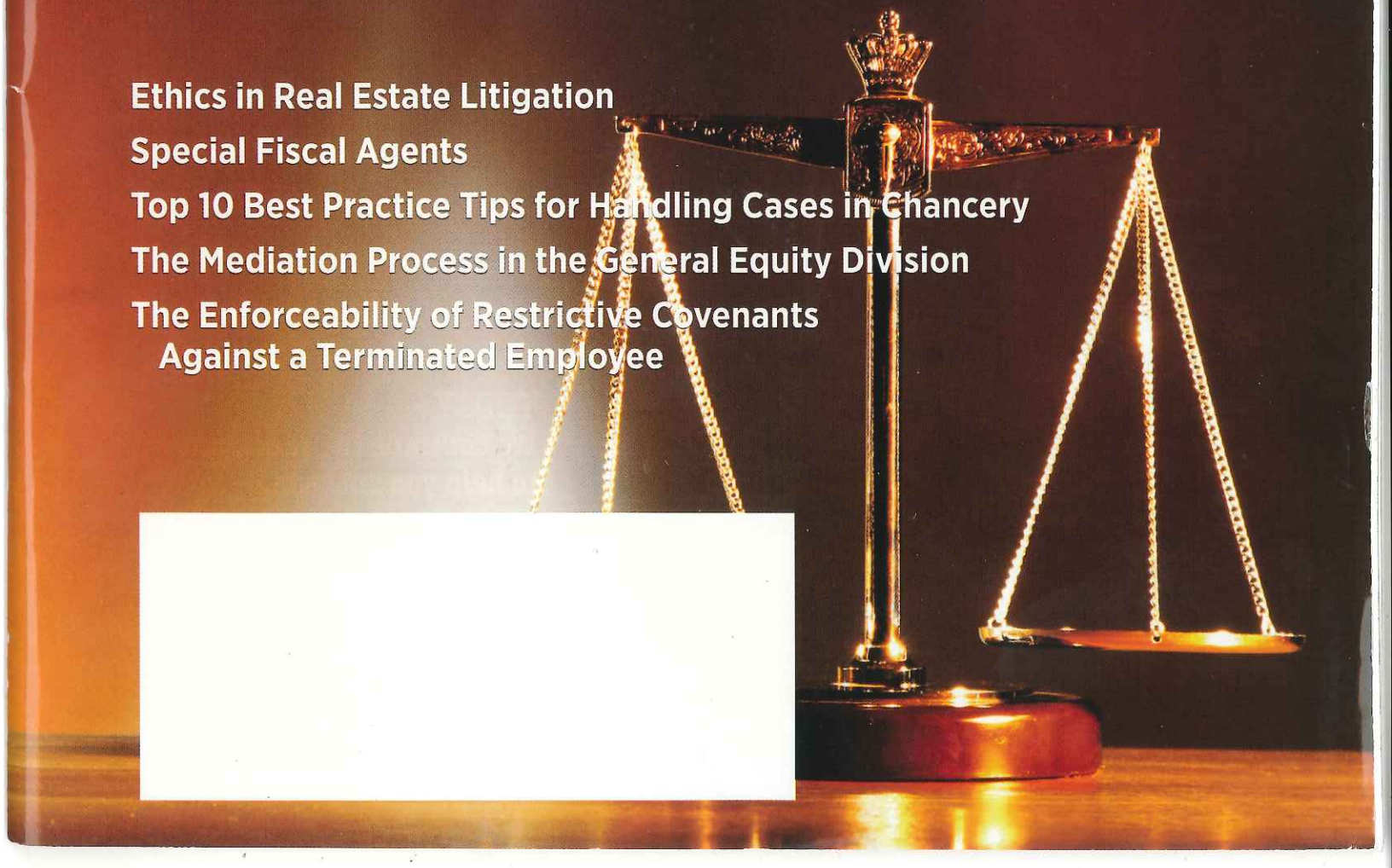
NEW JERSEY LAWYER
Magazine
April 2014/ No. 287

CHANCERY PRACTICE



Ethics in Real Estate Litigation

Special Fiscal Agents

Top 10 Best Practice Tips for Handling Cases in Chancery

The Mediation Process in the General Equity Division

The Enforceability of Restrictive Covenants Against a Terminated Employee

New Remedies for LLC Members

Oppression and Fiduciary Duties Under the Revised Uniform Limited Liability Company Act

by Andrea J. Sullivan and Steven B. Gladis

Now that the Revised Uniform Limited Liability Company Act[1] has replaced the New Jersey Limited Liability Company Act[2] as the sole statutory authority governing the rights and responsibilities of limited liability companies (LLCs) and their members,[3] it will provide chancery litigators with new tools and clearer guidance in representing and counseling aggrieved LLC members.

Perhaps most importantly, the revised act goes beyond its predecessor in specifically recognizing a cause of action for oppression and granting courts broad discretion to employ a variety of equitable remedies, up to and including dissolution of the LLC, to remedy such oppression. The revised act also goes further than its predecessor in expressly defining the fiduciary duties members owe to an LLC, and to one another, while still leaving members with the flexibility to modify those duties that is one of the hallmarks of the LLC form.

Oppressed Minority Members Under the Revised Act

While the original act permitted a court to dissolve an LLC upon a finding that it "is not reasonably practicable to carry on the business in conformity with an operating agreement,"[4] it did not provide any judicial remedy for situations where controlling members' oppressive conduct may harm minority members even while the company is still able to carry on its business. Indeed, courts specifically rejected claims of oppression by minority LLC members because the statute did not provide them with rights similar to those available under the oppressed minority shareholder statute.[5]

The revised act, on the other hand, specifically permits a court to order dissolution of an LLC "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."[6]

Although this language, taken from the model uniform statute, is not quite identical to the "oppression" provision of the oppressed minority shareholder statute,[7] courts will almost certainly look to the existing law governing shareholder oppression to give substance to the revised act's oppression provision. Therefore, an oppressed LLC member will have a cause of action when the controlling members engage in: 1) illegal conduct, 2) fraudulent conduct, or 3) unfair conduct that frustrates the minority member's reasonable expectations.[8]

The revised act...specifically permits a court to order dissolution of an LLC "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."

Dissolution is not the only remedy available to an oppressed member.[9] Indeed, the revised act goes beyond the model uniform act on which it is based by specifically describing certain equitable remedies available to oppressed mem-

NJSBA.COM

bers, which are similar to the remedies available under the oppressed minority shareholder statute. For example, the revised act provides that "[t]he court shall appoint a custodian or one or more provisional managers if it appears to the court that such an appointment may be in the best interests of the limited liability company and its members."[10]

The revised act also permits a court to order a buy-out to remedy oppression: "The court may...order the sale of all interests held by a member who is a party to the proceeding to either the limited liability company or any other member who is a party to the proceeding, if the court determines in its discretion that such an order would be fair and equitable to all parties under all of the circumstances of the case."[11] This buy-out remedy is substantively identical to the buy-out remedy available under the oppressed minority shareholder statute.[12] Therefore, although the revised act does not provide any further guidance regarding valuation or the mechanics of such a buy-out, courts will likely look to the oppressed minority shareholder statute, and cases decided under it, for guidance.[13]

One issue that is not resolved by the text of the statute is retroactivity: Can a minority member seek remedies for oppression that occurred before the effective date of the revised act?

Since oppression is often an ongoing series of acts, rather than a single, isolated incident, this may not be a concern in many cases where the oppressive conduct continues after the effective date of the revised act. However, in situations where the alleged oppressive conduct occurred only before the revised act took effect, defendants may have an argument to avoid liability. Generally, New Jersey courts favor prospective application of statutes and will apply statutes retroactively only in very narrow circumstances, such as when the Legislature expressly provides for retroactivity.[14] Therefore, in appropriate circumstances, a court may find alleged oppressive conduct that solely predates the effective date of the revised act falls outside the scope of the revised act's oppression remedy, although no court has yet had occasion to address the issue.

The oppression cause of action, and the remedies available under it, were not available under the original act, and will open new paths for minority LLC members to seek relief when controlling members engage in unfair conduct that does not necessarily render the business completely unable to function.

Fiduciary Duties Under the Revised Act

The revised act also provides additional clarity by more specifically setting forth the fiduciary duties—especially the duty of loyalty—members owe to the LLC and to one another.

Where the original act did not define the scope of the duty of loyalty, the revised act specifically explains that the duty of loyalty

> 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.[15]

In particular, the revised act's default rule is far more restrictive with regard to self-dealing than its predecessor. The original act explicitly removed any prohibition on interested-party transactions, providing that:

> a member or manager may lend money to, borrow money from, act as a surety, guarantor or endorser for, guarantee or assume one or more specific obligations of, provide collateral for, and transact other business with a limited liability company and, subject to other applicable law, has the same rights and obligations with respect to any such matter as a person who is not a member or manager.[16]

The revised act, on the other hand, specifically prohibits self-dealing.[17] However, the harshness of this prohibition is mitigated by the fact that fairness to the LLC is a defense to any claim of self-dealing.[18]

Regarding the duty of care, the revised act is consistent with its predecessor in requiring only that members or managers "refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."[19]

Importantly, the revised act also clarifies that members in a member-managed LLC owe fiduciary duties not only to the entity, but also to one another.[20] The original act, on the other hand, did not address this issue, and courts had suggested that only managing members owed fiduciary duties to other members, while non-managing members did not owe such duties to other members.[21]

Thus, the revised act's more clearly defined fiduciary duties, and the fact that members in a member-managed LLC expressly owe these duties to one another, regardless of how management authority is distributed, will provide additional avenues for an aggrieved member to seek redress. At the same time, however, a member's right to sue

personally for breach of fiduciary duty is still limited by the requirement that, to state a direct action rather than a derivative action, the aggrieved member must "plead and prove an actual or threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the limited liability company."[22]

Contractual Modification of Fiduciary Duties Under the Revised Act

Although the revised act imposes more robust fiduciary duties than its predecessor, it still leaves members a substantial amount of the flexibility that is central to the LLC form. As with most aspects of LLC governance, the fiduciary duties set forth in the revised act are merely default rules and the members may, through their operating agreement, substantially modify or eliminate their duties.

For example, the revised act permits an operating agreement, "if not manifestly unreasonable," to "alter the duty of care, except to authorize intentional misconduct or knowing violation of law."[23] That means an LLC may exonerate its members or managers from grossly negligent or reckless breaches of the duty of care.

Likewise, "if not manifestly unreasonable, an operating agreement may" restrict or eliminate any aspect of the default duties of loyalty established by the revised act, discussed above.[24] The operating agreement also may, so long as not manifestly unreasonable, "identify specific types or categories of activities that do not violate the duty of loyalty,"[25] or "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."[26] And, even if the operating agreement does not prospectively authorize an act that would otherwise violate the duty of loyalty, the members may retrospectively "authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty."[27]

In each instance, members' rights to absolve breaches of the fiduciary duties through their operating agreement are subject to the requirement that such exculpatory provisions not be "manifestly unreasonable." Therefore, even where an operating agreement purports to restrict or eliminate members' duties, an aggrieved member may still challenge those restrictions as manifestly unreasonable. However, the revised act sets a high bar for such a challenge.

In deciding whether a term is manifestly unreasonable, a court must "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."[28] A court may only invalidate a provision as manifestly unreasonable "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."[29] Given this restrictive standard of review, manifestly unreasonable challenges will likely be a narrow avenue of relief for litigants whose operating agreements bar fiduciary-duty claims.

Conclusion

These provisions of the revised act illustrate one of the fundamental tensions in LLC law: Preserving the flexibility that has made the LLC form so popular while protecting against overreaching by controlling members. In balancing those interests, the revised act goes further than its predecessor in protecting minority members, including by recognizing a cause of action for oppression and by setting out more robust default standards of fiduciary duty. These new provisions of the revised act will provide new tools, and new challenges, for chancery practitioners representing LLCs and their members. ⚖

Endnotes

1. N.J.S.A. 42:2C-1 to -94.
2. N.J.S.A. 42:2B-1 to -70.
3. The revised act was adopted in Sept. 2012, and took effect in stages. Beginning on March 18, 2013, it applied only to LLCs created on or after that date, and to existing LLCs that specifically amended their operating agreements to adopt it, while other existing LLCs continued to be governed by the original act. N.J.S.A. 42:2C-91(a). On March 1, 2014, the revised act took effect for all LLCs and superseded the original act completely. N.J.S.A. 42:2C-91(b).
4. N.J.S.A.42:2B-49.
5. *See Tutunikov v. Markov*, 2013 N.J. Super. Unpub. LEXIS 1935, at *22-23 (App. Div. Aug. 1, 2013) (*citing Denike v. Cupo*, 394 N.J. Super. 357, 378 (App. Div. 2007), *rev'd on other grounds*, 196 N.J. 502 (2008)).
6. N.J.S.A. 42:2C-48.
7. *See* N.J.S.A. 14A:12-7(c) (authorizing oppression remedy where "directors or those in control have acted fraudulently or illegally, mismanaged the corporation, or abused their authority as officers or directors or have acted oppressively or unfairly toward one or more minority shareholders in their capacities as shareholders, directors, officers, or employees").
8. *See, e.g., Brenner v. Berkowitz*, 134 N.J. 488, 506 (1993) ("Oppression has been defined as frustrating a shareholder's reasonable expectations.").
9. N.J.S.A. 42:2C-48(b)("[T]he court may order or a party may seek a remedy other than dissolution.").
10. *Id.*; *see also* N.J.S.A. 14A:12-7(3), (4) (authorizing appointment of provi-

sional directors or custodian "if it appears to the court that such an appointment may be in the best interests of the corporation and its shareholders").

11. N.J.S.A. 42:2C-48(b).
12. N.J.S.A. 14A:12-7(8).
13. *See, e.g.*, N.J.S.A. 14A:12-7(8); *Balsamides v. Protameen Chems., Inc.*, 160 N.J. 352 (1999).
14. *See, e.g., Cruz v. Cent. Jersey Landscaping, Inc.*, 195 N.J. 33 (2008) ("We have long followed a general rule of statutory construction that favors prospective application of statutes.... To be sure, retroactivity is appropriate, in general, when it is expressed, when an amendment is curative, or when the expectations of the parties so warrant. Only if one of those grounds is present, will we give a statute retroactive effect." (Internal quotation marks and citations omitted)).
15. N.J.S.A. 42:2C-39(b), (i)(1).
16. N.J.S.A. 42:2B-9.
17. N.J.S.A. 42:2C-39(b)(2).
18. N.J.S.A.42:2C-39(g).
19. N.J.S.A. 42:2C-39(c), (i)(1); *cf.* N.J.S.A. 42:2B-26, 30.
20. N.J.S.A. 42:2C-39(a).
21. *In re D'Amore*, 472 B.R. 679, 689 (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. However, in the absence of management responsibility and control, members do not owe such fiduciary duties to each other. There is no basis in law 'for imposing such a duty upon one member of an LLC in relation to others who stand on equal footing.'" (citations omitted) (*quoting Antolino v. Quinn*, 2009 N.J. Super. Unpub. LEXIS 1181, at *4 (App. Div. May 18, 2009))).
22. N.J.S.A. 42:2C-67(b).
23. N.J.S.A. 42:2C-11(d)(3).
24. N.J.S.A. 42:2C-11(d)(1).
25. N.J.S.A. 42:2C-11(d)(2).
26. N.J.S.A. 42:2C-11(e).
27. N.J.S.A. 42:2C-39(f).
28. N.J.S.A. 42:2C-11(h)(1).
29. N.J.S.A. 42:2C-11(h)(2).

Andrea J. Sullivan *is a partner in the litigation department of Greenbaum, Rowe, Smith & Davis LLP, who focuses her practice in the areas of chancery, probate and other complex commercial litigation.* ***Steven B. Gladis*** *is an associate in the litigation department of Greenbaum, Rowe, Smith & Davis LLP, who focuses his practice in the area of complex commercial litigation.*