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When the Statute is Your LLC Operating Agreement

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Many people form a New Jersey limited liability company (LLC) without the benefit of legal advice from an attorney. It is easy enough to do so by using the online business formation services of the New Jersey Division of Revenue and Enterprise Services (NJDORES).¹ However, you get what you pay for when you take this course.

Preliminary Matters

New Jersey's LLC statute, the New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA),² only requires a certificate of formation to include the name of the LLC, the address of the registered office of the LLC, and the name of the registered agent at such address.³ However, NJDORES requests additional information, such as the LLC's business purpose, the names and addresses of its members/managers, and its business address. A change to the foregoing will require filing a certificate of amendment,⁴ which is why most experienced business attorneys do not include this unnecessary additional information in a certificate of formation. They include them in an operating agreement.

When an attorney is not involved in the formation of an LLC, the LLC will likely not have a written operating agreement for one or more reasons. First, a written operating agreement is not required by statutory law.⁵

Second, if an accountant assisted with the LLC formation, the accountant is prohibited by law from preparing an operating agreement (or any other agreement) since doing so would be the unauthorized practice of law.⁶ Third, some banks do not require a written operating agreement to open a bank account.⁷ Fourth, some people may not even know about LLC operating agreements. Fifth, some people may not have the money to have an operating agreement prepared in the startup phase of a business. Sixth, some people may not believe that there is a need for an operating agreement.⁸

LLC Statute as Default Operating Agreement

If an LLC does not have an operating agreement, then by default the LLC statute, NJ-RULLCA, controls. In the absence of an operating agreement, the members (i.e., owners) of an LLC, as well as a court, will rely on the LLC statute. In other words, the LLC statute will be the operating agreement.⁹

This article will review the default statutory provisions in NJ-RULLCA that will serve as the operating agreement of the LLC and govern the rights and duties of, and the relationship among, the members. It will be organized into three main sections: 1) economic rights, 2) management rights, and 3) exit rights. It will assume that the LLC was formed in New Jersey and has two

or more members who are natural people (as opposed to entities). It does not address litigation issues, such as judicial dissolution due to the oppression of a member.

Economic Rights

A member will want to know their rights, duties, and obligations regarding the economics of the venture. For example, they may be obligated to make capital contributions to, and have a right to receive cash distributions from, the LLC. These matters are discussed in NJ-RULLCA, but not as specifically or comprehensively as they would be in a written operating agreement.

Capital Contributions. A person is not required to make a capital contribution to become a member of an LLC.¹⁰ But if the members are required to contribute, it may take any form, including cash, property (either tangible or intangible), a promise to contribute (through a promissory note or other agreement), and services performed or to be performed.¹¹ A member's obligation to make a required contribution is not excused by death, disability, inability to perform, or dissociation (e.g., withdrawal or resignation as a member).¹²

Compensation. A member is not entitled to any compensation for providing services to an LLC.¹³ A member is entitled to the reimbursement of any reasonable expenses he incurred on behalf of the LLC.¹⁴

Interim Distributions. A member has no right to any distributions before the dissolution and winding up of an LLC, unless the LLC decides to make interim distributions.¹⁵ If an LLC makes distributions, they are made in equal shares among the members (as well as any dissociated members).¹⁶ Members are often surprised to learn that, absent an operating agreement, they will receive equal distributions, even when, for example, the members made unequal capital contributions.

Liquidating Distributions. After the dissolution and winding up of an LLC, the LLC makes liquidating distributions to the members (and any dissociated members). First, each person holding a transferable interest receives an amount equal to the value of any unreturned capital contributions.¹⁷ Then, the members (as well as any dissociated members) receive liquidating distributions in equal shares.¹⁸ For example, assume there is a surplus of \$200,000 and one of two members made a capital contribution of \$100,000, which has not been returned. The member will receive the return of the \$100,000 before each of the two members receives \$50,000 in liquidating distributions.

Income Taxes. An LLC with two or more members is classified as a partnership for New Jersey income tax purposes, unless the LLC elects to be taxed as a corporation for federal income tax purposes, in which case the LLC will likewise be taxed as a corporation for New Jersey income tax purposes.¹⁹ As such, the LLC will file an income tax return (NJ-1065) and each member will receive a Schedule NJK-1 showing their share of the LLC's income and other tax items. Each member reports their share of the LLC's income and other tax items on their personal income tax returns and pays taxes on this income, even if they receive no cash distributions from the LLC.²⁰

Personal Liability. The debts, obligations, and any other liabilities of an LLC, whether arising in contract, tort, or otherwise, are the debts, obligations, and liabilities of the LLC. A member is not personally liable for the LLC's debts, obligations, or liabilities solely because the person is or acted as a member of the LLC.²¹

Management Rights

A member will want to know their rights, duties, and obligations regarding the management of the venture. (For example, their rights to manage the business, vote on various actions, and receive information from the LLC, and their duties when managing the LLC). These matters are discussed in NJ-RULLCA, but again, not as specifically or comprehensively as they would be in a written operating agreement.

Member-Managed. An LLC is managed by its members unless an operating agreement says otherwise. So, in the absence of an operating agreement, by statute the LLC is managed by its members,²² with each member having an equal right to manage the LLC.²³

Voting on Ordinary Matters. Each member has an equal right to manage the LLC, and any matter in the ordinary course of business of the LLC is decided by a majority of the members.²⁴ That is, each member has an equal vote even if they made unequal capital contributions.

Voting on Extraordinary Matters. Any matter outside the ordinary course of business of the LLC is decided by all members; that is, it requires the unanimous consent of all members.²⁵ Therefore each member has veto power.

Some extraordinary matters requiring a unanimous vote include a merger of the LLC,²⁶ conversion of the LLC into a different type of entity (e.g., corporation),²⁷

domestication of the LLC (i.e., moving the LLC entity from New Jersey to another state),²⁸ dissolution of the LLC,²⁹ and admitting a person as a member of the LLC.³⁰

Duty of Care. Each member has a duty of care in managing and conducting the business of the LLC, which is not to engage in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.³¹ This is a low standard of conduct. By comparison, many operating agreements require a member to perform his duties in good faith, in a manner he reasonably believes to be in the best interests of the LLC, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. A member's duty of care is owed to the LLC and the other members.³²

Fiduciary Duty of Loyalty. Each member has a fiduciary duty of loyalty to the LLC and the other members.³³ This duty of loyalty consists of three parts.

First, a member must account to the LLC and hold as trustee for the LLC any property, profit, or benefit received by the member from (a) conducting the LLC's business, (b) using the LLC's property, or (c) appropriating an opportunity of the LLC.³⁴

Second, a member must refrain from self-dealing with the LLC.³⁵ That is, a member cannot do business with the LLC, whether lending money to or borrowing money from the LLC, renting real or personal property to or from the LLC, etc. However, these transactions are common between an LLC and its members. If such a transaction occurs, it must be fair to the LLC for a member to have a defense to a claim that the transaction violates the fiduciary duty of loyalty.³⁶

Third, a member must not compete with the LLC's business.³⁷ This requires a member to present all competitive business opportunities to the LLC. Otherwise, the member violates the duty.

NJ-RULLCA lets all members of an LLC unanimously authorize or ratify any specific act or transaction that violates the duty of loyalty, after full disclosure of all material facts.³⁸ Therefore, all members must provide permission or forgiveness.

Good Faith and Fair Dealing. A member must discharge their duties, and exercise their rights, under the LLC statute consistent with the contractual obligation of good faith and fair dealing.³⁹ This is appropriate since the LLC statute serves as the LLC's operating agreement.

Right to Information. With reasonable prior notice, a member has the right to inspect and copy any record maintained by the LLC regarding its business, financial

condition, and other circumstances, to the extent the information is material to the member's rights and duties under the statute.⁴⁰ The term "record" is defined broadly to include documents and computer or electronic records.⁴¹

An LLC must provide each member, without demand, with any information concerning the LLC's business, financial condition, and other circumstances that the LLC knows is (and that is) material to the proper exercise of the member's rights and duties under the statute, except to the extent the LLC establishes that it reasonably believes the member already knows the information.⁴² An LLC must provide each member, on demand, with any other information concerning the LLC's business, financial condition, and other circumstances, except to the extent the demand or information demanded is unreasonable or otherwise improper under the circumstances.⁴³

An LLC has the right to impose reasonable restrictions and conditions on access to and use of this information, including designating information confidential and imposing nondisclosure and safeguarding obligations on the member receiving the information.⁴⁴

Indemnification. An LLC must indemnify a member for their expenses (i.e., reasonable costs, disbursements and attorney's fees) if the member succeeds on the merits or otherwise in any proceeding brought against the member because he was a member of the LLC.⁴⁵ A "proceeding" is broadly defined as any pending, threatened, or completed civil, criminal, or administrative action, lawsuit, or other proceeding, or an arbitration, any appeal from the same, and any inquiry or investigation that could lead to a proceeding.⁴⁶

An LLC must also indemnify a member for any debt, obligation, expense, or other liability (i.e., settlements, judgments, fines, and penalties) paid or incurred by the member in the course of their activities on behalf of the LLC, as long as the member complied with their duties to the LLC and the other members under the statutory provisions dealing with limitations on distributions and standards of conduct.⁴⁷

Exit Rights

A member will want to know their rights, duties, and obligations when exiting the LLC. These matters are discussed in NJ-RULLCA, but not as specifically or comprehensively as they would be in a written operating agreement. For example, neither the LLC nor the other

members has an obligation to buy the exiting member's transferable interest in the LLC, even on his death.

Duration. An LLC has perpetual duration; that is, it continues until terminated under the LLC statute.⁴⁸

Withdrawal. A member has the power to dissociate at any time by withdrawing (i.e., resigning) as a member.⁴⁹ A member does so by giving the LLC notice of withdrawal.⁵⁰

A dissociated member no longer has the right to manage or conduct the business of the LLC.⁵¹ As a result, they no longer have the right to vote or consent to any action. Their fiduciary duties end regarding matters arising after the dissociation; so, for example, they may compete against the LLC.⁵² Their transferable interest is owned only as a transferee (not as a member).⁵³ A dissociated person has no right to a buyout or a special distribution,⁵⁴ but has the right to continue receiving distributions as if they were a member.⁵⁵

A dissociated member remains liable for any debts, obligations, or other liabilities to the LLC or the other members incurred while a member.⁵⁶ For example, capital contributions promised but not made by the member.

Transfer of Transferable Interest. A "transferable interest" gives a member the right to receive distributions from an LLC.⁵⁷ It is personal property,⁵⁸ and a member may transfer all or part of their transferable interest.⁵⁹

A transferee does not become a member of the LLC unless all other members unanimously consent to their admission as a member.⁶⁰ A transferee has the right to receive the distributions that the transferring member was entitled to receive.⁶¹ A transferee has no right to participate in the management or conduct of the LLC's business.⁶² That is, they have no right to vote or consent to any action of the LLC. A transferee is not entitled to access to any records or other information about the LLC's business,⁶³ but on dissolution of an LLC, a transferee is entitled to an accounting of the LLC's transactions from the date of dissolution.⁶⁴

Expulsion. A person's transfer of their entire transferable interest does not result in the dissociation of the member.⁶⁵ Instead, the person remains a member, but without the right to receive distributions (since

the distributions will be received by the transferee).⁶⁶ However, this person may be expelled as a member by the unanimous consent of the other members.⁶⁷ A person also may be expelled as a member by the unanimous consent of the other members if it is unlawful to carry on the LLC's business with the person as a member.⁶⁸

Death. The death of a member is an event of dissociation,⁶⁹ and the estate of a deceased member has the status of a transferee (not a member).⁷⁰ As a dissociated person, the estate has no right to a buyout or a special distribution,⁷¹ but it has the right to continue receiving distributions. This article explains the rights of a dissociated person and a transferee, which largely apply to the estate of a deceased member.⁷²

Dissolution. An LLC may be dissolved, liquidated, and thereafter terminated with the unanimous consent of all members.⁷³ An LLC is also dissolved when an LLC does not have any members for 90 consecutive days.⁷⁴ But the LLC will not be dissolved if within this 90 day period the last person who was a member (or the legal representative of such a person) designates a person, and such designated person agrees, to become a member.⁷⁵ As noted above, the members (and any dissociated members) are entitled to equal liquidating distributions after the winding up of the LLC's affairs.⁷⁶

Conclusion

When forming an LLC, it is prudent to engage an experienced business attorney to prepare a written operating agreement to reflect the understanding of the members. Otherwise, by statutory default, NJ-RULLCA will be the operating agreement, as described in this article, and the members may be surprised by some of the resulting terms, which may not reflect their expectations. ■

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Endnotes

1. njportal.com/DOR/BusinessFormation/Home/Welcome.
2. N.J.S.A. 42:2C-1 et seq.
3. N.J.S.A. 42:2C-18(b).

4. N.J.S.A. 42:2C-19(e).
5. In New Jersey, an operating agreement may be written, oral, implied, or any combination of the foregoing. N.J.S.A. 42:2C-2 (definition of operating agreement). If the members disagree on the terms of an oral or implied operating agreement, they would need to prove the terms and resolve the dispute in a legal proceeding (e.g., litigation or arbitration).
6. See, e.g., Committee on Authorized Practice of Law Opinion 47 (June 13, 2011).
7. For example, Bank of America and Wells Fargo do not mention operating agreements on their websites. See bankofamerica.com/smallbusiness/deposits/resources/documents/limited-liability-company/; wellsfargo.com/biz/required-documents/. Chase Bank may require a written operating agreement. See chase.com/business/resources/business-bank-account-information. PNC Bank will not require a written operating agreement if it is not required by state statute. See pnc.com/en/small-business/banking/business-checking-overview/checking-app-requirements.html#accordion-9206c95d67-item-c57e1d5000.
8. For a brief explanation of why a written operating is important, see Gianfranco A. Pietrafesa, “An Operating Agreement Is Essential Under RULLCA”, New Jersey Law Journal (November 19, 2012), a copy of which is available at archerlaw.com/a/web/8CkRCgzmNwZPYMdm2MTnhG/pietrafesa_11_19_12.pdf.
9. N.J.S.A. 42:2C-11(b). See also *IE Test, LLC v. Carroll*, 226 N.J. 166, 178 (2016), citing *Union Cty. Improvement Auth. v. Artaki*, 392 N.J. Super. 141, 152 (App. Div. 2007), and *Kuhn v. Tumminelli*, 366 N.J. Super. 431, 440 (App. Div. 2004). Even if there is a written operating agreement, any issue not addressed in the agreement may be resolved under the LLC statute.
10. N.J.S.A. 42:2C-31(d).
11. N.J.S.A. 42:2C-34.
12. N.J.S.A. 42:2C-33 & -47(b).
13. N.J.S.A. 42:2C-37(f).
14. See N.J.S.A. 42:2C-38(c).
15. N.J.S.A. 42:2C-34(b).
16. N.J.S.A. 42:2C-34(a).
17. N.J.S.A. 42:2C-56(b)(1).
18. N.J.S.A. 42:2C-56(b)(2).
19. N.J.S.A. 42:2C-92(a). This LLC would be taxed as a partnership for federal income tax purposes, unless the LLC elected to be taxed as a corporation. See Internal Revenue Code 701, 702, & 704(a).
20. See N.J.A.C. 18:35-1.3.
21. N.J.S.A. 42:2C-30(a).
22. N.J.S.A. 42:2C-37(a). See also N.J.S.A. 42:2C-37(b)(1).
23. N.J.S.A. 42:2C-37(b)(2).
24. N.J.S.A. 42:2C-37(b)(3).
25. N.J.S.A. 42:2C-37(b)(4).
26. N.J.S.A. 42:2C-75(a).
27. N.J.S.A. 42:2C-79(a).
28. N.J.S.A. 42:2C-83(a)(1).
29. N.J.S.A. 42:2C-48(a)(2).
30. N.J.S.A. 42:2C-31(c)(3). For a discussion of the statutory provisions requiring unanimous consent, see Gianfranco A. Pietrafesa, “NJ-RULLCA Provisions Requiring Unanimous Consent of Members”, Business Law Section Newsletter (New Jersey State Bar Association, July 2017), a copy of which is available at archerlaw.com/a/web/6u37TKa35jPi47TtUZGcLg/pietrafesa-article-nj-rullca-provisions-requiring-unanimous-consent-of-members-april-2017.pdf.
31. N.J.S.A. 42:2C-39(c).
32. N.J.S.A. 42:2C-39(a).
33. N.J.S.A. 42:2C-39(a).

34. N.J.S.A. 42:2C-39(b)(1).
35. N.J.S.A. 42:2C-39(b)(2).
36. N.J.S.A. 42:2C-39(g).
37. N.J.S.A. 42:2C-39(b)(3).
38. N.J.S.A. 42:2C-39(f).
39. N.J.S.A. 42:2C-39(d).
30. N.J.S.A. 42:2C-40(a)(1).
41. N.J.S.A. 42:2C-2 (The term “record” is defined as “information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.”).
42. N.J.S.A. 42:2C-40(a)(2)(a).
43. N.J.S.A. 42:2C-40(a)(2)(b).
44. N.J.S.A. 42:2C-40(g).
45. N.J.S.A. 42:2C-38(b). See also N.J.S.A. 42:2C-38(a)(1) (definition of expenses).
46. N.J.S.A. 42:2C-38(a)(5).
47. N.J.S.A. 42:2C-38(c), citing N.J.S.A. 42:2C-35 (limitations on distributions) and -39 (standards of conduct). See also N.J.S.A. 42:2C-38(a)(4) (definition of liabilities).
48. N.J.S.A. 42:2C-4(c).
49. N.J.S.A. 42:2C-45(a).
50. N.J.S.A. 42:2C-46(a).
51. N.J.S.A. 42:2C-47(a)(1).
52. N.J.S.A. 42:2C-47(a)(2).
53. N.J.S.A. 42:2C-47(a)(3).
54. N.J.S.A. 42:2C-34(b).
55. N.J.S.A. 42:2C-34(a) & -56(b)(2).
56. N.J.S.A. 42:2C-47(b).
57. N.J.S.A. 42:2C-2 (definition of transferable interest).
58. N.J.S.A. 42:2C-41.
59. N.J.S.A. 42:2C-42(a)(1).
60. N.J.S.A. 42:2C-31(c)(3).
61. N.J.S.A. 42:2C-42(b).
62. N.J.S.A. 42:2C-42(a)(3)(a).
63. N.J.S.A. 42:2C-42(a)(3)(b).
64. N.J.S.A. 42:2C-42(c).
65. N.J.S.A. 42:2C-42(a)(2).
66. N.J.S.A. 42:2C-42(g).
67. N.J.S.A. 42:2C-46(d)(2).
68. N.J.S.A. 42:2C-46(d)(1).
69. N.J.S.A. 42:2C-46(f)(1).
60. N.J.S.A. 42:2C-47(a)(3).
71. N.J.S.A. 42:2C-34(b).
72. See the discussions under “Withdrawal” and “Transfer of Transferable Interest”. For a comprehensive explanation of what occurs on the death of a member, see Gianfranco A. Pietrafesa, “Death and the NJ LLC”, Business Law Section Newsletter (New Jersey State Bar Association, November 2017), a copy of which is available at archerlaw.com/a/web/hEXBm8hcBaKXviaBJSuu9P/death-and-the-nj-llc-.pdf.
73. N.J.S.A. 42:2C-48(a)(2).
74. N.J.S.A. 42:2C-48(a)(3).
75. N.J.S.A. 42:2C-31(c)(4).
76. See the discussion under “Liquidating Distributions.”