LLC's FROM A TO Z

2024 Seminar Material

MI0004.24

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LLC's FROM A TO Z

Moderator

Anthony Wilkinson, Esq.
Wilkinson Law LLC
(Edison)

Speaker

Alan F. Kornstein, Esq.
McCarter & English, LLP
(Newark)

Jason J. Krisza, Esq.
Wilentz, Goldman & Spitzer, P.A.
(Woodbridge)

Gianfranco A. Pietrafesa, Esq.
Archer & Greiner, P.C.
(Hackensack)

Ektaa Sanghvi Shah, CPA, MST
CPA4TAX, LLP
(Kendall Park)

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LLCs From A to Z

Materials

Prepared by

Gianfranco A. Pietrafesa, Esq.
Archer & Greiner, P.C.
(Hackensack, NJ)

201.498.8559
gpietrafesa@archerlaw.com

PowerPoint Slides

- DE LLCs vs. NJ LLCs
- Consequences of Not Having a Written Operating Agreement
- Rights of Members and Managers to Address in Operating Agreement
- Separating from a NJ LLC

Articles and Papers

1. NJ LLC vs. DE LLC – A Comparison of Five Major Default Provisions
2. An Operating Agreement is Essential Under RULLCA
3. Avoiding Legal Malpractice in LLC Formations
4. Avoid Problems with Properly Drafted LLC Operating Agreements
5. The Duty of Loyalty under the New Jersey Revised Uniform Limited Liability Company Act
6. NJ-RULLCA Provisions Requiring Unanimous Consent of Members
7. Non-Waivable Provisions Under the New Jersey Revised Uniform Limited Liability Company Act
8. The Manifestly Unreasonable Standard Under NJ-RULLCA
9. Death and the NJ LLC
10. Events Triggering Buy-Sell Obligations
11. Valuation Methods for Determining Purchase Price Under Buy-Sell Agreements

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LLCs from A to Z

Presented by
Gianfranco A. Pietrafesa, Esq.

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DE LLCs vs. NJ LLCs

Are there advantages
to forming an LLC
in Delaware
as compared to
New Jersey?

DE LLCs vs. NJ LLCs

DE LLCs have only a few advantages over NJ LLCs.

One is privacy –

- Delaware does not require the names of the members of an LLC to be listed in the Certificate of Formation or in the annual franchise tax filing. Further, there is no annual report required.
- Therefore, the identity of a DE LLC's members remains private and is not available to the general public.
- In NJ, a manager or managing member needs to be identified in the annual report.

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DE LLCs vs. NJ LLCs

DE LLCs have only a few advantages over NJ LLCs.

A second is the continuous improvement in DE's LLC statute.

- DE reviews and amends its LLC statute annually. NJ, not so much; in fact, amendments are rare.
- For most businesses, this is not an important advantage.

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DE LLCs vs. NJ LLCs

DE LLCs have only a few advantages over NJ LLCs.

A third is the DE courts.

- The Court of Chancery handles many disputes concerning LLCs and, therefore, management and ownership have confidence in the ability of the DE courts to understand LLC issues.
- NJ has a complex business litigation program with specific judges assigned to such cases, but it doesn't compare to the DE Court of Chancery.
- For most businesses, this is not an important advantage.

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DE LLCs vs. NJ LLCs

DE LLCs have only a few advantages over NJ LLCs.

A fourth is the case law from the DE courts.

- The Court of Chancery and the DE Supreme Court writes many opinions concerning LLC issues, which help in understanding DE's LLC statute.
- NJ courts do not write many opinions, published or unpublished, concerning LLC issues.
- For most businesses, this is not an important advantage.

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DE LLCs vs. NJ LLCs

The State of Delaware itself provides information on the benefits of forming a business entity in DE. See Why Delaware? (Why Businesses Choose Delaware) at https://corplaw.delaware.gov/why-businesses-choose-delaware.

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DE LLCs vs. NJ LLCs

Aside from the foregoing, whether a DE LLC has advantages over a NJ LLC depends on the perspective of (1) the manager or member of an LLC or (2) a majority/controlling member or minority/silent member of an LLC. Therefore, it is important to know some of the significant differences between DE LLCs and NJ LLCs.

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DE LLCs vs. NJ LLCs

Until 2013, NJ's LLC statute was modeled after DE's LLC statute. However, in 2013, NJ repealed its LLC statute and the New Jersey Revised Uniform Limited Liability Company Act ("NJ-RULLCA") came into effect.

- NJ-RULLCA is modeled after the Revised Uniform Limited Liability Company Act ("RULLCA") promulgated by the Uniform Law Commission (which drafted the UCC, GP, and LP statutes).
- RULLCA has been adopted in 20 states plus DC.

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DE LLCs vs. NJ LLCs

Issue	DE	NJ
Statutory protection of minority members	No, minority members need to protect themselves in the LLC agreement, but often do not have the bargaining power to do so	Yes
Freedom of contract	Yes, virtually absolute	Yes, with major guardrails (see N.J.S.A. 42:2C-11)
Elimination of fiduciary duties	Yes	Duty of loyalty may be altered but not eliminated and duty of loyalty may be altered or eliminated, unless manifestly unreasonable

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DE LLCs vs. NJ LLCs

Issue	DE	NJ
Indemnification	No; it must be addressed in the LLC agreement	Yes, but it may be altered or eliminated in the operating agreement
Voting	Pro rata based on members' LLC interests, etc.	Per capita, meaning every member has an equal vote, unless otherwise provided in the operating agreement
Distributions	Pro rata based on members' LLC interests, etc.	Per capita, meaning every member receives an equal share, unless otherwise provided in the operating agreement

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DE LLCs vs. NJ LLCs

Issue	DE	NJ
Initial cost	$110	$125
Annual cost	$300	$75

I never understood why someone doing business in NJ would want to form a DE LLC and then qualify it to do business in NJ. Results:

- Must pay annual costs in NJ and DE.
- Must pay a third party to serve as a registered agent in DE.

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DE LLCs vs. NJ LLCs

For two perspectives on NJ vs DE LLCs, see the following:

- Lawrence A. Goldman, "Delaware LLC vs. New Jersey LLC for Complex Business Transactions", New Jersey Law Journal (June 16, 2014), available at https://media.gibbonslaw.com/wp-content/uploads/2019/01/07160208/GoldmanNJLJ.pdf.
- Jason D. Navarino, "Avoiding New Jersey's LLC Minority Oppression Statute through Domestication" (October 31, 2016), available at https://riker.com/publications/avoiding-new-jerseys-llc-minority-oppression-statute-through-domestication.

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DE LLCs vs. NJ LLCs

My two  :

I prefer NJ LLCs, unless there are compelling reasons to use a DE LLC (e.g., the LLC will be seeking venture capital or private equity investors; however, a NJ LLC can very easily convert / domesticate to a DE LLC).

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Consequences of Not having a Written Operating Agreement

What are the consequences
– the disadvantages –
of not having
a written operating agreement
for a NJ LLC?

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Consequences of Not having a Written Operating Agreement

Voting on *ordinary* matters
(i.e., matters in the ordinary course of business)

- Approval by the majority of members (per capita, NOT pro rata). [NJSA 42:2C-37(b)]

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Consequences of Not having a Written Operating Agreement

Dan has 60% profit percentage
Sam has 20% profit percentage
Wendy has 20% profit percentage

A majority of members (per capita) makes decisions; so, Members Sam and Wendy, who together own only 40% of the profit percentages, decide ordinary matters for the LLC.

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Consequences of Not having a Written Operating Agreement

Voting on *extraordinary* matters
(i.e., matters outside the ordinary course of business, such as a merger or sale of all assets, and amendment of operating agreement)

- Unanimous approval by all members. [NJSA 42:2C-37(b)(4), -37(b)(5) & -37(c)(4)]

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Consequences of Not having a Written Operating Agreement

Distributions

- Equal shares to members and dissociated members (per capita, NOT pro rata). [NJSA 42:2C-34(a)]

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Consequences of Not having a Written Operating Agreement

Duty of care

[N.J.S.A. 42:2C-39(c)]

- refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law
- is this low standard of care satisfactory for most LLCs?

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Consequences of Not having a Written Operating Agreement

Duty of care

[N.J.S.A. 42:2C-39(c)]

- If not manifestly unreasonable, an operating agreement may alter (but not eliminate) the duty of care, but may not authorize conduct involving intentional misconduct or knowing violation of law. [N.J.S.A. 42:2C-11(d)(3)]

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Consequences of Not having a Written Operating Agreement

Duty of care

[N.J.S.A. 42:2C-39(c)]

- For example, an operating agreement can impose a higher standard of care: For a member to perform his/her duties in good faith, in a manner he/she reasonably believes to be in the best interest of the Company, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.

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Consequences of Not having a Written Operating Agreement

Duty of loyalty—Account to LLC

[N.J.S.A. 42:2C-39(b)(1)]

- account to the LLC, and hold as trustee for it, any property, profit or benefit derived by member/manager
  - in the conduct or winding up of its business
  - from use of LLC property by member/manager
  - from appropriating LLC opportunity

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Consequences of Not having a Written Operating Agreement

Duty of loyalty—No self-dealing

[N.J.S.A. 42:2C-39(b)(2)]

- no self-dealing with LLC
- this prohibition presents a problem for most family-owned and closely-held LLCs

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Consequences of Not having a Written Operating Agreement

Duty of loyalty—No self-dealing

[N.J.S.A. 42:2C-39(b)(2)]

- Self-dealing sounds bad, but is common in closely-held and family-owned LLCs. Examples:
  - Loans from members and managers (or their affiliates) to LLC.
  - Leasing of real and personal property by members and managers (or their affiliates) to LLC.

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Consequences of Not having a Written Operating Agreement

Duty of loyalty—No self-dealing

- NOTE: A member or manager has a statutory defense to a claim alleging a breach of the duty of loyalty by self-dealing—the transaction is fair to the LLC [N.J.S.A. 42:2C-39(g)].
- Examples:
  - Terms commercially fair and reasonable to the LLC
  - Terms no less favorable to the LLC than those generally provided to or available from unrelated third parties

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Consequences of Not having a Written Operating Agreement

Duty of loyalty—No competing

[N.J.S.A. 42:2C-39(b)(3)]

- refrain from competing with LLC
- this prohibition can present a problem for LLCs that are real estate holding companies and for members who are silent investors in many LLCs

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Consequences of Not having a Written Operating Agreement

Duty of loyalty

- If not manifestly unreasonable, an operating agreement may restrict/alter and even eliminate some or all aspects of the statutory fiduciary duty of loyalty [N.J.S.A. 42:2C-11(d)(1)]
  - an operating agreement may identify specific types or categories of activities that do not violate the duty of loyalty [N.J.S.A. 42:2C-11(d)(2)]
    - Example: eliminate duty of non-competition in RE Holdco

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Consequences of Not having a Written Operating Agreement

Duty of loyalty

- If not manifestly unreasonable, an operating agreement may restrict/alter and even eliminate some or all aspects of the statutory fiduciary duty of loyalty [N.J.S.A. 42:2C-11(d)(1)]
  - an operating agreement may specify a method for one or more disinterested and independent persons (e.g., retired judge) to authorize or ratify a specific act or transaction that would otherwise violate the duty of loyalty after full disclosure of material facts [N.J.S.A. 42:2C-11(e)]

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Consequences of Not having a Written Operating Agreement

Duty of loyalty

- NOTE: Even in the absence of an operating agreement altering or eliminating the duty of loyalty, all members may, after full disclosure of all material facts, authorize or ratify a specific act or transaction that violates the duty of loyalty [N.J.S.A. 42:2C-39(f)]

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Consequences of Not having a Written Operating Agreement

Resignation

- A member has the power to resign (i.e., dissociate) at any time by withdrawing as a member. [NJSA 42:2C-45(a)]

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Consequences of Not having a Written Operating Agreement

Resignation

Effect of resignation/withdrawal/dissociation:

- no right to vote or participate in the management of the LLC
- no fiduciary duties as of the date of dissociation
- mere transferee, who owns an economic interest
- still liable for debts to LLC while a member (e.g., capital contributions promised but not made)

[NJSA 42:2C-47]

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Consequences of Not having a Written Operating Agreement

Resignation

- A resigning / withdrawing member is NOT entitled to a buy out of his/her membership interest for fair value.
- Instead, he/she is a dissociated member entitled to continue receiving distributions, if any.

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Consequences of Not having a Written Operating Agreement

Economic Effect of Resignation

Dan owns 60%

Sam and Wendy each owns 20%, and Wendy resigns

Before Wendy's withdrawal

Dan, Sam and Wendy each get 33.33% of distributions

After Wendy's withdrawal

Dan, Sam and Wendy each continue to get 33.33% of distributions

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Rights of Members and Managers to Address in Operating Agreement

What are the factors to consider when drafting or negotiating member, manager, board and minority member rights in an LLC operating agreement?

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Rights of Members and Managers to Address in Operating Agreement

Factors to consider when drafting and negotiating the rights of members and managers in an LLC operating agreement.

- First, success in negotiating rights to be addressed in an operating agreement depends on the bargaining power of the parties
  - If it's important, address it in the operating agreement, or
  - If it's important, and it's not address it in the operating agreement, walk (or run) away

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Management of LLC
  - Member-managed LLC (statutory default)
    - All members (like a general partnership)
    - One or more managing members (hybrid of general and limited partnerships)
      - Address rights and obligations of non-managing members in operating agreement
  - Manager-managed LLC
    - One or more managers (like a limited partnership)
    - Board of directors (like a corporation)
    - Appointment and removal, with or without cause

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Voting
  - Ordinary matters
  - Extraordinary matters
  - Major decisions
    - Supermajority vote
    - Unanimous vote

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Distributions
  - Waterfall
  - Priority return of capital contributions
  - Tax distributions
  - Mandatory vs discretionary
    - Required distributions from cash flow (less cash reserves)
    - Who makes decision
  - Profits interest

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Deadlock
  - One party has extra vote to break deadlocks
  - One party has 50.1% ownership and thus final decision making
  - Designate a person to break deadlocks
  - Dissolve and liquidate the LLC
  - One party sets a purchase price and the other party decides whether to sell or buy at that price

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Deadlock
  - Mediation with an independent mediator
  - Binding arbitration with an independent arbitrator
  - Good ole litigation
  - Coin flip
  - Do nothing and let the parties work it out

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Transfer restrictions
  - Permitted transfers
  - Change of control of entity owners
  - Unanimous, supermajority or majority approval
  - Full membership interest vs economic interest only

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Information/inspection rights
  - Statutory only vs. contractual (broader / more liberal rights)
  - Restrictions on access to information/inspection (e.g., competitors)
  - Regular financial reports (e.g., annual, quarterly, monthly)
  - Full tax return or member's K-1 only

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Fiduciary duties
  - Care
  - Loyalty
- Scope – alteration or elimination
- Good faith and fair dealing

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Capital calls – additional capital contributions
  - Objective need for capital
  - Right to contribute to maintain ownership percentage (preemptive rights / non-dilution)

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Failure to contribute additional capital
  - Dilution
  - Loan
  - Loss of distributions
  - Loss of voting rights
  - Buyout at discounted price

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Rights of Members and Managers to Address in Operating Agreement

Items to address in an operating agreement:

- Buy-Sell (addressed in next set of slides)

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Separating from a NJ LLC

What are prudent approaches for members to separate from a NJ LLC?

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Separating from a NJ LLC

- As noted, under NJ-RULLCA, a member has the power to resign (i.e., dissociate) at any time by withdrawing as a member. [NJSA 42:2C-45(a)]
- A resigning / withdrawing member is NOT entitled to a buy out of his/her membership interest for fair value (which was the case under the repealed statute). Instead, he/she is a dissociated member entitled to continue receiving distributions, if any.
- As a result, it would be prudent to include buy-sell provisions in an operating agreement.

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Separating from a NJ LLC

Buy-Sell Triggering events

- Death
- Disability
- Divorce
- Departure
  - Resignation
  - Termination
- Bankruptcy

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Separating from a NJ LLC

Buy-Sell – Valuation and Purchase Price

- Return of capital / capital account balance
- Certificate of value or agreed value
- Formula
- Appraisal
  - Fair value vs. fair market value (discounting vs.no discounting)

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Separating from a NJ LLC

- Buy-Sell – Payment terms
  - Funding
  - Redemption vs. cross-purchase

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NJ LLC vs. DE LLC – A Comparison of Five Major Default Provisions

By Gianfranco A. Pietrafesa, Esq. (Archer & Greiner, P.C.)

This paper reviews five major default provisions under the New Jersey Revised Uniform Limited Liability Company Act ("NJ-RULLCA") compares them to the default provisions under the Delaware Limited Liability Company Act.[1]

1. Distributions.

NJ	DE
Under NJ-RULLCA, each member of an LLC is entitled to an equal share of the profits or losses, regardless of capital contributions or percentage ownership interests. This applies to both regular distributions, N.J.S.A. 42:2C-34(a), and liquidating distributions (after the payment of unreturned capital contributions). N.J.S.A. 42:2C-55(b).	Under Delaware law, each member is entitled to share in the profits or losses based on the agreed value of each member's capital contribution to the LLC. 6 Del. 18-504.

2. Voting.

NJ	DE
Under NJ-RULLCA, ordinary matters are decided by a majority of the members, with each member having one vote ("per capita"), N.J.S.A. 42:2C-37(b)(3), and extraordinary matters, including mergers, are decided unanimously by the members. N.J.S.A. 42:2C-37(b)(4).	Under Delaware law, most matters, including mergers, are decided by a majority of the members' current profit percentages. 6 Del. 801(a) & 402.
Under NJ-RULLCA, dissolution of an LLC requires the unanimous approval of all members. N.J.S.A. 42:2C-48(a).	Under Delaware law, dissolution requires the approval of two-thirds of the members' then current profit percentages. 6 Del. 18-801.

3. Resignation.

NJ	DE
Under NJ-RULLCA, a member may resign, but continues to own an economic interest as a dissociated member of an LLC. N.J.S.A. 42:2C-45(a). As such, he continues to receive distributions, if any, made by the LLC, but has no management or voting rights. N.J.S.A. 42:2C-34(a), 47(a) & 56(b)(2).	Under Delaware law, a member may not resign from an LLC, unless permitted by the LLC agreement. 6 Del. 18 603. However, if a member is permitted to resign, but the LLC agreement does not specify the terms of the LLC's purchase of the resigning member's equity interest, the member is entitled to fair value for its LLC interest. 6 Del. 18-604.

[1] This article is based, in part, on an article by the author published in the January 2013 Newsletter of the New Jersey Chapter of the Association of Corporate Counsel (NJCCA). © 2024 by Gianfranco A. Pietrafesa. All Rights Reserved.

4. Duty of Loyalty.

NJ	DE
Under NJ-RULLCA, members of a member-managed LLC and managers of a manager-managed LLC owe a duty of loyalty to the LLC and to the members. N.J.S.A. 42:2C 39(a) & -39(i)(1). (In a manager-managed LLC, the members do not have a duty of loyalty.) The duty of loyalty includes refraining from competing with the LLC and accounting to the LLC for any profits or benefits derived by a member or manager from misappropriating an opportunity belonging to the LLC. N.J.S.A. 42:2C 39(b). NJ-RULLCA permits the duty of loyalty to be restricted and even eliminated in an LLC operating agreement, so long as doing so is not manifestly unreasonable. N.J.S.A. 42:2C-11(d). It also allows an LLC agreement to include a mechanism for disinterested and independent persons, after full disclosure of all material facts, to authorize or ratify an act that violates the duty of loyalty. N.J.S.A. 42:2C-11(e). Even if the LLC agreement does not restrict or eliminate the duty of loyalty, the members may unanimously authorize or ratify a member's act that violates the duty. N.J.S.A. 42:2C-39(f).	Delaware LLC law does not specify any duty of loyalty, but states that fiduciary duties may be restricted or eliminated. 6 Del. 1101(c).

5. Oppression.

NJ	DE
NJ-RULLCA provides protection for an oppressed minority member of an; for example, permitting the appointment of a custodian or provisional managers and requiring the LLC and the other members to purchase the equity interest of an oppressed member. N.J.S.A. 42:2C 48. These rights and remedies are similar to those available to an oppressed minority shareholder of a corporation under New Jersey's Business Corporation Law. N.J.S.A. 14A-12-7(c).	Delaware LLC law does not provide a member with any statutory rights or remedies for oppression. There is very little case law protecting oppressed minority member. A member of a Delaware LLC needs to negotiate protection in the LLC agreement.

AN OPERATING AGREEMENT IS ESSENTIAL UNDER NJ-RULLCA

By Gianfranco A. Pietrafesa*

The New Jersey Revised Uniform Limited Liability Company Act (the "Act" or "NJ-RULLCA") was enacted on September 19, 2012. It applied to new limited liability companies ("LLCs") formed after March 18, 2013, and to all LLCs as of March 1, 2014. The Act is codified at N.J.S.A. 42:2C-1 et seq. For a general summary of the Act, see Gianfranco A. Pietrafesa, "New Jersey Adopts the Revised Uniform Limited Liability Company Act," available at https://www.archerlaw.com/en/news-resources/client-advisories/new-jersey-adopts-the-revised-uniform-limited-liability-company-act.

NJ-RULLCA updated and, on the whole, improved New Jersey's LLC law. Like New Jersey's repealed LLC law, NJ-RULLCA governs any matter not addressed in an LLC's operating agreement. There are at least four matters that should be addressed in an operating agreement to avoid application of the default provisions under NJ-RULLCA. This paper examines the default provisions of these matters under NJ-RULLCA and compares them to the default provisions under the repealed law (which was in existence from 1993 until its repeal with the adoption of NJ-RULLCA).

Distributions. Under the repealed law, each member was entitled to share profits or losses based on the agreed value of each member's capital contribution to the LLC. By contrast, under NJ-RULLCA, each member is entitled to an equal share of the profits or losses, regardless of capital contributions. The foregoing applies to both regular distributions, NJ-RULLCA, § 34(a), and liquidating distributions (after the payment of unreturned capital contributions). NJ-RULLCA, § 55(b).

By way of example, assume Laura contributes $75,000 and Lisa contributes $25,000 to an LLC. Under the repealed law, Laura would receive 75% ($75,000 / $100,000) and Lisa would receive 25% ($25,000 / $100,000) of the profits. Under NJ-RULLCA, Laura and Lisa will each receive 50% of the profits, regardless of their unequal capital contributions.

These default provisions can be changed by the majority vote of the members each time a distribution is made, or by distribution provisions set forth in an LLC operating agreement. Therefore, if Laura and Lisa do not want to share distributions equally (because, for example, their capital contributions are not equal), they should enter into a written operating agreement that states how regular and liquidating distributions will be made by the LLC. They may decide, for example, to make distributions based on the agreed value of their capital contributions to the LLC.

Voting. Under the repealed law, most matters, including mergers, were decided by a majority of the members' current profit percentages. Under NJ-RULLCA, ordinary matters are

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* Gianfranco A. Pietrafesa is a partner in the Business Counseling and M&A Practice Groups of Archer & Greiner, in Hackensack. He is a director and former chairman of the Business Law Section of the New Jersey State Bar Association and a member of the select committee that drafted NJ-RULLCA for adoption in New Jersey. A version of portions of this paper were previously published in the *New Jersey Law Journal* on November 19, 2012.

decided by a majority of the members, with each member having one vote (i.e., per capita), and extraordinary matters, including mergers, are decided unanimously by the members. NJ-RULLCA, § 37(b). The admission of new members, the expulsion of existing members and the dissolution of the LLC still require the consent of all members. NJ-RULLCA, §§ 31(c), 46(d) & 48(a).

By way of example, assume Laura, Marc and Lisa are the three members of an LLC, with Marc receiving 51% of the profits. Under the repealed law, Marc would have 51% of the vote based on his profit percentage and would make most decisions for the LLC. Under NJ-RULLCA, each member has an equal vote. Therefore, in the prior example, Laura and Lisa, together receiving only 49% of the profits, can outvote Marc, 2-1, and make decisions on ordinary matters for the LLC even though together they own a minority interest in the LLC.

This default provision can be changed by an LLC operating agreement. The members would enter into an agreement that specifically sets forth the voting requirements on ordinary matters. Marc, for example, would insist that decisions be made based on the members' current profit percentages. They may also consider changing the required vote for approving mergers and dissolution from a unanimous to a majority vote so that one person does not have veto power.

Fiduciary Duty of Loyalty. New Jersey's repealed LLC statute did not address fiduciary duties, and there are no state court decisions discussing such duties with respect to New Jersey LLCs. Under NJ-RULLCA, members (and managers) of New Jersey LLCs have defined fiduciary duties of care and loyalty and a "contractual" covenant of good faith and fair dealing that applies to rights and duties under an LLC's operating agreement and under the Act.

Under NJ-RULLCA, members of a member-managed LLC owe a duty of loyalty to the LLC and to the other members. NJ-RULLCA, § 39(a). (In a manager-managed LLC, the members do not have a duty of loyalty.) The duty of loyalty includes refraining from competing with the LLC and accounting to the LLC for any profits or benefits derived by a member from misappropriating an opportunity belonging to the LLC. NJ-RULLCA, § 39(b).

The duty of loyalty may create problems for LLCs and their members. For example, assume an LLC is formed by three members to operate a fast food restaurant. If one member is interested in opening another fast food restaurant, alone or with others, the duty of loyalty may require her to first present the opportunity to the existing LLC. Or worse, she may be precluded from operating another fast food restaurant because doing so would constitute competition with the existing LLC.

Although NJ-RULLCA imposes a statutory duty of loyalty, it permits the members to eliminate the duty through their operating agreement. NJ-RULLCA, § 11(d)(1). If the members do not eliminate the duty of loyalty, they can restrict it by, for example, identifying specific acts that do not violate the duty. NJ-RULLCA, § 11(d)(2). For example, allowing a member to own other fast food restaurants that are located a specific distance away from the restaurant owned and operated by the LLC.

As an alternative, the operating agreement may include a mechanism for a disinterested and independent person, after full disclosure of all material facts, to authorize or ratify an act that violates the duty of loyalty. NJ-RULLCA, § 11(e). If the operating agreement does not restrict or eliminate the duty of loyalty, then the members must unanimously authorize or ratify a member's act that violates the duty. NJ-RULLCA, § 39(f). Therefore, to avoid the requirement of a unanimous vote, it would be prudent for the members to eliminate or restrict the duty of loyalty in their operating agreement.

Resignation. Under the repealed law, a member could resign from an LLC and have his equity purchased by the LLC for fair value, less applicable discounts. Under NJ-RULLCA, a resigning member continues to own his equity interest as a dissociated member. NJ-RULLCA, § 45(a). As such, he continues to receive distributions, if any, made by the LLC, but has no management or voting rights. NJ-RULLCA, §§ 34(a), 47(a) & 56(b)(2). He is, in essence, an assignee who has an economic interest in the LLC.

For example, a member resigns from an LLC. Under the repealed law, the LLC was required to use its cash flow to buy the resigning member's equity interest in the LLC instead of using the cash flow to operate the business of the LLC, which may have included hiring and paying an employee to provide the services to the LLC previously performed by the resigning member. The payment to the resigning member, alone or in combination with its operational cash needs, could cripple the LLC, which could cause a succession of resignations and, eventually, a dissolution and liquidation of the LLC. By contrast, under NJ-RULLCA, the resigning member becomes a dissociated member and is entitled to receive distributions from the LLC, if any. If the LLC does not make distributions, and will have little liquidation value in the future, the resigning member will never receive fair value for his interest, or may receive fair value when the LLC is liquidated years later. While the result under the repealed law was harsh to the LLC and the remaining members, the result under NJ-RULLCA can be just as harsh to the resigning member.

Under the above circumstances, a member with thoughts of a possible resignation will not want to be a dissociated member. Therefore, members should address the matter of resignation (a.k.a. withdrawal) in the LLC's operating agreement. The agreement should include provisions to establish a valuation for the LLC and purchase rights for a resigning member's equity interest, based on terms that they believe will be fair to both the resigning member and the LLC and its remaining members. For example, the LLC can pay the resigning member fair value for his equity interest over a period of time, giving the resigning member liquidity over time and leaving the LLC with sufficient cash to fund its operations and continue its existence.

Conclusion. As noted, NJ-RULLCA made some significant changes to New Jersey's LLC law. As a result, it is important for LLCs to have written operating agreements to address the matters outlined in this article to avoid the default provisions under the Act.

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Avoiding Legal Malpractice in LLC Formations

by Gianfranco A. Pietrafesa

This article highlights the issues an attorney needs to be aware of when forming a limited liability company (LLC) in New Jersey. By being aware of the issues, and following some practical suggestions, an attorney can minimize or even avoid claims of legal malpractice when forming an LLC.[1]

This is not, however, an article on how to form an LLC or draft an operating agreement. Nor does this article address the elements of a cause of action for legal malpractice or the defenses available to such a claim.[2] Nor does it address ethical issues, such as identifying and addressing conflicts of interest and confirming the fee arrangement in writing.[3]

Choice of Entity—Know the Differences between LLCs and Corporations

When asked to form an LLC, an attorney should question a client to determine whether an LLC is the proper type of entity to be formed. Although LLCs are the entity of choice, comprising over 80 percent of all entities formed in New Jersey,[4] sometimes there are good reasons to form a corporation. One example would be if the client wants to offer stock options to key employees. Although LLCs may offer something similar to stock options, the client needs to know the challenges and complexities of using an LLC instead of a corporation in this regard. Therefore, an attorney needs to know the basic differences between LLCs and corporations.

One difference involves the number of formalities that must be observed by a corporation vis-à-vis an LLC. A corporation requires an organizational meeting to adopt bylaws, elect officers, issue shares of stock, etc.,[5] and annual meetings of shareholders to elect directors.[6] By contrast, an LLC is not required to observe such formalities.[7]

Another difference involves management. A corporation has a centralized management where shareholders elect directors and the board of directors elects officers.[8] The directors and

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officers, not the shareholders, manage the corporation.[9] By contrast, an LLC may be member-managed or manager-managed,[10] and an LLC provides its owners with the flexibility to define the management structure in its operating agreement.[11] An LLC may have centralized management (like a corporation), be managed by one or more managers (like a limited partnership), or be managed by all members (like a general partnership).

Another difference involves transfers of equity. In a corporation, shareholders may freely transfer shares of stock (unless there is a shareholders agreement restricting such transfers).[12] In an LLC, however, members may transfer only economic rights (*i.e.*, the right to receive income allocations and cash distributions). A person receiving an LLC interest receives an economic interest and is a transferee. Such a person will not become a member (which gives him or her certain rights, such as the right to vote and manage the LLC) unless the other members agree to allow him or her to become a member of the LLC.[13]

Understand Basic Differences in Taxation

An attorney forming an LLC also needs to know the basic tax differences between LLCs and corporations; for example, pass-through versus double taxation. A single-member LLC is a disregarded entity, and its income and other tax items are reported on Schedule C of the sole member's personal income tax return. A multimember LLC is considered a partnership for tax purposes, and its income and other tax items are allocated among the members as set forth in the operating agreement (*e.g.*, based on their ownership percentages or unreturned capital contributions) and reported on the members' personal income tax returns.

Clients need to know that, generally, the LLC does not pay income taxes, but the LLC's members pay taxes on their allocated share of the LLC's income, whether or not they receive any cash distributions from the LLC (commonly known as phantom income). Clients also need to know that a person cannot be both a member and an employee of an LLC for tax purposes.[14] Instead, such a member is considered self-employed for tax purposes, resulting in the member paying all employment taxes (*e.g.*, Social Security and Medicare), including the employer's share of these taxes.

By contrast, a corporation pays taxes on its income, and the shareholders pay taxes on dividends received from the corporation, thus resulting in double taxation. If a corporation elects to be taxed as an S corporation, there is one level of taxation. An S corporation's income is allocated among the shareholders based on their ownership interests. The shareholders pay taxes on their allocated share of the corporation's income, which is reported on their personal income tax returns. Therefore, the tax treatment of an S corporation is similar to an LLC; however, with an S corporation income must be allocated based on the shareholders' respective ownership interests.[15] Unlike an LLC, there is no flexibility in making special allocations among shareholders of an S corporation.[16]

Limit the Scope of Services

If an attorney is not comfortable providing tax advice (or advice on any other issues, such as securities laws), he or she may limit the scope of services in his or her engagement letter.[17] In such a scenario, the attorney should work with his or her client's accountant or with a tax attorney or experienced corporate attorney. Otherwise, the client will expect his or her attorney to provide advice on all aspects and issues associated with doing business as an LLC.

Understand New Jersey LLC Law

Once it is determined that an LLC is the correct entity, an attorney must understand the law governing LLCs, including the differences between the new and old laws. The New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA)[18] became effective on March 18, 2013, for newly formed LLCs, and on March 1, 2014, for all LLCs, which is when the prior statute was repealed.[19] NJ-RULLCA made significant changes to New Jersey's LLC law. To name but a few differences, the new law provides for equal distributions to members regardless of their contributions or ownership interests in the LLC, includes specific fiduciary duties on managers or members of an LLC (discussed below), and does not provide for a buyout of a resigning or withdrawing member's ownership interest for fair value.[20] This is the law governing an LLC, unless the operating agreement alters these statutory defaults.

In this regard, an attorney needs to know which statutory provisions can be altered or eliminated and which statutory provisions cannot (because they are mandatory).[21] If an attorney does not understand NJ-RULLCA, he or she will not be able to draft an effective operating agreement.

Know the Issues to be Addressed in an Operating Agreement

An attorney forming an LLC needs to know what provisions should be included in an operating agreement and whether to alter or eliminate certain statutory default provisions.[22] For example, the parties may want to alter or eliminate the fiduciary duty of loyalty, which prohibits self-dealing and competition with the LLC.[23] If a member of an LLC lends money or leases real or personal property to the LLC, he or she is engaged in self-dealing. Although self-dealing sounds bad, it is common in small businesses. Therefore, self-dealing should be addressed in the operating agreement; for example, by outlining when and how a member may lend

money or lease property to the LLC.[24]

The members of the LLC may also want the ability to compete with the LLC. For example, the LLC may have been formed to hold a parcel of real estate. Under the fiduciary duty of loyalty, if a member wants to acquire another parcel of real estate, he or she must bring that opportunity to the LLC. If he or she doesn't, he or she is deemed to be competing with the LLC, which is a violation of the fiduciary duty of loyalty.[25] LLCs that are real estate holding companies usually eliminate this aspect of the fiduciary duty in their operating agreements.

The operating agreement should also address when and how distributions are made to members, including whether tax distributions must be made to members. If the operating agreement does not address distributions, then cash is distributed equally to all members, including dissociated members,[26] regardless of their ownership interests and capital contributions.[27] In an LLC, income may be allocated, but no cash distributed, to members for a variety of reasons, including the fact that the LLC needs the cash to fund operations. A tax distribution intends to provide cash to members so they can pay their taxes based on their allocated income.

The operating agreement should address the voting rights of members; otherwise, the statutory default provisions will apply. For example, the statute provides for equal voting of all members regardless of their capital contributions.[28] The member contributing the majority of the capital will not want equal voting. The statute also provides for unanimous approval of extraordinary actions, such as mergers.[29] The members of the LLC may not want unanimous approval; they may want majority or super-majority approval to prevent a minority member from having the power to veto extraordinary matters.

There are other provisions that should be included in an operating agreement aside from provisions altering or eliminating default provisions in the statute. For example, allocations of income and loss were addressed in the repealed statute,[30] but are not addressed in NJ-RULLCA. Therefore, they need to be addressed in the operating agreement. There are numerous other issues that should be addressed in an operating agreement, including the consequences of a member failing to make a promised capital contribution to the LLC and a member dying, becoming disabled, departing through resignation or termination, etc.[31]



Understand the Economics of the Deal

An attorney needs to understand the economic terms of the deal in order to properly draft an operating agreement. Without knowing the economics, an attorney will not know how to draft the allocation and distribution (including liquidating distribution) provisions of an operating agreement. For example, if one member is contributing cash and the other member is contributing services, is cash flow distributed 50-50 or is it first distributed to the financier until he or she receives the return of his or her capital contribution? In other words, does the financier receive a return of his or her money before the service member receives any cash distributions?

Upon liquidation of the LLC, are liquidating distributions to be made based on capital account balances, ownership percentages or some other method of distribution? There are real economic differences. An example would involve two members, each owning 50 percent of an LLC. The financier contributes $50,000 and the service member contributes $10,000 and a promise to provide services. Assume the LLC sustains a $20,000 loss in its first year of business and the members decide to liquidate the LLC at the end of the year. If liquidating distributions are based on capital accounts, the financier would receive $40,000 ($50,000 capital contribution less $10,000 loss) and the service member would receive nothing ($10,000 contribution less $10,000 loss). If liquidating distributions are based on ownership percentages, the financier and service member would each receive $20,000 ($60,000 total contributions less $20,000 loss, times 50 percent), which hardly seems fair to the financier. Without knowing the economics, and without explaining the different consequences to clients, an attorney may draft an operating agreement that has unintended results.

Use Checklists and Forms

An attorney should use a checklist when forming an LLC, especially when drafting an operating agreement. It is probably impossible to address every issue in an agreement, but using a checklist will minimize the possibility of forgetting to address an important issue. There are numerous checklists available, both in print and online, including a comprehensive checklist published by the American Bar Association.[32]

For the same reason, an attorney should also use form operating agreements to begin the drafting process. However, an attorney should not be a slave to the form. In other words, a form is a good starting place, but an attorney needs to revise and customize the form agreement to ensure it meets the needs of the specific LLC. There are several sources of good forms of operating agreements.[33]

Explain Operating Agreement to Clients

Once an attorney drafts an operating agreement, he or she should meet with the clients to summarize and explain its important provisions. Although an unpublished decision, attorneys should read *Cottone v. Fox Rothschild*,[34] which holds that an attorney must explain the provisions of an agreement to a client, even if he or she is a sophisticated business client. It modifies and extends the principles established by the New Jersey Supreme Court in *Conklin v. Hannoch Weisman*[35] about explaining the risks of transactions to clients in terms they can understand based on their needs and sophistication.

If a meeting or telephone conference cannot be arranged because of a client's schedule, reluctance to meet, or other reasons, an attorney should send a letter to the client summarizing and explaining the important provisions in the agreement and offering to answer any questions. It is a best practice to do so even after meeting with a client.

Confirm it in Writing

Finally, attorneys provide legal advice, but clients make decisions. An attorney may recommend a proposed course of action, but clients make decisions on whether to spend the money on such recommendations. In such an event, it is a best practice for an attorney to confirm his or her advice and the client's decisions in writing, which may minimize or even prevent future misunderstandings.

Conclusion

An attorney needs to be aware of and understand the issues outlined in this article and should discuss them with clients when forming an LLC. By doing so, an attorney will likely minimize or even avoid a claim of legal malpractice. ⚖

Gianfranco A. Pietrafesa *is a partner in the law firm of Archer & Greiner in Hackensack. He is a director and former chair of the NJSBA Business Law Section and a member of the committee that drafted NJ-RULLCA. He has served as a consultant and expert witness in litigation involving legal malpractice and legal ethics in transactional matters. This article reflects his views and not necessarily the views of his firm or its other attorneys.*

ENDNOTES

1. A hat tip to John M. Cunningham, a member of the New Hampshire and Massachusetts bars and the principal author of *Drafting Limited Liability Company Operating Agreements* (Wolters Kluwer 2015), who has lectured and written on many of the issues addressed in this article.
2. These topics are addressed elsewhere. *See, e.g.,* New Jersey Model Civil Jury Charge 5.51A (available at judiciary.state.nj.us/civil/charges/5.51A.pdf); *Conklin v. Hannoch Weisman*, 145 N.J. 395, 416 (1996) (stating requisite elements of a cause of action for legal malpractice).
3. *See* New Jersey Rule of Professional Conduct 1.7 (Conflict of Interest—General Rule) and 1.5 (Fees). It should be noted that a violation of the Rules of Professional Conduct does not constitute malpractice, but it is evidence of malpractice. *See, e.g., Baxt v. Liloia*, 155 N.J. 190, 197-203 (1998).
4. New Jersey Division of Revenue, New Business Filing in 2014 (available from the author).
5. N.J.S.A. 14A:2-8.
6. N.J.S.A. 14A:5-2.
7. *See* N.J.S.A. 42:2C-30(b). A corporation's failure to observe such formalities is a factor in a claim for piercing the corporate veil to hold shareholders personally liable for the corporation's debts, liabilities and obligations.
8. *See* N.J.S.A. 14A:6-3(1) & 6-15(1).
9. N.J.S.A. 14A:6-1(1) & 6-15(4).
10. N.J.S.A. 42:2C-37(a).
11. N.J.S.A. 42:2C-11(i).
12. N.J.S.A. 14A:7-12(1).
13. N.J.S.A. 42:2C-41 & 2C-42. For other non-tax differences, *see John R. MacKay II, et al., New Jersey Corporations and other Business Entities* (3d ed.), Chapter 2, (Matthew Bender & Co., 2014).
14. *See, e.g.*, Rev. Rul. 69-184.
15. There are certain requirements or restrictions for a corporation to elect and maintain S corporation status. Among other things, there must be one class of stock only (although voting and non-voting stock are permissible), no more than 100 shareholders, and in general only individuals who are U.S. citizens and resident aliens may be shareholders. *See* 26 U.S.C. 1361(b).
16. For other tax differences, *see* Carter G. Bishop and Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law* (Warren Gorham & Lamont, 1994). For a basic discussion of the tax and non-tax differences between corporations and LLCs, *see* Gianfranco A. Pietrafesa, Choice of Entity: Corporation or Limited Liability Company? (March 2014), located at archerlaw.com/files/articles/Choice_of_Entity_-_Corporation_or_LLC_March_2014.PDF.
17. *See* RPC 1.2(c).
18. N.J.S.A. 42:2C-1 *et seq.*
19. N.J.S.A. 42:2C-91.

20. For a summary of the changes to New Jersey LLC law brought by NJ-RULLCA, *see* Gianfranco A. Pietrafesa, New LLC Law Became Effective on March 1st, 215 *N.J.L.J.* 619 (March 3, 2014), available at archerlaw.com/files/articles/ Pietrafesa_3.3.14.pdf; Gianfranco A. Pietrafesa, An Operating Agreement is Essential under RULLCA, 210 *N.J.L.J.* 664 (Nov. 19, 2012), available at archerlaw.com/files/articles/Pietrafesa_11_19_12.pdf.

21. *See* N.J.S.A. 42:2C-11.

22. For an article explaining the importance of a written operating agreement under NJ-RULLCA, *see* Gianfranco A. Pietrafesa, An Operating Agreement is Essential under RULLCA, 210 *N.J.L.J.* 664 (Nov. 19, 2012), available at archerlaw.com/files/articles/ Pietrafesa_11_19_12.pdf.

23. N.J.S.A. 42:2C-39(b).

24. Even if it is not addressed, NJ-RULLCA provides a safe harbor—self-dealing will not violate the duty of loyalty as long as the terms of the loan or lease are fair to the LLC. *See* N.J.S.A. 42:2C-39(g).

25. N.J.S.A. 42:2C-39(b)(3).

26. A dissociated member is one who has withdrawn from the LLC, either voluntarily or involuntarily. *See* N.J.S.A. 42:2C-46 (events causing dissociation). Among the limited rights of a dissociated member is the right to receive distributions from the LLC. *See* N.J.S.A. 42:2C-34(a).

27. N.J.S.A. 42:2C-34(a).

28. *See* N.J.S.A. 42:2C-37(b)(2) & (3).

29. N.J.S.A. 42:2C-37(b)(4) & (c)(4).

30. N.J.S.A. 42:2B-34 (repealed).

31. A checklist or comprehensive form of operating agreement, which are discussed below, may be used to identify issues to include in an operating agreement. For articles on other items that should be addressed in operating agreements, *see* Ira B Marcus and Denise Walsh, New Jersey Limited Liability Companies–Some Keys to Drafting Operating Agreements that Work, 240 *N.J. Lawyer Magazine* 18 (June 2006), and Peter Ehrenberg, Marie DeFalco and Brian Silikovitz, Learning to Live in the Brave New World of Limited Liability Companies: Avoiding the Ten Greatest Pitfalls in Structuring a Limited Liability Company, NJSBA *Business Law Section Newsletter* (circa 2004-2005), copies of which are available from the author.

32. The American Bar Association (ABA) checklist is available to ABA members at americanbar.org/tools/digitalassetabstract.html/content/dam/aba/publications/business_lawyer/2014/69_4/report-llc-checklist-201408.pdf, but prior drafts can be found online.

33. *See, e.g.*, Lawrence A. Goldman and Alyce C. Halchak, *New Jersey Limited Liability Company: Forms and Practice Manual* (2d ed.) (Data Trace 1995). *See also* 21A *New Jersey Practice Series, Skills and Methods* (3d ed.), § 46; 9 *New Jersey Forms: Legal and Business*, Ch. 18A; John M. Cunningham and Vernon R. Proctor, *Drafting Limited Liability Company Operating Agreements* (Wolters Kluwer 2015).

34. 2014 N.J. Super. Unpub. LEXIS 2143 (App. Div. Sept. 2, 2014).

35. 145 N.J. 395 (1996).

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Avoid Problems with Properly Drafted LLC Operating Agreements

Prepared by:
Gianfranco A. Pietrafesa, Esq.
Archer & Greiner, P.C. (Hackensack, NJ)

Topic

1. Voting on Matters in the Ordinary Course of Business
2. Voting on Extraordinary Matters
3. Distributions
4. Withdrawal/Resignation
5. Fiduciary Duty of Loyalty – Self-Dealing
6. Fiduciary Duty of Loyalty – Competition
7. Failure to Make a Capital Contribution
8. Death of a Member
9. Deadlock

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Introduction

- The New Jersey Revised Uniform Limited Liability Company Act ("NJ-RULLCA")
    - Beginning on March 1, 2014, it applies to all NJ LLCs, including those formed under the repealed LLC law.
- It is based on the Revised Uniform Limited Liability Company Act drafted by the Uniform Law Commissioners (the good folks who gave us the UCC), with NJ-specific revisions drafted by a special committee appointed by the Board of Directors of the Business Law Section of the NJSBA.
    - It has been adopted in 20+ states, plus DC, including CA, CT, FL, IL and PA.
    - As a result, the comments of the Uniform Law Commissioners, case law from other jurisdictions, law review articles, etc. can be used to understand NJ-RULLCA.

It is important to have a written operating agreement to avoid the default provisions in NJ-RULLCA, which can surprise clients and attorneys. If there is no operating agreement, the default provisions apply. In this regard, N.J.S.A. 42:2C-11 (Operating Agreement; Scope, Function, and Limitations) provides in pertinent part:

a. … the operating agreement governs:
    (1) relations among the members as members and between the members and the limited liability company;
    (2) the rights and duties under this act of a person in the capacity of manager;
    (3) the activities of the company and the conduct of those activities; and
    (4) the means and conditions for amending the operating agreement.
b. To the extent the operating agreement does not otherwise provide for a matter described in subsection a. of this section, this act governs the matter.

1. Voting on Matters in the Ordinary Course of Business

Applicable Law:

N.J.S.A. 42:2C-37 (Management of LLC) provides in pertinent part:

a. A limited liability company is a member-managed limited liability company unless the operating agreement [provides that it is manager-managed] …
b. In a member-managed limited liability company, the following rules apply:
   1) The management and conduct of the company are vested in the members.
   2) Each member has equal rights in the management and conduct of the company's activities.
   3) A difference arising among members as to a matter in the ordinary course of the activities of the company may be decided by a majority of the members.
   4) An act outside the ordinary course of the activities of the company may be undertaken only with the consent of all members. (emphasis added)

LLC Operating Agreement:

In order to avoid the default provisions in NJ-RULLCA, which mandate a per capita vote regardless of capital contributions or ownership percentage interest, the members of an LLC must address voting in an operating agreement. The following is a simple provision:

> Voting Requirements. Each Member shall have a vote equal to such Member's Membership Interest. Except as otherwise specifically provided in this Agreement, wherever this Agreement requires the approval of the Members, the affirmative vote of Members holding more than fifty percent (50%) of the Membership Interests then outstanding (the "Majority Interest") shall be required to approve the matter.

2. Voting on Extraordinary Matters

Applicable Law:

N.J.S.A. 42:2C-37 (Management of LLC) provides in pertinent part:

a. A limited liability company is a member-managed limited liability company unless the operating agreement [provides that it is manager-managed] …
b. In a member-managed limited liability company, the following rules apply:
    1) The management and conduct of the company are vested in the members.
    2) Each member has equal rights in the management and conduct of the company's activities.
    3) A difference arising among members as to a matter in the ordinary course of the activities of the company may be decided by a majority of the members.
    4) An act outside the ordinary course of the activities of the company may be undertaken only with the consent of all members. (emphasis added)

N.J.S.A. 42:2C-48 (Events Causing Dissolution) provides in pertinent part:

a. A limited liability company is dissolved, and its activities shall 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 one or both of the certificate of formation and the operating agreement; or
    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. (emphasis added)

LLC Operating Agreement:

As in the prior example, the same provision can be modified to address voting on extraordinary matters:

> Voting Requirements. Each Member shall have a vote equal to such Member's Membership Interest. Except as otherwise specifically provided in this Agreement, wherever this Agreement requires the approval of the Members, the affirmative vote of Members holding more than fifty percent (50%) of the Membership Interests then outstanding (the "Majority Interest") shall be required

to approve the matter, including any matter outside the ordinary course of business. (emphasis added)

However, most operating agreements identify certain action that requires greater than a simple majority, but less than unanimous approval. For example:

> Actions Requiring Consent of Members with Super-Majority Interest. Notwithstanding anything to the contrary in this Agreement, the following actions will require the affirmative vote or written consent of the Members holding two-thirds (66.67%) of the membership interests (the "Super-Majority Interest"):
>
> (a) Borrow money in excess of $100,000;
> (b) Make, execute or deliver (A) any assignment for the benefit of creditors on behalf of the Company, or (B) any bond, security agreement, deed, guaranty, surety or indemnity bond on behalf of the Company;
> (c) Assign, transfer, pledge, compromise, discharge or release any of the claims of or debts owed to the Company, except upon receiving full payment thereof;
> (d) Amend the Certificate of Formation or this Agreement;
> (e) Admit any Person, including an assignee of a Membership Interest, as an additional Member;
> (f) Approve the merger or consolidation of the Company with any other entity;
> (g) Approve the sale, lease or transfer of all or substantially all assets of the Company;
> (h) Convert the Company into a corporation or other form of entity;
> (i) File for bankruptcy (e.g., insolvency or reorganization) of the Company; and
> (j) File for dissolution and termination of the Company.

Note that an operating agreement may designate various actions requiring 1) majority approval, 2) super-majority approval (even using different percentages for each action), and 3) unanimous approval. There is much flexibility when drafting an operating agreement.

An operating agreement should also address dissolution in order to avoid the default provision in NJ-RULLCA requiring unanimous vote or consent. Selecting the percentage requires balancing—you don't want to make it too easy (greater than 50%) or too difficult (unanimous, where a member holding a 1% membership interest can veto any action). For example:

> Dissolution. The Company shall be dissolved and its affairs wound up upon the occurrence of any of the following events: (1) the written consent of the Members holding a Super-Majority Interest; …

3. Distributions

Applicable Law:

N.J.S.A. 42:2C-34 (Sharing of and Right to Distributions before Dissolution) provides in pertinent part:

a. Any distributions made by a limited liability company before its dissolution and winding up shall be in equal shares among members and dissociated members, except to the extent necessary to comply with any transfer effective under section 42 and any charging order in effect under section 43 of this act. (emphasis added)

LLC Operating Agreement:

The distributions provisions of an operating agreement can be heavily negotiated, and the drafter of the provisions should ensure that the language of the provisions reflects the actual deal terms agreed upon by the members. Among the issues to consider are the following:

Are distributions "automatic" (e.g., real estate holding company) or does someone have to make a determination on when and how much to distribute?
If the latter, in a member-managed LLC, who makes the determination and how?

- Majority, Super-Majority, Unanimous

What is distributed?

- Net Cash Flow (which is a defined term)
- Return of Capital
- Annual Return (e.g., "interest")
- Tax Distributions

How are distributions made?

- Per Capita (equally as provided under NJ-RULLCA)
- Pro Rata
  - Based on ownership percentages
  - Based on capital contributions
- Waterfall (e.g., takes into account return of capital, annual return, priority return, tax distributions, etc.)

The following is a typical example of a provision where distributions are made based on pro rata ownership of the members:

> Distribution of Net Cash Flow. Except as provided in paragraph [__] (liquidating distributions), the Company's Net Cash Flow (hereinafter defined) shall be distributed from time to time, as determined by the Members holding a majority of the membership interests, to the Members of the then outstanding membership interests in accordance with their respective membership interests. The foregoing distributions may be made without regard to the balances in the Capital Accounts of the Members at the time of distribution.

> For purposes of this Agreement, "Net Cash Flow" for any period shall mean the Company's cash receipts (including as a receipt any release cash amounts previously held in reserve), less the sum of the amount of its cash disbursements and an amount retained as a reasonable cash reserve for Company operations and debts, liabilities and other obligations as determined by the Members holding a majority of the membership interests.

It's also important to address tax distributions in an operating agreement to ensure that members receive some cash to pay taxes on the LLC's income allocated to them. The following is a sample provision for tax distributions on an annual basis (tax distributions may also be made quarterly to coincide with estimated tax payment dates):

> Tax Distributions. In the event that any taxable income is allocated to a Member for any year for which such Member does not receive an equivalent amount of cash distribution from the Company, the Members may, to the extent there is Net Cash Flow available for distribution, cause the Company to distribute to the Members, no later than March 15 of the following year, the excess, if any, of (a) the product of (i) the amount of income so allocated multiplied by (ii) the highest marginal combined federal and state income tax rate for that year, over (b) the cash previously distributed to such Member attributable to income for that year.

4. Withdrawal/Resignation

Applicable Law:

N.J.S.A. 42:2C-34 (Sharing of and Right to Distributions before Dissolution) provides in pertinent part:

a. Any distributions made by a limited liability company before its dissolution and winding up shall be in equal shares among members and dissociated members, except to the extent necessary to comply with any transfer effective under section 42 and any charging order in effect under section 43 of this act.
b. A person has a right to a distribution before the dissolution and winding up of a limited liability company only if the company decides to make an interim distribution. A person's dissociation does not entitle the person to a distribution. (emphasis added)

N.J.S.A. 42:2C-45 (Member's Power to Dissociate; Wrongful Dissociation) provides in pertinent part:

a. A person has the power to dissociate as a member at any time, rightfully or wrongfully, by withdrawing as a member by express will under section 46 of this act.
b. A person's dissociation from a limited liability company is wrongful only if the dissociation:
   (1) is in breach of an express provision of the operating agreement; or
   (2) occurs before the termination of the company and:
      (a) the person is expelled as a member by judicial order under subsection e. of section 46 of this act;
      (b) the person is dissociated under paragraph (1) of subsection g. of section 46 of this act, by becoming a debtor in bankruptcy; or
      (c) in the case of a person that is not a trust other than a business trust, an estate, or an individual, the person is expelled or otherwise dissociated as a member because it willfully dissolved or terminated; or
   (3) in the case of a company for a definite term or particular undertaking, by withdrawing as a member by express will under section 46 of this act before the expiration of the term or the completion of the undertaking.
c. A person that wrongfully dissociates as a member is liable to the limited liability company and, subject to section 67 of this act, to the other members for damages caused by the dissociation. The liability is in addition to any other debt, obligation, or other liability of the member to the company or the other members. (emphasis added)

N.J.S.A. 42:2C-46 (Events Causing Dissociation)
A person is dissociated as a member from a limited liability company when:

a. The company has notice of the person's express will to withdraw as a member, but, if the person specified a withdrawal date later than the date the company had notice, on that later date;
b. An event stated in the operating agreement as causing the person's dissociation occurs;
c. The person is expelled as a member pursuant to the operating agreement;
d. The person is expelled as a member by the unanimous consent of the other members if:

(1) it is unlawful to carry on the company's activities with the person as a member;
(2) there has been a transfer of all of the person's transferable interest in the company, other than:
(a) a transfer for security purposes; or
(b) a charging order in effect under section 43 of this act which has not been foreclosed;

***

e. On application by the company, the person is expelled as a member by judicial order because the person:
(1) has engaged, or is engaging, in wrongful conduct that has adversely and materially affected, or will adversely and materially affect, the company's activities;
(2) has willfully or persistently committed, or is willfully and persistently committing, a material breach of the operating agreement or the person's duties or obligations under section 39 of this act; or
(3) has engaged, or is engaging, in conduct relating to the company's activities which makes it not reasonably practicable to carry on the activities with the person as a member; (emphasis added)

***

N.J.S.A. 42:2C-47 (Effect of Person's Dissociation as Member) provides:

a. When a person is dissociated as a member of a limited liability company:
(1) the person's right to participate as a member in the management and conduct of the company's activities terminates;
(2) if the company is member-managed, the person's fiduciary duties as a member end with regard to matters arising and events occurring after the person's dissociation; and
(3) subject to section 44 and Article 10 (sections 73 through 87 of this act), any transferable interest owned by the person immediately before dissociation in the person's capacity as a member is owned by the person solely as a transferee.
b. A person's dissociation as a member of a limited liability company does not of itself discharge the person from any debt, obligation, or other liability to the company or the other members which the person incurred while a member.
c. A court that expels a member from a company pursuant to subsection e. of section 46 of this act may order the sale of the interests held by such person immediately before dissociation to either the company or to any other persons who are parties to the action if the court determines, in its discretion, that such an order is required by any other law, rule or regulation, or that such an order would be fair and equitable to all parties under all of the circumstances of the case. (emphasis added)

LLC Operating Agreement:

Unlike prior law, which allowed a member to withdraw/resign and have his membership interest purchased for fair value, NJ-RULLCA takes a different approach. A member's withdrawal/resignation does not compel a buyout for fair value. Instead, the member becomes a

dissociated member, which means that he loses his right to manage or vote, but he continues to have an economic interest in the company.

Operating agreements usually include several provisions in different sections making it clear that member may not resign/withdraw from the LLC or withdraw his monies from the LLC, such as:

> Withdrawal. No Member shall withdraw or resign as a Member without the prior written consent of the other Members.
>
> No Withdrawal or Return of Capital. Except as otherwise provided in this Agreement, no Member shall have the right to withdraw or receive the return of her capital contributions except with the consent of the Manager or upon the dissolution of the Company (in the latter case, only to the extent provided in Section [__]).
>
> No Right to Distributions. No Member shall have the right to demand or receive distributions of any amount, except as expressly provided in this Agreement.

As provided in NJ-RULLCA, a member always has the power to resign/withdraw, even if he doesn't have the right to do so. As a result, an operating agreement can address the effect of a withdrawal/resignation (which is an event of dissociation). For example:

> Dissociation.
>
> (a) Events of Dissociation. A Member shall be dissociated from the Company upon the occurrence of any of the following events:
>
> (i) the Company receives notice of the Member's resignation as a Member; …
>
> (b) Effect of Dissociation.
>
> (i) Upon a Member's dissociation, such dissociated Member shall cease to be a Member, such dissociated Member's Membership Interest shall immediately be converted to an Economic Interest and such dissociated Member shall have only the rights of an assignee / transferee as set forth in Section [__], except as otherwise provided in this Agreement. The dissociation of a Member shall not result in the dissolution of the Company.
>
> (ii) [ALTERNATIVE 1: The Company shall have the right, but not the obligation, to purchase the Economic Interest of the dissociated Member, with the purchase price determined by Section [__] and payable pursuant to Section [__].]
>
> or
>
> [ALTERNATIVE 2: The Company shall purchase the Economic Interest of the dissociated Member, with the purchase price determined

by Section [__] and payable pursuant to Section [__], provided that that the purchase price shall be reduced by fifty percent (50%) and shall be payable in one hundred twenty (120) consecutive equal monthly installments, without any cash payment at the closing.]

(iii) The purchase price shall be reduced for any amounts owed to the Company from the dissociated Member, including capital contributions and any damages resulting from any breach of this Agreement.

5. Fiduciary Duty of Loyalty – Self-Dealing

Applicable Law:

N.J.S.A. 42:2C-39 (Standards of Conduct for Members and Managers) provides in pertinent part:

a. A member of a member-managed limited liability company owes to the company and, subject to subsection b. of section 67 (dealing with direct action by member) of this act, the other members, the duties of loyalty and care stated in subsections b. and c. of this section.

b. The fiduciary duty of loyalty of a member in a member-managed limited liability company includes the duties:
   1. to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
      d. in the conduct or winding up of the company's activities;
      e. from a use by the member of the company's property; or
      f. from the appropriation of a company opportunity;
   2. to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company; and
   3. to refrain from competing with the company in the conduct of the company's activities before the dissolution of the company.

***

f. All of the members of a member-managed limited liability company or a manager-managed limited liability company may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

g. It is a defense to a claim under paragraph (2) of subsection b. of this section and any comparable claim in equity or at common law that the transaction was fair to the limited liability company. (emphasis added)

N.J.S.A. 42:2C-11 (Operating Agreement; Scope, Function, and Limitations) provides in pertinent part:

***

c. An operating agreement may not:

***

(4) subject to subsections d. through g. of this section, eliminate the duty of loyalty, the duty of care, or any other fiduciary duty;

***

d. If not manifestly unreasonable, the operating agreement may:
   (1) restrict or eliminate the duty:
      (a) as required in paragraph (1) of subsection b. and subsection g. of section 39 of this act, to account to the limited liability company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's business, from a use by the member of the company's property, or from the appropriation of a limited liability company opportunity;

(b) as required in paragraph (2) of subsection b. and subsection g. of section 39 of this act, to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and

(c) as required by paragraph (3) of subsection b. and subsection g. of section 39 of this act, to refrain from competing with the company in the conduct of the company's business before the dissolution of the company;

(2) identify specific types or categories of activities that do not violate the duty of loyalty;

(3) alter the duty of care, except to authorize intentional misconduct or knowing violation of law;

(4) alter any other fiduciary duty, including eliminating particular aspects of that duty; and

(5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing under subsection d. and subsection g. of section 39 of this act.

e. The operating agreement may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts. (emphasis added)

LLC Operating Agreement:

Self-dealing sounds bad, but it is common in all small businesses. It includes:

- a member or her affiliate lending money to the LLC; and
- a member or her affiliate leasing real property or personal property (e.g., equipment) to the LLC.

If the self-dealing transaction is fair to the LLC, the member has a defense to a claim alleging a breach of the duty of loyalty. What's fair?

- Terms commercially fair and reasonable to the LLC.
    - Terms no less favorable to the LLC than those generally provided to or available from unrelated third parties.
        - Loan with a market interest rate.
        - Lease with market rent.
- Arm's length transaction.
- Basically, no sweetheart deals for the member.

Unlike the repealed LLC statute, NJ-RULLCA imposes specific fiduciary duties, including a duty of loyalty, which is comprised of several prongs, including a duty not to engage in self-dealing. However, NJ-RULLCA fortunately allows the members to restrict (i.e., alter/modify) and, in some circumstances, even eliminate aspects of the fiduciary duty of loyalty.

Self-dealing can be addressed in an operating agreement as follows:

> Related Party Transactions. Each Member understands and acknowledges that the conduct of the Company's business may involve transactions, agreements, contracts and undertakings with the other Members and/or their respective Affiliates. In any of those cases, those dealings and undertakings shall be at arm's length and on terms commercially fair and reasonable to the Company.
>
> and/or
>
> Activities Not Violating Duty of Loyalty. A Member (individually or through an Affiliate) may, without violating any duty of loyalty, loan monies, lease real and personal property, sell goods and provide services to, and transact other business with, the Company, provided such transactions are on terms commercially fair and reasonable to the Company.

6. Fiduciary Duty of Loyalty – Competition

Applicable Law:

N.J.S.A. 42:2C-39 (Standards of Conduct for Members and Managers) provides in pertinent part:

b. The fiduciary duty of loyalty of a member in a member-managed limited liability company includes the duties:
   1. to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
      a. in the conduct or winding up of the company's activities;
      b. from a use by the member of the company's property; or
      c. from the appropriation of a company opportunity;
   2. to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company; and
   3. to refrain from competing with the company in the conduct of the company's activities before the dissolution of the company. (emphasis added)

LLC Operating Agreement:

An operating agreement can address competition and, where the LLC is formed to hold real estate, it usually does. The following provision restricts the duty of loyalty to the following:

> Fiduciary Duty of Loyalty. A Member's duty of loyalty to the Company and the other Members is limited to account to the Company and hold as trustee for it any property, profit or benefit derived by the Member (i) in the conduct and/or winding up of the Company's business, (ii) from a use of the Company's property, and (iii) from a misappropriation of a Company opportunity in the Business, as specifically provided in this Agreement.

By not including competition in the scope of agreed upon fiduciary duties, the members are not restricted and may compete with the LLC.

An operating agreement may further clarify a member's freedom to pursue other activities, including those that may be competitive with the LLC. For example:

> By way of clarification, and for the avoidance of any doubt, a Member (x) shall have no exclusive duty to act on behalf of the Company, (y) may have other business interests and may engage in other activities in addition to those relating to the Company, including activities that may be competitive with the Company, and (y) shall not incur any liability to the Company or any other Member as a result of engaging in any other business or venture. Neither the Company nor any other Member shall have any right, by virtue of this Agreement, to share or participate in any other business, investments or activities of a Member.

7. Failure to Make a Capital Contribution

Applicable Law:

N.J.S.A. 42:2C-33 (Liability for contributions) provides in pertinent part:

a. A person's obligation to make a contribution to a limited liability company is not excused by the person's death, disability, or other inability to perform personally. If a person does not make a required contribution of property or services, the person or the person's estate is obligated, at the option of the company, to contribute money equal to the value of the part of the contribution which has not been made.

N.J.S.A. 42:2C-46 (Events Causing Dissociation) provides in pertinent part:
A person is dissociated as a member from a limited liability company when:

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e. On application by the company, the person is expelled as a member by judicial order because the person:
   (1) has engaged, or is engaging, in wrongful conduct that has adversely and materially affected, or will adversely and materially affect, the company's activities;
   (2) has willfully or persistently committed, or is willfully and persistently committing, a material breach of the operating agreement or the person's duties or obligations under section 39 of this act; or
   (3) has engaged, or is engaging, in conduct relating to the company's activities which makes it not reasonably practicable to carry on the activities with the person as a member; (emphasis added)

N.J.S.A. 42:2C-48 (Events causing dissolution) provides in pertinent part:

a. A limited liability company is dissolved, and its activities shall be wound up, upon the occurrence of any of the following:

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4) on application by a member, the entry by the Superior Court of an order dissolving the company on the grounds that: …
   b. it is not reasonably practicable to carry on the company's activities in conformity with one or both of the certificate of formation and the operating agreement; … (emphasis added)

LLC Operating Agreement:

Judicial Expulsion: If a member fails to make an initial capital contribution, the members can seek the judicial expulsion (i.e., judicial dissociation) of a member on the grounds that the members had an oral and/or implied operating agreement (or a written operating agreement as reflected in an exchange of emails) that each member would make a capital contribution in accordance with such member's ownership percentage and such a member has materially breached such operating agreement. The same argument can be made with regard to an additional capital contribution if the members had an oral and/or implied operating agreement (or a written operating agreement as

reflected in an exchange of emails) concerning the same. Obviously the members would need to prove their case and face all of the risks of litigation.

Judicial Dissolution: The members can seek judicial dissolution of the LLC on the grounds that "it is not reasonably practicable to carry on the company's activities in conformity with … the operating agreement." This is a more difficult argument because not only must the members prove the existence of an oral and/or implied operating agreement (or a written operating agreement as reflected in an exchange of emails), but the members need to prove that "it is not reasonably practicable to carry on the company's activities in conformity with … the operating agreement." Although it is fact sensitive, some examples of not reasonably practicable include (1) deadlock, (2) the LLC is not profitable or economically viable, and (3) the LLC can no longer do what it was intended to do under the operating agreement.

Due to the difficulty of succeeding on judicial expulsion or judicial dissolution, the members should address the failure to make capital contributions in an operating agreement. The repealed NJ LLC statute provided examples of options on how an operating agreement could deal with a member's failure to make a capital contribution, including an additional capital contribution:

> An operating agreement may provide that the limited liability company interest of any member who fails to make any contribution that he is obligated to make shall be subject to specified penalties for, or specified consequences of, such failure. Such penalty or consequence may take the form of [1] reducing or eliminating the defaulting member's proportionate interest in a limited liability company, [2] subordinating his limited liability company interest to that of nondefaulting members, [3] a forced sale of his limited liability company interest, [4] forfeiture of his limited liability company interest, [5] the lending by other members of the amount necessary to meet his commitment, [6] a fixing of the value of his limited liability company interest by appraisal or by formula and redemption or sale of his limited liability company interest at such value, or [7] other penalty or consequence. N.J.S.A. 42:2B-33(c) (repealed)

The following is a typical provision allowing the other members to make the contributions that should have been made by a non-contributing, followed by a dilution of the non-contributing member's membership interest:

> Additional Contributions.
>
> a. The Manager may, from time to time, determine that the Company requires additional capital. In such an event, the Manager shall provide written notice to the Members setting forth (i) the aggregate capital required, (ii) the purpose for which such capital is required, and (iii) the pro rata portion of the aggregate capital required from each Member, which shall be calculated based on the Membership Interest of each Member (the "Pro Rata Amount"). Within thirty (30) days after the receipt of such notice, each Member shall fund his Pro Rata Amount ("Additional Capital Contribution").

b. If any Member fails to make any such Additional Capital Contribution, the other Members shall have the right, but not the obligation, to increase their participation by making Additional Capital Contributions, *pro rata* in proportion to the Membership Interests of such participating Members, or as they may otherwise agree, in an aggregate amount equal to the Pro Rata Amount of the Member failing to make an Additional Capital Contribution, and the Membership Interests of all Members shall be recalculated after any such Additional Capital Contributions, with the Membership Interest of such failing Member being diluted pro rata, and the Manager shall update Exhibit A to reflect the same.

c. This provision is solely for the benefit of the Company and its Members, and nothing contained herein is intended to create or establish any right on the part of a creditor of the Company or any other third party, whether purporting to act directly or to be acting by or in the right of the Company, to require or enforce the payment of Additional Capital Contributions.

The following is a typical provision allowing the other members to make the contributions that should have been made by a non-contributing, with the contributing members treating the contributions as loans to the non-contributing member:

Defaulting Member.

In the event any Member fails to make his required additional capital contribution by the required date ("Defaulting Member"), the other Members, within the ten (10) day period following such failure, shall have the right, but not the obligation, to individually or collectively elect to lend to the Defaulting Member an amount equal to the additional Capital Contribution that was supposed to have been contributed by the Defaulting Member to the extent it did not do so (which amount the Defaulting Member hereby agrees shall be contributed directly to the Company by the Lending Member (as hereinafter defined) as an additional capital contribution of the Defaulting Member) (each such loan being a "Default Loan," each such lender being a "Lending Member" and if there is more than one Lending Member the Default Loan shall be funded in proportion to their respective ownership percentages or in such other ratio as they shall jointly agree). A Default Loan shall be subject to the following terms: (1) to the extent not otherwise paid by the Defaulting Member to Lending Member, such Default Loan including all costs and expenses of the Lending Member (including attorneys' fees and costs with respect to such Default Loan) plus interest on the Default Loan (at the prime rate as published by *The Wall Street Journal* on the date such Default Loan is made plus three percent (3%)) shall be paid solely out of distributions otherwise made to the Defaulting Member until the Default Loan including all costs and expenses of the Lending Member (including attorneys' fees and costs with respect to such Default Loan) and interest on the Default Loan has been fully satisfied; and (2) all monies paid as repayment of such Default Loan shall first be applied to the costs and expenses of the Lending Members, including attorneys' fees and costs with respect to such Default Loan, secondly towards accrued and unpaid interest on the Default Loan, and finally towards the outstanding principal balance. In the event the

Lending Members shall make a Default Loan, the Defaulting Member shall have the right to fully cure the default hereunder by paying to the Lending Member as reimbursement of such Default Loan (x) all costs and expenses of the Lending Member (including attorneys' fees and costs with respect to such Default Loan), (y) interest on the entire Default Loan from the date such Default Loan was made, plus (z) the outstanding principal amount of such Default Loan, whereupon the Default Loan shall be paid in full.

8. Death of a Member

Applicable Law:

N.J.S.A. 42:2C-46 (Events Causing Dissociation)
A person is dissociated as a member from a limited liability company when:

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f. In the case of a person who is an individual:
   (1) the person dies; (emphasis added)

N.J.S.A. 42:2C-47 (Effect of Person's Dissociation as Member) provides:

a. When a person is dissociated as a member of a limited liability company:
   (1) the person's right to participate as a member in the management and conduct of the company's activities terminates;
   (2) if the company is member-managed, the person's fiduciary duties as a member end with regard to matters arising and events occurring after the person's dissociation; and
   (3) subject to section 44 and Article 10 (sections 73 through 87 of this act), any transferable interest owned by the person immediately before dissociation in the person's capacity as a member is owned by the person solely as a transferee. (emphasis added)

LLC Operating Agreement:

The heirs of a deceased member of an LLC will not be happy with their role in the LLC under the default provisions of NJ-RULLCA. In essence, they hold an economic interest, which is a right to receive distributions if there are any profits, but with no right to vote or be involved in management of the LLC. In order to have the right to vote and manage, all of the other members must unanimously agree to admit the heirs as members of the LLC. Therefore, it is important to address death in an operating agreement.

One simple provision follows, which allows the spouse of a member to automatically become a member of the LLC if the spouse signs a document to be legally bound to the operating agreement, but any other heir must be admitted as a member by the unanimous consent of the other members of the LLC:

> Death. Upon a Member's death, his Membership Interest shall be converted into an Economic Interest and the estate of the deceased Member shall become a Holder of an Economic Interest. If the estate distributes the Economic Interest to a Member's spouse, the spouse shall have the right to become a Member of the Company; *provided*, *however*, that if the spouse is not already an existing Member of the Company, she shall first execute a counterpart signature page of this Agreement, or an admission or joinder agreement, pursuant to which such she agrees to be legally bound by the terms and provisions of this Agreement as if an original signatory hereto. Any other transferee of an Economic Interest shall be a

> Holder of an Economic Interest and shall not have a right to become a Member of the Company except with the prior consent of the other Members, which consent shall be in the sole discretion of such Members. If the Members consent to such transferee becoming a Member of the Company, such transferee shall first execute a counterpart signature page of this Agreement, or an admission or joinder agreement, pursuant to which such she agrees to be legally bound by the terms and provisions of this Agreement as if an original signatory hereto.

The members of an LLC usually do not want to deal with spouses or children of a deceased member, and the deceased member usually wants to provide for his spouse and children by having the estate sell his membership interests to the LLC or the surviving members. Therefore, the operating agreement usually includes buy-sell provisions, which are often comprehensive and deal with valuation of the company, determination of the purchase price, payment terms, etc. The following is only the beginning of such buy-sell provisions:

> Mandatory Transfer Upon Death.
>
> a. Upon the death of any Member, the estate of the deceased Member shall immediately be deemed to have offered to sell to the Company and the surviving Member(s) all of the deceased Member's Interest in the Company now owned or hereafter acquired by him. The purchase of the deceased Member's Interest shall be at the price and upon the terms and conditions set forth in Section [__].
>
> b. The Company shall have ninety (90) days from such offer to elect to purchase all of the Interest from the estate of the deceased Member. If the Company does not elect to make such a purchase, then the surviving Member(s) shall purchase all of the Interest of the deceased Member. If there is more than one surviving Member, the Members shall purchase the Interest in proportion to their respective ownership of the Interests (excluding the Interest of the deceased Member), or in such other proportion as they shall agree upon.

9. Deadlock

Applicable Law:

NJ-RULLCA does not use the term "deadlock". You have to know where to look, and even then it's not at all clear:

> N.J.S.A. 42:2C-48 (Events causing dissolution) provides in pertinent part:
> a. A limited liability company is dissolved, and its activities shall be wound up, upon the occurrence of any of the following: …
> 4) on application by a member, the entry by the Superior Court of an order dissolving the company on the grounds that: …
> b. it is not reasonably practicable to carry on the company's activities in conformity with one or both of the certificate of formation and the operating agreement; … (emphasis added)

LLC Operating Agreement:

There are numerous ways to break deadlocks, none of them being 100% satisfactory to all parties. Some of them are:

1. One party has extra vote to break deadlocks
2. One party has 50.1% ownership and thus final decision making
3. Designate a person to break deadlocks
4. Dissolve and liquidate the LLC
5. One party sets a purchase price and the other party decides whether to sell or buy at that price
6. Mediation with an independent mediator
7. Binding arbitration with an independent arbitrator
8. Good ole litigation
9. Coin flip
10. Do nothing and let the parties work it out

The members of an LLC should want to address deadlock in an operating agreement to avoid having a third party, such as the court, decide their fate. The following is a deadlock provision distinguishing between major and minor deadlock, which is sometimes difficult to do because what is minor to one member may be major to another member.

> 13. Deadlock. If the Members are unable to make decisions or effect action on one or more matters with respect to the Company's management, business or affairs, a "Deadlock" will be deemed to exist. The Members shall first seek to resolve any Deadlock through mediation in accordance with paragraph [__]. If the Members are unable to resolve the Deadlock through mediation, then if the Deadlock involves a minor, the provisions of Section 13(a) shall apply, but if the Deadlock involves a major matter, then the provisions of Section 13(b) shall apply.

a. Minor Deadlock. In the event of an minor Deadlock, a Member may submit the Deadlock to arbitration by one arbitrator mutually agreed upon by the Members, and if the Members cannot mutually agree upon one arbitrator within fifteen (15) days, then by one arbitrator chosen by JAMS. The arbitration shall take place in Hackensack, New Jersey, in accordance with JAMS' Streamlined Arbitration Rules then in effect, and any decision, judgment or award rendered in such arbitration will be final and binding on the Members and, if applicable, may be entered in any court having jurisdiction thereof.

b. Major Deadlock.

i. In the event of a major Deadlock of the Members, a Member (the "Initiating Member") may offer in writing (the "Deadlock Notice") to purchase all (but not less than all) of the other Member's (the "Responding Member") Membership Interest at its Fair Market Value as determined in accordance with Section 13(c). Within thirty (30) days after receipt of the Deadlock Notice, the Responding Member shall give written notice to the Initiating Member electing to do one of the following: (1) sell such Responding Member's entire Membership Interest in the Company at its Fair Market Value; or (2) purchase all (but not less than all) of the Initiating Member's Membership Interest in the Company at its Fair Market Value; or (3) provide written notice to the Initiating Member that the matter with respect to the Deadlock has been resolved in favor of the Initiating Member. If the Responding Member fails to deliver such written notice of election to the Initiating Member within said thirty (30) day period, the Responding Member shall be deemed to have elected to sell his entire Membership Interest in the Company to the Initiating Member.

ii. If the Responding Member exercises his right to purchase or sell pursuant to Section 13(b)(i) above, the Initiating Member shall be obligated to sell or purchase, as appropriate, unless within fifteen (15) days following the expiration of the thirty (30) day period described in Section 13(b)(i) above, the Initiating Member gives written notice to the Responding Member that the matter with respect to the Deadlock has been resolved in favor of the Responding Member.

c. Fair Market Value. The fair market value of a Member's Membership Interest shall be equal to (i) the amount agreed to by the Initiating Member and the Responding Member or (ii) if they cannot agree on an amount, then the fair market value shall be determined by an independent appraiser chosen in accordance with the provisions of Section 13(d) (the "Fair Market Value"). The Fair Market Value shall be determined as of the end of the calendar month preceding the Deadlock. In determining the Fair Market Value, the Members and the appraiser(s), if applicable, shall consider the fair market value of the real property held by the Company, any mortgage or other debt of the Company secured by the real property, and any cash held by the Company.

d. Selection of Appraiser. The Initiating Member and the Responding Member shall jointly choose the qualified appraiser. If they are unable to agree on an appraiser, the Initiating Member and the Responding Member shall each choose a qualified appraiser, who in turn shall jointly choose a third qualified appraiser, which third appraiser shall make the determination of Fair Market Value. The determination of Fair Market Value by the appraiser chosen in accordance with the foregoing provisions shall be conclusive, final and binding on the Members. The Initiating Member and the Responding Member shall share equally the fees and expenses of the appraiser(s).

The Duty of Loyalty under the New Jersey Revised Uniform Limited Liability Company Act

by Gianfranco A. Pietrafesa

On March 1, 2014, the New Jersey Limited Liability Company Act was repealed[1] and replaced by the New Jersey Revised Uniform Limited Liability Company Act (NJRULLCA).[2] On that date, NJRULLCA began to govern all limited liability companies (LLCs) in New Jersey.[3]

NJRULLCA has made significant changes in New Jersey's LLC law.[4] Among them are specific statutory fiduciary duties for managers and members of LLCs.[5] One such fiduciary duty is the duty of loyalty.

What is the Duty of Loyalty?

The statutory duty of loyalty is comprised of the following specific duties:

1. to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
   (a) in the conduct or winding up of the company's activities;
   (b) from a use by the member of the company's property; or
   (c) from the appropriation of a company opportunity;
2. to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company [*i.e.*, self-dealing]; and
3. to refrain from competing with the company in the conduct of the company's activities before the dissolution of the company.[6]

Thus, a member or manager must account to the LLC for any profits derived from: 1) conducting the business of the LLC and dissolving the LLC, 2) using the LLC's property, and 3) appropriating business opportunities of the LLC. Also, a member or manager must refrain from engaging in self-dealing and competing with the LLC. The prohibitions against self-dealing and competing with the LLC may present problems for certain LLCs, but any problems can be addressed in an operating agreement.

To Whom Does the Duty Apply?

An LLC may be managed by its members or by one or more managers,[7] and who manages the LLC determines who is bound by the duty of loyalty. Thus, the duty applies to the members of a member-managed LLC[8] or to the managers (but not the members) of a manager-managed LLC.[9] Note that in a member-managed LLC, a member has a duty to refrain from competing with the LLC *before the dissolution of the LLC*, whereas in a manager-managed LLC, a manager has a duty to refrain from competing with the LLC *until the completion of the winding up of the LLC*.[10]

Comparison to Prior New Jersey LLC Law

New Jersey's prior statute did not include a duty of loyalty.[11] In fact, the term "fiduciary duty" was mentioned once, at the end of the statute.[12] In addition, there is virtually no New Jersey case law discussing the duty of loyalty in the context of an LLC. The sparse case law that does exist is contradictory and, as a result, not helpful.[13]

Some have argued that, unless otherwise expressed in an operating agreement, managers and members did not have any fiduciary duties, including the duty of loyalty.[14] Others assumed that managers and controlling members must have had fiduciary duties.[15]

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Comparison to Other New Jersey Entity Laws

The duty of loyalty imposed by NJRULLCA is substantially similar to the duty of loyalty under New Jersey's general partnership and limited partnership statutes.[16] This should come as no surprise since all three laws were drafted by the uniform law commissioners.[17]

However, the duty of loyalty for managers and members of an LLC is broader than the comparable duty for partners of a general partnership or general partners of a limited partnership. First, the general partnership statute states that "[t]he *only* fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in [the statute]."[18] By comparison, NJRULLCA does not include such a limiting term.[19] Second, NJRULLCA implies that managers and members may be subject to *other* fiduciary duties,[20] meaning fiduciary duties developed by the courts under the common law.[21]

By contrast, New Jersey's corporate statute does not include a duty of loyalty. Instead, the duty of loyalty of directors and officers to a corporation and its shareholders is determined by the courts under the common law. Although the duty of loyalty is determined on a case-by-case basis, and thus cannot be defined with precision, it includes a duty to act in the best interests of the corporation, without self-dealing and usurping corporate opportunities.[22]

Comparison to Delaware LLC Law

While NJRULLCA clearly specifies the duty of loyalty in New Jersey LLCs, the duty of loyalty for managers and members of Delaware LLCs is not so certain. In fact, the issue of fiduciary duties caused a significant disagreement between the Delaware Supreme Court and the chancery court (which decides disputes involving the internal affairs of LLCs, corporations and other business entities).

In Jan. 2012, the chancery court held that the manager of an LLC had default fiduciary duties to the LLC and its members, which confirmed the common understanding under prior case law that a manager had fiduciary duties unless contradicted by an operating agreement.[23] In Nov. 2012, the Delaware Supreme Court disagreed and held that the chancery court's pronouncement about default fiduciary duties was "improvident and unnecessary" and "dictum without precedential value."[24] A few weeks later, the chancery court again held that default fiduciary duties apply to managers of an LLC.[25]

The Delaware Legislature ended the controversy by amending its LLC statute.[26] Thus, managers and controlling members of Delaware LLCs have a duty of loyalty to the LLC and its members. However, the nature and scope of the duty is still determined through case law.

Alter or Eliminate the Duty

The statutory duty of loyalty is a default provision that will apply if the LLC's operating agreement does not modify the duty. Fortunately, NJRULLCA provides an LLC with several methods to alter, or even eliminate, the duty. These methods are contained in Sections 11 and 39 of NJRULLCA.[27] The provisions appear complex and even contradictory, and thus confusing, but as explained below, they do provide LLCs with great flexibility to deal with the duty of loyalty to suit the circumstances of each particular LLC.

Section 11 of NJRULLCA initially states that "[a]n operating agreement may *not*…(4) subject to subsections d. through g. of this section, eliminate the duty of loyalty, the duty of care, or any other fiduciary duty."[28] But in subsections d. through g., NJRULLCA provides several methods to address the duty of loyalty.

First, Section 11(d) of NJRULLCA provides in part that, "[i]f not manifestly unreasonable, the operating agreement *may* (1) restrict or eliminate the duty as required in [N.J.S.A. 42:2C-39(b)(1)-(3) & (i)],"[29] which is the duty of loyalty. Thus, as long as it is not manifestly unreasonable, an operating agreement may restrict, and even eliminate, all or parts of the duty of loyalty.[30]

For example, an operating agreement in a member-managed LLC[31] may eliminate the duty of loyalty, as follows:

> *No Duty of Loyalty*. No Member owes any fiduciary duty of loyalty to the Company or the other Members.

Or, an operating agreement may restrict the duty of loyalty; for example, by limiting it to some of the statutory duties and thus eliminating others:

> *Duty of Loyalty*. A Member's duty of loyalty to the Company and the other Members is limited to accounting to the Company and holding as trustee for it any property, profit or benefit derived by the Member (A) in conducting and winding up the Company's business, (B) from using the Company's property, and (C) from appropriating a business opportunity of the Company. No Member owes any other fiduciary duty of loyalty to the Company or the other Members.

Under the above example, the duties against self-dealing and competing with the LLC are eliminated. For further clarification, the last sentence can be modified with the addition of the following phrase at the end of the sentence: ", including the duty against self-dealing and competing with the Company."

Identify Acts Not Violating the Duty

Next, Section 11(d) of NJRULLCA provides in part that, "[i]f not manifestly unreasonable, the operating agreement *may*…(2) identify specific types or categories of activities that do not violate the duty of loyalty."[32] This method may be used when the managers or members of

an LLC are active in the specific business of the LLC through other companies, positions, etc. For example, the members of a real estate holding company may currently or in the future want to own commercial real estate individually or with others, and not be required to own such other real estate through the LLC or even with the same members.

Thus, an operating agreement for a real estate holding company may identify certain types or categories of activities that do not violate the duty of loyalty, such as:

> *Other Interests*. A Member may, directly or indirectly, own and/or manage other real estate. Neither the Company nor any other Members shall have any right, by virtue of this Agreement, to share or participate in the ownership or management of such other real estate of the Member or to the income or proceeds derived therefrom.[33]

An operating agreement for an operating company may include the following provision:

> *Other Interests*. Each Member acknowledges that the other Members may, directly or indirectly, own and/or manage other businesses, including businesses that may compete with the Company. Each Member agrees that a Member shall not be prohibited from engaging or investing in any other business, including a business that may compete with the Company, and that a Member shall not be required to present such business opportunities to the Company or the other Members, even if such business opportunities are similar to the business of the Company. Neither the Company nor any other Members shall have any right, by virtue of this Agreement, to share or participate in the ownership of such business opportunities of the Member or to the income or proceeds derived therefrom.

Such a provision should be useful in attracting experienced businesspeople to join the LLC as members, which they might not otherwise do because of the duty against competing with the LLC and appropriating business opportunities of the LLC.

Not Manifestly Unreasonable

As noted, a provision restricting or eliminating the duty of loyalty or identifying acts that do not violate the duty must not be manifestly unreasonable.[34] NJRULLCA provides that whether a term is manifestly unreasonable is an issue for the court.[35] A court may invalidate a term as manifestly (*i.e.*, clearly or obviously) unreasonable only if it is readily apparent the objective of the term is unreasonable or the term is an unreasonable means to achieve its objective.[36] 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,[37] and in light of the LLC's purpose and business.[38] In making its determination, the court should also consider that NJRULLCA, like the prior statute, "is to be liberally construed to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."[39]

An operating agreement can include a provision where the members agree the provisions altering fiduciary duties are reasonable and provides for the court to modify any such provisions deemed manifestly unreasonable by the court:

> *Reasonable Provisions*. Each Member acknowledges and agrees that the provisions in Section X are reasonable, important and necessary for the success of the Company. If a court determines that any provision in Section X is manifestly unreasonable, the Members agree that the court shall have the power to modify any such unreasonable provision to the extent deemed necessary by the court to render it reasonable and enforceable (and that comes closest to expressing the intention of the unreasonable provision), and that such modified provision shall be enforced by the court.

Independent Authorization or Ratification

Section 11(e) of NJRULLCA provides that an operating agreement "may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts."[40] This method is intended to be used for self-dealing; that is, for transactions between the LLC and its managers and members.[41]

For example, an operating agreement may provide for a special committee, an advisory board, or any disinterested and independent person, such as a retired judge or a person with experience in the particular industry of the LLC. Under this method, one or more disinterested and independent persons would review all material facts: 1) *before* an act or transaction to *authorize* it, or 2) *after* an act or transaction to *ratify* it. This method 'cleanses' the act or transaction otherwise violating the duty of loyalty.

A simple provision for such a method would be the following:

> *Independent Authorization or Ratification*. After full disclosure of all material facts, the majority vote of the Company's special committee, which shall be comprised of disinterested and independent persons (e.g., persons that are not Members or Managers or affiliates of Members or Managers), may authorize or ratify an act or transaction violating the duty of loyalty.

No Duty for Non-Managing Members

An operating agreement of a member-managed LLC may appoint certain

members as the managing members of the LLC. In such a situation, the non-managing members may not want to owe any duty of loyalty to the LLC or the other members because they are not managing the LLC and do not have the authority to legally bind the LLC. Section 11(f) of NJRULLCA allows an operating agreement to relieve non-managing members from fiduciary duties, including the duty of loyalty:

> To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of a responsibility that the member would otherwise have under this act and imposes the responsibility on one or more other members, the operating agreement may, to the benefit of the member that the operating agreement relieves of the responsibility, also eliminate or limit any fiduciary duty that would have pertained to the responsibility.[42]

Thus, an operating agreement may provide as follows:

> *No Duty of Loyalty for Non-Managing Members*. The LLC is member-managed by the Managing Member, who shall have the authority to legally bind the LLC. As a result, none of the other Members shall owe any duty of loyalty to the Company or the other Members.

Authorization or Ratification by Members

In the event an operating agreement does not eliminate, restrict or otherwise deal with the duty of loyalty, NJRULLCA provides that "[a]ll of the members… may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that would otherwise violate the duty of loyalty."[43] This provision applies to both member-managed and manager-managed LLCs, but it is always the members (not the managers) who have the power of authorization and ratification.[44]

There is nothing in NJRULLCA that prohibits the members from including a provision in an operating agreement allowing *less than all* members to authorize or ratify an act or transaction violating the duty of loyalty. Thus, a majority or super-majority of the members, but not including the interested member, may authorize or ratify an act or transaction violating the duty of loyalty. For example:

> *Authorization or Ratification by Members*. A majority of the Members, not including the Member violating the duty of loyalty, may authorize or ratify, after full disclosure of all material facts, a specific act or transaction by a Member that otherwise violates the duty of loyalty.

Defense to Self-Dealing

As noted, the duty of loyalty requires managers and members "to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company."[45] Self-dealing sounds bad, but is common in many closely held and family-owned businesses.[46] It includes lending money and leasing real property to an LLC.

As noted, the duty of loyalty may be restricted or eliminated in an operating agreement, but if it is not, NJRULLCA provides a defense to a claim that a transaction violates the duty prohibiting self-dealing. If a transaction is fair to the LLC, then there is no violation of the duty of loyalty.[47] Examples of transactions that are fair to the LLC include loans to the LLC at market interest rates and leases of real property to the LLC at fair market rents.[48]

An operating agreement may permit self-dealing (as provided under the prior law) or it may include a provision addressing self-dealing to reflect NJRULLCA, as follows:

> *Related Transactions*. Each Member and the Affiliates of a Member may, without violating the duty of loyalty, loan monies, lease real and personal property, sell goods and provide services to, and transact other business with, the Company, *provided* that such transactions are on terms commercially fair and reasonable to the Company and no less favorable to the Company than those generally being provided to or available from unrelated third parties.

No Indemnification or Exculpation

NJRULLCA provides both indemnification of members and managers,[49] and allows an operating agreement to limit or even eliminate the personal liability of a member or manager for money damages.[50] However, a member or manager breaching the duty of loyalty is not entitled to indemnification or exculpation of liability for money damages.[51] Yet, as noted, an operating agreement may restrict or entirely eliminate the duty of loyalty.[52]

Specific Purpose

An LLC may also reduce or even eliminate claims of a breach of the duty of loyalty by including a specific purpose for the LLC in its certificate of formation.[53] Alternatively, the operating agreement may include a specific, narrow purpose rather than a general, broad purpose for the LLC. For example:

> *Purpose*. The purpose of the Company shall be to produce, sell and distribute gluten-free cookie products.

Presumably, a member or manager involved in other businesses producing other food products, perhaps even non-gluten-free cookies, would not be violating the duty of loyalty because the LLC and the other businesses would not be competitors.

Conclusion

It can be argued that New Jersey's LLC law has been improved by having the duty of loyalty specifically defined in its statute rather than being determined on a case-by-case basis by the courts under the common law. In any event, such a statutory duty of loyalty is a significant change in New Jersey LLC law. However, the statute provides LLCs with many different methods to deal with the duty of loyalty, including the complete elimination of the duty. ⚖

Endnotes

1. P.L. 2013, c.276, §10 (clarifying that the repeal date is March 1, 2014); P.L. 2012, c.50, §95 (repealed).
2. At the writing of this article, New Jersey is one of 10 states and districts enacting RULLCA. The others are California, Idaho, Utah, Wyoming, Nebraska, Iowa, Minnesota, Florida and the District of Columbia. RULLCA legislation has been introduced in other states. *See* www.uniformlaws.org.
3. N.J.S.A. 42:2C-91(b).
4. *See*, *e.g.*, Gianfranco A. Pietrafesa, New LLC Law Became Effective on March 1, 215 *N.J.L.J.* 619 (March 3, 2014).
5. N.J.S.A. 42:2C-39.
6. N.J.S.A. 42:2C-39(b). In the context of an LLC formed for business purposes, the term "activities" means "business." NJRULLCA uses "activities" instead of "business" because an LLC may also be formed for non-profit purposes. *See* N.J.S.A. 42:2C-4(b).
7. N.J.S.A. 42:2C-37.
8. If the operating agreement appoints one or more managing members, it may also relieve the remaining non-managing members from the duty of loyalty. *See* N.J.S.A. 42:2C-11(f), discussed *infra* at "No Duty for Non-Managing Members."
9. N.J.S.A. 42:2C-39(a), (b) & (i). Note that there is nothing in the statute that precludes an operating agreement from imposing a duty of loyalty on the members of a manager-managed LLC. It may be appropriate to impose such a duty on the members when a controlling majority member appoints or 'elects' the manager of a manager-managed LLC. In such a situation, the majority member controls the LLC through the manager, but is able to take actions that violate the duty of loyalty, such as appropriating business opportunities belonging to the LLC.
10. *See* N.J.S.A. 42:2C-39(i)(1).
11. The prior statute did, however, address self-dealing, which was permitted unless otherwise provided in an operating agreement. *See* N.J.S.A. 42:2B-9.
12. *See* N.J.S.A. 42:2B-66(b) (repealed) ("To the extent that, at law or in equity, a member or manager has duties (including fiduciary duties) and liabilities[,]…the member's or manager's duties and liabilities may be expanded or restricted by provisions in an operating agreement."). The prior statute did, however, include a duty of care. *See* N.J.S.A. 42:2B-26 & -30 (repealed).
13. *See In re Robert Hickman*, 2014 Bankr. LEXIS 437, *22 (Bankr. D.N.J. Jan. 31, 2014) ("Absent a duty provided for in the Operating Agreement of the LLC, the NJ LLC Act does not impose a fiduciary duty on LLC members."); *In re Anthony P. D'Amore III*, 472 B.R. 679, 688 (Bankr.D.N.J. 2012) ("[A]bsent a contrary provision in an LLC's operating agreement, managing members of an LLC owe the traditional fiduciary duties of loyalty and care to non-managing members of that LLC."); *Antolino v. Quinn*, 2009 N.J. Super. Unpub. LEXIS 1181, *2 (App. Div. May 18, 2009) (There is no basis in law "for imposing such a [fiduciary] duty upon one member of an LLC in relation to others who stand on equal footing."). Obviously, none of this case law is binding on a New Jersey court and should not be considered authoritative.
14. Recently retired Delaware Supreme Court Chief Justice Myron T. Steele believed that managers of Delaware LLCs do not have any fiduciary duties unless expressly imposed by an operating agreement. *See* Myron T. Steele, Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 32 *Del. J. Corp. L.* 1 (2007). New Jersey's prior LLC statute was modeled after Delaware's LLC statute.
15. *See* Lawrence A. Goldman and Alyce C. Halchak, *New Jersey Limited Liability Company: Forms and Manual*, §7.10 at 7-40 (Data Trace 2014) [hereinafter Goldman]. *See also* Peter D. Hutcheon, The New Jersey Limited Liability Company Statute: Background and Concepts, 18 *Seton Hall. Legis. J.* 111, 146-146 (1993) (suggesting that if the facts warrant, a court has the equitable power to impose a duty on managers or members and hold them personally liable).
16. *See* N.J.S.A. 42:1A-24(b); N.J.S.A. 42:2A-3 (mandating that in the absence of a specific provision, the general partnership law will apply to a limited partnership).
17. *See* www.uniformlaws.org. The term "uniform law commissioners" is the alternate name for the National Conference of Commissioners on Uniform State Laws (NCCUSL).
18. N.J.S.A. 42:1A-24(a) (emphasis added).
19. *See* N.J.S.A. 42:2C-39(a) ("A member [and manager]…owes to the company and…the other members, the duties of loyalty and care stated in

[N.J.S.A. 42:2C-39(b) and (c)].").

20. NJRULLCA refers to the phrase "any other fiduciary duty" in N.J.S.A. 42:2C-11(c)(4) & (d)(4).
21. Limiting fiduciary duties, as in the partnership act, is known as 'cabining' fiduciary duties. *See* Daniel S. Kleinberger and Carter G. Bishop, The Next Generation: The Revised Uniform Limited Liability Company Act, 62 *The Business Lawyer* 615, 522-524 (2007) (explaining why the uniform law commissioners changed their approach from cabining to "un-cabining" fiduciary duties). The late Larry E. Ribstein was not a fan of the un-cabining approach. He thought it "opens a Pandora's Box of potential uncertainty about what other duties members and managers may have" and "explicitly invites courts to create new duties." Larry E. Ribstein, An Analysis of the Revised Uniform Limited Liability Company Act, 3 *Va. L. & Bus. Rev.* 35, 62-63 (2008) [hereinafter Ribstein]. Other commentators believe the un-cabining approach allows the courts to address novel or egregious conduct. *See, e.g.*, Rutheford B. Campbell Jr., The 'New' Fiduciary Standards Under the Revised Uniform Limited Liability Company Act: More Bottom Bumping from NCCUSL, 61 *Me. L. Rev.* 28, 48 n.98-99 (2009).
22. *See, e.g., AYR Composition, Inc. v. Rosenberg*, 261 N.J. Super. 495, 501 (App. Div. 1993). *See generally* John R. MacKay II, et al., *New Jersey Corporations and other Business Entities (3d ed.)*, §§12.07[5] (officer's duty of loyalty) and 12.08[6] (director's duty of loyalty) (Matthew Bender & Co., 2013).
23. *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 849 (Del. Ch. 2012).
24. *Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1218 (Del. 2012). At that time, the Supreme Court was led by Chief Justice Myron T. Steele, who recently retired.
25. *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 659-653 (Del. Ch. 2012).
26. 6 Del. Code 18–1104.
27. N.J.S.A. 42:2C-11 and -39.
28. N.J.S.A. 42:2C-11(c)(4) (emphasis added). As part of its effort toward the harmonization of business entity acts, NCCUSL has revised the provisions in subsequent drafts of NJRULLCA in an attempt to clarify them. *See* Harmonization of Business Entity Acts RULLCA Draft dated Jan. 14, 2013, §§ 105(c)(5) & (d)(3), at www.uniformlaws.org.
29. N.J.S.A. 42:2C-11(d)(1) (emphasis added).
30. Under New Jersey's prior LLC law, fiduciary duties, such as the duty of loyalty, could be restricted, but not eliminated. *See* N.J.S.A 42:2B-66(b). Thus, although the ability to restrict the duty of loyalty under NJRULLCA may be stricter than under the prior LLC law because such restriction must not be manifestly unreasonable, a standard not included in the prior law, NJRULLCA also allows the elimination of the duty, whereas the prior law did not. *Compare* N.J.S.A. 42:2C-11(d)(1) *with* N.J.S.A. 42:2B-66(b). Note that Delaware has amended its LLC statute to allow the elimination of fiduciary duties. 6 Del. Code 18-1101(c).
31. For convenience, all examples in this article will be for member-managed LLCs and have been kept simple to illustrate the principle or concept being addressed.
32. N.J.S.A. 42:2C-11(d)(2) (emphasis added).
33. For a more comprehensive provision, *see* Goldman, *supra*, Form 7-25 (§5.4.2).
34. *See* N.J.S.A. 42:2C-11(d)(1) & (2).
35. N.J.S.A. 42:2C-11(h).
36. N.J.S.A. 42:2C-11(h)(2).
37. N.J.S.A. 42:2C-11(h)(1).
38. N.J.S.A. 42:2C-11(h)(2).
39. N.J.S.A. 42:2C-11(i). For a further discussion of the "not manifestly unreasonable standard," *see* Gianfranco A. Pietrafesa, The Manifestly Unreasonable Standard under RULLCA, Vol. 30 No. 1 NJSBA *Business Law Section Newsletter* (June 2014).
40. N.J.S.A. 42:2C-11(e).
41. *See* NCCUSL commentary to RULLCA Section 110(e), available at www.uniformlaws.org.
42. N.J.S.A. 42:2C-11(f). In seminars, the author has described the statutory provision as a 'savings clause' to save acts from violating the duty of loyalty.
43. N.J.S.A. 42:2C-39(f).
44. N.J.S.A. 42:2C-39(i)(3).
45. N.J.S.A. 42:2C-39(b)(2).
46. It is perhaps for this reason that New Jersey's prior LLC law permitted self-dealing unless otherwise provided in an operating agreement. *See* N.J.S.A. 42:2B-9 (repealed).
47. N.J.S.A. 42:2C-39(g).
48. Note that even if the transaction is fair to the LLC, it may not be fair to the other members. For example, the controlling member may make a loan to the LLC at a market interest rate, but the other members do not have the opportunity to make a similar loan. The operating agreement can address this situation by providing that when the LLC is in need of a loan, all members shall have the opportunity to make a loan to the LLC based on their respective LLC interests.
49. N.J.S.A. 42:2C-38.
50. N.J.S.A. 42:2C-11(g).
51. N.J.S.A. 42:2C-11(g)(1) & -38(c). *See also* NCCUSL commentary to NJRULLCA Section 110(g) ("The restrictions…apply both to indem-

nification and exculpation.").

52. One commentator has asked: If the members can eliminate the duty of loyalty, why can't they eliminate liability for a breach of the duty of loyalty? *See* Ribstein, *supra*, at 68-69.
53. N.J.S.A. 42:2C-18(c) ("a certificate of formation may also contain statements as to matters other than those required by [N.J.S.A. 42:2C-18(b)]).")

Gianfranco A. Pietrafesa *is a partner in the corporate group of Archer & Greiner, in Hackensack. He is a former chair of the Business Law Section and a member of the committee that drafted NJRULLCA for adoption in New Jersey. In recognition of his efforts, he received the 2012 Distinguished Legislative Service Award from the NJSBA.*

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NJ-RULLCA Provisions Requiring Unanimous Consent of Members

by Gianfranco A. Pietrafesa

There are numerous provisions in the New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA)[1] requiring the consent of all members of a limited liability company (LLC) regarding certain actions. Fortunately, NJ-RULLCA implicitly authorizes the members of an LLC to agree in the company's operating agreement to require something less than unanimous consent of the members. N.J.S.A. 42:2C-11(c) expressly identifies the provisions an operating agreement may not alter or eliminate (unless done in accordance with NJ-RULLCA). By implication, any other statutory provisions may be altered or even eliminated in the operating agreement. In further support of this principle is the statutory language included in NJ-RULLCA about the freedom of contract and the enforceability of operating agreements.[2]

The following list identifies the actions requiring the unanimous consent or vote of the members under NJ-RULLCA. As noted, an operating agreement may change the required vote from unanimous to something less than unanimous, such as a simple majority or super-majority vote.

1. After the formation of an LLC, a person may become a member only with the consent of all existing members.[3]
2. Any action, matter or decision outside the ordinary course of business, regardless of whether the LLC is member-managed or manager-managed[4] (This includes decisions to (a) sell, lease, exchange or otherwise dispose of all or substantially all of the LLC's property outside the ordinary course of business, (b) mergers, (c) conversions and (d) domestications.)[5]
3. Amending the operating agreement, regardless of whether the LLC is member-managed or manager-managed[6]
4. Authorizing or ratifying an act or transaction that violates the fiduciary duty of loyalty[7]
5. Expelling a member from the LLC pursuant to the provisions of NJ-RULLCA. However, the vote of the member being expelled is not required (obviously)[8]
6. Dissolving the LLC[9]
7. As noted, merging the LLC with or into another entity, converting the LLC into another type of business entity, and domesticating the New Jersey LLC into another state so that it becomes an LLC of the other state[10]
8. With regard to any merger, conversion or domestication, if a member will be subject to personal liability as a result of the merger, conversion or domestication, that member must approve the merger, conversion or domestication. Since almost all members will be similarly situated, any merger, conversion or domestication that will result in personal liability to the members will require the approval of all members.[11] ■

Gianfranco A. Pietrafesa is a partner of Archer & Greiner, P.C. in its Hackensack office, where he is a member of its business counseling group. He is a director and past chair of the Business Law Section and served on the select committee that drafted NJ-RULLCA.

Endnotes

1. N.J.S.A. 42:2C-1 *et seq.*
2. N.J.S.A. 42:2C-11(i).
3. N.J.S.A. 42:2C-31(c)(3).
4. N.J.S.A. 42:2C-37(b)(4) & -37(c)(4)(c).
5. *See* N.J.S.A. 42:2C-37(c)(4), -75(a), -79(a) & -83(a). (Note that NJ-RULLCA uses the term "activities" instead of "business" because an LLC may be used for nonprofit purposes. *See* N.J.S.A. 42:2C-4(b); Uniform Law Commission Comment to RULLCA Section 108(b)).
6. N.J.S.A. 42:2C-37(b)(5) & (c)(4)(d).
7. N.J.S.A. 42:2C-39(f).
8. N.J.S.A. 42:2C-46(d).
9. N.J.S.A. 42:2C-39(a)(2).
10. N.J.S.A. 42:2C-75(a); 42:2C-79(a); 42:2C-83(a).
11. N.J.S.A. 42:2C-86.

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Non-Waivable Provisions Under the New Jersey Revised Uniform Limited Liability Company Act

by Gianfranco A. Pietrafesa

Almost all of the default provisions in the New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA)[1] may be altered, except as otherwise provided in Section 11 of the statute.[2] Indeed, NJ-RULLCA provides that it "is to be liberally construed to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."[3] This article identifies and explains the statutory default provisions that may not be altered under Section 11 of the statute, the so-called 'non-waivable' provisions.

Litigation

A limited liability company (LLC) has the capacity to sue and be sued in its own name.[4] An operating agreement may not vary an LLC's right to engage in litigation.[5]

The Uniform Law Commission (ULC) August 19, 2015 Comments (2015 Comments) to its Revised Uniform Limited Liability Company Act (RULLCA) state that an LLC is an entity distinct from its members and that its members lack the power to alter that characteristic.[6] This provision is likely a carryover from the ULC's general partnership act, which provides that a partnership is distinct from its partners. It is not a controversial provision.

Applicable Law

NJ-RULLCA provides that New Jersey law governs: 1) the internal affairs of a New Jersey LLC, and 2) the liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of an LLC.[7] An operating agreement may not vary this applicable law.[8]

The ULC 2015 comments state that an operating agreement may lawfully incorporate by reference the provisions of another state's LLC statute.[9] For example, an operating agreement of a New Jersey LLC may incorporate by reference Delaware's LLC statute. New Jersey law would still govern the agreement, but Delaware's LLC statute and the operating agreement would govern the members of the LLC to the extent not prohibited by NJ-RULLCA. As noted in the ULC 2015 comments, this approach raises complex drafting issues and is rarely, if ever, a good idea.

Court Power

A court has the power to enter orders regarding the signing and filing of records.[10] An operating agreement cannot interfere with the court's power in this regard.[11]

Fiduciary Duties

Members of a member-managed LLC and managers of a manager-managed LLC have fiduciary duties of loyalty and care.[12] Although NJ-RULLCA provides that an operating agreement may not eliminate the duty of loyalty, the duty of care, or any other fiduciary duty,[13] it further provides that, if not manifestly unreasonable,[14] an operating agreement may restrict or eliminate the duty of loyalty,[15] alter (but not eliminate) the duty of care,[16] and alter or eliminate any other fiduciary duties, meaning fiduciary duties under the common law.[17]

Good Faith and Fair Dealing

The members and, if applicable, the managers must discharge their duties and exercise their rights under the operating agreement and NJ-RULLCA consistent with the contractual obligation of good faith and fair dealing.[18] An operating agreement may not eliminate this obligation,[19] but, if not manifestly unreasonable, it may prescribe standards by which to measure the performance of the obligation.[20]

Information Rights

Members, managers and even dissociated members have certain rights to receive information about the LLC.[21] An operating agreement may restrict such rights, or the duties to provide such information, but may not do so unreasonably.[22] In addition to restrictions or conditions in an operating agreement, an LLC may

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impose reasonable restrictions and conditions on access to and use of records and information, including designating information as confidential and imposing nondisclosure and safeguarding obligations on the recipient.[23]

The ULC 2015 comments note that in determining whether a restriction is reasonable, a court might consider: 1) the danger or other problem the restriction seeks to avoid, 2) the purpose for which the information is sought, and 3) whether, in light of both the problem and the purpose, the restriction is reasonably tailored.[24]

Judicial Dissolution

A court has the power and authority to dissolve an LLC on various statutory grounds.[25] An operating agreement may not vary the court's power to judicially dissolve a New Jersey LLC under these statutory grounds.[26] However, an operating agreement can limit the remedies the court has the power to impose to dissolution only; for example, it can provide that a court cannot enter an order for the sale and purchase of LLC interests.[27]

Winding Up a Dissolved LLC

An LLC in dissolution must wind up its business as provided in NJ-RULLCA.[28] An operating agreement may not vary this requirement.[29] For example, an LLC cannot continue its business indefinitely and cannot make distributions to members in lieu of payments to creditors.

Direct or Derivative Action

NJ-RULLCA provides members with the right to maintain direct and derivative actions.[30] An operating agreement may not unreasonably restrict such rights.[31] The ULC 2015 comments note that reasonable provisions in an operating agreement include forum selection, mediation prior to litigation, arbitration of direct and derivative claims, waiver of jury trial and a demand in all derivative cases. By contrast, the ULC 2015 comments note that it would be unreasonable, by way of example, for an operating agreement to require a would-be derivative plaintiff to make demand regardless of futility.[32]

Approval of Extraordinary Action

NJ-RULLCA requires the members to unanimously approve extraordinary action, such as a merger, conversion or domestication.[33] Nothing in the statute prevents an operating agreement from altering this unanimity requirement to a simple majority or supermajority requirement.

However, if a merger, conversion or domestication will result in the members having personal liability as the owners of the surviving, converted or domesticated company, then the members will have the right to unanimously approve the action.[34] For example, if an LLC for some reason wants to convert to a general partnership, it must receive the unanimous approval of the members since they would have unlimited personal liability as partners in the general partnership. In such situations, an operating agreement may not restrict a member's right to approve such a merger, conversion or domestication.[35]

Rights of Third Parties

An operating agreement may restrict the rights of a member and manager,[36] as well as a dissociated person and transferee,[37] but not the rights of third parties, such as creditors.[38]

Indemnification and Exculpation

NJ-RULLCA provides for an LLC's indemnification of members, managers and others.[39] However, an operating agreement may alter and even eliminate such indemnification.[40] An operating agreement may also eliminate a member or manager's personal liability to the LLC and its members for money damages.[41] However, under no circumstances may an operating agreement permit indemnification or exculpation of a member or manager for certain 'bad acts,' such as breaching the duty of loyalty,[42] receiving an improper personal benefit, making improper distributions,[43] intentionally inflicting harm on the LLC or a member,[44] or intentionally violating criminal law.[45]

Conclusion

Section 11 provides that certain provisions of NJ-RULLCA cannot be altered—the so-called non-waivable provisions. However, as noted, many of the non-waivable provisions may, in fact, be altered as provided in NJ-RULLCA. ■

Gianfranco A. Pietrafesa is a partner of Archer & Greiner, P.C. in its Hackensack office, where he is a member of its business counseling group. He is a director and past chair of the Business Law Section and served on the select committee that drafted NJ-RULLCA.

Endnotes

1. N.J.S.A. 42:2C-1 *et seq.*
2. N.J.S.A. 42:2C-11(C), *as modified by* N.J.S.A. 42:2C-11(D) Through 42:2C-11(G).

3. N.J.S.A. 42:2C-11(I).
4. N.J.S.A. 42:2C-5.
5. N.J.S.A. 42:2C-11(C)(1).
6. ULC 2015 Comment to Section 105(C)(2). NJ-RULLCA is Based on the ULC's July 20, 2011 Version of RULLCA. *See* http://www.Uniformlaws.Org/Shared/Docs/Limited%20liability%20company/Ullca_Final_06rev.Pdf. Since then, the ULC Has Revised RULLCA and its Comments. The current version of RULLCA is dated Aug. 19, 2015. *See* Http://Www.Uniformlaws.Org/Shared/Docs/Limited%20liability%20company/ULLCA_Final_2014_2015aug19.Pdf. N.J.S.A. 42:2C-11 is based on Section 110 of the 2011 version, which was revised and renumbered as Section 105 in the 2015 version. A table with cross-references of N.J.S.A. 42:2C-11, 2011 RULLCA Section 110 and 2015 RULLCA Section 105 accompanies this article.
7. N.J.S.A. 42:2C-6.
8. N.J.S.A. 42:2C-11(C)(2).
9. ULC 2015 Comment to Section 104(1).
10. N.J.S.A. 42:2C-21.
11. N.J.S.A. 42:2C-11(C)(3).
12. N.J.S.A. 42:2C-39(A) & -39(I)(1). *See* N.J.S.A. 42:2C-39(B) (Duty of Loyalty) and N.J.S.A. 42:2C-39(C) (Duty of Care).
13. N.J.S.A. 42:2C-11(C)(4).
14. NJ-RULLCA addresses how a court is to determine whether a term in an operating agreement is manifestly unreasonable, but there is no case law explaining the term or its application. *See* Gianfranco A. Pietrafesa, The Manifestly Unreasonable Standard Under NJ-RULLCA, *NJSBA Business Law Section Newsletter*, Vol. 38, No. 1 (July 2014).
15. N.J.S.A. 42:2C-11(D)(1). In addition to eliminating or altering the duty of loyalty, an operating agreement may identify the specific types or categories of activities that do not violate the duty of loyalty. N.J.S.A. 42:2C-11(D)(2). For example, in a real estate holding company, the operating agreement will often provide that the ownership of other real estate by the members does not violate the aspect of the duty of loyalty prohibiting a member from competing with the LLC. *See* N.J.S.A. 42:2C-39(B)(3). *See Also* Gianfranco A. Pietrafesa, The Duty Of Loyalty Under The New Jersey Revised Uniform Limited Liability Company Act, 290 *N.J. Lawyer Mag.* 12 (Oct. 2014).
16. N.J.S.A. 42:2C-11(D)(3). Although an operating may alter the duty of care, it cannot authorize intentional misconduct or knowing violations of law, which is not surprising. *Id*.
17. N.J.S.A. 42:2C-11(D)(4). It is not clear whether there are any other fiduciary duties, but a court may conclude that a member or manager has the duty to maintain the confidentiality of the LLC's confidential information and the duty to make certain disclosures to the LLC, its managers and members.
18. N.J.S.A. 42:2C-39(D).
19. Every contract in New Jersey includes an implied covenant of good faith and fair dealing, which is identical to the contractual obligation of good faith and fair dealing; therefore, it makes sense that the contractual obligation of good faith and fair dealing cannot be eliminated. Note that the obligation includes the exercise of rights and the discharge of duties under NJ-RULLCA (in addition to those under the operating agreement), which makes sense since the statute serves as the default operating agreement in the absence of an operating agreement. *See* N.J.S.A. 42:2C-11(B) ("To The Extent That The Operating Agreement Does Not Otherwise Provide For A Matter Described In Subsection A. Of This Section, This Act Governs The Matter").
20. N.J.S.A. 42:2C-11(D)(5). There is no case law explaining the concept of prescribing standards to measure performance of the contractual covenant of good faith and fair dealing. *See* Gianfranco A. Pietrafesa, Standards To Measure Good Faith And Fair Dealing Under NJ-RULLCA, 216 *N.J.L.J.* 362 (May 5, 2014). *See* ULC 2015 Comment to RULLCA §105(C)(6) for examples of contract provisions purporting to create standards to measure performance of the contractual covenant of good faith and fair dealing.
21. N.J.S.A. 42:2C-40.
22. N.J.S.A. 42:2C-11(C)(6).
23. N.J.S.A. 42:2C-40(G).

24. ULC 2015 Comment to RULLCA 105(C)(8).
25. N.J.S.A. 42:2C-48(A)(4) & (5). These statutory grounds include, but are not limited to, it being not reasonably practicable to carry on the LLC's business in conformity with the operating agreement, N.J.S.A. 42:2C-48(A)(4)(B), and oppression of one or more members by the managers or controlling members, N.J.S.A. 42:2C-48(A)(5)(B).
26. N.J.S.A. 42:2C-11(C)(7).
27. ULC 2015 Comment to RULLCA 701(B) ("…[N.J.S.A. 42:2C-48(B)] Can Be Overridden By The Operating Agreement. Thus, The Members May Agree To Restrict Or Eliminate A Court's Power To Craft A Lesser Remedy, Even To The Extent Of Confining The Court (And Themselves) To The All-Or-Nothing Remedy Of Dissolution.").
28. N.J.S.A. 42:2C-49(A) & -49(B)(1).
29. N.J.S.A. 42:2C 11(C)(8).
30. N.J.S.A. 42:2C-67 through -72.
31. N.J.S.A. 42:2C-11(C)(9).
32. *See* ULC 2015 Comments to Section 105(C)(11).
33. N.J.S.A. 42:2C-75(A), -79(A) & -83(A)(1).
34. N.J.S.A. 42:2C-86(A).
35. N.J.S.A. 42:2C-11(C)(10). An operating agreement cannot sidestep such a unanimous vote requirement through a provision allowing an amendment of the agreement with less than the unanimous consent of the members. *See* N.J.S.A. 42:2C-86(B).
36. N.J.S.A. 42:2C-11(C)(11).
37. *Id.*; N.J.S.A. 42:2C-13(B). For example, an operating agreement may restrict a transferee of a transferable interest from becoming a member unless the transferee satisfies certain conditions, such as agreeing to be bound to the terms of the operating agreement.
38. N.J.S.A. 42:2C-11(C)(11). As noted, an operating agreement may limit the power of a court to dissolution of an LLC as opposed to the grant of lesser remedies for oppression. *See Supra* N.27.
39. N.J.S.A. 42:2C-38.
40. N.J.S.A. 42:2C-11(G).
41. *Id.*
42 However, As Noted, An Operating Agreement May Eliminate The Duty Of Loyalty. *Supra* N.15.
43 *See* N.J.S.A. 42:2C-36.
44 This prohibition against indemnifying or exculpating a member or manager for intentionally inflicting harm on a member includes oppressive conduct.
45 N.J.S.A. 42:2C-11(G).

Table of Applicable Provisions under
NJ-RULLCA v. 2011 RULLCA and 2015 RULLCA

NJ-RULLCA	RULLCA (7-20-11)	RULLCA (8-19-15)
	NJ law based on this version	*Current version*
42:2C-11(c)(1)	110(c)(1)	105(c)(2)
42:2C-11(c)(2)	110(c)(2)	105(c)(1)
42:2C-11(c)(3)	110(c)(3)	105(c)(4)
42:2C-11(c)(4)	110(c)(4)	105(c)(5)
42:2C-11(c)(5)	110(c)(5)	105(c)(6)
42:2C-11(c)(6)	110(c)(6)	105(c)(8)
42:2C-11(c)(7)	110(c)(7)	105(c)(9)
42:2C-11(c)(8)	110(c)(8)	105(c)(10)
42:2C-11(c)(9)	110(c)(9)	105(c)(11)
42:2C-11(c)(10)	110(c)(10)	105(c)(13)
42:2C-11(c)(11)	110(c)(11)	105(c)(15)
42:2C-11(g)	110(g)	105(c)(7)

The Manifestly Unreasonable Standard under NJ-RULLCA

by Gianfranco A. Pietrafesa

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]

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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.

Gianfranco A. Pietrafesa is a partner in the law firm of Archer & Greiner. He is a former chair of the NJSBA Business Law Section and a member of the committee that drafted NJ-RULLCA.

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.

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Death and the NJ LLC

by Gianfranco A. Pietrafesa

What happens when a member of a limited liability company (LLC) dies? The New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA)[1] provides that death is an event causing a member to become dissociated from the LLC.[2] An event of dissociation has certain statutory consequences, which, as set forth below, may be changed in an operating agreement.

For clarity, this article focuses on the estate of a deceased member, but the consequences described in this article also apply to the heirs of a deceased member inheriting the deceased member's interest in the LLC.

Equity Interest

The deceased member's equity interest is converted into an economic interest, known as a transferable interest[3] under NJ-RULLCA, and the deceased member's estate has the status of a transferee, previously known as an assignee under the repealed statute.[4] The estate of a deceased member is not admitted as a member of the LLC, except with the unanimous consent of all surviving members.[5]

Distributions

A member's death does not entitle the estate to a special distribution or buyout of the deceased member's interest in the LLC.[6] Instead, as the owner of a transferable interest, the estate has the right to receive distributions that the deceased member would have received from the LLC, if and when the LLC decides to make such distributions.[7] The estate will also receive allocations of income and pay taxes on such income. When the LLC is dissolved and wound up (which can be many years after the death of a member), the estate is entitled to receive any capital contributions made by, and not previously returned to, the deceased member, and then a liquidating distribution.[8]

Management

As a dissociated member and transferee, the estate of the deceased member has no right to participate in the management of the LLC.[9] As a result, the estate has no right to vote on any matter in or outside the ordinary course of business.[10] Nor does the estate have any fiduciary duties with regard to matters arising and events occurring after the date of death of the deceased member.[11] Therefore, the estate (and any other holder of a transferable interest) may, for example, compete with the business of the LLC.[12]

Obligations

Death does not relieve the estate from making capital contributions to the LLC promised but not made by the deceased member, including contributions of money equal to the value of any services the deceased member was required to contribute to the LLC.[13] Likewise, a member's death does not discharge the estate from any debt, obligation or other liability to the LLC or the other members the deceased member incurred while a member.[14]

Information Rights

As a transferee, the estate has no right to receive information about or from the LLC.[15] However, as a dissociated member the estate has a right to information the member was entitled to receive that pertains to the period of time the deceased member was a member of the LLC; provided, however, that the estate seeks the information in good faith and satisfies the statutory requirements imposed on a member seeking information from a manager-managed LLC.[16] In other words, the estate must seek the information for a purpose material to its transferable interest, the written demand must describe with reasonable particularity the information sought and the purpose for seeking the information, and the information sought must be directly connected to such purpose.[17]

Further, for purposes of settling the estate, it has the information rights of a current member of the LLC.[18] Presumably this entitles the estate to the information necessary to value the deceased member's interest in the LLC. An LLC may, however, impose reasonable restrictions and conditions on providing information to the estate, such as a confidentiality agreement.[19]

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Dissolution

In a multi-member LLC, a member's death does not cause the dissolution of the LLC.[20] When the LLC does eventually dissolve, the transferee holding the transferable interest received from the deceased member is entitled to an accounting by the LLC from the date of dissolution.[21] However, this is a limited information right, essentially limited to information about the allocation of net assets among the LLC's creditors, members and transferees.[22]

In a single-member LLC, the death of the member is an event of dissolution if the LLC does not have a member for 90 consecutive days.[23] However, the LLC is not dissolved if the estate designates a person (or more than one person) to become a member of the LLC and the person consents to be a member of the LLC.[24] Otherwise, the LLC must be dissolved.

Operating Agreement

NJ-RULLCA lists the statutory provisions that cannot be altered or eliminated in an operating agreement.[25] By not addressing the foregoing items on the list, NJ-RULLCA implicitly authorizes all of the foregoing statutory default provisions, and their consequences, to be altered by the members in an LLC operating agreement.[26] Therefore, for example, the operating agreement may provide for a spouse's (or other heir's) automatic admission as a member, or buy-sell provisions requiring or allowing the estate to sell the deceased member's interest to the LLC and/or the surviving members (as opposed to the estate being a mere transferee). In this regard, the members of an LLC have a great deal of flexibility to use the operating agreement to address the consequences of the death of a member to avoid the statutory default provisions. ■

Gianfranco A. Pietrafesa is a partner of Archer & Greiner, P.C. in its Hackensack office, where he is a member of its business counseling group. He is a director and past chair of the Business Law Section and served on the select committee that drafted NJ-RULLCA.

Endnotes

1. N.J.S.A. 42:2C-1 *et seq.*
2. N.J.S.A. 42:2C-46(f)(1).
3. N.J.S.A. 42:2C-2 (definition of transferable interest). Note that NJ-RULLCA does not define the entire bundle of LLC rights (*e.g.*, economic, management and information), commonly called an interest, membership interest or LLC interest.
4. N.J.S.A. 42:2C-47(a)(3). *See* N.J.S.A. 42:2C-2 (definition of transferee).
5. N.J.S.A. 42:2C-31(c)(3). *See also* N.J.S.A. 42:2C-42(c)(3).
6. N.J.S.A. 42:2C-34(b).
7. N.J.S.A. 42:2C-2 (definition of transferable interest); N.J.S.A. 42:2C-34(a) & (b).
8. N.J.S.A. 42:2C-56(b)(1) & (2).
9. N.J.S.A. 42:2C-47(a)(1); N.J.S.A. 42:2C-42(a)(3)(a).
10. *See* N.J.S.A. 42:2C-37(b).
11. N.J.S.A. 42:2C-47(a)(2).
12. *See* N.J.S.A. 42:2C-39(b)(3).
13. N.J.S.A. 42:2C-33(a).
14. N.J.S.A. 42:2C-47(b).
15. N.J.S.A. 42:2C-40(f); N.J.S.A. 42:2C-42(a)(3)(b).
16. N.J.S.A. 42:2C-40(c).
17. *See* N.J.S.A. 42:2C-40(b)(2).
18. N.J.S.A. 42:2C-44.
19. *See* N.J.S.A. 42:2C-40(g).
20. *See* N.J.S.A. 42:2C-48(a).
21. N.J.S.A. 42:2C-44; N.J.S.A. 42:2C-42(c).
22. Uniform Law Commission 2015 Comments to RULLCA Section 502(c).
23. N.J.S.A. 42:2C-48(a)(3).
24. N.J.S.A. 42:2C-31(c)(4).
25. N.J.S.A. 42:2C-11. *See also* Gianfranco A. Pietrafesa, Non-Waivable Provisions Under the New Jersey Revised Uniform Limited Liability Company Act, NJSBA *Business Law Section Newsletter*, Vol. 41, No. 1 (Aug. 2017).
26. *See* N.J.S.A. 42:2C-11(b).

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EVENTS TRIGGERING BUY-SELL OBLIGATIONS

By GIANFRANCO A. PIETRAFESA

The purpose of buy-sell agreement is to ensure that only desired owners own equity in a business entity. Some common events triggering a buy-sell obligation are discussed below. However, the specific events triggering buy-sell obligations to be incorporated into an agreement will depend on several factors, including the type of business. For example, a business comprised of individuals providing services will likely have different buy-sell provisions than a business that is a real estate holding company.

These materials are limited to the different events that can trigger an obligation to buy/sell equity. They do not address such issues as whether to use a redemption by the entity or a cross-purchase by the other owners and how to value the equity for purposes of the buy-sell.

Events triggering buy-sell:

1. Death
2. Disability
3. Termination of Employment
4. Reaching a Certain Age ("Retirement")
5. Bankruptcy or Insolvency
6. Divorce
7. Non-Permitted Transfers / Bona Fide Offers
8. Breach of Agreement
9. Call upon Specified Vote
10. Put Right ("Withdrawal")
11. Deadlock
12. Competition with the Business
13. Loss of Qualification to own Equity
14. Pledge of Equity Interest
15. Tag-Along / Drag-Along

1. Death

Buy-sell obligations can be triggered upon the death of an owner. Reasons:

- The remaining owners do not want to be in business with members of the deceased owner's family.
- It also provides liquidity to the deceased owner's estate. A business entity is unlikely to pay a salary, dividends or other distributions to family members of the deceased owner.

The initial question to be asked is whether the buy-sell should be mandatory or optional. The obligation is typically mandatory, especially where the owners are active in the business. However, the obligation can be optional where they are not. For example, where the business is a real estate holding company with growth opportunities and/or an income stream and managed by non-owners, should the estate be required to sell?

Alternatives:

The family members of the deceased owner may continue to own equity in the business, but:

- the remaining owners have a call right if the family members create problems, and/or
- the estate or family members have a put right to sell the equity to the entity or the remaining owners in the future.

Another alternative:

The deceased owner's equity interest can be converted into a non-voting equity interest, thus providing growth opportunities and/or income to family members.

2. Disability

Buy-sell obligations can be triggered upon the total and permanent disability of an owner who is also an employee. Reasons:

- A disabled owner-employee can no longer perform his/her duties for the business and a buy-sell eliminates such a non-contributing owner.
- A disabled owner-employee will no longer receive a salary and the buy-sell provides the disabled owner with cash.

The same initial question asked about the buy-sell upon death also needs to be answered in connection with a buy-sell upon disability. The additional questions are 1) whether there is a disability, 2) whether it is a total (as opposed to partial) disability and 3) whether it is a permanent (as opposed to temporary) disability.

Defining the triggering event of "total and permanent disability:"

- Disability buy-sell insurance policy – use the same definition as in the policy to ensure that there will be proceeds to buy the equity.
- Disability income policy – receipt of (or eligibility to receive) payment under the policy triggers the buy-sell.

If there is no insurance policy, then disability can be determined as follows:

- The opinion of a physician (or group of physicians) selected by the parties and based upon an examination of the disabled owner or medical information provided to the physician, or
- The decision of a majority (or supermajority) of the owners, in their sole discretion, based upon all of the relevant information available to them, or
- A period of time, such as six months of continuous total disability or disability for 180 (non-continuous) out of 365 days.

3. Termination of Employment

Buy-sell obligations can be triggered upon the termination on employment of an owner who is also an employee. Reasons:

- It encourages an owner-employee to increase the value of the business during his/her employment with the comfort of knowing that he/she will be paid for his/her equity upon termination of employment.
- Upon termination of employment, the owner who is no longer an employee will desire dividends or other distributions, but the owners who are still employees may not be able or willing to make such payments to non-employee owners. The buy-sell provides the terminated owner-employee with cash.

An obligation to purchase the equity of an owner-employee whose employment is terminated may cause a financial hardship on the entity and/or the remaining owners. To prevent such a hardship:

- the obligation to purchase the equity can be optional rather than mandatory, and/or
- the purchase price can be paid over a period of years instead of a lump sum.

Note:

- Consider an optional buy-sell to avoid situations where an owner-employee terminates his/her employment to force a buyout of his/her equity at the best time for him/her and the worst time for the entity and the other owners.
- Consider different valuations amounts for terminations for cause and without cause (however, the price and other terms must be reasonable).
- Consider a mandatory buy-sell upon termination for cause. For example, if an owner is terminated as an employee due to the commission of a felony or a crime involving dishonesty (e.g., theft), the other owners will likely want to completely sever ties with the owner by purchasing his/her equity.

Alternatives:

A terminated owner-employee may continue to own equity in the business, but:

- the entity or the remaining owners have a call right if the terminated owner-employee creates problems, and/or
- the terminated owner-employee has a put right to sell the equity to the entity or the remaining owners in the future.

4. Reaching a Certain Age ("Retirement")

Buy-sell obligations can be triggered upon an owner reaching a certain age and/or a certain number of "service" years with the business. Reason:

- Transition of ownership to the next generation.
- The retired owner's employment will terminate and a buy-sell will provide cash payments to the retired owner in place of his/her salary.

Alternatives:

A retired owner may continue to own equity in the business, but:

- the entity or the remaining owners have a call right if the retired owner creates problems, and/or
- the retired owner has a put right to sell the equity to the entity or the other owners in the future.

Also:

- Consider requiring non-competition/non-solicitation provisions as a condition of any buy-out.

5. Bankruptcy or Insolvency

Buy-sell obligations can be triggered upon bankruptcy or insolvency of an owner. Reason:

- The entity and the other owners do not want a bankruptcy trustee, a creditor or some other third party as an owner.

Note:

- An owner should be obligated to sell and the business entity or the remaining owners obligated to purchase the equity of a bankrupt or insolvent owner. This mandatory obligation will make it more likely that the buy-sell agreement will not be voided in the bankruptcy as an "executory" agreement.
- In such an event, the parties can provide for a lower purchase price and/or a purchase price paid out over a longer period of time. However, such a provision must have an objective rationale in order to be binding upon a bankruptcy trustee. For example, a longer payout (e.g., 10 years vs. 3-5 years) can be used in all triggering events except where the business entity or the remaining owners are in control of the trigger and can "plan ahead" for the purchase obligation.

6. Divorce

A buy-sell agreement can be triggered on the divorce of an owner. Reasons:

- The owners do not want any equity owned by a former spouse of an owner. Therefore, owners will want to prevent a transfer of an ownership interest to a former spouse.

Courts do not consider a general restriction on lifetime transfers to cover an award of equity in a divorce. Therefore, the buy-sell needs to specifically include divorce as a triggering event.

Note:

- The triggering event of divorce should provide for an optional, not a mandatory, purchase.
    - A mandatory purchase may compel a court to view an unmarketable ownership interest as marketable and/or increase the liquidity and therefore the value of the equity.
    - A mandatory purchase may cause harm to the entity and the remaining owners if they unexpectedly are required to purchase the divorced owner's equity.
- When divorce is a trigger, typically the buy-sell provides the divorcing owner with the first right to purchase the equity.

7. Non-Permitted Transfers / Bona Fide Offers

Buy-sell obligations can be triggered upon an owner's transfer or attempted transfer of equity in violation of the parties' agreement, or upon an owner advising the entity and the other owners of a desire to sell his/her equity to a third party making a bona fide offer.

8. Breach of Agreement

Buy-sell obligations can be triggered by an owner's breach of the parties' agreement other than a non-permitted transfer of equity. Typically, this is an optional, not a mandatory, purchase of the breaching owner's equity.

Note:

- The agreement can provide for notice to the breaching owner and the opportunity to cure the breach.
- The buy-sell trigger can be based on a final adjudication of whether there is a breach or on a determination by the other owners in their sole discretion.

9. Call upon Specified Vote

Buy-sell obligations can be triggered upon the majority (or supermajority) vote of the owners. In other words, an owner can be forced to sell his/her equity by the requisite vote of the other owners. This type of provision allows the owners to remove an unwanted owner under any circumstances.

10. Put Right (Withdrawal)

Buy-sell obligations can be triggered by an owner exercising a put right, which requires the entity or the remaining owners to purchase the withdrawing owner's equity. Reasons:

- An owner may need to sell his/her equity for a variety of reasons, such as he/she wants to pursue other business interests, no longer gets along with the other owners, needs cash, has suffered an unexpected life crisis (e.g., spouse is ill), etc.

The put right can be mandatory or optional. If optional, it gives the entity and the other owners a right of first refusal. If they do not purchase the equity, then the withdrawing owner can sell his/her equity to a third party.

11. Deadlock
Buy-sell obligations can be triggered by a deadlock between the owners. One way to resolve a deadlock is to require an owner to make an offer at a specified price and allow the other owner to decide whether to sell his/her equity or buy the equity of the other owner.

12. Competition with the Business
Buy-sell obligations can be triggered by an owner competing with the business (regardless of whether he/she is also an employee). Typically, this is an optional, not a mandatory, purchase of the equity of the competing owner.

Note: The entity and the other owners may not want to fund the competing owner's other business venture with a lump sum payment. Therefore, the buy-sell may provide for payments over time, including requiring the first payment one year after the effective date of the buy-out.

13. Loss of Qualification to Own Equity
Buy-sell obligations can be triggered when an owner is no longer qualified to be an owner. For example, an owner may lose his/her license to practice law and, therefore, as a matter of law will not be permitted to own equity in a law firm.

14. Pledge of Equity Interest
If the parties' agreement does not prohibit an owner from pledging his/her equity as collateral for a personal loan, then a buy-sell obligation can be triggered when a lender threatens to foreclose on the equity interest.

Note:
A lender may argue that a general restriction on transfers does not prohibit an involuntary transfer of equity upon foreclosure. Therefore, the language must specifically state that a transfer incident to foreclosure is subject to the buy-out provision.

15. Tag-Along / Drag-Along
A buy-sell obligation can be triggered where a majority owner sells his/her equity to a third party. In such a case, a minority owner will also sell his/her equity to the third party. This provision can be mandatory ("drag-along") or optional ("tag-along").

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VALUATION METHODS FOR DETERMINING PURCHASE PRICE UNDER BUY-SELL AGREEMENTS

By Gianfranco A. Pietrafesa*

1. INTRODUCTION

This paper addresses the three types of valuation methods used to determine the purchase price under a buy-sell agreement. They are: (a) agreed value; (b) appraisal; and (c) valuation formula.[1]

A. AGREED VALUE

Under the agreed value method, the shareholders, in conjunction with the corporation's accountant, set a price per share when they enter into the buy-sell agreement. Thereafter, on a periodic basis, typically once per year, the shareholders agree on a new price per share, and attach a signed certificate of value to the buy-sell agreement. The rationale in using this method is that there is no one in a better position than the shareholders and the corporation's accountant to determine the value of the corporation and the price per share.

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* Gianfranco A. Pietrafesa is a partner in the law firm of Archer & Greiner, P.C., in Hackensack, N.J., where he advises clients on business transactions and related litigation. He is a past chairman of the Business Law Section of the New Jersey Bar Association and a trustee and the vice president of the Hudson-Bergen Inn of Transactional Counsel.

This paper reflects the views of the author, Gianfranco A. Pietrafesa, and not necessarily the views of Archer & Greiner, P.C. or its other attorneys. This paper is for educational and informational purposes only. It is not intended, and should not be construed, as legal advice, and may not be used or relied upon as a substitute for legal advice regarding a specific legal matter.

[1] This paper uses a corporation and its shareholders for illustrative purposes. However, the comments also apply to other forms of business entities, such as limited liability companies and partnerships, and their owners. Also, although the term "buy-sell agreement" is used, a buy-sell obligation can be included in various documents, such as corporate bylaws, a stockholders agreement, an LLC operating agreement and a partnership agreement.

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One drawback is that often the shareholders do not update the certificate of value. Therefore, the agreement should include a mechanism to determine the value/purchase price of the shares when there is an event triggering the buy-sell obligation in the absence of a current certificate of value. Among other mechanisms, the agreement can provide for (a) an adjustment of the price per share based upon an increase or decrease in the corporation's book value since the last certificate or (b) an appraisal.

B. APPRAISAL

The second type of valuation method is an appraisal or valuation, typically by an independent certified public accountant with experience in business valuations. The buy-sell agreement may specify the person or entity to do the appraisal or provide a method for the selection of an appraiser. The buy-sell agreement can also specify the method of valuation and/or any adjustments to be made to earnings or assets (discussed below under valuation formulas).

With regard to the selection of an appraiser, the buy-sell agreement can provide that:

i. The parties mutually agree on an appraiser
ii. If they cannot agree, then each party selects an appraiser
    - Sometimes, the two appraisers select a third appraiser and
        i. All three appraisers prepare appraisals, or
        ii. Only the third appraiser prepares an appraisal
iii. The two appraisers prepare appraisals and, if the two appraisals are within a certain value, such as 5%-10%, then the two appraisals are averaged
iv. If the two appraisals are more than 5%-10% apart, then the two appraisers select a third appraiser and
    a. the third appraiser can select from the two existing appraisals, or
    b. the third appraiser prepares an appraisal and
        i. three appraisals are averaged, or
        ii. the two closest appraisals are averaged, or
        iii. the middle appraisal is the binding valuation, or
        iv. the third appraiser's appraisal is binding,

Some of the more common valuation methods used by appraisers to determine the value of a corporation are described below.

C. VALUATION FORMULA

The third type of valuation method is the use of a formula specified in the buy-sell agreement. There are numerous formulas that can used to determine the value of a corporation. This paper summarizes some of the more common formulas. An attorney should select the valuation formula only after consultation with the shareholders and the corporation's accountant.

i. BOOK VALUE

An easy way to determine the value of a corporation is to simply use its book value as reflected on the corporation's financial statements. Book value is also known as net worth—the difference between the corporation's assets and liabilities. The problem with using book value is that the valuation does not reflect (a) assets, liabilities, income and expenses that are not disclosed on the financial statements or (b) the fair market value of the corporation's assets on the financial statements. Book value reflects the original cost of the assets less depreciation. For example, a corporation may have purchased a building for $1,000,000, and taken depreciation of $600,000, resulting in the building showing a value of $400,000 on the corporation's balance sheet. However, the current fair market value of the building may be $5,000,000. Therefore, the use of book value may result in a valuation that does not reflect the real value of the corporation.

ii. ADJUSTED BOOK VALUE

Due to the aforementioned problem of simply using book value, another valuation method is to use adjusted book value. Under this method, adjustments (increases and decreases) are made to the book value of specific assets and other items. For example, in the example above, for valuation purposes, the book value of the building would be adjusted from its book value of $400,000 to its fair market value of $5,000,000. Other items that may be adjusted or considered include the following:

i. Machinery and equipment, which are reflected on the balance sheet at their original cost and not fair market value
ii. Inventory, which is usually reflected on the balance sheet at its original cost and not fair market value
iii. Assets not on the balance sheet, such as:
    1. Goodwill / going concern
    2. Work in progress
    3. Know-how
    4. Trade name or brand name
    5. Patents, trademarks and other IP
    6. Operating leases (e.g., real estate and equipment leases)
    7. Customer list
iv. Contingent liabilities that are not on the balance sheet, such as
    1. Operating leases (e.g., real estate and equipment leases)
    2. Deferred revenue (e.g., customer deposits)
    3. Litigation
v. Insurance proceeds
vi. Loss of a shareholder's services to the corporation
vii. Accounts receivable, which may need adjustment due to the age of receivables

The buy-sell agreement must specify the items to be adjusted or considered when determining the adjusted book value of the corporation.

iii. CAPITALIZATION (OR MULTIPLE) OF EARNINGS

Another way to determine the value of a corporation is the capitalization of earnings over a period of several years. This is sometimes called the multiple of earnings method.

Earnings are also known as profits, net earnings and net profits. However, these terms are not universally defined. That is, they mean different things to different people. For example, profits can mean profits before taxes to one shareholder and profits after taxes to another. Therefore, the buy-sell agreement must define the term.

a. Earnings Per Share. The corporation's earnings divided by the number of issued and outstanding shares results in the corporation's earnings per share ("EPS"). For example, assuming $10,000 in earnings and 100 shares, the EPS is $100. When determining the value of a corporation under the capitalization (or multiple) of earnings method, the EPS can be weighted by giving more weight to recent years. The average EPS is then applied to the capitalization rate to determine the value of the corporation. For example, the earnings of the corporation over the last five years may be as follows:

Year	Price per Share		Weight		Weighted Price per Share
2023	$100 per share	x	5	=	$500
2022	$95 per share	x	4	=	$380
2021	$70 per share	x	3	=	$210
2020	$65 per share	x	2	=	$130
2019	$40 per share	x	1	=	$ 40
	$370		15		$1,260

The average EPS is $74 ($370/5). However, the weighted average EPS is $84 ($1,260/15).

As shown in the next example, although the dollar amounts are exactly the same as above, the years in which they have been earned are different, resulting in a different weighed average EPS:

Year	Price per Share		Weight		Weighted Price per Share
2023	$70 per share	x	5	=	$350
2022	$65 per share	x	4	=	$260
2021	$100 per share	x	3	=	$300
2020	$40 per share	x	2	=	$ 80
2019	$95 per share	x	1	=	$ 95
	$370		15		$1,085

Again, the average EPS is $74 ($370/5). However, the weighted average EPS is $72.33 ($1,085/15), as compared to $84 in the prior example.[2]

b. Capitalization Rate. Next, a capitalization rate must be selected. The buy-sell agreement must specify the rate or how it is to be determined. The capitalization rate is a fair rate of return. For our purposes, assume that the capitalization rate is five percent (5%). This means that the shareholders have agreed that they should be entitled to a rate of return of five percent (5%) on their investment in the corporation. Therefore, using the weighted average EPS in the first example, the price per share is $1,680 ($84/.05).

As noted above, this method is also known as the multiple of earnings method, where a multiple is applied against the earnings to determine a purchase price per share. In the example above, the multiple is twenty (20). Therefore, average earnings of $84 per share times a multiple of 20 equals a purchase price per share of $1,680 ($84 x 20).

c. Adjustments to Earnings. Often, the corporation's earnings must be adjusted in connection with determining the true value of a corporation. For example, the shareholders may receive generous salaries and fringe benefits, which are often added back to the corporation's earnings. Likewise, other adjustments may be needed to accurately reflect the fair market value of the corporation. For example, the accounting method used for inventory may cause lower profits and, consequently, a valuation may not reflect fair market value. Therefore, an adjustment to earnings may be needed to take into account the accounting method used for inventory.

Sometimes, the valuation is as straightforward as using a multiple of some amount; for example, two times (2X) the average of the last three fiscal years of gross revenues or earnings or EBIT or EBITDA.

2. "FAIR MARKET VALUE" VS. "FAIR VALUE"

There is a difference between "fair market value" and "fair value." Fair value is the value of a shareholder's pro rata portion of the entire corporation. Generally, minority discounts are not taken into account when determining fair value. Fair market value is the value of the shareholder's percentage interest in the corporation, which takes into account minority discounts and discounts for lack of marketability of the shares. See Robert D. Frawley, "Valuation Issues in Shareholder and Operating Agreements—The Benefits of Using a Formula," N.J. Lawyer Magazine, 18, 20 (June 2006).

Therefore, assuming that a corporation is worth $1,000,000, the fair value of a shareholder's 25% interest in the corporation is $250,000. However, the fair market value of the shareholder's 25% interest can be significantly less than $250,000 after

[2] These examples have been derived from Howard M. Zaritsky, Structuring Buy-Sell Agreements—Analysis with Forms, §9.03[3][a][ii].

taking into account discounts for lack of control (i.e., minority discount) and lack of marketability of the shares.

When determining the value of a corporation and the purchase price under a buy-sell agreement, the valuation is usually based on the fair market value of the shareholder's shares. However, the shareholders can specify in their agreement whether or not discounts will be applied in determining value, which will result in the terminology of fair market value versus fair value to be immaterial.

3. VALUATION DATE

Some thought should be given to the date of the valuation. Should it be the date of the triggering event? Should it be the end of the last fiscal year or last fiscal quarter?

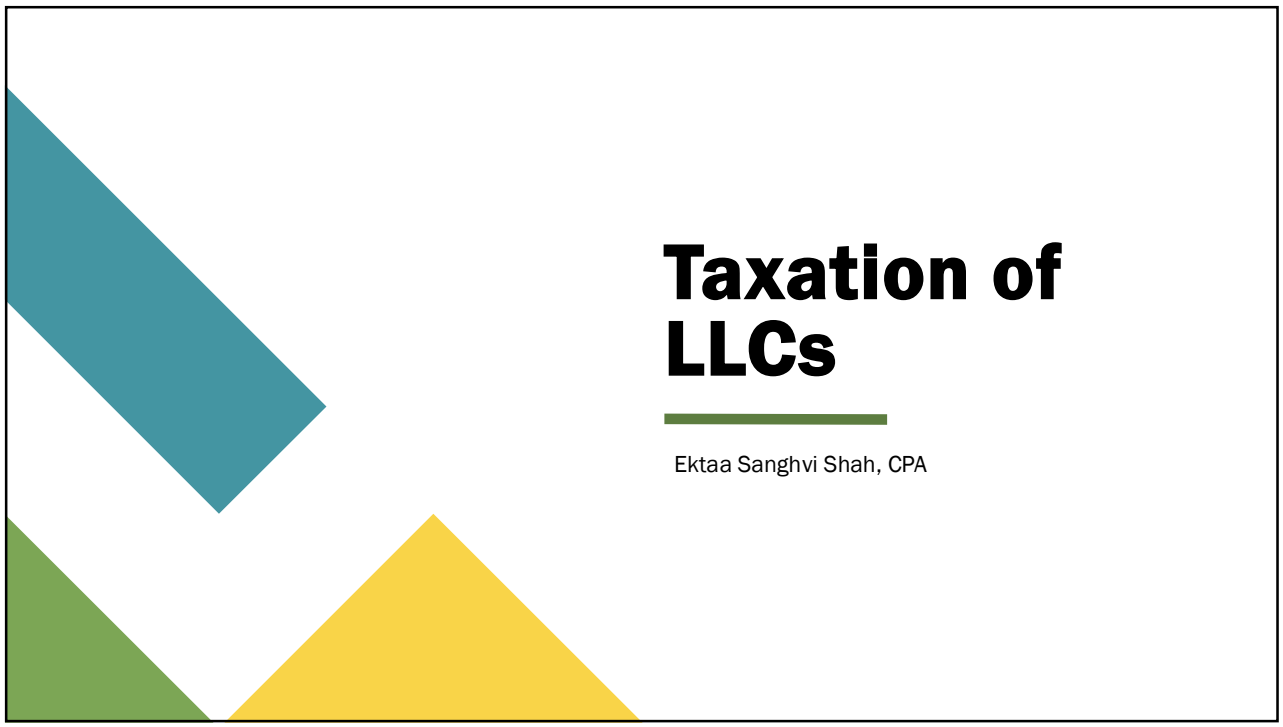
Generally, if the valuation date is a date when the corporation will normally prepare financial statements (e.g., end of a fiscal quarter or fiscal year), the corporation will avoid the additional cost of preparing financial statements as of the date of the triggering event. However, a party may give up an increase in the corporation's value by using a date other than a triggering date. For example, the corporation may have had a great year from January through the triggering event in November, but the buy-sell agreement requires the use of the last day of the last fiscal year as the valuation date (e.g, December 31 of the last fiscal year), when the corporation had a lower value.

The converse is true as well. The corporation may have had a terrible year from January through the triggering event in November, but the buy-sell agreement requires the use of the last day of the last fiscal year as the valuation date, when the corporation had a higher value.

Also, the buy-sell agreement can provide different valuation dates for different triggering events. For example, if the triggering event is death or disability, then the date of the event can be the valuation date. For other triggering events, the last day of the last fiscal year can be the valuation date.

4. DIFFERENT VALUATIONS FOR DIFFERENT TRIGGERING EVENTS

Finally, the buy-sell agreement can provide for different valuation methods depending on the triggering event. For example, adjusted book value can be used for the triggering events of death or disability, whereas unadjusted book value can be used for triggering events such as termination of employment with cause of a shareholder-employee. Likewise, 100% of the valuation can be used for the triggering events of death or disability, whereas 50% of the valuation can be used for triggering events such as termination of employment with cause of a shareholder-employee. It is important to make certain that the valuation method used is applicable to all triggering events or, if the valuation methods differ as to specific triggering events, that a valuation method be clearly assigned to the specific triggering event.



1

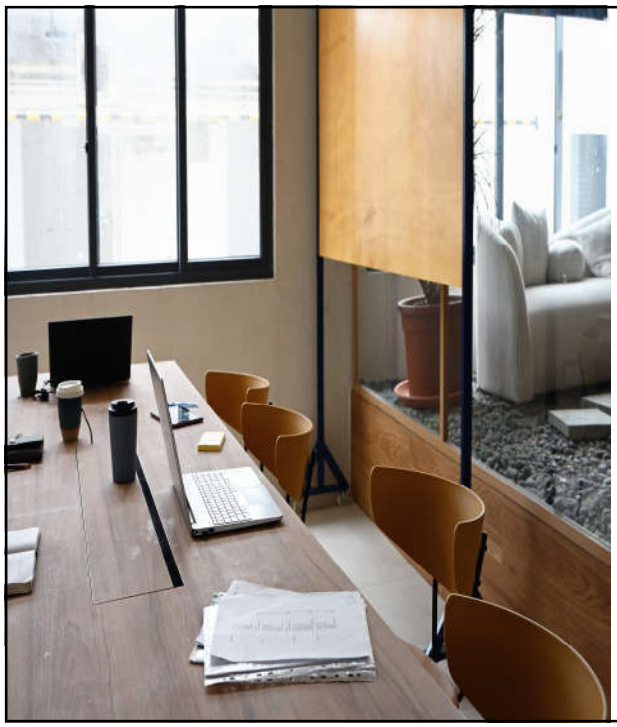
Agenda

- Introduction
- High level comparison
- Deeper dive:
  - S Corp
  - C Corp
  - SMLLC
  - Partnership
- Pass-through Entity Taxes
- LLCs & TCJA
- Questions

About Me

- CPA, MsT
- Family-owned CPA practice
- Based in Kendall Park, NJ
- Tax-focused practice helping small to medium sized businesses & individuals with tax compliance and planning needs





Default Tax Classification & Available Elections

What's the best option?

Tax Classification

- Default tax classification of a multi-member LLC is a **partnership**
- LLC can elect to be taxed as:
  - S Corporation – assuming requirements are met
  - C Corporation
- Election requires Form 8832 to be filed with IRS for S & C Corp
- Form 2553 is required for S Corp
  - Similar form may need to be filed at the state level as well (ex. NJ)

Major Differences in Taxation

SMLLC	Partnership
• Default classification for LLC with one member • Files Schedule C with Form 1040 • Owner pays Income & self-employment taxes on net income of business	• Entity files Form 1065 • Partners receive Schedule K-1 • Active partners take guaranteed payments • Active partners pay income tax & self-employment taxes on ordinary income & guaranteed payments

Major Differences in Taxation (cont'd)

S-Corp	C-Corp
• Entity Files Form 1120-S • Owner-employees (active) generally draw a salary & receive Form W-2 • Shareholder receives Schedule K-1 • Shareholder pays only income tax on ordinary income per K-1	• Entity Files Form 1120 • Owner-employees (active) generally draw a salary & receive Form W-2 • Shareholders receive dividends & pays income tax on dividends

S Corp vs. Partnership: An Example

- **Assumptions:**
  - LLC is member is actively involved in the business & all income is FICA taxable
  - There are no expenses (it's a simple example!)
  - In the S Corp, $200,000 is considered a reasonable compensation
  - The taxpayer files MFJ
  - The taxpayer is a NJ resident & has only NJ sourced income

Example, cont'd

	2024	
	S Corp	LLC
INCOME		
S Corporation net income	84,700	
S Corporation wages	200,000	
Self-employment income		300,000
Self-employment tax deduction		14,470
Adjusted Gross Income	$284,700	$285,530
DEDUCTIONS		
Standard / Itemized deductions	29,200	29,200
Taxable Income	$255,500	$256,330
INCOME TAX		
Tax after credits	47,405	47,604
Self-employment tax		28,940
Other taxes		243
Federal income tax	47,405	76,787
State income tax	7,595	14,940
Total Income Taxes	$55,000	$91,727
PAYROLL TAXES		
FICA tax paid by the S Corp	12,883	
S Corp employee FICA W/H	12,883	
Total Taxes and Expenses	**$80,766**	**$91,727**


Pass Through
Entity Tax

SALT Cap Workaround = PTET

- TCJA caps the SALT deduction at $10,000
- IRS Notice 2020-75
- Allows pass through entities (partnerships, S Corps) to pay & deduct tax at the entity level for Federal purposes and credits the tax the owner on their personal level
- Calculation is based on net income taxed at various rates as proscribed by the state
- 36 states & NYC have enacted PTE taxes
- Most effective for taxpayers in highest tax bracket

The Tax Cuts & Jobs Act

LLC taxation & TCJA sunset



Now What?

- Many provisions of TCJA are set to sunset by 2026
  - Sec 199A - Qualified Business Income Deductions (QBID) – 20% deduction on pass-through income (subject to limitations)
  - C-Corp 21% rate **DOES NOT** expire
  - Highest marginal tax rate reverts to 39.6% from 37%
  - SALT Cap – where does that leave PTET regimes?
  - Estate exclusion to revert to $7M from nearly $13M

Thank you!

Ektaa Sanghvi Shah, CPA
CPA4TAX, LLC
ektaa.shah@cpa4tax.com
www.cpa4tax.com

Allocation and Distribution Provisions in LLC Operating Agreements

Alan F. Kornstein, Esq.
McCarter & English, LLP
akornstein@mccarter.com

Introduction

- Objectives
  - Obtain a practical understanding of LLC allocation and distribution provisions
  - Emphasis on drafting considerations (including “targeted allocations”)
- Relevant for any unincorporated business entity with ≥2 members classified as a partnership for income tax purposes
  - Including LLC, limited partnership, general partnership, LLP and common law joint venture
  - Assume no “check-the-box” election to be classified as a corporation
  - Distinguish LLC with one member classified as “disregarded entity”
- Certain terms used interchangeably for convenience
  - LLC = partnership = joint venture
  - Member = partner

Pervasive Themes and Common Misconceptions

- Allocations *vs.* distributions
- Liquidating distributions *vs.* nonliquidating distributions
- Distributions of operating cash flow *vs.* distributions of capital transaction proceeds (whether before or after liquidation)
- Distributions *vs.* payments
- Book allocations *vs.* tax allocations
- Capital account *vs.* basis (i.e., partner's "**outside basis**")
- Preferred return on capital *vs*. preferential distribution of capital
- Permanent preference *vs*. timing preference
- Communication problems presented by lack of standard vocabulary

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LLC Allocation Provisions: Viewed in Context of Non-Tax Provisions

- Allocations cannot be looked at from a pure tax standpoint
- Must be reviewed in broader context of certain other provisions of the operating agreement (both tax and non-tax)
- Key non-tax provisions relevant to understanding allocations:
  - Capital contributions
    - Initial contributions
    - Additional contributions
    - Remedies for default
  - Cash distributions generally (operations; capital events; liquidation)
  - Cash distributions to fund partner' tax liabilities (commonly called "tax distributions")
  - Effect of loan guarantees
  - Governance provisions

LLC Allocation Provisions: Viewed in Context of Other Tax Provisions

- Allocation provisions also must be reviewed in context of other tax-related provisions of operating agreement:
  - Maintenance of capital accounts
  - Tax elections (including §754 elections)
  - Adoption of accounting methods and taxable year
  - Preparation of tax returns
  - Handling of tax audits, appeals and litigation
  - Designation of "partnership representative" under BBA partnership tax audit rules
  - Member/partner indemnification of LLC for share of BBA "imputed underpayment"
  - Tax withholding mandated by applicable law
  - Tax issues presented by transferability provisions
  - Special rules applicable to partnership redemptions

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LLC Allocation Provisions: Advance Planning

- Can't dive into allocation provisions without understanding business deal
- No such thing as the "tax section" of an operating agreement
  - Tax provisions typically scattered throughout
  - Numerous defined terms
- Allocation provisions must be coordinated with rest of agreement (for both tax and non-tax considerations)
- Resist temptation to view tax-related provisions as pure "boilerplate"
- Drafting approach may depend on client perspective
  - Negotiating leverage
  - Tax sensitivity
  - Budget
- Beware of conflicts of interest

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LLC Allocation Provisions: The Critical Role of Liquidating Distributions

- *Capital account-based drafting approach*:
  - Liquidating distributions based on positive capital account balances
    - Economics on liquidation driven by P&L allocations (since P&L allocations directly affect capital accounts)
    - Critical for P&L allocations to be correct → otherwise liquidating distributions could be incorrect
    - P&L allocation and capital account provisions typically very detailed
    - In most cases → language attempts to comply with safe harbor in §704(b) regulations
    - Sometimes referred to as §704(b) "safe harbor" drafting approach
- *Distribution-based drafting approach*:
  - Liquidating distributions based on cash waterfall
    - P&L allocations generally have no effect on economics (since liquidation *not* based on capital accounts)
    - Different drafting strategies for allocating P&L (including, but not limited to, "targeted allocations")
    - No IRS guidance as to compliance with §704(b) regulations
- "*Start at the back*"

P&L Allocations *vs.* Cash Distributions

- Totally separate concepts that are frequently confused
- To avoid confusion, should be set forth in separate sections of operating agreement (but unfortunately are often lumped together)
- Profits/losses ("**P&L**"):
  - Accounting measure of financial performance at partnership level
  - Tax character determined at partnership level
  - P&L allocated to partner on Schedule K-1 → to be reported on partner's own tax return, *whether or not cash distributions made*
  - Adjustments to each partner's capital account and outside basis
- Distributions:
  - Money or other property *actually transferred* to partner with respect to partner's partnership interest
  - Reduces partner's capital account and outside basis
  - Generally tax-free to extent of outside basis (as adjusted), with excess treated as capital gain
    - But there are significant exceptions

Maintenance of Capital Accounts

- Fundamental capital account equation:
  - Each partner's capital account = capital contributions plus share of profits minus share of losses minus distributions
  - Over life of deal, each partner's capital account should end up at zero
- Contributions or distributions of property taken into account at FMV (not tax basis) for purposes of maintaining capital accounts
- Beware of situations in which book value of partnership assets "booked up" or "booked down" to FMV even in absence of actual sale
  - Adjustments to book value result in "bookup" or "bookdown" of capital accounts even though no change in tax basis
- Purchaser/transferee of membership interest steps into shoes of seller/transferor's capital account (not based on purchase price)

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Brief Detour: Allocation Requirements Under Section 704(b)

- Plain English explanation:
  - P&L cannot be allocated arbitrarily among partners
  - Allocations generally must be consistent with manner in which benefits and burdens of partnership operations are shared among partners
- Technical tax explanation:
  - In effect: P&L allocations respected under Treas. Reg. §1.704-1(b) if one of three tests satisfied
  - All tests based on "book" allocations and "book" capital accounts
- Three regulatory tests:
  - Safe harbor test for allocations having "substantial economic effect" (allocations must have "economic effect" and economic effect must be "substantial")
  - Partner's interest in the partnership test (allocations must be in accordance with partner's "interest in the partnership" based on all facts and circumstances)
  - Certain allocations deemed to be in accordance with partner's interest in the partnership (relevant for sharing of (i) deductions and gain attributable to nonrecourse debt and (ii) tax credits)

How to Handle Non-Liquidating Distributions

- Usually not much difference between capital account-driven agreement and distribution-driven agreement
- Capital accounts generally not relevant to non-liquidating distributions
  - Very common for pre-liquidation distribution tiers in waterfall to be based on "unrecovered capital contributions" (but usually not capital accounts)
  - Some agreements prohibit distribution to extent recipient's capital account would go negative
- Timing and amount of non-liquidating distributions
  - Often varies for operating cash flow *vs.* capital transaction proceeds
  - Beware of sloppy drafting → particularly as to freeing-up of previously-established reserves
- Preferences and priorities
  - Very tedious to get it right
  - Defined terms critical
  - Clients often don't focus on the details (and use shorthand terminology)

How to Handle Non-Liquidating Distributions [cont'd]

- Distributions of assets in kind
- Effect of tax withholding and payments
- Tax distributions
  - Crediting against future regular distributions? Clawback?
  - What if there are tax losses in some years?
  - Preferable to avoid looking at any member's actual tax attributes
- Impact of prior capital call default
- Tax consequences of distributions (whether cash or other property)
  - Usually not addressed in the agreement
- Distinguish "payments" to partners
  - Guaranteed payments under §707(c)
  - Payments to partner acting in non-partner capacity under §707(a)

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Capital Account-Driven Agreements: Overall Drafting Approach

- Liquidating distributions *contractually required* to be made in accordance with positive capital account balances
  - P&L allocations serve an *economic* function as well as a *tax* function (because partner's capital account is adjusted upward or downward by P&L)
  - "*Cash follows tax*" (not vice versa)
- Need for absolute precision in drafting P&L allocations and related adjustments to capital accounts (including bookups and bookdowns)
  - Any mistake affects manner in which distributions made upon liquidation
  - Potentially greater burden on tax attorney → since allocation provisions must anticipate every possible permutation in life cycle of deal
- No requirement for non-liquidating distributions to follow capital accounts
- Due diligence issues for purchaser of partnership interest

Capital Account-Driven Agreements: When to Use

- Typically (although not exclusively) used in those deals in which there are tax reasons for complying with safe harbor in §704(b) regulations
  - Highly tax-sensitive investors generally
  - Tax-exempt entities wishing to avoid UBTI for leveraged real estate investments by complying with §514(c)(9)(E) fractions rule
- Some deals in which it may be easier to keep track of each partner's economic entitlement based on capital accounts rather than cash distribution waterfalls (irrespective of desire for §704(b) safe harbor)
  - Any partnership in which P&L allocations may vary from year to year and profits are reinvested in the business (typically, professional partnerships)
  - Certain types of profits interests
  - Partnerships in which unrealized gains and losses are marked to market
- No clearly articulated reason → just inertia due to many years of practice

Distribution-Driven Agreements: Overall Drafting Approach

- Distribution-driven agreement provides for liquidating distributions based on cash distribution waterfall
- Although capital accounts not relevant in determining amounts distributed to partners, they are relevant in determining P&L allocated to partners
- Liquidating provisions typically cross-reference regular distribution provisions elsewhere in agreement
  - May be necessary in some deals to draw a distinction between operating cash flow and capital transaction proceeds (necessitating tracing)
- Since positive capital account balances not determinative of liquidating or non-liquidating distributions, P&L allocations serve no *economic* function
  - Except for those agreements which provide for "tax distributions" dependent on taxable income allocated to each partner

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Distribution-Driven Agreements: Alternative Drafting Strategies

- How are P&L allocations determined under a distribution-driven agreement (where capital accounts have no effect on economics)?
- *There is no standard approach!*
  - Given fact that capital accounts have no contractual impact on liquidating distributions, there is no tax or other legal requirement to have detailed P&L allocation provisions or otherwise worry about capital accounts (except for purposes of determining allocations on K-1 schedules)
- *In theory only* → distribution-driven agreement could contain no allocation provisions whatsoever!
  - §704(b) regulations would then kick in by operation of law
  - But this approach rarely seen and not recommended; not considered "market" since investors have come to expect usual and customary guidelines regarding allocations in operating agreement (and how they are handled from a governance perspective), even if not driving the economics
  - *Beware of unanticipated outcome under state law statutory default rules if agreement silent on allocations*

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Distribution-Driven Agreements: Alternative Drafting Strategies [cont'd]

- Alternative drafting approaches in distribution-driven agreements:
  - Most common approach (particularly for deals with complex waterfalls) → "targeted" allocations based on hypothetical liquidation at year-end, without detailed allocations in the agreement other than special rules involving nonrecourse debt
  - Increasingly less common → but some agreements still spell out specific allocation provisions (perhaps with same level of detail as in capital account-driven agreement), even though liquidating distributions not made in accordance with capital accounts
    - With or without "savings clause" to make adjustments in attempt to comply with §704(b) regulations
    - What happens if allocations violate §704(b) regulations but agreement has no savings clause?
  - Some agreements simply require allocations in accordance with partners' "interests" in the partnership pursuant to §704(b) regulations, but without setting forth detailed allocations → not recommended unless your client is in control
- "*Tax follows cash*" (not vice versa)

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Distribution-Driven Agreements: Example of Savings Clause Approach

- The following savings clause assumes that a distribution-driven agreement contains specific P&L allocations in Sections 5.1 and 5.2:

> 5.3 **Savings Clause.** Notwithstanding Sections 5.1 and 5.2, the allocations of Profits or Losses (or items thereof) for any Fiscal Year (or applicable portion thereof) shall be adjusted, to the extent necessary or advisable by the Managing Member, so that the adjusted allocations are in accordance with the Members' "interests" in the Company within the meaning of Treasury Regulations §1.704-1(b)(3).

- Possible variations:
  - Instead of cross-referencing the subjective "interests in the partnership" test, some savings clauses set forth full-blown targeted allocation principles
  - Instead of implementing savings clause for *every* taxable year, some agreements limit application of savings clause to tax periods after partnership begins liquidating process
  - Instead of including "items" of P&L (such as gross income) for *every* taxable year, some savings clauses limited to net profits or net losses for all tax periods until partnership begins liquidating process (at which time agreement might allow allocations of gross items)

"Targeted" or "Forced" Allocations: No Longer Just an Emerging Trend

- Increasingly common in last 15-20 years for distribution-driven partnership agreements to use "targeted allocations" → also known as "target allocations", "targeteds" or "forced allocations"
- Overall concept → allocations for each year determined with benefit of hindsight under a "hypothetical liquidation" or "plug" approach
- Income or loss allocated to "force" each partner's capital account to equal liquidating distribution that *would have been* received if partnership engaged in the following hypothetical transaction:
  - Partnership sells all assets on last day of taxable year for hypothetical selling price equal to §704(b) "book value" (not FMV) → hence no gain or loss except for minimum gain chargebacks
  - Partnership debts paid out of hypothetical sale proceeds (or by those partners who have recourse liability or additional capital call obligations)
  - Net proceeds distributed in accordance with liquidation waterfall

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"Targeted" or "Forced" Allocations: Sample Language

- No standard drafting approach for preparing targeted allocation provisions
- Sample provisions set forth below solely for illustration
- Based on the following assumptions:
  - Distribution-driven agreement (hence capital accounts do not govern on liquidation)
  - Agreement does not contain specific P&L allocations (other than regulatory allocations relating to nonrecourse debt)
  - Not all capitalized terms defined in this slide deck

"Targeted" or "Forced" Allocations: Sample Language – Alternative 1

7.1 **Allocation of Net Income or Net Loss.**

(a) After giving effect to the special allocations required by Section 7.2, the Company's remaining Net Income or Net Loss for any Allocation Period (and, to the extent necessary, individual items of income, gain, loss or deduction) shall be allocated among the Members in a manner such that, immediately after giving effect to such allocations, the Capital Account balance of each Member (which balance may be positive or negative) is, as nearly as possible, equal to (i) the amount of the distribution that would be made to such Member pursuant to Section 13.3 if the Company were dissolved, its affairs wound up and its assets sold for cash equal to their respective Section 704(b) Book Values as of the end of such Allocation Period (except that any Company asset actually sold during such Allocation Period shall be treated as sold for the actual proceeds of the sale), all liabilities of the Company were satisfied (limited with respect to each Nonrecourse Liability to the aggregate Section 704(b) Book Value of the assets securing such liability), and the net assets of the Company were distributed, in accordance with Section 13.3, to the Members immediately after making such allocations, minus (ii) the sum of (A) the amount, if any, that such Member would be obligated to contribute to the capital of the Company, plus (B) such Member's share of Company Minimum Gain, plus (C) such Member's share of Member Nonrecourse Debt Minimum Gain, in each case computed immediately prior to the hypothetical sale of assets.

(b) [OPTIONAL LANGUAGE: This Section 7.1 is intended to cause each Member's share of the Company's Net Income or Net Loss for any Allocation Period to be determined consistently with the provisions of Section 704(b) of the Code and the Treasury Regulations thereunder.] The Managing Member may modify the allocations otherwise required by Section 7.1(a) for any Allocation Period if, and to the extent that, such modification is necessary or advisable in order to achieve compliance with Code Section 704(b) and the Regulations thereunder.]

"Targeted" or "Forced" Allocations: Sample Language – Alternative 2

6.1 Profits. After giving effect to the special allocations set forth in Section 6.3, Profits for any Allocation Period shall be allocated to the Members having Capital Account Shortfalls as of the end of such Allocation Period (as determined after taking account of all contributions, distributions, and Regulatory Allocations during such Allocation Period, but before taking account of allocations of Profits or Losses for such Allocation Period) in proportion to their respective Capital Account Shortfalls.

6.2 Losses. After giving effect to the special allocations set forth in Section 6.3, Losses for any Allocation Period shall be allocated to the Members having Capital Account Excesses as of the end of such Allocation Period (as determined after taking account of all contributions, distributions, and Regulatory Allocations during such Allocation Period, but before taking account of allocations of Profits or Losses for such Allocation Period) in proportion to their respective Capital Account Excesses.

6.3 *[Regulatory Allocations would be set forth in 6.3]*

6.4 *[misc. allocation rules would be set forth in 6.4]*

6.5 [OPTIONAL LANGUAGE: Intent of Allocations. The allocation provisions set forth in Sections 6.1 and 6.2 are intended to be determined consistently with the provisions of Code Section 704(b) and the Regulations thereunder. The Managing Member may modify the allocations otherwise required by Sections 6.1 and 6.2 for any Allocation Period if, and to the extent that, such modification is necessary or advisable in order to achieve compliance with Code Section 704(b) and the Regulations thereunder.]

[Definitions of key capitalized terms on next slide]

"Targeted" or "Forced" Allocations: Sample Language – Alternative 2 [cont'd]

Key Defined Terms

"***Capital Account Excess***" means, with respect to each Member, the excess (if any) of such Member's Capital Account over such Member's Target Account.

"***Capital Account Shortfall***" means, with respect to each Member, the excess (if any) of such Member's Target Account over such Member's Capital Account.

"***Target Account***" means, with respect to any Member for any Allocation Period, an amount equal to the hypothetical distribution such Member would receive if: (a) all assets of the Company, including cash at the end of such Allocation Period, were sold for cash equal to their Gross Asset Value (taking into account any adjustments to Gross Asset Value for such Allocation Period); (b) all liabilities allocable to such assets were then due and were satisfied according to their terms; (c) all chargebacks of Company Minimum Gain and Member Nonrecourse Debt Minimum Gain required by this Agreement were made; (d) all obligations of Members to contribute additional capital to the Company were satisfied; and (e) all remaining proceeds from such sale were distributed to the Members pursuant to Section 7.5.4 (except that amounts deemed constructively distributed pursuant to the computation of prior Target Account balances shall not be treated as having been actually distributed for the computation of such given Target Account balance).

"Targeted" or "Forced" Allocations *vs.* Capital Account-Driven Approach

- Both approaches rely on the fundamental capital account equation but with dramatically different perspectives
- **Capital Account-Driven Agreement**:
  - Year-end capital account = capital account at beginning of year plus contributions plus profits minus losses minus distributions
    - P&L allocations are precisely set forth in the agreement
    - Year-end capital account actually affects each partner's contractual entitlement to liquidating distributions
- **Distribution-Driven Agreement**:
  - P&L allocated to each partner = (i) year-end capital account based on hypothetical liquidation at book value minus (ii) capital account at beginning of year adjusted solely for contributions and distributions during that year
    - P&L allocation is a plug number
    - Year-end capital account has no relevance whatsoever for purposes of determining contractual entitlement to liquidating distributions

"Targeted" or "Forced" Allocations: Technical Issues and Uncertainties

- No guidance from IRS (yet) on whether targeted allocations can be respected under §704(b) regulations
  - Economic effect equivalence?
  - Consistent with partners' "interests in the partnership"?
- Practitioners not yet fully settled on any "boilerplate" or "state of the art" drafting approach
- Consider whether agreement should include regulatory provisions for allocations attributable to nonrecourse debt (e.g., nonrecourse deductions, minimum gain, etc.)
  - Most commentators believe yes
  - But not clear if regulatory safe harbor for nonrecourse debt-related allocations would be available (or if this is pure "window dressing")

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"Targeted" or "Forced" Allocations: Technical Issues and Uncertainties [cont'd]

- Should agreement include qualified income offset ("QIO")?
  - Perhaps not necessary – particularly if relying on partners' interest in the partnership test?
  - Good "window dressing"?
  - Some practitioners believe QIO may enhance argument that targeted allocations may satisfy "economic equivalence" test
- Not always clear whether net income or gross income should be used to implement certain preferred returns
- Not clear if tax-exempt partner can rely on §514(c)(9)(E) fractions rule to avoid UBTI
- What happens if P&L allocations are incorrect?

Distribution-Driven Agreements: Advantages

- Reduces risk of getting the economics wrong
  - Because cash waterfall governs on liquidation
  - Contrast capital account-driven agreement:
    - Incorrect P&L allocations would cause capital accounts to be inconsistent with the intended business deal
    - Incorrect bookups or bookdowns (or failure to make bookup or bookdown) would further distort the economics
- Easier to understand the economic deal
  - Because cash distributions set forth exclusively in waterfall
  - No need to figure out how P&L allocations affect capital accounts

Distribution-Driven Agreements: Advantages [cont'd]

- Can provide assurances to client:
  - Economics spelled out in one place (in waterfall)
  - Economics not dependent on interpretation of arcane tax rules
- Easier and less time-consuming for attorney to draft P&L allocations in distribution-driven agreement
  - Perhaps reduce legal fees; but "punt" to accountant who must then spend more time to figure out allocations when preparing return (although query, as a practical matter, how many accountants actually spend the time to implement targeted allocations)
  - Contrast capital account-driven agreement → P&L allocations must take into account multiple permutations and "what-ifs" making it harder for tax counsel to draft; but presumably accountant can then rely on those contractual allocations without need for "heavy lifting" to implement targeteds

Distribution-Driven Agreements: Disadvantages

- Greater burden imposed on accountant who prepares tax return
  - Contrast capital account-driven agreement which contains specific allocations
  - Query discussing in advance with client and accountant
- Less attractive to highly tax-sensitive partners who may want greater advance predictability regarding allocations
- Query if greater risk of IRS challenge (due to lack of authority regarding targeted allocations and similar drafting approaches)?
- Puts more pressure on drafting waterfall provisions
  - Particularly where waterfall varies depending on "bucket" of cash (e.g., how to "trace" undistributed operating cash flow vs. undistributed capital transaction proceeds)
- Risk to tax-exempt partner desiring to avoid UBTI under §514(c)(9)(E) fractions rule

Governance Issues: Who Makes Allocation Decisions?

- Important business and drafting issue → who has authority to make discretionary allocation decisions in a distribution-driven agreement (particularly as to targeted allocations)?
- Depends on drafting approach in agreement on governance matters:
  - GP / manager / managing member?
  - Some specified percentage vote of managers or managing members?
  - Subject to approval by a specified percentage of *non*-managing members?
  - Give discretion to accountant (coupled with dispute resolution procedure)?
- Distinguish other tax-related governance matters:
  - Who signs tax return?
  - "Tax matters partner" (pre-2018 taxable years)
  - "Partnership representative" (post-2017 taxable years)
- Beware of potential conflict of interest among partners
- Similar governance issues for distribution decisions

Different Categories of P&L: Book vs. Tax

- Taxable income (loss):
  - Determined under Internal Revenue Code
  - Definitional issues; certain items separately stated
- Section 704(b) "book" profit (loss):
  - Potentially misleading term of art → but key to §704(b) analysis
    - §704(b) book ≠ P&L per GAAP
    - §704(b) book ≠ P&L per books and records
    - §704(b) book ≠ taxable income (loss)
  - Determined by starting with taxable income (loss) and making certain adjustments required by regulations
    - Add tax-exempt income
    - Subtract certain nondeductible expenditures
    - Adjustments for built-in gain (loss) upon certain events
    - Can add much complexity to agreement

Allocations of Taxable Income (Loss)

- Important to distinguish allocations of Section 704(b) "book" profit from allocations of taxable income
  - Absolute dollar amounts could differ
  - But each item entering into calculation of taxable income generally allocated in same manner as corresponding item entering into calculation of Section 704(b) "book" profit
    - Exceptions for §704(c) built-in gain or loss
- Drafting approach
  - Preferred approach → include taxable income allocations in separate subsection to avoid confusion with book profit
  - But many agreements lump together (although tax law ultimately controls)

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Allocations of Partnership "Built-in Gain": How They Can Help (or Hurt) Your Client

- Basic fact pattern → contribution of appreciated property
  - Capital contribution of property (other than money) in exchange for partnership interest
  - FMV > tax basis of contributed property in hands of contributing partner
  - Contributing partner is given capital account credit for full FMV for purposes of determining economic deal under the partnership agreement
- Alternative fact pattern → revaluation of appreciated property
  - Capital contribution of money in exchange for partnership interest
  - Partnership already owns property with FMV > tax basis
  - Property may be "revalued" for book purposes with resulting "bookup" in capital accounts (existing partners are given credit for full FMV for purposes of determining economic deal under amended partnership agreement)
- Similar considerations for property with built-in loss

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Allocations of Partnership "Built-in Gain": Simplistic Example – Nondepreciable Property

- Assumptions
  - Partner A contributes cash of $1,000,000
  - Partner B contributes raw land with FMV of $1,000,000 and basis of $600,000 (built-in gain = $400,000). B's initial capital account = $1,000,000.
  - A and B each get a 50% interest in Partnership AB
  - AB sells the land for $3,000,000 when its basis is still $600,000
- Gain on sale:
  - Tax gain: $3,000,000 - $600,000 = $2,400,000
  - Book gain: $3,000,000 - $1,000,000 = $2,000,000
- Allocation of gain
  - Book gain of $2,000,000 split 50/50
  - First $400,000 of tax gain must be allocated to B
  - Remaining $2,000,000 of tax gain split 50/50 (same as book gain)
- Economics not affected → each partner still receives $1,500,000 cash

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Allocations of Partnership "Built-in Gain": How They Can Help (or Hurt) Your Client

- Why do we care about partnership built-in gain?
  - Special rules for allocating built-in gain among partners when contributed (or revalued) property eventually sold (per example above)
  - Special rules for allocating depreciation or amortization deductions (if the appreciated property is eligible for such deductions)
- Regulations contain flexibility as to precise allocation method
  - Traditional / curative / remedial
  - But there is a potential conflict between contributing partner and other partners regarding choice of method
  - Hence governance issues presented → i.e., who has the right to choose method?

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Partnership Allocations of "Built-in Gain": Practice Points

- Negotiate business deal → must agree on FMV of contributed property
- Partnership must obtain basis information from contributing partner to determine built-in gain
- Choice of §704(c) allocation method requires behind-the-scenes tax calculations
- Who chooses allocation method?
  - Specify method in agreement?
  - Give discretion to manager, managing member, etc.?
  - Frequently subject to heavy negotiation
- Contributing partner may want partnership to covenant not to sell contributed property for some period of time (if built-in gain substantial)
- Be careful with terminology in agreement

Partnership Allocations: Malpractice Risks

- Inadequate communication with client
  - Regarding client's understanding of business deal (and how deal interfaces with approach to "book" and "tax" allocations)
  - Implications of drafting approach → economic certainty vs. tax certainty
- Negotiating the deal
- Drafting the agreement
- Preparing tax returns
- Interfacing with IRS (audit, administrative appeal, litigation)
- Coordination between business lawyer and tax lawyer
  - Business lawyer must beware of malpractice exposure if he or she lacks tax expertise and fails to obtain the input of qualified tax counsel in connection with preparation or review of agreement
  - Can't mindlessly rely on "boilerplate" language from the last deal

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The content in this slide deck is current as of June 10, 2024.


Incentive Compensation by LLCs Taxed as Partnerships
Anthony Wilkinson, Esq.
anthony@wilkinsonlawllc.com
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wilkinsonlawllc.com (732) 410-7595
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What are LLCs Taxed as Partnerships?

- An LLC that has more than one member will default to being classified as a partnership for federal income tax purposes unless it files IRS Form 8832 and elects to be treated a corporation.
- An LLC taxed as a partnership is a business organization that merges the "pass-through" taxation benefits of a partnership with the limited liability of a corporation.
- The tax liability for these entities is passed through to their individual members, who then report their share on their personal tax returns.
- This tax structure influences the types of incentive compensation available to LLCs taxed as partnerships.

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What Is Incentive Compensation by LLCs Taxed as Partnerships?

- Incentive compensation is paid under a variable compensation system where team members' pay is directly tied to specific pre-set goals, reflecting both their individual performance and organizational success.
- This aligns employee interests with the company's performance, motivating members to achieve peak performance as the business benefits from increased productivity.
- LLCs Taxed as Partnerships utilize equity and cash-based incentives to boost employee morale while elevating company success.

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What Are Equity Incentives?

- Equity incentives grant team members an ownership stake or interest in the company, aligning their interests with the firm's long-term prosperity.
- There are three types of equity incentives: capital interests, profit interests, and options on capital interests.
- Capital interests grant members an ownership stake, while options on capital interests offer team members an opportunity to purchase capital interests at a predetermined price.
- Profit interests grant team members a share of the company's future profits.

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How Can Capital Interests Be Used as Incentive Compensation by LLCs Taxed as Partnerships?

- Capital interests confer members with an ownership stake in the company's underlying assets and entitle them to a proportionate share of the capital upon liquidation.
- Tiered capital interest structure allocates different classes of capital interests depending on team member responsibility and seniority. Thus, there can be one class of capital interests for founders and a different class of capital interests for other team members.
- Grants of capital interests can be linked to performance metrics, motivating team members to reach their best while elevating company success.
- LLCs Taxed as Partnerships use capital interests to retain top talent by linking them to vesting schedules that determine when the interests become fully owned by the member. Thereby, team members are incentivized to extend their tenure with the company as they anticipate receiving additional grants of capital interests according to their vesting schedule.

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How Can LLCs Taxed as Partnerships Use Profit Interests as Incentive Compensation?

- They motivate employees by aligning their long-term goals with the company's success.
- Profit interests offer team members a right to the LLC's future profits in exchange for services. Upon the liquidation or sale of the company, holders of profit interests may also be eligible to receive a share of the proceeds.
- As long as grants of profit interests fall within the rules of an IRS safe harbor, they are tax free for both the team member and the company at grant.
- Upon the liquidation or sale of the company, proceeds received by holders of fully vested profit interests may be taxed at ordinary income rates or at short-term or long-term capital gains rates depending upon the structure of the liquidation or sale and the value of the company at that time.

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What are the Potential Issues With Using Options on Capital Interests as Incentive Compensation by LLCs Taxed as Partnerships?

- Options on capital interests present team members with an opportunity to purchase capital interests in the future at a predetermined price called the exercise or strike price.
- This approach is less preferred because of the tax implications on team members who pay ordinary income tax on the difference between the exercise price and the fair market value in circumstances where the exercise price is lower than the fair market value.
- Also, assuming the company has some value, the team member must pay cash to exercise the option and obtain the capital interests.
- Furthermore, obtaining the value of small private LLCs can be difficult.

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What are Cash Incentives?

- Cash incentives provide immediate financial recognition for the diligent efforts of team members.
- They present a straightforward means for incentive compensation, bypassing complex taxation regulations.
- They are contract-based arrangements for incentive compensations.
- They can be structured as phantom equity or as performance-based bonuses.

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How Can Phantom Equity Be Used as Incentive Compensation by LLCs Taxed as Partnerships?

- Phantom equity bestows team members with a stake in the company's future financial success without transferring actual ownership.
- Team members receive cash bonuses linked to the company’s value, or increase in value, ensuring control remains with the current owners while incentivizing key contributors.
- Phantom equity enhances member retention and motivation.

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How Can LLCs Taxed as Partnerships Use Performance-Based Bonuses as Incentive Compensation?

- Performance-based bonuses provide immediate cash payouts based on either individual or company performance.
- Performance-based bonuses are popular because they confer immediate gratification to the team members, recognizing their hard work, and elevating their motivation.
- Bonuses linked to team member performance cultivate a performance driven culture as workers are more motivated to achieve higher goals.
- They do not confer any ownership to recipients, making them simpler to administer compared to equity compensation plans.

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What Is the Role of Vesting in Incentive Compensation by LLCs Taxed as Partnerships?

- Vesting establishes the condition for gradually acquiring full rights in equity grants and eliminates the risk of forfeiture.
- LLCs taxed as partnerships utilize time-based and performance-based vesting when granting equity.
- Under time-based vesting, the recipient earns the rights to the compensation gradually over time or in full after a certain amount of time has transpired, i.e. cliff vesting.
- Under performance-based vesting, the team member must achieve specific performance milestones to earn the right to the incentive.

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Section 83(b)

- Section 83(b) of the Internal Revenue Code offers a tax strategy that enables members of partnership-taxed LLCs to elect to pay taxes on the value of their interests at the time of grant, rather than at the time of vesting, which is the default approach for taxation.
- Members potentially face lower tax liability when they expect the value of their interests to increase over time.

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Tax Issues Relating to Granting Profit Interests

- The safe harbor for profit interests is a set of tax provisions that ensure the issuance of profit interests by a partnership-taxed LLC is not considered a taxable event. To qualify for this tax advantage, the LLC must meet specific requirements, including:
  - Treating the team member as an owner rather than a W-2 employee.
  - Ensuring the profit interest is not related to substantially certain or predictable income streams.
  - Not allowing the LLC to take a tax deduction for the FMV of the profits interest.
  - Prohibiting the team member from disposing of the profit interest within two years of receipt.
  - Requiring the liquidation value of the profit interest to be $0 at the time of grant.
- If there is a risk that the grant of a profit interest will not fall within the safe harbor, it is permissible for the grantee to make what is called a “protective Section 83(b) election” at the time of grant -- otherwise a Section 83(b) election would not be required.

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Tax Issues Relating to Granting Capital Interests

- Taxations depends on whether the team member made a Section 83(b) election.
- Team members pay tax at the ordinary income tax rates on the difference between the FMV and the amount, if any, they paid for the capital interests.
  - If a Section 83(b) election is made, the time to pay such tax and to assess such FMV is the time of grant.
  - If a Section 83(b) is not made, the time to pay such tax and to assess such FMV is the time of vesting. It is worth noting that if there are multiple points in time for vesting, then there will be multiple points in time to pay the tax and assess the FMV.

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Tax Issues Relating to Granting Options on Capital Interests

- Unvested options on capital interests are not taxed when granted.
- Vesting does not result in a taxable event.
- Taxation occurs when the team member chooses to exercise these options.
- The difference between the FMV and the exercise price is treated as ordinary income for tax purposes.

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Tax Issues Relating Granting Phantom Equity and Cash Incentives

- Unvested phantom equity and other cash incentives are not subject to taxation upon grant, nor is there a taxable event upon vesting.
- They are treated as ordinary income when the team member receives the cash payout.

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What should you know about valuing a company for incentive compensation purposes in LLCs taxed as partnerships?

- Your client is sure to ask: “Why do I have to get a valuation?”.
- Valuation of a company helps determine its fair market value for incentive compensation purposes.
- LLCs taxed as partnerships primarily utilize the market-based or income-based approaches to determine their FMV.
- Under the market-based approach, the LLC is compared to similar companies in the market to ascertain its value.
- The income-based approach involves determining the company’s FMV from projections of its current and future cash flows.

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Valuation When Granting Profit Interests

- Determining the company's FMV helps set the "distribution hurdle".
- The distribution hurdle is the company's threshold value before team members holding profit interests are entitled to a share of the proceeds from a liquidation event such as the sale of the company.
- Knowing the FMV helps the company avoid setting a hurdle that is too low, which can cause tax related issues related to whether the granting of the profit interest fell within the IRS's safe harbor provisions.

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Valuation When Granting Capital Interests

- A Section 83(b) election means the recipient will be taxed on the difference between the purchase price and the FMV at grant, calling for an accurate valuation.
- If the recipient does not make a Section 83(b) election, then they will be taxed on the difference between the purchase price and the FMV at each vesting point, which requires the company to assess its value at each such point.

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Valuation When Granting Options on Capital Interests

- Partnership-taxed LLCs must conduct a valuation to set an exercise price that is no less than the FMV to comply with certain tax laws.
- If the FMV exceeds the exercise price, the team member is subject to ordinary income taxation on the difference between the two values.

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Valuation When Granting Phantom Equity and Other Cash Incentives

- When a contract for phantom equity or other cash incentives makes payment a function of the value of the company at a certain point in time, then a valuation is necessary whenever the value of the company is not known in the context of the event.
- For example, one would expect the value of the company to be established in the context of an arms-length sale of the company, but not known on the fifth anniversary of the founding of the company except by means of obtaining a valuation.

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How Does Termination for Cause Affect Incentive Compensation by LLCs Taxed as Partnerships?

- What typically happens when a team member violates their contract due to misconduct, violation of company policy, or other reasons for which the company can prove the worker was at fault?
  - Grants of capital interests are forfeited at cost, or simply forfeited if they were granted for no consideration.
  - Unexercised options on capital interests are forfeited for no consideration.
  - Profit interests are forfeited for no consideration.
  - Cash incentives are terminated without payment.

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How Does Termination Other Than for Cause Affect Incentive Compensation by LLCs Taxed as Partnerships?

- Team members may be allowed to keep granted and fully vested capital interests or profit interests, or they may be redeemed by the company at fair market value.
- Unexercised and fully vested options on capital interests are either terminated, or the team member is given a limited period to exercise them.
- Cash incentives are either terminated without payment or paid at the value of such incentives as of the date of termination.

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What Are the Implications of Selling the Company on Incentive Compensation by LLCs Taxed as Partnerships?

- If the company is acquired through a sale of assets, the tax treatment of the proceeds received by equity holders will depend upon the nature of the assets sold. Capital income assets, such as real estate, will trigger capital gains taxes, while ordinary income assets, such as patents and copyrights, will trigger ordinary income taxes.
- If it's a equity sale, holders' share of returns will be subject to short-term capital gains tax if they've held them for under a year. If they've held the interests for more than a year, they will be subject to long-term capital gains tax.
- Team members holding options on capital interests must first exercise these options to become company owners and receive a payout.
- Upon the company's sale, holders of profit interests will receive their payouts as long as the distribution hurdle has been met.
- The sale of an LLC may trigger phantom equity and cash incentive payouts, which are subject to ordinary income tax.

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What is Section 409(A) of the Internal Revenue Code?

- A deferred compensation plan withholds a portion of a team member's compensation until certain conditions are met at a certain point in time.
- There are qualified deferred compensation plans such as pension plans and 401(k) plans. There are also nonqualified deferred compensation plans.
- Section 409A of the Internal Revenue Code governs nonqualified deferred compensation plans and aims to prevent companies from using such plans to obtain inappropriate tax advantages.
- Here are some of its requirements:
  - Subject to various exceptions, participants must make an initial deferral election before the beginning of the year in which they are to perform the services related to the deferred compensation.
  - Distributions from a deferred compensation plan can only occur during specific events such as separation from service, disability, death, a predetermined date or schedule, or an unforeseeable emergency.
  - The company is not allowed to accelerate the payment of deferred compensation.
  - If participants wish to make subsequent deferral elections, they must follow specific guidelines.

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How Does Section 409A Affect Incentive Compensation by LLCs Taxed as Partnerships?

- Grants of capital interests are not viewed as deferred compensation.
- If the exercise price of options on capital interests is equal to or greater than the Fair Market Value (FMV) at the time of the grant, they are exempt from Section 409A.
- Most companies set the exercise price equal to the FMV to avoid the complex laws pertaining to Section 409A.
- Grants of profit interests that fall within the IRS safe harbor are not subject to Section 409A.
- Phantom equity and other cash incentives are deemed deferred compensation and may be subject to Section 409A and the complex legal nuances associated with it, unless they fall within one of the exceptions to Section 409A.

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The Short Term Deferral Exception

- Serves as an exemption to Section 409A
- To qualify, a deferred reward must be paid within 2.5 months after the end of the tax year in which the team member's right to the reward is no longer subject to a "substantial risk of forfeiture."
- By fulfilling these requirements, the payment is exempt from Section 409A and its intricate regulations.
- Most phantom equity and other cash incentives plans utilize the short term deferral exception to avoid the complexities of Section 409A.

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What Are the Securities Law Implications of Incentive Compensation by LLCs Taxed as Partnerships?

- SEC Rule 701 grants private companies an exemption from registering securities issued as compensation to their team members with the Securities and Exchange Commission (SEC).
- Conditions that companies must satisfy to qualify for an exemption under Rule 701:
  - The securities must be issued as part of a written compensatory benefit plan (which may be an agreement or a contract).
  - During a 12-month period, the value of the securities must not exceed: (a) $1 million; (b) 15 percent of the company's total assets; or (c) 15 percent of the outstanding securities of the class being offered.

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How Can Incentive Compensation Be Incorporated Into Business Succession Planning for LLCs Taxed as Partnerships?

- Partnership taxed LLCs must first begin by establishing well-defined incentive compensation agreements.
- These agreements must unambiguously outline the particular offered incentives, delineate vesting schedules, and specify the circumstances under which incentives may be forfeited or redeemed.

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How Can Incentive Compensation Be Incorporated Into Business Succession Planning for LLCs Taxed as Partnerships?

- The incentive compensation agreements should be aligned with the business succession goals.
- If the plan focuses on transferring ownership to new partners, consider incorporating accelerated vesting triggered by events like retirement or death.
- If the aim is to sell the business to an outside party, then include change of control provisions.
- The plan needs to clarify the roles and responsibilities of everyone involved in the ownership transition or business sale, along with provisions for transferring or redeeming incentive compensation awards.
- Collaborating with a knowledgeable tax professional is crucial to thoroughly address all tax considerations within the business succession plan, avoiding potential pitfalls and ensuring compliance.

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What Key Agreements and Documents Are Necessary for Incentive Compensation Documentation in LLCs Taxed as Partnerships?

- The Operating Agreement: Delineates the rights and responsibilities of team members while outlining the eligibility for equity and cash-based incentive compensation grants.
- The Services Agreement: Delineates the terms and conditions of a team member's engagement with the LLC through a written contract. Depending on the specific context, it may be referred to as an employment, consulting, or advisor's agreement

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What Are the Best Practices for Administering Incentive Compensation by LLCs Taxed as Partnerships?

- Identify the Ideal Plan Administrator: An entity or individual tasked with overseeing the incentive compensation plan. The plan administrator could be the board of managers, the compensation committee, another designated committee, or one or more officers chosen by the board of managers or the compensation committee.
- Creating a Dedicated Reserve: By setting aside a dedicated reserve of cash or equity for these grants, companies can effectively design a compensation plan that drives success and keeps your team motivated without diluting the overall structure.

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What Are the Best Practices for Administering Incentive Compensation by LLCs Taxed as Partnerships?

- Share Recycling: Incentive compensation plans for partnership-taxed LLCs must carefully address how to handle equity awards subject to expiration, forfeiture, cancellation, or cash settlement. The key question is whether these awards will again be made available for issuance under the plan.
- Optimal Award Adjustments: Partnership-taxed LLCs should attentively manage award adjustments during corporate events, ensuring equity award holders' rights remain balanced and protected. Events that necessitate adjustments include mergers, consolidations, reorganizations, recapitalizations, and capital structure changes.

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How Can the Success of Incentive Compensation by LLCs Taxed as Partnerships Be Evaluated and Measured?

- Member Retention Rates: High retention rates among team members who receive incentive compensation plans indicate that the incentive compensation plans are achieving their goal of retaining top talent.
- Member Engagement: Using thoughtfully designed surveys and various feedback mechanisms, LLCs can determine if those who receive incentive compensation are engaged and motivated to perform at their best.

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How Can the Success of Incentive Compensation by Llcs Taxed as Partnerships Be Evaluated and Measured?

- Attainment of Business Objectives: When a company reaps substantial profits following the granting of incentive compensation plans to its team members, it underscores the impact of profit interests as potent motivators.
- The ROI of the Incentive Compensation Plan: LLCs weigh the costs involved in implementing the incentive plan against the financial gains it produces. A positive ROI showcases the triumph of the incentive compensation plan.

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WILKINSON LAW LLC
Anthony Wilkinson, Esq.
anthony@wilkinsonlawllc.com
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LLCs From A to Z

When should a limited liability company seek professional advice about compliance with the Corporate Transparency Act?

Jason Krisza, Esq.

WILENTZ
ATTORNEYS AT LAW
WILENTZ, GOLDMAN & SPITZER, P.A.

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Corporate Transparency Act History

- Effective Date: January 1, 2024
- Codified: 31 U.S.C. 5336 as part of the Anti-Money Laundering Act of 2020 in the National Defense Authorization Act for Fiscal Year 2021
- Purpose: curb money laundering by increasing transparency of ownership in otherwise unregulated entities
- Basic Requirements: smaller and unregulated business entities must disclose certain ownership and control information to the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN)

Unconstitutional?

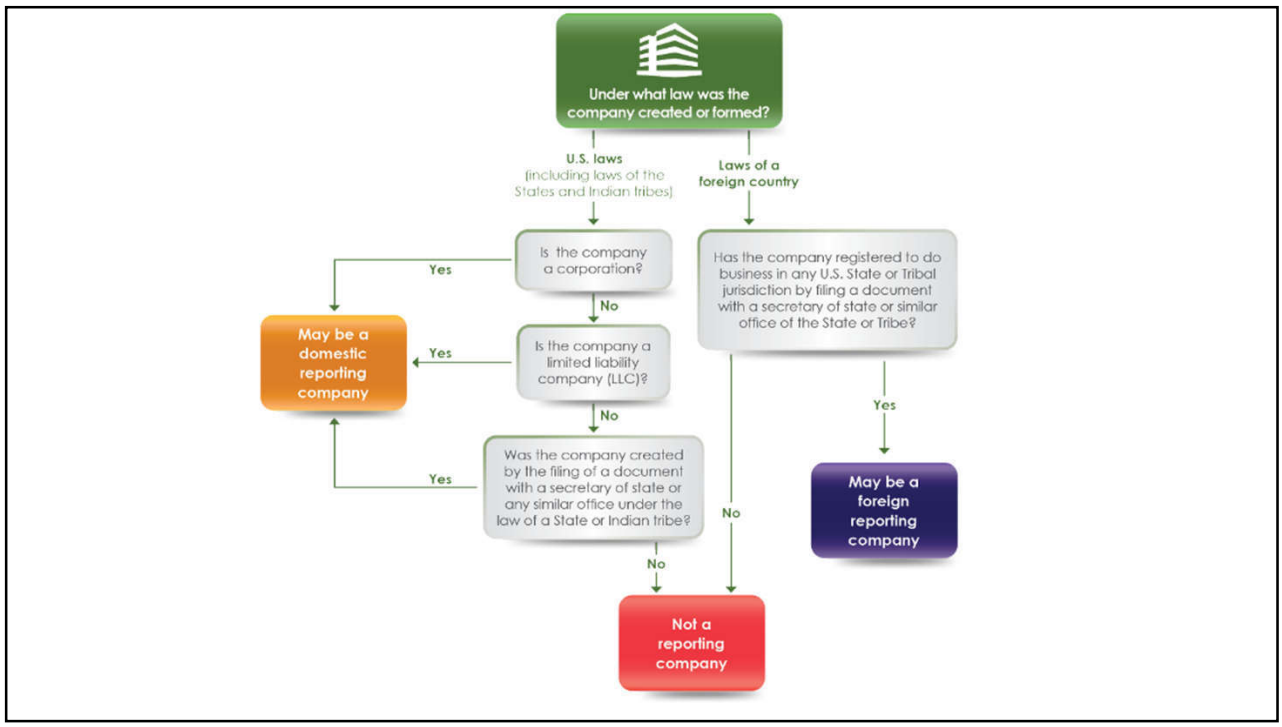
- United States District Court for the Northern District of Alabama in *Nat'l Small Bus. United v. Yellen*, No. 5:22-CV-1448-LCB, 2024 WL 899372 (N.D. Ala. Mar. 1, 2024)



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CTA Basics

- The Act refers to entities which are required to report beneficial ownership information as “reporting companies”.
- Reporting companies are corporations, limited liability companies, or other similar entities that are (i) created by the filing of a document with the secretary of state or a similar office under the law of a state or Indian tribe or (ii) formed under the law of a foreign country and registered to do business in the United States by filing a document with a secretary of state or similar office under the laws of a state or Indian tribe. 31 U.S.C. 5336(a)(11)(A).


Under what law was the company created or formed?
U.S. laws (including laws of the States and Indian tribes)
Laws of a foreign country
Is the company a corporation?
Yes
No
May be a domestic reporting company
Is the company a limited liability company (LLC)?
Yes
No
Was the company created by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe?
Yes
No
Not a reporting company
Has the company registered to do business in any U.S. State or Tribal jurisdiction by filing a document with a secretary of state or similar office of the State or Tribe?
Yes
No
May be a foreign reporting company

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Exemptions

- Twenty-three exemptions are narrow. Most of these exceptions are for entities which are already required to provide the beneficial ownership information under separate statutory or regulatory regimes, e.g., banks.
- FinCEN has published a checklist to guide individuals through the process of whether the entity is a reporting entity or meets one of the exceptions. The checklist is available at: https://www.fincen.gov/sites/default/files/shared/BOI_Small_Compliance_Guide_FINAL_Sept_508C.pdf

Exemptions

Exemption No.	Exemption Short Title
1	Securities reporting issuer
2	Governmental authority
3	Bank
4	Credit union
5	Depository institution holding company
6	Money services business
7	Broker or dealer in securities
8	Securities exchange or clearing agency
9	Other Exchange Act registered entity
10	Investment company or investment adviser
11	Venture capital fund adviser
12	Insurance company
13	State-licensed insurance producer
14	Commodity Exchange Act registered entity
15	Accounting firm
16	Public utility
17	Financial market utility
18	Pooled investment vehicle
19	Tax-exempt entity
20	Entity assisting a tax-exempt entity
21	Large operating company
22	Subsidiary of certain exempt entities
23	Inactive entity

Large Operating Entity Exemption

- Six elements:
  - more than twenty full time employees;
  - at least twenty employees are employed in the United States;
  - operating presence at a physical office in the United States;
  - filed a federal income tax or information return in the United States for the previous year demonstrating more than $5,000,000 in gross receipts or sales;
  - reported this greater-than-$5,000,000 amount as gross receipts or sales (net of returns and allowances) on the entity's applicable IRS form; and
  - when gross receipts or sales from sources outside the United States are excluded from the entity's amount of gross receipts or sales, the amount remains greater than $5,000,000 (specific analysis for affiliated group of corporations that are filing consolidated returns)

Beneficial Owners

- Any individual who, directly or indirectly:
  - Exercises substantial control over a reporting company; or
  - Owns or controls at least twenty-five percent of the ownership interests of a reporting company.

Beneficial Owners

- Ownership or control can be obtained through contract, arrangement, understanding, relationship or other means.
- CTA requires disclosure of all individuals who exercise substantial control over the reporting company, not just the one or two that the reporting entity may want to report.
- An individual exercises substantial control over a reporting company if they meet any of the following four general criteria:
  - the individual is a senior officer;
  - the individual has authority to appoint or remove certain officers or a majority of directors of the reporting company;
  - the individual is an important decision-maker; or
  - the individual has any other form of substantial control over the reporting company.
- These definitions are intentionally broad and open ended.

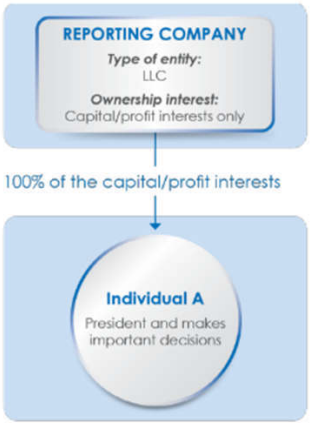
Beneficial Owners

- "Important Decision Makers"
  - Business, such as:
    - Nature, scope and attributes of the business
    - The selection or termination of business lines or ventures, or geographic focus
    - The entry into or termination, or the fulfillment or non-fulfillment, of significant contracts
  - Finances, such as:
    - Sale, lease, mortgage, or other transfer of any principal assets
    - Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget
    - Compensation schemes and incentive programs for senior officers
  - Structure, such as:
    - Reorganization, dissolution, or merger
    - Amendments of any substantial governance documents of the reporting company, including articles of incorporation or similar formation documents, bylaws, and significant policies or procedures
  - See FinCEN FAQ Chart 3, available at https://www.fincen.gov/sites/default/files/shared/BOI_Small_Compliance_Guide_FINAL_Sept_508C.pdf.

Beneficial Owners (Complicated Structures)

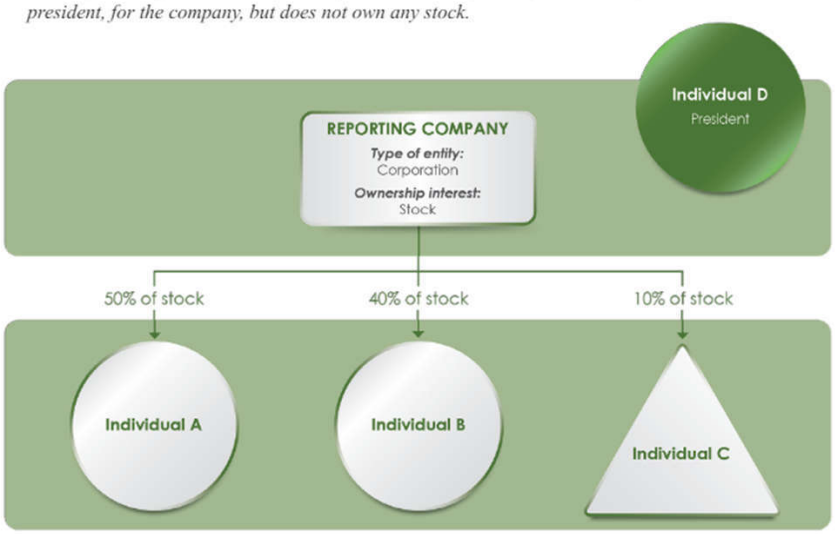
- Complicated corporate structures, such as private equity investment vehicles, is often murky as ownership is often shrouded in convertible instruments, purchase options, warrants, profit interest, and “B” shares. FinCEN does consider these types of interests similarly to physical ownership interests, with very limited exceptions.
- There are a series of exceptions for beneficial owners, including minor children, future inheritors, employees (non-senior officers), creditors, and advisors, e.g., tax and legal professionals.

Example 1: The reporting company is a limited liability company (LLC). Individual A is the sole owner and president of the company and makes important decisions for the company. No one else owns or controls ownership interests in the company or exercises substantial control over the company.



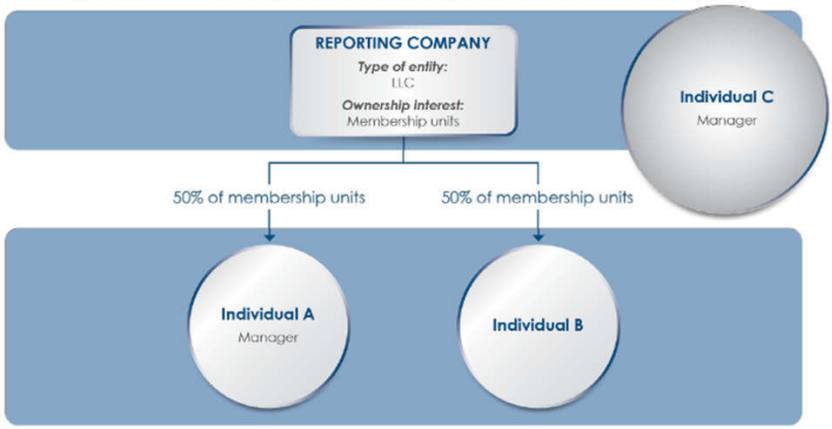
Individual A is a beneficial owner of the reporting company in two different ways, assuming no other facts. First, Individual A exercises substantial control over the company because Individual A is a senior officer of the company (the president). Second, Individual A is also a beneficial owner because Individual A owns 25 percent or more of the reporting company's ownership interests.

Example 2: The reporting company is a corporation. The company's total outstanding ownership interests are shares of stock. Three people (Individuals A, B, and C) own 50 percent, 40 percent, and 10 percent of the stock, respectively, and one other person (Individual D) acts as the president, for the company, but does not own any stock.



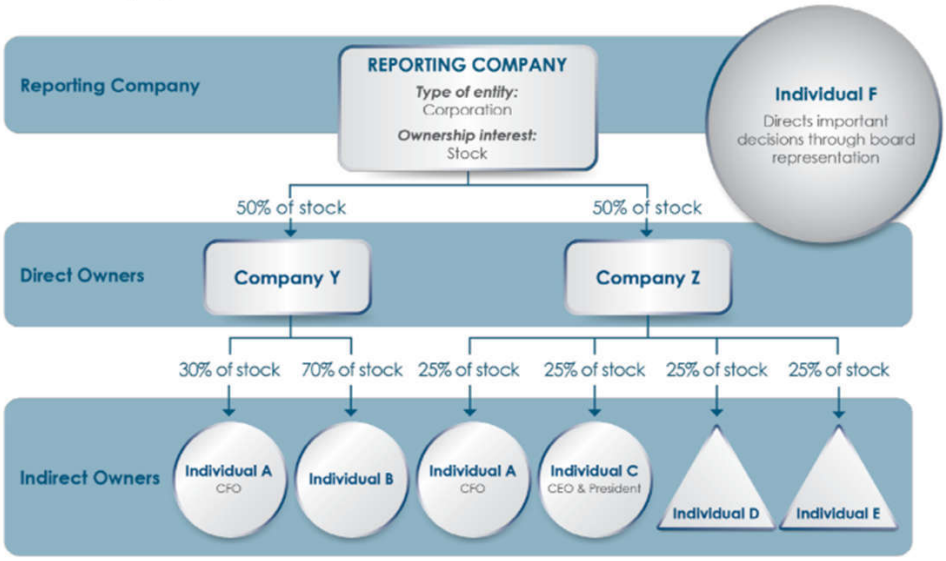
Assuming there are no other relevant facts, Individuals A, B, and D are all beneficial owners of the company and their information must be reported. Individual C is not a beneficial owner.

Example 3: The reporting company is an LLC with two managers, Individuals A and C. Individual A also owns 50 percent of the "membership units" in the LLC while Individual C does not. Individual B owns the remaining membership units in the LLC but is not a manager.



Owners of membership units (which are a type of "capital or profit interest" ownership interest) in an LLC are sometimes called "members" of the LLC. A member may not automatically be required, or authorized, to make decisions for the LLC; depending on the internal organization of the LLC, however, a member may also be a "manager." In this example, Individual A is a member and a manager. Individual B is a member but not a manager, while Individual C is a manager but not a member. All three are beneficial owners of the reporting company.

Example 4: A reporting company is a corporation with multiple indirect owners through Company Y and Company Z.



In this example, Individuals A, B, C, and F are beneficial owners.

Company Applicants

- In addition to beneficial owners, FinCEN also requires the disclosure of Company applicants
  - individual(s) who creates/forms the domestic reporting company
  - the individual who creates the foreign company (not the person who qualified it to do business in the United States)
  - someone who is primarily responsible for directing or controlling such filing.
- Company applicants have to be reported for any reporting company that is created or registered on or after January 1, 2024.
- They are either the direct filer, e.g., attorney or paralegal, or the individual that directs or controls the filing, even if that individual directed the filing. 31 C.F.R. 1010.380(e).

Required Reporting

- Full legal name of the reporting company;
- Any trade name or "doing business as" name(s);
- Principal place of business in the United States;
- Jurisdiction of formation;
- For foreign reporting entities, the jurisdiction of first registration in the United States; and
- Taxpayer Identification Number or the equivalent for a foreign registration.

- For each beneficial owner and company applicant, the following must be reported:
  - Full legal name;
  - Date of birth;
  - Current residential street address (not P.O. Box) and this can be a foreign address; and
  - Unique identifying number, issuing jurisdiction, and image of one of the following documents:
    - US Passport;
    - State Driver's license;
    - Identification document issued by state, local government, or tribe; or
  - If the individual does not have any of these, a foreign passport.

Deadlines

Creation Date	Filing Deadline
Before January 1, 2024	January 1, 2025
Between January 1, 2024 and December 31, 2024	Within 90 calendar days of earlier of: (i) date received actual notice of creation or registration; or (ii) date SOS first provides public notice of creation or registration
On or after January 1, 2025	Within 30 calendar days of earlier of: (i) date received actual notice of creation or registration; or (ii) date SOS first provides public notice of creation or registration
Once Exempt but No Longer Exempt	Within 30 calendar days after no longer meeting exemption criteria

Deadlines

- Following the initial report, reporting companies have an obligation to report any changes to FinCEN within thirty (30) calendar days after the date on which the change occurred.
- A reporting company is not required to file an updated report for any changes to previously reported personal information about a company applicant.
- Some examples of reportable changes include the registration of a new d/b/a or the sale of the company resulting in new ownership.

Penalties

- Failure to comply with the Act can result in high penalties and possible imprisonment.
- The escalating fines range from $500 to $10,000 per violation and jail time of up to two years.

When to Consult an Attorney?

- Complicated business structures
- Questions regarding applicability of exemptions

LLCs from A to Z

When Should a Limited Liability Company Seek Professional Advice About Compliance with the Corporate Transparency Act?

Helpful Resources

FinCEN Small Entity Compliance Guide	https://www.fincen.gov/sites/default/files/shared/BOI_Small_Compliance_Guide.v1.1-FINAL.pdf
FinCEN FAQ	https://www.fincen.gov/boi-faqs#C_2
FinCEN Quick Reference Guide	https://www.fincen.gov/sites/default/files/shared/BOI-Informational-Brochure-April-2024.pdf
BOI E-Filing Portal	https://boiefiling.fincen.gov/
Create FinCEN ID	https://fincenid.fincen.gov/

Prepared By:

Jason J. Krisza, Esq.
Wilentz, Goldman & Spitzer, P.A.
732-855-6452
jkrisza@wilentz.com

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About the Panelists…

Alan F. Kornstein is a Partner in McCarter & English, LLP in Newark, New Jersey, where he concentrates his practice in tax planning and tax disputes involving complex commercial and personal transactions. He regularly advises clients on the organization, financing, operation and sale of business and investment entities, with particular emphasis on equity-raising transactions, joint ventures, mergers and acquisitions, business restructurings, tax-free reorganizations, real estate transactions, qualified opportunity funds, business divorces and insolvency situations. He also represents individuals, partnerships and corporations involved in tax disputes with the Internal Revenue Service and the New Jersey Division of Taxation.

Admitted to practice in New Jersey and New York, and before the United States District Court for the District of New Jersey and the United States Tax Court, Mr. Kornstein is a past Chair of the New Jersey State Bar Association's Taxation Law Section. He is a member of the Section's Executive Committee and Past Chair of the Section's Partnership Tax Committee and of the Tax, Trust & Estates Committee of the Essex County Bar Association. The recipient of several honors, he is a frequent lecturer at seminars and conferences on tax-related topics and served as an adjunct professor in the Professional Accounting Program at Rutgers Business School from 2017-2022.

Mr. Kornstein received his B.A., *cum laude*, from Yale University, his J.D. from the University of Pennsylvania Law School and his LL.M. in Taxation from New York University School of Law. He received his M.B.A. from the Wharton School, University of Pennsylvania.

Jason J. Krisza is a Shareholder in Wilentz, Goldman & Spitzer, P.A. in Woodbridge, New Jersey, and a member of the Corporate and Health Law Groups. He represents health care entities and individual healthcare professionals as well as businesses and business owners in legal disputes, business transactions and regulatory matters affecting their operations.

Mr. Krisza is admitted to practice in New Jersey and New York. He is the recipient of several honors.

Mr. Krisza received his B.A. from Ramapo College of New Jersey and his J.D. from Syracuse University College of Law.

Gianfranco A. Pietrafesa is a Partner in Archer & Greiner, P.C. in the firm's Hackensack, New Jersey, and New York City offices, where he is a member of the firm's Business Counseling Group. His practice includes business formation and governance, mergers and acquisitions, protection of business information and business divorce litigation.

Admitted to practice in New Jersey and New York, and before the United States District Court for the District of New Jersey and the Southern District of New York, the Third Circuit Court of Appeals, the United States Tax Court and the United States Supreme Court, Mr. Pietrafesa is Past Chair of the Board of Directors of the New Jersey State Bar Association's Business Law Section, served on the select committee that drafted the New Jersey *Revised Uniform Limited Liability Company Act* (RULLCA), and is a Trustee and Vice President of the Hudson-Bergen Inn of Transactional Counsel. He was appointed to a district fee arbitration panel, which he chaired

for two years, and a district ethics committee, and is a member of the Board of Directors of the Commerce & Industry Association of New Jersey. He was appointed several times by the New Jersey Supreme Court to serve as a condemnation commissioner and also served on the Editorial Board of the *New Jersey Lawyer Magazine* for 15 years.

Mr. Pietrafesa has lectured on corporate law, LLC law, contract drafting, litigation and legal ethics, and has taught the law of business organizations at Fairleigh Dickinson University and the mergers and acquisitions transactional skills course at Seton Hall Law School. He is the author of numerous articles which have appeared in the *New Jersey Law Journal*, *New Jersey Lawyer Magazine* and other publications. Mr. Pietrafesa is the author of the chapter on drafting complaints in *New Jersey Federal Civil Procedure 2010* (New Jersey Law Journal Books) and the chapter on post-trial motions in the Defense Research Institute's *Trial Tactics Defense Litigation Manual*. He was the recipient of the 2012 Distinguished Legislative Service Award from the New Jersey State Bar Association in recognition of his work on and advocacy for the RULLCA and the 2020 Alfred C. Clapp Award, ICLE's highest honor, for excellence in continuing legal education.

Mr. Pietrafesa received his B.S., *summa cum laude*, from Fairleigh Dickinson University and his J.D. from Seton Hall University School of Law, where he was an Editor of the *Seton Hall Legislative Journal*. He was a law secretary to the late Honorable Nicholas G. Mandak, Assignment Judge, Passaic County Vicinage, Superior Court of New Jersey.

Ektaa Sanghvi Shah, CPA, MST is a Shareholder in CPA4TAX, LLP in Kendall Park, New Jersey. After beginning her career at a renowned Big 4 firm, where she gained experience in diverse Industries including life sciences and consumer goods, she joined CPA4TAX in 2019 and works alongside her father to lead the firm to success and innovation.

Ms. Shah is involved in community service and leadership. She is Treasurer and a member of the Board of Directors of the non-profit organization Womanspace.

Ms. Shah received her undergraduate and graduate degrees from Rutgers Business School.

Anthony Wilkinson, Wilkinson Law LLC in Edison, New Jersey, has an extensive background in technology, finance and business law, and analyzes his clients' industries, business interests and legal needs. He helps clients fund, grow, protect and sell their businesses.

Admitted to practice in New Jersey and New York, Mr. Wilkinson has served as President of an organization that managed the investment activities and tax reporting of the corporate general partner for a five-member investment partnership. He is Adjunct Professor of Business Law at Pillar College and has lectured for ICLE, the New Jersey State Bar Association and other organizations.

Mr. Wilkinson received his B.S. in Electrical Engineering, *summa cum laude*, from the University of Michigan and his J.D. from Yale Law School, where he was Editor of *Yale Law and Policy Review*. He was a judicial law clerk to Chief Justice Robert N. Wilentz, New Jersey Supreme Court.