

NEW JERSEY APPELLATE DIVISION DECISION PROVIDES GUIDANCE ON APPLICATION OF LLC ACT FOR FORCED MEMBER BUYOUT DURING INTER-MEMBER DISPUTES AND HIGHLIGHTS GAP IN EXISTING LAW

By Kevin J. O'Connor*

In my prior blogs I've addressed the importance of having an operating agreement for any business owner operating as a limited liability company ("LLC"), and have also covered the recent legislative changes in New Jersey with the adoption of the Revised Uniform Limited Liability Company Act (the "Revised LLC Act").

A new Appellate Division decision in New Jersey, styled All Saints University Of Medicine Aruba v. Chilana, App. Div. (per curiam) (Dec. 24, 2012), highlights the intricacies in the law for inter-member disputes and the importance of having a clear operating agreement, and that is particularly so with the adoption of the Revised LLC Act. All Saints provides guidance on the type of conduct that will cause a court to allow a forced dissociation with the business (there, failure to advance working capital and interruption with business operations), and also clarifies that a forced sale of the dissociated member's shares is not permitted under the existing LLC Act.

All Saints involves the "judicial dissociation" of two shareholders in a New Jersey limited liability company, ASUMA, LLC, through a final order expelling them from further involvement in the LLC's business. The LLC was formed in connection with a fledgling medical school in Aruba where the founding members sought and obtained a financial infusion by a New Jersey resident who acquired a minority interest in the company. After the school developed financial and other problems, litigation over the entity's operations ensued in the Bergen County Chancery Division involving the LLC's four shareholders, plaintiffs Joshua Yusuf and Richmond Paulpillai, and defendants Gurmit Singh Chilana and Peter Silberie. In the course of the litigation, the court appointed a fiscal agent for the school.

Following a bench trial, the Chancery judge ordered that Yusuf and Paulpillai be expelled from the LLC, upon finding that they had engaged in conduct authorizing such judicial dissociation pursuant to both subsections 3(a) and 3(c) of N.J.S.A. 42:2B-24(b). Yusuf appealed various rulings below, including the trial court's determination that the value of his interest need be arrived at as part of a forced sale, and the determination that he had engaged in conduct authorizing dissociation.

On appeal, the appellate panel affirmed the trial court's final judgment ordering plaintiffs' dissociation from the LLC based solely upon subsection 3(c) of the statute, which pertains where a member engaged in "conduct relating to the [LLC's] business which makes it not reasonably practicable to carry on the business . . . as a member of the

[LLC]." The trial court had looked to the LLC Act for grounds of dissociation since the parties' operating agreement failed to speak to that issue. As grounds for dissociation, the Appellate Division found persuasive the failure of the two shareholders to advance working capital, causing the medical school to have significant financial problems, and the actions of the shareholders in causing a deadlock over the company's financial accounts which led banks to freeze company accounts.

The court did take issue with the trial judge's determination that N.J.S.A. § 42:2B-24(b) compels the sale of the shares of a dissociated member, and remanded the matter for further proceedings below on that issue. The court observed that the parties' operating agreement spoke to the issue, stating that no shareholder could be "compelled to give up or sell [his] shares for any reason." Lastly, the All Saints case does provide some guidance on the expert proofs needed in determining value of shares in an inter-member dispute.

In September 2012, New Jersey enacted the Revised Uniform Limited Liability Company Act (the "Revised LLC Act"), which will replace the current statute governing New Jersey limited liability companies ("LLC's"). The bill was created in an attempt to fill gaps in New Jersey law regarding the operation of LLCs, as well as to update existing law that had become outdated and contains a number of very important changes from the existing law. Members of New Jersey LLC's and those wishing to form LLC's in New Jersey will need to fully understand the impact of the changes to the LLC law and consider how best to address those changes.

The Revised LLC Act will go into effect in February 2013 for all new companies formed after that date, and, in February 2014, it will apply to all LLCs, whenever formed.

Members of companies that are currently operating in the form of an LLC should take notice of significant changes in the law that could have a material effect on the way an LLC operates and how inter-member disputes are adjudicated. While we generally view the Revised LLC Act favorably as a business-friendly modern regulatory scheme for the creation and operation of LLCs, the bill has mandated significant changes that could be a trap for the unwary, including a new provision dealing with the precise issue of a forced sale/buyout:

"A court that expels a member from a company pursuant to subsection e. of section 46 of this act may order the sale of the interests held by such person immediately before dissociation to either the company or to any other persons who are parties to the action if the court determines, in its discretion, that such an order is required by any other law, rule or regulation, or that such an order would be fair and equitable to all parties under all of the circumstances of the case." [(Revised LLC Act, N.J.S.A. § 42:2C-47)(emphasis added).]

All Saints and the new LLC law both highlight the importance of drafting a written operating agreement for any business to avoid prolonged and expensive litigation in the event of member discord and management issues. Our corporate and commercial litigation practice groups are available to counsel your business in these areas, whether it be to help you adopt a written operating agreement or to provide counsel with respect to any inter-member disputes or litigation.

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