

# Why New Jersey Should Adopt RULLCA

by Ira B. Marcus

The limited liability company (LLC) is a relatively new form of unincorporated business entity. It was first introduced into the United States when Wyoming adopted an LLC statute in 1977. It received little attention until 1988, when the Internal Revenue Service (IRS) promulgated the Kintner regulations.<sup>1</sup> These regulations provided that limited liability, by itself, would not disqualify an unincorporated entity from partnership tax treatment so long as it had, on the whole, more partnership characteristics than corporate characteristics. Thus, it was possible, with careful planning, for a limited liability company to combine the limited liability of a corporation with the pass-through tax treatment of a partnership.

New Jersey became the 35th state to enact LLC legislation when it adopted the New Jersey Limited Liability Company Act,<sup>2</sup> which became effective on Jan. 26, 1994. At that time, there were two types of LLC statutes being enacted by the states. Some contained rigorous requirements that precluded LLCs from having too many "corporate characteristics" that would jeopardize their partnership tax status. Others allowed more flexibility, but required practitioners forming an LLC to carefully plan with the Kintner regulations in mind.

Our Legislature initially intended to model our LLC statute on Colorado's, which was a statute of the first type, having been the first enabling statute enacted after the adoption of the Kintner regulations. With input from the Corporate and

Business Law Section of the New Jersey State Bar Association, however, it reconsidered, and instead modeled our statute on the more flexible Delaware Limited Liability Company Act,<sup>3</sup> enacted in 1992.

The popularity of LLCs began to explode in 1997, when the IRS eliminated the tax classification issues, borne of the complexity of the Kintner regulations, that had plagued the LLC. Starting in 1997, per so-called 'check-the-box' regulations, an unincorporated business entity may choose to be taxed either as a partnership or a corporation (special treatment applies to single-member entities). As a result, LLCs have become the business entity form of choice for new businesses, and far more New Jersey LLCs were formed in 2008 than corporations and limited partnerships combined. This is consistent with other states' experiences.

The Delaware Limited Liability Company Act, on which our statute was modeled, has been extensively revised, amended and restated. In fact, it is reviewed annually and amended often. By comparison, New Jersey's statute has undergone only the most modest revisions. Several technical amendments have been made, and following the adoption of the check-the-box regulations New Jersey's statute was revised to permit increased flexibility (e.g., allowing single-member LLCs).

The National Conference of Commissioners on Uniform State Laws (NCCUSL) is a nonprofit, unincorporated association that consists of commissioners appointed by each state, the District of Columbia,

the Commonwealth of Puerto Rico and the U.S. Virgin Islands. The purpose of the organization is to draft proposed uniform acts for those areas of the law that it determines could benefit from uniformity among the states. NCCUSL is best known for its work on the landmark Uniform Commercial Code, which it drafted in conjunction with the American Law Institute. In July 2006, NCCUSL adopted the Revised Uniform Limited Liability Act (RULLCA). RULLCA was the product of a three-year drafting effort with advisors from the American Bar Association present.

When the Business Entities Committee that I chair started studying our LLC statute, we quickly concluded that it was sorely in need of revision and updating. We initially considered piecemeal amendments, but when we studied RULLCA we soon came to the realization that it presented a scholarly yet pragmatic approach, combining the best elements of 'first-generation' LLC acts, such as ours, with modern elements borne of the check-the-box tax regulations, court cases, and practitioners' experience. Our committee issued its report to the directors of the Business Law Section early this year, and on April 6, 2009, the directors unanimously voted to support New Jersey's adoption of RULLCA, as proposed by the committee. At its October 2009 meeting, the trustees of the New Jersey State Bar Association also voted to support our committee's proposal.

It should be noted that the committee has proposed certain changes to RULLCA, as promulgated by the

NCCUSL, based on our experience as practicing lawyers in this state. For example: 1) we did not adopt the RULLCA requirement that there be a member at the time of formation, unless the certificate of formation states otherwise. We thought this provision was hyper-technical and unnecessary; 2) we included a more extensive deadlock/oppression section, modeled on N.J.S.A. 14A:12-7 (which is the subject of an insightful article by Gianfranco Pietrafesa in this newsletter); 3) we expanded RULLCA's indemnification section (which is the subject of a thoughtful article by Phil Chapman in this newsletter); 4) we deleted RULLCA's permissive name "limited company," or "LC" for short (there is already confusion regarding these entities, sometimes called limited liability corporations); and 5) we added a statutory norm that profits and losses be allocated in the same manner as distributions.

Unlike our present statute and the Delaware act, RULLCA leaves the allocation of profits and losses to tax, accounting and regulatory

requirements. We thought that including such a provision would be useful, especially given the large number of unsophisticated people who are forming their own LLCs without written operating agreements.

Other changes we made to RULLCA were necessitated by the structure and organization of New Jersey's existing statutes. Thus, for example, we added provisions dealing with alternate names (note: our provision is similar to N.J.S.A. 14A:2-2.1 in that it does not require an alternate name to include an LLC identifier). We also added a provision (Article 11) that provides for the filing of annual reports.

In all cases, we have been assured by members of NCCUSL's drafting committee that our changes did not detract from the essential benefits to be derived from the adoption of this uniform law.

This article sets forth the compelling reasons for replacing New Jersey's existing statute with a limited liability company statute based largely on RULLCA.

1. **We need and deserve a modern LLC statute.** Our existing LLC statute is a first-generation statute enacted long before the check-the-box regulations referred to above. Although our statute was amended after the check-the-box regulations became effective, these amendments were somewhat limited in scope and incomplete. By contrast, RULLCA is a second-generation LLC statute that takes into account the best elements of the first-generation LLC statutes and two decades of legal developments in the field. A modern statute will encourage business people to form their LLCs in New Jersey rather than in other states. Enacting a complete product like RULLCA is clearly preferable to adopting yet another set of amendments to our existing statute, which might not be internally or philosophically consistent with the balance of the statute.
2. **We can benefit from adopting a uniform law.** By adopting RULLCA, we will obtain the benefit of many years of hard work by NCCUSL that would be virtually impossible to replicate. We will also obtain the benefits attendant to adopting a uniform law. These benefits include guidance for our judges and practitioners from the thoughtful analysis of uniform laws by professional journals, law reviews, and the courts of other jurisdictions. New Jersey has already adopted the Uniform Partnership Act (1966)<sup>4</sup> and the Uniform Limited Partnership Law (1976),<sup>5</sup> both of which were promulgated by NCCUSL, and parallel the provisions of RULLCA in key ways.
3. **RULLCA eliminates pitfalls.** Our present statute, perhaps for historical reasons, contains a number of pitfalls for the unwary practitioner or layperson forming a limited liability company. For example, unless a certificate of formation provides that the LLC will have perpetual exist-

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tence, it will have a limited life. By way of further example, our statute provides, as a statutory norm, that a resigning member is entitled to receive the fair value of his or her LLC interest as of the date of resignation. This is a harsh, abnormal provision. By way of yet further example, as a default rule our statute permits an LLC to merge or consolidate with only a simple majority vote, and does not provide for appraisal rights for non-consenting members. This is likely contrary to the expectations of an LLC investor. RULLCA eliminates these pitfalls, and contains provisions more consistent with the expectations of business people.

4. **RULLCA permits domestication and conversion.** RULLCA provides enhanced ease and flexibility. Unlike our existing statute, it provides streamlined methods for domestication (e.g., allowing an LLC formed under the laws of another state to become a New Jersey LLC) and conversion (e.g., allowing a corporation to become an LLC).
5. **RULLCA provides remedies for deadlock and oppression.** RULLCA includes thoughtful provisions dealing with deadlock and the oppression of minority owners. The new statute New Jersey is being asked to enact has expanded on these RULLCA provisions by incorporating some of the best elements of the New Jersey Business Corporation Act<sup>6</sup> (BCA). The incorporation of these BCA provisions is important, because case law has suggested the courts will not utilize the remedies explicated in the BCA in the case of LLCs without authorizing legislation.
6. **The need for written operating agreements is problematical.** Although all 50 states and the District of Columbia have enacted LLC statutes, less than a handful require that operating agreements be in writing, as New Jersey's does. This require-

ment poses significant problems, since anecdotal evidence suggests that most LLCs formed in this state do not have written operating agreements. RULLCA permits operating agreements to be oral, written or implied based on the way in which an LLC has operated. This is not to say that counsel will not seek to draft appropriate operating agreements. RULLCA gives people forming LLCs great flexibility. For example, they can limit traditional fiduciary duties, provide broad exculpatory rights, and waive the right to have a receiver appointed.

7. **RULLCA provides for the indemnity of members and managers.** Our existing law provides for only permissive indemnification. Thus, a member or manager of an LLC is not entitled to be indemnified by the LLC except to the extent provided by the common principles of agency law. NCCUSL included a thoughtful indemnification provision in RULLCA. The new statute New Jersey is being asked to enact has expanded on the RULLCA provisions, again by incorporating some of the best elements of the BCA in this regard.
8. **We need better treatment regarding derivative actions.** New Jersey's current LLC law treats derivative actions in a somewhat cursory manner. By contrast, RULLCA's provisions are well-organized and more comprehensive. RULLCA permits an LLC to appoint a special litigation committee of independent and disinterested persons. Romney Grippo has written an astute article on this subject that is contained in this newsletter.

Will the 'conversion' to RULLCA be difficult? Not at all. Although RULLCA makes meaningful changes to our limited liability company law, it is similar enough to our current law that the transition should be relatively seamless. For example, the

transition would be much more difficult if, as in some other states, LLCs had to be denominated as being either member-managed or manager-managed in their certificates of formation. RULLCA is very creative when it comes to dealing with existing LLCs. The law is designed to take effect shortly (e.g., 60 days) after it is enacted, and to govern all LLCs formed after the effective date. However, it will not apply to existing LLCs until an "all-inclusive" date, one to two years after the effective date. This will give existing LLCs and their counsel time to study RULLCA and consider whether changes in structure or in the operating agreement are merited in light of the new law.

Twenty-one years have passed since the IRS issued the Kintner regulations that permitted Wyoming's LLCs to be taxed as partnerships notwithstanding that their members, like shareholders of corporations, were shielded from the liabilities of the entity. Twelve years have passed since the check-the-box regulations led to the boom in the number of LLCs that are formed. It is time for New Jersey to adopt a modern statute such as RULLCA to replace its current, outdated, statute. This will help New Jersey resurrect its reputation as a good state to do business in, and without any cost to its taxpayers. ■

#### ENDNOTES

1. 26CFR30.7701-1 to 301.7701-4.
2. N.J.S.A. 42:2B-1 *et seq.*
3. 6 Del. C. 18-101 *et seq.*
4. N.J.S.A. 42:1A-1 *et seq.*
5. N.J.S.A. 42:2A-1 *et seq.*
6. N.J.S.A. 14A:1-1 *et seq.*

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