THE NEW JERSEY LIMITED LIABILITY COMPANY STATUTE: BACKGROUND AND CONCEPTS

*Peter D. Hutcheon**

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A limited liability company (LLC) is a hybrid entity that combines attributes of both corporations and partnerships, but at its essence is neither.[1] An LLC is organized consensually like a partnership, with extraordinary flexibility to contract for particular arrangements among constituents, typically called members. In

* B.A., Williams College; J.D., Harvard Law School. Mr. Hutcheon is a corporate partner in the law firm of Norris, McLaughlin & Marcus, P.A., in Somerville, N.J. He is co-chairman of the Joint Limited Liability Company Working Group of the New Jersey State Bar Association's Corporate & Business Law and Taxation Law Sections. Mr. Hutcheon is a long-time member of the ABA Business Law Section's Partnership and Unincorporated Business Organization Committee and the editor of its newsletter, the *PUBOGRAM*. The author is grateful for the assistance of Steven J. Sauro, Esq. and Robert S. Wolmer, Esq., associates at Norris, McLaughlin & Marcus, in documenting authority for aspects of this article.

[1] Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 379 (1992). *See also* Bart J. Colli & Debra S. Groisser, *10 Points of Light on Limited Liability Companies*, 135 N.J.L.J. 1035 (1993) (defining an LLC as an entity combining characteristics of both a partnership and a corporation).

addition, federal tax law generally recognizes LLCs as partnerships. Therefore, if the LLC is structured properly, as with partnerships, no federal income tax is imposed on the LLC at the entity level; rather, a tax is imposed on its members.[2] Like a corporation and a limited partnership, an LLC can be created only by obtaining express recognition from the sovereign.[3] And similar to shareholders of a corporation, the state grants the members of an LLC statutory protection from liability.[4] An LLC member risks only the capital that the member agrees to contribute to the LLC. LLC legislation was signed into law in New Jersey on July 30, 1993.[5]

I. Introduction

The choice of a particular form of entity for carrying on economic and social activities is a matter of considerable importance because, unlike Louis Sullivan's observation about architecture, form in business law does not necessarily follow function.[6] Indeed, the abstract architecture of the entity form may effectively constrain its functions. In that sense, the law is less flexible than structural steel and more demanding of preliminary planning than masonry and stone. Moreover, the legal architecture for most entities remains a matter of state rather than federal law. Therefore, the potential exists for parochial anomalies among the several jurisdictions.

Until January 24, 1993, New Jersey offered three main alternatives for economic and social activity entities: corporations, profit or nonprofit; limited partnerships; and general partnerships. The last, general partnerships, may not even be entities separate and apart from their partners. The Uniform Partnership Act adopted

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2 *Id.* at 380. In other words, the LLC is a "pass-through" entity for tax purposes so that income tax is imposed at the constituent level. *See* Edward J. Roche et al., *Limited Liability Companies Offer Pass-Through Benefits Without S Corp. Restrictions*, 74 J. TAX'N 248, 248-50 (1991); Treas. Reg. § 301.7701-1(a)(3) (1993).

3 Keatinge et al., *supra* note 1, at 386. Consequently, an organization document must be filed with the state government in order for the LLC to exist.

4 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, LIMITED LIABILITY COMPANIES, 1-2, 1-3 (1992) [hereinafter RIBSTEIN & KEATINGE].

5 Limited Liability Companies Act, ch. 210, 1993 N.J. Sess. Law Serv. 611 (West) (to be codified at N.J. STAT. ANN. §§ 42:2B-1 to -70). The act is due to take effect 180 days after its enactment, approximately January 26, 1994.

6 Louis H. Sullivan, *The Tall Office Building Artistically Considered*, LIPPINCOTT'S MAG., Mar. 1896, at 408-09.

in New Jersey in 1916 generally favors the aggregate theory over the entity.[7] Each of the three alternatives lacks certain flexibilities and capacities. Business corporations traditionally offer limited liability to constituents, but are taxed federally at the entity level, unless organized under Chapter S of the Internal Revenue Code of 1986 (Code), as amended.[8] Any distribution to constituents out of earnings and profits in other than S corporations generally results in another layer of federal tax at the constituent level.[9] The State of New Jersey taxes at both levels.[10]

S corporations are not taxed federally at the entity level and now enjoy a significantly reduced New Jersey tax, generally 2%, at the entity level.[11] The Code imposes, however, very demanding requirements to qualify as an S corporation including: a fixed upper limit on the number of shareholders (thirty-five); a prohibition on multiple classes of equity (hence limiting divisions between economic interest and corporate power); a bar to ownership by any other corporation, pension plan or non-U.S. citizen who is not a permanent resident alien in the United States; and a prohibition on having subsidiaries.[12]

Nonprofit corporations are only rarely usable for economic and social activities which seek both the benefits of distributing economic value to constituents while also offering pass-through tax

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7 *See* N.J. STAT. ANN. §§ 42:1-1 to -43 (West 1993) (New Jersey's Uniform Partnership Law). *See also* N.J. STAT. ANN. § 42:1-6 (West 1993) (defining a partnership as an association of more than one person to carry on a business as co-owners); Randolph Prod. Co. v. Manning, 83 F. Supp. 857, 859 (D.N.J. 1948), *aff'd*, 176 F.2d 190 (3d Cir. 1949) (stating that although a partnership may be comprised of some of the same characteristics as a distinct entity, it has never been recognized as such). Under the aggregate theory, the whole is simply a sum of the partners; while under the entity theory, the whole is greater than or different from the sum of the partners.

8 I.R.C. § 1361-63 (1992).

9 *Id.* § 61(a)(7) (1992).

10 The New Jersey Corporation Business Tax includes a component based on earnings, currently 9% with a 0.375% surcharge. *See* N.J. STAT. ANN. § 54:10A-5 to -5.1 (West 1986 & Supp. 1993). There is no deduction for distributions to shareholders. *See* N.J. STAT. ANN. § 54:10A-4(k) (West 1986). Recipient shareholders are subject to the New Jersey personal income tax. *See* N.J. STAT. ANN. §§ 54A:2-1 to -4 (West 1986).

11 Taxation of S Corporations, ch. 173, sec. 2(c), § 5(c), 1993 N.J. Sess. Law Serv. 513, 518 (West) (amending N.J. STAT. ANN. § 54:10A-5 (West 1986)) (recognizing S corporations as a separate class of corporations and imposing a tax equal to the difference between the rate of the New Jersey Corporation Business Tax (without surcharge), currently 9%, and the highest rate applicable to individual taxpayers, currently 7%). *See* I.R.C. § 1361-63 (1992);

12 I.R.C. § 1361(b) (1992).

treatment. Indeed, the notion of a nonprofit corporation making a distribution of economic value to its members is inconsistent with the Code's concept of tax structure; such that, at least to the extent of gain from some unrelated trade or business, the nonprofit corporation would be taxed at the entity level as though it were a profit- oriented enterprise.[13]

In any event, corporations are structurally less tolerant of innovations affecting the rights and interests of constituents *inter se* than other entity forms. Thus, a great deal of the resolution of liquidity and transfer issues are in most private corporations handled by separate contracts among the constituents, such as shareholder agreements.

Limited partnerships offer pass-through tax treatment; that is, generally no tax is imposed by either the federal government or the State of New Jersey at the entity level.[14] Limited partnerships offer great flexibility in design because the essence of their internal structures are set out in partnership agreements, which may be crafted with some limitations to fit any particular arrangement of interest.[15] The Code permits some separation of profit and loss allocation from ownership interest.[16] There may be different classes of partner interests with significantly different economic and/or control consequences between classes. The limited partners have no liability for partnership obligations beyond the amount of their investments, including any call obligations that are part of their investments. In addition, limited partnership law in New Jersey has benefitted from recent substantial restructuring in the form of the Revised Uniform Limited Partnership Act (NJRULPA).[17]

One major limiting factor affecting the utility of limited part-

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13 I.R.C. §§ 501(c), 511-13 (1992).

14 I.R.C. § 701 (1992); N.J. STAT. ANN. § 54A:2-2 (West 1986).

15 *See* N.J. STAT. ANN. §§ 42:2A-1 to -72 (West 1993) (New Jersey's Revised Uniform Limited Partnership Act). *See also* N.J. STAT. ANN. § 42:2A-5 (West 1993) (defining a partnership agreement as any valid agreement between the partners regarding the affairs of the limited partnership).

16 *See* I.R.C. § 704 (1992) (stating that a partner's share of the loss or profit is determined by the partner's interest in the partnership unless the partnership agreement provides otherwise).

17 N.J. STAT. ANN. §§ 42:2A-1 to -72 (West 1993). NJRULPA was adopted in New Jersey in 1984 and then significantly revised in 1985 and 1988, in each case with the active assistance of the Corporate and Business Law Section of the New Jersey State Bar Association.

nerships is the need for at least one general partner.[18] The general partner is typically the organizer and leader of the entity. The general partner, in turn, must have unlimited liability for both the tort and contract obligations of the partnership.[19] Limited partnership law raises the concept of "the penalties of leadership" to an entirely new level by requiring that the entire net worth of the leader "stand behind" the enterprise. A typical solution to this structural requirement is to use a corporate general partner. That amalgam, in turn, raises its own complexities. First, unless S corporation treatment is available, which might not be the case if, for example, a nonresident foreigner is the entrepreneurial spark for the enterprise, pass-through tax treatment will be unavailable to the shareholders of the corporate general partner. Second, to avoid having a "shell" general partner, substantial capital which might be employed elsewhere must be committed to the general partner in what is effectively standby status.[20] Third, all of the corporate formalities noted above are now grafted onto a structure that had as one of its principal attractions its open-ended flexibility.

The foregoing discussion of limited partnerships leads naturally to a consideration of general partnerships. All partnerships, whether limited or general, are "association[s] of two or more persons to carry on as co-owners a business for profit."[21] Thus, they must have a business or profit motive. This constraint precludes their use in certain financing structures where the vehicle doing the financing must be a nonprofit entity.[22] General partnerships are in all other respects the most flexible of organizations, requiring only an agreement among the partners to be formed and to continue to exist, which does not need to be in writing.[23] The economic arrangements among the partners may be varied to meet the particulars of any transaction or relationship. General part-

18 N.J. STAT. ANN. § 42:2A-5(c) (West 1993).

19 N.J. STAT. ANN. § 42:2A-32(b) (West 1993).

20 Rev. Proc. 89-12, 1989-1 C.B. 798; Rev. Proc. 91-13, 1991-1 C.B. 477.

21 N.J. STAT. ANN. § 42:1-6(1) (West 1993).

22 Large scale projects involving public and private entities, such as public parking garages and buildings occupied by both schools and commercial offices, are often organized as nonprofit membership corporations as they are unable to organize as partnerships. An LLC organized under the New Jersey statute offers significantly greater flexibility in organizational structure and would permit subsequent capital calls.

23 Ruta v. Werner, 63 A.2d 825 (N.J. Super. Ct. Ch. Div. 1949).

ners, however, are also individually liable, jointly, but not severally, for the obligations of the partnership.[24] The debate between the entity and aggregate theories of general partnerships does not affect this ultimate liability of the partners.[25] Nor does the currently proposed Revised Uniform Partnership Act, which endorses the entity nature of general partnerships, alter the unlimited liability of each general partner for partnership obligations.[26] The risk of unlimited liability has made general partnerships a sometimes difficult choice for investors. Nonetheless, its flexibility and privacy make it extremely useful. Many "corporate" joint ventures formed to allow ongoing collective efforts between separate corporations are general partnerships. General partnerships are not taxed by either the federal government or the State of New Jersey at the entity level.[27]

These circumstances suggested the need for a hybrid organizational form that would combine limited liability for its constituents, pass-through tax treatment and flexibility of internal arrangements among constituents. Such an organizational form has been widely recognized in Europe and Latin America as the *limitada* or limited company.[28] Interestingly, in civil law systems, which tend to view decisional law as derivative and which often have a general interest approach both to political regimes and private orderings, the development of such a hybrid was seen as a logical application of policies favoring private investment.[29] In the United States, such a hybrid was seen as something of an unexpected anomaly, despite all of the vaunted emphasis on freedom of contract and private sector initiatives.[30] In any event, the limited liability company, if properly formed, offers precisely that combination of features.

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24 N.J. STAT. ANN. § 42:1-15(b) (West 1993).

25 JUDSON A. CRANE & ALAN R. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP 18-29 (1968).

26 REVISED UNIF. PARTNERSHIP ACT § 201 (1993).

27 I.R.C. § 701 (1992); N.J. STAT. ANN. § 54A:2-2 (West 1986).

28 RIBSTEIN & KEATINGE, *supra* note 4, at 13-3.

29 *See generally* ARTHUR TAYLOR VON MEHREN & JAMES RUSSEL GORDLEY, THE CIVIL LAW SYSTEM 3-101 (1957).

30 Edward R. Schwartz, *The Limited Partnership Association - An Alternative Corporation for the Small Business with "Control" Problems?*, 20 RUTGERS L. REV. 29, 88 (1965).

II. A Note on Origins

The LLC is a creature of opportunity.[31] In 1977, the first limited liability company statute was enacted. It was passed in Wyoming as special interest legislation, the equivalent of a private bill, to accommodate an oil company that had been unable to get comparable legislation passed in Alaska.[32] Subsequently, another LLC formed under the new Wyoming law obtained a private letter ruling from the Internal Revenue Service (IRS) that it would be treated as a partnership for federal tax purposes.[33] One day earlier, the IRS had issued proposed regulations that would have denied partnership classification to any organization that did not have at least one member personally liable for the obligations of the organization.[34] After receiving considerable comments in opposition, the IRS withdrew the proposed regulations and began a study on the proper classification of LLCs.[35]

In 1982, Florida passed its own LLC statute, apparently in an attempt to encourage additional private investment.[36] Some LLCs

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31 The American forerunner of LLCs was the limited partnership association, which was a type of entity created under statutes in Pennsylvania, Michigan, New Jersey and Ohio between 1874 and 1881. Keatinge et al., *supra* note 1, at 381. The New Jersey version, N.J. STAT. ANN. §§ 42:3-1 to -29 (West 1993), was passed in 1880. *See* Schwartz, *supra* note 31, at 31. Thus, one might assert that the new statute is merely a restoration of an earlier New Jersey idea.

32 RIBSTEIN & KEATINGE, *supra* note 4, at 1-7. *See also* Keatinge et al., *supra* note 1, at 383.

33 *See* Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980). For tax purposes, a corporation will be treated as a taxable association if "there exists a preponderance of the corporation characteristics of continuity of life, centralization of management, limited liability and free transferability of interests." *Id.* Because the subject organization lacked "continuity of life and free transferability of interests, [ ] [it] will not have a preponderance of corporate characteristics." *Id.* This subject organization, therefore, "will be treated as a partnership for federal income tax purposes and not as an association taxable as a corporation." *Id. See also* Keatinge et al., *supra* note 1, at 383; Treas. Reg. § 301.7701-2(a)(2) (1993).

34 The regulation stated that "[a]n organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization." Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,709 (1980). *See also* Keatinge et al., *supra* note 1, at 383.

35 I.R.S. News Release IR-822-145 (Dec. 16, 1982). *See also* Keatinge et al., *supra* note 1, at 383.

36 FLA. STAT. ANN. §§ 608.401-.471 (West 1993). The Florida statute that enacted the LLC provisions to stimulate private investment provided a very broad purpose for its creation. The statute provides that "[a] limited liability company may be organized . . . for any lawful purpose, except that special statutes for the regulation and control

were formed in Florida.[37] Due to the absence of a definitive pronouncement from the IRS, however, the LLC existed as an entity possibility only in Wyoming and Florida. Compounding the uncertainty of tax treatment were concerns for the level of recognition, if any, other states might accord to LLCs and their constituent members. For instance, if a Wyoming LLC transacted business in either Alaska, Delaware or Texas, would those states and their courts recognize the entity's status as an LLC and would the limited liability of constituent members really be respected? Finally, the IRS announced the results of its study and stated that limited liability would not by itself act as a disqualifying characteristic for partnership tax treatment.[38] This ruling precipitated the current rush to enact LLC legislation in the remaining 48 states.

In 1990, both Colorado and Kansas enacted statutes.[39] In 1991, Utah, Virginia, Texas and Nevada joined the fold,[40] followed by ten additional states in 1992, including, most significantly, Delaware.[41] That tide continued in 1993 as New Jersey became the

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of specific types of business shall control when in conflict herewith." *Id.* § 608.403. *See also* Keatinge et al., *supra* note 1, at 383.

37 *See generally* Keatinge et al., *supra* note 1, at 383.

38 Rev. Rul. 88-76, 1988-2 C.B. 360.

39 *See* COLO. REV. STAT. §§ 7-80-101 to -913 (Supp. 1992); KAN. STAT. ANN. §§ 17-7601 to -7650 (Supp. 1992). The Colorado Legislature enacted its statute to allow LLCs the same freedom of business conduct afforded to partnerships with limited partners. *See* COLO. REV. STAT. § 7-80-103. Similarly, the Kansas statute allows an LLC to conduct any legal business that a partnership may conduct. KAN. STAT. ANN. § 17-7603(a). The Kansas law, however, also notes that an LLC is a separate entity and not a corporation. *Id.* § 17-7603(b).

40 *See* NEVADA REV. STAT. §§ 86.011-.571 (Supp. 1991); TEXAS REV. CIV. STAT. ANN. arts. 1528n-1.01 to -9.02 (Supp. 1993); UTAH CODE ANN. §§ 48-2b-101 to -156 (Supp. 1992); VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993). All four states have statutes that allow a LLC to be established for any lawful purpose. Specifically, the Nevada statute provides that "the limited liability company may be organized for any lawful purpose, except banking or insurance." NEVADA REV. STAT. § 86.141. Similarly, the Texas law provides that a "limited liability company . . . may engage in any lawful business unless a more limited purpose is stated in its articles of organization or regulations." TEXAS REV. CIV. STAT. ANN. art. 1528n-2.01A. In Utah "a limited liability company may conduct or promote any lawful business or purpose which a partnership, general corporation, or professional corporation may conduct or promote." UTAH CODE ANN. § 48-2b-104. Likewise, in Virginia "every limited liability company . . . has the purpose of engaging in any lawful business, except as otherwise provided by the law of this Commonwealth, unless a more limited purpose is set forth in the articles of organization." VA. CODE ANN. § 13.1-1008.

41 ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1993); DEL. CODE ANN. tit. 6, §§ 18-101 to -1106 (Supp. 1992); ILL. ANN. STAT. ch. 805, paras. 180/1-1 to 1-60

thirty-fifth state to enact LLC legislation when the proposed legislation was signed into law.[42]

During the same period, two separate but related attempts to develop model[43] legislation began. The first, now complete, was the effort of the Subcommittee on Limited Liability Companies of the Partnership and Unincorporated Business Organization Committee (Partnership Committee) of the American Bar Association's (ABA) Business Law Section, to draft a "Prototype" LLC statute.[44] The second is the more formal effort (now in process) of the National Conference of Commissioners of Uniform State Laws (NC-

(Smith-Hurd Supp. 1993); IOWA CODE ANN. §§ 490A.100-.1601 (Supp. 1993); LA. REV. STAT. ANN. §§ 12:1301-1369 (West Supp. 1993); MD. CORPS. & ASSN'S CODE ANN. §§ 4A-101 to -1103 (Supp. 1993); MINN. STAT. §§ 322B.01-.955 (Supp. 1993); OKLA. STAT. tit. 18, §§ 2000-2060 (Supp. 1993); R.I. GEN. LAWS §§ 7-16-1 to -75 (1992); W. VA. CODE ANN. §§ 31-1A-1 to -69 (Supp. 1993). The scope of the state statutes vary. For example, the Arizona statute indicates that "[a] limited liability company may be organized . . . and may conduct or promote business and other activities . . . except banking and insurance." ARIZ. REV. STAT. ANN. § 29-609. The Delaware law states that a limited liability company can have a lawful business except a business that grants policies of insurance or assumes insurance risks or operates as a bank. DEL. CODE ANN. tit. 6, § 18-106. The law in Illinois allows a limited liability company to conduct any business "except banking or insurance unless carried on as a business of a syndicate or limited syndicate." ILL. REV. STAT. ch. 805, para. 180/1-25. The Louisiana law provides that "[a] limited liability company may be organized . . . and may conduct business, but may not be formed for the purpose of banking or insurance underwriting in all their several forms or for the purpose of operating homesteads or building and loan associations." LA. REV. STAT. ANN. § 12:1302. The law in Maryland states that any limited liability company may be established and conduct business, except the business of acting as an insurer. MD. CORPS. & ASSN'S. CODE ANN. § 4A-201. Oklahoma permits a limited liability company to be established and conduct business in every state for any legal business, except banking and insurance. OKLA. STAT. tit. 18, § 2002. Rhode Island law states that "[e]very limited liability company . . . has the purpose of engaging in any business which a limited partnership may carry on, except the provision of professional services . . . unless a more limited purpose is set forth in the articles of organization." R.I. GEN. LAWS § 7-16-3. Finally, the West Virginia statute provides that "[l]imited liability companies may be organized . . . for any lawful purpose." W. VA. CODE ANN. § 31-1A-3.

42 Limited Liability Companies Act, ch. 210, 1993 N.J. Sess. Law Serv. 611 (West) (to be codified at N.J. STAT. ANN. §§ 42:2B-1 to -70). The law was signed by Governor James Florio on July 30, 1993 and is due to take effect 180 days later.

43 One of the continuing concerns for businesses in the United States that are active in more than one state is the availability of uniformity. Model legislation is intended both to guide and induce uniformity in the several states.

44 PROTOTYPE LIMITED LIABILITY COMPANY ACT (draft Nov. 19, 1992) (Working Group on the Prototype Limited Liability Co. Act, Subcommittee on Limited Liability Cos., Comm. on Partnerships and Unincorporated Business Org. Comm. of the ABA Business Law Section) (copies are available from the ABA Business Law Section, 750 North Lake Shore Drive, Chicago, Ill. 60611).

CUSL) to draft a Uniform Limited Liability Company Act.[45] The ABA Prototype effort and the formation of the LLC Subcommittee grew out of the efforts of a Colorado practitioner, Robert R. Keatinge, who had been deeply involved in the 1990 passage of LLC legislation in Colorado and who became a proselytizer to his colleagues in the ABA Partnership Committee.[46] The ABA Partnership Committee in turn urged NCCUSL to take on the Uniform LLC Act project.[47]

As each new LLC statute was enacted, the increasing complexity and range of choice offered by the drafters in the several states became apparent. The Wyoming statute is a bare bones enactment, while the Florida legislation is considerably longer and more complex. The Colorado statute was the first post-IRS ruling enactment and had the benefit of significant conceptual analysis. For a variety of reasons, the least being a concern to obtain a "bullet proof" statute, Colorado used its existing corporation law as an initial model and strove to design a law that was generally foolproof.[48] Along with that corporate law baseline came a number of hierarchical rigidities which some Colorado attorneys, including Mr. Keatinge, would like to

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45 UNIF. LIMITED LIABILITY COMPANY ACT (Mar. 16, 1993 Draft).

46 Peter D. Hutcheon, *Section Subcommittee Considers Implications as States Authorize Limited Liability Companies*, 11 BUS. LAW. UPDATE, July/Aug. 1991, at 4. At the 1990 spring meeting of the Section's Partnerships and Unincorporated Business Organizations Committee, Mr. Keatinge chaired the subcommittee on limited liability companies. *Id.* The subcommittee addressed the legal ramifications of the LLCs and it also acted "as a clearinghouse for drafted information." *Id.*

47 Keatinge et al., *supra* note 1, at 456. As a direct response to letters drafted by the Limited Liability Companies Subcommittee, the Scope and Program Committee of the NCCUSL "recommended the commencement of a study project on a Uniform LLC Act." *Id. See also* Hutcheon, *supra* note 46, at 4 (NCCUSL began drafting a Uniform LLC act at the suggestion of the Subcommittee on LLCs).

48 Thus, if one organized an entity under the Colorado statute it was both an LLC for state law purposes and entitled to partnership tax treatment for federal law purposes. *See* John R. Maxfield et al., *Colorado Enacts Limited Liability Legislation*, 19 COLO. LAW. 1029, 1030 (1990). Colorado's Uniform Partnership Act of 1981 and the Corporation Code were used as models to draft provisions delineating formation and operation of the LLCs. *Id.* An IRS study (study project LR-298-82) analyzed the formation of rules for various entities' federal tax classifications. *Id.* at 1032. Subsequently, the IRS posted a ruling whereby a Wyoming LLC was favorably granted partnership classification for federal income tax purposes. *Id.*; *see also supra* note 38 and accompanying text. Following the favorable ruling for the Wyoming LLC, it is believed that Colorado LLCs will receive similar classification for federal income tax purposes. *See* Maxfield et al., *supra*, note 48, at 1034.

revisit.[49]

A number of subsequently enacted LLC statutes were written using the ABA Prototype as a guide.[50] Delaware attorneys, however, when drafting their statute looked instead to Delaware's version of the Revised Uniform Limited Partnership Act (RULPA).[51] A key conceptual notion underlying partnership tax treatment and the flexibility of arrangements among LLC constituent members *inter se* is that an LLC is a special type of partnership onto which a limited liability shield for each member has been grafted. The expectations in Delaware were to permit LLC members to freely contract among themselves with respect to the internal affairs of the company.[52] Furthermore, the operational as opposed to formational provisions of RULPA generally make sense when applied to LLCs, thus domesticating a new hybrid entity and giving it a comfortable stature as a quasi-limited partnership.

III. A New Jersey Legislative History Outline

The first LLC bill in New Jersey was A-5179, introduced on November 25, 1991, by then Assemblyman Mecca.[53] The current Administration was elected in November 1989 and substantially raised taxes.[54] In the 1991 legislative elections all of the 120 legislators were up for election. The November 1991 election was a landslide for the opposition party, resulting in its gaining control of both legislative houses by so-called "veto proof" majorities. Thus, A-5179 was introduced during the "lame duck" period after the No-

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49 Interview with Robert R. Keatinge, Chairman of the Subcommittee on LLCs, Partnership & Unincorporated Business Organization Committee, ABA Business Law Section, in New York, N.Y. (Aug. 9, 1993).

50 RIBSTEIN & KEATINGE, *supra* note 4, at 1S-3. For example, versions of the Prototype influenced the original statutes drafted in Louisiana, Idaho and Montana. *Id.*

51 Letter from Martin Lubaroff, Esq., member of the Delaware Bar LLC Drafting Committee, to the author (June 2, 1992) (on file with the *Seton Hall Legislative Journal*). The Delaware statute was enacted in July 1992 and took effect October 1, 1992.

52 *Id.*

53 A. 5179, 204th N.J. Leg., 2d Sess. (1991). A-5179 was apparently suggested by the Commerce and Industry Association of New Jersey. Letter from Edward M. Schotz, Chairman of the Commerce and Industry Association of New Jersey to the author (Aug. 19, 1991) (on file with the *Seton Hall Legislative Journal*).

54 New Jersey legislative and gubernatorial elections are held on odd number years (generally variant from most other states and certainly from federal elections). *See* N.J. CONST. art. IV, § 1. *See also* N.J. CONST. art. V, § 1. Each New Jersey Legislature must fulfill a two year term commencing in January in every even numbered year. *See* N.J. CONST. art. IV, § 1.

vember elections and before the beginning of the next legislative session. Not surprisingly, after A-5179 was referred to the Assembly Commerce and Regulated Professions Committee, it was never heard from again. The significance of A-5179 is that the drafters of the bill in 1991 looked for a model and identified Colorado's LLC law as the then leading exemplar.[55]

On May 21, 1992, Assemblywoman Derman and Assemblyman Azzolina introduced A-1464, as co-sponsors, in the new legislative session.[56] A-1464 contained the same text as A-5179 from the prior session. On June 1, 1992, Senators Sinagra and Inverso followed suit and co-sponsored the introduction of S-890 in the upper house.[57] S-890 was also a renumbered version of A-5179. S-890 was referred to the Senate Commerce Committee and languished. A-1464 was referred to the Assembly's Judiciary Committee, which had in prior sessions dealt with NJRULPA, revisions to New Jersey's Business Corporation Act and revisions to New Jersey's Nonprofit Corporation Act.

The Corporate and Business Law Section of the New Jersey State Bar Association, while chaired by the author, had created a joint LLC working group with members of the Taxation Law Section. Members of the working group, functioning as individual private practitioners, brought to Assemblywoman Derman's attention certain inflexibilities inherent in the Colorado approach incorporated in A-1464. After considerable review, the working group concluded that the new Delaware act offered a better model for an LLC statute, although its very flexibility carried its own risks.[58] As a result, Assemblywoman Derman and Assemblyman Azzolina introduced A-2350[59] as substitute legislation for A-1464.

In view of the potential impact on state tax revenue that LLCs would have, LLC legislation would have to be approved by the Appropriations Committee in the Assembly.[60] A-2350 was referred di-

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55 Telephone Interview with Walter C. Kowalski, Esq. of the Commerce, Labor and Industry Section of the Office of Legislative Services (Jan. 13, 1993).

56 A. 1464, 205th N.J. Leg., 1st Sess. (1992).

57 S. 890, 205th N.J. Leg., 1st Sess. (1992).

58 *See generally* Letter from Peter D. Hutcheon to Assemblywoman Harriet Derman (Jan. 7, 1993) (on file with the *Seton Hall Legislative Journal*).

59 A. 2350, 205th N.J. Leg., 2d Sess. (1992) (introduced Mar. 1, 1993)

60 N.J. GENERAL ASSEMBLY R. 80. The rule stipulates that any use of state or public funds must be referred to the Appropriations Committee "for further fiscal analysis, evaluation and report." *Id.*

rectly to the Appropriations Committee to eliminate the need for two committee approvals in the Assembly. A-2350 was reported out favorably by the Appropriations Committee on June 14, 1993, was approved in the Assembly on the same day, and was sent later that day to the Senate where Senator Sinagra endorsed it as a committee substitute to S-890.

The New Jersey Society of Certified Public Accountants played a major role in pressing for LLC legislation. The accounting profession has been the subject of ever increasing liability suits in the last ten to fifteen years and witnessed the financial collapse of a national accounting firm.[61] Most of the large accounting firms are organized as general partnerships because the disparate requirements of the professional service corporation statutes of fifty different states do not allow for organization under any one of them. Thus, as now organized, each partner of a so-called "Big Six" or other national accounting firm, or even regional firm, faces unlimited liability for the obligations of the firm. The potential for using LLCs as a vehicle to limiting the liability of a member for entity obligations and the potential for interstate recognition of LLCs made this a very desirable form of organization for accountants.[62] Hence, the New Jersey Society of Certified Public Accountants lobbied vigorously for the enactment of LLC legislation.[63]

Initially, the accountants were especially interested in emulating Virginia and other states whose statutes authorize professionals to organize as LLCs.[64] There was considerable concern among the business and tax lawyers involved in urging the passage of A-2350. Organized opposition was expected had the bill contained provisions expressly authorizing the use of LLCs by professionals because such legislation might be characterized as limiting

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61 RIBSTEIN & KEATINGE, *supra* note 4, at 15-12 ("[P]erhaps because of their greater experience with personal liability under the partnership form, accountants have been the first to study limited liability companies as a practice vehicle on a profession-wide basis.)"

62 *See infra* notes 89-92 and accompanying text.

63 *See, e.g.*, Meeting with Rodney Freylinghuysen, Chairman of the Assembly Appropriation Committee, at the Statehouse in Trenton, N.J. (May 13, 1993) (meeting attended by the President and Executive Director of the New Jersey Society of CPA's and its outside lobbyist).

64 VA. CODE ANN. § 13.1-1008 (Michie 1993). The Virginia statute states that the articles of organization must include a statement that the LLC's registered agent is either a Virginia resident and manager or member of the LLC or that the registered agent is a professional corporation. VA. CODE ANN. § 13.1-1011A(2)(ii).

professional liability.[65] After numerous meetings and exchanges, the accountants agreed to the approach taken by A-2350, which broadly authorizes the use of an LLC but does not expressly address its use by professionals.

IV. Summary of Tax Classification Issues

As discussed, a principal attribute of LLCs is the ability to be classified for federal tax purposes as a partnership. The New Jersey statute, however, because of its flexible design can be used to create an LLC that will not be classified as a partnership for federal tax purposes.[66] If the LLC is not classified as a partnership for federal income tax purposes, New Jersey will, pursuant to section 69 of the statute, follow the federal income tax classification.[67] The tax classification of an entity formed under the New Jersey statute is not automatic. It is extremely important to have an understanding of tax classification issues because those issues directly affect the design choices to be made in structuring an LLC under the New Jersey statute.

An entity is classified as a corporation for federal tax purposes if it has at least three of the following four characteristics: (1) limited liability; (2) centralized management; (3) continuity of life; and (4) free transferability of interests.[68] Thus, to be classified as a partnership, an LLC must not have more than two of those four characteristics.

Although some statutes may allow waiver, limited liability is indeed a hallmark of LLCs.[69] An LLC conveys as part of its essence the cloak of limited liability for its constituent members. There-

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65 It might be noted that the use of the LLC form will not affect the liability of a professional for malpractice or the liability of other professionals in the firm for failing to supervise or review the work of the malpracticing professional. The LLC form would, however, insulate a member of the firm from personal liability for the malpractice of another member, unlike the partner of a general partnership.

66 In other words, the LLC will be classified as a corporation and taxed at the entity level.

67 *See* Limited Liability Companies Act, ch. 210, § 69, 1993 N.J. Sess. Law Serv. 611, 633 (West) (stating that an LLC must "be classified as a partnership unless classified otherwise for federal income tax purposes.").

68 Treas. Reg. § 301.7701-2 (1993).

69 *See, e.g.*, VA. CODE ANN. § 13.1-1019 ("[N]o member, manager or other agent of a limited liability company shall have any personal obligation for any liabilities of a limited liability company.").

fore, planning concerns must focus on the remaining three characteristics.

Centralized management in the corporate sense means the delegated representational management provided by a board of directors and the officers of the corporation. In a general partnership, all partners have apparent authority to bind the partnership; thus, no one partner or group of partners can have executive authority. Accordingly, centralized management does not exist. Applying this concept to limited partnerships, the IRS has generally held that limited partnerships have centralized management because governing authority is delegated to the general partner or partners.[70] However, the IRS has been willing to concede an absence of centralized management if the general partners of a limited partnership hold at least a 20% interest in both capital and profits.[71] In the case of LLCs, those managed by their constituent member *en masse* should not be seen as having centralized management; those LLCs that have a representational management group, in contrast, will have this corporate characteristic.

Continuity of life refers to the typical corporation that has authority for perpetual existence under its organizational documents.[72] In general, the withdrawal of a partner by death, insanity, retirement, resignation or expulsion, as well as bankruptcy, will cause a dissolution of the partnership.[73] The traditional view of the IRS was that to avoid having the corporate characteristics of continuity of life, the partnership could not continue unless it was reformed or formed anew by an agreement between all of the remaining partners.[74] In the case of limited partnerships, the IRS

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70 Treas. Reg. § 301.7701-3 (1993). *See also* Treas. Reg. § 301.7701-2(c)(1) (1993) (exclusive authority to conduct the business of the organization constitutes centralized management).

71 Rev. Proc. 89-12, 1989-1 C.B. 798.

72 This characteristic is not fact-based and is unaffected by the actual vicissitudes of economic life and death.

73 N.J. STAT. ANN. § 42:1-31 (West 1993) (providing that dissolution can also occur by judgment of court, express will of a partner if there is no definite term or specific undertaking or upon completion of the definite term or particular undertaking).

74 *See* Treas. Reg. § 301.7701-2(b) (1993). The regulation states:

> An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist.

had taken a similar view.[75] It has now modified that position to allow limited partnerships to continue without being viewed as having "continuity of life" if either all of the remaining general partners or a majority of all remaining partners agree to such continuation.[76] The willingness of the IRS to allow a majority of partners to determine continuation should prove helpful in addressing some LLC planning issues, although the IRS has yet to clearly address this question in the LLC context.

A related question is what dissolution-triggering events are required. For example, in limited partnerships continuity of life is not created if the partnership continues despite the withdrawal of a limited partner (as opposed to a general partner). If an LLC has managers from among its members, the managers might be compared to general partners of a limited partnership for these purposes, so that manager withdrawal would be a dissolution event while the withdrawal of an ordinary member would not be. Guidance in the LLC context on this issue is not available. Of course, if the LLC is managed by nonmember managers the analogy to the limited partnership becomes more diluted. It is also uncertain whether the IRS will require LLCs to have the "standard" partnership withdrawal events to avoid having continuity of life. Finally, it is important to note that the continuity of life concept is tied to withdrawal events and to the nature of partnership and its contractual origins in contrast to the entity status of a corporation. Therefore, simply having a fixed term of years will not ensure that an LLC has avoided having continuity of life, despite the literal illogic of such a position.

The fourth corporate characteristic is the transferability of in-

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Id.

[75] *Id.* The IRS stated: "If the retirement, death, or insanity of a general partner of a limited partnership causes a dissolution of the partnership, unless the remaining general partners agree to continue the partnership or unless all remaining agree to continue the partnership, continuity of life does not exist." *Id.*

[76] *See* Prop. Treas. Reg. § 301.7701-2, 58 Fed. Reg. 28,501 (1993). The proposal provides that

> continuity of life does not exist notwithstanding the fact that a dissolution of the limited partnership may be avoided, upon such an event of withdrawal of a general partner, by the remaining general partners agreeing to continue the partnership or by at least a majority in interest of the remaining partners agreeing to continue the partnership.

Id. (citing Glensder Textile Co. v. Commissioner, 46 B.T.A. 176 (1942), 1942-1 C.B. 8)).

terests, meaning the ability for a holder to convey stock or debt securities issued by a corporation without restrictions intrinsic in the nature of the entity and in the interest held in the entity by the constituent member. It is precisely this characteristic that forces the construction of separate shareholder agreements to organize the arrangements among shareholders and the corporation. Along with the other corporate characteristics, transferability is more complex than might first appear. Partnership law has long recognized the distinction between an economic interest and an ownership/participation interest.[77] Generally, economic interests may be assigned without the consent of the other partners and the partnership will still not have the corporate characteristic of free transferability, so long as the assignee cannot become a partner without the consent of the other partners.[78] The IRS also tolerates transfers of partnership interests with the consent of a majority of partners as not being equivalent to free transferability.[79] Similarly, the IRS has ruled that a partnership that restricts the transfer of more than 20% of all interests in capital, income, gain, loss, deduction and credit, lacks free transferability.[80]

There is no significant guidance from the IRS in the LLC context. As noted above, it is possible that the IRS might be willing to view member-managers of an LLC as functionally akin to the general partners of a limited partnership such that only their consent rather than a majority of all members must be obtained for the transfer of LLC membership. Again, the result may not be the same if nonmember managers are involved.

This summary should underscore the complexity in assessing the corporate characteristics of a particular LLC. The very flexibility offered by the New Jersey statute also mandates the involvement of competent tax professionals at the earliest planning stage of LLC design.

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77 N.J. STAT. ANN. § 42:1-27 (West 1993) ("[E]ntitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.").

78 Treas. Reg. § 301.7701-2 (1993).

79 *Cf.* Rev. Proc. 92-35, 1992-1 C.B. 791 (remaining general partners or majority of all remaining partners avoid dissolution by agreeing to continue the partnership after the removal of the general partner).

80 Rev. Proc. 92-33, 1992-1 C.B. 782.

V. The New Jersey Statutory Scheme

A. *Scope*

The New Jersey LLC statute authorizes an LLC organized under it to "carry on any lawful business, purpose or activity."[81] The statute intentionally does not restrict LLCs to business or profit-oriented entities. Section 8(a) is designed to permit the maximum availability of LLCs subject only to the constraints of illegality. Thus, it will be possible to use an LLC organized under the New Jersey statute as a nonprofit financing vehicle for transactions such as, buildings or air rights owned by public charities, where a nonprofit, pass-through vehicle is desirable.[82] When used in such a transaction, the LLC also provides limited liability protection to its constituent members.

This broad purpose clause is expressly linked to the powers granted by the statute in Section 8(b), which provides:

> A limited liability company *shall* possess and *may* exercise all the powers and privileges granted by this act or by any other law *or by its operating agreement*, together with any powers incidental thereto, so far as such powers and privileges are necessary or convenient to the conduct, promotion or attainment of the business, purposes or activities of the limited liability company.[83]

Section 8(b) grants an LLC the broadest scope of powers available; it "shall possess" them, even if the LLC does not elect to use them. The section then provides for three distinct sources of powers and privileges and an inclusive standard for assessing whether a particular power or privilege is available.

Those three sources are: the LLC statute; other laws; and the operating agreement of an LLC. At first glance this structure of sources might appear to raise questions about impermissible delegation of law-making authority to private parties.[84] In reality, however, the statutory design is intended to deal with the often vague and incomplete

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81 Limited Liability Companies Act, ch. 210, § 8(a), 1993 N.J. Sess. Law Serv. 611, 616 (West).

82 The Internal Revenue Service has not yet addressed this proposed use of LLCs and may limit or preclude their use for nonprofit ventures.

83 § 8(b), 1993 N.J. Sess. Law Serv. at 616 (emphasis added).

84 *See* Ridgefield Park Educ. Ass'n v. Ridgefield Park Bd. of Educ., 393 A.2d 278, 287 (N.J. 1978) ("Both state and federal doctrines of substantive due process prohibit delegations of governmental policy-making power to private groups where a serious potential for self-serving action is created thereby.").

nature of granted authority in the several statutes. The law allows considerable private ordering now in leases and contracts subject only to particular limitations. Perhaps even more aptly, joint ventures may generally do whatever is lawful, leaving the venture agreement to fill in the gaps of legislative authority. As history evolves, even "limited purpose" corporations such as banks take on powers and privileges not envisioned by the legislative drafters.[85] If an LLC and its members face attack on the grounds of ultra vires, the utility of LLCs would be constrained far more than the "any lawful" standard of section 8(a) until case law reached the point that it generally has for corporations.[86] Thus, section 8(b) allows LLCs to fill in the gaps of express statutory authority and simultaneously avail themselves of the presumptive legitimacy accorded by section 8(b). This is accomplished by using the operating agreement to address the particular powers and privileges needed by an LLC for its lawful operation. In that sense, section 8(b) does invest private parties with quasi law-making power, by expressly endorsing the concept of private ordering as a source of common law. Additionally, section 67 provides that "[i]n any case not provided for in this act, the rules of law and equity, including the law merchant, shall govern."[87]

The standard used by section 8(b) to determine whether a power or privilege is available is whether it is "necessary or convenient." It is expected that New Jersey courts will read "convenient" quite literally.[88]

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85 Due to the evolution of banking, banks have taken on additional powers. *See* N.J. STAT. ANN. § 17:9A-24.9 (West 1984 & Supp. 1993) (delineating the supplemental powers of banks and savings banks). *See also* InforComp Corp. v. Somerset Trust Co., 358 A.2d 557, 560-61 (N.J. Super. Ct. App. Div. 1979) (holding that the New Jersey Legislature's intent regarding bank regulations will be upheld).

86 N.J. STAT. ANN. § 14A:3-2 (West 1969) (with limited exceptions, abolishing defense of ultra vires). *See generally* HARRY C. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS, 477-84 (1983) (discussing the traditional and the modern ultra vires doctrines).

87 § 67, 1993 N.J. Sess. Law Serv. at 633. The citation to the law merchant underscores the recognition given by the Legislature to concepts of commercial flexibility in evolving market situations since the law merchant has evolved from the standards of commercial conduct first recognized in the courts of *Cinque Ports*. *See generally* THEODORE F.T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 657-70 (5th ed. 1956). *See also* N.J. STAT. ANN. § 12A:-1-103 (West 1990) (providing that unless supplanted by specific provisions of the Uniform Commercial Code, the rules of law and equity and law merchant supplement its provisions).

88 If a power or privilege is helpful, useful, etc., even though not necessary, that power or privilege will be available.

Although LLCs created under the New Jersey statutes have a very broad and self-defining scope of powers and privileges, that does not mean that a New Jersey LLC may lawfully be used for all purposes. As noted above, the New Jersey Society of Certified Public Accountants was most interested in having the LLC statute passed so that they might avail themselves of the LLC form.[89] There is nothing in New Jersey's LLC statute which expressly authorizes professionals to organize using the LLC form. Furthermore, there is nothing in the statute and particularly in section 8 which prevents the use of LLCs by professionals. In effect, the New Jersey LLC statute leaves the issue of availability of LLCs to professional licensing statutes and to the respective governing bodies of the several professions.

The American Institute of Certified Public Accountants has expressly authorized accountants to organize using any form of organization lawful in a state.[90] It might at first glance appear, therefore, that accountants have no professional impediment to organizing their practice as LLCs in New Jersey. The New Jersey statute under which accountants are licensed to practice, however, only permits accountants to organize as partnerships or professional corporations.[91] Therefore, that statute will require amendment in order to allow accountants to organize as LLCs.[92]

The practice of law in New Jersey is the province of the Supreme Court pursuant to the New Jersey Constitution.[93] Currently, the court rules permit attorneys practicing in New Jersey to organize as professional corporations, if certain conditions are met,[94] however, the Supreme Court has not yet addressed LLCs. It is difficult to interpret the existing court rules as authorizing the use of LLCs, even by a very free extension of analogy theory. Hence, it is unlikely that attorneys

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89 *See supra* note 63 and accompanying text.

90 AICPA CODE OF PROFESSIONAL CONDUCT Rule 505 (Am. Inst. of Certified Pub. Accountants 1992).

91 N.J. STAT. ANN. § 45:2B-14 (West 1991).

92 Currently, a bill is pending that would allow public accounting firms to organize as LLCs. *See* S. 2102, 205th N.J. Leg., 2d Sess. (1993). The legislation would amend N.J. STAT. ANN. §§ 45:2B-3, 14-17, 19, 23, 24 (West 1991) and permit "certified public accounting firms and public accounting firms in this State to have any organizational structure not prohibited by law." SENATE STATEMENT TO S. 2102, 205th N.J. Leg., 2d Sess., at 1 (1993).

93 N.J. CONST. art. 6, § 2, cl. 13.

94 N.J. CT. R. 1:21-1A.

may properly organize to practice in New Jersey as LLCs until the Supreme Court has expressly authorized their use.

The circumstances for other professionals will surely also vary and the pronouncement of professional governing bodies must be reviewed carefully to determine whether members of other professions may practice as LLCs.

B. *Formation*

An LLC may be formed under the New Jersey statute by filing a certificate of formation with the Secretary of State.[95] Analogous to limited partnership law, there is no such thing as a de facto LLC. An LLC only exists when a properly completed and signed certificate of formation is filed, although section 11(b) allows some leeway for "substantial compliance" with the statutory requirements.[96] Section 11(b) emphasizes several aspects of this de jure approach. It states that "[a] limited liability company is *formed* at the time of filing of the initial certificate of formation . . . *or* at any later date or time specified in the certificate of formation if, in either case, there has been substantial compliance with the requirements of this section."[97]

A certificate of formation must be signed by one or more "authorized persons," but need not be signed by a member.[98] As is typical of the New Jersey statute, the operating agreement may

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95 Limited Liability Companies Act, ch. 210, § 11(a), 1993 N.J. Sess. Law Serv. 611, 616 (West).

96 § 11(b), 1993 N.J. Sess. Law Serv. at 616.

97 *Id.* (emphasis added). The new law also states that "[a] limited liability company formed under this act shall be a separate legal entity." *Id.* Section 11(b) should be read in connection with section 18 which states:

> A certificate of formation filed in the office of the Secretary of State is notice that the entity formed . . . is a limited liability company formed under the laws of this State and is notice of all other facts set forth therein which are required or permitted to be set forth in a certification of formation by paragraphs (1) and (2) of subsection a. of section 11 of this act.

§ 18, 1993 N.J. Sess. Law Serv. at 618.

98 § 11(a), 1993 N.J. Sess. Law Serv. at 616. Indeed, section 15(b) states:

> Unless otherwise provided in an operating agreement, any person may sign any certificate . . . by an agent, including an attorney-in-fact. An authorization, including a power of attorney, to sign any certificate . . . need not be in writing, need not be sworn to, verified or acknowledged, and need not be filed in the office of the Secretary of State, but if in writing, must be retained by the limited liability company.

§ 15(b), 1993 N.J. Sess. Law Serv. at 617.

freely vary the otherwise applicable statutory process. In the absence of such variance, however, "any person" is an "authorized person." Thus, an LLC may be formed by nonmembers, including a nonmember manager or an attorney or other agent, much the way corporations are incorporated in New Jersey.

The certificate of formation does have certain formal and structural requirements. It must include: the LLC's name; the address of the LLC's registered office; the registered agent's name and address for service of process; a statement that the LLC has more than one member; the latest date of dissolution if the LLC has a designated date of dissolution; and any additional matters the members wish to include.[99]

The first two certificate of formation requirements invoke other provisions of the statute, which are generally similar to comparable provisions in New Jersey's Business Corporation Act, Nonprofit Corporation Act and NJRULPA.[100] Section 3 of the LLC statute provides that the name of an LLC must include either "Limited Liability Company" or "LLC" and may contain the name of a person who is a member or a manager.[101] The required use of "Limited Liability Company" or "LLC" is intended to inform third parties as to the kind of entity with which they are dealing. The use of the name of a member or manager is intended to permit LLCs to "trade on" the recognition accorded a constituent or a governing person. Section 3(c) requires that the name be sufficiently unique as to permit the Secretary of State to index it efficiently.[102] If there are confusing similarities, either a consent from the other entity may be obtained or an alternate name may be used.[103] Section 3(d) prevents the use of any word or abbreviation in the name of an LLC where that use is subject to regulation under other statutory schemes, unless the LLC has met the requirements imposed

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99 § 11(a)(1)-(5), 1993 N.J. Sess. Law Serv. at 616.

100 *See* N.J. STAT. ANN. § 14A:2-7 (West 1969) (Business Corporation Act); N.J. STAT. ANN. § 15A:2-8 (West 1984 & Supp. 1993) (Nonprofit Corporation Act); N.J. STAT. ANN. § 42:2A-14 (West 1993) (NJRULPA).

101 § 3(a), (b), 1993 N.J. Sess. Law Serv. at 612.

102 § 3(c), 1993 N.J. Sess. Law Serv. at 612.

103 §§ 3(c), 4(b), 1993 N.J. Sess. Law Serv. at 612-13. Failure to comply with the alternate name registration provisions will not impair the validity of any contract, but will act as a "door closer," barring access to New Jersey courts until the registration deficiency is remedied. § 4(f), 1993 N.J. Sess. Law Serv. at 613.

by those other statutes.[104] Section 5 provides a mechanism for the advance reservation of the exclusive right to use a name.[105]

The second certificate of formation requirement, a registered office and a registered agent for service process, is delineated in section 6.[106] When a registered office or registered agent is changed, notice filed under section 6 automatically serves to amend the certificate of formation without further amendment.[107] Section 7 provides for the resignation of registered agents.[108] Unlike the existing provisions under other statutes, it is possible for a registered agent to resign without obtaining the signature of an authorized person for the LLC.[109] This should allow registered agents, who are oftentimes the counsel involved in forming a new entity, to remove themselves from any further statutory obligation when an LLC becomes inactive, bankrupt, etc.[110]

The third cited requirement for the certificate of formation does not require naming the members, but it does require a certification of fact. The certificate of fact must state that the LLC has two or more members, which if false can subject the signer to penal consequences for perjury in the third degree.[111] More significantly, the LLC will not be properly formed if it does not have at least two members.[112]

This provision underscores two distinct aspects of the LLC's

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104 § 3(d), N.J. Sess. Law Serv. at 612.

105 § 5, 1993 N.J. Sess. Law Serv. at 613-14.

106 § 6(b), 1993 N.J. Sess. Law Serv. at 614-15.

107 § 6, 1993 N.J. Sess. Law Serv. at 614-15.

108 § 7, 1993 N.J. Sess. Law Serv. at 615-16.

109 *Id.*

110 Sections 7(c)(3) and (4) put the burden in such circumstances on the LLC, subject to a penalty of $200 per year which may be docketed as a judgment and allowing the Secretary of State to put the LLC on inactive status after two years. § 7(c), 1993 N.J. Sess. Law Serv. at 615-16. Section 7(c)(4) carefully notes that this transfer does not affect the liability of any member of the LLC. *Id.* At the request of the Secretary of State, Senator Bennett introduced S. 2098 on September 13, 1993, to repeal subsections 7(c)(3) and (4). S. 2098, § 1, 205th N.J. Leg., 2d Sess. (1993). The sanction available to the Secretary of State for noncompliance with filing and fee payment requirements under the statute would be a refusal by the Secretary of State to provide reports or photocopies of the filed documents or reports. *Id.* § 2. In addition, this legislation imposes an express requirement on LLCs to file annual reports similar to that found in N.J. STAT. ANN. § 14A:4-5, N.J. STAT. ANN. § 15A:4-5 and N.J. STAT. ANN. §§ 42:2A-69, 70. S. 2098, § 3. Furthermore, the legislation creates a dedicated fund of fees paid for expedited services. *Id.* § 4.

111 §§ 11(a), 15(c), 1993 Sess. Law Serv. at 616-17.

112 § 11(a), 1993 N.J. Sess. Law Serv. at 616.

origins. First, the LLC is a hybrid of corporate and partnership characteristics. All partnerships require two or more partners because one cannot be a partner with oneself. There can be no contract with only one contracting party. This emphasis on contractual origins reoccurs throughout the New Jersey LLC statute in the form of the key role played by the operating agreement. At least one jurisdiction has enacted an LLC statute permitting an LLC comprised of one person.[113] It is possible that the law may evolve in the future to accept the LLC as a formal abstract person akin to a corporation without concern that it have a contractual "nature." However, this is not yet the case in New Jersey. Second, the favorable tax treatment accorded by the IRS to LLCs formed under the laws of other states is to tax them as "partnerships."[114] It is not certain whether the IRS will accept the abstraction without a paradigmatic requirement for partnerships; namely, partners. Thus, for both reasons, the New Jersey LLC statute requires a minimum of two members to form an LLC and the cancellation of a certificate of formation whenever there are less than two members.[115]

A certificate of formation must also set forth the latest date on which the LLC is to dissolve if the LLC has a specific date of dissolution.[116] This requirement raises one of the key characteristics used by the IRS for classifying entities as partnerships and not corporations; namely, continuity of life.[117] Thus, the decision as to how to deal with this particular conditional requirement should be addressed in connection with overall tax planning.

The fifth and final requirement, which permits the certificate of formation to contain additional matters, is permissive.[118] Again, this presents planning opportunities which should be carefully considered. It is frequently necessary when dealing with third parties to provide evidence that internal procedural formalities have been followed. In some instances a favorable opinion of counsel may be required. Section 15(b) allows any person to sign certifi-

113 TEX. REV. CIV. STAT. ANN. art. 1528n-3.01 (Supp. 1993). Note, however, that under the Code in order to be taxed as partnership there must be two or more partners. *See* Keatinge et al., *supra* note 1, at 430.

114 *See supra* text accompanying notes 33-38.

115 § 14(a), 1993 N.J. Sess. Law Serv. at 617.

116 § 11(a)(4), 1993 N.J. Sess. Law Serv. at 616.

117 *See supra* notes 72-76 and accompanying text.

118 § 11(a)(5), 1993 N.J. Sess. Law Serv. at 616.

cates by an agent, unless otherwise required by the operating agreement.[119] LLCs formed under the New Jersey statute may be controlled by managers as set out in the operating agreement.[120] Accordingly, the identity or position of the person or persons having signatory authority may not be readily apparent without careful review of an LLC's internal documents. Hence, it may be useful to spell out in the certificate of formation who or what positions have authority to act for the LLC. Once again, however, a careful assessment of tax classification issues should be made. If it is not desirable to have centralized management, then it would be inappropriate to indicate in the certificate of formation that a representative form of government with managers is being used.[121] Consideration should also be given to providing notice of the provisions in the operating agreement which lower or eliminate governance standards.[122]

Section 13 describes how a certificate of formation may be amended.[123] This is in addition to automatic amendments accomplished by notice filings under section 6.[124] Section 19 permits the filing of restated certificates of formation.[125] Section 17 covers the obligations of the Secretary of State with respect to filings.[126]

There are several other important provisions in this part of the statute. Section 12 incorporates into the LLC statute a similar provision found in other New Jersey business statutes which allows the post hoc filing of a certificate of correction to overcome any "inaccuracy or defect" and to relate back to the date of original filing.[127] Section 12 also provides that the correction is not effective for anyone who in good faith actually relied to his or her detriment on the incorrect filing.[128] Filings under this section require the consent of

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119 § 15(b), 1993 N.J. Sess. Law Serv. at 617.

120 § 2, 1993 N.J. Sess. Law Serv. at 612.

121 See *supra* text accompanying notes 70-71 for a discussion of centralized management.

122 §§ 26, 30, 1993 N.J. Sess. Law Serv. at 623-24. *See* discussion *infra* part V.D.

123 § 13, 1993 N.J. Sess. Law Serv. at 617. The amendment process requires a filing of a certification of amendment with the Secretary of State setting forth the limited liability company's name and the amendment itself. *Id.*

124 § 6, 1993 N.J. Sess. Law Serv. at 614-15.

125 § 19, 1993 N.J. Sess. Law Serv. at 618-19.

126 § 17, 1993 N.J. Sess. Law Serv. at 618.

127 § 12, 1993 N.J. Sess. Law Serv. at 616-17.

128 *Id.*

the Secretary of State.[129] Akin to a provision in NJRULPA, section 16(a) of the LLC statute permits anyone adversely affected by a person's refusal to sign a certificate required by the LLC statute to petition the court and obtain an order directing the Secretary of State to file an appropriate certificate.[130] Section 16(b) extends that concept to the signing of an operating agreement or an amendment and permits the court to "enter an order granting appropriate relief."[131]

Although an operating agreement is not necessary to form an LLC under the New Jersey statute, it is nonetheless appropriate to discuss the operating agreement here. For most LLCs, the operating agreement will undoubtedly be the critical organizational document. From the discussion above, it should be apparent that the certificate of formation is a relatively short and simple document. The certificate of formation is the only publicly available document concerning the LLC, which is why there may be practical and notice reasons to utilize the permissive fifth item on the certificate of formation: namely, to make third parties aware of particular attributes of a given LLC.

In contrast to the certificate of formation, the operating agreement is "a written agreement of the members as to the affairs of a limited liability company and the conduct of its business."[132] The New Jersey statute does not require an LLC to have an operating agreement. The operating agreement, however, is the means to vary otherwise applicable statutory rules and structures. In other words, absent an operating agreement, the New Jersey statute sets out an entire set of prescribed rules and structural requirements for an LLC. It is, however, most difficult to imagine that persons participating in an LLC would not want to use an operating agreement. The operating agreement for an LLC is intended to function for an LLC much like the limited partnership agreement functions for a limited partnership, except that an operating agree-

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129 *Id.*

130 *See* § 16(a), 1993 N.J. Sess. Law Serv. at 617. *See also* N.J. STAT. ANN. § 42:2A-20 (West 1993) (NJRULPA).

131 § 16(b), 1993 N.J. Sess. Law Serv. at 618. The section provides that "[i]f the court finds that the operating agreement or amendment thereof should be executed and that any person required to execute the operating agreement or amendment thereof has failed to do so, it shall enter an order granting appropriate relief." *Id.*

132 § 2, 1993 N.J. Sess. Law Serv. at 612 (defining the terms relevant to the New Jersey Limited Liability Company Act).

ment can provide lawful authority, as expressly permitted by the statute, for actions of the LLC.[133]

C. *Members and Membership*

A person becomes a member of an LLC formed under the New Jersey statute in connection with that formation on the later of: (1) the LLC's formation; or (2) the time delineated in the operating agreement, so long as the conditions in the operating agreement are met; or (3) if the operating agreement is silent, when membership is reflected in the LLC's books.[134] There are no prohibitions or limitations on who (or what) may be a member. After the LLC is formed, a person becomes a member as set out in section 21(b).[135] This section distinguishes between the acquisition of an interest directly from the LLC and the acquisition of an interest from another member.[136] If a prospective member is "buying into" the LLC, the person becomes a member pursuant to the provisions in the operating agreement. If the operating agreement is silent, a person becomes a member upon the consent of all the existing members.[137] If the prospective member is obtaining an interest from an existing member, the prospective member obtains membership when all members other than the transferor consent.[138] The timing and conditions of admission are governed by

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133 § 8(b), 1993 N.J. Sess. Law Serv. at 616. *See also supra* text accompanying notes 84-87.

134 § 21(a), 1993 N.J. Sess. Law Serv. at 621.

135 § 21(b), 1993 N.J. Sess. Law Serv. at 621. The statute states:

> b. After the formation of a limited liability company, a person acquiring a limited liability company interest is admitted as a member of the limited liability company:
>
> (1) In the case of a person acquiring a limited liability company interest directly from the limited liability company, at the time provided in and upon compliance with the operating agreement or, if the operating agreement does not so provide, upon the consent of all members and when the person's admission is reflected in the records of the limited liability company; or
>
> (2) In the case of an assignee of a limited liability company interest, (a) as provided in section 46 of this act and (b) at the time provided in and upon compliance with the operating agreement or, if the operating agreement does not so provide, when the assignee's permitted admission is reflected in the records of the limited liability company.

Id.

136 *Id.*

137 *Id.* The LLC's records must also reflect the member's admission. *Id.*

138 §§ 21(b)(2), 46, 1993 N.J. Sess. Law Serv. at 621, 628. Section 46 provides that

the operating agreement or, if silent, when the LLC's records reflect membership.[139] Section 21(d)(1) notes that the operating agreement may require that a new member sign it or other membership documentation.[140] The operating agreement will not be unenforceable because the new member does not sign it or because it was signed on behalf of the member or others by an agent.[141]

The membership provisions in the operating agreement must take into account the IRS's position on the transferability of LLC interests.[142] Section 44 expressly provides that an LLC interest is assignable in whole or part, but the assignee does not have any right to participate in the business of the LLC except with either the consent of all members other than the assignor or as provided in the operating agreement.[143] Section 44 allows for flexibility in dealing with assigned interests in the operating agreement.[144] If not addressed in the operating agreement, the assignment is a distributive share.[145] As a result of the assignment, the assignee does not assume any liabilities except as provided in

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an assignee of an interest in a limited liability company may become a member when all of the members other than the member assigning the interest consent or upon compliance with the procedure set forth in the operating agreement. § 46, 1993 N.J. Sess. Law Serv. at 628. Further, that section details the assignees rights and obligations. *Id.*

139 § 21(b), 1993 N.J. Sess. Law Serv. at 621.

140 § 21(d)(1), 1993 N.J. Sess. Law Serv. at 621. The agreement

> [m]ay provide that a person shall be admitted as a member, or shall become an assignee of a limited liability company interest . . . (a) if the person (or a representative authorized by the person orally, in writing or by other action such as payment for a limited liability company interest) executes the operating agreement or any other writing evidencing the intent of the person to become a member or assignee, or (b) without such execution, if the person . . . complies with the conditions for becoming a member or assignee as set forth in the operating agreement or any other writing and requests (orally, in writing or by other action such as payment for a limited liability company interest) that the records of the limited liability company reflect such admission or assignment.

Id.

141 § 21(d)(2), 1993 N.J. Sess. Law Serv. at 621-22.

142 *See supra* text accompanying notes 77-80.

143 § 44(a), 1993 N.J. Sess. Law Serv. at 627.

144 *Id.* It allows the assignee to participate in the management of the business, provided that either (1) all members, other than the assignee, approve; or (2) the assignee has complied with the procedure in the operating agreement. *Id.*

145 § 44(b)(1), 1993 N.J. Sess. Law Serv. at 627. That is, the assignee is entitled "to share in the profits and losses, to receive the distribution or distributions, and to

the operating agreement and then only to the extent agreed to by the assignee.[146] Section 45 allows a judgment creditor of a member to obtain a charging order, entitling the creditor to be an assignee with respect to the member's LLC interest.[147] If an assignee does become a member, section 46(b) makes clear that the new member is liable for any required contribution of his assignor.[148] Similarly, the member does not assume any obligation "unknown to the assignee at the time he became a member and which could not be ascertained from an operating agreement."[149]

The contribution obligation of a member may be cash, property, services, promissory note or other obligation for future payment of cash or property or performance of services.[150] This removes any doubt about the legitimacy of future payment or performance as consideration for the current receipt of an LLC interest.[151] The future obligations, however, will be enforced against the estate in case of death.[152] Any unpaid or unperformed contribution may not be compromised without the consent of all members, unless otherwise provided in the operating agreement.[153] In any case, no compromise is effective against a creditor who relied on the obligation in granting credit.[154] Consequently, a bank which lent to an LLC, having reviewed the LLC's books which showed payments due or a staged buy in by members, can enforce

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receive the allocation of income, gain, loss, deduction or credit or similar item to which the assignor was entitled." *Id.*

146 § 44(d), 1993 N.J. Sess. Law Serv. at 627.

147 § 45, 1993 N.J. Sess. Law Serv. at 627. The judgment creditor will then have the rights of a limited liability interest assignee. *Id.*

148 § 46(b), 1993 N.J. Sess. Law Serv. at 628. However, the operating agreement may provide otherwise. *Id.*

149 *Id.*

150 § 32, 1993 N.J. Sess. Law Serv. at 625.

151 *See, e.g.*, STUART L. PACHMAN, TITLE 14A CORPORATIONS 201-02 (Gann Law Books 1993). The receipt of an interest in an LLC in return for services performed or to be performed raises the issue of whether the LLC interest is compensation for tax purposes. The tax consequences depend in part upon what type of LLC interest is received. RIBSTEIN & KEATINGE, *supra* note 4, at 17-11 to -17, 1S-25.

152 § 33(a), 1993 N.J. Sess. Law Serv. at 625. The section provides that "a member is obligated to a limited liability company to perform any promise to contribute cash or property or to perform services, even if he is unable to perform because of death, disability or any other reason." *Id.*

153 § 33(b), 1993 N.J. Sess. Law Serv. at 625.

154 *Id.*

the unpaid buy in obligations despite any purported "compromise" among the LLC and the members *inter se.*

The question of sanctions for failing to meet a scheduled contribution payment or performance is left to the operating agreement.[155] The statute suggests, however, that sanctions may include a forfeiture of partnership interest to other members, a forced sale of the interest, a loss of the interest, a subordination of the interest or other adjustments to value and or distributive rights.[156]

Section 24 states that a person ceases to be a member, when the member makes an assignment for creditors, files for bankruptcy or for reorganization or is adjudged bankrupt.[157] However, this can be changed by the operating agreement or by the written consent of all of the members.[158]

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155 § 33(c), 1993 N.J. Sess. Law Serv. at 625.

156 *Id.*

157 § 24, 1993 N.J. Sess. Law Serv. at 622-23. Specifically this section states:

A person ceases to be a member of a limited liability company upon the happening of any of the following events:

a. Unless, otherwise provided in an operating agreement, or with the written consent of all members, a member:

(1) Makes an assignment for the benefit of creditors;

(2) Files a voluntary petition in bankruptcy;

(3) Is adjudged bankrupt or insolvent, or has entered against him an order for relief, in any bankruptcy or insolvency proceeding;

(4) Files a petition or answer seeking for himself any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law or regulation;

(5) Files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against him in any proceeding of this nature;

(6) Seeks, consents to or acquiesces in the appointment of a trustee, receiver or liquidator of the member or of all or any substantial part of his properties; or

b. Unless otherwise provided in an operating agreement, or with the written consent of all members, 120 days after the commencement of any proceeding against the member seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law or regulation, if the proceeding has not been dismissed, or if within 90 days after the appointment without his consent or acquiescence of a trustee, receiver or liquidator of the member or of all of any substantial part of his properties, the appointment is not vacated or stayed, or within 90 days after the expiration of any such stay, the appointment is not vacated.

Id.

158 *Id.* Any variation in the operating agreement from the statutory provisions re-

In addition, section 38 allows a member to resign from an LLC at a time or upon occurrences specified in the operating agreement.[159] If the operating agreement is silent, a member may resign on at least six months prior notice to the LLC and to each other member.[160] An operating agreement may, however, bar resignation prior to dissolution of the LLC.[161]

D. *Governance Limited Liability and Standards*

The statute provides that "[u]nless otherwise provided in an operating agreement, the management of a limited liability company shall be vested in its members in proportion to the then current percentage . . . in the profits," with those holding over 50% controlling.[162] This provision should avoid the LLC being seen as having centralized management, unless of course it is otherwise provided in the operating agreement.[163] Section 27 goes on specifically to permit management by managers, who hold positions as specified in the operating agreement.[164] As set out in section 28, a manager may, but need not, be a member.[165] Section 28 also specifies that a person who is both a manager and a member has dual powers and dual responsibilities, except as provided in the operating agreement.[166]

Section 22 of the statute permits an operating agreement to provide for classes or groups of members with different rights and powers including provisions for future creation of the same; this is

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quires careful consideration of the IRS positions regarding continuity of life. *See supra* text accompanying notes 72-76.

159 § 38, 1993 N.J. Sess. Law Serv. at 626.

160 *Id.*

161 *Id.* The linked issues of permissive resignation and wrongful withdrawal will be discussed further below in connection with the discussion of the financial provisions of the LLC statute. *See* discussion *infra* part V.E.

162 § 27, 1993 N.J. Sess. Law Serv. at 623-24. Additionally, for LLC operating agreements that provide for management, that designated manager will be vested with all the power provided in the agreement. *Id.*

163 *Id.*

164 § 27, 1993 N.J. Sess. Law Serv. at 623-24.

165 § 28, 1993 N.J. Sess. Law Serv. at 624. "A manager of a limited liability company may make contributions to the limited liability company and share in the profits and losses . . . as a member." *Id.* For example, a real estate development LLC could hire a manager who had no ownership stake to manage the LLC for what may well be passive investors in the LLC.

166 *Id.* These responsibilities are relative to the extent that he participates as a limited liability company member. *Id.*

similar to the "blank check" preferred stock provision in a corporate charter.[167] Section 22 also permits the operating agreement to provide for action, including amendment of the operating agreement, without the vote of any member or class of members.[168] Specified, weighted or other skewed voting rights may be accorded members or classes of members.[169] Voting may be on a per capita, financial or any other basis, but if the operating agreement does not address this, then the more protective per capita basis applies.[170]

These provisions of section 22 address member voting, which is conceptually akin to ownership voting. Contrast this to section 27 which, in the absence of another provision in an operating agreement, allows members to manage the LLC's affairs based on the vote of a majority of the profit interest.[171] This potential conflict can be resolved as follows: the per capita voting provision under section 22 only applies to membership voting if there is an operating agreement that does not otherwise address the basis for member voting. Section 27's majority of profit provision only applies when there is no operating agreement and then only to votes on management issues.[172]

Sections 60 through 64 govern the rights of members to bring derivative actions against other members or managers.[173] The bases for such an action may be fundamentally affected by provisions in the operating agreement that provide for the standards of governance and limits of liability adopted pursuant to section 26, as to

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167 § 22(a), 1993 N.J. Sess. Law Serv. at 622. *See* ASARCO Inc. v. Court, 611 F. Supp. 468 (D.N.J. 1985) (discussing blank check preferred stock).

168 § 22(a), 1993 N.J. Sess. Law Serv. at 622.

169 § 22(b), 1993 N.J. Sess. Law Serv. at 622.

170 *Id.* Per capita is more protective of each member because each member has the same voting power independent of how small a financial stake that member has.

171 §§ 22, 27, 1993 N.J. Sess. Law Serv. at 622-24. Section 27 states that members who own in excess of 50% of the profits are controlling. § 27, 1993 N.J. Sess. Law Serv. at 624.

172 §§ 22, 27, 1993 N.J. Sess. Law Serv. at 622-24. Section 29 parallels § 22 in allowing for classes or groups of managers, limited or skewed voting rights and various procedural requirement such as quorum and notice as set out in the operating agreement. § 29, 1993 N.J. Sess. Law Serv. at 624.

173 §§ 60-64, 1993 N.J. Sess. Law Serv. at 631. The right to bring an action, however, is contingent upon the plaintiff's membership both at the time the action is brought and at the time the transaction complained of occurred. § 61, 1993 N.J. Sess. Law Serv. at 631.

members, and/or section 30, as to managers.[174] Section 60 does not require a demand on management and refusal to act as a precondition to bringing the action; it recognizes "demand excused" situations.[175] Section 62, however, does require detailed pleading with respect to a demand or the reasons "excusing" it.[176]

Section 61 requires that the plaintiff be a member at the time of the alleged wrong or that he subsequently become a member by operation of law or pursuant to the operating agreement and his predecessor was a member at the time of the wrong.[177]

Section 63 permits the LLC to request security for expenses unless the plaintiff has an interest equal to 5% or more of either the contributions to the LLC or the profit interest in the LLC or an interest having a fair value of more than $100,000.[178] This is a traditional provision found generally in corporate statutes and in NJRULPA and is intended to limit so-called "strike suits."[179] Section 64, paralleling NJRULPA, expressly allows a court to award counsel fees and expenses to a successful plaintiff.[180]

Section 25 gives members the right, subject to standards set in the operating agreement, to obtain information "for any purpose reasonably related to the member's interest" including: financial information; a member list; organizational documents; evidence of contribution payment; and subject to potential confidentiality restriction, other information about the LLC which is just and reasonable.[181] Managers are given specific rights of access to records

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174 *See supra* text accompanying notes 193-97.

175 § 60, 1993 N.J. Sess. Law Serv. at 631. *See generally* Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469 (1990) (discussing the requirement in the corporate context that before shareholders bring a derivative action, they demand that the board of director's of the corporation bring a claim, unless such a demand would be futile).

176 § 62, 1993 N.J. Sess. Law Serv. at 631. Specifically, the complaint must set forth "with particularity the effort, if any, of the plaintiff to secure an initiation of the action by a manager or member or the plaintiff's reasons for not making the effort." *Id.*

177 § 61, 1993 N.J. Sess. Law Serv. at 631.

178 § 63, 1993 N.J. Sess. Law Serv. at 631. These expenses include attorney's fees resulting from the action. *Id.*

179 *See* N.J. STAT. ANN. § 14A:3-6 (West 1969) (Business Corporation Act); N.J. STAT. ANN. § 42:2A-65 (West 1993) (RULPA).

180 § 64, 1993 N.J. Sess. Law Serv. at 631. *See also* N.J. STAT. ANN. § 42:2A-66 (West 1993) (NJRULPA).

181 § 25(a), 1993 N.J. Sess. Law Serv. at 623.

needed for their positions.[182] Section 25(c) permits a manager to keep confidential from members any trade secret information or "other information the disclosure of which the manager in good faith believes is not in the best interest of the limited liability company or could damage the limited liability company."[183] This right could of course be the subject of abuse, especially in the context of a dispute or struggle for control. The traditional standards of "good faith" are likely to be strictly construed by a court in the absence of objective and compelling bases for the manager's decision, such as an opinion of counsel, an investment banker, etc.[184]

Section 23 is in many ways the most important provision of the statute. It reads in full:

> Except as otherwise provided by this act, the debts, obligations and liabilities of a limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company; and no member, manager, employee or agent of a limited liability company shall be obligated personally for any such debt, obligation or liability of the limited liability company, or for any debt, obligation or liability of any other member, manager, employee or agent of the limited liability company, by reason of being a member, or acting as a manager, employee or agent of the limited liability company.[185]

The language is express; obligations of the LLC are entity obligations, not obligations of its members. Further, no member or manager, employee or agent "shall be obligated personally" for: (1) any entity obligation; or (2) for any obligation or liability of any other member, manager, employee or agent by reason of being a member or acting as manager, employee or agent, as the case may be, of the

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182 § 25(b), 1993 N.J. Sess. Law Serv. at 623. The manager's need for this information, however, must be "reasonably related to his position as a manager." *Id.*

183 § 25(c), 1993 N.J. Sess. Law Serv. at 623. This right includes information which the "limited liability company is required by law or by agreement with a third party to keep confidential." *Id.*

184 *Cf.* N.J. STAT. ANN. § 14A:6-14 (West 1969) (general good faith obligation of corporate directors). *See also* Delmarmo Assoc. v. New Jersey Eng'g & Supply Co., 424 A.2d 847 (N.J. Super. Ct. App. Div. 1980) (corporation resisting a shareholder's demand to inspect corporate records has the burden of showing that the shareholder was not acting in good faith).

185 § 23, 1993 N.J. Sess. Law Serv. at 622.

LLC.[186] The only exceptions are in the case of unpaid or performed contribution, which may be enforced against the obligated member by, among others, creditors of the LLC.[187]

Section 9 clarifies further, that, except as otherwise provided in the operating agreement, a member or manager may lend to an LLC or borrow from it, act as a guarantor and otherwise transact business with an LLC to the same extent as an unrelated third party.[188] In other words, members and managers are not subject to disabling conflicts because of their status. There are comparable provisions in NJRULPA.[189] Should the facts of a particular case evidence "overreaching" by a member or manager in dealing with the LLC, it is quite probable that a New Jersey court would hold the member or manager liable for the consequences.[190] Section 9 is intended to prevent any judicial presumption that a disabling conflict or risk of misdealing is inherent in business relations between a member or manager and an LLC.

Members and managers are statutorily protected under section 31 from liability if they rely in good faith on records of the LLC and on reports of others, including both internal reports and outside opinions.[191] While not dissimilar from provisions in other statutes, section 31 is considerably broader in scope and detail than found in comparable provisions.[192]

Section 26 sets out that the operating agreement may specify terms and conditions for member performance and specified sanc-

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186 *Id.* It bears repeating that this section covers any debts arising from tort, contract, or otherwise. *Id.*

187 *Id.*

188 § 9, 1993 N.J. Sess. Law Serv. at 616. These transactions are, of course, subject to other applicable laws. *Id.*

189 *See* N.J. STAT. ANN. § 42:2A-11 (West 1993) (allowing partners in a limited partnership to lend money to and transact business with the partnership unless the partnership agreement prohibits same).

190 *See* Hill Dredging Corp. v. Risley, 114 A.2d 697, 712 (N.J. 1955) (transactions between director of corporation and same corporation are subject to close scrutiny and must be characterized by absolute good faith); Berkowitz v. Power/Mate Corp., 342 A.2d 566, 573 (N.J. Super. Ct. App. Div. 1975) (majority shareholders cannot use their powers for personal advantage and to detriment of minority shareholders).

191 § 31, 1993 N.J. Sess. Law Serv. at 624-25. The member or manager, however, must have reasonably relied on the "professional or expert competence" of a person selected by the LLC "with reasonable care." *Id.*

192 *Compare* N.J. STAT. ANN. § 14A:6-14 (West 1969) (Business Corporation Act) *with* N.J. STAT. ANN. § 15A:6-14 (West 1984 & Supp. 1993) (Nonprofit Corporation Act).

tions for failure to adhere to those standards.[193] Unless otherwise provided in the operating agreement, the liability standard is gross negligence or willful misconduct.[194] Section 26 goes on to permit the operating agreement to "eliminate or limit the personal liability of the member" for failing to meet the standards.[195]

Accordingly, an operating agreement could reduce performance standards to negligible levels and preclude any personal liability. It is quite possible that New Jersey courts would apply various equitable considerations, including adhesion contract analysis, should the facts seem to warrant it.[196] It may be appropriate in view of the public notice afforded by the certificate of formation to consider including or summarizing performance standards in the certificate. This would parallel the approach taken under both the Business Corporation Act and the Nonprofit Corporation Act, which require that altered liability standards be included in charter provisions.[197] At the very least, this area would warrant careful disclosure to any prospective new member.

Finally, section 10 provides that an LLC, subject to "standards and restrictions, if any, as set forth in its operating agreement," may indemnify any member or manager or other person from any and all claims.[198] There is no distinction between derivative and third party claims or between civil and criminal matters.[199] The operating agreement is a key document for protection of managers and of members involved in management against liability.[200] It is possible that, in abu-

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193 § 26, 1993 N.J. Sess. Law Serv. at 623. A member who fails to comply with the operating agreement may be subject to certain penalties set forth in the agreement. *Id.*

194 *Id.*

195 *Id.* Section 30 contains essentially identical provisions concerning managers and their performances. § 30, 1993 N.J. Sess. Law Serv. at 624.

196 *See, e.g.*, Rudbart v. North Jersey Dist. Water Supply Comm'n, 605 A.2d 681, 689 (N.J. 1992) (declining to follow appellate division decision that extended doctrine of adhesion contracts to regulated securities transactions).

197 *See* N.J. STAT. ANN. § 14A:2-7(3) (West 1969) (Business Corporation Act); N.J. STAT. ANN. § 15A:2-8(c) (Supp. 1993) (Nonprofit Corporation Act).

198 § 10, 1993 N.J. Sess. Law Serv. at 616.

199 *Compare* N.J. STAT. ANN. § 14A:3-5 (West 1969) (Business Corporation Act) *with* N.J. STAT. ANN. § 15A:3-4 (West 1984) (Nonprofit Corporation Act). Both define "proceeding" as "any pending, threatened or completed civil, criminal, administrative or arbitrative action, suit or proceeding, and any appeal therein." N.J. STAT. ANN. § 14A:3-5; N.J. STAT. ANN. § 15A:3-4.

200 *Compare* N.J. STAT. ANN. § 14A:3-5(8) (West 1969) (clarifying that indemnification of directors, officers and employees of a corporation "shall not exclude any other

sive circumstances and despite the literal text of section 10, a New Jersey court would impose obligations of good faith and fair dealing on any member or manager in a control position seeking indemnification from an LLC.

E. *Economic Provisions*

The statutory provisions governing the economic interests of members all defer to the operating agreement. This feature underscores the flexibility of an LLC formed in New Jersey. It is critically important to remember that the LLC, if structured to take account of tax classification characteristics discussed above, will be treated as a partnership for federal tax purposes.[201] Federal tax law imposes significant and complex limitations on the ability to create special allocations of profits or losses.[202] Section 34 provides that the operating agreement may provide for the allocation of the profits and losses to the members or groups of members.[203] If the operating agreement is silent, section 34 provides further that profits and losses will be allocated on a pro rata basis, grounded on the agreed value of member contributions as that value is stated on the LLC's book to the extent paid by and not already returned to a member.[204] This is an almost literal parallel to the comparable section of NJRULPA.[205]

Similarly, section 35 follows the pattern of NJRULPA in dealing with distribution.[206] Distributions, whether cash or other assets, are to be made to the members or groups of members in accordance with the operating agreement.[207] If the agreement is silent, distributions will be allocated based on the stated value of contributions paid in and not returned.[208]

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rights to which a corporate agent may be entitled" under the corporate charter, bylaws, shareholders' vote, or any other agreement). *Id.*

201 *See supra* note 2 and accompanying text.

202 I.R.C. § 704 (1992). This is yet another reason to have a competent tax professional involved in the planning and design stages of LLC formation.

203 § 34, 1993 N.J. Sess. Law Serv. at 625. Generally, these allocations shall be made in accordance with the provisions of the operating agreement. *Id.*

204 *Id.*

205 N.J. STAT. ANN. § 42:2A-37 (West 1993).

206 *Compare* § 35, 1993 N.J. Sess. Law Serv. at 625 *with* N.J. STAT. ANN. § 42:2A-38 (West 1993) (NJRULPA).

207 § 35, 1993 N.J. Sess. Law Serv. at 625.

208 *Id.* Unlike N.J. STAT. ANN. 42:2A-38, § 35 specifically provides that "[i]f the oper-

Section 40 provides that, unless otherwise provided in the operating agreement, a member has no right to a distribution in any form other than cash.[209] Conversely, except as provided in the operating agreement, a member cannot be compelled to accept an amount of in-kind distribution that is greater than the member's pro rata entitlement to distribution.[210] This again parallels NJRULPA.[211] Section 40 concepts can be extremely important in particular situations, such as where a petroleum marketing company is a member of an LLC formed for oil and gas exploration. That member may want in-kind rather than cash distributions.

Section 41 provides that a member, at the time the member becomes entitled to a distribution, has the status and possesses the remedies of a creditor of the LLC.[212] Unlike NJRULPA, the New Jersey LLC statute makes this right expressly subject to contrary provisions in the operating agreement and a payout limitation in section 42 tied to solvency and the priority of payment limitations in section 51 in the case of winding up.[213]

These variants from NJRULPA are of considerable significance. In the first case, the operating agreement can vary, defer or eliminate payment rights. It is improbable that a court would enforce provisions that diverged materially from a member's reasonable expectations in the context of an investment vehicle in the absence of very clear disclosures.[214] On the other hand, in commercial transactions with sophisticated members, limitations on

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ating agreement does not so provide, distributions shall be made on the basis of the agreed value" of each member's contributions. *Id.*

209 § 40, 1993 N.J. Sess. Law Serv. at 626. This restriction applies regardless of the nature of the member's contribution. *Id.*

210 *Id.*

211 N.J. STAT. ANN. § 42:2A-43 (West 1993).

212 § 41, 1993 N.J. Sess. Law Serv. at 626.

213 *See* §§ 41, 42, 51, 1993 N.J. Sess. Law Serv. at 626-29; N.J. STAT. ANN. § 42:2A-44. A member who receives a distribution in violation of § 42(a) and who knew of the violation at the time of the distribution, shall be liable to the LLC for the amount of the distribution. If the member was unaware of the violation, he or she shall not be liable to the LLC. *Id.*

214 *See, e.g.*, Rudbart v. North Jersey Dist. Water Supply Comm'n, 605 A.2d 681, 687 (N.J. 1992) (holders of construction notes were bound by their provision for notice of redemption by publication despite the fact that the notes fit the definition of "adhesion contracts" because although they were publicly traded securities among a vast number and array of alternative investments, the issuer did not hold a "superior bargaining position permitting it to dictate its own terms.").

the enforcement rights of a member as to distributions might reasonably be tied to other aspects of the arrangement.

Section 41 also expressly authorizes an operating agreement to include provisions for a record date for allocations and distributions.[215] This is a helpful reminder to include this practical arrangement in the operating agreement to allow for systematic allocations and distributions. It will also tend to prevent unintended periods of inaction, by creating a more regularized payment and valuation structure. Of course, such an arrangement also means regular and timely consultations with accounting professionals to determine what allocation and distributions, if any, might be appropriate.

Section 42 of the LLC statute parallels a NJRULPA provision while section 41 simply makes the constraint imposed by section 42 an express limit to the rights accorded by section 41.[216] Section 42 also addresses the use of non-recourse and partial recourse financing in LLC transactions.[217] In creating a balance sheet solvency test as the basis for limiting distributions, section 42 subtracts from total LLC liabilities both LLC liabilities to members on account of their LLC interests and LLC liabilities which are limited to recourse against specific LLC assets.[218] Similarly, section 42 excludes from total LLC assets the value of those assets against which creditors may have recourse for non-recourse debt.[219] Thus, in the case of an LLC that had borrowed funds from a bank to finance a warehouse, where the loan was non-recourse against the LLC with recourse only to a warehouse and land, and the warehouse and land

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215 § 41, 1993 N.J. Sess. Law Serv. at 626.

216 *See* §§ 41, 42, 1993 N.J. Sess. Law Serv. at 626-27; N.J. STAT. ANN. §§ 42:2A-45, -46. Specifically, an LLC

> shall not make a distribution to a member to the extent that at the time of the distribution, after giving effect to the distribution, all liabilities of the limited liability company, other than liabilities to members on account of their limited liability company interests and liabilities for which the recourse of creditors is limited to specified property of the limited liability company, exceed the fair value of the assets of the limited liability company, except that the fair value of property that is subject to a liability for which the recourse of creditors is limited shall be included in the assets of the limited liability company only to the extent that the fair value of that property exceeds that liability.

§ 42(a), 1993 N.J. Sess. Law Serv. at 626-27.

217 § 42(a), 1993 N.J. Sess. Law Serv. at 626-27.

218 *Id.*

219 *Id.*

had a value of $100,000 more than the amount of debt, the bank loan would not be counted as a liability and the warehouse and land would be treated as an asset worth $100,000. The section 42 balance sheet solvency test is otherwise straightforward; if the effect of a distribution would leave the assets of an LLC worth less than its liabilities, the distribution is prohibited.

Section 42(b) goes on to make a member, who knew a distribution was in violation of this standard, liable to return the distribution.[220] Section 42(b) exonerates the unknowing recipient of a violative distribution and, subject to statute of limitations constraints, leaves unaffected obligations or liabilities of a member under the operating agreement or other applicable law for the amount of a distribution.[221] This both underscores the ability to fashion liability regimes under the operating agreement and reminds one of the possible application of laws against fraudulent conveyance and the like.[222]

Section 42(c) provides that, unless otherwise agreed, no recipient of a violative distribution has liability for its return after three years from the distribution.[223] This is one of the two places in the statute that does not specify that the agreement to vary the statutory rule must be in the operating agreement.[224] Section 42(c)

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220 § 42(b), 1993 N.J. Sess. Law Serv. at 627.

221 *Id.*

222 *See, e.g.*, N.J. STAT. ANN. §§ 25:2-20 to -34 (Supp. 1993). The Uniform Fraudulent Transfer Act in pertinent part states:

> A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
>
> a. With actual intent to hinder, delay, or defraud any creditor of the debtor; or
>
> b. Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
>
> (1) Was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
>
> (2) Intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they become due.

Id. § 25:2-25.

223 § 42(c), 1993 N.J. Sess. Law Serv. at 627. It is an automatic cut off, unless a lawsuit is begun before the end of three years and the member is adjudged liable in that lawsuit.

224 *Id.* The other place permitting agreement other than in the operating agree-

represents an effort to create a point of finality or certainty for distributions. This is helpful for all concerned, although it may make settlement less likely in litigation, as time may eventually provide a total shield unless an adverse judgment is entered.

Section 43 states that, as in partnership law, an interest in an LLC is personal property and a member has no interest in any LLC property.[225] Section 38 provides that a member may resign at any time or on the occurrence of specified events as set out in the operating agreement.[226] If the operating agreement is silent, section 38 allows a member to resign on at least six months written notice to the LLC and to each member or manager.[227] An operating agreement may prohibit resignation and/or assignment of the LLC interest prior to dissolution and winding up.[228] In the case of a resignation in violation of the operating agreement, section 39 would permit the deferral or forfeiture of the member's right to receive distributions.[229] Moreover, section 39 permits an operating agreement to limit or prevent a member from receiving the fair value of his LLC within a reasonable time of resignation.[230] These provisions substantially parallel similar provisions in NJRULPA.[231] It is, however, important to address the particulars of penalties for wrongful withdrawal at the planning stage and to make certain that the provisions clearly spell out both what constitutes wrongful withdrawal and the consequences.

Section 37 creates a parallel provision for managers who resign but expressly authorizes the operating agreement to eliminate any right to resign.[232] Section 37 allows resignation even in the face of a bar in the operating agreement, upon notice to all mem-

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ment is § 20(g) dealing with the effect of a merger. *See infra* notes 250-56 and accompanying text.

225 § 43, 1993 N.J. Sess. Law Serv. at 627.

226 § 38, 1993 N.J. Sess. Law Serv. at 626.

227 *Id.*

228 *Id.*

229 § 39, 1993 N.J. Sess. Law Serv. at 626. Any resigning member is entitled to receive his distribution as provided for in the agreement. If the agreement does not provide for this, he is entitled to receive the fair value of his LLC interest as of the date of resignation. *Id.*

230 *Id.*

231 N.J. STAT. ANN. § 42:2A-42 (West 1993).

232 § 37, 1993 N.J. Sess. Law Serv. at 626. A manager may resign at the time or upon the occurrence of certain conditions set forth in the operating agreement. *Id.*

bers and all other managers.[233] The operating agreement may in that case, in addition to any other remedies available at law, allow recovery from the resigning manager for breach of the agreement and allow the offset against any amount "otherwise distributable" to the resigning manager.[234]

F. *Withdrawal, Dissolution and Winding Up*

Section 48 provides that an LLC dissolves and its affairs are to be wound up on the first to occur of: (1) reaching the time limit set in the operating agreement or, if none, thirty years; (2) upon events specified in the operating agreement; (3) the consent of all the members; (4) the death, retirement, resignation, bankruptcy, expulsion or dissolution of any member or any other membership ending event, unless all remaining members consent to continue within ninety days or pursuant to a right to continue under the operating agreement; or (5) pursuant to a judicial decree.[235] The operating agreement has two distinct purposes here: it may specify "end time" events and it may set forth a mechanism for continuing the LLC different from the statutory one. Of course, this second purpose must be approached with the pronouncements of the IRS in mind on what constitutes continuity of interest.[236]

Section 49, which employs the same statutory standard found in NJRULPA, allows a New Jersey court on application from a member or manager to order dissolution of an LLC "whenever it is not reasonably practicable to carry on the business in conformity with an operating agreement."[237] This provision, as with its NJRULPA cognate (which subsumes the existence of a partnership agreement), subsumes the existence of an operating agreement.[238]

Section 50 allows a manager who has not wrongfully dissolved an LLC or if no manager, a member owning more than 50% of the interest in profits, to wind up an LLC's affairs.[239] A New Jersey

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233 *Id.*

234 *Id.*

235 § 48, 1993 N.J. Sess. Law Serv. at 628.

236 *See supra* text accompanying notes 72-76.

237 § 49, 1993 N.J. Sess. Law Serv. at 628.

238 *See id.*; N.J. STAT. ANN. § 42:2A-52 (West 1993). Accordingly, it may be far more difficult to obtain judicial intervention to order dissolution where there is no operating agreement as there is no "base line" against which a court could measure LLC operations.

239 § 50, 1993 N.J. Sess. Law Serv. at 628-29. More specifically, the statute states:

court may direct the affairs of the LLC or appoint a trustee on application for "good cause shown."[240] Section 50 cross references section 14 concerning the filing of a certificate of cancellation.[241] Upon dissolution and until the certificate of cancellation is filed, the persons winding up the LLC's affairs may carry on the business and proceed to wind up, without affecting the liability of members, managers or any liquidating trustee.[242]

Section 51 governs the priority of payments upon winding up and requires that payment go first to creditors, expressly including members and managers except for liability for distributions due members or managers upon specified events or upon resignation.[243] Thereafter, distributions are to be made to members and former members with respect to distributions upon specified events or resignation.[244] Finally, members are to receive a return of their respective contributions and then a proportionate share of all remaining distributions.[245] All distribution payments rights may

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> Unless otherwise provided in an operating agreement, a manager who has not wrongfully dissolved a limited liability company or, if there is no manager, the members or a person approved by the members or, if there is more than one class or group of members, then by each class or group of members, in either case, by members who own more than 50 percent of the then current percentage or other interest in the profits of the limited liability company owned by all of the members or by the members in each class or group, as appropriate, may wind up the limited liability company's affairs.

Id.

240 *Id.*

241 §§ 14, 50, 1993 N.J. Sess. Law Serv. at 617, 628-29. Section 50 provides, in pertinent part, that:

> Upon dissolution of a limited liability company and until the filing of a certificate of cancellation as provided in section 14 of this act, the persons winding up the limited liability company's affairs may, in the name of, and for and on behalf of, the limited liability company, prosecute and defend suits . . . , gradually settle and close the limited liability company's business, dispose of and convey the limited liability company's property, discharge or make reasonable provision for the limited liability company's liabilities, and distribute to the members any remaining assets of the limited liability company, all without affecting the liability of members and managers and without imposing liability on a liquidating trustee.

§ 50(b), 1993 N.J. Sess. Law Serv. at 629.

242 § 50, 1993 N.J. Sess. Law Serv. at 628-29.

243 § 51, 1993 N.J. Sess. Law Serv. at 629. This provision closely parallels NJRULPA. *See* N.J. STAT. ANN. § 42:2A-54 (West 1993).

244 § 51(a)(2), 1993 N.J. Sess. Law Serv. at 629.

245 § 51(a)(3), 1993 N.J. Sess. Law Serv. at 629.

be varied by the operating agreement.[246] Section 51(b) requires the LLC to set aside sufficient funds to settle claims and contingencies.[247]

Section 14 then applies to require the filing of a certificate of cancellation with the Secretary of State.[248] That certificate must set forth: the name of the LLC; the date of filing its certificate of formation; the reason for filing the certificate of cancellation; the effective date (if not immediate) of the cancellation; and any other information deemed appropriate by the filer.[249] Interestingly, as noted above, section 14(a) requires the cancellation of a certificate of formation either upon "dissolution and the completion of winding up" or whenever there are fewer than two members or upon merger or consolidation, if the LLC is not the survivor.[250] Hence, the loss of a member in a two person LLC would automatically work a cancellation.[251]

G. *Merger Provisions*

The New Jersey LLC statute contains in section 20 an extensive inter-entity merger and consolidation agreement.[252] Section 20 would permit merger and consolidation with any "other business entity" which is defined to include a corporation, profit and

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246 § 51(a), 1993 N.J. Sess. Law Serv. at 629.

247 § 51(b), 1993 N.J. Sess. Law Serv. at 629. Section 51(b) provides, in pertinent part, that:

> A limited liability company which has dissolved shall pay or make reasonable provision to pay all claims and obligations, including all contingent, conditional or unmatured claims and obligations, known to the limited liability company and all claims and obligations which are known to the limited liability company but for which the identity of the claimant is unknown.

Id.

248 § 14, 1993 N.J. Sess. Law Serv. at 617. More specifically, the statute states:

> A certificate of formation shall be canceled upon the dissolution and the completion of winding up of a limited liability company, or at any other time there are fewer than two members, or upon the filing of a certificate of merger or consolidation if the limited liability company is not the surviving or resulting entity in a merger or consolidation.

Id.

249 *Id.*

250 *Id.*

251 §§ 11, 14, 1993 N.J. Sess. Law Serv. at 616-17. Section 11(a)(3) provides that the certificate of formation must state that the LLC has more than one member. § 11(a)(3), 1993 N.J. Sess. Law Serv. at 616.

252 § 20, 1993 N.J. Sess. Law Serv. at 619-20.

nonprofit, a business trust or association, a real estate investment trust, a common law trust, any other unincorporated business, including both general and limited partnerships, and foreign LLCs.[253] The "other business" entity may for section 20 purposes be formed under New Jersey law, the law of any other state or the law of the United States or any foreign country. Existing New Jersey statutes governing "other business entities" organized under New Jersey law do not authorize this type of inter-entity or cross-entity merger or consolidation.[254] The comparable laws of some other jurisdictions, perhaps most notably Delaware, do permit such transactions.[255] Thus, section 20 will, at the least, facilitate such transactions among New Jersey LLCs and other business entities from such states. Section 20 also provides that, unless otherwise agreed in the operating agreement or elsewhere, a merger or consolidation, even when the LLC is not the surviving entity, will not require the LLC to wind up its affairs and pay liabilities and distribute assets under section 51.[256] Section 20 specifies in detail the filings required with the Secretary of State in New Jersey and makes clear that the merger or consolidation works to vest all assets in the surviving entity and also to transfer all debts, liabilities and duties to the surviving entity.[257] Section 20 also provides that the certificate of merger or consolidation filed with the Secretary of State will itself serve to cancel the certificate of formation of an LLC which is not the surviving entity, without the need for a separate filing of a certificate of cancellation under section 14.[258]

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253 *Id.* It should be noted that it is uncertain whether conversion from partnership status to an LLC, where some of the partners in a limited partnership or all in a general partnership have unlimited liability, will trigger the application of New Jersey's Industrial Site Recovery Act. *See* ch. 139, 1993 N.J. Sess. Law Serv. 359 (West) [hereinafter ISRA]. In general, conversion of the ownership entity holding an industrial establishment in New Jersey to an LLC does not fall expressly within either ISRA's definition of "change of ownership" or ISRA's safe harbor of what is not a "change of ownership." *See* sec. 3, § 3, 1993 N.J. Sess. Law Serv. at 361-62. Clearly, the conversion to an LLC does not entail a change of use or control. However, the issue must be addressed on the facts of each particular case.

254 *See, e.g.*, N.J. STAT. ANN. § 14A:10-7 (West 1969) (limited to business corporations); N.J. STAT. ANN. § 15A:10-7 (West 1984) (limited to nonprofit corporations).

255 *See, e.g.*, DEL. CODE ANN. tit. 8, § 263 (1991).

256 §§ 20, 50, 51, 1993 N.J. Sess. Law Serv. at 619-21, 628-29.

257 § 20, 1993 N.J. Sess. Law Serv. at 619-21.

258 §§ 14, 20(e), 1993 N.J. Sess. Law Serv. at 617-20.

H. *Foreign LLCs*

Section 52 is an express statutory statement of the internal affairs doctrine.[259] It provides that the laws of the place (be it New Jersey, another state or a foreign country) where an LLC is organized "govern its organization and internal affairs and the liability of its members and managers."[260] Furthermore, the law provides that New Jersey may not refuse to register a foreign LLC because of any variance between the law of its place of organization and New Jersey law.[261] Hence, a one-person LLC organized under the Texas statute may register to do business in New Jersey despite the fact that such an entity would not be an LLC under New Jersey law.[262] The next following seven sections, 53 through 59, govern the registration of foreign LLCs in New Jersey.[263] Section 53 requires a foreign LLC to register with the Secretary of State before "doing business" in New Jersey.[264] Section 53 specifies that the application contain: (1) the name of the LLC and the name it proposes to register in New Jersey; (2) the place and date of its organization and a statement that it validly exists under its home law; (3) the nature of the business it intends to conduct in New Jersey; (4) the address of its registered office in New Jersey and name and address of its registered agent in New Jersey; (5) a statement appointing the Secretary of State as agent for service of process; and (6) the date it intends to commence business in New Jersey.[265] Significantly, section 53(b) adds that a person is not deemed doing business in New Jersey solely because the person is a member or manager of either a New Jersey or foreign LLC.[266] This provision may be comforting to high worth managers or members who would not wish to have to concede the kind of presence in New Jersey that doing business registration entails.

Section 54 governs the filing obligation of the Secretary of

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259 § 52, 1993 N.J. Sess. Law Serv. at 629.

260 *Id.*

261 *Id.*

262 § 52, 1993 N.J. Sess. Law Serv. at 629. Section 52 is essentially equivalent to the comparable provision in NJRULPA. *See* N.J. STAT. ANN. § 42:2A-55 (West 1993). *See also* TEXAS REV. CIV. STAT. ANN. art. 1528n-3.01.

263 §§ 53-59, 1993 N.J. Sess. Law Serv. at 629-31.

264 § 53, 1993 N.J. Sess. Law Serv. at 629-30.

265 *Id.*

266 *Id.*

State.[267] Section 55 requires prompt correction of any inaccuracy in the filing.[268] Section 56 permits the filing of a certificate of cancellation but also provides that such filing does not terminate the authority of the Secretary of State to accept service of process on that foreign LLC "with respect to causes of action arising out of doing business" in New Jersey.[269] Section 59 extends to foreign LLCs and those signing certificates on their behalf, the provisions of section 15 which makes the signing of a certificate equivalent to swearing an oath and subjects false swearers to penalties for perjury in the third degree.[270]

Section 57 bars a foreign LLC from New Jersey's courts until it registers and pays all fees and penalties.[271] Section 57 also provides that failure to register does not impair a contract, the right to sue on a contract or prevent the foreign LLC from defending any lawsuit in a New Jersey court.[272] Section 57 further provides that neither a member nor a manager is liable for the obligations of the foreign LLC for failing to register.[273]

Section 58 grants the New Jersey courts power to enjoin any foreign LLC from doing business in New Jersey without registering or if it has falsely obtained registration or if it is dissolved in its place of organization.[274] The Attorney General is given express authority to bring the litigation.[275] Section 58 also provides that its remedies are not exclusive and allows a court to impose any other appropriate remedy and permits the court to proceed in a summary manner.[276]

VI. The Tax Classification of LLCs Under New Jersey Law

Section 69 of the statute provides that an LLC formed in New Jersey or qualified to do business in New Jersey will be classified as a partnership "[f]or all purposes of taxation under the law" of New Jersey, unless "classified otherwise for federal income tax pur-

267 § 54, 1993 N.J. Sess. Law Serv. at 630.
268 § 55, 1993 N.J. Sess. Law Serv. at 630.
269 § 56, 1993 N.J. Sess. Law Serv. at 630.
270 §§ 14, 59, 1993 N.J. Sess. Law Serv. at 617, 631.
271 § 57, 1993 N.J. Sess. Law Serv. at 630.
272 § 57(b)(1)-(3), 1993 N.J. Sess. Law Serv. at 630.
273 § 57, 1993 N.J. Sess. Law Serv. at 630.
274 § 58, 1993 N.J. Sess. Law Serv. at 631.
275 *Id.*
276 *Id.*

poses."[277] If the LLC is classified as a corporation for federal tax purposes, New Jersey will follow suit.[278] Similarly, members are taxed as partners under New Jersey law so long as the entity is classified as a partnership for federal income tax purposes.[279] In that case New Jersey will also follow the federal tax classification.[280]

VII. The Limits of LLCs

LLCs formed under the New Jersey statute are likely to be complex entities resulting from careful planning by competent business law and tax professionals. As such, they will be more expensive to form than more established organizational types and more appropriately used in transactions which can bear such expense.

The more compelling limitations are the uncertainties, which are numerous. First, there is little or no case law under any of the LLC statutes and none in New Jersey, so that it is not possible to predict with assurance how a New Jersey court will judge particular provisions of an operating agreement. Second, many aspects of LLC formation are subject to careful tax analysis. The guidance to date from the IRS has been helpful but has not necessarily been dispositive.

Further, as of now there are some ten to fifteen states, including New York, Pennsylvania and California which do not have LLC statutes.[281] It is uncertain how a New Jersey LLC would be treated if it began doing business in a non-LLC jurisdiction.[282] This situation should eventually be cured as more states adopt LLC statutes. However, until this happens there are resulting constraints on the use of LLCs. Moreover, even after every state enacts LLC legislation there will still be a sufficient level of nonuniformity, that will

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277 § 69, 1993 N.J. Sess. Law Serv. at 633. *See also* Robert R. Keatinge, *Report of the Subcommittee on Limited Liability Companies*, A.B.A. PUBOGRAM, (ABA Comm. on Partnerships and Unincorporated Business Orgs., Chicago, Ill.), Aug. 1993, at 8.

278 *See* § 69, 1993 N.J. Sess. Law Serv. at 633. No realty transfer fee is imposed under N.J. STAT. ANN. § 46:15-5 to -14 (West 1989) and N.J. ADMIN. CODE tit. 18, § 16-5.10 (1986) for distributions of real estate to partners of a partnership. Although section 69 of the LLC statute does not directly control the imposition of a fee, it may be hoped that it will be extended by analogy to the realty transfer fee.

279 § 69, 1993 N.J. Sess. Law Serv. at 633.

280 *Id.*

281 *Id.*

282 *See generally* Keatinge et al., *supra* note 1, at 447-56.

mandate a review of the LLC statute and tax treatment at the state level in each state outside New Jersey, where a New Jersey LLC proposes to enter.

Finally, there are at least four tax issues which remain open. First, there is an exposure to federal self-employment tax for members whose LLC performs services.[283] The self-employment tax under the Code contains specific exemptions for a person receiving distributions of rent and of gain or loss from the disposition of property.[284] The Code also contains an exemption for limited partner distributions.[285] Although the IRS has ruled that LLCs are partnerships for federal income tax purposes, the IRS has not formally addressed the tax consequences of obtaining an interest on partnership profits.[286] Second, the New Jersey LLC statute has not yet been the subject of a ruling from the IRS. The IRS ruling on the Delaware statute, which New Jersey closely parallels, is very helpful.[287] Nonetheless, until a ruling is received, uncertainty remains as to whether an LLC formed under the New Jersey statute will enjoy partnership tax treatment. Third, LLCs may be classified as "enterprises" for purposes of certain regulations of the IRS, which would make cash method accounting, as opposed to accrual method, unavailable.[288] This classification will depend on whether federal and state security regulators determine that interests in LLCs are securities and that a particular transaction requires registration that no exemption is available.[289] Finally, there have been some indications that the Ways and Means Committee of the United States House of Representatives may hold hearings on LLCs.[290] A congressional enactment could of course eliminate or materially limit the ability or availability of LLCs.

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283 I.R.C. § 1402(a) (1986).

284 I.R.C. § 1402(a) (1986).

285 I.R.C. § 1402(a) (1986).

286 RIBSTEIN & KEATINGE, *supra* note 4, at 17-16.

287 Rev. Rul. 93-38, 1993-21 I.R.B. 4.

288 *See* Treas. Reg. § 1.448-1T (1992).

289 The New Jersey Bureau of Securities has not yet announced a formal position, although the Bureau Chief has directed one of the Bureau's regulatory officers to develop a policy position on LLC interests. Interview with Jared Silverman, Chief of the New Jersey Bureau of Securities, in Washington, D.C. (Nov. 10, 1993); Telephone Interview with Jared Silverman, Chief of the New Jersey Bureau of Securities (Nov. 15, 1993).

290 James L. Dam, *Should You be the First Lawyer to Start an LLC?*, LAW. WKLY. USA, Aug. 2, 1993, at 13-15.

Nonetheless, LLCs are, much like the common law constructs of the judges of King's Bench and perhaps especially Lord Mansfield,[291] a reasoned and practical response to the needs of business and commercial transactions.

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291 C.H.S. FIFOOT, LORD MANSFIELD *passim* (1936).