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'No Fault' Removal Of an LLC Member

An LLC member can be expelled based on conduct, whether or not illegal or wrongful

Your client decides to start a business with associates and wants to form a limited liability company (LLC) to take advantage of the characteristics that an LLC boasts in the face of other alternatives like partnerships or corporations. Although the venture starts out well, the participation of one of the LLC members in the business eventually becomes more of a hindrance than a help. Is it possible to have this member removed from the LLC in New Jersey, even though he has not acted illegally or committed some other form of misconduct? Can it be that members can band together to remove another member without cause? Does the LLC Act, N.J.S.A. 42:2B-1 et seq., truly contain such a “no fault” provision? These are questions that have not yet been definitively decided by the New Jersey courts. The answers lie within an interpretation of the LLC Act, influenced by the dynamic and hybrid nature of an LLC.

An LLC incorporates the features of a general partnership, a limited partnership and a closely held corporation. “The New Jersey Limited Liability Company Statute: Background and Concepts,” Peter D. Hutcheon, 18 Seton

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Hall Legis. J. 111 (1993). In New Jersey, LLCs were first created by statutory enactment known as the LLC Act, which became effective on Jan. 26, 1994. While LLCs are hybrid entities incorporating characteristics of other business forms, LLCs most closely resemble general partnerships in regard to the removal of a member without cause. The law governing general partnerships provides the best guidance, as the Uniform Partnership Act, N.J.S.A. 42:1A-31e (UPA), contains the same “no fault” language for dissociation of a partner. This distinctive mechanism differs from the laws governing limited partnerships and closely held corporations, which do not expressly provide for such a means to dissociate a partner or shareholder.

In the absence of an operating agreement, the LLC Act establishes the terms by which the LLC will be governed. When an operating agreement is silent in regard to the involuntary dismissal of an LLC member, the parties likewise must resort to the LLC Act. The LLC Act provides for dissociation of a member by judicial decree if the member committed a material breach of the operating agreement, or if the member had engaged in wrongful conduct that adversely and negatively affected the company’s business, such as perpetration of a fraud. N.J.S.A. 42:2B-24b(3)(a), (b). The LLC Act further provides for dissociation of a member if “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.” N.J.S.A. 42:2B-24b(3)(c). Whether a member is guilty

of breach, fraud or similar wrongdoing may require judicial intervention and determination, but generally is more easily discernable than the amorphous standard that appears to allow removal without cause. When is it no longer “reasonably practicable” to carry on the business with the member? New Jersey courts have not directly addressed the meaning of the “not reasonably practicable” standard.

A look at the plain language of the LLC Act reveals that the provision containing the “not reasonably practicable” standard for dissociation of a member is separate from the provisions providing for expulsion of a member when the member’s conduct is wrongful or in breach of agreement. It seems manifest that the Legislature therefore intended to provide a distinct means for dissociation of an LLC member on a “no fault” basis. The statutory language employed suggests that a member can be removed from an LLC for his poor performance, destruction of working relationships with customers, vendors or co-workers, or whatever conduct makes it “not reasonably practicable” to carry on the business with that member involved. If a member of an LLC has philosophical differences as to the company’s direction and this stymies the company’s growth, such contradicting opinions may constitute grounds for dissociation under 42:2B-24b(3)(c).

The UPA provides the same “no fault” means for the removal of a partner. The UPA provides for dissociation by judicial decree if “the partner engaged in conduct relating to the partnership business which makes it not reasonably practicable to carry on the business in partnership with the part-

ner.” N.J.S.A. 42:1A:31e(3). Thus, this UPA provision is identical to the corresponding provision in the LLC Act. In the general partnership context, the “not reasonably practicable” standard has been discussed only in the context of dissolution of a partnership. Nevertheless, courts have recognized the object of a commercial partnership is profit, and therefore when the business for which the partnership was formed cannot be carried on except at a loss, it may be deemed impracticable to continue the partnership. *Seighorner v. Weissenborn*, 20 N.J. Eq. 172 (reversed in part on other grounds), 21 N.J. Eq. 483 (1869). Moreover, when the objective of a partnership cannot be met because “all confidence between the parties has been destroyed,” the partners cannot continue working together. *Stark v. Reingold*, 18 N.J. 251 (1955). Specifically, if a partner learns about a business opportunity through his participation in the partnership and diverts these opportunities to his own use, grounds for dissolution exist. *Id.* Thus, the consequences of the conduct of one of the partners appears to play an important role, at least in applying the “not reasonably practicable” standard as a basis for dissolution.

The Uniform Limited Partnership Act, N.J.S.A. 42:2A:1, et seq. (ULPA), does not expressly provide a means by which a partner can be expelled from the partnership. However, the ULPA does contain the same “not reasonably practicable” standard in regard to the dissolu-

tion of the partnership. Limited partnerships can be dissolved by judicial order “whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement.” N.J.S.A. 42:2A-52. This provision has been applied to conduct committed by any partner, the consequences of which make it “impossible for the partnership to carry on its ordinary business.” *Cusano v. Cusano*, 19 N.J. Super. 255 (App. Div. 1952).

In terms of closely held corporations, a form of “no fault” removal appears to be available. Where the shareholders are divided in voting power or the directors are deadlocked, it may be possible to cause the sale of a shareholder’s stock. N.J.S.A. 14A:12-7(i)(a)(b) and (8). This concept stems from a sense that cooperation among the owners of an entity is a necessary component to successful operation. The court in *Stark* relied upon *Warwick v. Stockton*, 55 N.J. Eq. 61 (Ch. 1896), noting that disagreements between owners can become so severe and the relationship so strained, as to require the court to order dissolution. Courts may order dissolution of a corporation where the shareholders are so divided in voting, and the dissension is so great that it results in a paralysis of the corporate function. *In re Evening Journal Association*, 15 N.J. Super. 58 (Ch. 1951). But what about removal of a shareholder under these circumstances? Similar to relief available under the LLC Act and the UPA, a shareholder possibly

can be ordered to sell his stock without cause, namely, because of deadlock. Obviously, while deadlock may be considered a “no fault” reason, it still differs greatly from the “not reasonably practicable” standard in the LLC Act. In a deadlock situation, there must be extreme divisiveness or paralysis whereas defining the conduct making it “not reasonably practicable” to conduct business is somewhat elusive (as demonstrated herein).

Thus, the LLC Act is most closely aligned with the UPA because both provide an express mechanism by which a member or partner can be expelled from the company based on the consequences of their conduct, whether or not illegal or wrongful. This is a powerful provision in the LLC Act which may make LLCs more attractive to business associates concerned with potential internal or personal conflicts. Nevertheless, it is highly recommended that LLC members enter operating agreements that include provisions governing the involuntary dismissal of LLC members. The LLC Act accords maximum weight to the enforceability of these operating agreements. By crafting their own agreements, members can define for themselves the circumstances under which it becomes “not reasonably practicable” to carry on the business of the LLC. ■