NJ SUPREME COURT OUTLINES 7-PART TEST FOR FORCED DISASSOCIATION OF LLC MEMBER

By Kevin J. O'Connor*

In the first significant opinion to interpret New Jersey's Revised Uniform Limited Liability Company Act ("RULLCA"), New Jersey's Supreme Court ruled on August 2, 2016 that members of an LLC seeking to disassociate another member have a "high bar" to meet. In IE Test, LLC v. Carroll, 2016 WL 4086260 (N.J. Aug. 2, 2016), Justice Patterson outlined the test to be applied when suing to expel another LLC member.

New Jersey adopted the RULLCA which became fully effective in early 2014. The statute, like the predecessor statute, allows for expulsion of an LLC member on several grounds, including where that member

> "(1) has engaged, or is engaging, in wrongful conduct that has adversely and materially affected, or will adversely and materially affect, the company's activities;
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> (2) has willfully or persistently committed, or is willfully and persistently committing, a material breach of the operating agreement or the person's duties or obligations under section 39 of this act; or
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> (3) has engaged, or is engaging, in conduct relating to the company's activities which makes it not reasonably practicable to carry on the activities with the person as a member" [N.J.S.A. 42:2c-46(e)].

In IE Test, three members (Defendant Carroll, and Third-Party Defendants Cupo and James) formed the LLC to carry on a business that had previously operated as a Delaware entity but had gone into bankruptcy. The prior bankruptcy had caused Carroll to lose a substantial amount of money. After they formed the new LLC, they tried to agree upon an operating agreement but were unable to do so, largely because Carroll insisted on being paid back for his prior losses through the new venture. The members bickered and could not agree on how Carroll should be compensated or whether he should receive profits.

Cupo and James caused IE Test to sue Carroll for a forced expulsion of Carroll. After dismissing Carroll's counterclaims seeking to recoup his losses from the prior business, the trial court granted summary judgment to IE Test and then held a trial where it determined the buyout price for Carroll's membership. Carroll appealed.

The Appellate Division affirmed in an unpublished opinion in which it largely focused on the impracticability of the three members continuing to operate IE Test due to future challenges, such as alleged difficulty in obtaining financing, and their disagreement on the form of an operating agreement. The Supreme Court reversed.

The Court held that the mere absence of an operating agreement does not and cannot constitute grounds for relief under the "reasonably practicable" language of the statute. It recognized that the Legislature envisioned that members of an LLC might have difficulty arriving at agreement on the terms of an operating agreement which is why the RULLCA provides for default provisions to govern where no operating agreement exists. The Court also held that it was not proper to focus on future, hypothetical events. The Court adopted a 7-part test that should be applied by the trial courts:

> "[A] trial court should consider the following factors, among others that may be relevant to a particular case: (1) the nature of the LLC member's 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 the 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." Id. * 8.

Since the record showed that Carroll had not interfered with the management of IE Test and, in fact, that IE Test's financial performance had not been impacted by any dissension, it was not appropriate to have expelled Carroll. The Court ruled that the proofs needed to expel a member raise a "high bar," and the standard of proof is "stringent." Id.

IE Test teaches that an attempted expulsion of a co-member must be carefully thought out and documented. For instance, while Culpo and James claimed that they had difficulty getting financing because of the disagreements with Carroll, the Court ruled that the proofs in the record did not support such an argument. Expulsion of a co-member who has made it difficult or impossible to run a business remains an option, but that legal strategy must be carefully planned and properly documented in order to succeed.

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