Western Montana Estate Planning Council

December 14, 1999

Missoula, Montana

SELECTED 1999 REVISIONS TO THE MONTANA LIMITED LIABILITY COMPANY ACT

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1. Introduction

a. Genesis of the MLLCA

i. The use of limited liability companies in Montana has been affected by two particularly important changes in the past few years: the adoption of the check-the-box regulations by the Internal Revenue Service [Reg. §301.7701-1, -2, and -3], and the adoption of amendments taken from the 1996 Uniform Limited Liability Company Act (ULLCA (1996)) by the Montana legislature in 1999.

ii. The Montana Limited Liability Company Act (MLLCA) was originally adopted by the Montana Legislature in 1993. It is based on the July 1992 Draft of the American Bar Association Prototype Limited Liability Company Act, with some revisions. Consequently, the MLLCA as it now exists is an amalgam of the ABA Prototype Act and the Uniform LLC Act.

b. Check-the-Box Regulations

i. The check-the-box regulations [Treas. Regs. §§301.7701-1, -2, -3, -4] allowed increased flexibility and certainty in the structuring of limited liability companies, and the 1999 revisions adopted by the Montana legislature provided new ways to structure limited liability companies and therefore greater planning opportunities.

ii. States such as Montana have flexible LLC statutes which permit the LLC to be structured either so that it is taxable as a partnership or as an association taxable as a corporation, and with the recently adopted check-the-box regulations the members will have even greater flexibility in choosing how the LLC will be taxed.

iii. Montana allows formation of one-member LLC's. The check-the-box regulations make clear that such a LLC will be ignored for tax purposes. §301.7701-2(c) states that for federal tax purposes, "a business entity that has a single owner and is not a corporation under paragraph (b) of this section is disre-

garded as an entity separate from its owner." One-member LLC's, therefore, will be taxed as sole proprietorships.

iv. Under the check-the-box regulations, therefore, LLC's can be taxed in one of three ways: (i) as partnerships; (ii) as corporations; or (iii) as sole proprietorships.

v. Prior to the promulgation of the check-the-box regulations, in order to be taxed as a partnership, a LLC could have no more than two of the four corporate attributes: 1) limited liability; 2) perpetual duration; 3) free transferability of interests; and 4) centralized management. The default provisions in most flexible LLC statutes, including Montana, were designed to avoid at least two of the corporate characteristics. Since limited liability was generally desirable, the drafters of these statutes generally attempted to avoid two of the remaining three characteristics. Articles of organization and operating agreements that deviated from the default provisions in the statutes were also structured to avoid at least two of these characteristics. In some instances, this approach resulted in provisions dealing with duration, transferability and management that reflected the requirements of the Internal Revenue Service rather than the business goals and objectives of the client. The adoption of the check-the-box regulations affords to attorneys and their clients the flexibility to structure a LLC to achieve business goals and objectives rather than adhering to a rigid structure in order to achieve a desired tax benefit.

vi. The advent of the check-the-box regulations was a significant factor in the adoption of the 1999 revisions to the MLLCA, since providing default provisions that would result in pass-through tax treatment of the LLC was no longer as important a consideration as when the original MLLCA was adopted in 1993.

c. **Effective Date / References to M.C.A., Commission Comments, ULLCA**

i. The 1999 amendments were given an immediate effective date. The bill was signed by the Governor April 12, 1999.

ii. All citations in this outline are to the Montana Code Annotated unless noted otherwise.

iii. All references herein to the "Commission Comments" or citations to "Comments" are to the comments of the National Conference of Commissioners on Uniform State Laws contained in the Uniform Limited Liability Company Act (1996).

iv. All references herein to the ULLCA are to the Uniform Limited Liability Company Act (1996).

2. General Provisions [Part 1]

a. Definitions [35-8-102]

i. Most of the definitions found in the MLLCA are based on the ABA Prototype Act, with the exception of definitions derived from the Montana Professional Corporation Act for disqualified person, foreign professional limited liability company, licensing authority, professional limited liability company professional service, and qualified person.

ii. New Definitions

(1) With the 1999 revisions, new definitions taken from §101 of the Uniform Limited Liability Company Act have been added:

(a) "At will company" means a limited liability company other than a term company.

(i) This is one of two new forms of LLC now recognized by the MLLCA. The other is a term company, as defined below.

(ii) The distinctions between these two types of LLC and planning opportunities will be discussed below. See 3.a.i.

(b) "Business" includes every trade, occupation, profession, or other lawful purpose, whether or not carried on for profit.

(i) Note that a profit motive is not required under this definition. As long as there is a lawful purpose, a "business" need not be carried on for profit.

(ii) The definition of a partnership has always included a profit motive. The Montana Uniform Partnership Act provides that a partnership is "an association of two or more persons to carry on as co-owners a business for profit ... ." 35-10-102(5)(a).

(iii) With the increased use of family limited partnerships to get discounts in values for gift and estate tax purposes, one of the concerns was that in the absence of a profit motive, there could be no partnership and consequently no discount of value.

(iv) **Planning Pointer:** Now, it appears that if a family were to

form a LLC for the purpose of obtaining discounts in value, the lack of a business purpose would not necessarily be fatal. Presumably, it would be possible to form a LLC for no purpose other than holding stocks, bonds and mutual funds, or other forms of investments, (activities that generally are not considered a "business") and it would still be considered a "business" under this definition.

(c) "Debtor in bankruptcy" means a person who is the subject of an order for relief under Title 11 of the United States Code or a comparable order under federal, state, or foreign law governing insolvency.

(d) "Distribution" means a transfer of money, property or other benefit to a member in that member's capacity as a member of a limited liability company.

(i) According to the ULLCA Comments, this term includes all sources of a member's distributions including the member's capital contributions, undistributed profits, and residual interest in the assets of the company afer all claims, including those of third parties and debts to members, have been paid. Comment, ULLCA, §101.

(ii) The definitions of "distribution" and "distributional interest" are intended to clarify the distinction between a transfer of an interest that does not include management rights from a transfer that does.

(e) "Distributional interest" means all of a member's interest in the distributions of a limited liability company. This term does not include a member's broader rights to participate in the management of the company. Comment, ULLCA, §101.

(f) "Manager-managed company" means a limited liability company that is so designated in its articles of organization.

(g) "Member-managed company" means a limited liability company other than a manager-managed company.

(h) "Record" means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is recoverable in a perceivable form.

(i) "Sign" means to identify a record by means of a signature, mark,

or other symbol with the intent to authenticate it.

(j) "Term company" means a limited liability company designated as a term company in its articles of organization.

iii. Modified Definitions

(1) Other definitions have been modified as follows (omitted provisions stricken and new provisions underlined):

(a) "Articles of organization" means articles filed pursuant to 35-8-201 and those articles as amended or restated. In the case of a foreign limited liability company, the term includes all records serving a similar function required to be filed under the laws of the state or country where it is organized.

(b) "Manager" means~~, with respect to a limited liability company that has set forth in its articles of organization that it is to be managed by managers, the person designated in accordance with 35-8-302~~ a person who, whether or not a member of a manager-managed company, is vested with authority under 35-8-301.

(c) "Operating agreement" means an agreement, including amendments, ~~written or oral,~~ as to the conduct of the business and affairs of a limited liability company and the relations among the members, managers, and the company that is binding upon all of the members.

iv. Deleted Definitions

(1) Finally, one definition has been deleted, that of "limited liability company interest" or "interest in the limited liability company."

b. **Effect of Operating Agreement — Non-waivable Provisions [35-8-109]**

i. This new section is based on ULLCA §103.

ii. An operating agreement is "an agreement, including amendments, as to the conduct of the business and affairs of a limited liability company and the relations among the members, managers, and the company that is binding upon all of the members." 35-8-102(22).

iii. The MLLCA provides the default rules, but the operating agreement can override almost any provision of the Act. To the extent the operating agreement alters the default rules, consideration should be given to giving notice of those

changes in the articles of organization, so that third parties will have constructive notice of the changes.

(1) 35-8-109 states "To the extent that the operating agreement does not otherwise provide, this chapter governs relations among the members, managers, and company."

(2) The Comments to the ULLCA state, "Accordingly, an operating agreement may modify or eliminate any rule specified in any section of this Act except matters specified in subsection ([3]). To the extent not otherwise mentioned in subsection ([3]), every section of this Act is simply a default rule, regardless of whether the language of the section appears to be otherwise mandatory. This approach eliminates the necessity of repeating the phrase 'unless otherwise agreed' in each section and its commentary." Comment, ULLCA, §103.

iv. **Practice Pointer:** This Comment may lead to a broader interpretation of this section than is warranted. The statute states the operating agreement controls as to relations among the members, managers and company. Presumably third parties are no more bound by the provisions of the operating agreement than they were in the past, so that at least constructive knowledge of relevant agreement provisions would be required in order to bind a third party. (*See*, also, 35-8-102(22) which defines "operating agreement" as "an agreement, including amendments, as to the conduct of the business and affairs of a limited liability company and the relations among the members, managers, and the company that is binding upon all of the members.) Since the code provides the default provisions, it may be advisable to refer in the articles of organization to provisions of the operating agreement that alter the default rules, so that third parties will have constructive notice of them. This also is a reminder of the need for third parties to obtain from the Secretary of State a copy of the articles of organization whenever conducting major transactions with a LLC. An example of when the failure to do so could be detrimental is when dealing with a manager-managed LLC; members of such a LLC do not have agency authority and any contracts entered into with members who are not managers could presumably be avoided. There may be other matters as to which the default rules are modified by the operating agreement, so third parties would be well-advised to obtain a copy of the articles of organization and any amendments, since they will be deemed to have constructive notice of them in any event.

v. Certain provisions cannot be waived. 35-8-109(3) states that the operating agreement may not:

(1) unreasonably restrict a right to information or access to records under 35-8-405;

(2) eliminate the duty of loyalty under 35-8-310, but the agreement may:

(a) identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; and

(b) specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;

(3) unreasonably reduce the duty of care under 35-8-310;

(4) eliminate the obligation of good faith and fair dealing under 35-8-310, but the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;

(5) vary the right to expel a member in an event specified in 35-8-803;

(6) vary the requirement to wind up the limited liability company's business in a case specified in 35-8-901(1)(c) or 35-8-902; or

(7) restrict the rights of a person under the MLLCA, other than a manager, member, and transferee of a member's distributional interest.

vi. The operating agreement may be oral, written, or “in the form of a record.”

(1) The statute provides that the operating agreement “need not be in writing.” 35-8-109(1).

(2) The Commission Comments state, “Although many agreements will be in writing, the agreement and any amendments may be oral or may be in the form of a record. Course of dealing, course of performance and usage of trade are relevant to determine the meaning of the agreement unless the agreement provides that all amendments must be in writing.” Comment, ULLCA, §103.

(3) **Practice Pointer:** The Act, as interpreted by the Code Commissioners, effectively does away with the parol evidence rule by allowing course of dealing, course of performance and usage of trade to determine the meaning of the operating agreement and by stating an amendment may be “in the form of a record” the Act might be interpreted to do away with the necessity that a writing proffered to establish the terms of an operating agreement or amendment be signed by the party against whom enforcement is sought. A party desiring to establish an amendment to the operating agreement in general has wide latitude under the default rule of the Act since oral amendments, “records,” course of dealing, course of performance and usage of trade are all

allowed for purposes of establishing the agreement or amendment. This cuts two ways, however. The Act makes it clear that the operating agreement can override the default rule, and that if the operating agreement contains a provision requiring that all amendments be in writing, none of these other means of establishing an amendment are permitted. An operating agreement containing such a provision might make more difficult to establish an amendment than it otherwise would be. Including a provision in an operating agreement that all amendments must be in writing is a common practice, but thoughtful drafters might wish to consider their options carefully, especially with clients who are not always careful to document their agreements. Including a clause requiring all amendments be in writing could lead to some harsh results for members of a LLC who habitually deal with each other in an informal manner, but not requiring amendments to be in writing leaves wide open the manner in which parties could argue the operating agreement had been amended. The choice is not necessarily clear cut.

vii. Certain provisions of an operating agreement specifically must be in writing.

(1) 35-8-109(2) states that an operating agreement need not be in writing except as otherwise provided in the MLLCA to:

(a) vary the recordkeeping requirements under 35-8-405;

(b) vary the rights of members to share in distributions under 35-8-601 or 35-8-903; or

(c) vary the process for admission of members under 35-8-707.

(2) **Alert:** This subsection (2) was not part of the ULLCA and its insertion creates some confusion. The ULLCA in subsection (1) begins, "Except as provided in subsection (2), all members of a limited liability company may enter into an operating agreement ..." and subsection (2) contains the provisions regarding matters that cannot be waived in an operating agreement. The MLLCA inserts a new subsection (2) and the provisions regarding matters that cannot be waived in an operating agreement are contained in subsection (3), yet subsection (1) still begins, "Except as provided in subsection (2) ... ." This appears to be an error; one that may not be of great significance, but one that might change the meaning intended by the Commissioners when they drafted the ULLCA, and accordingly this ought to be considered for clarification in the next Legislature.

(3) The language in subsection (2) is also confusing, at least as to this author, as to whether the intent is to require that the enumerated matters be in writing or to exclude them from that requirement.

(a) Subsection (2) begins, "An operating agreement need not be in writing except as otherwise provided in this chapter to:" and then goes on to list the matters shown above. Using the first item enumerated as an example, this language appears to state that an operating agreement need not be in writing to vary the recordkeeping requirements under 35-8-405. That section, however, requires a written operating agreement to excuse the LLC from keeping specified records at its place of business. So, a re-reading of subsection (2), giving effect to the clause "except as otherwise provided in this chapter" goes something like this: "In the following instances, a written operating agreement is not required unless it is required elsewhere in this chapter, and in each of the following instances a written operating agreement *is* required elsewhere in this chapter." Though a bit circular, this appears to be the proper interpretation.

(b) According to John Oitzinger, chairman of the committee of the State Bar that was responsible for drafting the bill that made these changes to the MLLCA, the intent of subsection (2) was to gather in one place matters the MLLCA required to be in writing and accordingly subsection (2) is intended to state that as to those specified matters, a written agreement is required, except to the extent the cross-referenced provisions allow otherwise.

viii. Amendments to the operating agreement have to be unanimous, unless the operating agreement provides otherwise.

(1) The ULLCA Comments state, "The operating agreement is the essential contract that governs the affairs of a limited liability company. Since it is binding on all members, amendments must be approved by all members unless otherwise provided in the agreement." Comment, ULLCA, §103.

(2) **Practice Pointer:** A comprehensively drafted operating agreement might provide for amendment with less-than-unanimous consent as to some matters, reserving unanimous consent for other matters deemed to be of greater significance.

c. **Uniformity of Application and Construction [35-8-111]**

i. This new section is modeled after ULLCA §1202.

ii. This section states, "Unless otherwise provided in this chapter, this chapter must be applied and construed to effectuate its general purpose to make the law with respect to the subject of this chapter among states enacting the Uniform Limited Liability Company Act."

iii. **Alert:** This section contains a typographical error: the word "uniform" which was included in the ULLCA has been omitted. It should appear in the phrase "to make uniform the law" but instead the phrase reads "to make the law." This makes this section nonsensical as adopted and should be considered for correction by the next Legislature.

iv. **Alert:** This section, if corrected as noted in the preceding paragraph, will state that the MLLCA should be applied and construed so as to make our law uniform with other states adopting the ULLCA. The problem this creates is that the MLLCA is primarily based on the July 1992 Draft of the American Bar Association Prototype Limited Liability Company Act, with some revisions. The 1999 amendments adopted provisions from the ULLCA, but did not adopt the ULLCA in its entirety. How the courts will eventually construe this amalgam so that it is uniform with other states adopting the ULLCA should be interesting to observe.

3. Formation [Part 2]

a. Articles of Organization [35-8-202]

i. Term Companies and At Will Companies

(1) Prior to the 1999 amendments, the articles of organization were required to state the latest date on which the LLC was to dissolve. This requirement has been replaced by a requirement that the articles of organization specify whether a LLC is a term company and if it is, the term of the company. If the articles of organization are silent, the LLC will be treated as an at-will company. 35-8-202(b).

(2) A term company is a LLC designated as a term company in its articles of organization. 35-8-102(31).

(a) A term may be specified in any manner which sets forth a specific and final date for the dissolution of the company. As an example, the term may be specified as "50 years from the date of filing of the articles" or "the period ending on January 1, 2020." Comment, ULLCA, §203.

(b) Specification of a particular undertaking of an uncertain duration is not sufficient unless it is within a longer fixed period. An example would be "2020 or until the building is completed, whichever occurs first." *Id.*

(c) When the term is incorrectly specified, the company will be an at-will company. *Id.*

(d) Even if the term is correctly specified in the articles, a company will be an at-will company among the members under Section 35-8-202(3)(1) if that is what the operating agreement provides. *Id.*

(e) If a term company continues after the expiration of its term, it will be an at-will company. *Id.*

(3) An at-will company is a LLC other than a term company. 35-8-102(2).

(4) The default rules applicable to a term company significantly differ from those applicable to an at-will company. An operating agreement may alter any of these rules.

(a) In general, a member of an at-will company may rightfully dissociate at any time whereas a dissociation from a term company prior to the expiration of the specified term is wrongful. Comment, ULLCA, §203.

(b) As a result, a dissociated member of an at-will company is entitled to have the company purchase that member's interest for its fair value determined as of the date of the member's dissociation. In contrast, the dissociated member of a term company usually must wait for the expiration of the agreed term to withdraw the fair value of the interest determined as of the date of the expiration of the agreed term. So, a dissociated member in an at-will company receives the fair value of the interest sooner than in a term company and also does not bear the risk of valuation changes for the remainder of the specified term. *Id.*

(5) A new provision requires, upon request, the Secretary of State to provide a certificate of existence for a LLC which, among other things, sets forth whether the LLC is a term company or an at-will company, and if it is a term company, the specified term.

(6) If a term company is continued after the expiration of the specified term, it will dissolve unless either its articles are amended before the expiration of the specified term to provide an additional specified term or the members or managers simply continue the company as an at-will company.

ii. Scope of Articles of Organization

(1) A new subsection (3) has been added which sets general parameters of what the articles of organization may contain.

(2) First, it states that the articles of organization may not vary the non-waivable provisions of 35-8-108.

(3) Second, it states that as to all other matters, if any provision of an operating agreement is inconsistent with the articles of organization:

(a) the operating agreement controls as to managers, members, and members' transferees; and

(b) the articles of organization control as to persons, other than managers, members and their transferees, who reasonably rely on the articles to their detriment.

b. **Knowledge and Notice [35-8-219]**

i. A new section 35-8-219 has been added which defines under what circumstances a person has notice or knowledge of a fact.

ii. Under this new section, an entity is deemed to know or to have notice when an individual conducting the transaction for the entity knows or has notice of the fact or when the fact would have been brought to the individual's attention had the entity exercised reasonable diligence. 35-8-219(5).

4. Rights and Duties of Members and Managers [Part 4]

a. **Continuation of Term Company After Expiration of Specified Term [35-8-411]**

i. If a term company is continued beyond its term, it continues as an at-will company and, in general, the rights and duties of the members and managers remain the same as they were at the expiration of the term.

ii. A term company's articles can be amended to provide for an additional term, but that typically requires the unanimous consent of the members. 35-8-307(3)(c). A single member could block the amendment. If the articles are not amended, a company may only be continued as an at-will company. The Commission Comments state, "The decision to continue a term company as an at-will company does not require the unanimous consent of the members and is treated as an ordinary business matter with disputes resolved by a simple majority vote of either the members or managers. See Section [35-8-307]. In that case, subsection ([2]) provides that the members' conduct amends or becomes part of an operating agreement to 'continue' the company as an at-will company. The amendment to the operating agreement does not alter the rights of creditors who suffer detrimental reliance because the company does not liquidate after the expiration of its specified term. See Section [35-8-202(3)(b)]." Comment, ULLCA, §411.

iii. The Commission Comments further state, "Preexisting operating-agreement provisions continue to control the relationship of the members under subsection ([1]) except to the extent inconsistent with the rights and duties of members of an at-will company with an operating agreement containing the same provisions. However, the members could agree in advance that, if the company's business continues after the expiration of its specified term, the company continues as a company with a new specified term or that the provisions of its operating agreement survive the expiration of the specified term." *Id.*

5. Finance [Part 5]

a. **Liability for Contribution [35-8-502]**

i. Subsection (3)(b) has been amended to provide that a creditor of a limited liability company who extends credit or otherwise acts in reliance on an obligation by a member to make a contribution, and without notice of any compromise under Section 35-8-307(3)(d), may enforce the original obligation. This amendment is based on subsection (b) of ULLCA §402.

ii. The MLLCA provides that a promise by a member to contribute to the LLC has to be in writing to be enforceable. The ULLCA allows enforcement of oral commitments, but the ULLCA provisions in that regard have not been adopted.

iii. 35-8-502(2)(a) provides that, "a member is obligated to the limited liability company to perform any enforceable promises ... to perform services even if the member is unable to perform because of death ... ." Now there's a challenging provision for the courts to enforce.

6. Ownership and Transfer of Property [Part 7]

a. **Nature of Distributional Interest [35-8-703]**

i. One of the more significant changes of the 1999 amendments is to distinguish between management rights and property rights arising out of a membership interest.

ii. Prior to the 1999 amendments, 35-8-703 described the nature of a membership interest. It has now been amended to describe the nature of a distributional interest, or property rights related to a membership interest.

iii. **Practice Pointer:** When drafting operating agreements, it may be preferable to distinguish distributional interests from other interests, rather than just referring to membership interests.

iv. A member is not a co-owner of, and does not have a transferable interest

in, property of a LLC.

v. The distributional interest of a member, however, may be transferred in whole or in part.

vi. Distributional interests may be represented by certificates but need not be.

b. **Rights of Judgment Creditor [35-8-705]**

i. A judgment creditor has only the right to a charging order, which is obtained by making application to a court of competent jurisdiction and which gives the creditor the same rights as the assignee of the debtor-member's distributional interest.

ii. A charging order constitutes a lien on the judgment debtor's distributional interest, which the court may order foreclosed. A purchaser at the foreclosure sale has the rights of a transferee.

iii. At any time before foreclosure, a distributional interest in a limited liability company which is charged may be redeemed:

(1) by the judgment debtor;

(2) with property other than the company's property, by one or more of the other members; or

(3) with the company's property, but only if permitted by the operating agreement.

iv. 35-8-705 provides the exclusive remedy by which a judgment creditor of a member or a transferee may satisfy a judgment out of the judgment debtor's distributional interest in a limited liability company.

c. **Transfer of Distributional Interest; Rights of a Transferee [35-8-707]**

i. This section replaces 35-8-704, which had governed assignments of membership interests.

ii. This new section makes clear that a transfer of a distributional interest does not entitle the transferee to become a member or to exercise any rights of a member. The transferee merely has the right to receive distributions to which the transferor would be entitled. 35-8-707(1).

iii. In order to acquire any rights as a member, other than distribution rights, either the transferor must give the transferee the rights in accordance with authority

described in writing in the operating agreement or if all the other members must consent. 35-8-707(2).

iv. Free transferability of interest is a corporate characteristic. Because of the advent of the check-the-box regulations, the presence of this corporate characteristic is not a concern regarding the tax treatment of a LLC.

v. The transfer of all of a member's distributional interest is an event of dissociation, but the transfer of less than all of a member's distributional interest is not. 35-8-803(3).

vi. Upon the transfer of all of a member's distributional interest, the member ceases to be a member.

vii. The other members may expel any member who has transferred "substantially all" of the member's distributional interest, but this requires unanimous consent of the other members. 35-8-803(5), The expulsion is an event of dissociation.

viii. A transferee who becomes a member:

(1) has the rights and powers and is subject to the restrictions and liabilities of a member under the operating agreement of the LLC;

(2) is liable for the transferor member's obligations to make contributions;

(3) is liable for the transferor member's obligations to return unlawful distributions; but

(4) is not liable for the transferor member's liabilities unknown to the transferee at the time the transferee became a member. 35-8-707(3).

ix. The transferor is not released from liability to the LLC under the operating agreement or the provisions of the MLLCA, even if the transferee becomes a member. 35-8-707(4).

x. A transferee who does not become a member:

(1) is not entitled to participate in the management or conduct of the LLC's business;

(2) may not require access to information concerning the company's transactions; and

(3) may not inspect or copy any of the company's records. 35-8-707(5).

xi. A transferee who does not become a member is entitled to:

(1) receive distributions to which the transferor would otherwise be entitled;

(2) seek judicial dissolution and winding up of the company's business. 35-8-707(6).

xii. A LLC is not required to give effect to a transfer until it has notice of the transfer. 35-8-707(7).

xiii. The rights of a dissociated member to participate in future management of the LLC are similar to the rights of a transferee, but a dissociated member retains additional rights accruing from that person's membership, such as the right to enforce purchase rights under 35-8-805 Comment, ULLCA, §503.

7. Admission and Withdrawal of Members [Part 8]

a. **Events Causing Member's Dissociation [35-8-803]**

i. A member is dissociated from a limited liability company upon the occurrence of any of the following events:

(1) the member's notice of express will to withdraw;

(2) an event agreed to in the operating agreement;

(3) upon transfer of all of a member's distributional interest, other than a transfer for security purposes or a court order charging the member's distributional interest which has not been foreclosed;

(4) the member's expulsion pursuant to the operating agreement;

(5) the member's expulsion by unanimous vote of the other members;

(6) the member's expulsion by judicial determination;

(7) the member's bankruptcy or similar events;

(8) in the case of a member who is an individual:

(a) the member's death;

(b) the appointment of a guardian or general conservator for the member; or

(c) a judicial determination that the member has otherwise become incapable of performing the member's duties under the operating agreement;

(9) in the case of a member that is a trust, distribution of the trust's entire rights to receive distributions from the company;

(10) in the case of a member that is an estate, distribution of the estate's entire rights to receive distributions from the company; or

(11) termination of the existence of a member if the member is not an individual, estate, or trust other than a business trust.

ii. The term "dissociation" refers to the change in the relationships among the dissociated member, the company and the other members caused by a member's ceasing to be associated in the carrying on of the company's business. Comment, ULLCA, §601. Member dissociation from either an at-will or term company, whether member- or manager-managed is not an event of dissolution of the company unless otherwise specified in an operating agreement. *Id.* However, member dissociation will generally trigger the obligation of the company to purchase the dissociated member's interest under Part 8. *Id.*

iii. The death of a member can have significantly different results depending on whether the company is at-will or term. The Commission Comments state: "Although a member is dissociated upon death, the effect of the dissociation where the company does not dissolve depends upon whether the company is at-will or term. Only the decedent's distributional interest transfers to the decedent's estate which does not acquire the decedent member's management rights. See Section [35-8-805(2)(a)]. Unless otherwise agreed, if the company was at-will, the estate's distributional interest must be purchased by the company at fair value determined at the date of death. However, if a term company, the estate and its transferees continue only as the owner of the distributional interest with no management rights until the expiration of the specified term that existed on the date of death. At the expiration of that term, the company must purchase the interest of a dissociated member if the company continues for an additional term by amending its articles or simply continues as an at-will company. See Sections [35-8-411] and [35-8-808(1)(b)] and Comments. Before that time, the estate and its transferees have the right to make application for a judicial dissolution of the company under Section [35-8-902(2)] as successors in interest to a dissociated member. ... Where the members have allocated management rights on the basis of contributions rather than simply the number of members, a member's death will result in a transfer of management rights to the remaining members on a proportionate basis. This transfer of

rights may be avoided by a provision in an operating agreement extending the Section [35-8-808] at-will purchase right to a decedent member of a term company."

b. **Member's Power to Dissociate — Wrongful Dissociation [35-8-804]**

i. A member has the power to dissociate at any time, rightfully or wrongfully. 35-8-804(1).

ii. Unless otherwise provided by the operating agreement, dissociation is wrongful only if:

(1) it is in breach of an express provision of the agreement; or

(2) before the expiration of the specified term of a term company:

(a) the member withdraws by express will;

(b) the member is expelled by judicial determination;

(c) the member is dissociated by becoming a debtor in bankruptcy; or

(d) in the case of a member who is not an individual, trust other than a business trust, or estate, the member is expelled or otherwise dissociated because it willfully dissolved or terminated its existence. 35-8-804(2).

(3) A member who wrongfully dissociates is liable to the company and to the other members for damages caused by the dissociation, and damages will be offset against distributions otherwise due the member after the dissociation. 35-8-804(3), (4).

(4) A member's power to withdraw by express will may be eliminated by an operating agreement. Comment, ULLCA, §602. If a member has the power to withdraw, it is considered a corporate characteristic, but under the check-the-box regulations, the presence or absence of this factor need not affect the manner in which the LLC is taxed. According to the Commission Comments, an operating agreement may eliminate a member's power to withdraw by express will to promote the business continuity of an at-will company by removing member's right to force the company to purchase the member's distributional interest, but the member could still seek a judicial dissolution of the company. Comment, ULLCA, §602.

(5) Even if a member's power to withdraw by express will is not eliminated in an operating agreement, all dissociations, including withdrawal by

express will, may be made wrongful in both an at-will and term company by the inclusion of a provision in an operating agreement. *Id.*; 35-8-804(2)(a).

(6) Even where an operating agreement does not eliminate the power to withdraw by express will or make any dissociation wrongful, the dissociation of a member of a term company is wrongful in specified instances. 35-8-804(2)(b).

c. **Effect of Member's Dissociation [35-8-805]**

i. Dissociation does not cause dissolution unless otherwise specified in the operating agreement. Comments, ULLCA, §§603, 801.

ii. Dissociation results in much different purchase requirements, depending on whether the LLC is a term company or an at-will company.

(1) In an at-will company, the company must cause the dissociated member's distributional interest to be purchased as provided under 35-8-808 and 35-8-809.

(2) In a term company,

(a) if the company dissolves and winds up its business on or before the expiration of its specified term, Part 9 of the MLLCA applies to determine the dissociated member's rights to distributions; and

(b) if the company does not dissolve and wind up its business on or before the expiration of its specified term, the company must cause the dissociated member's distributional interest to be purchased under 35-8-808 and 35-8-809 on the date of the expiration of the term specified at the time of the member's dissociation.

iii. **Planning Pointer:** Choosing whether the LLC is to be a term company or an at-will company should be given careful consideration. In an at-will company, dissociation can trigger an immediate buy-out of the member's interest, which in addition to cash-flow problems presumably would decrease the amount of any gift and estate discounts available for this form of LLC. On the other hand, in a term company, payment for the dissociated member's interest could be postponed until expiration of the company's term, which would eliminate the necessity to immediately fund a buy-out, but would also leave the dissociated member as an owner in the business with the benefit of any appreciation that occurred in between the dissociation and the expiration of the term. This form of company presumably would result in greater discounts for estate planning purposes since the ability to

have access to payment for the membership interest would be postponed.

iv. Several important results flow from a member's dissociation:

(1) The member's right to participate in the management and conduct of the company's business terminates, except as otherwise provided in Section 35-8-903 (relating to winding up the LLC) and the member ceases to be a member and is treated the same as a transferee of a member (i.e., with rights to receive distributions but no right to participate in management and conduct of the company's business);

(2) the member's duty of loyalty under 35-8-310(2)(c) terminates; and

(3) the member's duty of loyalty under 35-8-310(2)(a) and (2)(b) and duty of care under 35-8-310(3) continue only with regard to matters arising and events occurring before the member's dissociation, unless the member participates in winding up the company's business pursuant to 35-8-903. 35-8-805(2).

d. **Company Purchase of Distributional Interest [35-8-808]**

i. The MLLCA now contains a default buy-sell agreement. Of course, these provisions can be modified by an operating agreement.

ii. An at-will company must purchase a dissociated member's distributional interest if the dissociation does not cause a dissolution of the company. The purchase price is the fair value determined as of the date of dissociation. 35-8-808(1)(a). Any damages for wrongful dissociation must be offset against the purchase price. 35-8-808(6).

iii. Dissociation from a term company in general does not require an immediate purchase of the member's interest.

(1) In general, a term company must only purchase the dissociated member's distributional interest on the expiration of the specified term that existed on the date of the member's dissociation. The purchase price is equal to the fair value of the interest determined as of the date of the expiration of that specified term. 35-8-808(1)(b).

(2) However, the operating agreement may specify that dissociation is an event of dissolution, in which event the member would receive a distribution as part of the dissolution and winding up of the company's business. 35-8-808(1)(b), 35-8-903.

(3) In any event, any damages for wrongful dissociation must be offset against the purchase price. 35-8-808(6).

iv. A dissociated member of a term company (that is not dissolved as a result of the dissociation) assumes the risk of loss between the date of dissociation and the expiration of the then stated specified term, but the dissociated member may file application to dissolve the company under 35-8-901. Comment, ULLCA, §701.

v. Fair value is the default valuation standard, but an operating agreement may fix a method or formula for determining the purchase price and the terms of payment and could also modify the purchase right. For example, an operating agreement may eliminate a member's power to withdraw from an at-will company which narrows the dissociation events contemplated by this section. However, a provision in an operating agreement providing for complete forfeiture of the purchase right may be unenforceable where the power to dissociate has not also been eliminated. Comment, ULLCA, §701.

vi. The company must deliver a purchase offer to the dissociated member within 30 days after the date determined under subsection (1). The offer must be accompanied by information designed to enable the dissociated member to evaluate the fairness of the offer. 35-8-808(2).

vii. The company and the dissociated member must reach an agreement on the purchase price and terms within 120 days. Otherwise, the dissociated member may file suit within another 120 days to enforce the purchase. 35-8-808(4). The court will then determine the fair value and terms of purchase. 35-8-808(5). The member's lawsuit is not available if the parties have previously agreed to price and terms in an operating agreement. 35-8-808(3).

e. **Court Action to Determine Fair Value of Distributional Interest [35-8-809]**

i. This new section is based on ULLCA §702.

ii. In an action brought to determine the fair value of a distributional interest in a limited liability company, the court shall:

(1) determine the fair value of the interest;

(2) specify the terms of the purchase; and

(3) require the dissociated member to deliver an assignment of the interest to the purchaser upon receipt of the purchase price or the first installment of the purchase price. 35-8-809(1).

iii. Fair value is the default valuation standard. This is a broad standard under which a court may determine use a fair market, liquidation, or any other method deemed appropriate under the circumstances. Fair market value is not the default standard because it is too narrow, often inappropriate, and assumes a fact not

contemplated by this section -- a willing buyer and a willing seller. Comment, ULLCA, §702.

iv. In specifying terms of the purchase, the court may include in its order any conditions it deems necessary to safeguard the interests of the company and the dissociated member or transferee, such as terms for installment payments, subordination of the purchase obligation to the rights of the company's other creditors, security for a deferred purchase price, and a covenant not to compete or other restriction on a dissociated member. 35-8-809(1)(b); Comment, ULLCA, §702.

v. If the purchase is not completed in accordance with the specified terms, the company is to be dissolved upon application under 35-8-902(1)(d).

vi. If the court finds that a party to the proceeding acted arbitrarily, vexatiously, or not in good faith, it may award one or more other parties their reasonable expenses, including attorney's fees and the expenses of appraisers or other experts, incurred in the proceeding. The finding may be based on the company's failure to make an offer to pay or to comply with 35-8-808(2). 35-8-809(4).

vii. Interest may be awarded from the date the dissociated member's interest should have been purchased to the date of payment. 35-8-809(5).

8. Dissolution [Part 9]

a. **Dissolution [35-8-901]**

i. A limited liability company is dissolved and its affairs must be wound up when one of the following occurs:

(1) at the time or upon the occurrence of events specified in writing in the articles of organization or operating agreement;

(2) consent of the number or percentage of members specified in the operating agreement;

(3) an event that makes it unlawful for all or substantially all of the business of the company to be continued, but any cure of illegality within 90 days after notice to the company of the event is effective retroactively to the date of the event for purposes of this section;

(4) the expiration of the term specified in the articles of organization; or

(5) entry of a decree of judicial dissolution under 35-8-902. 35-8-901(1)

ii. In general, a LLC continues after dissolution only for the purpose of

winding up its business. 35-8-901(2).

iii. At any time after the dissolution of a LLC and before the winding up of its business is completed, the members may unanimously waive the right to have the company's business wound up and the company terminated. In that case, it is treated in general as if the dissolution had never occurred. 35-8-901(3).

iv. Prior to the check-the-box regulations, members of LLC's had to be concerned whether the LLC had continuity of life, because that was a corporate characteristic. If the LLC dissolved and its business wound up upon specified events, it would not have that corporate characteristic and thus would be that much closer to being taxed as a partnership rather than as a corporation. Since the advent of the check-the-box regulations, the presence or absence of this factor need not affect the manner in which the LLC is taxed.

v. Although the dissolution rules of this section are mostly default rules which may be modified by an operating agreement, an operating agreement may not modify or eliminate the dissolution events specified in subsection (1)(c) (illegal business) or subsection (1)(e) (judicial dissolution). Comment, ULLCA, §801.

vi. Unless member dissociation is specified as an event of dissolution in the operating agreement, such dissociation does not dissolve the company. Comment, ULLCA, §801.

b. **Judicial Dissolution [35-8-902]**

i. On application by or for a member or a dissociated member, a district court may order dissolution of a limited liability company, or other appropriate relief, when:

(1) the economic purpose of the company is likely to be unreasonably frustrated;

(2) another member has engaged in conduct relating to the company's business that makes it not reasonably practicable to carry on the company's business with that member;

(3) it is not otherwise reasonably practicable to carry on the company's business in conformity with the articles of organization and the operating agreement;

(4) the company failed to purchase the petitioner's distributional interest as required by 35-8-805; or

(5) the members or managers in control of the company have acted, are

acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner. 35-8-902(1).

ii. On application by a transferee of a member's interest, a district court may determine that it is equitable to wind up the company's business:

(1) after the expiration of the specified term, if the company was for a specified term at the time the applicant became a transferee by member dissociation, transfer, or entry of a charging order that gave rise to the transfer; or

(2) at any time, if the company was at will at the time the applicant became a transferee by member dissociation, transfer, or entry of a charging order that gave rise to the transfer; or

(3) the expiration of the term specified in the articles of organization. 35-8-902(2).

iii. A member or dissociated member whose interest is not required to be purchased by the company under 35-8-805 may make application under subsection (1) of this section for the involuntary dissolution of both an at-will company and a term company, and a transferee may make application under subsection (2).

iv. A court should take into account other rights and remedies of the applicant. For example, a court should not grant involuntary dissolution of an at-will company if the applicant member has the right to dissociate and force the company to purchase that member's distributional interest. Comment, ULLCA, §801.

c. **Agency Power and Liability of Members or Managers After Dissolution [35-8-904]**

i. A new subsection (6) is added which is modeled after ULLCA §904(b).

ii. Formerly, articles of dissolution were filed with the Secretary of Sate to give notice of dissolution. That is now accomplished by filing articles of termination. 35-8-904(2).

iii. New subsection (6) states that a member or manager who, with knowledge of the dissolution, subjects a limited liability company to liability by an act that is not appropriate for winding up the company's business is liable to the company for any damage caused to the company arising from the liability.