



The New NC Limited Liability Company Act BY STACEY A. BRADY

EIGHT REASONS WHY YOU NEED A WRITTEN OPERATING AGREEMENT OR SHOULD CONSIDER UPDATING YOUR EXISTING ONE

The new NC LLC Act, Chapter 57D of the North Carolina General Statutes (the “New Act”), went into effect on January 1, 2014 and replaces Chapter 57C of the North Carolina General Statutes (the “Old Act”). The New Act draws largely from the premise that the agreement among the owners of a limited liability company (an “LLC”) should be paramount in governing their relationship. It is, therefore, now more important than ever that an LLC have an operating agreement. Except for certain limited provisions listed in Section 57D-2-30 of the New Act (many of which deal with administrative matters within the purview of the Secretary of State), the owners of an LLC are free to override the default provisions of the Act and dictate the terms of their business relationship through their operating agreement. Considering this expanded flexibility and the revised default provisions of the New Act, below are eight reasons why owners of an LLC should consider adopting a written operating agreement (if they don’t already have one) or reviewing and updating their existing operating agreement. This list is by no means an exhaustive list of the changes in the New LLC Act, but merely highlights some considerations for members of an LLC that is formed under North Carolina law. The following bulleted items are discussed in more detail in the sections below:

- Possible problems under the New Act with oral or implied agreements among members.
- Definitional changes in the New Act that may impact existing operating agreements.
- Inconsistencies between an LLC’s Articles of Organization and its operating agreement.
- Changes in the New Act affecting professional LLCs and L3Cs.
- Provisions in the New Act that permit the direct issuance of economic interests (interests with less than full membership rights) and that address valuation of non-cash capital contributions.
- Expanded flexibility under the New Act for structuring management rights and delegating management authority.
- Changes in the New Act that may affect fiduciary duties, indemnification, and exculpation of managers.

- Revised provisions in the New Act addressing a member’s right to information.
1. Avoiding Oral or Implied Agreements that May Lead to Future Disputes. Under the New Act, LLCs are now permitted to override non-mandatory provisions of the Act with an oral or implied operating agreement. While this offers more flexibility than the Old Act, which only permitted the default rules of the act to be modified by a written operating agreement, without a written agreement, the risks are higher that the terms of the operating agreement may not be clearly stated or understood by all owners and such terms may fail to address important or relevant issues. In these cases, if the owners of an LLC fail to see eye-to-eye on a matter they will be left attempting to prove the terms of their oral or implied agreement, possibly through litigation. A few notes of caution to consider are:
 - a. The New Act provides that a person who acquires an interest in an existing LLC is bound by the operating agreement of the LLC regardless of its form (whether written, oral, or implied, or any combination thereof) and regardless of whether the new owner has actually agreed to its terms.¹ This is a change from the Old Act (which provided that a member was only bound by an operating agreement to which the member expressly agreed or was in effect at the time he became a member and the terms of which were in writing or actually known by the member²) and puts the onus on persons becoming owners of an LLC to fully ascertain the terms of the operating agreement of the LLC, which may be difficult to do if such terms are oral or implied.
 - b. Keep in mind that even if an LLC’s operating agreement is in writing, it may now be subject to amendment or supplementation by oral or implied agreements unless the terms of the written operating agreement prohibit such methods of supplementation or amendment.
 2. Accounting For Definitional Changes in the Act. The New Act contains a number of new defined terms and updates some existing defined terms.³ Members may want to review their existing operating agreement with these new definitions in mind. Although the New Act provides that references to provisions of the Old Act will be deemed to be made to corresponding provisions of the New Act,⁴ to the extent applicable, this may be easier to

1 See NCGS Section 57D-2-31(b).

2 See NCGS Section 57C-3-05.

3 See NCGS 57D-1-03.

4 See NCGS 57D-11-03(e).

apply in some cases than others. For example, if an operating agreement referred to an “assignee” as a defined term under the Old Act, presumably this would refer to an “economic interest owner” under the New Act. However, if an operating agreement referred to “executives” or “directors” as defined under the Old Act, the New Act does not contain definitions that correspond directly to these definitions and instead lumps all such persons exercising management authority on behalf of an LLC into the single category of “company officials.” If the roles of “executives” or “directors” were not otherwise clearly spelled out in the LLC’s operating agreement, it might be helpful to clarify the agreement under the New Act.

3. Addressing Inconsistencies Between Articles of Organization and Operating Agreements. Another concept introduced under the New Act is that the Articles of Organization of an LLC are now considered part of its Operating Agreement.⁵ So what happens if an LLC’s Articles and Operating Agreement contain inconsistent terms? The New Act provides that in the event of a conflict between the operating agreement and a provision in any document of an LLC filed by the Secretary of State, the operating agreement shall prevail as to the parties to the operating agreement and company officials and the document filed by the Secretary of State shall prevail as to third parties to the extent that they reasonably rely on it.⁶ Since the Articles of Organization are considered part of the Operating Agreement under the New Act, it remains to be seen how conflicts between the two may be resolved among the parties to the Operating Agreement, but presumably contract law would apply. Members may want to review their operating agreements and Articles of Organization to address any inconsistencies proactively.

4. Considering Clarifications In the Act Relating to Certain Special Types of LLCs. The New Act clarifies how to apply the professional corporation provisions of Chapter 55B of the North Carolina General Statutes to professional limited liability companies.⁷ Professional LLCs may want to review these new provisions. The New Act also removes provisions from the Old Act related to low profit limited liability companies (“L3Cs”). Although the statute no longer contains special provisions applying to L3Cs, the New Act is flexible enough to accommodate the organization of limited liability companies that qualify for “program related investments” under Section 4944(c) of the Internal Revenue Code by private foundations without any additional or special provisions in the Act.

5 See NCGS 57D-1-03(23).

6 See NCGS 57D-2-30(d).

7 See NCGS 57D-2-02.

5. Clearly Defining The Type and Amount of Ownership Interests to be Received by Interest Owners.

- a. Changes Allowing Direct Issuance of Economic Interests. The New Act now allows LLCs to issue Economic Interests (an interest that entitles its holder to share in allocations of income or loss and distributions without giving such holder voting or other member rights) directly to interest owners.⁸ Under the Old Act, a person could only become an assignee (similar to a holder of an economic interest) if such person was a transferee of a member or obtained such person's interest in the LLC pursuant to a plan of merger or conversion and was not admitted as a member of the LLC.

- b. Changes Effecting Contributions of Property or Services to an LLC. Under the Old Act, unless otherwise provided in an LLC's operating agreement, distributions were to be made in proportion to the agreed value of the contributions made by the members to the LLC.⁹ The Old Act further provided that in the case of non-cash contributions, the agreed value of the contributions was the fair market value of the contribution as agreed to by the LLC and the contributing member.¹⁰ This required an agreement to exist between the LLC and the member making a non-cash capital contribution. Under the New Act, no agreement as to the value of a non-cash contribution is required between the contributing member and the LLC. Instead, contributions may be made in any form and distributions are made in proportion to the members' contribution amounts.¹¹ A member's contribution amount includes the fair market value (net of liabilities assumed by the LLC or to which the contributed property is subject) of the money, property, or services contributed (or promised to be contributed) to the LLC reduced by the value of any money, property, or services promised to the LLC that are discharged without performance.

Therefore, while the Old Act would require agreement between a member contributing services to an LLC in exchange for an interest therein and the LLC as to the value of the services performed, the New Act does not require such an agreement. A service provider will be deemed to have made a capital contribution to the LLC

8 See NCGS 57D-3-01(b).

9 See NCGS 57C-4-04.

10 See NCGS 57C-4-01.

11 See NCGS 57D-1-03(6), 57D-4-01, and 57D-4-03.

equal to the fair market value of the services performed. While this new default rule may grant a service provider more protection because the fair market value of his capital contribution will be objectively determined rather than dependent upon agreement of the parties, this approach may also result in adverse tax consequences (in the form of a taxable capital shift) to a service provider who becomes entitled to receive a pro-rata share of distributions based on the fair market value of the services performed or promised to be performed.

Further, since the full value of services promised to be performed counts toward the service provider's contribution amount prior to the services being performed, the members will want to make sure that their operating agreement clearly documents (i) what services are to be performed, (ii) how long they will be performed, and (iii) what will happen if the service provider fails to provide the promised services for the promised time period. If the operating agreement fails to provide for such circumstances, the default rules under the New Act provide for a reduction in an interest owner's contribution amount for the value of any services that are discharged without performance. In addition, while the New Act generally relies on contract law to determine the remedies available to the parties in the event that an interest owner is excused from performing such interest owner's promised contribution (whether due to death, disability or other impossibility or impracticability)¹², the default rules would also permit an LLC to require an interest owner who is excused from performing promised services to pay to the LLC an amount of money equal to the value of the unperformed services.¹³ This could result in unanticipated hardship to the contributing interest owner. Notwithstanding the default provision, interest owners are free to provide for their own remedies for capital contribution obligations that are in default in their operating agreement.¹⁴

6. Clarifying Management Rights and Management Structure.

The New Act eliminates the need for an LLC to state in its Articles of Organization whether it will be a member-managed or manager-managed entity and provides members of an LLC with greater flexibility in establishing their management structure.¹⁵ An LLC may be managed by its members, its managers, or other "company officials" having such

¹² Depending on the facts and circumstances, such remedies could include a reduction in or cancellation of the service provider's interest in the company depending on the actual services performed.

¹³ See NCGS Section 57D-4-02.

¹⁴ See NCGS Section 57D-2-32.

¹⁵ See NCGS Sections 57D-2-21 and 57D-3-20.

titles and duties as are set forth in the Operating Agreement of the LLC. This allows members to provide for a management structure that works best for their business needs in their operating agreement.

- a. Default Voting Rules. If an LLC's operating agreement fails to set forth the management structure and voting rights of the members, the default under the New Act will be that each member is a manager and each manager gets one vote regardless of the member's contributions to the capital of the LLC.¹⁶ Approval of a majority of the votes cast is required to take action. This may come as a surprise to majority owners; however, this is not a change from the Old Act where each manager got one vote unless otherwise provided in a written operating agreement.¹⁷ As noted in comment #1 above, in the case of oral or implied agreements the members may have a difficult time proving the existence of a management structure other than the default provisions.
 - b. Changes Effecting Delegation of Management Authority. One point to keep in mind is that the New Act reverses position on the ability of managers of an LLC to delegate their management rights. Under the Old Act, unless authorized to do so in a written operating agreement a manager was not entitled to delegate its management rights.¹⁸ Under the New Act, managers are permitted to delegate their management authority unless the LLC's operating agreement prohibits them from doing so.¹⁹ If members did not specifically address whether or not managers could delegate their management authority under their existing operating agreement, they may want to revisit this issue to make sure that their operating agreement reflects the members' intent.
7. Clearly Defining the Manager's Fiduciary Duties and Rights to Exculpation and Indemnification. While the Old Act seemingly did not provide for the modification of a manager's duties and limited the extent to which a manager's rights to exculpation and indemnification could be expanded, the New Act clarifies that such duties and rights may be modified, subject only to the general restriction that the operating agreement is subject to agency and contract law, including the implied contractual covenant of good faith and

16 See NCGS Section 57D-3-20(b).

17 See NCGS Section 57C-3-20(b).

18 See NCGS Section 57C-3-24(a).

19 Compare NCGS Section 57C-3-24(a) to NCGS Section 57D-3-22.

fair dealing, and the requirement that the terms of the operating agreement not be unconscionable at the time they are made.²⁰ With this in mind, members may want to review these provisions in their operating agreements and in doing so, consider the following:

- a. Changes to Default Fiduciary Duties. While a manager's default duty of care is generally the same under the New Act as under the Old Act (to act in good faith, with the care an ordinary and prudent person in a like position would exercise under similar circumstances and in a manner that the manager believes to be in the best interests of the LLC), the New Act clarifies that a manager's duty to act in the best interests of the LLC is subject to the operating agreement.²¹ This clarification protects managers who rely in good faith on the provisions of the Operating Agreement; therefore, if they have not already done so, members and managers should consider the following questions. Should the operating agreement provide for circumstances when the manager may act in his, her or its sole discretion rather than in the best interests of the LLC? Should the manager be able to consider the interests of a member (including one that appointed the manager) when acting on behalf of the LLC? Should the operating agreement alter the manager's duties (subject to the implied contractual covenant of good faith and fair dealing and the requirement that terms in the operating agreement not be unconscionable when made)?

- b. Changes to Permissive Exculpation and Indemnification Standards. What do provisions in existing operating agreements that provide for the exculpation or indemnification of managers to the fullest extent permitted by law mean under the New Act? Under the Old Act an operating agreement could eliminate or limit the personal liability of a manager for monetary damages for breach of duty and could provide for indemnification of the manager other than for liabilities arising from (i) acts or omissions that the manager knew at the time were clearly in conflict with the interests of the LLC or (ii) any transaction from which the manager derived an improper personal benefit.²² Therefore, under the Old Act an agreement that provided for exculpation or indemnification of a manager to the fullest extent permitted by law, would be limited as provided by (i) and (ii) in the immediately preceding sentence. Under the New Act, the only limitation on an LLC's ability to exculpate and

20 See NCGS Section 57D-2-30(e).

21 See NCGS Sections 57C-3-22(b) and 57D-3-21(b).

22 See NCGS Section 57C-3-32.

indemnify a manager is that the manager may not be exculpated or indemnified for liabilities arising out of acts or omissions that are in breach of the implied contractual covenant of good faith and fair dealing.²³ Whether this standard would provide limits on exculpation or indemnification of managers similar to the Old Act is debatable; therefore, members may want to revisit any provisions in an operating agreement that provide for exculpation and indemnification of managers to the fullest extent permitted by law to clarify how they such provisions are intended to apply under the New Act.

- c. Changes to Default Mandatory Indemnification Provisions. While the default rules of the Old Act required an LLC to indemnify members, managers, directors and executives who were wholly successful on the merits for expenses incurred in their defense of any proceeding to which they were a party by reason of being a member, manager, director or executive,²⁴ the New Act extends such indemnification only to members, managers, and other company officials who were interest owners in the LLC at the time, leaving company officials who are not members to negotiate for such protection on their own behalf.²⁵ The New Act also provides members with protection from liabilities incurred if the member acted within the scope of such member's duties and standards of conduct set forth in the LLC's operating agreement. This additional protection for members who act within their scope of duties and standards of conduct is new; therefore, members will want to think carefully about the scope of their duties and standards of conduct set forth in the LLC's operating agreement.

8. Clarifying Members' Rights to Company Information. The New Act spells out in more detail the records required to be maintained by an LLC and whether and to what extent the LLC's operating agreement may limit a member's rights to access such information (including clarifying that except for certain limited information, an LLC need not disclose to any member any information related to any other member).²⁶ Members may want to review the terms of their operating agreements to make sure they provide for appropriate disclosures of information and any desired limitations on disclosures of information that may be permissible under the New Act.

23 See NCGS Section 57D-2-30(e).

24 See NCGS Section 57C-3-31.

25 See NCGS Section 57D-3-31.

26 See NCGS Section 57D-3-04.

As a business evolves, it is always a good idea to revisit existing agreements to make sure they still meet the needs of the LLC, its managers and owners. While members are not required to amend their LLC operating agreement solely based on the New Act, if some time has passed since the operating agreement of an LLC was last reviewed and updated, now may be a good time to for members to update their existing operating agreement or to prepare a new written operating agreement with the New Act in mind.

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