The Metropolitan Corporate Counsel®

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October 2013 Volume 21, No. 10

A New Statutory Remedy For Oppressed Members Of LLCs – Not Necessarily A Panacea

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New Jersey and at least seven other states and the District of Columbia have adopted the Revised Uniform Limited Liability Company Act, codified in New Jersey as *N.J.S.A.* 41:2C-1, *et seq.* ("RULLCA"). RULLCA is effective as to all New Jersey LLCs formed on and after March 18, 2013 and, unless an earlier opt-in is elected by a pre-existing LLC, to all New Jersey LLCs effective March 1, 2014.

Among the notable differences between RULLCA and its predecessor New Jersey statute, as well as many of the first generation limited liability company statutes, is the inclusion of an oppressed member remedy. *See N.J.S.A.* 41:2C-48a(5)(b). That section permits a member to apply to court for "an order dissolving the company on the grounds that the managers or those members in control of the company … have acted … in a manner that is illegal or fraudulent; or … in a manner that is oppressive and was, is, or will be directly harmful to the applicant."

Under New Jersey's original Limited Liability Company Act, *N.J.S.A.* 42:2B-1, *et seq.* (the "Old Act"), a dissatisfied member could simply resign from the company. *N.J.S.A.* 42:2B-38. A resigned member

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would be entitled to receive, within a reasonable time following resignation, the fair value of the member's interest in the company, less applicable valuation discounts. *N.J.S.A.* 42:2B-39. Both of the foregoing remedial provisions could be modified or eliminated by an operating agreement. The Old Act also provided for the possibility of judicial dissolution on application by a member upon a showing that it was "not reasonably practicable to carry on the business in conformity with an operating agreement," *N.J.S.A.* 42:2B-49, a remedy addressed to irreconcilable differences and deadlock (the "Deadlock Remedy"). The Deadlock Remedy continued under RULLCA at *N.J.S.A.* 42:2C-48a(4). The Old Act also provided for the possibility that a member could be expelled by a judicial determination that the member "engaged in wrongful conduct that adversely and materially affected the limited liability company's business." *N.J.S.A.* 42:2B-24(b)(3)(A). But, the Old Act did not provide a specific remedy for an aggrieved minority member. *Tutunikov v. Markov,* 2013 WL 3940889, at *8 (N.J. App. Div. Aug. 1, 2013) (noting that the Old Act has no oppressed member provision).

The potential new remedy to an oppressed minority member of a New Jersey limited liability company is comparable to the statutory remedy provided to minority shareholders of closely held New Jersey corporations under the New Jersey Business Corporation Act (the "BCA"). *See N.J.S.A.* 14A:12-7. RULLCA, as adopted in New Jersey, like its counterpart in the BCA, permits a court to order a remedy other than dissolution, such as the appointment of a custodian or one or more provisional managers. One noticeable difference is that under the BCA, the court can award attorneys fees to a selling shareholder if the court finds that "the action was maintainable under paragraph 14A:17-7(1)(c)" *or* to any party if the court finds another party has acted "arbitrarily, vexatiously, or otherwise not in good faith." *N.J.S.A.* 14A:12-7(8)(d) and 14A:12-7(10). Under RULLCA, the court can only award attorneys fees if it makes a finding that another party has acted "arbitrarily, vexatiously, or otherwise not in good faith." *N.J.S.A.* 42:2C-48(c). There was no entitlement to attorneys fees under the Old Act. *Tutunikov v. Markov,* 2013 WL 3940889, at *13.

Notably, the Delaware Limited Liability Company Act, the statute of choice for many sophisticated business ventures organized as LLCs, does not contain an express oppressed minority member remedy. It does provide a Deadlock Remedy.

Whether the new remedy under RULLCA will be meaningful to an allegedly oppressed member of a New Jersey limited liability company or an LLC formed under a RULLCA counterpart in another jurisdiction is questionable. Existing case law under the corporation oppressed minority shareholder provision suggests that the remedy is available only sparingly.

A statutory claim for oppression under Section 14A:12-7(1)(c) authorizes only "limited bases for statutory relief." *Brenner v. Berkowitz*, 134 N.J. 488, 506 (1993). The guiding principal for courts asked to review

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matters of corporate governance remains the business judgment rule. *Id*. "Mere disagreement or discord between the shareholders is not sufficient for a violation of the close corporation statutory provision." *Id*. Rather, New Jersey remains firmly committed to the principle of majority rule in corporate governance. *Strasenburgh v Straubmuller*, 146 N.J. 527, 555 (1996).

To succeed on their claim of oppression, plaintiffs must demonstrate that their "reasonable expectations" as shareholders have been frustrated. *See, e.g., Brenner,* 134 N.J. at 506. As shareholders, plaintiffs have no more than "an underlying reasonable expectation that [their] stock will sooner or later provide an economic return." *Kelley v. Axelsson,* 296 N.J. Super. 426, 431 (App. Div. 1997) (internal quote omitted).

To establish oppression, plaintiffs also must demonstrate acts "specifically targeted" at them and a "nexus" between the challenged conduct and their investment interest in the company. *Brenner,* 134 N.J. at 508. Moreover, plaintiffs must show that their investment has been *uniquely* harmed: conduct that "d[oes] not affect the interests of minority shareholders to any greater extent than it impact[s] upon the interests of majority shareholders" cannot constitute oppression. *Whalen v. Schoor, DePalma & Canger Group,* 305 N.J. Super. 501, 508 (App. Div. 1997).

Shareholders' expectations not only must be "reasonable," but they must also be balanced against the corporation's ability to run its business efficiently, which is evaluated under the business judgment rule. *See Brenner,* 134 N.J. at 517, *Strasenburgh,* 146 N.J. at 555; *see also Muellenberg v. Bikon Corp.,* 143 N.J. 168, 179 (1996) ("[M]inority shareholders' expectations must, however, be balanced against the corporation's ability to exercise its business judgment and run its business efficiently.")

Arguably, in many cases, the statutory remedy for allegedly an oppressed minority owner of an LLC should even be more difficult to obtain.

Unlike a corporation, where the standards of corporate operations and governance are grounded in statute and case law, the hallmark of an LLC has always been and continues under RULLCA to be the right of the members to structure their relationship and their rights, duties and obligations vis-a-vis each other in an operating agreement. Indeed, as enacted in New Jersey, RULLCA "is to be liberally construed to give the maximum effect to the principal of freedom of contract and to the enforceability of operating agreements." *N.J.S.A.* 42:2C-11(i).

This freedom of contract is not absolute, and RULLCA does list several statutory default rules that may not be varied under an operating agreement. Notably, one of these items is the power of a court to decree dissolution on application by an oppressed member under *N.J.S.A.* 42:2C-48a(5). Nevertheless, whether a minority member of an LLC has been oppressed must be assessed with due regard to the overall terms of the contract that the member has signed.

In a corporation, the control persons owe minority shareholders the fiduciary duties of care and loyalty. However, an LLC operating agreement may eliminate these duties "if not manifestly unreasonable." *N.J.S.A.* 41:2C-11(d). Thus, for example, by contract, control persons of an LLC may be permitted to usurp company opportunities, may engage in competing businesses, and may use company proprietary information for their personal benefit.

Moreover, an operating agreement may not afford minority members any voting rights or any protection against anti-dilution, may restrict access to company information, may specifically provide for the authorization of equity interests senior to those held by existing members, and may give control persons unfettered discretion in setting management fees and compensation payable to themselves.

If a minority member signs an agreement that affords such person virtually no protection by way of duties owed by control persons or otherwise, it seems to follow that it would be very hard – if not impossible – for a minority member to show that his or her reasonable expectations were frustrated where the majority member acted in accordance with the terms of the operating agreement.

The minority investor in a newly formed venture structured as an LLC may be willing to accept contractual subjugation to the will of the majority based upon the investor's faith and trust in the control persons or a comfort level with the individuals who control the controlling parties. Indeed, signing an agreement containing seemingly draconian terms may be the only means to co-invest with a controlling private equity or venture capital fund.

As noted above, operating agreement provisions eliminating default standards of care and fiduciary duties owed by control persons are permissible only "if not manifestly unreasonable." The statute provides guidance to courts in making a determination whether a term of an operating agreement is manifestly unreasonable. The determination must be made as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time. A court may invalidate the term only if, in light of the purposes of the company, it is readily apparent that the objective is unreasonable or the term is an unreasonable means to achieve the provision's objective. *N.J.S.A.* 42:2C-11(h).

There is some helpful commentary to RULLCA in the form approved by the National Conference of Commissioners of Uniform State Laws (available at *www.uniformlaws.org/Acts.aspx*.) regarding the "not manifestly unreasonable" standard. In particular, the commentary contains the following 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. This individual has a rare combination of skills, experiences, and contacts, which are particularly appropriate for the LLC's startup. 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 turned prosaic and the manager's talents and background are not nearly so crucial, a member challenges the fiduciary duty limitations as manifestly unreasonable. The relevant time under subsection (h)(1) is when the LLC began. Subsequent developments are not relevant, except as they might inferentially bear on the circumstances in existence at the relevant time.

The bottom line is that a practitioner advising a prospective minority member in a business organized as an LLC or counseling a person who claims to have been oppressed by the control persons needs to recognize the importance of the operating agreement of an LLC. This principle applies regardless of whether the applicable enabling statute contains an express oppressed minority member remedy as long as the statute emphasizes freedom of contract. The parties' initial expectations can be grafted into an agreement by way of recitals or otherwise.

In most cases, the oppressed minority member remedy is likely to be unattainable. The best route to an exit from a limited liability company investment that does not meet an investor's expectations at inception always has been and remains negotiating the terms of a buy-out into the operating agreement.