

When LLC Members Just Can't Get Along The standard for expelling a fellow member

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When people come together to form a new business, everything usually starts off great – it is all smiles and handshakes. Most new businesses do not contingently plan for what happens if the relationship amongst the principals turns sour. So what happens when things get so bad that it is impractical for all the parties to remain in business together? Well, if the business is a limited liability company (“LLC”), one option to consider is seeking a judicial determination to force out a minority member of the LLC.

The New Jersey Limited Liability Company Act

One of the most common forms of business for small and medium sized companies is a LLC. For many years, LLCs formed in New Jersey were governed by the New Jersey Limited Liability Company Act (“LLCA”). The LLCA provided that a member could be “dissociated” (i.e., expelled) by a judicial determination for various reasons including where the member: (1) has engaged in wrongful conduct; (2) materially breached the LLC’s operating agreement; or (3) has engaged in conduct “which makes it not reasonably practicable to carry on the activities with the person as a member.” N.J.S.A. 42:2B-24(b)(3). In 2013, the Legislature repealed the LLCA and replaced it with the Revised Uniform Limited Liability Company Act (“RULLCA”). The RULLCA contains essentially the same expulsion provisions. See N.J.S.A. 42:2C-46(e). However, despite the long-standing statutory mechanism for expelling a LLC member where it was not “reasonably practicable” to carry on the business with that member, there was a dearth of case law interpreting this ambiguous phrase.

IE Test LLC v. Carroll - The Chancery Court Orders Expulsion

In a matter of first impression, the New Jersey Appellate Division in IE Test LLC v. Carroll, A-6159-12T4, 2015 N.J. Super. Unpub. LEXIS 567 (Mar. 17, 2015), set forth the standard for an LLC to expel a fellow member, where the majority members wished to carry on the business—in other words, where dissolution was not sought. This is believed to be the first time that a New Jersey court set forth a specific test for expelling a member where the majority desired to continue operation. Given the prevalence of the LLC as a preferred form for small businesses in New Jersey, this Appellate decision gives important guidance that should be taken into account by LLC members and attorneys who advise LLCs.

The genesis of the dispute in IE Test was a prior LLC, in which the Defendant was the majority member. The prior LLC experienced financial problems resulting in the decision to close the prior LLC and to form the Plaintiff entity. At the time of its closure, the prior LLC owed the Defendant minority member approximately \$2.5 million. The Plaintiff was owned equally by three members, including the Defendant. The three members attempted to negotiate an operating agreement. The Defendant minority

member sought to include a provision in the proposed operating agreement that would require the Plaintiff (the new LLC) to repay the debt owed to the Defendant minority member from the prior LLC. The other members of the Plaintiff refused and the parties were unable to reach an agreement on the terms of an operating agreement.

Thereafter, the Plaintiff LLC filed a complaint in the Essex County Chancery Division seeking to expel the minority member from the LLC. The Plaintiff claimed that the failure to enter into an operating agreement was harming the LLC because it prevented the LLC from securing a bank line of credit, which required the LLC to obtain financing through less favorable means. The LLC also alleged that the failure to enter into an operating agreement left unresolved other issues, including "issues of corporate governance, succession, buyouts and compensation." IE Test, 2015 N.J. Super. Unpub. LEXIS 567, at * 8.

The trial court entered partial summary judgment in favor of the Plaintiff and entered an order expelling the minority member. In finding for the LLC and expelling the minority member, the trial court found while the Plaintiff LLC failed to establish any wrongful conduct by the minority member, "it was not reasonably practicable to continue the business with [the Defendant] as a member." Id. at *10. For example, the trial court noted that the three LLC members "can't talk to each other," "[t]hey can't agree on anything," and that "[t]here will be those times when they have to concur and they have to agree and we know that's not going to happen when people really hate each other, where they dig in their heels, and it's perverse." Id. at *11.

IE Test LLC v. Carroll - The Appellate Division Affirms and Articulates a New Standard

On appeal to the Appellate Division, the Court noted that an explosion under N.J.S.A. 42:2B-24(b)(3)(c) does not require proof of a past misconduct or that the expelled member "committed any wrongful conduct." Id. at *13. Rather, under the explosion provision, the trial court can expel a member, where the Court looks forwards and makes a determination that it is "not reasonably practicable to carry on the business' if the member remains." Id. at *14 (quoting N.J.S.A. 42:2B-24(b)(3)(c)) (emphasis in original). This approach requires judges to "engage in predictive reasoning" by looking at the current conduct of the members and resulting circumstances "will make continued operations of the business reasonably impractical." Id. (emphasis in original). In doing this analysis, a court need not find "complete impracticably," rather a court only needs to determine that it is "not reasonably practicable" for the status quo of the current membership to remain. Id.

In reaching its conclusion as to what it means to no longer be reasonably practicable for the status quo to remain, the Appellate Division quoted from 51 American Jurisprudence Second, Limited Liability Companies, Section 35 (2011) to describe such circumstances as where "the LLC's management has become so dysfunctional or its business purpose so thwarted that it is no longer practicable to operate the business, such as in the case

of a voting deadlock of where the defined purpose of the entity has become impossible to fulfill.” Id. at *15-16.

In determining precisely what circumstances make it not reasonably practical for the status quo to remain, the Appellate Division found persuasive a seven-factor test that was set forth in a Colorado court decision. In Gagne v. Gagne, 338 P.3d 1152, 1159 (Colo. Ct. App. 2014), the Colorado Court of Appeals, in interpreting the same “reasonably practicable” language as set forth in the LLCA and RULLCA, set forth a number of factors to be considered, including:

- (1) whether the management of the entity is unable or unwilling reasonably to permit or promote the purposes for which the company was formed;
- (2) whether a member or manager had engaged in misconduct;
- (3) whether the members have clearly reached an inability to work with one another to pursue the company’s goals;
- (4) whether there is deadlock between the members;
- (5) whether the operating agreement provides a means of navigating around any deadlock;
- (6) whether, due to the company’s financial position, there is still a business to operate; and
- (7) whether continuing the company is financially feasible.

Id. at *17.

Applying the Colorado test, the Appellate Division found that the trial court properly entered partial summary judgment expelling the minority member. The Appellate Division noted that the discord among the parties arose immediately after the formation of the LLC, the parties relationship never recovered from the initial disputes, and the minority member was unwilling to alter his negotiating position regarding the repayment of the prior LLC’s obligation to him. Consequently, the Court found it was not practical for the individuals to continue in business together.

The Takeaway

The facts of the IE Test case should not be unfamiliar to any business litigator in New Jersey. Many of us have litigated internal disputes amongst members of a LLC. This decision provides a roadmap as to how future trial courts will evaluate an application to expel a recalcitrant member of a LLC. Under IE Test, a party need not show that the minority member has done anything wrongful to be expelled. Rather, it is sufficient to show that the parties cannot get along and in the future, are not reasonably likely to be able to run the business together in the future, and that it is not financially feasible to

attempt to do so. Of course, minority members still have protections, however, in seeking to avoid being forced out of an LLC. The best avenue is to ensure that the LLC has a strong operating agreement that sets forth precisely the rights and responsibilities of all members of the LLC—and has specific provisions for dispute resolution, the expulsion process, and dissolution. But see N.J.S.A. 42:2C-11(c)(2) (noting that an operating agreement may not “vary the law applicable under [the dissociation provisions of the RULLCA].”). If the minority member acts in accordance with the operating agreement, a trial court will be hard pressed to issue an order expelling the minority member.