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## **TOP FIVE IN BUSINESS TORTS – NJAJ BOARDWALK SEMINAR 2017**

**IE Test, LLC v. Carroll**, 226 N.J. 166 (2016) (Decided August 2, 2016)  
Reversing IE Test, LLC v. Carroll, (Unpublished) 2014 WL 8132907 (App. Div. 2015)

**Holdings:** A disagreement among the members of an LLC over the terms of an operating agreement does not necessarily compel the expulsion of a dissenting LLC member, under the Limited Liability Company Act (“LLCA”) (N.J.S.A. 42:2B-24(b)(3)(c)) or the Revised Uniform Limited Liability Company Act (“RULLCA”) (N.J.S.A. 42:2C-46(e)(3)), provided that the LLC can be managed without an operating agreement by invoking the default, majority rule provisions of the statute.

In deciding whether it is “not reasonably practicable” to operate an LLC in light of the LLC member’s conduct, under the LLCA, “a trial court should consider the following factors, among any others relevant to a particular case: (1) the nature of the LLC 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 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 financial feasible.” The factors are non-exclusive. There is no requirement that all factors support expulsion, and no single factor is determinative.

### **Facts and Legal Analysis:**

IE Test, LLC was an engineering consulting firm held by three members, Kenneth Carroll, Patrick Cupo, and Byron James, which designed testing systems used by manufacturers to evaluate their products. The three members of IE Test, LLC had previously been involved in another LLC, Instrumentation Engineering, LLC. Instrumentation Engineering had been held fifty-one percent (51%) by Carroll, and forty-nine percent (49%) by Cupo. James had worked for the company as a manager and, later, as an officer.

In 2009, Instrumentation Engineering had filed for Chapter 7 bankruptcy protection, at a time when Carroll claimed the company was indebted to him and his entities for over 2 million dollars.

Cupo formed IE Test, a New Jersey LLC, shortly before Instrumentation Engineering's bankruptcy. Cupo was initially the sole member of the LLC. He later claimed to have sold a fifty-percent interest to James two months after the company was formed. Carroll then purchased the intellectual property and hardware of Instrumentation Engineering from its Bankruptcy trustee. He later claimed that he had transferred those assets to IE Test, but Cupo disputed that contention.

The three members of IE Test eventually entered into a preliminary, written agreement acknowledging that all three of them were members, at thirty three percent (33%) Carroll, thirty-four percent (34%) Cupo, and thirty-three percent (33%) James. The agreement anticipated that the three of them would be entering into an Operating Agreement relative to the company.

Once operations commenced, Cupo managed the engineering, manufacturing, and financial components of the business, and James was responsible for business development. Carroll had no discernable role in the day-to-day management or operations of IE Test. The company generated 1.5 million dollars in revenue in or about its first year of operations, and both Cupo and James drew salaries of \$170,000 with several \$10,000 bonuses, while Carroll was paid no salary or compensation, due to an evident dispute over the manner in which he was to be compensated.

Carroll raised the issue of the prior debts of Instrumentation Engineering. Though he acknowledged that IE Test had no legal obligation to repay them, he pressed for compensation that would allow him to recoup his losses, demanding either (1) an equal share of company profits plus a premium, or (2) an equal share of company profits plus a salary. As a result of his demands within the first few months of operations, Cupo and James decided that they no longer wanted to work with Carroll. The three members met on January 7, 2010, and Carroll contended that Cupo and James had declined to honor his membership interest. No formal operating agreement was ever signed. Though Carroll had furnished a draft, no counter-proposal was made by Cupo and James. The three members ceased communicating about IE Test's business.

IE Test filed suit on January 25, 2010, less than four months after the preliminary agreement as to membership had been signed, asserting claims for breach of fiduciary duty, breach of contract, and breach of good faith and fair dealing, and seeking Carroll's dissociation under the LLCA and/or RULLCA. After discovery, the company then moved for partial summary judgment dissociating Carroll on the basis of two statutory grounds (a) "wrongful conduct that adversely and material affected the limited liability company's business" or (c) Carroll's having engaged in conduct which made it "not reasonably practicable" to carry on the business of IE Test with him as a member.

The Trial Court found no wrongful conduct to justify dissociation on the former grounds. It reasoned that while Carroll's demands for compensation may have been unreasonable, they were neither unlawful, nor harmful to IE Test. However, the Trial Court found grounds for dissociation under sub-provision (c), noting a likelihood that significant problems managing the LLC would arise in the future with a dissenting member involved. The principal concern raised by IE Test in this regard appears to have been difficulty obtaining credit and/or financing from a bank due to the lack of a written Operating Agreement. The Trial Court expelled Carroll as a member, but granted

a stay of judgment pending appeal. It then valued the company and entered final judgment directing a buy-out of Carroll's interest for approximately \$250,000.

Carroll appealed, and the Appellate Division affirmed in an unpublished decision, finding that N.J.S.A. 42:2B-24(b)(3) and N.J.S.A. 42:2C-46(e) required the Trial Judge to engage in predictive reasoning to evaluate the future impact of current conduct. The New Jersey Supreme Court granted Carroll's petition for certification. See 222 N.J. 15 (2015).

In analyzing the judicial dissociation provisions of the LLCA and RULLCA, the Supreme Court first considered the twenty-year history of the original Act, noting, among other things, that "[t]he statute...encouraged LLC members to collectively devise an individualized governance and management plan that best advanced the goals of their business." (pp. 177-178). The Court further noted the default majority rule provisions of the LLCA relative to day-to-day management, quoting N.J.S.A. 42:2B-27(a)(1). It then summarized the grounds for judicial dissociation set forth in the LLCA, which were carried forward into the RULLCA with substantial fidelity.<sup>1</sup> Notably, the Court stated, "if a court makes a judicial finding that an LLC member meets the standard of one of the three subsections, it must grant the remedy of expulsion." (p. 179, emphasis supplied).

The Court next analyzed the plain language of N.J.S.A. 42:2B-24(b)(3)(c) in the context of the statutory framework, noting that no definition of "not reasonably practicable" appears in either the LLCA or the RULLCA. The legislative history of the original act was also silent as to its definition, and therefore the Court found guidance in the contrast between that sub-provision and sub-provision 3(a) (wrongful conduct that adversely and materially affected the company's business). The Court reasoned that subsection 3(a) involves wrongful conduct that has damaged an LLC's business in the past, while 3(c) does not require a finding of any material effect on the business. Instead, 3(c) requires a prospective analysis of the impact of the member's conduct on the LLC's future.

With respect to the requirements of the "not reasonably practicable" standard for judicial expulsion, the Court noted "the Legislature prescribed a stringent standard of prospective harm: the LLC member's conduct must be so disruptive that it is 'not reasonably practicable' to continue the business unless that member is expelled." (p. 182). It further stated that "the pivotal language

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<sup>1</sup> The LLCA (N.J.S.A. 42:2B-24(b)(3)(a)-(c)) provides for judicial dissociation of a member because:

- (a) The member engaged in wrongful conduct that adversely and materially affected the limited liability company's business;
- (b) The member willfully or persistently committed a material breach of the operating agreement; or
- (c) The member engaged in conduct relating to the limited liability company business which makes it not reasonably practicable to carry on the business with the member as a member of the limited liability company[.]

The RULLCA (N.J.S.A. 42:2C-46e) permits judicial dissociation if a 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;
- (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;<sup>2</sup> or
- (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[.]

suggests that it must be unfeasible, despite reasonable efforts, to keep the LLC operating while the disputed member remains affiliated with it.” (p. 182). The Court also made clear that mere conflict among the members does not suffice. Instead, an analysis of whether the LLC can be managed notwithstanding the conduct complained of, in light of at least seven, non-exclusive factors, is required.

Applying those factors, the Court found that material issues of fact warranted the denial of partial summary judgment and precluded judicial expulsion. (p. 184). The court found that Carroll had provoked a distracting dispute among the members of IE Test that was never resolved, but that there was no evidence that he had actively interfered with its business or undermined its operations. There was similarly no evidence of disparagement to employees, vendors, or client. The Court further noted that material issues of fact precluded any finding that Carroll had interfered with financing, or was unwilling to cooperate in pursuit of credit. IE Test had claimed no deadlock, and the Court noted that Cupo and James had ceased negotiations over the draft operating agreement without a counter-proposal. Moreover, the company was able to be effectively managed without an operating agreement under the default provisions of the LLCA, operations were ongoing, and revenues were increasing. Thus, the New Jersey Supreme court found no grounds for expulsion of Carroll as a member, reversed the decisions of the Courts below, and remanded for further proceedings.

### **Questions Raised:**

To what extent does the change in language between the governance provisions of the LLCA and the RULLCA affect the rationale behind the Court’s decision, as it relates to majority rule?

N.J.S.A. 42:2B-27(a)(1) of the LLCA stated:

Unless otherwise provided in an operating agreement, the management of [an LLC] shall be vested in its members in proportion to the then current percentage or other interest of members in the profits of the [LLC] owned by all of the members, the decisions of members owning more than 50 percent of the then current percentage or other interest in the profits controlling.

By contrast, the RULLCA states at N.J.S.A. 42:2C-37b.:

In a member-managed limited liability company, the following rules apply:

- (1) The management and conduct of the company are vested in the members.
- (2) Each member has equal rights in the management and conduct of the company's activities.
- (3) A difference arising among members as to a matter in the ordinary course of the activities of the company may be decided by a majority of the members.

The difference would seem to be particularly acute in a two-member LLC with an disparity of interest between the members.

To what extent did (a) the potential profit-motive for the attempted expulsion of Carroll, and (b) the lack of a counter-proposal from Cupo and James on the operating agreement influence the Court's decision relative to dissociation. (See p. 181 "Nor does the statute permit the LLC members to expel a member to avoid sharing an LLC's profits with that member...")?

The two widest points of distinction between "wrongful acts that have damaged an LLC's business" and conduct that is "so disruptive that it is 'not reasonably practicable' to continue business unless that member is expelled" would seem to be the timing (i.e. past v. future) and the requirement that the conduct be "wrongful."

Therefore, the question is what form of conduct, other than pure deadlock, is sufficiently disruptive to compromise future business operations, without amounting to "wrongful conduct" in the legal sense? For example, the opinion (p. 185) seems to suggest that disparagement of IE Test to employees, vendors, or clients could help to justify expulsion, but such conduct would also likely constitute a breach of fiduciary duty to the entity or other members, and thus fall within the "wrongful conduct" standard.

To what extent did the procedural posture of the decision appealed, a summary judgment decision in which Carroll was the non-moving party, affect the outcome and analysis of the factors that the Court had just articulated?

**Points to Consider:**

According to the Court, mere animosity, disagreements, conflicts or disputes between the members of the LLC that do not bear a nexus to the LLC's business will not justify expulsion, no matter how difficult they otherwise make it for the members to work together. (See p. 181). Instead, the LLC Member's conduct must evidently be so disruptive that it is virtually unfeasible to continue the business unless that member is expelled. Ibid.

Given the multi-factor nature of the test articulated, claims under this provision would seem to be ill-suited for summary judgment, absent undisputed circumstances approaching complete and total deadlock in operations without a reasonable basis.

Points of focus in opposing an application for dissociation highlighted by IE Test include: the member's willingness to cooperate with majority management, albeit under some degree of protest; continuing operations of the company; lack of direct disparagement or hindrance of operations; and favorable revenue outcomes during the pendency of litigation.