The Duty of Loyalty under the New Jersey Revised Uniform Limited Liability Company Act

by Gianfranco A. Pietrafesa

On March 1, 2014, the New Jersey Limited Liability Company Act was repealed¹ and replaced by the New Jersey Revised Uniform Limited Liability Company Act (NJRULLCA).² On that date, NJRULLCA began to govern all limited liability companies (LLCs) in New Jersey.³

NJRULLCA has made significant changes in New Jersey’s LLC law.⁴ Among them are specific statutory fiduciary duties for managers and members of LLCs.⁵ One such fiduciary duty is the duty of loyalty.

What is the Duty of Loyalty?
The statutory duty of loyalty is comprised of the following specific duties:

1. to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member: (a) in the conduct or winding up of the company’s activities; (b) from a use by the member of the company’s property; or (c) from the appropriation of a company opportunity;
2. to refrain from dealing with the company in the conduct or winding up of the company’s activities as or on behalf of a person having an interest adverse to the company [i.e., self-dealing]; and
3. to refrain from competing with the company in the conduct of the company’s activities before the dissolution of the company.⁶

Thus, a member or manager must account to the LLC for any profits derived from: 1) conducting the business of the LLC and dissolving the LLC, 2) using the LLC’s property, and 3) appropriating business opportunities of the LLC. Also, a member or manager must refrain from engaging in self-dealing and competing with the LLC. The prohibitions against self-dealing and competing with the LLC may present problems for certain LLCs, but any problems can be addressed in an operating agreement.

To Whom Does the Duty Apply?
An LLC may be managed by its members or by one or more managers,⁷ and who manages the LLC determines who is bound by the duty of loyalty. Thus, the duty applies to the members of a member-managed LLC or to the managers (but not the members) of a manager-managed LLC.⁸ Note that in a member-managed LLC, a member has a duty to refrain from competing with the LLC before the dissolution of the LLC, whereas in a manager-managed LLC, a manager has a duty to refrain from competing with the LLC until the completion of the winding up of the LLC.⁹

Comparison to Prior New Jersey LLC Law
New Jersey’s prior statute did not include a duty of loyalty.¹⁰ In fact, the term “fiduciary duty” was mentioned once, at the end of the statute.¹¹ In addition, there is virtually no New Jersey case law discussing the duty of loyalty in the context of an LLC. The sparse case law that does exist is contradictory and, as a result, not helpful.¹²
Some have argued that, unless otherwise expressed in an operating agreement, managers and members did not have any fiduciary duties, including the duty of loyalty.¹³ Others assumed that managers and controlling members must have had fiduciary duties.¹⁴
Comparison to Other New Jersey Entity Laws

The duty of loyalty imposed by NJRULLCA is substantially similar to the duty of loyalty under New Jersey’s general partnership and limited partnership statutes. This should come as no surprise since all three laws were drafted by the uniform law commissioners.

However, the duty of loyalty for managers and members of an LLC is broader than the comparable duty for partners of a general partnership or general partners of a limited partnership. First, the general partnership statute states that “[t]he only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in [the statute].” By comparison, NJRULLCA does not include such a limiting term. Second, NJRULLCA implies that managers and members may be subject to other fiduciary duties, meaning fiduciary duties developed by the courts under the common law.

By contrast, New Jersey’s corporate statute does not include a duty of loyalty. Instead, the duty of loyalty of directors and officers to a corporation and its shareholders is determined by the courts under the common law. Although the duty of loyalty is determined on a case-by-case basis, and thus cannot be defined with precision, it includes a duty to act in the best interests of the corporation, without self-dealing and usurping corporate opportunities.

Comparison to Delaware LLC Law

While NJRULLCA clearly specifies the duty of loyalty in New Jersey LLCs, the duty of loyalty for managers and members of Delaware LLCs is not so certain. In fact, the issue of fiduciary duties caused a significant disagreement between the Delaware Supreme Court and the chancery court (which decides disputes involving the internal affairs of LLCs, corporations and other business entities).

In Jan. 2012, the chancery court held that the manager of an LLC had default fiduciary duties to the LLC and its members, which confirmed the common understanding under prior case law that a manager had fiduciary duties unless contradicted by an operating agreement. In Nov. 2012, the Delaware Supreme Court disagreed and held that the chancery court’s pronouncement about default fiduciary duties was “improvident and unnecessary” and “dictum without precedential value.”

A few weeks later, the chancery court again held that default fiduciary duties apply to managers of an LLC. The Delaware Legislature ended the controversy by amending its LLC statute. Thus, managers and controlling members of Delaware LLCs have a duty of loyalty to the LLC and its members.

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Alter or Eliminate the Duty

The statutory duty of loyalty is a default provision that will apply if the LLC’s operating agreement does not modify the duty. Fortunately, NJRULLCA provides an LLC with several methods to alter, or even eliminate, the duty. These methods are contained in Sections 11 and 39 of NJRULLCA. The provisions appear complex and even contradictory, and thus confusing, but as explained below, they do provide LLCs with great flexibility to deal with the duty of loyalty to suit the circumstances of each particular LLC.

Section 11 of NJRULLCA initially states that “[a]n operating agreement may not…(4) subject to subsections d. through g. of this section, eliminate the duty of loyalty, the duty of care, or any other fiduciary duty.” But in subsections d. through g., NJRULLCA provides several methods to address the duty of loyalty. First, Section 11(d) of NJRULLCA provides in part that, “[i]f not manifestly unreasonable, the operating agreement may (1) restrict or eliminate the duty as required in [N.J.S.A. 42:2C-39(b)(1)-(3) & (i)],” which is the duty of loyalty. Thus, as long as it is not manifestly unreasonable, an operating agreement may restrict, and even eliminate, all or parts of the duty of loyalty.

For example, an operating agreement in a member-managed LLC may eliminate the duty of loyalty, as follows:

No Duty of Loyalty. No Member owes any fiduciary duty of loyalty to the Company or the other Members.

Or, an operating agreement may restrict the duty of loyalty; for example, by limiting it to some of the statutory duties and thus eliminating others:

Duty of Loyalty. A Member’s duty of loyalty to the Company and the other Members is limited to accounting to the Company and holding as trustee for it any property, profit or benefit derived by the Member (A) in conducting and winding up the Company’s business, (B) from using the Company’s property, and (C) from appropriating a business opportunity of the Company. No Member owes any other fiduciary duty of loyalty to the Company or the other Members.

Under the above example, the duties against self-dealing and competing with the LLC are eliminated. For further clarification, the last sentence can be modified with the addition of the following phrase at the end of the sentence: “, including the duty against self-dealing and competing with the Company.”

Identify Acts Not Violating the Duty

Next, Section 11(d) of NJRULLCA provides in part that, “[i]f not manifestly unreasonable, the operating agreement may…(2) identify specific types or categories of activities that do not violate the duty of loyalty.” This method may be used when the managers or members of
an LLC are active in the specific business of the LLC through other companies, positions, etc. For example, the members of a real estate holding company may currently or in the future want to own commercial real estate individually or with others, and not be required to own such other real estate through the LLC or even with the same members.

Thus, an operating agreement for a real estate holding company may identify certain types or categories of activities that do not violate the duty of loyalty, such as:

Other Interests. A Member may, directly or indirectly, own and/or manage other real estate. Neither the Company nor any other Members shall have any right, by virtue of this Agreement, to share or participate in the ownership or management of such other real estate of the Member or to the income or proceeds derived therefrom.

An operating agreement for an operating company may include the following provision:

Other Interests. Each Member acknowledges that the other Members may, directly or indirectly, own and/or manage other businesses, including businesses that may compete with the Company. Each Member agrees that a Member shall not be prohibited from engaging or investing in any other business, including a business that may compete with the Company, and that a Member shall not be required to present such business opportunities to the Company or the other Members, even if such business opportunities are similar to the business of the Company. Neither the Company nor any other Members shall have any right, by virtue of this Agreement, to share or participate in the ownership of such business opportunities of the Member or to the income or proceeds derived therefrom.

Such a provision should be useful in attracting experienced businesspeople to join the LLC as members, which they might not otherwise do because of the duty against competing with the LLC and appropriating business opportunities of the LLC.

Not Manifestly Unreasonable
As noted, a provision restricting or eliminating the duty of loyalty or identifying acts that do not violate the duty must not be manifestly unreasonable. NJRULLCA provides that whether a term is manifestly unreasonable is an issue for the court. A court may invalidate a term as manifestly (i.e., clearly or obviously) unreasonable only if it is readily apparent the objective of the term is unreasonable or the term is an unreasonable means to achieve its objective. This determination is made as of the date the term was added to the operating agreement, based on the specific facts and circumstances of the LLC existing at that time, and in light of the LLC’s purpose and business. In making its determination, the court should also consider that NJRULLCA, like the prior statute, “is to be liberally construed to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements.”

An operating agreement can include a provision where the members agree the provisions altering fiduciary duties are reasonable and provides for the court to modify any such provisions deemed manifestly unreasonable by the court:

Reasonable Provisions. Each Member acknowledges and agrees that the provisions in Section X are reasonable, important and necessary for the success of the Company. If a court determines that any provision in Section X is manifestly unreasonable, the Members agree that the court shall have the power to modify any such unreasonable provision to the extent deemed necessary by the court to render it reasonable and enforceable (and that comes closest to expressing the intention of the unreasonable provision), and that such modified provision shall be enforced by the court.

Independent Authorization or Ratification
Section 11(e) of NJRULLCA provides that an operating agreement “may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts.”

For example, an operating agreement may provide for a special committee, an advisory board, or any disinterested and independent person, such as a retired judge or a person with experience in the particular industry of the LLC. Under this method, one or more disinterested and independent persons would review all material facts: 1) before an act or transaction to authorize it, or 2) after an act or transaction to ratify it. This method ‘cleanses’ the act or transaction otherwise violating the duty of loyalty.

A simple provision for such a method would be the following:

Independent Authorization or Ratification. After full disclosure of all material facts, the majority vote of the Company’s special committee, which shall be comprised of disinterested and independent persons (e.g., persons that are not Members or Managers or affiliates of Members or Managers), may authorize or ratify an act or transaction violating the duty of loyalty.

No Duty for Non-Managing Members
An operating agreement of a member-managed LLC may appoint certain
members as the managing members of the LLC. In such a situation, the non-managing members may not want to owe any duty of loyalty to the LLC or the other members because they are not managing the LLC and do not have the authority to legally bind the LLC. Section 11(f) of NJRULLCA allows an operating agreement to relieve non-managing members from fiduciary duties, including the duty of loyalty:

To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of a responsibility that the member would otherwise have under this act and imposes the responsibility on one or more other members, the operating agreement may, to the benefit of the member that the operating agreement relieves of the responsibility, also eliminate or limit any fiduciary duty that would have pertained to the responsibility.42

Thus, an operating agreement may provide as follows:

No Duty of Loyalty for Non-Managing Members. The LLC is member-managed by the Managing Member, who shall have the authority to legally bind the LLC. As a result, none of the other Members shall owe any duty of loyalty to the Company or the other Members.

Authorization or Ratification by Members

In the event an operating agreement does not eliminate, restrict or otherwise deal with the duty of loyalty, NJRULLCA provides that “[a]ll of the members... may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that would otherwise violate the duty of loyalty.”43 This provision applies to both member-managed and manager-managed LLCs, but it is always the members (not the managers) who have the power of authorization and ratification.44

There is nothing in NJRULLCA that prohibits the members from including a provision in an operating agreement allowing less than all members to authorize or ratify an act or transaction violating the duty of loyalty. Thus, a majority or super-majority of the members, but not including the interested member, may authorize or ratify an act or transaction violating the duty of loyalty. For example:

Authorization or Ratification by Members. A majority of the Members, not including the Member violating the duty of loyalty, may authorize or ratify, after full disclosure of all material facts, a specific act or transaction by a Member that otherwise violates the duty of loyalty.

Defense to Self-Dealing

As noted, the duty of loyalty requires managers and members “to refrain from dealing with the company in the conduct or winding up of the company’s activities as or on behalf of a person having an interest adverse to the company.”45 Self-dealing sounds bad, but is common in many closely held and family-owned businesses.46 It includes lending money and leasing real property to an LLC.

As noted, the duty of loyalty may be restricted or eliminated in an operating agreement, but if it is not, NJRULLCA provides a defense to a claim that a transaction violates the duty prohibiting self-dealing. If a transaction is fair to the LLC, then there is no violation of the duty of loyalty.” Examples of transactions that are fair to the LLC include loans to the LLC at market interest rates and leases of real property to the LLC at fair market rents.48

An operating agreement may permit self-dealing (as provided under the prior law) or it may include a provision addressing self-dealing to reflect NJRULLCA, as follows:

Related Transactions. Each Member and the Affiliates of a Member may, without violating the duty of loyalty, loan monies, lease real and personal property, sell goods and provide services to, and transact other business with, the Company, provided that such transactions are on terms commercially fair and reasonable to the Company and no less favorable to the Company than those generally being provided to or available from unrelated third parties.

No Indemnification or Exculpation

NJRULLCA provides both indemnification of members and managers,49 and allows an operating agreement to limit or even eliminate the personal liability of a member or manager for money damages.50 However, a member or manager breaching the duty of loyalty is not entitled to indemnification or exculpation of liability for money damages.51 Yet, as noted, an operating agreement may restrict or entirely eliminate the duty of loyalty.52

Specific Purpose

An LLC may also reduce or even eliminate claims of a breach of the duty of loyalty by including a specific purpose for the LLC in its certificate of formation.53 Alternatively, the operating agreement may include a specific, narrow purpose rather than a general, broad purpose for the LLC. For example:

Purpose. The purpose of the Company shall be to produce, sell and distribute gluten-free cookie products.

Presumably, a member or manager involved in other businesses producing other food products, perhaps even non-gluten-free cookies, would not be violating the duty of loyalty because the LLC and the other businesses would not be competitors.
Conclusion

It can be argued that New Jersey’s LLC law has been improved by having the duty of loyalty specifically defined in its statute rather than being determined on a case-by-case basis by the courts under the common law. In any event, such a statutory duty of loyalty is a significant change in New Jersey LLC law. However, the statute provides LLCs with many different methods to deal with the duty of loyalty, including the complete elimination of the duty.

Endnotes

1. P.L. 2013, c.276, §10 (clarifying that the repeal date is March 1, 2014); P.L. 2012, c.50, §95 (repealed).
2. At the writing of this article, New Jersey is one of 10 states and districts enacting RULLCA. The others are California, Idaho, Utah, Wyoming, Nebraska, Iowa, Minnesota, Florida and the District of Columbia. RULLCA legislation has been introduced in other states. See www.uniformlaws.org.
3. N.J.S.A. 42:2C-91(b).
6. N.J.S.A. 42:2C-39(b). In the context of an LLC formed for business purposes, the term “activities” means “business.” NJRULLCA uses “activities” instead of “business” because an LLC may also be formed for non-profit purposes. See N.J.S.A. 42:2C-4(b).
8. If the operating agreement appoints one or more managing members, it may also relieve the remaining non-managing members from the duty of loyalty. See N.J.S.A. 42:2C-11(f), discussed infra at “No Duty for Non-Managing Members.”
9. N.J.S.A. 42:2C-39(a), (b) & (i). Note that there is nothing in the statute that precludes an operating agreement from imposing a duty of loyalty on the members of a manager-managed LLC. It may be appropriate to impose such a duty on the members when a controlling majority member appoints or ‘elects’ the manager of a manager-managed LLC. In such a situation, the majority member controls the LLC through the manager, but is able to take actions that violate the duty of loyalty, such as appropriating business opportunities belonging to the LLC.
11. The prior statute did, however, address self-dealing, which was permitted unless otherwise provided in an operating agreement. See N.J.S.A. 42:2B-9.
12. See N.J.S.A. 42:2B-66(b) (repealed) (“To the extent that, at law or in equity, a member or manager has duties (including fiduciary duties) and liabilities[,]...the member’s or manager’s duties and liabilities may be expanded or restricted by provisions in an operating agreement.”). The prior statute did, however, include a duty of care. See N.J.S.A. 42:2B-26 & -30 (repealed).
14. Recently retired Delaware Supreme Court Chief Justice Myron T. Steele believed that managers of Delaware LLCs do not have any fiduciary duties unless expressly imposed by an operating agreement. See Myron T. Steele, Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 32 Del. J. Corp. L. 1 (2007). New Jersey’s prior LLC statute was modeled after Delaware’s LLC statute.
15. See Lawrence A. Goldman and Alyce C. Halchak, New Jersey Limited Liability Company: Forms and Manual, §7.10 at 7-40 (Data Trace 2014) [hereinafter Goldman]. See also Peter D. Hutcheon, The New Jersey Limited Liability Company Statute: Background and Concepts, 18 Seton Hall. Legis. J. 111, 146-146 (1993) (suggesting that if the facts warrant, a court has the equitable power to impose a duty on managers or members and hold them personally liable).
16. See N.J.S.A. 42:1A-24(b); N.J.S.A. 42:2A-3 (mandating that in the absence of a specific provision, the general partnership law will apply to a limited partnership).
17. See www.uniformlaws.org. The term “uniform law commissioners” is the alternate name for the National Conference of Commissioners on Uniform State Laws (NCCUSL).
19. See N.J.S.A. 42:2C-39(a) (“A member [and manager]...owes to the company and...the other members, the duties of loyalty and care stated in
[N.J.S.A. 42:2C-39(b) and (c)].

20. NJRULLCA refers to the phrase “any other fiduciary duty” in N.J.S.A. 42:2C-11(c)(4) & (d)(4).


24. Gatz Properties, LLC v. Auriga Capital Corp., 59 A.3d 1206, 1218 (Del. 2012). At that time, the Supreme Court was led by Chief Justice Myron T. Steele, who recently retired.


30. Under New Jersey’s prior LLC law, fiduciary duties, such as the duty of loyalty, could be restricted, but not eliminated. See N.J.S.A 42:2B-66(b).

31. For convenience, all examples in this article will be for member-managed LLCs and have been kept simple to illustrate the principle or concept being addressed.


33. For a more comprehensive provision, see Goldman, supra, Form 7-25 (§.4.2).

34. See N.J.S.A. 42:2C-11(d)(1) & (2).

35. N.J.S.A. 42:2C-11(h).


40. N.J.S.A. 42:2C-11(e).

41. See NCCUSL commentary to RULLCA Section 110(e), available at www.uniformlaws.org.

42. N.J.S.A. 42:2C-11(f). In seminars, the author has described the statutory provision as a ‘savings clause’ to save acts from violating the duty of loyalty.


44. N.J.S.A. 42:2C-39(i)(3).


46. It is perhaps for this reason that New Jersey’s prior LLC law permitted self-dealing unless otherwise provided in an operating agreement. See N.J.S.A. 42:2B-9 (repealed).

47. N.J.S.A. 42:2C-39(g).

48. Note that even if the transaction is fair to the LLC, it may not be fair to the other members. For example, the controlling member may make a loan to the LLC at a market interest rate, but the other members do not have the opportunity to make a similar loan. The operating agreement can address this situation by providing that when the LLC is in need of a loan, all members shall have the opportunity to make a loan to the LLC based on their respective LLC interests.


50. N.J.S.A. 42:2C-11(g).

51. N.J.S.A. 42:2C-11(g)(1) & -38(c). See also NCCUSL commentary to NJRULLCA Section 110(g) (“The restrictions...apply both to indem-
nification and exculpation.

52. One commentator has asked: If the members can eliminate the duty of loyalty, why can’t they eliminate liability for a breach of the duty of loyalty? See Ribstein, supra, at 68-69.

53. N.J.S.A. 42:2C-18(c) (“a certificate of formation may also contain statements as to matters other than those required by [N.J.S.A. 42:2C-18(b)].”

Gianfranco A. Pietrafesa is a partner in the corporate group of Archer & Greiner, in Hackensack. He is a former chair of the Business Law Section and a member of the committee that drafted NJRULLCA for adoption in New Jersey. In recognition of his efforts, he received the 2012 Distinguished Legislative Service Award from the NJSBA.