report**

Relating to

**Uniform Limited Liability Company Act**

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## **Introduction**

The Uniform Limited Liability Company Act was recommended for enactment by the National Conference of Commissioners on Uniform State Laws in 1996, and was later revised and amended in 2006. The Revised Uniform Limited Liability Company Act (RULLCA) permits the formation of limited liability companies (LLCs), which provide the owners with the advantages of both corporate-type limited liability and partnership tax treatment.

The LLC as a distinct form of business organization has a recent history. The first legislation in Wyoming in 1977 introduced the concept. An LLC is generally characterized as a business organization which looks like a partnership or limited partnership in terms of internal structure and relationships among members, or members and managers, but with the additional characteristic of a liability shield from vicarious liability for members and managers. An LLC has members who primarily contribute capital to the company and who share in the profits or losses. It may have managers who do the business of the company. A member may be a manager, but non-member (i.e. disinterested) managers are also allowed. If there are no designated managers, members run the company as general partners in a general partnership would. An LLC statute has certain key features: a means of creating the company, usually by filing a certificate; a liability shield provision; rules governing the relations between members, and between members and any managers; rules governing distributions of profits or losses to members and a member's creditor's rights; rules governing a member's exit rights from the company; rules on dissolution of the company, and rules governing mergers and conversions. An LLC is usually governed by an operating agreement that almost always supersedes and overcomes a particular state's statutory rules.

The LLC originated in the desire to have a full liability shield while retaining the so-called "pass-through" qualities of a partnership. This means that the company itself pays no federal income tax, leaving any tax liability to members receiving taxable distributions from the company. Before LLCs, full limitation of liability was available only for corporation shareholders. While some corporations are treated as partnerships for tax purposes, most, however, are taxed as separate individuals on corporate income, and shareholders are also taxed on distributions made to them. The ability to obtain pass-through status provided very substantial incentive for states to enact limited liability company statutes. States did this, but without anything like coherent uniformity. The great wave of statutes preceded the promulgation of the 1996 Uniform Act.

New Jersey first promulgated LLC laws in 1993. *N.J.S.A. § 42:2B-1 et. seq.*, "New Jersey Limited Liability Company Act" (NJLLCA). The Legislature initially intended LLCs to be a distinct corporate entity that was limited in scope and function. *See* Senate Commerce Committee Statement, 2004 Main Volume, Senate, No. 890--L.1993, c. 210. Since 1993, the definition and business utility of the LLC has changed significantly. In order to have the state law reflect national business trends, the New Jersey Legislature continuously amended NJLLCA to reflect these changes. While the amendments to NJLLCA are progressive in nature and reflect current business perspectives, they have inevitably created a "patch-work" structure. *See generally* NJLLCA. The Revised Uniform Limited Liability Company Act (RULLCA) is similar in substantive to the NJLLCA; it would modify the LLC law in New Jersey only slightly.

However, RULLCA would benefit New Jersey law by providing a comprehensive guideline for LLC operations while streamlining the current “patch-work” provisions already in place.

Since its introduction in 2006, RULLCA has been enacted in five states, Idaho, Iowa, Nebraska, Utah, and Wyoming. RULLCA has also been enacted in District of Columbia. In 2011, RULLCA was introduced in California, Kansas, Minnesota, and New Jersey. The New Jersey Bar Association reviewed RULLCA and recommended it with a few minor differences. In June of 2011, Senator Paul Sarlo introduced a version of RULLCA based on the Bar Association proposal. The bill was later referred to the Senate Commerce Committee.

As noted, there are some areas of difference between the RULLCA and the current NJLLCA, often because RULLCA includes subjects that are not in current New Jersey law. There are also a few differences between the pending bill and the RULLCA approved by the Uniform Law Commission. These differences are:

- **Perpetual Duration.** RULLCA eliminates the default (and often overlooked) rule that LLCs have a limited life. As is the case with corporations, RULLCA provides for LLCs to have perpetual duration.
- **Flexible management structure.** Under RULLCA, it is possible to have any type of management structure the LLC members want, including a corporate-style board of directors and officers. The type of management structure is set forth in the operating agreement.
- **LLCs may engage in any lawful purpose.** Under RULLCA, an LLC is not restricted to for-profit business activities. It can have "any lawful purpose, regardless of whether for profit." This expands the availability of LLCs to family vacation homes and organizations whose activities might be classified as non-profit.
- **Permissible form of operating agreement.** RULLCA permits operating agreements to be oral, written or implied based on the way an LLC has operated. This is consistent with the vast majority of states and in line with the organization of many LLCs formed in New Jersey.
- **Shelf LLCs.** RULLCA permits an LLC to form even though it does not have any members at the time of formation. This type of formation requires two filings. The first filing would have to contain a statement to the effect that the LLC did not have any members. The second filing, which is required to be made no more than 90 days after the first filing, would be made at the time as members did exist. The benefit of this shelf LLC filing allows the formation of an LLC, which becomes public record, prior to memorializing of its members and operating agreement. This may provide a benefit to members. For example, the LLC may be formed before the precise identity and contributions of the members have been decided. The two step filing process creates a period in which an LLC can form without members. The pending bill does not include this provision.

- **Deadlock, Oppression and Express Equitable Remedies.** The New Jersey Bar Association and Senator Sarlo proposed a stronger deadlock provision that has been modeled on *N.J.S. 14A:12-7*.<sup>1</sup> Equity courts currently have the authority to order a broad range of remedies other than dissolution. NJSBA and Senator Sarlo felt that these powers were rarely exercised and in their proposal expressly authorize the court to grant additional remedies. These include the appointment of a custodian or more provisional managers, if it appears in the best interest of the LLC. Unlike the RULLCA proposal, the current bill expressly authorizes the court to award counsel fees if it determines that a party has acted vexatiously or otherwise not in good faith. The bill also makes it explicit that a party may seek remedies other than dissolution.
- **Internal affairs default rules.** RULLCA contains a basic set of internal affairs default rules governing the relationship members and managers of an LLC between themselves and each other, most of which can be varied by the operating agreement. For example, if the operating agreement is silent on the type of management structure, an LLC is member-managed by default. There are also default rules for decisions by members and managers and for other matters.
- **Duties and liabilities of managers.** RULLCA incorporates the fiduciary duties of loyalty and due care for managers and clarifies the contractual status of the duty of good faith and fair dealing. These duties may be restricted or eliminated "if not manifestly unreasonable." The business judgment rule is applicable to a case involving a breach of due care claim. The operating agreement may limit or eliminate liability of a manager to the LLC or other members for monetary damages except for breaches of the duty of loyalty, improper distributions, intentional infliction of harm to the LLC or a member or an intentional violation of criminal law. These rules are similar to those found in state corporation statutes.

However, Senator Sarlo's bill and the proposal by the New Jersey State Bar differ slightly from the RULLCA standards. The current standard of care for a New Jersey LLC is to refrain from willful misconduct and engaging in gross negligence. While RULLCA refers to a standard of ordinary care, in application it may be softened by the business judgment rule. It appears that New Jersey has incorporated the gross negligence standard in lieu of business judgment rule protection.

- **Indemnification.** Current New Jersey law indicates that a limited liability company *may* indemnify and hold harmless a member, manager, or other person. RULLCA provides that a limited liability company *must* indemnify members and managers for expenses or liabilities. Senator Sarlo's bill expands RULLCA's indemnification provisions. It makes it so that "company agents" entitled to indemnification include all persons who are members of a member managed company; a manager of a manager-managed company; or an officer, employee or agent of the indemnified company or a constituent company absorbed by it. The New Jersey definition also includes people who were serving as managers, officers, directors, trustees, employees or agents of any "other enterprise" serving as such at the request of the indemnifying company.

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<sup>1</sup> RULLCA introduces a new provision for dissolution which is similar to *N.J.S.A. 14A:12-7*.

- **Agency authority.** The authority of members and managers to bind an LLC is determined by agency law and not by status, as is the case under most existing LLC statutes. Certificates of authority may be filed in the office of the Secretary of State (and in the case of real estate in the office where real estate records are kept) to provide notice that only certain members or managers have authority to conduct business on behalf of the LLC. As is the case under current New Jersey Law, RULLCA allows an LLC to file statements of authority with the Division of Revenue in the Department of the Treasury (and in the case of real estate, in the office where real estate records are maintained) authorizing certain people or entities to bind the LLC.
- **Charging orders.** RULLCA clarifies and simplifies the rules governing charging orders, the exclusive remedy for a creditor of a member to obtain a member's financial rights to distributions from the LLC. RULLCA also provides the rules for foreclosing on a charging order and makes it absolutely clear that a purchaser of a foreclosed interest only obtains financial rights and does not become a member of the LLC by virtue of the foreclosure.
- **Distributions.** RULLCA specifies the circumstances under which distributions from an LLC can and cannot be made and contains provisions for recovery of improper distributions. RULLCA also makes it clear that payment for reasonable compensation and for retirement plans or other benefits programs are not distributions.
- **Direct and derivative claims, special litigation committees.** Under RULLCA, a member can bring a direct action for injuries to that member and can bring a derivative action to enforce a claim of an LLC. If a derivative action is filed, the LLC may form a special litigation committee to investigate the asserted claims. This stays the litigation while the committee does its investigation. The objective of the investigation is to determine if the litigation is for the good of the company.
- **Domestication and Conversion.** RULLCA provides enhanced ease and flexibility for domesticating, merging and converting an entity other than a domestic limited liability company, if permitted by the law under which it was formed. Its comprehensive provisions offer streamlined methods for domestication (*e.g.*, allowing an LLC formed under the laws of another state to become a New Jersey LLC) and conversion (*e.g.*, allowing a corporation to become an LLC).

In conclusion, the New Jersey Law Revision Commission finds that RULLCA represents a significant advancement in this area of law. RULLCA will provide a comprehensive and coherent body of law regulating limited liability companies. In addition, there are some benefits of uniformity in reduced compliance costs, streamlined administration (which reduces costs to states) and decisive consistency across jurisdictions. Enactment of the pending Senate bill, which adopts RULLCA with a few New Jersey specific provisions, would be beneficial to LLC law in New Jersey.