Published on *The National Law Review* https://natlawreview.com

Right for the Wrong Reasons: NJ Court Values LLC Buyout Using Partnership Principles

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On Friday, Nov. 18, 2022, a three-judge panel of the New Jersey Superior Court, Appellate Division, issued a 67-page decision, per curiam, in Care One LLC, et al., v. Adina Strauss and Jeffrey Rubin, 2022 WL 17072371, reversing in part and affirming in part, NJ Super. Ct. (Ch. Div.), No. C-000026-19.

The Appellate Division decision reversed a two page 23 November 2020 decision of the New Jersey Superior Court, Chancery Division, which had granted Care One and affiliated entities Summary Judgment dismissing “defendant’s breach of contract claims relating to [a 2015 amendment to Care One’s Operating Agreement which added an optional right of the Majority in interest of the Members to buyout the minority Members and adopted a formula for calculating the buy-out price] and remand[ed the case] for the trial court to enter summary judgment to defendants on those claims relating to the adoption of the repurchase formula, and for proceedings to determine the amount of damages to be awarded to Adina and Rubin for the ‘fair value’ of their membership interests in Care One, minus any amount already received.” In addition, the Appellate Division directed that “the trial court shall also address defendants’ claim that Care One failed to make the required tax distributions in 2015.”

Further, the Appellate Division affirmed the dismissal of defendants’ claims that their removal as Members breached their contract as Members of Care One, “as well as their claims for breach of the covenant of good faith and fair dealing, breach of fiduciary duty, and aiding and abetting a breach of fiduciary duty.”

Care One, a Limited Liability Company organized in 1997 under the Limited Liability Company Act of Delaware, owns and operates --apparently quite successfully-- “skilled nursing homes and assisted living facilities.” The Members were primarily from the Strauss family. Four of those Strauss family members had inherited a nursing home business from their father in 1978; that business was sold in 1997. Daniel Strauss, the leader of the family, led them to form Care One with Members including a family adviser holding a minor interest (a person who does not subsequently appear in the decision except in a reference to his family trust) and Jeffrey Rubin, who at that time was married to Daniel’s sister, Adina Strauss.

The Operating Agreement for Care One was adopted on April 1, 1999 (in retrospect, not a fortuitous date), with Daniel the Managing Member. Especially important was Section 11.4 of the Operating Agreement, which prohibits any amendment that would reduce a Member's economic entitlements unless the Member consents to the change. In addition, Annex Section A1.9 of the Operating Agreement provides (as is typical in Operating Agreements) that each Member would receive an annual distribution equal to 40% of allocated Net Profits, intended to be sufficient to pay the Member's tax liability with respect to that allocation. The Operating Agreement was amended in 2006, 2009, 2010, 2012 and, as noted, in 2015. While each amendment had its own details, in general they worked to increase Daniel's power, and accordingly reduced the limited powers (and in some cases the ownership interests) of the other Members. In related developments, in 2006 Adina Strauss and Jeffrey Rubin divorced, and half of his ownership interest was transferred to Adina. In 2014 Adina Strauss received a capital call from Care One. Then Daniel offered to buy her out, to which she gave a positive response conditioned on getting "a full [fair market value] analysis." Not satisfied with the information given her, she filed a federal lawsuit in New Jersey "seeking access to their books and records." That suit was later dismissed. She also rejected Daniel's purchase offer.

On Aug. 24, 2015, the Members owning a supermajority in interest in Care One (Daniel and two entities owned by him) voted to exercise a Membership buy-out option in the amended Operating Agreement as to all minority Members. In the case of Adina Strauss and Jeffrey Rubin, that buy-out led to the issuance of a check to each of them for $546,506.61. In calculating those amounts, Daniel and Care One had used a valuation expert that applied the buy-out formula contained in the 2015 Amendment, which in turn was based on the ***FAIR MARKET VALUE*** (emphasis added) of each Membership interest. Adina and Jeffrey subsequently retained a different well-known valuation firm, which:

1. disagreed materially with the magnitude of the discounts applied by the Care One formula;
2. objected to subtracting the amount of indebtedness for the net value of Care One without adequately valuing the real estate securing that debt; and
3. most importantly, insisted that the base computation should be based on the ***FAIR VALUE*** (emphasis added) of each Membership interest. The defendants' valuation expert determined that the value of each of Adina's and Jeffrey's Membership interest was $18,252,444. Clearly the defendants would not accept Care One's tendered payments.

After a series of litigation fits and starts, the present case was begun by plaintiffs (Daniel and his affiliates) on Jan. 22, 2019, seeking a declaratory judgment that the 2015 amendments to the Care One Operating Agreement were valid and binding and seeking specific performance of the removal of defendants as Members of Care One. Defendants challenged the legitimacy of allowing Daniel and Care One to force them out of Membership in Care One, asserting claims for breach of the following: contract; fiduciary duty; and the obligation of good faith and fair dealing. Defendants also asserted that, even if their Membership interests could lawfully be terminated, they were entitled to far more generous purchase amounts, i.e., amounts based on FAIR VALUE calculations. Finally, Jeffrey Rubin claimed that he and Adina Strauss were owed the tax payment distributions for 2015, computed based on the Net Profits allocated to each of them on the 2015 Forms K-1 provided to each of them and to the Internal Revenue Service by Care One.

The Appellate Division begins the explanation of its decision with a 20-+page exegesis on Delaware law applicable to unincorporated entities (typically called "alternate entities" by attorneys familiar with Delaware practice), including general partnerships, limited partnerships, business trusts, and limited liability companies. The Appellate Division, concurring with the trial court, noted that the Delaware Limited Liability Company Act "is modelled on its Limited Partnership Act." Using the extensive discussion of Delaware law, the Appellate Division followed and affirmed the trial court's conclusion that both [Delaware statutory law [Section 18-702(e)]] and the Operating Agreement specifically allowed the buyout of an LLC member. What neither Court considered was the possible viability of claims that the decision to force members out of their interests in an LLC could be a breach of the Operating Agreement contract, fiduciary duties to the members, and the contractual obligation of good faith and fair dealing. It must be noted that there is long-standing Delaware case law that focuses on whether the control person had a justifiable business reason to support the forced termination of participation in a prospering enterprise. The New Jersey Courts nonetheless seem to have been wedded to the plain language of the 2015 amendment as a permissible exercise of Daniel's power.

In the words of the Appellate Division, "[t]he trial court determined that under Delaware law [the defendants] were entitled to receive only 'fair market value' for their membership interests, rather than 'fair value,' because their interests in Care One were 'akin to limited partnership interests' rather than general partnership interests." What is extraordinary is that neither Court focused on the appropriate valuation approach to determining the economic price for an LLC interest itself, as though that were a question of first impression under Delaware law. But first a word about the two bases of value. Delaware has a very developed and complex law on entity valuations primarily arising in the appraisal context: for example, when a transaction has occurred, and an interest owner (stock, partnership interest or limited liability company interest) challenges the amount accruing to the owner from the price in the transaction. While the case law is not always in a straight line, generally (and especially lately) the transaction price is the primary determinant of value, unless the challenger can raise issues about the fairness of the transaction process. So it follows that valuation cases involving transactions will almost automatically focus on "fair market value," i.e., the value of an asset where there is a willing seller and a willing buyer, each with a reasonably complete knowledge of the material facts relevant to reaching the transaction price. "Fair market value" literally presupposes the existence of a market. Contrast that with the facts here: the defendants were not willing sellers and, as noted, had great difficulty (see Adina Strauss's federal lawsuit) to try to obtain the books and records of Care One.

The alternative valuation approach that defendants asserted should have been used by Daniel is "fair value," which is typically understood to be the fundamental value of an asset, i.e., its actual inherent worth without regard to market forces. The Appellate Division labored mightily with Delaware case law, especially cases involving limited partnerships, citing one Delaware Chancery Court decision (Gelfman v. Weeden Investors, L.P., 859 A 2nd 89, Del. Ch.. 2004) that held that "fair market value" was the proper approach and opined "fair value in the strict and jurisprudentially specific sense used in [Delaware] appraisal decisions is not the governing standard in the limited partnership context," having already conceded that it was "reluctant to import into the limited partnership context all of the artificial complexities of [the Delaware] corporate appraisal jurisprudence." Having erected this "straw man" from Gelfman, the Appellate Division noted that the Gelfman Court found that the Delaware Limited Partnership Act does "not address a removed or expelled partner." Hence, the Appellate Division further noted that the Gelfman Court looked to the Delaware Uniform Partnership Act, which the Gelfman Court found was the "closest analogy" to the facts at hand, where the Delaware Uniform Partnership Act provides that an expelled partner is entitled to the "fair value" of his economic interest. The Appellate Division does not even acknowledge the existence of the "linkage" issue, relating to how the uniform limited partnership and uniform general partnership laws interlock.

The Appellate Division in the Strauss case, similarly to the Gelfman Court, found no guidance in the Delaware Limited Liability Company Act, so it asserted that it would abide by the "gap filler" provision in that statute that prescribes "the rules of law and equity…shall govern." Instead of directly addressing the valuation issue head on, the Appellate Division engaged in a fascinating excursus of legerdemain. First, it contrasted the Gelfman case, where the limited partnership agreement called for payment of "fair market value," with another Chancery Court decision where that Court awarded "fair value," applying the Delaware general partnership act provision.

The Appellate Division, noting the absence of direct guidance in the Delaware Limited Liability Company Act, then pronounced:

> *Given this vacuum, we conclude the court should consider whether Care One more closely resembles a partnership, i.e., a member-managed governance arrangement, such that the Delaware Partnership statute should be applied…or a corporation, i.e., a manager-managed entity, with a board of directors, and other corporate features, such that Delaware corporate law should be applied.*

Proceeding from this binary view of the business entity universe (somewhat reminiscent of Aristotle's writings about actuality v. potentiality; or Kierkegaard's "Either/Or") the Appellate Division decided that:

> *…the company [Care One] more closely resembles a partnership than a corporation. That is Care One is managed by a single member, Daniel, with some decisions requiring the vote of additional members of the LLC. There is no oversight by any board of directors, nor any other attributes of a corporation… For Federal tax purposes, Care One chose to be treated as a partnership rather than a corporation.*

As a result, the Appellate Division concluded that the provision of the Delaware Uniform Partnership Act should apply and that "removed/expelled partners are entitled to receive the 'fair value' for their membership interests in Care One, and not 'fair market value,' Section 11.4 of the Operating Agreement precluded the validity of any amendment which would reduce the rights of a Member, if such reduction "would adversely affect such Member," unless the Member consented. Here, defendants had never consented to the 2015 Amendment to the Operating Agreement, and the change from "fair value" to "fair market value" did work a reduction, quite a material reduction apparently to the membership interests of defendants. The Appellate Division states that it "significantly and improperly diminished" defendants' membership rights. Accordingly, the Appellate Division held that the buy-out formula contained in the 2015 Amendment was "invalid and unenforceable." Thus, the Appellate Division remanded the case for entry of "judgment in defendants' favor" on the claim for breaching the Operating Agreement and for "further proceedings to determine the amount of compensation [the defendants] should receive for their membership interests under a fair value analysis." In addition, the Appellate Division directed the trial court on remand to address the issue of "defendants' entitlement to tax distribution in 2015."

One might critique the decisions of both the trial court and of the Appellate Division on at least three grounds, as follows:

1. Neither the Appellate Division nor the trial court analyzed whether there were sufficient business grounds for allowing Daniel basically to expropriate the economic stakes of the defendants through the exercise of his untrammeled power;

2. neither Court considered what valuation method was more appropriate in the absence of any fundamental transaction, i.e., when there was no “market”; and

3. the Appellate Division decided, from the beginning, that the valuation rule had to be based on a binary classification system that did not allow of hybrid entities.

As to the last, it is unclear how the Appellate Division might have ruled if presented with a manager-managed LLC, or a Board of Managers. Although such a structure is not only available, but also quite normal for LLCs, especially ones that are larger operating enterprises. Nonetheless, under all the facts detailed in the Care One case, it seems that a reasonably equitable resolution was reached. It can be said with some confidence that the Appellate Division reached the right conclusion, even if the analysis and reasoning was – as it is for most of us – imperfect.

National Law Review, Volume XIII, Number 128