

**Part V**  
**Drafting the Operating Agreement**

by  
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**A. INTRODUCTION**

**1. How the Operating Agreement Relates to the Articles of Organization**

A limited liability company is formed by filing Articles of Organization with the Montana Secretary of State.<sup>1</sup> The Articles of Organization are a public document.

Once the Articles of Organization have been filed, the members need to decide how it is that they desire to conduct the day to day operations of the limited liability company. The operating agreement is the principal document which governs the affairs of the limited liability company.<sup>2</sup> The operating agreement is similar in concept to the bylaws of a corporation or to the partnership agreement of a partnership. As with LLCs in general, the operating agreement draws on both corporate and partnership

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<sup>1</sup> 35-8-201, M.C.A. The author is unaware of any body of law for *de facto* LLC's that would be analogous to that for *de facto* corporations, but the principles certainly would seem to be analogous. Under such principles, it may be possible to have a LLC without having complied with all the requirements of law for formation, as long as there was some good faith attempt at compliance with those requirements. At any rate, filing Articles of Organization with the Secretary of State would appear to be the minimum requirement for treatment as a limited liability company.

<sup>2</sup> Comments to the July 16, 1992 draft of the "Prototype Limited Liability Company Act," American Bar Association, hereinafter, the "Prototype Act."

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characteristics. In contrast to the Articles of Organization, there is no statutory requirement that the LLC have an operating agreement, though the cautious practitioner would almost always recommend having one.

The Articles of Organization and the operating agreement are intertwined. The Articles of Organization themselves may constitute the operating agreement of the limited liability company,<sup>3</sup> though for reasons of privacy and flexibility, they almost always are separate documents. Because of the close connection between the Articles of Organization and the operating agreement, this portion of the outline will begin with an examination of the provisions of the Articles of Organization, so as to provide a better understanding of what to include in the operating agreement

### 2. Statutory Provisions

The Montana Limited Liability Company Act defines an operating agreement as “an agreement, written or oral, as to the conduct of the business and affairs of a limited liability company that is binding upon all of the members.”<sup>4</sup> Other than that, there are no specific statutory provisions in the Montana Limited Liability Company Act as to what is required of an operating agreement. The Montana Limited Liability Company Act, though, does make several references to the operating agreement and provides a great deal of flexibility for the members to vary the statutory provisions by agreeing

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<sup>3</sup> See Commentary following §101 of the Prototype Act.

<sup>4</sup> 35-8-102(16), M.C.A.

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among themselves to some differing arrangement. The operating agreement is a contract among the members of the limited liability company,<sup>5</sup> and as such is restricted in content only to the extent contract law provides.

### 3. Complexity of Operating Agreements

Because of the relatively greater flexibility of the operation of LLCs as contrasted to corporations, the provisions of an operating agreement cannot be as standardized as the terms of the bylaws of a corporation. Most LLCs are going to be taxed as partnerships and therefore the provisions of partnership tax law must be considered when drafting the operating agreement. Flexibility comes with a cost, however. There are more opportunities, but also more decisions and greater complexity when drafting for the choices available under the provisions of an operating agreement. For example, special allocations are permitted for LLCs that are taxed as partnerships. Special allocations of such items as income and deductions will be governed by Section 704 of the Internal Revenue Code and the regulations under it. Anyone who has had occasion to review those regulations understands well the complexity involved in drafting special allocation provisions. The complexity, while something the drafter may not enjoy wading through, does nonetheless provide potentially valuable planning opportunities.

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<sup>5</sup> The comments to the Prototype Act refer to the operating agreement as a contract. Following §101, the commentary provides that the operating agreement “... is the contract which governs the affairs of the limited liability company. ... This is consonant with the principle that a limited liability company is essentially contractual in nature . . . .”

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Consequently, it is essential that the attorney be aware of the choices available so as to provide guidance to the client.

### **4. Overlap Between the Articles of Organization and the Operating Agreement**

The Articles of Organization may contain many of the provisions that would otherwise be covered by the operating agreement. There are several references in the Montana Limited Liability Company Act to provisions that may be contained either in the Articles of Organization or in the operating agreement. Some Articles of Organization can be quite complex, but in drafting the Articles of Organization it may be prudent to consider that the procedure for amending Articles of Organization is somewhat more burdensome than what would be required to amend the operating agreement. In some cases that additional burden may be desirable. It may be the choice of the organizers that certain provisions not be easily amendable and therefore placing such provisions in the Articles of Organization may be the preferred method. However, for many LLCs, the flexibility allowed by placing any optional provisions in the operating agreement rather than in the Articles of Organization will be the preferred method. One additional reason that a particular provision may be included in the operating agreement rather than the Articles of Organization is to maintain privacy. Of course, the Articles of Organization are a public document and as a result, the provisions of the Articles of Organization are open to inspection by the public at large.

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### 5. “Notice” Purpose of the Montana Limited Liability Company Act

The Montana statute is what may be referred to as a “bare bones” disclosure statute. In other words, the Articles of Organization are required only to state certain formal information such as limited liability company's name, principal place of business, registered office, and registered agent. Other states have more specific statutes that require the disclosure of a greater amount of information. For example, the Florida statute that requires that the Articles of Organization be accompanied by an affidavit “setting forth the amount of cash and a description of the agreed value of the property other than cash contributed and the amount anticipated to be contributed...”<sup>6</sup>

### 6. Other States

It is not the function of this outline to explore the variety of state statutes. However, the Montana attorney should be aware that certain differences do exist and should make no assumption that another state's limited liability company statute is similar to Montana's. The Montana Limited Liability Company Act, however, is based on the Prototype Limited Liability Company Act (July 16, 1992) drafted by the American Bar Association, so there will be some standardization to the extent other states have also adopted the Prototype Act. Furthermore, the Uniform Code Commissioners have recently promulgated the Uniform Limited Liability Company Act. At the time the Montana legislature considered the Prototype Act, the Uniform Code Commissioners

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<sup>6</sup> Fla. Stat. Ann. §608.407 (West Supp. 1994).

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had not promulgated the Uniform Limited Liability Company Act. In fact, many states passed their statutes prior to the promulgation of the Uniform Act. It may be that the Uniform Code Commissioners have missed an opportunity to achieve uniformity.

As of 1988 only three states had limited liability company acts. By the time Montana passed its statute, it was one of at least thirty-six states that had a limited liability company act. As of late 1994, at least forty-six states and the District of Columbia had enacted LLC statutes.

An important feature of the Uniform Act is that it permits organization of a LLC by only one person and allows the LLC to have just one member. ULLC Act Section § 202(A). Montana has a similar provision allowing one-member LLCs. It should be noted, however, that most states do not have a statute permitting one-member LLCs and that the Internal Revenue Service has not determined what such a company would be for tax purposes.<sup>7</sup>

## **B. THE ARTICLES OF ORGANIZATION**

### **1. The Purpose of the Operating Agreement**

The well-drafted operating agreement will in general cover the life of the limited liability company. In other words, the operating agreement will cover what is required upon formation of a limited liability company, how the limited liability company is to

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<sup>7</sup> Bishop & Kleinberger, *Limited Liability Companies - Tax and Business Law*, Warren, Gorham & Lamont (1994) (hereinafter, *Bishop & Kleinberger*), ¶ 2.08[4].

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operate, and what events may cause a termination or dissolution of the limited liability company. The drafter must be highly aware of the provisions of tax law that determine whether the limited liability company will be taxed as a partnership or as an association taxable as a corporation. This tax determination may depend on the provisions included in the operating agreement. The drafter should also be aware of non-tax provisions that the Montana Limited Liability Company Act allows to be altered by the operating agreement. The purpose of the section of this outline is to examine some of those tax and non-tax provisions.

### **2. What the Articles of Organization Must Include**

The Montana Limited Liability Company Act provides that the Articles of Organization are the sole source of authority for certain provisions. For example, the Articles of Organization are required to set forth the name of the limited liability company, the latest date on which it is to dissolve, the address of its principal place of business in the state (and, if different, its registered office and the name and address of its resident agent), and a statement of whether the limited liability company is to be managed by a manager or by its members. If the limited liability company is to be managed by a manager, the names and street addresses of managers are required to be set forth. If it is managed by the members, the names and street addresses of the initial members are required. For a professional limited liability company, the Articles of

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Organization must include a statement that it is a professional limited liability company and a statement of the professional services it will render.

### 3. What the Articles of Organization May Include

a. Limitations on Agency Authority

The Articles of Organization may also set forth limitations on the authority of members or management to bind the limited liability company.<sup>8</sup>

#### **Planning Note**

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Whenever dealing with a limited liability company on an important transaction, it is advisable to check the Articles of Organization on file with the Secretary of State to determine whether there are any limitations on the authority of the members or managers to bind the limited liability company.

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b. Powers

It is not necessary to set out in the Articles of Organization any of the powers enumerated at 35-8-107, M.C.A.<sup>9</sup> Any other powers, however, should be set forth in the Articles of Organization.

#### **Drafting Note**

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Before filing the Articles of Organization, review the Montana Limited Liability Company Act to determine whether any powers in addition to those set forth at 35-8-107, M.C.A. should be set forth.

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<sup>8</sup> 35-8-202, M.C.A.

<sup>9</sup> 35-8-202(2), M.C.A.



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c. Other Provisions

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The Articles of Organization may include “any other provision, not inconsistent with law, that the members elect to set out in the articles.”<sup>10</sup>

### **4. Amending the Articles of Organization**

#### a. Statutory Requirements

The Articles of Organization are amended by filing Articles of Amendment with the Secretary of State.<sup>11</sup> The Articles of Amendment must set forth the name of the limited liability company, the date its Articles of Organization were filed, and the amendment to the Articles of Organization.

#### b. Contrasted to the Operating Agreement

No particular statutory procedure is set forth for amending the operating agreement. The procedure for amending the operating agreement is a matter to be negotiated and agreed upon the same as any other provisions of the operating agreement. Presumably, operating agreements in general will be less burdensome to amend than Articles of Organization.

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<sup>10</sup> 35-8-202(1)(g), M.C.A.

<sup>11</sup> 35-8-203, M.C.A.

## C. THE OPERATING AGREEMENT

### 1. Statutory Provisions

#### a. *Montana*

One of the areas in which LLC statutes differ is the scope of the what may be governed by the operating agreement. Some state statutes are rather specific. The Montana statute, as with many other states' statutes, is fairly general. The Montana statute simply provides that an operating agreement is “an agreement, written or oral, as to the conduct of the business and affairs of a limited liability company that is binding upon all the members.”<sup>12</sup>

#### b. *Other States*

Other states may be fairly specific in the grant of the authority under operating agreements. Those areas generally cover membership (such as requirement for admitting members, withdrawal of members), governance (such as management structure, voting rights, classes of membership interest), finance (requirements for member contributions and priorities in liquidation), and dissolution (including events that trigger dissolution).<sup>13</sup>

### 2. Conflicts Between the Operating Agreement and the Articles of Organization

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<sup>12</sup> 35-8-102(16), M.C.A.

<sup>13</sup> Bishop & Kleinberger, ¶ 5.06[2][a], pp. 5-68 to 5-70.

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a. *In General*

It is possible of course that the provisions of the operating agreement and the Articles of Organization will conflict, especially because the Montana Limited Liability Company Act permits the Articles of Organization to include any provision not inconsistent with law.<sup>14</sup> The question then arises as to which will control.

The enabling statute may state a clear preference for one document over another. Here again, however, the choice to include more or less detail in the Articles of Organization versus the operating agreement is a question that should be decided in favor of less detail in the Articles of Organization and more detail in the operating agreement. The fewer provisions in the Articles of Organization, the less chance there is that some conflict will arise between the two documents.

The Montana attorney however, must be aware that the provisions of other state's statutes may not be similar to Montana's. In such an event, if there ever is a question as to what controls, a Montana attorney must be careful to verify which document will control for purposes of that particular state. Some states do provide that there is one clear preferences for one document over another, but it is possible for the enabling statute to have mutually contradictory preferences or to reserve the particular subject

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<sup>14</sup> 35-8-202(2), M.C.A.

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matter to the Articles of Organization, in which event the Articles of Organization would govern.<sup>15</sup>

### 3. Adopting the Initial Operating Agreement

#### a. Level of Consent Required

As with the bylaws of a corporation, or the partnership agreement of a partnership, the operating agreement of a limited liability company must be adopted by the owners, which in a LLC are the members. Although the Montana statute does not have any provision regarding an initial meeting of members, the occurrence of an initial meeting of members would be advisable if for no other purpose than to adopt an operating agreement. The operating agreement will govern the relations of the members from the outset, therefore it should be one of the first orders of business. Some state statutes specify the level of consent that is required for the adoption of an operating agreement. Montana merely provides that the operating agreement is “an agreement ... binding upon all the parties.”<sup>16</sup> The operating agreement is governed by general contract law,<sup>17</sup> which would require unanimous consent, unless the parties agreed otherwise. As a practical matter, the formation of the limited liability company generally will involve a relatively few number of people who are in concert as to the purpose and as to the provisions that are required by an agreement and therefore a unanimous consent should be expected.

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<sup>15</sup> See Bishop & Kleinberger, pp. 5-72 to 5-75.

<sup>16</sup> 35-8-102(16), M.C.A.

<sup>17</sup> See note 3.

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b. *Level of Consent Specified in Articles of Organization*

To what extent could the Articles of Organization vary the presumed requirement for unanimous consent? It should be noted that under the definition of operating agreement found in the Montana Limited Liability Company Act, it would appear that some point there be unanimous consent as to the terms and provisions of an operating agreement, since the terms and conditions of an operating agreement states that it is binding upon all of the members. It maybe contemplated that the Articles of Organization could include a provision regarding the operating agreement and the level of consent required to adopt the operating agreement. Any provision not inconsistent with law may be included in the Articles of Organization.<sup>18</sup> Presumably, this would include a provision regarding the voting or the level of consent required to adopt an operating agreement that would be binding upon all of the members. Query: how far such a provision may be taken. By agreeing to contribute property to and become a member of a LLC, presumably a member would be consenting to the Articles of Organization and thereby could be considered to consent to the provision therein setting forth a less-than-unanimous requirement for adoption of an operating agreement . At any rate, the provisions under Montana law are not iron-clad as to the consent required to adopt an operating agreement, but this is an issue that only rarely will arise with

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<sup>18</sup> 35-8-202 (1)(g), M.C.A.

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closely-held LLCs because members will consent to the original operating agreement unanimously.

### c. Oral Operating Agreements

There is no requirement under the Montana LLC Act that the operating agreement be in writing. The statute specifically contemplates that an operating agreement may be oral.<sup>19</sup> Of course, the preferable option is to have the operating agreement in writing, so as to avoid disputes as the just what the agreement provided.

## D. TAX CONSIDERATIONS

### 1. The Four Factors

The Operating Agreement should be drafted with tax considerations in mind. Very often, firms select the LLC form of business entity in order to avoid the double tax of C-corporations and to ensure that they are treated as a partnership for income tax purposes. As mentioned in other parts of this Outline, the tax treatment of a LLC will depend on how many of the four distinguishing factors it possesses. Again, those are (1) limited liability, (2) centralized management, (3) continuity of life, and (4) free transferability of interests. In order to be treated as a partnership for income tax purposes, the LLC must have no more than two of these four corporate characteristics. Because Montana has a flexible statute rather than a bulletproof statute, it is possible for

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<sup>19</sup> 35-8-102(16), M.C.A.

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the members of an LLC to make agreements affecting those factors. Obviously the factor of limited liability is one of statutory control and so generally not a factor that would be affected by the Articles of Organization or Operating Agreement. The other three factors, however, are subject to modification by the members through agreement. The manner in which they structure their operations will determine whether they have centralized management. There is some need to consider at the time of filing the Articles of Organization the issue of continuity of life. Finally, the members will also be able to determine whether there is any free transferability of interests.

Flexibility permitted by the Montana statute provides planning opportunities, but it also comes with a cost. The variety of the provisions that the members may agree upon necessarily leads to uncertainty as to the tax treatment of the LLC. A mistake regarding classification could be costly to the members, particularly if that mistake does not come to light until several years later. The default provisions in the Montana Limited Liability Company Act are designed to meet the requirements for treatment as a partnership for federal income tax purposes. By varying any of the default provisions, however, an element of uncertainty is created and that uncertainty should either be discussed with the client and the client agree to accept that risk or the attorney may also advise the client to obtain a private letter ruling from the Internal Revenue Service. Of course with the filing fees now imposed by the Internal Revenue Service, private letter rulings can be expensive to obtain.



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The Montana Limited Liability Act includes default rules that ensure partnership characterization under current rules, including rules that require unanimous member consent for transfer of management rights, and that provide for management directly by members and for dissolution upon member dissociation. These are, however, only default rules and the members may vary them by contrary agreement.

### 2. Limited Liability

a. *The Limited Liability Veil*

The Montana Limited Liability Company Act provides members of a LLC with limited liability.<sup>20</sup> In other words, a member is not liable for the debts and obligations of the LLC or for the conduct of managers, employees, agents or members of the LLC.<sup>21</sup>

b. *Exceptions: Tort and Contract Liability*

A member is not, however, relieved of a liability incurred in his individual capacity. The Montana Limited Liability Act is not intended to relieve a member from liability arising out of his own acts or omissions to the extent such acts or omissions would be actionable, either in contract or in tort, against the member if he were acting in his individual capacity.<sup>22</sup> An example of this would be a member who is liable in contract to a third party creditor of the LLC through a guarantee or some similar arrangement. That member could not escape liability through the shield provided by the

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<sup>20</sup> 35-8-304, M.C.A.

<sup>21</sup> See Commentary, §306, Prototype Act.

<sup>22</sup> Comments to 35-8-304 M.C.A.

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LLC. Another example might be a member who was liable in tort for claims against the LLC arising out of that member's negligence in appointing, supervising, or participating in the activity in question with a manager, employee, agent or other member of the LLC.

c. Liability Exposure of Managers

On the other hand, the comments to the Prototype Act clearly indicate that this section does not address a manager's liability for the debts and obligations of the LLC because, like a corporate officer, a manager serves only as an agent of the LLC so that as a general rule there should be no grounds for imposing liability on the manager.

d. Piercing the Limited Liability Veil

The Montana comments to 35-8-304, M.C.A., indicate that the limited liability company "veil" will be difficult to pierce. Those comments state:

"The failure of a limited liability company to observe the formalities customarily followed by business corporations or requirements relating to the exercise of its powers or management of its business and affairs is not a ground for courts disregarding the separate entity status of an limited liability company or for imposing personal liability on the members for liabilities of the limited liability company. Courts should not pierce the limited liability 'veil' merely as a result of failure to follow normal formalities required of a corporation. See Keatinge *et. al* , *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375,446(1992). See also Gazur and Goff, *Assessing the Limited Liability Company*, 41 CASE WESTERN RES. L.REV. 401-403(1991). Of course, the court may still pierce the limited liability company veil if piercing the veil otherwise is necessary to prevent fraud or necessary to achieve equity. See *e.g.*, Jody J. Brewster (comment), *Piercing the Corporate Veil in Montana*, MONT. L.REV. (1983)."

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e. Unauthorized Distributions

On the other hand, the LLC may not simply distribute assets if doing so would render the LLC insolvent.<sup>23</sup> Doing so would subject the responsible members to personal liability to the extent of the distributions.<sup>24</sup>

f. The Tax Test for Limited Liability

The regulations<sup>25</sup> provide the following definition of limited liability:

*An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim. A member of the organization who is personally liable for the obligations of the organization may make an agreement under which another person, whether or not a member of the organization, assumes such liability or agrees to indemnify such member for any such liability. However, if under local law the member remains liable to such creditors notwithstanding such agreement, there exists personal liability with respect to such member. In the case of a general partnership subject to a statute corresponding to the Uniform Partnership Act, personal liability exists with respect to each general partner. Similarly, in the case of a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act, personal liability exists with respect to each general partner, except as provided in subparagraph (2) of this paragraph (d).*

### 3. Centralized Management

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<sup>23</sup> 35-8-604, M.C.A.

<sup>24</sup> 35-8-605, M.C.A.

<sup>25</sup> Treas. Reg. §301.7701-2(d).

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a. Default Rule: No Centralized Management

The Montana Limited Liability Company Act provides that, by default, a LLC will not have the corporate characteristic of centralized management. By default, LLCs are to be managed by all the members, who will have authority to manage the affairs of the LLC and to make all necessary decisions.<sup>26</sup> It should be noted, however, that the statute does permit the Articles of Organization to vest management of the LLC in a manager or managers.<sup>27</sup> It is possible, therefore, to draft the Articles of Organization and the operating agreement in such a manner that the LLC will have the corporate characteristic of centralized management.

b. Management by Managers

If the Articles of Organization do vest management of the LLC in one or more managers, the managers are then permitted to manage the business or affairs of the LLC as provided either in the Articles of Organization or the operating agreement.<sup>28</sup> If management by managers is desired, it must be included in the Articles of Organization, but the terms of the management authority may be set forth either in the Articles of Organization or the operating agreement. Unless varied by the terms of the Articles of Organization or the operating agreement, the managers (a) must be designated, appointed, elected, removed, or replaced by a vote, approval, or consent of more than

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<sup>26</sup> 35-8-401 M.C.A.

<sup>27</sup> 35-8-401, M.C.A.

<sup>28</sup> 35-8-401(2) M.C.A.

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one-half of the members; (b) need not be members of the LLC or natural persons; and (c) unless they have been earlier removed or have earlier resigned, shall hold office until their successors are elected and qualified.<sup>29</sup>

c. Reasons for the Default Rule

The drafters of the Prototype Act provided three basic reasons for the default provision calling for management directly by the members.<sup>30</sup> First, LLC interests are not freely transferable. Consequently, if a member were dissatisfied with his investment, he would have to resort to active involvement in the affairs of the LLC rather than simply sell the membership interest as would generally be possible for a shareholder of a public corporation. Second, if management were vested in one or more managers, that generally would result in centralized management for tax purposes under §7701 of the Internal Revenue Code. That would constitute a corporate characteristic and would take the LLC one step closer to being treated as a corporation for tax purposes. Third, it was the feeling of the drafters that closely held enterprises generally prefer management directly by the owners. The management authority or duties of a member in a member-managed LLC are very similar to those of a general partner in a limited partnership. In other words, the members manage and make policy decisions restricted only by the terms of the operating agreement of the Montana Limited Liability Company Act.

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<sup>29</sup> 35-8-401(2), M.C.A.

<sup>30</sup> See Commentary to Sec. 401 of the Prototype Act.

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d. *The Tax Test for Centralized Management*

The regulations<sup>31</sup> define centralization of management as the:

- Continuing
- Exclusive
- Authority to make independent business decisions
- On behalf of the organization
- Which do not require ratification by the members of such organization.

This decision-making power may be possessed by any person or group of persons which does not include all the members. In many ways, this is similar to the function of the board of directors of a corporation.<sup>32</sup>

The persons holding such power may but they need not be members of the LLC.<sup>33</sup> But, the corporate characteristic of centralized management will not be present if such persons are merely agents performing ministerial acts at the direction of a principal.<sup>34</sup>

e. *The Test for Exclusive Authority*

The regulations require that the authority to make independent business decisions on behalf of the LLC be *exclusive*.<sup>35</sup> By this, the regulations mean that such person or

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<sup>31</sup> Treas. Reg. §301.7701-2(c)(3).

<sup>32</sup> Treas. Reg. §301.7701-2(c)(1).

<sup>33</sup> Treas. Reg. §301.7701-2(c)(2).

<sup>34</sup> Treas. Reg. §301.7701-2(c)(3).

<sup>35</sup> Treas. Reg. §301.7701-2(c)(4).

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persons have the sole authority to make decisions.<sup>36</sup> Again, the approach adopted by the regulations is that the decision-making authority should be analogous to that possessed by a board of directors of a corporation. If it is present, the LLC will possess the corporate characteristic of centralized management. If, on the other hand, the authority to make such decisions remains in the hands of the members, then the LLC appears to be organized more along the lines of a partnership. Centralized management is not present in general partnership. Any one partner can bind a partnership, so the decision-making power is not exclusive. Moreover, even if the partnership agreement provided that one of the partners was to have exclusive management authority, an innocent third party would not be bound by the agreement.

A manager-run LLC (whether the manager is a member or non-member) with authority meeting this definition would have the corporate characteristic of centralized management. A member-run LLC in which all members have an equal voice in management would lack this corporate characteristic. The issues will arise with LLC's which have something in between.

f. Choices Available

The flexibility provided by the Montana Limited Liability Company Act permits a continuum of management rights and powers being vested in the managers, ranging from those of a corporate officer (which would generally include administrative but not

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<sup>36</sup> Treas. Reg. §301.7701-2(c)(4).

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policy-setting management authority) to those of a general partner or a combined corporate officer and director (namely, both administrative and policy-setting management authority).

### Drafting Note

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If the intention of the members is that the LLC be taxed as a partnership, the Articles of Organization and the operating agreement could provide that the limited liability company will be managed by members.

If the intention of the members is that the LLC be treated as an association taxable as a corporation, the Articles of Organization and operating agreement could provide that the LLC will be managed by one or more managers who have decision-making authority.

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#### g. *The Use of Management Committees*

In a private letter ruling addressing the issue of whether a general partnership could convert to a LLC and continue to use the cash method of accounting, the IRS seems to have ratified the concept of using a management committee within a LLC while still lacking the corporate characteristic of centralized management.<sup>37</sup> But this was in a private letter ruling, so it cannot be relied on as precedent.

In this private letter ruling, none of the members was a corporation, the LLC had been organized so as to qualify for partnership tax treatment, and all of the members

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<sup>37</sup> Priv. Ltr. Rul. 93-28005.



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were actively engaged in the business (though not necessarily the management). The partnership did have an executive committee of partners that managed the partnership, which was to continue to manage the LLC after conversion. There was to be a change, however, in that after conversion, a vote of all LLC members would be required in order for the LLC to take certain action, such as admitting or expelling a member; determining compensation of members; making expenditures in excess of a specified amount; borrowing funds in excess of a specified amount; opening or closing a branch office; changing the name of the LLC or the location of its principal office; selling or otherwise disposing of all or substantially all of the assets of the LLC; dissolving the LLC; and amending the operating agreement. Under these facts, the IRS ruled that the LLC would be taxed as a partnership.

It appears, therefore, that having managers consisting of some but not all members is permissible. It is uncertain whether non-member management would pass muster. This probably is a question of degree.

### h. Management Authority vs. Agency Authority

The provisions regarding management authority are distinct and separate from the provisions regarding the authority of members and managers to bind the firm. The default rule is that every manager is an agent of the LLC for the purpose of its business or affairs and the act of any member binds the LLC.<sup>38</sup> If the Articles of Organization

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<sup>38</sup> 35-8-301(1), M.C.A.

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provide that management of the LLC is vested in a manager or managers, however, then no member, acting solely in the capacity as a member, is an agent of the LLC.<sup>39</sup> The Montana Limited Liability Company Act is intended to include a simple default provision for manager-managed companies that do not have detailed operating agreements.<sup>40</sup> Larger, more sophisticated, companies have the resources to include more detailed provisions in operating agreements. Smaller and simpler firms, the drafters felt, were likely to adopt default rules.

i. Qualifications of Managers

The Act does not specify any qualifications for managers or persons vested with governance authority. The members have the flexibility to designate managers and who may serve in such capacity for an indefinite period of time, on the other hand, to provide for election, removal and replacement of managers on an annual or other basis. The drafters felt that the annual meetings for election of managers would be unnecessarily costly for small LLCs so they did not include any such requirement in the Prototype Act.<sup>41</sup> If the LLC does wish to have annual meetings or other corporate formalities, those can be provided in the operating agreement.

### 4. Continuity of Life

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<sup>39</sup> 35-8-301(2) M.C.A.

<sup>40</sup> 35-8-301(2) M.C.A. *See also* Commentary to §401 of the Prototype Act.

<sup>41</sup> *See* Commentary following §401 of the Prototype Act.

## Drafting the Operating Agreement

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a. *Default Rule: No Continuity of Life*

The Montana Limited Liability Company Act provides that a limited liability company is dissolved and its affairs are wound up when any one of several specified events occur.<sup>42</sup> As a result, a Montana limited liability company will as a general rule lack the corporate characteristic of continuity of life. This again can be changed by contrary agreement of the members of the LLC. Consequently, this is a factor that needs to be taken into consideration when drafting the operating agreement.

b. *Distinguishing “Dissolution” From “Dissociation”*

It is important to distinguish “dissolution” from “dissociation.” When a limited liability company is dissolved, its affairs are wound up and it terminates. Dissolution may be caused by any of the events specified in 35-8-901, M.C.A., one of which is dissociation of a member (except as otherwise provided in the statute). The events of dissociation are set forth in 35-8-802, M.C.A., and include among other things withdrawal or removal of a member.

c. *The Tax Test for Continuity of Life*

The corporate attribute of continuity of life does not exist if “death, insanity, bankruptcy, retirement, resignation or expulsion of any member will cause dissolution of the organization.”<sup>43</sup> The Montana Limited Liability Act ties into this regulatory requirement in that it provides that death, insanity, bankruptcy, retirement, resignation

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<sup>42</sup> 35-8-901, M.C.A.

<sup>43</sup> Treas. Reg. §301.7701-2(b)(2).

## Drafting the Operating Agreement

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or expulsion of a member will each cause dissolution, but only if the business of the LLC is not continued by all remaining members within 90 days.<sup>44</sup> In other words, the LLC would automatically dissolve upon the occurrence of any one of the specified events, and therefore the LLC lacks continuity of life. The members, however, are permitted to agree either in the Articles of Organization or in the operating agreement that the dissolution of the LLC would not occur if any one of those events were to occur.<sup>45</sup> Due to this provision, members of the LLC can override the statutory default provision that would result in dissolution of the LLC and therefore the members can by agreement provide that the LLC will have continuity of life.

Continuity of life does not exist notwithstanding the fact that a dissolution may be avoided by the remaining members agreeing to continue the LLC or by at least a majority in interest of the remaining members agreeing to continue the LLC.<sup>46</sup>

“Dissolution” is described to mean “the alteration of the identity of an organization by reason of a change in the relationship between its members as determined by local law.”<sup>47</sup> For example, since the resignation of a partner from a general partnership destroys the mutual agency which exists between such partner and his copartners and thereby alters the personal relation between the partners which constitutes the identity

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<sup>44</sup> 35-8-901(3), M.C.A.

<sup>45</sup> 35-8-901(3), M.C.A.

<sup>46</sup> *Cf.* Treas. Reg. §301.7701-2(b)(1).

<sup>47</sup> Treas. Reg. §301.7701-2(b)(2).

## Drafting the Operating Agreement

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of the partnership itself, the resignation of a partner dissolves the partnership. That regulation goes on to provide as follows:

*A corporation, however, has a continuing identity which is detached from the relationship between its stockholders. The death, insanity, or bankruptcy of a shareholder or the sale of a shareholder's interest has no effect on the identity of the organization. An agreement by which an organization is established may provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization. Thus, there may be a dissolution of the organization and no continuity of life although the business is continued by the remaining members.*

The Internal Revenue Service in Rev. Rul. 88-76<sup>48</sup> determined that a LLC created under the Wyoming act would lack the corporate characteristic of continuity of life. A Wyoming LLC will dissolve upon the death, retirement, resignation, expulsion, bankruptcy, and certain other events, but the Wyoming act also permits the dissolution to be avoided if the remaining members unanimously agree to continue the business. In that Revenue ruling, unanimous consent was required and under the Montana act unanimous consent would be required in order to continue the business of the LLC.

Note that it is possible under the Montana Act to provide for something other than unanimous consent if so provided either under the Articles of Organization or under the operating agreement. Caution should be used if anything other than unanimous consent will be required to continue the business. Revenue Ruling 88-76 does not specify the

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<sup>48</sup>

Rev. Rul. 88-76., 1988-2 CB 360.

## Drafting the Operating Agreement

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tax consequences of providing that the LLC may be continued on a less than unanimous vote following member dissociation. Drafters of the Prototype Act were uncertain what consequences would flow from having a less than unanimous consent required for continuation of the business.<sup>49</sup> Consequently, the Act was drafted with a unanimous consent required.

d. *The Purpose of Dissolution Upon Dissociation*

In effect, the Montana Limited Liability Company Act provides dissolution-at-will, as a default rule. Dissolution is caused by:

- (1) the occurrence of events specified in writing in the Articles of Organization or the operating agreement;
- (2) the written consent of all members;
- (3) an event of dissociation of a member; or
- (4) entry of a decree of judicial dissolution under 35-8-902, M.C.A.

An “event of dissociation of a member” includes the withdrawal of a member.<sup>50</sup> There are important exceptions to this rule, and those exceptions will be explored subsequently. But at this point, it is important to understand that the withdrawal of a member, under the default rules of the Montana Limited Liability Company Act, will cause a dissolution of the LLC, and in that sense, any member may dissolve an LLC at-will.

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<sup>49</sup> Commentary, §901 Prototype Act.

<sup>50</sup> 35-8-802(3), M.C.A.

## Drafting the Operating Agreement

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The purpose of dissolution-at-will, in the eyes of the drafters, is to provide liquidity for the members' interests.<sup>51</sup> The same purpose could have been achieved by allowing members to withdraw and cash out, but the drafters felt that in very closely held firms accurate valuation may be difficult or impossible without a sale of all the assets. In addition, the members may well be relying on the management skills of other members, and accordingly would expect to liquidate when one of them leaves. Valuation and interdependence of members presumably are not as problematic in larger firms. The statute, however, was drafted with the smaller firm in mind, because they would be less likely to have a detailed operating agreement. The drafters, therefore, decided the default rule should be dissolution-at-will.<sup>52</sup>

e. Choices Under the Statute

The statute does provide flexibility, however. Dissolution-at-will is only the default rule. In general, a member may withdraw at any time by giving 30 days' written notice to the other members.<sup>53</sup> The Articles of Organization or the operating agreement may provide to the contrary.

An important exception to the rule that dissociation of a member causes dissolution of the LLC is found in 35-8-901(3), M.C.A., which provides that the LLC will not dissolve if within 90 days following an event of dissociation, the remaining members

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<sup>51</sup> Commentary, §901, Prototype Act.

<sup>52</sup> Commentary, §901, Prototype Act.

<sup>53</sup> 35-8-802(3), M.C.A.

## Drafting the Operating Agreement

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consent to continue the LLC. This permits the remaining members to avoid dissolution of the limited liability company, although the statute does require unanimous consent of the remaining members and therefore any one member could stand in the way of preventing a dissolution.

It should also be noted that this subsection permits the general rule of dissolution upon dissociation to be avoided by otherwise providing in writing in the Articles of Organization or operating agreement. This rule of dissolution can be overcome only by having the contrary provision in writing and only if the provision is found in the Articles of Organization or operating agreement.

f. *Period of Duration*

The Articles of Organization may provide that the LLC is to continue for a stated period or until the completion of a stated undertaking or they may provide for the termination of the LLC at will or otherwise. In determining whether any member has the power of dissolution, the regulations provide that it will be necessary to examine the agreement and to ascertain the effect of such agreement under local law.<sup>54</sup> For example, if the Articles of Organization expressly provide that the LLC can be terminated by the will of any member, it is clear that the organization lacks continuity of life. However, if the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect

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<sup>54</sup> Treas. Reg. §301.7701-2(b)(3).



## Drafting the Operating Agreement

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of the agreement is that no member has the power to dissolve the organization in contravention of the agreement. Nevertheless, if, notwithstanding such agreement, any member has the power under local law to dissolve the organization, the organization lacks continuity of life. Accordingly, under the default provisions of 35-8-901, M.C.A., a limited liability company would lack continuity of life.

The Articles of Organization require a statement as to the latest date on which the LLC is to dissolve.<sup>55</sup> LLC statutes in several states provide that the Articles of Organization must specify the period of the LLC's duration, which may not exceed thirty years.<sup>56</sup> The thirty-year limitation in and of itself is not sufficient to cause the LLC to lack the corporate characteristic of continuity of life.<sup>57</sup> The Montana Limited Liability Act does not contain this limitation. The attorney should not assume that merely by specifying a period of years for the duration of the LLC that it thereby lacks continuity of life. The regulations provide that a stated period is only one method of providing for lack of continuity of life.<sup>58</sup>

g. *Dissociation*

The events upon which there is a dissociation are set forth at 35-8-802, M.C.A. In general, there will be a dissociation when a member:

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<sup>55</sup> 35-8-202(1)(b), M.C.A.

<sup>56</sup> For example, see Wyo. Stat. §17-15-107(a)(ii) (1977); Colo. Rev. Stat. 7-80-  
<sup>57</sup> See Commentary §201, Prototype Act, citing Gazer & Goff "Assessing the Limited Liability Company" 41 CASE WESTERN RES. L.REV. 399-400 (1991).

<sup>58</sup> Treas. Reg. §301.7701-2(b)(3).

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- (a) withdraws by voluntary act
- (b) assigns his interest and the assignee becomes a member with respect to the assigned interest;
- (c) is removed as a member;
- (d) in accordance with the Articles of Organization or the operating agreement;
- (e) makes an assignment for the benefit of creditors;
- (f) files a voluntary petition in bankruptcy;
- (g) is adjudicated as bankrupt or insolvent;
- (h) dies;
- (i) is adjudicated incompetent;
- (j) becomes a disqualified person (in the case of a professional LLC).

This list is not complete. 35-8-802, M.C.A. provides other events of dissociation.

By providing for these events of dissociation, and providing in 35-8-901, M.C.A. that the LLC will be dissolved upon an event of dissociation, the dissociating member is ensured payment for his interest. There is a cost, to dissolution, however, in that the business has to be wound up.

In effect, all of the dissociation causes are subject to contrary written provision in the Articles of Organization or operating agreement. Accordingly, the operating agreement may provide that, for example, death or bankruptcy does not constitute an

## Drafting the Operating Agreement

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event of dissociation or that the member cannot withdraw by voluntary act.<sup>59</sup> With such a provision, an LLC member, like a corporate shareholder, would have no right to “put” his interest back to the firm. If no public market exists for a LLC interest, such a put may be a suitable default term; but, at the same time, the parties should be able to contract around the term if they determine that the costs of dissociation outweigh the benefits in particular situations.

### 5. Free Transferability of Ownership Interests

#### a. Default Rule: No Free Transferability of Interests

Montana LLC's generally will not have free transferability of interests. That is because a member has the right only to transfer rights to distributions.<sup>60</sup> This could be changed by the operating agreement or the Articles of Organization,<sup>61</sup> which would result in the LLC having the corporate characteristic of free transferability of interest.

#### b. The Tax Test for Free Transferability of Ownership Interests

The regulations define free transferability of ownership interests as the power without the consent of the other members to substitute for oneself in the same organization a person who is not a member.<sup>62</sup> In other words, an organization has the corporate characteristic of free transferability of interests if each of its members or those

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<sup>59</sup> Commentary, §802, Prototype Act.

<sup>60</sup> 35-8-704(1)(b), M.C.A.

<sup>61</sup> 35-8-704(1), MCA.

<sup>62</sup> Treas. Reg. §301.7701-2(b)(2).

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members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization.

Under this definition, it is not enough to have the power to assign one's interest, if the assignment does not carry with it *all* attributes of the member's interest in the organization, including voting rights and rights to distributions. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization.

The right to share in the profits is not enough transfer of interest to constitute free transferability of interest.<sup>63</sup> For example, the interest would not be transferable if the assignor could transfer the right to his share of income but could not also assign his right to participate in management. The characteristic of free transferability of interests does not exist in a case in which each member can, without the consent of other members, assign only his right to share in profits but cannot so assign his rights to participate in the management of the organization.

Finally, transferability will not exist if under local law the transfer results in dissolution of the old organization and formation of a new organization. Although the agreement provides for the transfer of a member's interest, there is no power of

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<sup>63</sup> Rev. Rul. 88-76.

## Drafting the Operating Agreement

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substitution and no free transferability of interest if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization.

Providing for a right of first refusal may be permitted. In other words, a requirement that a member first offer his interest to other members will be accorded less significance than an unmodified restriction. If each member of an organization can transfer his interest to a person who is not a member of the organization only after having offered such interest to the other members at its fair market value, it will be recognized that a modified form of free transferability of interests exists. In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form.

c. *Limitations on the Rights of Assignees*

The Montana Limited Liability Company Act not only denies the assignee voting and management rights, but also rights to information and any right to compel dissolution of the firm.<sup>64</sup> This result, however, may be changed by agreement.

### Drafting Note

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Some firms may want to give assignees a right to compel winding up to prevent them from being completely frozen in, and a right to information assignees need for federal tax purposes and to protect them from unfair dealing by the members.

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<sup>64</sup> Commentary, §704, Prototype Act.

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d. Continuing Rights of the Assignor

The assignor retains management and information rights notwithstanding the transfer.<sup>65</sup>

### Drafting Note

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Although the assignor retains management rights, the assignor and assignee can contract regarding exercise of these rights.

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e. Protection Afforded the Assignee

Until an assignee of a membership interest becomes a member, the assignee has no liability as a member solely as a result of the assignment.<sup>66</sup>

f. Continuing Liability of the Assignor

Until an assignee of a membership interest becomes a member, the assignor is not released from liability as a member solely as a result of the assignment.<sup>67</sup>

g. Security Interests As Assignments

The pledge or grant of a security interest, lien, or other encumbrance in or against any of the membership interest of a member is not an assignment and may not cause the member to cease to be a member or cease to have the power to exercise any rights or powers of a member.<sup>68</sup> The Articles of Organization or operating agreement may provide otherwise.

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<sup>65</sup> 35-8-704(1)(d), M.C.A.

<sup>66</sup> 35-8-704(1)(e), M.C.A.

<sup>67</sup> 35-8-704(1)(f), M.C.A.

<sup>68</sup> 35-8-704(3), M.C.A.

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### Drafting Note

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Consider providing in the Articles of Organization or the operating agreement restrictions on the rights of members to pledge membership interests as security.

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## 6. Examples

The Regulations<sup>69</sup> provide the following examples of the application of the tests to determine the tax status of an organization:

- (a) *Example:* A group of seven doctors forms a clinic for the purpose of furnishing, for profit, medical and surgical services to the public. They each transfer assets to the clinic, and their agreement provides that except upon complete liquidation of the organization on the vote of three-fourths of its members, no member has any individual interest in its assets. Their agreement also provides that neither the death, insanity, bankruptcy, retirement, resignation, nor expulsion of a member shall cause the dissolution of the organization. However, under the applicable local law, a member who withdraws does have the power to dissolve the organization. While the agreement provides that the management of the clinic is to be vested exclusively in an executive committee of four members elected by all the members,

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<sup>69</sup> Treas. Reg. §301.7701-2(g).

## Drafting the Operating Agreement

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this provision is ineffective as against outsiders who had no notice of it; and, therefore, the act of any member within the scope of the organization's business binds the organization insofar as such outsiders are concerned. While the agreement declares that each individual doctor alone is liable for acts of malpractice, members of the clinic are, nevertheless, personally liable for all debts of the clinic including claims based on malpractice. No member has the right, without the consent of all the other members, to transfer his interest to a doctor who is not a member of the clinic. The organization has associates and an objective to carry on business and divide the gains therefrom. However, it does not have the corporate characteristics of continuity of life, centralized management, limited liability, and free transferability of interests. The organization will be classified as a partnership for all purposes of the Internal Revenue Code.

- (b) **Example:** A group of 25 lawyers forms an organization for the purpose of furnishing, for profit, legal services to the public. Their agreement provides that the organization will dissolve upon the death, insanity, bankruptcy, retirement, or expulsion of a member. While their agreement provides that the management of the organization is to be vested exclusively in an executive committee of five members



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elected by all the members, this provision is ineffective as against outsiders who had no notice of it; and, therefore, the act of any member within the scope of the organization's business binds the organization insofar as such outsiders are concerned. Members of the organization are personally liable for all debts, or claims against, the organization. No member has the right, without the consent of all the other members, to transfer his interest to a lawyer who is not a member of the organization. The organization has associates and an objective to carry on business and divide the gains therefrom. However, the four corporate characteristics of limited liability, centralized management, free transferability of interests, and continuity of life are absent in this case. The organization will be classified as a partnership for all purposes of the Internal Revenue Code.

- (c) **Example:** A group of 25 persons forms an organization for the purpose of engaging in real estate investment activities. Each member has the power to dissolve the organization at any time. The management of the organization is vested exclusively in an executive committee of five members elected by all the members, and under the applicable local law, no one acting without the authority of this

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committee has the power to bind the organization by his acts. Under the applicable local law, each member is personally liable for the obligations of the organization. Every member has the right to transfer his interest to a person who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While the organization does have the characteristics of centralized management and a modified form of free transferability of interests, it does not have the corporate characteristics of continuity of life and limited liability. Under the circumstances presented, the organization will be classified as a partnership for all purposes of the Internal Revenue Code.

- (d) **Example:** A group of 25 persons forms an organization for the purpose of engaging in real estate investment activities. Under their agreement, the organization is to have a life of 20 years, and under the applicable local law, no member has the power to dissolve the organization prior to the expiration of that period. The management of the organization is vested exclusively in an executive committee

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of five members elected by all the members, and under the applicable local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Under the applicable local law, each member is personally liable for the obligations of the organization. Every member has the right to transfer his interest to a person who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While the organization does not have the corporate characteristics of limited liability, it does have continuity of life, centralized management, and a modified form of free transferability of interests. The organization will be classified as an association for all purposes of the Internal Revenue Code.

- (e) **Example:** A group of 25 persons forms an organization for purposes of engaging in real estate investment activities. Each member has the power to dissolve the organization at any time. The management of the organization is vested exclusively in an executive committee of five members elected by all the members, and under the applicable

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local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Under the applicable local law, the liability of each member for the obligations of the organization is limited to paid and subscribed capital. Every member has the right to transfer his interest to a person who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While the organization does not have the characteristic of continuity of life, it does have limited liability, centralized management, and a modified form of free transferability of interests. The organization will be classified as an association for all purposes of the Internal Revenue Code.

- (f) **Example:** A group of 25 persons forms an organization for the purpose of investing in securities so as to educate the members in principles and techniques of investment practices and to share the income from such investments. While the agreement states that the organization will operate until terminated by a three-fourths vote of the total membership and will not terminate upon the withdrawal or

## **Drafting the Operating Agreement**

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death of any member, under the applicable local law, a member has the power to dissolve the organization at any time. The business of the organization is carried on by the members at regular monthly meetings and buy or sell action may be taken only when voted by a majority of the organization's membership present. Elected officers perform only ministerial functions such as presiding at meetings and carrying out the directions of the members. Members of the organization are personally liable for all debts of, or claims against, the organization. No member may transfer his membership. The organization has associates and an objective to carry on business and divide the gains therefrom. However, the organization does not have the corporate characteristics of limited liability, free transferability of interests, continuity of life, and centralized management. The organization will be treated as a partnership for all purposes of the Internal Revenue Code.

### **E. NON-TAX CONSIDERATIONS**

Once there is a basic understanding of the tax concepts involved, the operating agreement can be drafted to cover other matters. Among other things, the following items might be considered for inclusion in the operating agreement:

## Drafting the Operating Agreement

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b. *Powers and Duties of Managers*

Is the LLC to be governed by a manager or by the members? If by a manager, will it be one manager, or more? What authority will the manager have, and conversely, what authority will members *not* have? Will a management committee be used?

c. *Restrictions on New Members*

What restrictions will be placed on the admission of new members? What level of consent will be required by the other members?

d. *Capital Contributions*

What contributions of capital to the LLC will be required of the members? When can they be obligated to contribute additional amounts? And who will make that determination?

e. *Profits and Losses*

How are items of income and loss to be allocated to the members? When will withdrawals of earnings be permitted?

f. *Transfer Restrictions*

What restrictions will be placed on the transfer of membership interests? Will a right of first refusal be given to the other members?

g. *Wrongful Dissociation*

Will there be any penalty for a wrongful dissociation?

h. *Indemnification*

## Drafting the Operating Agreement

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Should the manager or any members be indemnified for actions taken on behalf of the LLC?

i. Amendment

How is the operating agreement to be amended?

### F. SAMPLE AGREEMENT

Former University of Montana Law School Professor Steve Bahls (now dean at Capital University Law School in Columbus, Ohio), through the State Bar of Montana, has published a Model Operating Agreement for a Montana limited liability company, which is reproduced here by permission. It is included in the manual of corporate forms published by the State Bar, and may be purchased both in hard copy and on disk. This form will be in common use simply because it published by the State Bar. This form does not contain detailed provisions relating to special allocations under §704 of the Internal Revenue Code or other sophisticated provisions. For an example of a more detailed operating agreement, the reader might wish to review Bishop & Kleinberger.<sup>70</sup>

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*See note 7.*

**MODEL LIMITED LIABILITY COMPANY OPERATING AGREEMENT**

THIS AGREEMENT IS SUBJECT TO ARBITRATION UNDER THE  
MONTANA UNIFORM ARBITRATION ACT

**OPERATING AGREEMENT**

of

\_\_\_\_\_ **Limited Liability Company**

**SECTION 1**

Name, Place of Business, Term, Initial Members

**1.1 Name.** The name of the Limited Liability Company is \_\_\_\_\_.

**1.2 Principal Place of Business.** The principal place of business of the Limited Liability Company is \_\_\_\_\_.

**1.3 Term.** The Limited Liability Company begins on the date of filing its Articles of Organization with the Secretary of State, and continues until dissolved by an act specified in Section 9 of this Agreement or a date or act specified by the Limited Liability Company's Articles of Organization.

**1.4 Initial Members.** The initial Members of the Limited Liability Company are \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_. The Initial Limited Liability Company Percentages of the initial Members are set forth in Exhibit A.

**SECTION 2**

**Purposes of the Business**

The Limited Liability Company may engage in the business of \_\_\_\_\_ and in any other lawful business upon which Members owning a majority of the Limited Liability Company Percentages may agree.



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### SECTION 3

#### **Contributions to Capital and Assumption of Liabilities**

**3.1 Capital Accounts.** (a) Each initial Member shall contribute the property listed in Exhibit A to the Limited Liability Company.

(b) Each Member has an individual Capital Account. The amount of the Initial Capital Account of each Member is set forth in Exhibit A.

**3.2 Assumption of Liabilities.** (a) The Limited Liability Company assumes the liabilities of the initial Members described in Exhibit A.

(b) Neither the Limited Liability Company nor the Members assume any liabilities not described in Exhibit A.

**3.3 Warranty of Members.** Each Member represents and warrants to the Limited Liability Company and to each other that the Limited Liability Company has good and marketable title to the property contributed pursuant to Section 3.1(a) and described in Exhibit A and that the property is free and clear from all encumbrances at the time of contribution, except for those encumbrances relating to those liabilities specifically described in Exhibit A.

**3.4 Limitation on Withdrawal.** Except by unanimous vote of the Members, Members may not withdraw from the Capital Accounts or add to their Capital Accounts.

**3.5 Additional Contributions.** No Member shall be obligated to make any additional contributions to the Limited Liability Company Members.

### SECTION 4

#### **Profits and Losses**

**4.1 Income Account.** There is an Income Account for each Member. The amount of the Initial Income Accounts of the initial Members are set forth in Exhibit A.

**4.2 Allocation of Net Profits and Losses.** In accordance with generally accepted accounting principles, the Limited Liability Company's accountant or bookkeeper shall

## Drafting the Operating Agreement

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determine Net Profits or Losses of the Limited Liability Company as of the close of each fiscal year. The Limited Liability Company's accountant or bookkeeper shall allocate the Net Profits and Losses to each Member's Income Account in accordance with their Limited Liability Company Percentages as of the close of each fiscal year.

**4.3 Withdrawal from Income Accounts.** Withdrawals from the Income Accounts are limited to an amount determined by the Members owning a majority of the Limited Liability Company Percentages. The Members owning a majority of the Limited Liability Company Percentages may determine an amount of Required Balance per Limited Liability Company Percentage. Any amount in a Member's Income Account below the Required Balance may not be withdrawn except by unanimous vote of the Members.

**4.4 Interest.** As of the first day of each fiscal year, the Limited Liability Company's accountant or bookkeeper shall credit the balance in each Member's Income Account with interest at the prime rate stated in the Wall Street Journal on the last business day of the prior year.

### SECTION 5

#### Management

**5.1 Management.** Each Member has a vote in the management and conduct of the Limited Liability Company business.

**5.2 Vote Required.** If this Agreement does not specify the amount of the vote of the Limited Liability Company Percentages that is needed to make a decision, the decision may be made by an affirmative vote of the Members owning a majority of the Limited Liability Company Percentages entitled to vote.

**5.3 Salary.** Each Member may receive a salary. The amount of such salary must be approved by Members owning a majority of the Limited Liability Company Percentages. The Limited Liability Company shall treat the salaries of Members as a Limited Liability Company expense in determining Net Profits or Losses.

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### SECTION 6

#### Deadlock

**6.1 General.** If the Members are equally divided on the basis of Limited Liability Company Percentages on any aspect of the management of the property, business and affairs, and the deadlock is preventing action or non-action by the Limited Liability Company, then the Limited Liability Company may submit the deadlock to mediation in accordance with section 6.2. If the Members are unable to resolve the deadlock through mediation, the Members agree to submit the dispute to binding arbitration in accordance with section 6.3.

**6.2 Mediation.** If the Members are unable to resolve the deadlock itself, upon written request of Members owning 50% of the Limited Liability Company Percentages, the Members agree to submit the dispute to mediation and the following guidelines shall apply:

(a) The Members agree to have the dispute mediated by one of the following people or organizations (in the order listed, circumstances permitting):

- (i)
- (ii)
- (iii)

(b) The Members agree to follow the mediation procedure selected by the mediator.

(c) Mediation shall terminate upon the written request of the mediator or Members owning 50% of the Limited Liability Company Percentages.

**6.3 Arbitration.** If the Members are unable to resolve the deadlock through mediation, upon written request of Members owning 50% of the Limited Liability Company Percentages, the Members agree to submit the deadlock to binding arbitration in the following manner:

(a) The Members agree to have the dispute arbitrated by one of the following people or organizations (in the order listed), circumstances permitting.

- (i)
- (ii)
- (iii)

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(b) The arbitrator shall resolve the deadlock, if the arbitrator determines the arbitrator's resolution of the deadlock is in the best interests of the Limited Liability Company. The arbitrator may decide whether matters have been properly submitted to the arbitrator for decision, whether there exists a deadlock, and whether this section and the arbitration provisions provided here were properly invoked by the Limited Liability Company or applicable. The arbitrator may act until all questions, disputes and controversies are determined, adjudged, and resolved.

(c) The arbitrator shall conduct the arbitration proceedings in accordance with the rules of the American Arbitration Association, then in effect, except where this Operating Agreement makes a special provision.

(d) If the arbitrator finds that (i) there have been successive arbitrations, (ii) it is likely that there will be successive arbitrations in the future to resolve most major Limited Liability Company decisions, (iii) it is in the best interest of all Members that that Limited Liability Company or a group of Members buys the interest of one or more Members or that there be a dissolution, then the arbitrator may decree a dissolution or may decree that the Limited Liability Company buy out one or more of the Members. If the arbitrator decrees a buyout, the arbitrator shall decree the terms of the buyout.

(e) The arbitrator's decision shall be conclusive and binding upon the Members and Limited Liability Company. The Limited Liability Company may not revoke, amend or overrule the decision, except by an action of Members owning a majority of the Limited Liability Company Percentages.

### SECTION 7

#### Dissociation

**7.1 Events of Dissociation.** A Member ceases to be a Member of the Limited Liability Company upon the happening of one of these events of dissociation:

(a) after a Member reaches the age of \_\_\_\_, receipt by the Limited Liability Company of notice of the Member's express will to retire as a Member or upon any later date specified in the notice;

(b) after  (date) , receipt by the Limited Liability Company of notice of the Member's express will to withdraw as a Member or upon any later date specified in the notice;

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(c) receipt by the Limited Liability Company of notice of the Member's express will to withdraw as a Member on or prior to     (same date as in 7.1(b))     ;

(d) subject to the contrary written consent of all Members, the Member:

(i) makes an assignment for the benefit of creditors;

(ii) files a voluntary petition in bankruptcy;

(iii) is adjudicated a bankrupt or insolvent;

(iv) files a petition or answer seeking a reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation;

(v) files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against the Member in any proceeding under subsection (d); or

(vi) seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the Member or of all or any substantial part of the Member's properties;

(e) subject to the contrary written consent of all Members at the time if

(i) 120 days after the commencement of any proceeding against the Member seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution,

(ii) similar relief under any statute, law, or regulation, the proceeding has not been dismissed, within 90 days after the appointment without the Member's consent or acquiescence of a trustee, receiver, or liquidator of the Member or of all or any substantial part of the Member's properties, the appointment is not vacated or stayed; or

(iii) or within 90 days after the expiration of any stay, the appointment is not vacated;

(f) in the case of a Member who is an individual:

(i) the Member's death prior to age     (same age as in 7.1(a))     ; or

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(ii) the Member's death after the Member has attained the age of (same age as in 7.1(a)) ; or

(iii) the entry of an order by a court of competent jurisdiction adjudicating the member incompetent to manage the Member's person or estate;

(g) subject to the contrary written consent of all Members at the time, in the case of a Member who is a trustee or is acting as a Member by virtue of being a trustee of a trust, the termination of the trust, but not merely the substitution of a new trustee;

(h) subject to the contrary written consent of all members at the time, in the case of a Member that is a separate limited liability company, the dissolution and commencement of winding up of the separate limited liability company;

(i) subject to the contrary written consent of all members at the time, in the case of a Member that is an estate, the distribution by the fiduciary of the estate's entire interest in the Limited Liability Company; or

(j) the Member's expulsion by a vote of the remaining Members owning \_\_\_% of the Limited Liability Company Percentages if:

(i) it is unlawful to carry on the Limited Liability Company business with that Member;

(ii) the Member is convicted of a felony committed against the Limited Liability Company or involving the Limited Liability Company business;

(k) Subject to the contrary written consent of all members at the time, a Member voluntarily or involuntarily transfers that Member's Membership Interest in the Limited Liability Company in violation of this Agreement or the Montana Limited Liability Company Act.

**7.2 Purchase Price.** (a) Continuation. Members not dissociating (Remaining Members) may elect that the business of the Limited Liability Company be continued by the Remaining Members. This election must be made within 90 days of the date of dissolution by a unanimous vote of all of the Remaining Members. If an election to continue is made, the Member or the estate or legal representative of the Member causing the dissociation (Dissociated Member) shall be paid the following amount to be determined, unless otherwise stated, as of the date of dissociation.

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(i) Retirement or Death After Retirement Age. If an individual Member voluntarily withdraws pursuant to 7.1(a) or dies after reaching age specified in Section 7.1(f)(i), then the purchase price of the Member's interest shall be:

a. an amount per Limited Liability Company Percentage determined to be the purchase price pursuant to this section by the vote of Members owning \_\_\_\_% of the Percentages at the most recent annual meeting of the Limited Liability Company. If no amount was so determined at the last annual meeting, the amount determined at the prior recent annual meeting shall be the amount.

b. if the Limited Liability Company did not determine an amount at the most recent annual meeting or the prior year's annual meeting, then the amount shall equal the sum of Dissociated Member's:

- Capital Account (as of the close of the previous quarter of the fiscal year);
- Income Account (as of the close of the previous quarter of the fiscal year);
- Earned and unpaid salary due, if any;
- Proportional share (based on proportional Partnership Percentages) of the Appraised Surplus multiplied by \_\_\_\_.

The amount of Appraisal Surplus equals the Appraised Value of the Limited Liability Company minus the sum of all Capital Accounts and Income Accounts (as of close of the previous quarter of the fiscal year). The Appraised Value of the Limited Liability Company shall be determined by an appraiser named by the Limited Liability Company's principal bank. If the Limited Liability Company's principal bank does not appoint an appraiser within sixty days of a written request (made by either Dissociated Partner or the Partnership), the Partnership's principal accountant shall appoint the appraiser. The appraiser shall appraise the Limited Liability Company as a going concern, with no discount for lack of marketability of the Limited Liability Company interests.

(ii) Permitted Withdrawal After (date specified in Section 7.1(b)). If an individual Member voluntarily withdraws pursuant to Section 7.1(b), the purchase price

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This provision allows the Limited Liability Company to reduce the amount of payment to the retiring or deceased Member by an amount to reflect a discount for lack of marketability of the interest or a discount for a minority interest. Appropriate discounts might range from 5% to 50%. If a 5% discount is desired the attorney should complete the blank with a ".95."

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of the Member's interest shall be determined by Subsection (i) of Section 7.2 except the proportional share of the Appraisal Surplus shall be multiplied by \_\_\_\_.\*

(iii) Withdrawal before (date specified in Section 7.1(c)) or Expulsion. If the Member becomes a Dissociated Member by reason of Sections 7.1(c), 7.1(j) or 7.1(k), the purchase price shall be the sum of the Dissociated Member's

- Capital Account (as of the close of the previous quarter of the fiscal year);
- Income Account (as of the close of the previous quarter of the fiscal year);
- Earned and unpaid salary, if any,

minus (a) if the withdrawal is by reason of Section 7.1(c), the amount of any damages caused by the withdrawal of the Member before the date stated in Section 7.1(c); or (b) if the withdrawal is by reason of Section 7.1(j) or 7.1(k), the amount of damages described in subsection (a) of this paragraph plus the amount of other damages caused by the Dissociated Partner or the amount caused by the expelled Member.

(iv) Other Dissociations. If the Member becomes a Dissociated Member pursuant to any other Section, the purchase price shall be the sum of the Dissociated Members'

- Capital Account (as of the close of the previous quarter of the fiscal year);
- Income Account (as of the close of the previous quarter of the fiscal year);
- Earned and unpaid salary, if any.

**7.3 Terms of Payment.** (a) Terms of Promissory Note. The purchase price specified in Section 7.2, if positive, will be paid within 120 days of dissociation by a promissory note drawn on the Limited Liability Company. The promissory note will provide for equal monthly payment of principal and interest at the rate of 12% per annum. Such payments will be paid over a period of 36 months, starting with one month after the date of the promissory note. The promissory note will provide for no prepayment penalty and will be immediately due and payable if there is a failure to make a timely payment of principal or interest and such payment is not made within 20 days of the date written demand to make payment is received.

(b) Security for Payment. The promissory note will be secured by a security interest (junior to all security interests existing on the date of dissociation) in all the equipment, real estate, accounts receivable and inventory of the Limited Liability Company. The Limited Liability Company agrees to take such actions to perfect the security interest as the



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Dissociated Member reasonably requests. The Limited Liability Company agrees to execute such agreement or documents to perfect such security interest and to specify the rights of the secured party as an attorney to be appointed by the Limited Liability Company reasonably deems appropriate.

**7.4 Continuation of Limited Liability Company.** In the event the Limited Liability Company purchases the interest of the Dissociating Member pursuant to the unanimous vote of the Members, then the Remaining Members agree to continue the Limited Liability Company under the terms of this agreement, except that their Limited Liability Company Percentages will be increased on a pro-rata basis as of the date of dissociation. The Dissociated Member will have no rights, except those specified in this Section, as of the date of dissolution if the Remaining Members elect to continue the business. In the event that the Remaining Members do not unanimously elect to continue the Limited Liability Company, then the Limited Liability Company will be wound up in accordance with Section 9.

### SECTION 8

#### Assignment

**8.1 General Rules Regarding Assignment.** The rules in this Section govern the assignment of a Member Interest.

(a) a Membership Interest is assignable in whole or in part;

(b) an assignment entitles the assignee to receive, to the extent assigned, only the distributions to which the assignor would be entitled;

(c) an assignment of a Membership Interest does not entitle the assignee to participate in the management and affairs of the Limited Liability Company or to become or to exercise any rights of a Member;

(d) an assignee may not become a Member, except upon the unanimous consent of all Members.

(e) until the assignee of a Limited Liability Company Interest becomes a Member, the assignor continues to be a Member and to have the power to exercise rights of a Member, subject to the Members' or Limited Liability Company's right to remove the assignor pursuant to this Operating Agreement.

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**8.2 Pledge of Membership Interest.** The pledge or granting of a security interest, lien, or other encumbrance in or against any of the Membership Interests of a Member is not an assignment and may not cause the Member to cease to be a Member or to cease to have the power to exercise any rights or powers of a Member.

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### SECTION 9

#### Dissolution

**9.1 Events of Dissolution.** The Limited Liability Company is dissolved upon the happening of one of the following events:

- (a) at the time or upon the occasion of events specified in the Limited Liability Company's Articles of Organization;
- (b) a dissociation pursuant to Section 7.1 and no election has been made by the Remaining Members to continue the business pursuant to Section 7.2;
- (c) all of the Members consent to a dissolution;
- (d) the entry of a decree of judicial dissolution.

**9.2 Articles of Dissolution.** Upon the dissolution and the commencement of winding up of the Limited Liability Company, the Limited Liability Company shall file Articles of Dissolution with the Secretary of State.

**9.3 Procedure.** Upon dissolution, the affairs of the Limited Liability Company will be wound up upon dissolution by liquidating the assets of the Limited Liability Company. The liabilities of the Limited Liability Company will rank in order of payment as follows:

- (a) Those owing to creditors including Members, other than liabilities to Members for distributions pursuant to Section 7.
- (b) Those owing to the Member pursuant to Section 7.
- (c) Those owing to the Members in respect of the Member's Capital Accounts.
- (d) Those owing to the Members in respect of the Member's Income Accounts.

Any remaining funds or assets will be then distributed to the Members in accordance with their Limited Liability Company Percentages.

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### SECTION 10

#### Members' Powers and Limitations

**10.1 Bank accounts--checks.** The Limited Liability Company may maintain a bank account in such bank as it selects.

**10.2 Acts Beyond Powers of Member.** No Member may, without unanimous consent:

- (a) dispose of the goodwill of the Limited Liability Company or convey, encumber, or lease any other asset of the business outside the ordinary course of business;
- (b) cause the Limited Liability Company to be converted to another form of business entity;
- (c) do any act which would make it impossible to carry on the ordinary business of a Limited Liability Company; or
- (d) cause the Limited Liability Company to be merged with another business; and
- (e) cause the admission of a new Member.

### SECTION 11

#### Indemnification

**11.1 Mandatory Indemnification.** Subject to Section 11.2, the Limited Liability Company shall indemnify a Member for judgments, settlements, penalties, fines, or expenses incurred in a proceeding to which an individual is a party because the individual is or was a Member.

**11.2 Limitations on Indemnification.** The Limited Liability Company may not indemnify a Member from liability for

- (a) the amount of a financial benefit received by a Member to which the Member is not entitled;
- (b) an intentional infliction of harm by the Member on the Limited Liability Company or its Members;

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- (c) an intentional violation of criminal law by the Member; or
- (d) an unlawful distribution by the Member.

### SECTION 12

#### Miscellaneous

**12.1 Books and Records.** The Limited Liability Company shall keep at its principal place of business:

- (a) a current list in alphabetical order of the full name and last known business street address of each Member;
- (b) a copy of the Articles of Organization and all certificates of amendment to them, together with executed copies of any powers of attorney pursuant to which any certificate of amendment has been executed;
- (c) copies of the Limited Liability Company's federal, state and local income tax returns and reports, if any, for the three most recent years;
- (d) copies of any financial statements of the Limited Liability Company, if any, for the three most recent years; and
- (5) a copy of this Operating Agreement and any amendments thereto.

**12.2 Annual Meeting.** The Members shall meet annually at noon on the (first, second, etc.) (day of week) of each (month) at the principal place of business of the Limited Liability Company. They may meet at such other times as the Members owning 20% of the Membership Percentages specify in a written notice mailed or personally delivered to each Member at least five days before the meeting.

**12.3 Amendment.** The Members may amend this Agreement and Exhibit A upon execution of a written amendment signed by all of the Members.

**12.4 Fiscal Year.** The Limited Liability Company's fiscal year shall be a calendar year.

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**12.5 Governing Law.** This Agreement is governed by the laws of the State of Montana.

This Operating Agreement is signed on \_\_\_\_\_.

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### EXHIBIT A

Initial Limited Liability Company Percentages: (Section 1.4):

Member A

Member B

Member C

Description of Initial Property Contributed (Section 3.1(a)):

Member A

Member B

Member C

Value of Initial Capital Accounts (Section 3.1(b)):

Member A

Member B

Member C

Description of Liabilities Assumed (Section 3.2):

Member A

Member B

Member C

Value of Initial Income Accounts (Section 4.1):

Member A

Member B

Member C