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Mark Davidson summarizes important changes to the new North Carolina Limited Liability Company Act

January 1, 2014

North Carolina has rewritten its Limited Liability Company Act. New Chapter 57D replaced old Chapter 57C effective *January 1, 2014*.

A summary of the more important changes is provided below. *For more information or assistance in organizing your company in light of these changes, please contact Mark Davidson, who served on the committee which drafted the new Act, at 336-271-3126 or mdavidson@brookspierce.com*.

Important Substantive Changes

The new Act significantly expands the already generous freedom of contract afforded in the old Act. Under both the old and the new Acts, the parties can modify most of the rules by agreement. These rules are often referred to as "default rules" because they apply *unless* the parties provide a different rule in their agreement governing the company, known as an "operating agreement".

- Under the old Act many of the most important default rules could only be changed by written agreement. The new Act eliminates the writing requirement. Under the new Act, any default rule may be overridden by an oral agreement, or even by an agreement that is implied by the parties' conduct.

  While the best practice will continue to be to have a written operating agreement especially when a default rule is to be overridden, the liberalization permitted by the new Act in establishing the existence of an agreement to override a default rule may help a party avoid being stuck with a default rule that is contrary to the "deal" when the old Act would not have avoided that result.

- The new Act expands the rules that are subject to being overridden by agreement. In particular, the parties can eliminate the duties of those managing the company to act in the company's best interest and to use reasonable care, and eliminate liability for breach of those duties, subject to the limits that otherwise generally apply to the parties' ability to enter a contract, including the obligation of good faith and fair dealing and the requirement that contract terms not be unconscionable at the time the contract is made.
- Under the new Act a party's access to remedies in court may be enhanced or restricted by agreement.

  - The new Act provides that penalties agreed by the parties to be imposed upon the occurrence of an event, such as a failure to contribute money to the company, will be enforceable in court even though general contract law would otherwise refuse to enforce them.
  - Under the new Act a member may be prohibited by the operating agreement from bringing a "derivative action" in court to enforce the company's rights if the operating agreement provides an alternative remedy.
  - Under the new Act a member may be prohibited by the operating agreement from bringing an action in court to dissolve the company in certain circumstances if the operating agreement provides an alternative remedy.
- The new Act authorizes a company to issue interests that only have economic rights and no rights to participate in management. The old Act may have allowed creation of such economics-only interests only through a member having both economic and management rights assigning the member's economic rights.
- The new Act does not require *any* managers. The old Act permitted management to be vested in persons other than managers, but may have required that there be at least one manager.

Under both the old and the new Acts, a company cannot make distributions of cash or other property to its owners if following the distribution the company would be insolvent or, in the case of distributions following the company's dissolution, before first paying or making adequate provision for the company's liabilities. Under the new Act, these distribution limitations do not apply to distributions that constitute compensation for services or to payments made in the ordinary course of business under a bona fide retirement plan or other benefits program.

The new Act establishes a procedure whereby a company may obtain judicial approval of a reserve for contingent liabilities or liabilities that may arise after dissolution. The Company's establishment of the reserve approved by the Court is deemed to satisfy the Company's obligations with respect to those liabilities.

For the most part, the default rules themselves remain substantially the same under the new Act.

- For economics, the default rule continues to be that ownership is in proportion to the values of the parties' respective contributions of cash, other property, services, or promises to provide cash, other property, or services, to the company.

- For management rights, the default rule continues to be that each member has an equal vote, regardless of economic ownership. Based on our experience, this is the most problematic default rule because it is often contrary to expectations. While the new Act continues this default rule, it increases the ability of a party to establish the existence of an agreement to override it by allowing proof of an oral agreement or an agreement implied by the parties' conduct, while under the old Act this default rule could be overridden only by a written operating agreement.

Changes in Format and Terminology

The new Act reflects important changes in format from the old Act.

- The old Act identified default rules with words such as "except as otherwise provided in an operating agreement". The new Act does not identify default rules in this manner, but instead provides in a *separate section* of the new Act that the new Act's provisions are default rules *except* to the extent provided otherwise in that section. This new format may mislead a person who is not aware of the new special section into thinking that a rule is not a default rule when in fact the rule is a default rule.
- The new Act adopts several new specially defined terms, some of which could be misleading if careful attention is not paid.
    - The new Act refers to a company that is formed under the new Act or the old Act as an "LLC", while referring to a company that is formed under the laws of another jurisdiction as a "foreign LLC". References in the new Act to "limited liability company" can mean *either* an LLC or a foreign LLC.
    - Under the new Act, the holder of an interest in the company that has rights to participate in management is a "member" while the holder of an interest having only economic rights is an "economic interest owner". An "interest owner" refers to a member *or* an economic interest owner, and "ownership interest" refers to all the rights held by an interest owner, whether economic rights or management rights.
- Instead of providing that certain actions must be taken in a reasonable manner, the new Act adopts a global "reasonable" modifier stating that its provisions "are to be applied in a manner that is reasonable under the circumstances".

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