Business Law Section Newsletter

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Notes From the Editors

by Denise Walsh, Edward Sturchio and Thomas Zalewski

As business lawyers, we often counsel business owners about the importance of a good buy-sell agreement and what happens when the business marriage is headed for divorce.

Many of the articles contained in this edition of the *Business Law Section Newsletter* focus on the issues surrounding the breakup of a business. These articles deal with topics such as the rights of an oppressed owner of a business and the importance of a buy-sell agreement and its role in the valuation process.

Articles also continue to be written about New Jersey's Revised Uniform Limited Liability Company Act (RULLCA). This edition includes articles about the impact of the RULLCA on business breakups and when a court might order judicial dissolution of an LLC under the RULLCA.

In addition to the articles on business divorce, this edition contains a thoughtful article about the fundamentals of teaching third-party opinion practice to those new to the process, as well as a piece on the disregarded entity status of single-member LLCs. As promised, this edition of the newsletter includes the now regular column on opinion practice by Lydia Stefanowicz. This issue also includes an eye-opening article about recent changes to the derivative action statute under the New Jersey Business Corporation Act, which we think will be of interest to all business lawyers.

We think you will find the articles included in this edition to be informative and helpful for your practice. Thank you to all of the authors for contributing to this edition of the newsletter.

As always, we encourage you to submit an article for publication in the newsletter on a topic of interest to you and other members of the business law community. We also welcome input from you about topics you would like to see addressed in future editions of the newsletter. Please feel free to reach out to any of the editors with suggestions. ■

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Closely Held Family Businesses: What Happens When the Family is No Longer Close

by Rosaria A. Suriano and Melissa A. Clarke

Consider the case of a closely held family business started by a parent or grandparent. Hard work, sacrifice, and significant finances went into starting the business, building it, and overseeing profitable years. Now, the business is being turned over to the next generation, a process that can be fraught with disagreement regarding the transition and succession planning. Conflict develops as family members fail to see eye-to-eye on who can and should run the company. Each family member may have an ownership interest in the business; however, the more dominant family member may abuse his or her power, make decisions without involving other family members, and take control of the company. Can the controlling family member exclude or 'freeze out' the other members? What are the rights and remedies of the family members who do not control the company?

The Rights of Oppressed Minority Shareholders

In 1968, New Jersey enacted the minority oppression statute, codified at N.J.S.A 14A:12-7. The act, as amended in 1988, was designed to solve problems peculiar to "close corporations," corporations having "25 or less shareholders."[1] It was enacted to help address the concerns of powerless "minority" shareholders, who had been left in "freeze out" situations or where those in control acted fraudulently or illegally, mismanaged the corporation, abused their authority, or otherwise acted oppressively or unfairly toward one or more of the minority shareholders.[2]

In freeze out situations, the act gives a minority shareholder a remedy where he or she has been eliminated from the company, where his or her voting power has been drastically reduced, where the shareholder has been otherwise deprived of the ability to participate in the decisions of the company, or where he or she is deprived of corporate income or advantage to which he or she is entitled.[3] The act presently embodies a legislative determination that freeze out maneuvers in a close corporation constitute an abuse of power.[4]

The act, however, is not rendered inapplicable where a plaintiff is the majority shareholder. A majority shareholder not in control of the company may seek relief under the act.[5] The real concern of the statute, rather than the amount of stock held, is "protection from the abuse of *power*."[6] "[T]he question of whether one is a minority shareholder should not 'be determined through a mechanistic count of stock ownership percentages…but rather by a qualitative evaluation of the actual control a particular shareholder may exert on a closely held corporation..'"[7] As such, where a shareholder owns the majority interest in the corporation, an action under the act may be brought by the majority shareholder where such an individual cannot reach a majority vote and, consequently, does not have control of the company.[8] Under this scenario, the court will rule on the plaintiff's status based on a qualitative examination of his or her power in that corporation. Thus, a noncontrolling majority member in a closely held business may also seek relief under the act to protect his or her interest and/or to enjoin the controlling member from any oppressive and/or improper actions.

Deadlock Under the Shareholder Oppression Statute

What happens when the shareholders cannot agree on significant decisions or there is deadlock on major issues concerning the operations of the corporation? Deadlock can be proven if a party can show that directors "are unable to effect action on one or more substantial matters respecting the management of the corporation's affairs."[9] Where there is deadlock, a court can take remedial action.

Showing Oppression Under the Shareholder Oppression Statute

"[T]he intent and purpose of N.J.S.A. 14A:12-7 is to prevent abuse and oppression by those in control of a closely-held corporation upon those with inferior interests" or power.[10] A primary "measure of oppression in the small corporation is whether the fair expectations of the parties have been met."[11] "When personal relations among the participants in a close corporation break down, the 'reasonable expectations' that participants had, for example…*that they would enjoy meaningful participation in the management of the business*, become difficult, if not impossible, to fulfill."[12] When expectations involving the management of the corporation are not met, the act affords relief to the oppressed shareholder.

Remedies Under the Act

The act provides specific statutory remedies including, among others, injunctive relief, the appointment of a receiver, the purchase of a shareholder's stock, or dissolution. Courts are not limited to the statutory remedies but have a wide variety of other remedies available to them. The statute also permits the court to award counsel fees and costs to any party if the court finds the other party acted "arbitrarily, vexatiously, or without good faith."[13]

Action in Equity

The superior court, Chancery Division, general equity part has jurisdiction of all actions in which the plaintiff's primary right or principal relief is *equitable* in nature. One of the many benefits of an action in equity is that the court has the discretion to adapt the relief to the circumstances of the case and may compel or restrict the actions of one party. Indeed, the general equity part of the superior court may be best equipped for efficient disposition of a corporate deadlock or oppressed minority shareholder action because the court has the ability to order dissolution, to appoint a custodial receiver, fiscal agent, or provisional director, or to fashion another appropriate equitable remedy.

Procedurally, a complaint or a verified complaint and order to show cause (OSC) may be filed to initiate the case. If injunctive relief is sought, an emergent application may be made by filing an OSC *with temporary restraints*. An initial hearing regarding the temporary restraints will likely be required within a few days of filing of the action, pursuant to Rule 4:52-1(a). On the return date of the OSC, the court may impose a preliminary injunction that will last until final disposition of the case or until the defendant succeeds in moving for a dissolution of the restraints.

Where a family member finds him or herself a party to an oppressed minority shareholder suit, a decision regarding the control, and/or abuse of that control, or deadlock can be made on the return date of the OSC, pending a full resolution of all issues through litigation. An application to dissolve or modify a preliminary injunction may require more than a motion return date. The court may schedule a plenary hearing to consider the sworn testimony of accountants, financial advisors, and others to resolve any factual disputes and decide how to proceed.

The Limited Liability Company and the Minority Oppression Statute

Increasingly, many closely held businesses are being structured not as close corporations but as limited liability companies (LLCs). As a result, one might question whether a minority owner of an LLC has the same protections against oppression and whether the minority oppression statute can afford relief to LLC minority owners.

When the state Legislature first enacted the New Jersey Limited Liability Company Act (LLCA), codified at N.J.S.A. 42:2B-1 *et seq*., it did not incorporate the minority oppression contained in the New Jersey Business Corporation Act (BCA), codified at N.J.S.A. 14A:12–7(1)(c). Therefore, minority members of LLCs did not have an equivalent minority shareholder oppression cause of action. The problems common to both the corporation and the LLC have served as the basis for some courts to fill gaps in the LLCA using the BCA.[14] The New Jersey Appellate Division, however, has expressly held that LLCs in New Jersey are governed solely by the LLCA.[15] The District Court of New Jersey reached a similar conclusion and refused to permit a former member of an LLC to bring a claim of shareholder oppression under N.J.S.A. 14A:12–7(1)(c), noting that the court was "unaware of any case in which a member of a New Jersey limited liability company was able to successfully bring a cause of action under the shareholder oppression act."[16]

On Sept. 19, 2012, Governor Chris Christie signed the Revised Uniform Limited Liability Company Act RULLCA, codified at P.L. 2012, c.50, N.J.S.A. 42:2C 1 through 42:2C94, which applies to any LLCs formed on or after March 18, 2013, and all pre-existing LLCs beginning on April 1, 2014. The RULLCA affords minority members of an LLC several remedies for deadlock and oppression, including dissolution, appointment of a custodian, or sale of a member's LLC interest. Thus, where an LLC's managers or controlling members are acting illegally, fraudulently, or oppressively to another member, LLC members will be able to seek comparable relief under the RULLCA once the new statute takes effect. In the meantime, however, LLC minority owners will have little recourse, as the Appellate Division recently reiterated that "[g]iven the lack of an oppressed member provision in the LLCA, our holding in *Denike* and the Legislature's recent actions [enacting the Revised LLC Act with its oppressed member provision], we think it clear that the BCA's oppressed shareholder provisions have no application to an LLC."[17]

Conclusion

The minority oppression statute can serve as a powerful tool for those family members who find themselves powerless, oppressed, frozen out of decisions, or otherwise treated unfairly by another family member who is in control of the corporation. An action in the general equity part of the superior court via an order to show cause (with or without temporary restraints) may be the most efficient and effective source of relief for such a party, given the court's ability to fashion an equitable remedy. While the RULLCA now provides remedies for deadlock and oppression, oppressed minority members of LLCs existing prior to March 18, 2013, will have to wait until April 1, 2014, (when the new statute takes effect) for any relief, as the Appellate Division has made clear that the BCA's oppressed member provision does not extend to LLCs. ■

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Endnotes

1. N.J.S.A. 14A:12-7 (1)(c).
2. *Id.*
3. *Id.*
4. *Exadaktilos v. Cinnaminson Realty Co., Inc.*, 167 N.J. Super. 141, 154 (Law Div. 1979), *aff'd*, 173 N.J. Super. 559 (App. Div.), *certif. denied*, 85 N.J. 112 (1980).
5. *Bonavita v. Corbo*, 300 N.J. Super. 179, 187 (Ch. Div. 1996).
6. *Id.*
7. *Id.* (*quoting Berger v. Berger*, 249 N.J. Super. 305, 315 (Ch. Div. 1991)).
8. *See Balsamides v. Protameen Chemicals, Inc.*, 160 N.J. 352, 371 (1999).
9. N.J.S.A. 14A:12-7(6).
10. *Berger*, 249 N.J. Super. at 316.
11. *Muellenberg v. Bikon Corp.*, 143 N.J. 168, 180 (1996).
12. *Id.* (emphasis added).
13. *Belfer v. Merling*, 322 N.J. Super. 124, 146 (App. Div.), *certif. denied*, 162 N.J. 196 (1999).
14. *See Percontino v. Camporeale,* No. BER-C-5-05, 2005 WL 730234, at *3 (Ch. Div. March 24, 2005) (holding the court had the ability to appoint a receiver in the case of a limited liability company, regardless of the absence of any specific provision within the LLCA).
15. *Denike v. Cupo*, 394 N.J. Super. 357, 378 (App. Div. 2007), *rev'd on other grounds*, 196 N.J. 502 (2008).
16. *Casella v. Home Depot USA, Inc.*, No. CIV.A. 09-0421 (JAP), 2010 WL 3001919, at *3–4 (D.N.J. July 28, 2010) ("[A] former member of a limited liability company ... clearly does not fall within the plain meaning of the minority oppression statute which reserves the right solely for 'corporations with 25 or less shareholders.").
17. *Tutunikov v. Markov*, Docket No. A-1827-10T3 (App. Div. Aug. 1, 2013).

Business Divorce, Valuation and the Importance of a Buy-Sell Agreement

by Gerald A. Shanker

Buy-sell agreements are among the most important agreements entered into by business owners. Notwithstanding the importance, many businesses do not have buy-sell agreements in place, and for many that do, the agreements are ambiguous and outdated. An effective buy-sell agreement will eliminate or reduce the disputes arising from the death or retirement of a shareholder, and the absence of an effective agreement may result in a protracted and costly dispute. This article will review the items frequently overlooked in drafting or updating buy-sell agreements.

To determine if an existing buy-sell agreement still works for a business, the value of the business should be calculated pursuant to the agreement as if a triggering event had occurred. If there are no disputes over interpretation of the agreement, all parties believe the value result is fair and the funding mechanism is in place to make the required payments, then the agreement is still acceptable. Many companies that perform this exercise find the existing agreement to be unsatisfactory and in need of change. It is much better to perform this exercise and identify problems with the agreement prior to occurrence of a triggering event. In evaluation of the results of this exercise, the parties usually will be open minded and fair, because they do not know if they will be a buyer or seller when the actual triggering event occurs.

Types of Buy-Sell Agreements

Buy-sell agreements fall into three basic categories: fixed-price agreements, formula agreements, and agreements requiring the performance of a valuation.

In fixed-price agreements, the price is specified in the agreement and is generally tied in to and funded by an insurance policy, which was most likely purchased at the time the agreement was executed. These agreements usually contain a provision requiring the fixed price to be periodically updated, but this provision is frequently disregarded. Problems can arise when a triggering event occurs and the fixed-price value has not been updated because the actual value may have changed since the last time the value was determined pursuant to the agreement. A fixed-price agreement will be respected even if the price bears no relationship to actual value. In the case of *Estate of Claudia Cohen v. Booth Computers and James S. Cohen*, the Appellate Division held a family partnership agreement that provides for a buyout based on net book value may be enforced even where the disparity between book value and market value is significant.[1]

In a formula agreement, the business value is generally determined by a relatively simple formula such as a multiple or percentage of net or gross income. The problem with formula agreements is that although the formula undoubtedly made perfect sense when the agreement was drafted, it may no longer be relevant or yield a result that bears any relationship to current value. Furthermore, if net income is a component of the formula, each expense paid by the business can become the subject of a dispute. The author recently served as a valuation expert in a case involving the interpretation of the formula provisions of a shareholder agreement. In that case, the plaintiff challenged the deduction of almost every expense paid by the corporation, resulting in a protracted dispute that was ultimately resolved by court decision.

Agreements that require the performance of a valuation by a qualified expert are most likely to yield a fair result and less likely to be the subject of dispute, as opposed to fixed-price or formula agreements. The performance of the valuation will require payment of professional fees, but these fees will be far less than those that would be paid in the event of a dispute. Agreements often require each party to engage an expert to perform a valuation, and if the results are not within a specified range of each other, a third appraiser is engage to perform a final, binding valuation. In these situations, the initial appraisers become advocates for their clients, resulting in widely disparate value results and the necessity of engaging a third appraiser. Significant time and money would be saved if the agreement required the engagement of the neutral appraiser, because the parties would pay for only one valuation report.

Standard of Value

Standard of value is an important element of a buy-sell agreement. In New Jersey, the most frequently used standards of value are fair market value and fair value. An agreement that uses the generic term "value" and does not state the standard of value to be used will be the subject of dispute.

Fair market value is the price at which a property would change hands between a willing buyer and a willing seller, both having knowledge of all the relevant facts and neither being under a compulsion to buy or sell. In New Jersey, fair value is generally fair market value without discounts for lack of marketability or lack of control. Because the discounts for lack of control and lack of marketability can be significant, the difference in the value result between fair market value and fair value also will be significant.

Triggering Events

Common triggering events in a buy-sell agreement include shareholder death, disability and retirement. Other triggering events that should be considered are divorce, loss of professional license or one's continued failure to perform duties.

The agreement should distinguish between normal retirement, that is retirement at or within a range of ages stated by the agreement, and early retirement, where the shareholder retires prior to this age or range. Early retirement may be problematic for several reasons, including loss of a key employee, potential competition, and timing the early retirement to create a financial advantage for the retiree.

If the subject business has experienced several highly profitable years or is anticipating an economic downturn, a shareholder may strategically time his or her retirement to maximize the value of his or her ownership interest and retirement payment. Such unexpected retirement may be detrimental to the business because of the unexpected loss of a key employee and the obligation to make payments to purchase the retiree's ownership interest. This can be prevented by establishing a minimum retirement age and requiring substantial notice of early retirement, for example, one full year. Although an agreement cannot prevent early retirement, it can penalize the early retiree by reducing the amount paid for the ownership interest. The agreement may also include a provision permitting the remaining shareholders to waive the minimum retirement age and notice requirement.

For retirement resulting from disability, the agreement should define disability and the circumstances that trigger the purchase, for example, the inability to perform duties for a specified period of time. Many disability provisions require the opinion of a licensed medical professional.

In many situations, the business interest is the most valuable asset owned by the shareholder. In the event of a divorce, it is subject to equitable distribution and its value will most likely be disputed by the non-titled spouse. If the marital estate does not have sufficient other assets to satisfy equitable distribution, the non-titled spouse may be awarded an ownership interest in the business. To prevent this occurrence, consideration should be given to requiring the divorcing shareholder to sell his or her shares to the other shareholders.

In a divorce situation, there may be a conflict between standards of value. The standard of value for New Jersey divorce is fair value, which results in a higher value than fair market value because fair value does not include discounts for lack of control and lack of marketability. If the buy-sell agreement standard of value is fair market value, there will be a difference between the amount paid by the business to purchase the shares and their fair value for equitable distribution purposes. Presumably, an argument could be made that the purchase price of the shares pursuant to a mandatory divorce sale provision is the value for equitable distribution purposes.

Valuation Date

Upon the occurrence of a triggering event, the valuation date is the effective date of the valuation. In performing a valuation, the valuation analyst can only use information that was known or knowable as of the valuation date. This is important because an event occurring subsequent to the valuation date cannot be considered in the valuation. For example, the loss of a key customer, supplier, or employee, or the introduction of a competitive product or new competitor, or even a decline in the economy after the valuation date may reduce the value of the company and the subject interest, but not as of the valuation date.

For practical purposes, buy-sell agreements often establish the valuation date as the most recently completed year, quarter, or month end preceding the triggering event. As many closely held businesses do not perform full monthly or quarterly closings, and business valuations often use three or five years' historical financial data, setting a valuation date when there is no normal closing will require additional work and higher costs.

Discounts and Premiums

Discounts for lack of control and lack of marketability frequently give rise to disagreement between business valuation practitioners, as well as between practitioners and the Internal Revenue Service. When faced with the testimony of opposing experts, New Jersey courts more often than not 'split the baby' by choosing discounts that are the midpoint between the experts.

To avoid controversy over application and amount of discounts, consideration may be given to specifying a range or maximum discount in the buy-sell agreement. The author's firm was recently involved in a case in which the shareholder agreement limited the combined discount to 30 percent. Although this maximum discount may have been slightly low, it eliminated a major point of conflict.

Tax Effecting

Most closely held businesses operate as S corporations, partnerships, or limited liability companies taxed as partnerships. With limited exception, none of these entities pay federal or New Jersey income taxes. They are commonly referred to as pass-through entities, because the business income or loss passes through to the owners for inclusion and taxation on their individual income tax returns.

Because pass-through entities do not pay income taxes, controversy exists whether income tax expense should be recognized in valuation of these entities. If income tax expense is not recognized, the business value will generally be greater than if income tax expense is recognized.

The arguments and logic are fairly complicated, but the Internal Revenue Service and valuation practitioners who do not deduct income taxes in valuing pass-through entities simply argue that the pass-through entity does not pay any taxes and therefore, none should be considered in the valuation. Practitioners who favor tax effecting argue that taxes are paid on the income, but they are paid by the shareholder, and a purchaser of an ownership interest in the business would consider the tax obligation in determining the amount he or she is willing to pay for the interest. Another argument that favors tax effecting is that the published rate of return data used in valuing businesses is calculated on an after-tax basis, so consistency and comparability require tax effecting of the subject company to make the data comparable.

If tax effecting is included in a valuation, the analyst calculates hypothetical income tax expense using a tax rate based on his or her professional judgment. Often, this rate is based on the personal income tax rates paid by the business owners who are paying tax on the income.

In drafting a buy-sell agreement, consideration should be given to expressly addressing tax effecting in the agreement. Making a decision on tax effecting and including it in the agreement will help eliminate a point of potential controversy upon the occurrence of a triggering event.

Funding

Many buy-sell agreements rely partially or fully on life insurance to pay for the business interest, which is fine if the triggering event is the death of the business owner. However, the purchase of an ownership interest triggered by disability, divorce, early retirement, or the loss of a professional license also require payment for the business interest, and life insurance proceeds will not be available for such payment.

Many buy-sell agreements provide for a down payment following by periodic installment payments, with interest. In an installment payment situation, the shares are generally held in escrow until full payment for the shares is received. This can be risky for the seller because if the business cash flow declines the business may not be able to make the required installment payments. Consideration should be given in the agreement to the consequences of nonpayment of the installment obligation. Many agreements provide that upon an event of default in the payment of the installments, the selling shareholder can take back his or her stock, but this remedy may not be satisfactory if the business has experienced a decline. In any case, the installment payment amount must not be so large that it negatively affects business operations, because no one wins if it does.

Continuing Benefits

The agreement should address continuing benefits, that is, the treatment of the retiring shareholder or his or her estate between the occurrence of the triggering event and the actual purchase of the business interest. For example, pass-through entities often make distributions to their owners to reimburse the owners for taxes paid on pass-through income when the income is not distributed to the owners. After a triggering event, an owner of an interest in a pass-through entity or his or her estate continues to be liable for taxes on pass-through income. The agreement should address whether the retiring owner will continue to receive reimbursement for taxes in the same manner as was done prior to the triggering event. Other continuing benefit issues to consider include continuing payment by the business of compensation; health, life and disability insurance; qualified plan contributions; automobile expenses; and other perquisites previously paid by the business. The buy-sell agreement should address these issues in as much detail as possible, identifying each item and the circumstances under which payments will or will not continue.

Professional Practices

Professional practices such as law and accounting firms, and other businesses in which revenue is dependent on the relationships and services of the owners present special problems. If efforts are not made by the retiring owner to transition his or her relationships to the remaining owners, some of the clients may not remain with the firm, reducing firm revenue and value. To prevent this situation, the buy-sell agreement should require the retiring owner to cooperate in the transition and be available for reasonable consultations. Consideration should be given to a reduction of the purchase price of the interest if there is a substantial loss of clients and the retiring owner did not assist in the transition as required by the agreement. This will give the retiring owner financial incentive to insure a smooth transition of his or her relationships. However, the retiring owner should not be penalized if the loss of business is due to factors outside of his or her control.

Due to the uncertainty related to the outcome of their cases, plaintiff and other contingent fee law firms are particularly difficult to value. Although the value of contingent fee cases can be estimated, the estimate could be incorrect and the outcome may be unfair to the firm or the retiring partner.

In a real-life example, the author's firm counseled a personal injury law firm in which a partner retired because of the onset of a sudden, fatal illness. As of the partner's retirement date, the firm had many large cases, some of which were near resolution and others in various stages of completion. All parties desired a fair result for the retiring partner, but did not want to obligate the law firm to make payments that it could not afford. To protect the firm and the retiring partner, a plan was designed under which the retiring partner received a percentage of fees on resolved cases, based on the resolution date. During the first 12 months after retirement, he received a full share of the fee income. After the first 12 months, the percentage declined each month, ending after 60 months. This payment plan only applied to cases that were open as of the retirement date. The rationale for the declining payment percentage was that a case resolved close to the retirement date was substantially complete as of that date, but cases resolved long after retirement most likely required substantial additional effort after retirement, to which the retiring partner made reduced or no contribution.

Selection of a Valuation Professional

If the buy-sell agreement requires performance of a current valuation, a valuation professional must be selected. Selection of the professional after the triggering event may be difficult. Consideration should be given to identification of the firm or individual who will perform the valuation, along with alternates who can be engaged if the primary firm or individual is unable to accept the engagement for any reason.

Conclusion

Although it is impossible to anticipate every contingency and the source of every possible disagreement, an effective buy-sell agreement that is understood by all parties will go a long way in reducing disputes. A business partnership is like a marriage, everyone is in love in the beginning, but the love may not last forever. An effective buy-sell agreement protects all the parties if and when the love ends.

As previously discussed, business circumstances change, and the buy-sell agreement may require periodic updating to reflect such changing circumstances. It may be uncomfortable for the parties to discuss sensitive buy-sell issues, but it is far worse to ignore them. Issues not addressed do not go away; they become bigger and more often than not must be decided by a judge. Review of client buy-sell agreements presents an opportunity for legal counsel to be proactive in providing a valuable client service.

Gerald A. Shanker CPA is a member of Kreinces Rollins & Shanker, LLC in Rochelle Park. He is accredited in business valuation by the American Institute of Certified Public Accountants. The concepts discussed in this article come from his experiences assisting in the resolution of shareholder disputes and from the book Buy-Sell Agreements for Closely Held and Family Business Owners by Z. Christopher Mercer.

Endnote

1. 421 N.J. Super. 134, 22 A.3d 991 (App. Div. 2011).

Call for Articles

We are seeking articles for the winter 2013 issue of the Business Law Section Newsletter on topics of interest to business lawyers in New Jersey and written by New Jersey State Bar Association members.

The deadline for submitting articles for the winter 2013 edition is **Nov. 1, 2013**.

Interested in submitting? Contact any of the editors:

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Tom Zalewski at 973-966-8115 or tzalewski@daypitney.com

We look forward to hearing from you.

Successful Strategies Under New Jersey's RULLCA's Not Reasonably Practicable Standard

by John D. Cromie and Noel D. Humphreys

When Dad died, his three adult children inherited a profitable real estate business through a limited liability company (LLC). Now, despite the profits, an atmosphere of vituperative non-cooperation, suspicion and distrust characterizes the inheritors' ownership. Under New Jersey's recently revised limited liability company statute, what would one of the offspring argue to demonstrate that she is entitled to judicial dissolution of the entity?

The old statute[1] provided that a New Jersey court could decree dissolution "whenever it is not reasonably practicable to carry on the business in conformity with an operating agreement." New Jersey's new LLC statute,[2] which became effective a few months ago, provides essentially the same standard for a court-ordered dissolution: "not reasonably practicable to carry on the company's activities in conformity with one or both of the certificate of formation and the operating agreement."

New Jersey's new statute is modeled on the Revised Uniform Limited Liability Company Act (RULLCA), as adopted by the National Conference of Commissioners on Uniform State Laws. The RULLCA's modern regulatory scheme has developed what the commissioners hope are the best features of the prior generation LLC statutes. Eight states[3] and the District of Columbia have adopted the RULLCA. The nine RULLCA jurisdictions allow judicial dissolution of an LLC on the same grounds that New Jersey adopted.[4] The jurisdictions also prevent an LLC's operating agreement from waiving judicial dissolution as a remedy.

The RULLCA and its official comments do not define "not reasonably practicable to carry on the company's activities," what activities count, or how much conformity to an LLC's organizational documents a defendant must show. The U.S. Bankruptcy Court for the Northern District of Iowa was apparently the first U.S. court to apply the RULLCA's not reasonably practicable standard using Iowa's version of the RULLCA,[5] but the decision scarcely provides guidance. In that case, a creditor (not a member) requested an LLC's dissolution, though Iowa's LLC statute (like New Jersey's) calls for a member to apply for court-ordered dissolution. The court accepted the creditor's petition but declined to dissolve the LLC during the bankruptcy proceedings, saying there was no prevailing interpretation of what was meant by the phrase "not reasonably practicable."

The standard appears to require three separate inquiries. First, the court must discern the LLC's activities. Second, the court must determine how those identified activities conform to the LLC's foundational documents. Third, the court must determine the reasonable practicability in light of the circumstances of continuing those identified activities in conformity with the LLC's foundational documents.

What level of generality should the court use to identify the LLC's activities? Is the LLC activity ownership of a particular business or piece of real estate, for example? Or, do the activities consist of supporting the family of the dominant member? Or, is the activity simply making a profit in any way possible?

A second ambiguity arises in measuring whether the activities identified conform to the underlying documents. For many LLCs, even a written operating agreement provides only a generalized 'purposes' clause that permits the LLC to engage in any lawful activity. Does the court look at the existing operating agreement, as out of date as it may be, or as it would be if only the managers were involved? Operating the business and conformity to the underlying documents are separate inquiries.[6] Does the answer depend on whether the entity has a written operating agreement, rather than a *de facto* one based on the behavior of the members?

Determining reasonable practicability creates another level of ambiguity. Who bears the burden of persuasion on this question—management or dissenters? Is this a question of fact or a question of law? Is this a reasonable man test or is it subjective, based on the actual managers and members involved? If the business could succeed adequately if they hired a capable manager, would that be reasonably practicable? What is the lower threshold of how impaired the business must become before the operation becomes unreasonable? Would the outcome be different based on whether members managed the LLC or managers managed the LLC?

At least three separate approaches have emerged. This article refers to these three approaches as contractarian, economic, and deadlock. These avenues of interpretation will likely inform courts of what is not reasonably practicable in carrying on the company's activities.

The Contractarian View

A contractarian approach emphasizes the contractual nature of the relationship among an LLC's members. LLC supporters who favor this approach frequently mention the economic merits of freedom of contract. New Jersey's RULLCA states that it "is to be liberally construed to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."[7]

Expecting to give the operating agreement's language its plain meaning in judicial dissolution cases, contractarians have often looked to the operating agreement to determine whether the members can possibly continue to operate the LLC. Delaware is a non-RULLCA jurisdiction that allows judicial dissolution, and its courts have tended to champion this approach. There, courts have held its not reasonably practicable clause requires only that the company cannot do what the operating agreement directs it to accomplish.

Using this standard, a Delaware Chancery Court granted dissolution of an LLC (Silver Leaf) where the members were deadlocked and the LLC lost its sole client.[8] Without specifically identifying the court's knowledge of the LLC's purpose, the court said the LLC's sole purpose of servicing that client no longer existed. Therefore, the LLC could no longer conduct the business for which the members formed the entity. The chancery court dissolved Silver Leaf.

Virginia's Supreme Court used a similar standard, but reached a different result in *Dunbar Group LLC v. Tignor.*[9] The Court said, before a judicial dissolution of an LLC, a judge must examine the circumstances in light of the company's purpose. Only then can a court determine whether it is reasonably practicable for the LLC to remain. The *Dunbar* Court applied the standard of "deference to the parties' contractual agreement" to permit dismissal of a member for misconduct but did not deprive the expelled member of the economic benefits of an equity ownership. However, the Virginia Supreme Court reversed the lower court's decision to dissolve the LLC. The lower court had not explicitly determined whether, on the evidence, the LLC could function without the expelled member. If the company could function effectively without the expellee, then dissolution was not appropriate.

These decisions highlight the purposes clause of an operating agreement, even if neither decision actually explicitly refers to that clause. Is the court supposed to measure all the possible purposes, or only the formally identified activities or the actual ones that the LLC has so far undertaken? Such decisions tend to identify the purposes narrowly.[10]

If the operating agreement narrowly states the LLC's purposes, then a court can more easily decide whether the facts suggest the practicability of carrying on those activities. On the other hand, operating agreements and certificates of organization or formation often use generic language authorizing the LLC to engage in any type of lawful activity. In such cases, an LLC member opposing dissolution may present a plausible argument on how the LLC can still continue, such as in *Dunbar*. Where no written operating agreement exists, a court may have difficulty determining whether the LLC can carry on its business in accordance with the parties' understanding.

These cases have tended to arise in the context of 50-50 ownership, where management is clearly deadlocked. If a one-third owner seeks dissolution, then the contractarian approach exemplified by these cases may not work, because if two thirds of the members wish to continue a business, they may be able to show the reasonable practicability of continuing the entity.

The Economic View

New York and South Dakota allow judicial dissolution of LLCs, and courts in those states have viewed what is not reasonably practicable through the lens of the LLC's economic success. With this approach, the LLC's profitability becomes critical. In South Dakota, an LLC with ranching and livestock operations reached an impassable deadlock among the members. The LLC's operating agreement contained no procedure to resolve the deadlock. The state's Supreme Court upheld the trial judge's dissolution order because the impasse frustrated the LLC's economic purpose to the point where the LLC could no longer succeed as a business.[11]

A New York court, reviewing the not reasonably practicable provision of New York's LLC statute for the first time in that state, found judicial dissolution can be ordered only when the business sought to be dissolved cannot function or is failing financially.[12] In that decision, the court denied dissolution because the LLC was profitable and functioning. Subsequent New York decisions[13] have cast doubt on the usefulness of this decision, but the economic approach was clearly critical to the outcome.

Reasonably practicable decisions are not uniform. Although Delaware courts have often adopted a contractarian view, at least one Delaware court looked to the economic impacts on the parties for determining whether dissolution was appropriate. In *Haley v. Talcott,* a Delaware chancery court looked to economic facts and analogy to dissolution provisions of the Delaware General Corporation Law.[14] These corporation law provisions required that, for a judicial dissolution to occur, there must be two equal shareholders engaged in a joint venture, and those shareholders are unable to agree whether to discontinue the business or to dispose of its assets. In *Haley*, the members fit those parameters, but, in addition, the company agreement provided an exit for a departing member. However, because an exit in accordance with the contract terms would not free the departing member from obligations under a personal guarantee of the LLC's mortgage debt, the court ordered the dissolution and sale of the company's property as a remedy. The court found dissolution more equitable than strict enforcement of the members' contract.

An economics baseline to determine whether an LLC should be dissolved may be appropriate, especially when the operating agreement provides no relevant terms. The general purpose of any corporate entity is to be profitable. If membership tension has rendered the business no longer economically viable, a judicial dissolution may be in the best interest of all. On the other hand, where the entity is operating effectively, a court could adopt an economics-based view that profit effectively demonstrates the reasonable practicality of conduct of the business.

The Deadlock View

The authors have been unable to locate a New Jersey decision that addressed the RULLCA's not reasonably practicable standard in the LLC context. However, there is precedent under the Uniform Partnership Act (UPA), which New Jersey adopted in 2000. The UPA contains almost identical judicial dissolution language. In *DeBaRon Assocs. v. Van Slooten,*[15] the Appellate Division, in an unpublished opinion citing out-of-state decisions, found judicial dissolution is appropriate when partner discord renders it impracticable to carry on the business. The discord must be more than "mere trifling causes or temporary grievances." Even though the company in *DeBaRon* had an independent manager and was financially successful, the Appellate Division upheld the company's dissolution, because the family member partners' hard feelings and disagreements were so extreme.

DeBaRon stands for the proposition that dissolution may be appropriate when the parties have reached a high level of conflict and animosity, even when the LLC shows some level of functionality or profitability. Looking solely at the atmosphere of members' non-cooperation, suspicion and distrust may be too subjective at times. What is intolerable for one person may be standard fare for another. It is, however, sensibly pragmatic. Even if the company is functional and profitable, substantial member mistrust and animosity may drive the company to dysfunction and unprofitability soon enough, even though economic success can assuage a lot of anger.

DeBaRon also may stand for the proposition that, in an LLC with three members, even one of the three can successfully obtain a court-ordered dissolution if animosity, not impassable deadlock, drives the decision.

It seems likely a New Jersey court would apply these kinds of precedents to dissolution of an LLC with members who are seriously at odds with one another, even without a showing of serious oppression of one of the members.

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Endnotes

1. N.J. Stat. Ann. § 42:2B-49.
2. N.J. Stat. Ann. § 42:2C-48(a)(4)(b).
3. The eight states are Iowa, California (effective Jan. 1, 2014), Florida, Utah, New Jersey, Idaho, Nebraska and Wyoming.
4. Revised Uniform Limited Liability Company Act § 701(a)(4)(B). *See* Cal. Bus. & Prof. Code § 17707.03(b)(1); Iowa Code § 701(1)(d)(2); Fla. Stat. § 605.0702(1)(b)(2); Utah Code Ann. § 48-3-701(4)(b) (West 2013); N.J. Stat. Ann.§ 42:2C-48(a)(4)(b); Idaho Code Ann. § 30-6-701(1)(d)(ii); Neb. Rev. Stat. § 701(a)(4)(B); Wyo. Stat. Ann. § 17-29-701(a)(iv)(b).
5. *In re Hefel,* 2011 Bank. Lexis 3750 (Bankr. N.D. Iowa Sept. 19, 2011).
6. *See, e.g., Haley v. Talcott*, 864 A.2d 86, 2004 Del Ch. Lexis 190.
7. N.J. Stat. Ann. § 42:2C-11i.
8. A leading Delaware decision is *In re Silver Leaf LLC,* 2005 Del. Ch. Lexis 119 (*citing P.C. Tower Ctr. Inc, v. Tower Ctr. Dev. Assoc. LP,* 1989 Del. Ch. Lexis 72).
9. 593 S.E. 2d 216 (VA 2004).
10. Jane Coviello, RULLCA: Does Increased Statutory Flexibility create a Stronger Need for Formal Written Operating Agreements?, 37 *Business Law Section Newsletter* No. 1 page 19 (July 2013).
11. *Kirksey v. Grohmann,* 754 N.W. 2d. 825 (S.D. 2008).
12. *Schindler v. Niche Media Holdings, LLC*, 772 N.Y.S. 2d. 781 (N.Y. Sup. Ct. 2003).
13. *See, e.g., Tzolis v. Wolff*, 10 NY 3d 100, 884 N.E.2D 1005, 855 N.Y.S.2d 6 (2008).
14. 864 A.2d 86 (Del. Ch. 2004).
15. *DeBaRon Assocs. V. Van Slooten*, 2012 N.J. Super Unpub. Lexis 1520, 2012 WL 2428061.

Business Divorce After RULLCA

by Bonnie C. Park

New Jersey is home to many closely held, small businesses, and their entity type of choice is the limited liability company (LLC). As the LLC form provides significant liability protection, tax benefits, and control over how the members conduct their affairs, the entity is very attractive to small business owners.

Recently, the state Legislature brought about significant changes to New Jersey LLCs when it enacted the Revised Uniform Limited Liability Company Act (RULLCA). Given the popularity of LLCs, the RULLCA stands to impact a significant number of individuals and businesses, and in a relatively short amount of time.

The RULLCA was modeled on the uniform act drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL). The uniform act has been passed in only a handful of states so far.[1] The purpose of the RULLCA was to update and modernize the current act, the New Jersey Limited Liability Company Act (NJLLCA), drawing from the significant work of NCCUSL and resolving the problems encountered by practitioners in litigating under the NJLLCA.[2]

The RULLCA does resolve some typical problems encountered in LLC litigation, but it also presents the potential for problems in other areas. To avoid any unintended negative consequences that may result from the RULLCA, it is crucial for LLC members and their attorneys to become familiar with the RULLCA and to carefully evaluate how it will affect the LLC both in the conduct of its day-to-day business and upon its dissolution.

Resource Considerations for LLC Members

LLC members face a yet uncharted legal landscape when it comes to business dissolution under the RULLCA. The RULLCA currently applies only to LLCs formed on or after March 18, 2013, and there is not yet any case law interpreting the new provisions. LLCs formed prior to March 18, 2013, will not be affected until March 1, 2014.[3]

As many New Jersey LLCs are closely held, small businesses, the time and resources devoted to business dissolution and dissociation litigation are significant considerations for the LLC members. Resources spent on litigation take the LLC owners' attention away from their business activities and money out of their pockets. As the RULLCA stands to increase the complexities of dissolution litigation, LLC owners would be wise to invest a smaller portion of their resources in planning for these issues, rather than making up for them during a costly and tumultuous court battle.

Attorneys encounter routine issues when representing LLCs and their members in dissolution cases. The centerpiece of these cases is often the LLC's operating agreement, or lack thereof. As business dissolutions rarely occur under pleasant circumstances, attorneys have grappled with non-uniform treatment in the courts relating to the oppression of a member holding a minority interest by the LLC's majority interest holders. Another unclear area has been the extent to which the LLC members owe each other fiduciary duties and whether that provides the basis for additional causes of action. Unless the operating agreement addresses valuation, attorneys must deal with the valuation of a member's interest and applicable discounts upon the breakup of an LLC.

The RULLCA impacts and addresses many of these issues and significantly changes the landscape for LLC members. While newly formed LLCs are not necessarily immune from problems, as the RULLCA has governed their businesses from the start, previously formed LLCs are used to operating their businesses under the NJLLCA and may end up with very different results in a business dissolution under the RULLCA. To keep litigation costs reasonable and to ensure predictability in the management of business affairs, LLC members and their attorneys should carefully consider each of these above-identified issues and determine if the default rules under the RULLCA will ultimately serve the LLC members' interests or undermine them in the event the members go their separate ways.

It is worth noting that the scope of this article is limited to the impact of the RULLCA on business dissolution and dissociation of a member. The RULLCA does impact other aspects of the LLC's business, as well as the relationships of the members, which also should be fully reviewed and addressed by the members.

The Need to Craft Business Marriage With an Eye Toward Business Divorce

As has often been remarked, going into business with a partner is very much like marriage. Just like newlyweds, when business partners start a new venture, they experience a bit of a honeymoon period. The parties are excited about their new business, eager to work for themselves, and look forward to a bright future together. At the beginning, the partners typically experience so much optimism and have such inherent trust in each other that they cannot imagine anything going wrong. Once the honeymoon period ends and the day-to-day slogging takes over, problems can arise. At times, those problems become too much for the partners to handle, requiring that someone leave the business.[4]

In the same way that some view prenuptial agreements as being in bad taste, business partners often want to avoid planning for the dissociation of a member or dissolution of the LLC. This fact is especially true in the case of people going into business for themselves for the first time; many are naive in their expectations they will not encounter such problems. Additionally, the simple process of forming an LLC lulls many members into the false belief that they do not need an attorney to set up their business. Similar to a costly divorce of a married couple when the couple does not have a prenuptial agreement, the lack of planning and failure to observe formalities can make for a tumultuous and costly business divorce.

No Sole Reliance on a Written Operating Agreement

Under the RULLCA, LLCs will always have some form of operating agreement, regardless of whether the members actually put pen to paper. The RULLCA removed the requirement that an LLC's operating agreement had to be in writing. In addition to any written agreement among the members of the LLC, the RULLCA also looks to oral agreements and the course of dealing among the members to determine the terms of the LLC's operating agreement, even implying terms of the operating agreement from the parties' conduct.[5] Instead of depending on formalities, the RULLCA seeks to bind LLC members based on how they actually operate their businesses, much like the Uniform Commercial Code did for the realities of informal agreements and industry practices. This aspect of the law stands to make business dissolution proceedings better match the day-to-day operations of the business, rather than focusing solely on the terms of the written agreement. The RULLCA is silent on the priority of written, oral, and course of dealing terms if they do not agree, but it is reasonable to assume the courts will consider this issue in the same manner as general contract law.

Although the RULLCA falls in line with a majority of the states in not requiring the operating agreement to be in writing, this change in NJ's LLC law may result in more costly litigation upon a business divorce. In dissolution cases, an LLC may be dissolved on application of a member if "it is not reasonably practicable to carry on the company's activities in conformity with one or both of the certificate of formation and the operating agreement."[6] Before the passage of the RULLCA, the written operating agreement solely controlled the conformance inquiry. Now, the inquiry can encompass much more, creating the potential for significant questions of fact. Rather than defaulting to the terms of the written agreement or statutory guidelines, the parties and the courts will need to spend a significant amount of time determining what the oral and implied terms of the operating agreement are prior to determining conformity. Proving the members are not in conformance with the operating agreement likely will be more difficult when the members' conversations and actions are added to the inquiry.

Not requiring a written operating agreement also can subject more aspects of the business to closer scrutiny. A member may think his or her conduct in the business's daily operations may be innocent and later come to find out it created a new term under the LLC's operating agreement. LLC members should be advised their actions could have unintended consequences, and they should seek to make formal amendments to their written operating agreements if possible.

Cause of Action Codified for Oppressed Members

Under the NJLLCA, LLC members oppressed by the majority members found themselves in a perplexing situation. Although LLC members are nearly identical to shareholders of closely held businesses, the NJLLCA has no equivalent to the minority oppression statute under the Business Corporation Act.[7] While an LLC member could always voluntarily dissociate, the valuation of their interest was subject to certain discounts, including marketable discounts and lack of control discounts.[8] Oppressed shareholders, however, are immune from such discounts because of the majority's oppressive conduct, and can compel the sale of their shares to the company. Some trial courts have found that principles of equity should allow for similar treatment regarding minority LLC members and shareholders. The Appellate Division and Supreme Court have not addressed this issue. Thus, under the NJLLCA, LLC members might obtain different results from others similarly situated, depending on the judge.[9]

In an attempt to address this issue, the RULLCA now allows a member that is the victim of oppressive or harmful conduct by the majority members to seek dissolution.[10] However, as dissolution is a drastic remedy, the RULLCA also allows for the LLC or the other members to purchase the oppressed member's interest.[11] While the RULLCA does offer a new avenue to oppressed members, it is still different from the minority oppression statute in two key aspects. First, members (unlike shareholders under the minority oppression statute) cannot compel a sale of their interest to the LLC or the other members. While the courts can order this remedy, they are not required to do so, and the LLC member cannot force it. Second, the RULLCA is silent regarding valuation and discounts. Until dissolution litigation starts to make its way through the courts, the ability of LLC members to avoid discounts has yet to be definitively determined.

Causes of Action for Breach of Fiduciary Duties and Contractual Obligations

The current act is silent on exactly which fiduciary duties LLC members must uphold. The current act aimed for greater freedom of contract and it allows LLC members to determine the extent of the fiduciary duties owed, expanding or restricting those duties as the members deemed appropriate.

The RULLCA seeks to give some predictability regarding the fiduciary duties LLC members owe each other and the LLC itself. The RULLCA provides that LLC members owe each other and the LLC the duties of loyalty and care and allows for the expansion of fiduciary duties, but imposes a new standard regarding the restriction of such duties.[12] The attempt to restrict or eliminate fiduciary duties must not be "manifestly unreasonable."[13]

In addition, as previously mentioned, under the RULLCA every LLC has an operating agreement, whether in writing, oral, implied or a combination of the three. With any agreement comes the implied covenant of good faith and fair dealing. The RULLCA specifically codifies the contractual covenant of good faith and fair dealing.[14]

As a result of the changes brought about by the RULLCA, business divorce plaintiffs may now plead additional causes of action for breaches of the fiduciary duties imposed by the RULLCA and breaches of the covenant of good faith and fair dealing. Disgruntled members can plead a breach of the covenant of good faith and fair dealing even if the LLC has no written operating agreement, which is not possible under the NJLLCA.

No Right of a Member to Resign and Receive Fair Value

Finally, an LLC member who resigns under the NJLLCA can compel the purchase of his or her interest for fair value with discounts applied.[15] This often can create a significant disruption to the business as the remaining owners scramble to obtain the funds for the buyout.

As a default rule, the RULLCA does not on its face allow a member to force his or her buyout. Instead, resigning members have no rights to vote or manage the company, but become an economic interest holder only.[16] This provision allows for some stability in an LLC.

Conclusion

The RULLCA provides many benefits to LLC members that were not necessarily available under the NJLLCA. The RULLCA does stand to make many aspects of LLC ownership more predictable and better reflect the realities of each individual business. However, LLC members can be caught unaware by the breadth of the new changes, especially in the much more expansive view of an operating agreement taken by the RULLCA. Business divorce should always be a planning aspect of any LLC, but now even more so under the RULLCA.

LLCs are inherently creatures of contract, likely more so now that each LLC by default has an operating agreement. As is the case under the NJLLCA, the RULLCA specifically states that courts are to construe the act liberally to give maximum effect to the principle of freedom of contract.[17] The LLC members still have the ability to plan for members who wish to exit the business and should do so in the LLC's operating agreement. In the vein of an ounce of prevention being worth a pound of cure, a small upfront investment in planning for business divorce is a much better use of resources than making up for a failure to plan once litigation commences.

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Endnotes

1. Uniform Law Commission, Enactment Status Map. http://uniformlaws.org/Act.aspx?title=Limited%20Liability%20Company%20%28Revised%29.
2. Ira B Marcus, Why New Jersey Should Adopt RULLCA, 33 (2) *Business Law Section Newsletter* 3 (Jan. 2010).
3. N.J.S.A. § 42:2C-95 to -96.
4. OK, Partner, We Better Sign a Prenup, *Wall Street Journal*, May 11, 2008. Available at: http://online.wsj.com/article/SB121045347974183033.html.
5. N.J.S.A. § 42:2C-1.
6. N.J.S.A. § 42:2C-48(a)(4)(b).
7. N.J.S.A. § 14A:12-7(c).
8. N.J.S.A. § 42:2B-38 to -39.
9. Adam B. Schwartz and David White, N.J. Courts are on Trend Towards Applying State Oppressed Shareholder Statute to LLCs, *New Jersey Law Journal*, Dec. 9, 2010. Available at: http://www.pashmanstein.com/publication-details.php?id=19.
10. N.J.S.A. § 42:2C-48(a)(5)(b).
11. N.J.S.A. § 42:2C-48(b).
12. N.J.S.A. § 42:2C-39.
13. N.J.S.A. § 42:2C-11(c), (d).
14. N.J.S.A. § 42:2C-39(d).
15. N.J.S.A. § 42:2B-38.
16. N.J.S.A. § 42:2C-47.
17. N.J.S.A. § 42:2C-11(i).

Teaching Third-party Legal Opinion Practice Basics

by Barry J. Bendes

Teaching third-party opinion practice begins with an understanding that the opinion giver is rendering a third-party opinion to a non-client (a third party) pursuant to a specific request by the opinion giver's client. The request may be explicit (in the engagement letter or another writing) or implicit from the nature of the representation or the terms of the operative documents themselves. To render an opinion, be it a third-party opinion or an opinion directly to a client, the opinion giver must be conversant with applicable substantive law and aware of her or his ethical obligations to clients, adversaries and administrative agencies. Further, the opinion giver should be familiar with 'customary practice' in the negotiation and in the rendering of closing opinions or other third-party legal opinions when the opinion is being rendered to a non-client.

The Rules of Professional Conduct (RPC) provide the general rules that govern attorney ethics.[1] There are also special rules for attorneys representing clients in various other settings and areas of law (for example, the Securities and Exchange Commission, Internal Revenue Service, etc.). The Business Law Symposium, sponsored by the Business Law Section of the New Jersey State Bar Association, and a number of Institute for Continuing Legal Education programs have provided and will continue to provide excellent materials on the ethical duties, practices and responsibilities of transactional attorneys in this regard.

It is important that attorneys new to the third-party opinion process understand the language used in third-party legal opinions; the customary practice in the rendering and negotiation of third-party legal opinions (the lore); the exceptions, exclusions and limitations found in third-party legal opinions, generally; and the need for specific carve-outs from the opinion that are case specific. Not all opinions are 'clean' opinions (opinions that are clear on their face and do not need explanation). Some are what we call 'reasoned opinion' (opinions where legal analysis is needed and the resulting opinion may have qualifications and require explanation and discussion). Reasoned opinions are frequently used when, for instance, the legal issues are not clear, the Supreme Court of New Jersey has not ruled on an issue and the lower courts are split, the governing documents choose a law other than New Jersey law, or the matter involves non-consolidation issues in bankruptcy or the true sales of assets.

While the *Third-party Legal Opinion Report*, including the Legal Opinion Accord[2] is no longer in general use, an inexperienced attorney who is faced with a request for a third-party legal opinion should read the Legal Opinion Accord and the commentary accompanying the Legal Opinion Accord for a nutshell-type clear explanation of commonly requested opinions and commonly used terms, exceptions, exclusions and limitations. The *Statement on the Role of Customary Practice in the Preparation and Understanding of Third-party Legal Opinions*,[3] the TriBar reports on LLC opinions[4] and the *Guidelines for the Preparation of Closing Opinions* including the Legal Opinion Principles[5] also provide excellent places to find the basics in opinion practice.

The Restatement (Third) of the Law Governing Lawyers (Sections 51, 52, 95 and 98 (comment C)) provides considerable discussion of opinion letters and customary practice. Additional guidance can be found in bar association and in the TriBar opinion reports issued by a committee consisting of members of various bar association opinions committee representatives and generated from the materials published by the Working Group on Legal Opinions of the Business Law Section of the American Bar Association (ABA). These resources address specific opinion issues, such as law office opinion practices, negative assurances opinions in securities offerings, closing opinions in acquisition and financing transactions, limited liability company transaction opinions, remedies opinions and Uniform Commercial Code security interest opinions. A number of well-regarded treatises on opinion practice are also available from legal publishers. Many of these resources (other than the treatises) can be found at the ABA Section of Business Law Legal Opinions Resource Center.[6]

In teaching the 'lore' and practice of third-party opinion practice, it is important to pass along to the new practitioner an understanding of three important precepts:

Thou shalt not lie or issue a misleading opinion. RPC 4.1

Do not assist or participate in a fraud or crime. RPC 1.2(d)

Do not ask for an opinion that you yourself would not give under similar circumstances (the so called Golden Rule).

Most firms and attorneys adopt an internal process or procedure to assure the opinion is not misleading or otherwise improper. The process includes a review of the applicable client files and matters, the law involved in the engagement and documents, the governing documents in the matter, and the formation and governing documents of the entities involved (the certificate of incorporation or formation, bylaws, operating or partnership agreement, loan documents, leases, etc.). The negotiation and issuance of the opinion often involves the review of the opinion by another partner or senior attorney (whether pursuant to a formal opinion committee charter or other process).

Responses to requests to provide information to auditors are another form of opinion letter that attorneys must treat carefully. The Audit Response Committee of the ABA Business Law Section has recently issued a Second Edition (2013 edition) of its comprehensive *Auditor's Letter Handbook* that includes both the statement of policy regarding lawyers' responses to auditors' requests for information[7] (the so called Treaty with the Accountants) and reports subsequent to the Treaty with the Accountants giving further guidance to attorneys responding to requests from clients to provide information to auditors concerning loss contingencies and other matters. This is an excellent resource that all attorneys should know well and have available to them when responding to audit requests. It includes a comprehensive discussion of what should and what should not be included in such responses and forms to follow in issuing a response.

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Endnotes

1. In this regard, *see* RPC 2.3 and 4.1 in particular.
2. 47 Bus Law 1 (1991).
3. http://apps.abanet.org/buslaw/tribar/materials/20081013000000.pdf. Also available to NJSBA Business Law Section members on the NJSBA Business Law Section/Community/Library pages.
4. TriBar Opinion Committee, Third-Party Closing Opinions: Limited Liability Companies, 61 Bus. Law. 679 (2006); Supplemental TriBar LLC Opinion Report: Opinions on LLC Membership Interests, 66 Bus. Law 1065 (2011).
5. 57 Bus Law 875 (2002).
6. http://www.abanet.org/buslaw/tribar/home.shtml.
7. 31 Bus. Law 1709 (1976).

Being Disregarded

by Stuart L. Pachman

By combining corporate-style limited liability with partnership tax treatment and affording flexibility to entrepreneurs, a limited liability company (LLC) is a remarkable artificial creature. The single-member LLC is also awesome. By filing a certificate of formation (and being careful to respect the entity's separate existence), an individual is able to separate his or her business assets from personal assets, and thereby gain protection for the latter from liabilities arising out of the former. The frosting on this cake is that the single member achieves this result not only without incurring problems inherent in having a partner, but also without the necessity and cost of a separate tax return for an entity that is 'disregarded' for tax purposes. Being disregarded, however, notwithstanding the statute's limiting language, may lead to other consequences, as recently demonstrated by the Appellate Division in *Pereira v. Board of Review, Dep't. of Labor and Workforce Dev.*[1]

In the *Pereira* case, the sole member of an LLC that employed the plaintiff husband was his wife. During seasonal times when the LLC had no work and no need for the husband's services, the husband was 'laid off.' He applied and collected unemployment benefits until the agency denied them because "he was in the employ of his spouse," and therefore ineligible under the New Jersey Unemployment Compensation Law.[2] The brief opinion does not reveal whether or not the LLC had paid employment security taxes for the plaintiff husband.

The court affirmed the denial relying on N.J.S. 42:2B-69b (N.J.S. 42:2C-92b of the Revised Uniform Limited Liability Company Act), which disregards a single-member LLC for New Jersey taxation purposes. Because the LLC was disregarded under that statute, the plaintiff was working for his spouse and consequently disqualified from receiving unemployment benefits.

The court need not have relied on the way LLCs are taxed. In *Lazer v. Bd. of Review*,[3] not cited by the court, a similar result was reached in a case involving a "family corporation." There the court looked "through the form to the substance." Thus, use by the Pereiras of a sole shareholder corporation instead of a single-member LLC would not have advanced the scheme.

If the LLC had a second member rendering it ineligible to be treated as a disregarded entity for tax purposes, would the plaintiff have succeeded? Perhaps, the result probably would be dependent on the independence and authority of the second member, or, to use the court's words in *Lazar*, "a realistic interpretation of the facts and circumstances."

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Endnotes

1. No. A-1739-11T12013 WL 2371640 (N.J. Super. App. Div. June 3, 2013).
2. N.J.S. 43:21-19(i)(7)(c).
3. 77 N.J. Super. 251 (App. Div. 1962).

The Derivative Action Statute That Isn't There

by Stuart L. Pachman

P.L. 2013, Ch. 42 repealed N.J.S. 14A:3-6 effective April 1, 2013. This was the section in the New Jersey Business Corporation Act that governed actions by shareholders (derivative and class actions). Chapter 42 also supplemented Section 14A with N.J.S. 14A:3-6.1 to 3-6.9 (the new statute) ostensibly to replace Section 3-6, but the new statute fails to do so because it applies only to those corporations that expressly make its provisions applicable in their respective certificates of incorporation. Consequently for those corporations, which through ignorance, disinterest, or purposeful choice, fail to adopt the new statute, the New Jersey Business Corporation Act has no provision dealing with the corporate requirements for derivative and class actions.

The 'missing' statute had provided limits regarding which shareholders could bring a derivative action, the potential for fee shifting, and the ability of the corporation to seek security for costs in certain cases. It had been part of Title 14A since that comprehensive revision's enactment effective Jan. 1, 1969. Previously, former Title 14 had contained a similar provision,[1] which resulted from an amendment made to it in 1945 to eliminate or reduce abuses that had resulted in "a veritable racket of baseless law suits accompanied by many unethical practices."[2]

With the repeal of Section 3-6, what governs derivative actions involving those corporations that do not provide for the new statute in their respective certificates of incorporation? Most salient are the applicable state and federal court rules, Rule 4:32 and Federal Rules of Civil Procedure 23 and 23.1, which remain extant. Also, because remedial actions by shareholders have been recognized since at least the 19th century, long before Section 3-6 or its 1945 predecessor were enacted, there is a body of relevant common law.

The state Legislature may close the gap by restoring to the New Jersey Business Corporation Act the best parts of Section 3-6, but whatever the Legislature does (or does not do), it behooves counsel to those corporations whose principals believe the new statute provides a benefit to their entities to amend their certificates of incorporation accordingly. ■

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Endnotes

1. N.J.S. 14:3-15.
2. *Bookman v. R.J. Reynolds Tobacco Co.*, 138 N.J. Eq.312, 399 (Ch. 1946). *See also Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 547-548 (1949), providing a short history of actions by shareholders and the need for statutory regulation.

In My Opinion…
Due Execution and Delivery Opinion Revisited

by Lydia C. Stefanowicz

One of the core opinions in a third-party closing opinion letter has always been an opinion with respect to the due execution and delivery of the transaction documents. For example, in a loan transaction such an opinion might read as follows: "The borrower has duly executed and delivered the loan documents."

Although this opinion is frequently treated as one opinion, it does have two distinct components. Execution means the applicable documents have been signed by a person purporting to be authorized to sign on behalf of a party (in this case the borrower). Delivery means executed counterparts of the applicable documents have been transmitted by the borrower to a representative of the other party, or the documents have otherwise been 'delivered' as a matter of contract law.

When closings were held in-person, with all parties present around a conference room table, such an opinion was routine and not controversial. Nowadays, more often than not, execution and delivery of transaction documents in connection with a closing may be accomplished electronically. The opinion giver who does not personally witness the execution and delivery of the transaction documents but has been asked to render such an opinion will need to consider whether, as a matter of law, due execution and delivery have been accomplished. This may include, among other things, reliance on counterpart signatures provisions in the applicable documents and electronic signature laws. A review of certificates of corporate officers (or equivalent persons, in the case of alternative entities), certifying the authority, incumbency and specimen signatures of specified persons identified as authorized signatories of a party, are typically part of the due diligence engaged in by an opinion giver in connection with a due execution and delivery opinion.

When local counsel is asked to opine on the execution and delivery of the transaction documents, there may be additional considerations arising from their limited role and indirect participation in the transaction. Local counsel is not typically privy to either execution or delivery of the transaction documents, and frequently has no familiarity with the signatories to the transaction documents. In addition, delivery and other aspects of closing will likely be governed by the law of a state other than the local counsel's jurisdiction, in which case local counsel should consider the extent to which it is appropriate to address delivery in its opinion. Some local counsel refuse to give a due execution and delivery opinion.

In order to establish certain material facts in connection with a due execution and delivery opinion that may not be cost-effective or even possible to establish independently, by custom and practice, the opinion giver relies, either impliedly or expressly, on certain assumptions. For example, the opinion letter may state the following: "In all examinations of documents, we have assumed the genuineness of all signatures, the authenticity and completeness of all documents submitted to us, the conformity to the executed originals of all documents submitted to us as copies or drafts, and the legal capacity of all natural persons."

Most opinion letters assume all signatures are genuine. Opinion givers sometimes are requested to exclude from this type of assumption the signatures of or on behalf of the borrower or a guarantor. While such a request might seem reasonable on first impression, in effect such an exclusion could be construed to be an assurance on the part of the opinion giver that the signatures of the borrower or a guarantor are not forgeries, and the persons signing on behalf of such parties are, in fact, the persons they purport to be. Such an assurance is not a matter of law that can be covered appropriately by a legal opinion. Such an assurance is actually a matter of a fact that is outside of the knowledge and professional competence of counsel as an opinion giver. Even familiarity with the signatory over years of representation may not necessarily support a factual determination that, as a legal certainty, the person is who he or she purports to be. The *Dechert* case illustrates this point well.

Critical to the decision of the New York State Appellate Division in *Fortress Credit Corp. v. Dechert LLP*[1] was an assumption contained in that firm's opinion letter that was similar to the foregoing assumption. The New York State Appellate Division unanimously reversed the lower court decision that had denied Dechert's motion to dismiss the complaint filed by Fortress Credit. Fortress Credit's claim against Dechert was based on an opinion letter delivered by Dechert as counsel for the borrower in connection with a loan transaction that proved to be (seemingly unbeknownst to Dechert) a complete fraud on the lender perpetrated by the notorious New York lawyer, Marc Dreier. In refusing to hold Dechert responsible for the forged loan documents and closing certificates, the reasoning of the court was expressed in the following statement from the decision:

> The opinion was clearly and unequivocally circumscribed by the qualifications that defendant assumed the genuineness of all signatures and the authenticity of the documents, made no independent inquiry into the accuracy of the factual representations or certificates, and undertook no independent investigation in ascertaining those facts.

Of course, as with all assumptions generally, assuming the signatures are genuine would be inappropriate if the opinion giver knows or suspects otherwise. This fact should be sufficient comfort to the opinion recipient. If greater assurance regarding the identity of the signatories is required, it should be specifically discussed between the opinion giver and the opinion recipient, and the protocol upon which to establish such an assurance should be clearly established. But counsel has no particular professional expertise or skill to establish with certainty the identity of a signatory, and thus, the opinion giver should not be asked to bear the risk of forgery or fraud of which it is unaware.

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Endnote

1. 89 A.D. 3d 615, 934 N.Y.S. 2d 119 (App. Div., 1st Dept. 2011).