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**EDITORS-IN-CHIEF**

Michael L. Rich
973.889.4329
mlrich@pbnlaw.com

Charles J. Stoia
973.889.4106
cjstoia@pbnlaw.com

**CONTRIBUTING EDITORS**

C. John DeSimone, III
973.889.4272
cjdesimone@pbnlaw.com

## NJ Appellate Court Construes Statute Allowing For Judicial Expulsion of LLC Member if "Not Reasonably Practicable" to Carry on Together

***By Michael L. Rich***

The New Jersey Appellate Division recently tackled for the first time in *IE Test, LLC v. Kenneth Carroll* (N.J. Appellate Division, Docket No. A-6159-12T4, decided March 17, 2015) the standard for obtaining judicial expulsion of a fellow limited liability company (LLC) member for engaging in conduct making it "not reasonably practicable to carry on the business with the person as a member."

Given the case's filing date, the Court actually construed the provision in the former New Jersey Limited Liability Company Act (LLCA), N.J.S.A. 42:2B-24(b)(3)(c). However, this provision remained essentially unchanged in the Revised Uniform Limited Liability Company Act (RULLCA), specifically N.J.S.A. 42C-46(e)(3). The RULLCA, enacted September 19, 2012 and codified at N.J.S.A. 42:2C-1, *et. seq.*, took effect March 18, 2013 for all New Jersey LLCs formed after that date and any existing LLC that elected to be subject to the RULLCA by amendment to the LLC's operating agreement. The RULLCA became applicable to all New Jersey LLCs on March 1, 2014, regardless of election.

### The Facts

Defendant Kenneth Carroll (Carroll) and Patrick Cupo (Cupo) co-owned Instrumentation Engineering, LLC (IE), a company offering consulting, engineering and manufacturing services, with Carroll holding a 51% interest. Carroll and Cupo had worked together since the mid-1990s. Bryon James (James) served as IE's business development manager, and eventually its president.

Peter J. Gallagher
973.889.4147
pjgallagher@pbnlaw.com

Eliyahu S. Scheiman
973.889.4232
esscheiman@pbnlaw.com



By early 2009, IE was in "steep financial difficulties." In February 2009, Cupo wrote to Carroll expressing concern over the company's future, and recommended that IE reduce its staff and relocate to a small facility. Cupo maintained that "only a complete restructuring" could "save the company from failure."

In late spring 2009, IE retained Strategic Leadership LLC (SL), a consulting firm, to evaluate the company. SL recommended that IE file for bankruptcy. Its report estimated IE's total assets were substantially less than its total liabilities, which included (but was not limited to) over $2.5 million in debt owed to Carroll personally, or to entities he wholly owned. Based on the report, Cupo filed a Chapter 7 bankruptcy petition for IE in July 2009, although Carroll actually made the decision to file and to start a new business.

That same month, Cupo formed plaintiff-LLC. While the certificate of formation indicated Cupo was its sole member, he subsequently agreed to sell James a 50% interest in plaintiff. Thereafter, in September 2009, Carroll, Cupo and James signed an agreement stating that, while they intend to negotiate and sign a formal operating agreement, they agree that their percentage interests in plaintiff-LLC from inception are 33% Carroll, 34% Cupo, and 33% James.

Cupo and James expected that Carroll's day-to-day role in plaintiff's business would be quite limited. Carroll did not maintain an office at plaintiff's facility, and he participated in only one sales call. While Carroll claimed that he purchased the assets and intellectual property of IE from the bankruptcy trustee and transferred them to plaintiff, he conceded at his deposition that he possessed no documentary evidence indicating his transfer of that property to plaintiff. Cupo disputed the transfer.

The parties' relationship began to deteriorate within weeks of formation. Cupo and James attributed this to Carroll's "demand" during an October 2009 meeting that plaintiff's operating agreement include a provision for repayment of IE's debt to Carroll, seeking to have Cupo and James be personally responsible. As compensation to him for the prior IE debt, Carroll proposed that either plaintiff give him equal distribution of profits plus some premium, or he receive a salary and equal distribution of profits but no premium on the IE debt. Cupo and James declined. Not long thereafter, Cupo told Carroll that he no longer wanted him in the business.

Carroll complained that Cupo and James were reluctant to recognize his ownership interest in plaintiff-LLC and simply refused to enter into an operating agreement. Carroll further asserted that Cupo and James stopped "sharing data" with him, and neglected to include him in the "sales pipelines." For their part, James and Cupo maintained that it was clear that "the three of us can't work together and probably will never work together in the future." They further asserted that plaintiff-LLC was harmed by the members' inability to "come to an operating agreement ... [and] therefore ... govern the company."

Plaintiff-LLC filed its initial complaint in January 2010 seeking Carroll's expulsion from the LLC. Carroll asserted a counterclaim and third party complaint against Cupo and James, alleging a prior agreement that plaintiff and its members would compensate Carroll for $2.5 million of IE's prior indebtedness. By stipulation, Carroll's counterclaim and third party complaint were dismissed.

In August 2010, plaintiff-LLC moved for partial summary judgment on count one of its amended complaint seeking judicial expulsion pursuant to N.J.S.A. 42:2B-24(b)(3) under the LLCA. Carroll cross-moved for summary judgment, seeking dismissal of plaintiff's complaint and counsel fees pursuant to the frivolous suit statute.

Cupo and James both certified that the absence of an operating agreement had prevented plaintiff from securing a bank line of credit; that this inability to obtain bank financing led to less desirable means of financing the operations, including requiring the extension of personal loans to the company; and that material issues regarding management remain unresolved without an operating agreement, including issues of corporate governance, succession, buyouts, and compensation. During discovery, however, Cupo admitted that plaintiff had not sought financing during the litigation and only had "communications" with one bank in late 2009.

In response, Carroll submitted a letter from his counsel, dated September 7, 2010, attaching a proposed operating agreement. No proposed operating agreement had ever been previously exchanged. Plaintiff's counsel rejected the proposed operating agreement, specifically pointing to various provisions that accorded Carroll undue veto power over decision making and compensation, and included waivers of any right to seek "partition" of the LLC or judicial intervention.

In sum, plaintiff contended that Carroll's demand for repayment of IE's debt amounted to wrongful conduct, warranting expulsion under N.J.S.A. 42:2B-24(b)(3)(a). Alternatively, plaintiff argued that Carroll's conduct and the parties' inability to consummate an operating agreement made it not "reasonably practicable" for the relationship to continue, warranting expulsion under N.J.S.A. 42:2B-24(b)(3)(c). Carroll, in turn, argued there was no evidence supporting the contention that he interfered with the business, claiming it turned a profit (which plaintiff disputed). He further argued that, since Cupo and James agreed to his limited role in the day-to-day operations of plaintiff, Carroll's continued status as a member would not detrimentally affect the operations of the company. He also contended that the inability to reach consensus on the operating agreement was not per se grounds for his expulsion, and plaintiff failed to demonstrate that the lack of an operating agreement prevented it from obtaining financing.

**Holding by Chancery Judge**

Chancery Judge Klein found that plaintiff failed to establish that Carroll engaged in wrongful conduct that adversely and materially harmed plaintiff, and consequently dismissed the claim brought pursuant to subpart (a) of N.J.S.A. 42:2B-24(b)(3). She concluded, however, that pursuant to subpart (c) of N.J.S.A. 42:2B-24(b)(3), "it was not reasonably practicable to continue the business with Carroll as a member." She thus granted partial summary judgment to plaintiff-LLC, judicially expelling Carroll from membership. She observed that subsection (c) was "more liberal and much broader [than subsection (a)] and ... does not require .. that there ha[ve] been any adverse or material effect on the company's business."

Following trial, Judge Klein granted final judgment awarding Carroll 33% of the value of plaintiff, $227,497, plus interest. Carroll appealed.

**Holding by Appellate Division**

The Appellate Division affirmed.

On appeal, Carroll did not challenge the valuation of plaintiff-LLC or his share. Rather, his appeal was limited to only whether Carroll's expulsion was proper.

Carroll argued that plaintiff's proofs were insufficient, because the statute does not permit expulsion of a member based upon speculative "future disagreements or disputes between members." Plaintiff countered that (i) the Judge's findings and conclusions were amply supported by the record; and (ii) the statute does not prohibit consideration of the potential for future conflict once a finding of existent conduct has been made.

The Appellate panel first observed that the only terms that define the nature and quality of conduct by a member that justifies judicial expulsion under the operative subsection are found in the statutory language itself. The member's conduct must "relat[e] to the limited liability company business," and it must "make[] it not reasonably practicable to carry on the business with the member as a member." N.J.S.A. 42:2B-24(b)(3)(c).

The panel further noted that "the distinctions between subsection (a) and (c) are obvious, and those differences provide an overarching framework that guides our interpretation." A member could be expelled under subsection (a) only if his conduct was "wrongful" and actually harmed the LLC in a "adverse[] and material[]" manner. N.J.S.A. 42:2B-24(b)(3)(a). In contrast, subsection (c) does not require proof that the member committed any wrongful conduct or actually harmed the LLC in any adverse and material way. Instead, subsection (c) "is forward-looking and requires only proof that the member's conduct makes it 'not reasonably practicable to carry on the business' if the member remains." The Court thus found that, "[i]n order to reach a 'judicial determination' under subsection (c), the judge must engage in predictive reasoning." The Court observed: "The judge must decide if the current conduct of the member and the circumstances that resulted therefrom will make continued operation of the business reasonably impractical." The Court further observed that "the statute does not require a finding of complete impracticality." Rather, "it only requires that the continued operation of the LLC with the member as a member be 'not reasonably practicable.' "

The Court noted that there are no reported decisions in New Jersey interpreting this subsection, which incorporates verbatim the language of the Uniform LLC Act (1996) and which is virtually identical to the language in the RULLCA. Moreover, the Court's research was unable to locate a reported decision interpreting this provision from any sister states that adopted verbatim the language of the uniform acts.

The Court found the analysis in the Colorado court's decision in *Gagne v. Gagne*, 38 P.3d 1152 (Colo. Ct. App. 2014) to be persuasive. That case construed for the first time Colorado's LLC Act, which (similar to the RULLCA) permits judicial dissolution "if it is established that it is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement of said company." The Colorado court set forth a number of factors to be considered in reaching such a determination, which the Court in IE Test, LLC quoted and found that, as applied to the facts of this case, Judge Klein correctly granted plaintiff partial summary judgment.

The record demonstrated that discord among the members arose immediately after the company's formation, that no operating agreement was ever circulated, and that Carroll was at odds for a protracted period over whether he was due compensation by reason of a certain alleged debt. The Court found telling that, although Carroll at one time asserted Cupo and James agreed to the repayment and were legally bound to do so, Carroll subsequently admitted that he possessed "no legally enforceable right to seek repayment." The Court observed that "[e]ven if the genesis of the disagreement arose from hard-edged negotiations, it is undisputed that the relationship between Cupo, James and Carroll never recovered from the initial exchange."

Under the circumstances, the Court concluded that the record supported the decision that the continued operation of the limited liability company with Carroll as a member was "not reasonably practicable" under N.J.S.A. 42B-24(b)(3)(c) and, therefore, he was subject to judicial expulsion.

**Bottom Line**

The case illustrates the Court's power to judicially expel an LLC member without showing any wrongful conduct, or any past event that caused adverse material harm to the LLC. Plaintiff need not even show complete impracticality, but rather only that continued operation of the LLC with that person as a member will not be "reasonably practicable." Given the relatively low showing required under this subsection, this decision is likely to increase the number of actions for judicial expulsion when members do not get along, particularly where the parties cannot agree on an operating agreement or such agreement is inadequate for resolving fundamental issues. It remains to be seen how cautious trial judges will be in exercising the power to judicially expel on the basis of "not reasonably practicable" to carry on together. At bottom, this decision seemed to turn on both the Chancery Judge's and Appellate Division's aversion to the hard-edged negotiation tactics employed by the member who ultimately was judicially expelled.

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