

New Jersey Supreme Court Provides Test To Determine Whether A Limited Liability Company Member Can Be Judicially Expelled

9.26.16

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The New Jersey Supreme Court recently addressed in *IE Test, LLC v. Carroll*, ___ N.J. ___ (2016), the circumstances under which the member of a limited liability company (LLC) can be judicially expelled. The *IE Test* decision is important as LLC's are among the more common form of business organization throughout New Jersey. By providing seven factors for New Jersey trial courts to consider, guidance has now been provided to determine whether it is "not reasonably practicable" for a member to remain associated with an LLC that wishes to continue operating.

The dispute that prompted the *IE Test* litigation resulted from the failure of a prior business, Instrumentation Engineering, LLC, in which *IE Test*'s three LLC members were involved. Defendant Kenneth Carroll was the co-owner of Instrumentation Engineering with Patrick Cupo, while Byron James was employed at the company. In 2009, following a series of financial setbacks, Instrumentation Engineering filed for Chapter 7 bankruptcy. During the bankruptcy proceeding, Carroll claimed that Instrumentation Engineering owed him more than \$2.5 million. Ultimately, Instrumentation Engineering failed to repay this debt to Mr. Carroll.

As Instrumentation Engineering's business was failing, its owners contemplated establishing a new business. Ultimately, *IE Test* was formed as a New Jersey LLC shortly before Instrumentation Engineering filed for bankruptcy. *IE Test* had three members, which included Cupo at 34%, with Carroll and James each at 33%. From the outset of *IE Test*, Cupo and James played an active role in the business, while Carroll was a passive member. While the intention of the three members of *IE Test* was to enter into an operating agreement, this never came to fruition, primarily due to the fact that Carroll was seeking compensation that would allow him to recover

some of his lost investment in Instrumentation Engineering.

By early 2010, as a result of the members' failure to enter into an Operating Agreement, in addition to the belief of Cupo and James that they could no longer work together with Carroll, IE Test filed a lawsuit against Carroll seeking to remove him as a member. Specifically, IE Test alleged in its complaint that Carroll had engaged in conduct which made it "not reasonably practicable" pursuant to N.J.S.A. 42:2B-24(b)(3) of the New Jersey Limited Liability Company Act ("LLCA") to carry on the activities of IE Test with Carroll as a member.

The trial court agreed that it was not reasonably practicable for IE Test to continue as a business with Carroll as a member and entered an order expelling him from membership. Carroll appealed the trial court's decision, which was ultimately affirmed by the Appellate Division. The basis for the Appellate Division's ruling in March of 2015 was that N.J.S.A. 42:2C-46(e) of the Revised Uniform Limited Liability Company Act ("RULLCA"), which had replaced N.J.S.A. 42:2B-24(b)(3) of the LLCA in 2013, required that a trial judge engage in predictive reasoning in order to evaluate the future impact of an LLC member's current conduct. Utilizing predictive reasoning, the appellate panel found that the continued operation of IE Test with Carroll as a member was "not reasonably practicable" because Carroll's relationship with Cupo and James never recovered from Carroll's demand that he be compensated in a manner that permitted him to recoup his lost investment in Instrumentation Engineering.

The New Jersey Supreme Court reversed the Appellate Division ruling that LLC members seeking to expel a fellow member are required to clear a high bar. The Supreme Court indicated that neither N.J.S.A. 42:2B-24(b)(3)(c), nor its counterpart N.J.S.A. 42:2C-46(e)(3), authorizes a court to disassociate an LLC member merely because there is a conflict. Instead, both provisions require the court to evaluate the conduct of the LLC member relating to the LLC, and assess whether the LLC can be managed notwithstanding that conduct, in accordance with either the terms of an operating agreement or the default provisions of the statute.

In an effort to guide trial courts in the evaluation whether an LLC member should be expelled under the "not reasonably practicable" standard, the Supreme Court provided seven factors to be considered. The factors include: (1) the nature of the LLC's members conduct relating to the LLC's business; (2) whether, with the LLC member remaining a member, the entity may be managed so as to promote the purposes for which it was formed; (3) whether the dispute among the LLC members precludes them from working with one another to pursue the LLC's goals; (4) whether there is a deadlock among members; (5) whether, despite that deadlock, members can make decisions on the management of the company, pursuant to the operating agreement or in accordance with applicable statutory provisions; (6) whether, due to the LLC's financial position, there is still a business to operate; and (7) whether continuing the LLC, with the LLC member remaining a member, is financially feasible.

The Supreme Court summarized its view that a trial court considering an application to expel an LLC member should conduct a case-specific analysis of the record using the seven factors, as well as other considerations raised by the record, with no requirement that all factors support expulsion, and no single factor determining the outcome.

Pashman Stein Walder Hayden's Corporate Group is available to answer any questions that you may have about the recent New Jersey Supreme Court ruling and its impact on LLC's facing internal disputes among its members.