Delaware LLC vs. New Jersey LLC for Complex Business Transactions
Why it might be worth forming your business entity out of state
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You are advising a client regarding the organization of a new business venture to be based in New Jersey. You have determined to recommend a limited liability company as the form of business entity. Another decision remains: New Jersey LLC or Delaware LLC?

In many cases the decision will be easy because no compelling business reason will justify the additional annual costs, even though not material, of maintaining an out-of-state business entity qualified to transact business in New Jersey. However, if the agreement among the owners will be complex; if you anticipate partnering with a venture capital fund, private equity fund or other institutional investor; or if you anticipate accessing the capital markets for financial support, the balance ought to tip toward Delaware.

Why? Essentially for the same reasons that Delaware corporations are the vehicle of choice for complex and sophisticated business ventures that are organized in the corporate form:

• Business organizations are a cottage industry in Delaware. The Delaware Legislature, working with the business bar in Wilmington, regularly revises the Delaware Limited Liability Company Act, 6 Del. C. §18-101, et seq., (the “Delaware Act”) to address judicial decisions and business trends.

• The Court of Chancery is the premier business court in the United States. A judge well-versed in business issues will likely resolve a dispute among owners far more quickly than the Superior Court of New Jersey.

• On several matters of substantive concern in complex business arrangements involving LLCs, the Delaware Act is arguably superior to the New Jersey Revised Uniform Limited Liability Company Act, N.J.S.A. 42:2C-1, et seq. (the “New Jersey Act”).

This article will focus on select key differences between the New Jersey Act and the Delaware Act.

• Freedom of contract under the New Jersey Act is qualified. A hallmark of the LLC form is flexibility. Individuals may create an organization that, by contract in an operating agreement, reflects their view of the appropriate ownership and management rights and the other elements of their business arrangement.

   In this regard, §18-1101 (b) of the Delaware Act states a legislative intent to give maximum effect to the principle of freedom of contract and to the enforceability of
operating agreements. Similarly, N.J.S.A. 42:2C-11i states that the New Jersey Act “is to be liberally construed to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements.”

However, the statutory pronouncement in the New Jersey Act is misleading. Section 11i is oddly placed at the end of a section which otherwise tempers the contract freedoms of LLC members by delineating various things that an operating agreement may not do. This clause does not appear in the Model Revised Uniform Limited Liability Company Act promulgated by the National Conference of Commissioners of Uniform State Laws in July 2006, upon which the New Jersey Act was based. It was added by the New Jersey Legislature. In the very statutory section (N.J.S.A. 42:2C-11 or “Section 11”) that trumpets freedom of contract, the New Jersey Act contains stark differences with the truer freedom of contract existing under the Delaware Act.

- **The New Jersey Act’s approach to fiduciary duties is murky.** Under the Delaware Act, the existence and scope of fiduciary duties of LLC members and managers is clearly a matter that may be subject to the parties’ contract. The Delaware default rule (at §18-1104) is that traditional common law rules of law and equity relating to fiduciary duties apply to LLCs. However, the Delaware Act (at §18-1101(c)) also states that such duties may be “expanded or restricted or eliminated by” agreement.

The New Jersey Act’s approach to fiduciary duties is cumbersome and difficult to discern from the statutory language. Section 42:2C-39 of the New Jersey Act defines the fiduciary duties of loyalty and care, and the applicability of such duties in member-managed and manager-managed LLCs.

Section 11 prohibits eliminating the duty of loyalty, the duty of care or “any other fiduciary duty.” But the prohibition is qualified. “If not manifestly unreasonable” an operating agreement may:

- restrict or eliminate duties to account for use by a member of company property or the appropriation of a company opportunity;
- restrict or eliminate duties to refrain from dealing with the company in the conduct of the business or on behalf of a party having an interest adverse to the company;
- restrict or eliminate the duty to refrain from competing with the company;
- identify specific activities that do not violate the duty of loyalty;
- alter the duty of care, except to authorize intentional misconduct or knowing violation of law; and
- alter any other fiduciary duty, including eliminating particular aspects of that duty.
The notion that the duty of loyalty may not be eliminated, but that it may be modified puts the draftsperson in a conundrum. Equally confusing is the notion that any “other” undefined fiduciary duty may be altered and particular aspects eliminated. Moreover, “manifestly unreasonable” is not defined. Rather, the statute states that a reviewing court must engage in a facts-and-circumstances analysis at the time of the agreement as to whether: (i) the objective of the applicable operating agreement provision is unreasonable; and (ii) the provision is an unreasonable means to achieve its objectives. Thus, there is no assurance that contract provisions purporting to alter the statutory default rules on fiduciary duties will survive a challenge.

As a corollary to the right to eliminate fiduciary duties under the Delaware Act, §18-1101(e) of the Delaware Act also permits exculpation for breach of contract and breach of fiduciary duties. Thus, under the Delaware Act, the parties have the freedom to proscribe fiduciary duties, but eliminate liability for breach of such duties. The sole limitation is that the parties’ agreement may not limit liability for any “act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”

Section 11 of the New Jersey Act permits exculpation of members or managers for money damages, but the ability to exculpate is limited. Liability for the following may not be eliminated: (i) breach of the duty of loyalty; (ii) a financial benefit received by a member or manager to which the person is not entitled; (iii) breach of the liability for an unauthorized distribution by the company under Section 36 of the New Jersey Act, N.J.S.A. 42:2C-36; (iv) an intentional infliction of harm; or (v) an intentional violation of criminal law.

- **Delaware permits elimination of information rights; unclear in New Jersey.** The New Jersey Act has a statutory default rule giving members and managers the right to financial and other information regarding an LLC. N.J.S.A. 42:2C-40. However, Section 11 states that an operating agreement may not unreasonably restrict such rights.

The Delaware Act also affords members and managers information rights. However, the applicable section also states that information rights may be restricted by agreement. §18-305(g) of the Delaware Act. Thus, in Delaware, the contract freedom is not nuanced by a reasonableness standard.

- **The right to judicial dissolution may be waived in Delaware.** Both the New Jersey Act and the Delaware Act give members the right to seek judicial dissolution of an LLC if it is not reasonably practicable to carry on the company’s activities in conformity with its operating agreement. N.J.S.A. 42:2C-48(4)(b); §18-802 of the Delaware Act. Under Section 11 of the New Jersey Act, however, this member remedy is among the items which may not be varied by an operating agreement.
In contrast, the Delaware Act does not, by its terms, preclude parties from contracting out of the right to judicial dissolution.

A recent decision by the Delaware Court of Chancery highlighted that “Delaware law with regard to limited liability companies is contractarian.” In *Huatuco v. Satellite Healthcare*, 2013 WL 6460898 (Del. Ch. Dec. 9, 2013), the issue before the court was whether the members’ agreement that they “shall only have the power to exercise any and all rights expressly granted to the Members” under an operating agreement constituted a waiver of the right to petition for judicial dissolution in the case of a deadlock.

The court determined that the judicial dissolution provision was not mandatory, the parties had addressed dissolution in their agreement, and the parties had rejected all default rights under the Delaware Act except as otherwise required by law.

- **The Acts’ approaches to indemnification differ.** Under the Delaware Act, the existence and scope of an LLC’s obligation to indemnify and hold harmless members or managers are purely a matter of contract. There is no default rule requiring indemnification or placing a limit on permitted indemnification if it is included in an operating agreement. Under the New Jersey Act, N.J.S.A. 42:2C-38, if the matter is not addressed in an operating agreement, the general rule is that indemnification, subject to certain qualifications, is mandatory.

- **Transfers of LLC interests may have different consequences.** Neither the New Jersey Act nor the Delaware Act contains a defined term which describes the full bundle of rights held by a member of an LLC. Under the New Jersey Act, the right to receive distributions from the company originally associated with a person’s capacity as a member (in other words, the economic interest) is referred to as a “transferable interest.” N.J.S.A. 42:2C-2. The comparable term in the Delaware Act is “limited liability company interest,” defined as a member’s share of profits and losses and a member’s right to receive distributions from the company. §18-101(8) of the Delaware Act.

The acts’ default rules on the consequences of a transfer of economic rights are different. Under the Delaware Act, unless an agreement provides otherwise, on the transfer of all of a member’s “limited liability company interest” the member will cease to be a member and have the power to exercise the rights of a member (these may include voting and information rights). §18-702(b)(3) of the Delaware Act. However, under the New Jersey Act, unless an agreement provides otherwise, on a member’s transfer of the member’s “transferable interest,” the transferor will retain all rights and obligations of the member other than the interest in distributions transferred. While transfer provisions of operating agreements need to be carefully thought through under both acts, absent careful drafting under the New Jersey Act, the stakeholders in a New Jersey LLC may be surprised to learn that an economic...
transferor has retained voting rights and member burdens, such as the right to contribute capital.

In sum, while there is undoubtedly substantial contractual freedom under the New Jersey Act to structure the terms of members’ economic interests and to design a company governance structure, the New Jersey Act’s expression of maximum freedom of contract is contradicted by the very section in which it appears and other default rules under the act. In some respects, the New Jersey Act can be more aptly characterized as balancing an objective of contract freedoms against a perceived need to provide some degree of protection to persons who are not in control of an LLC.

It is difficult to explain to many clients why a new venture with a clear nexus to New Jersey should be formed under the laws of another state, and additional organizational and annual administrative costs incurred. An initial decision to go with the home state entity will not give rise to substantial costs if business developments ultimately dictate a change. A New Jersey LLC may be easily converted to a Delaware LLC under the domestication and conversion provisions of the New Jersey Act, N.J.S.A. 42:2C-82, and the Delaware Act, §18-214. Once converted, all property rights and obligations of the New Jersey entity will become property and obligations of the converted Delaware entity as a matter of law.

Expect the conversion request when the original members partner with sophisticated equity or debt investors.

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