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## BUSINESS LAW

### Oppressed Minority Shareholders Should Be Afforded Protection

An argument for a revision of the Limited Liability Act

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In January of 1994, the New Jersey Legislature enacted the New Jersey Limited Liability Company Act, N.J.S.A. 42:2B-1, et seq, which permits business owners to form and use limited liability companies as an alternative to the traditional corporation. When it enacted the new set of laws pertaining to LLCs, the Legislature did not incorporate the "Minority Oppression" statute contained in the New Jersey Business Corporation Act, which provides certain protections to minority shareholders of closely held companies who are subjected to oppression. Generally, "oppression has been defined as frustrating a shareholder's reasonable expectations." *Brenner v. Berkowitz*, 134 N.J. 488, 506 (1993).

Almost 15 years after the enactment of the LLC Act, the New Jersey Legislature is considering enacting a revised Limited Liability Corporation Act which may provide similar protections to those enjoyed by oppressed shareholders in closely held corporations. One purpose of this article is to

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advocate the inclusion of protections afforded by the Minority Oppression Statute, N.J.S.A. 14A:12-7(c), when the New Jersey Legislature revises the LLC Act. Another aim is to urge the judiciary to offer the same protections available to oppressed minority shareholders to similarly situated minority members of closely held limited liability companies. Finally, this article provides insight relating to the representation of minority members at the time the LLC operating agreement is drafted.

Since January 1994, the use of limited liability companies has grown in popularity. Attorneys and tax professionals often recommend the use of LLCs over traditional corporations because their members are afforded the same personal liability protections as corporations while enjoying the pass-through tax advantages similar to a partnership. The profits or losses of the LLC pass directly through to the members' personal income tax returns on their Form 1040. The LLC files a Form 1065, and then lists each member's taxable profit on Form K-1. Thus, the LLC does not itself file taxes.

Another reason professionals often prefer the use of limited liability

companies over traditional corporations is due to the fact that the members can draw up their own contract or "Operating Agreement," which allows for flexibility in management and responsibilities. Additionally, LLCs, provide members with more versatility in the allocation of income. All too frequently, the formation of an LLC is undertaken without thorough consideration of the need for protections for minority-member rights should the relationships between the members sour and deteriorate. First, it is important to understand that it is unclear whether the protections afforded to minority shareholders codified in the Minority Oppression Statute are available to an oppressed minority member of an LLC. There is no definitive decision guiding courts as to applicability of the Minority Oppression Statute to limited liability companies. For example, in *Hopkins v. Nightingale, et. al* (Civil Action No. 02-5589), the plaintiff, a minority member of Nightingale LLC, sought the appointment of a custodian to manage the LLC. Although the court denied the application for reasons unique to that case, the Honorable Mark Falk, U.S.M.J., ruled "regardless of membership in Nightingale [LLC], plaintiff has the right to assert claims as an oppressed minority shareholder, and the Court agrees." Judge Falk's decision was subsequently affirmed on appeal. *Duckett v. Hopkins*, 205 WL 1262907 (D.N.J. 2005). On the other hand, the New Jersey Appellate Division recently distinguished the treatment between members of a closely held limited liability

ity company and minority shareholders in a buy-out situation. See *Denike v. Cupo*, 394 N.J. Super. 357, 382 (App. Div. 2007), revised 196 N.J. 502 (2008). To date, the New Jersey Supreme Court has not provided any guidance as to whether the protections afforded by the Minority Oppression Statute apply to LLCs.

In addition, in the case of an oppressed minority shareholder, New Jersey law presumes that a “discount” will not be applicable to a court ordered buy-out. *Balsamides v. Protameen Chemicals, Inc.*, 160 N.J. 352 (1999); *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 383 (1999). The same may not be true in the case of a minority member of an LLC. If the Legislature does not amend the act to incorporate the Minority Oppression Statute and, if the courts decide against applying the Minority Oppression Statute to LLCs, then a minority member’s interest maybe subjected to discounts. N.J.S.A. 42:2B-39(b). That, of course, would have a negative financial impact on minority members of an LLC who are subjected to oppressive conduct.

In addition, it is unclear whether the statutory remedies available to redress unlawful oppression, such as the appointment of a receiver, are available to an oppressed minority member of an LLC. See N.J.S.A. 14A:12-7(c)(4). There are, however, at least two unreported decisions in which the New Jersey Chancery Courts have permitted the appointment of receivers despite the fact that the LLC Act does not have a specific provision permitting same. See, e.g., *Percontino v. Camporeale*, 2005 WL 730234 (Ch. Div.

2005); *Actives International, LLC v. Reitz*, 2005 WL 1861939 (Ch. Div. 2005).

The Legislature should apply or extend the Minority Oppression Statute to limited liability companies. The Legislature and the courts should recognize that the same rationale for protecting minority shareholders in closely held corporations, applies with respect to the minority members of LLCs. The New Jersey Legislature recognized this need to protect the interests of minority shareholders from disputes which inherently arise from the close relationships between the shareholders, the relatively small size of the closely held company, and the limited number of people who might be interested in buying an interest in a closely held company, when it included the Minority Oppression Statute. Closely held corporations and limited liability companies are similar in size and in the nature of the relationships shared among members, which tend to be more intimate and familiar than in a larger corporate environment. Personal clashes, consequently, tend to be more personal in both closely held corporations and limited liability companies. Hence, there is no reason the protections afforded by the Minority Oppression Statute should not be extended to oppressed minority members of LLCs.

In fact, the LLC Act provides a “catch-all” which arguably provides minority members the same protections codified in the Minority Oppression Statute. N.J.S.A. 42:2B-68. That section provides, “[i]n any case not provided for in this act, the rules of law and equity,

including the law merchant, shall govern.” Hence, courts of equity may utilize that provision either to apply the Minority Oppression Statute to limited liability companies or simply to use it for guidance when addressing an oppressive situation in the context of an LLC dispute.

Since it is unclear whether the protections afforded by the Minority Oppression Statute are applicable to LLCs or will be extended to them by the Legislature, it is incumbent on practitioners representing minority members to protect the rights of their clients during the inception phase of the entity. N.J.S.A. 42:2B-66(a) of the LLC Act provides that this “act is to be liberally construed to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements.” Hence, a practitioner would be wise to incorporate the protections afforded by N.J.S.A. 14A:12-7, the Minority Oppression Statute, into the operating agreement or, perhaps, when drafting the operating agreement, include language expressing that N.J.S.A. 14A:12-7 applies to the newly formed LLC. Moreover, the practitioner can suggest the inclusion of language guaranteeing all of the protections afforded to minority shareholders. Until the Legislature amends the existing statute or the Supreme Court provides a definitive ruling on the application of the Minority Oppression Statute to limited liability companies, the inclusion of this recommended language in the LLC’s governing documents may be the only means of guaranteeing the protection of minority members of an LLC. ■