Maintenance of LLC's:

How to avoid imposition of personal liability of

LLC members and unintended liquidation

David J. Dietrich
& Cory S. Steinmetz
Dietrich & Associates, P.C.
404 North 31st Street, Suite 213
P.O. Box 7054
Billings, MT 59103
Phone: 406-255-7150
Email: ddietrich@dietrichlaw.com

David J. Dietrich
Dietrich & Associates, P.C.
404 N. 31st Street, Suite 213
Billings, Montana 59103-7054

David is a fellow of the American College of Trust and Estate Counsel, one of fifteen in Montana. David is currently the Chair Elect of the 22,000 lawyer Real Property Trust and Estate (RPTE) Law Section of the American Bar Association. He is a past Co-Chair of the ABA's Property Preservation Task Force, which lately resulted in the Uniform Law Commission's adoption of the Uniform Partition of Heirs Property Act. David is currently on the University of Montana Tax Institute Advisory Board and serves on the Board of Trustees of Rocky Mountain College in Billings. He served for six years on the Board of Directors of the Montana Land Reliance, a private land trust in Montana, having in excess of 960,000 acres under protection.

His firm, Dietrich & Associates, P.C., has provided real estate, tax and estate planning services to the region for over 24 years; David also regularly forms business organizations, including Sub S Corporations, LLC's and LLLP's and has litigation and transactional experience in the liquidation, division, and merger of those organizations.

David J. Dietrich graduated from Whitman College with a BA degree with honors in 1979. He served in the Peace Corps in Abidjan, Ivory Coast. He attended the University Of Montana College Of Law and graduated with a Juris Doctor (JD) in 1984.

David is a fourth generation Montanan with a diverse ranching, real estate and estate planning background.

David's publications include the 2011 ABA Book **Conservation Easements: Tax and Real Estate Planning for Landowners and Advisors**; "Selected Post-Mortem Estate Tax Elections for the Small Business Owner", "Pleasing Mother Earth and the IRS: Using Conservation Easements to Save Open Space, Income and Estate Taxes" for the Heckerling Institute for Estate Planning for the University of Miami in January 2003 and other tax and real estate related topics for the State Bar of Montana.

David and his family enjoy living in the Big Sky Country; he is an avid photographer and likes outdoor activities in any season.

Cory S. Steinmetz
Dietrich & Associates, P.C.

Cory is an associate working in the areas of real estate, commercial transactions and estate planning. He is a Montana native and was born and raised in Billings. In May of 2015, he received his Juris Doctor from the University of Montana School of law.

Cory also received a Bachelors in Political Science from the University of Montana in 2012. Where he focused on International politics and development, learned modern standard Arabic and studied abroad in Amman, Jordan.

While in law school, Cory was a legal intern for the United States Department of Agriculture. While there, he represented various government agencies in real estate litigation, secured transactions, commercial contracts, and helped build relationships between the federal and tribal governments. He also wrote an article promoting the use of Trust Decanting in Montana and a proposed statute that may be taken to the state legislature in 2017. He volunteered at the Missoula Housing Authority where he helped low-income families obtain housing.

Cory enjoys snowboarding, golfing, fishing and getting out on Montana rivers and lakes.

A. Introduction

These materials discuss losing liability protection and avoiding judicial liquidation when using a Limited Liability Company "LLC", both of which are "meltdown" events for LLC's.

The doctrine of "piercing the corporate veil" is well established in the corporate context but has only recently begun to be applied to LLCs. Ignoring corporate formalities and applying the alter ego theory are key factors in piercing the corporate veil. On first analysis, the corporate analysis may seem inappropriate for LLCs because informality of organization and operation are hallmarks of LLC operations. However, courts have begun to apply that analysis to assign LLC liability to Members or Managers. The following materials describe the creation and operation of LLC's, how piercing LLC veil functions, what steps a practitioner can take to prevent piercing of the veil, and finally summarizes several important MT and national court cases on these subjects.

Likewise, state enabling statutes outside MT and operating agreements drafted in MT attempt at all costs to avoid court ordered liquidation, focusing instead in the LLC members' "contractual" provisions of the operating agreement. The issue goes to the essential power of a state court of liquidation over any state sanctioned LLC (Nevada, Delaware or Montana), even when members have relegated all conflict resolution to non judicial arbitration, inside or outside MT, and remains a growing trend in even the most "hands off" LLC states. The key practice pointer is to avoid placing the LLC in a position where liquidation will be ordered by a court.

B. The Montana Limited Liability Company ("LLC").

An LLC is an entity created by state law.[1] Normally, an LLC is created by filing Articles of Organization with the Secretary of State.[2] There is a significant contrast between articles of organization in MT and states which have adopted the Revised Uniform Limited Liablity Company Act, including all of MT's neighbor states, which relegate all important information to

[1] Mont. Code Ann. § 35-8-201 *et seq.*
[2] *Id.* at 202.

the operating agreement. (Contrast the Uniform Limited Liability Company Act which allows operating agreement minimization of fiduciary duties, enacted in CA, ID, MN, ND, NE, SD, WA, UT and WY.)[3]

In MT, the minimum information needed for the formation of a LLC is set forth in Mont Code Ann 35-8-202 (2015): (1) the name of the LLC, typically using LLC or LTD; (2) the mailing address of the principal place of business of the LLC; (3) whether the LLC is a term and if so what the term is to be; (4) whether the LLC is to be managed by a manager or managers (and if so the names and addresses of its managers) or by its members, including the initial members' addresses; (5) whether one or more of the members are to be responsible for the debts of the LLC; (6) if the LLC is to be a professional LLC, a statement to that effect and the nature of the professional services it is to provide; (7) "if the LLC has one or more series of members, the operating agreement of each series of members in writing;" (8) whether there is a liability wall between one series (or not) in relation to another series, in a series LLC; (9) in a series LLC, "the relative rights, powers, and duties" of each series of the members or indicating that the relative rights will be set forth in an operating agreement; (10) any other lawful provision, including restrictions on management authority for any member or manager."

C. Violation of Fiduciary Duty owed to Other Members.

Violation of fiduciary duties owed to other members or the LLC is a significant source of liability in a member managed LLC in MT. This is because the LLC articles may not vary the non-waivable provisions of Mont. Code Ann 35-8-109, the most important of which refer to the members' fiduciary standards of conduct Mont. Code Ann 35-8-310 (2015), which provide as follows:

---

[3] *See* Uniform Law Commisson Website: http://www.uniformlaws.org/shared/docs/limited%20liability%20company/ullca_final_2014.pdf)

(1) The only fiduciary duties that a member owes to a member-managed company and the other members are the duty of loyalty imposed by subsection (2) and the duty of care imposed by subsection (3).

(2) A member's duty of loyalty to a member-managed company and its other members is limited to the following:

(a) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's business or derived from a use by the member of the company's property, including the appropriation of a company's opportunity;

(b) to refrain from dealing with the company in the conduct or winding up of the company's business on behalf of a party or as a person having an interest adverse to the company; and

(c) to refrain from competing with the company in the conduct of the company's business before the dissolution of the company.

(3) A member's duty of care to a member-managed company and the other members in the conduct of and winding up of the company's business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

(4) A member shall discharge the duties under this chapter or the operating agreement to a member-managed company and its other members and exercise any rights consistently with the obligation of good faith and fair dealing.

(5) A member of a member-managed company does not violate a duty or obligation under this chapter or under the operating agreement merely because the member's conduct furthers the member's own interest.

(6) A member of a member-managed company may lend money to and transact other business with the company. As to each loan or transaction, the rights and obligations of the member are the same as those of a person who is not a member, subject to other applicable law.

(7) This section applies to a person winding up the limited liability company's business as the personal or legal representative of the last-surviving member as if the person were a member.

(8) In a manager-managed company:

(a) a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member;

(b) a manager is held to the same standards of conduct as those prescribed for members in subsections (2) through (6);

(c) a member who pursuant to the operating agreement exercises some or all of the rights of a manager in the management and conduct of the company's business is held to the standards of conduct prescribed for members in subsections (2) through (6) to the extent that the member exercises the managerial authority vested in a manager by this chapter; and

(d) a manager is relieved of liability imposed by law for violation of the standards prescribed for members by subsections (2) through (6) to the extent of the managerial authority delegated to the members by the operating agreement.

The members enter into an operating agreement which sets forth operation and managerial terms between the members.[4] There are no statutory provisions for what must be contained in the operating agreement and Montana state law provides essentially a default operating agreement. An operating agreement is vaguely analogous to a partnership agreement but a partner's liability under general partnership rules differ significantly from the LLC liability shield. (Any general partner actively conducting business under a general partnership should be converted to a LLP under MT law to enjoy the significant liability shield under Mont Code Ann 35-10-307 (2) (2015)).

From a federal tax standpoint, LLCs may be structured as a general partnership, a C Corporation or Sub S Corporation. The LLC may be member-managed, meaning that any or all members have a right to participate in management, or it may be manager-managed, meaning that the members have decided to appoint a manager, or group of managers, who will oversee the operations of the company. A manager does not need to be a member (owner) in the LLC and may be a person or entity. Similarly, members may be individuals, trusts, corporations, partnerships, other LLCs or other entities.[5]

Neither the members nor the managers of an LLC, solely by reason of that status, are liable personally for the debt obligations, or liabilities of the LLC.[6] This is the classic statement of the liability shield of the LLC. However, if a member is otherwise personally responsible for

[4] *Id*. at 109.
[5] *Id*.at 301.
[6] *Id*. at 304.

an act or omission that causes damage to a third party on a tort basis, or personally guarantees a debt or becomes liable under state or federal law (such as a breach of fiduciary duty), then that member can be personally liable. Most importantly, like a corporation, the protection of an LLC can be pierced if the LLC is formed or operated as a sham.[7]

LLCs that are taxed as partnerships act as a pass through entities, creating only one level of tax at the member level, providing the same benefits as an LP, with additional benefits. LLCs taxed as partnerships typically can be liquidated tax-free as well.[8] A member's basis will be increased by the debts of the LLC so long as the member did not guarantee the debt. This allows members to receive tax-free distributions of loan proceeds as well as take losses greater than their contributions to the LLC. Many LLC acts give members a right under state law to withdraw and receive value for his or her interest. Subject to state law, an LLC may be dissolved upon the death, retirement, expulsion, bankruptcy, or dissolution of a member. Similar to LPs, fringe benefits available to C corporation shareholder-employees are not available to members in an LLC. Like LPs, complex rules apply relative to the allocation of company debt and the allocation of profits and losses to the members.[9]

If there is any chance that operating the business may place the owners at risk for exposure to liability, the LLC will be the entity of choice in most cases. All members of an LLC can enjoy limited liability. LLC members may actively participate in the conduct of the business under the passive loss rules without risking liability. Members may also materially participate in the LLC's management without risk of becoming personally liable for the LLC's debt and liabilities. However, as will be discussed in the following sections the limited liability afforded to

---

[7] *See* Section G Piercing the LLC Veil.
[8] Mezzullo, *Estate Planner's Guide to Family Business Entities: Family Limited Partnerships, Limited Liability Companies, and More*, at 32-34.
[9] *Id.*

LLC members is not absolute. Maintaining formalities and respecting the operation and use of an LLC is critical to avoid liability or an unintended dissolution.

D. Series LLC

In 2013 the Montana State Legislature amended the Montana Limited Liability Company Act to include series LLC's.[10] Series is a separate and distinct part of an individual LLC. The series has separate members, managers, powers and duties with respect to its own obligations, profits, losses and distributions. Essentially, it removes the need to create multiple LLC's to hold a members various assets to provide liability protection to each one separately.

The name of each series must contain the name of the limited liability company and be distinguishable from the name of any other series set forth in the Articles of Organization. The operating agreement establishes the separate rights, powers and duties of the series and its members or managers, which can be done in the same fashion that an individual LLC operating agreement would be drafted.

The following requirements are used to establish a series as a separate legal entity:

1) The Articles of Organization must create notice of creation of the series.

2) The operating agreement creates the series and provides the rights and duties and the limitation on liabilities.

3) Separate and distinct records must be maintained for the series.

4) A series' assets must be kept separate from the LLC assets or any other series.[11]

E. Dissociation and Liquidation

[10] Mont Code Ann. § 35-8-202(h-j).
[11] *Id.*

Critical to LLC operations is the concept of dissociation which is vaguely analogous to a "triggering event" in a corporation's share purchase agreement, ie, death, disability, divorce, departure from the active participation in the business. But because of the inherently contractual nature of an LLC, dissociation can trigger liquidation or may not; if not, depending on the operating agreement or state law, it may trigger a mandatory buyout of the LLC member's interest. Legal Zoom or Rocket Lawyer LLC documents rarely provide language which meshes with state law. Mont. Code Ann § 35-8-803 (2015) provides as follows:

> (1) A member is dissociated from a limited liability company upon the occurrence of any of the following events:
>
> (a) the company's having notice of the member's express will to withdraw upon the date of notice or on a later date if specified by the member;
>
> (b) an event agreed to in the operating agreement as causing the member's dissociation;
>
> (c) upon transfer of all of a member's distributional interest, other than a transfer for security purposes or pursuant to a court order charging the member's distributional interest that has not been foreclosed;
>
> (d) the member's expulsion pursuant to the operating agreement;
>
> (e) the member's expulsion by unanimous vote of the other members if:
>
> (i) it is unlawful to carry on the company's business with the member;
>
> (ii) there has been a transfer of substantially all of the member's distributional interest, other than a transfer for security purposes or pursuant to a court order charging the member's distributional interest, which has not been foreclosed;
>
> (iii) within 90 days after the company notifies a corporate member that it will be expelled because it has filed a certificate of dissolution or the equivalent, its charter has been revoked, or its right to conduct business has been suspended by the jurisdiction of its incorporation, the member fails to obtain a revocation of the certificate of dissolution or a reinstatement of its charter or its right to conduct business; or
>
> (iv) a partnership or a limited liability company that is a member has been dissolved, and its business is being wound up;

(f) on application by the company or another member, the member's expulsion by judicial determination because the member:

(i) engaged in wrongful conduct that adversely and materially affected the company's business;

(ii) willfully or persistently committed a material breach of the operating agreement or of a duty owed to the company or the other members under 35-8-310; or

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

(g) the member's:

(i) becoming a debtor in bankruptcy;

(ii) executing an assignment for the benefit of creditors;

(iii) seeking, consenting to, or acquiescing in the appointment of a trustee, receiver, or liquidator of all or substantially all of the member's property; or

(iv) failing, within 90 days after the appointment, to have vacated or stayed the appointment of a trustee, receiver, or liquidator of the member or of all or substantially all of the member's property obtained without the member's consent or acquiescence or failing within 90 days after the expiration of stay to have the appointment vacated;

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

(i) the member's death;

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

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

(i) in the case of a member that is a trust or is acting as a member by virtue of being a trustee of a trust, distribution of the trust's entire rights to receive distributions from the company, except that this subsection does not apply to the substitution of a successor trustee;

(j) in the case of a member that is an estate or is acting as a member by virtue of being a personal representative of an estate, distribution of the estate's entire rights to receive distributions from the company, but not merely the substitution of a successor personal representative; or

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

(2)(a) Unless otherwise provided in the articles of organization or operating agreement, any event described in this chapter or in the articles of organization or operating agreement that causes a manager to cease to be a manager with respect to a series of members does not, in itself, cause the manager to cease to be a manager with respect to the limited liability company or with respect to any other series of members.

(b) Unless otherwise provided in the articles of organization or operating agreement, any event described in this chapter or in the articles of organization or operating agreement that causes a manager to cease to be associated with a series of members does not, in itself, cause any member to cease to be associated with any other series of members, terminate the continued membership of any member in the limited liability company, or cause the termination of the series of members, regardless of whether the member was the last remaining member associated with the series.

The effect of dissolution is set forth in Mont. Code Ann § 35-8-805 (2015):

(1) Upon a member's dissociation:

(a) in an at-will company, the company shall cause the dissociated member's distributional interest to be purchased as provided under 35-8-808 and 35-8-809; and

(b) in a term company:

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

(ii) if the company does not dissolve and wind up its business on or before the expiration of its specified term, the company shall ensure that the dissociated member's distributional interest is purchased under 35-8-808 and 35-8-809 on the date that was specified for the expiration of the term at the time of the member's dissociation.

(2) Upon a member's dissociation from a limited liability company:

(a) the member's right to participate in the management and conduct of the company's business terminates, except as otherwise provided in 35-8-903, and the member ceases to be a member and must be treated the same as a transferee of a member;

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

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

A member may have the power to dissociate, but it may be wrongful, under Mont. Code Ann § 35-8-804 (2015), as follows:

(1) Unless otherwise provided in the operating agreement, a member has the power to dissociate from a limited liability company at any time, rightfully or wrongfully, pursuant to 35-8-803(1)(a).

(2) If the operating agreement has not eliminated a member’s power to dissociate, the member’s dissociation from a limited liability company is wrongful only if:

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

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

(i) the member withdraws by express will;

(ii) the member is expelled by judicial determination under 35-8-803(1)(f);

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

(iv) in the case of a member that is not an individual, trust, other than a business trust, or estate, the member is expelled or otherwise dissociated because it willfully dissolved or terminated its existence.

(3) A member that wrongfully dissociates from a limited liability company is liable to the company and to the other members for damages caused by the dissociation. The liability is in addition to any other obligation of the member to the company or to the other members.

(4) If a limited liability company does not dissolve and wind up its business as a result of a member’s wrongful dissociation under subsection (2), damages sustained by the

company for the wrongful dissociation must be offset against distributions otherwise due the member after the dissociation.[12]

An LLC can be dissolved under the following conditions provided in Mont. Code Ann. § 35-8-901:

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

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

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

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

---

[12] OFFICIAL COMMENTS to Mont. Code Ann. § 35-8-804**:** A member has the power to withdraw from both an at-will company and a term company although the effects of the withdrawal are remarkably different. See Comments to Section 601 [35-8-803]. At a minimum, the exercise of a power to withdraw enables members to terminate their continuing duties of loyalty and care. See Section 603(b)(2) to (3) [35-8-805(2)(b) and (2)(c)].

A member's power to withdraw by express will may be eliminated by an operating agreement. New and important Internal Revenue Service announcements clarify that alteration of a member's power to withdraw will not cause the limited liability company to be taxed like a corporation. An operating agreement may eliminate a member's power to withdraw by express will to promote the business continuity of an at-will company by removing member's right to force the company to purchase the member's distributional interest. See Section 701(a)(1) [35-8-808(1)(a)]. However, such a member retains the ability to seek a judicial dissolution of the company. See Section 801(a)(4) [35-8-902(1)].

If a member's power to withdraw by express will is not eliminated in an operating agreement, the withdrawal may nevertheless be made wrongful under subsection (b) [subsection (2)]. All dissociations, including withdrawal by express will, may be made wrongful under subsection (b)(1) [subsection (2)(a)] in both an at-will and term company by the inclusion of a provision in an operating agreement. Even where an operating agreement does not eliminate the power to withdraw by express will or make any dissociation wrongful, the dissociation of a member of a term company for the reasons specified under subsection (b)(2) [subsection (2)(b)] is wrongful. The member is liable to the company and other members for damages caused by a wrongful dissociation under subsection (c) [subsection (3)] and, under subsection (d) [subsection (4)], the damages may be offset against all distributions otherwise due the member after the dissociation. Section 701(f) [35-8-808(6)] provides a similar rule permitting damages for wrongful dissociation to be offset against any company purchase of the member's distributional interest.

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

(e) entry of a decree of judicial dissolution under 35-8-902.

(2) Subject to subsection (3), a limited liability company continues after dissolution only for the purpose of winding up its business.

(3) At any time after the dissolution of a limited liability company and before the winding up of its business is completed, the members, including a dissociated member whose dissociation caused the dissolution, may unanimously waive the right to have the company's business wound up and the company terminated. In that case:

(a) the limited liability company resumes carrying on its business as if dissolution had never occurred, and any liability incurred by the company or a member after the dissolution and before the waiver is determined as if the dissolution had never occurred; and

(b) the rights of a third party accruing under the provisions of 35-8-904(1) or arising out of conduct by the third party in reliance on the dissolution before the third party knew or received a notification of the waiver are not adversely affected.

(4) The affairs of a series of members of a limited liability company must be wound up:

(a) at the time, if any, specified in the articles of organization;

(b) upon the occurrence of an event specified in the operating agreement;

(c) unless otherwise provided in the articles of organization or operating agreement, upon the affirmative vote or written agreement of all the members associated with the series of members; or

(d) upon entry of a decree of judicial termination of the series of members pursuant to 35-8-902.

(5)(a) Unless otherwise provided in the articles of organization or operating agreement, upon the occurrence of an event requiring the affairs of a series of members to be wound up, a manager of the series who has not wrongfully terminated the series or, if there is not a manager, the members associated with the series, or a person approved by all of the members of the series may wind up the affairs of the series.

(b) Unless otherwise provided in the articles of organization or operating agreement, the person or persons winding up the affairs of a series of members:

(i) may take all actions necessary or proper to wind up the affairs of the series; and

(ii) shall distribute the assets of the series of members to the creditors of the series and the members associated with the series.

In addition to the dissolution events outlined above, an LLC can be judicially dissolved upon an application by a member for the following reasons provided by Mont. Code Ann § 35-8-902:

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

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

(b) another member has engaged in conduct relating to the company’s business that makes it not reasonably practicable to carry on the company’s business with that member remaining as a member;

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

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

(e) the members or managers in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner.

(2) On application by a transferee of a member’s interest, a district court may determine that it is equitable to wind up the company’s business:

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

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

(3) Whenever it is not reasonably practicable to carry on the business of a series of members in conformity with the articles of organization or operating agreement and upon application by or for a member of the series of members, a district court may decree only

> the termination of the series of members and may not decree the dissolution of the limited liability company.[13]

A survey of LLC dissolution cases nationally show that dissolution is becoming a more readily available and applicable way for creditors to get at the assets of an LLC.[14] In a Montana case *Gordon v. Kuzara*, the court granted a petition to dissolve an LLC. The court found a member had violated several of the above factors, but stated that they are disjunctive and one alone is enough for a court to dissolve an LLC.[15] The court is given further deference when a member has received their interest in the LLC as a result of a judicial remedy or disassociating member. A court may find it equitable to dissolve an LLC at any time if the LLC is at will or at the expiration of a term LLC.[16]

---

[13] OFFICIAL COMMENTS to Mont. Code Ann § 35-8-902: In the case of applications under subsections (a)(4) and (a)(5) [35-8-902(1) and (2)], the applicant has the burden of proving either the existence of one or more of the circumstances listed under subsection (a)(4) [35-8-902(1)] or that it is equitable to wind up the company's business under subsection (a)(5) [35-8-902(2)]. Proof of the existence of one or more of the circumstances in subsection (a)(4) [35-8-902(1)], may be the basis of a subsection (a)(5) [35-8-902(2)] application. Even where the burden of proof is met, the court has the discretion to order relief other than the dissolution of the company. Examples include an accounting, a declaratory judgment, a distribution, the purchase of the distributional interest of the applicant or another member, or the appointment of a receiver. See Section 410 [35-8-410].

A court has the discretion to dissolve a company under subsection (a)(4)(i) [35-8-902(1)(a)] when the company has a very poor financial record that is not likely to improve. In this instance, dissolution is an alternative to placing the company in bankruptcy. A court may dissolve a company under subsections (a)(4)(ii), (a)(4)(iii), and (a)(4)(iv) [35-8-902(1)(b) through (1)(d)] for serious and protracted misconduct by one or more members. Subsection (a)(4)(v) [35-8-902(1)(e)] provides a specific remedy for an improper squeeze-out of a member.

In determining whether and what type of relief to order under subsections (a)(4) and (a)(5) [35-8-902(1) and (2)] involuntary dissolution suits, a court should take into account other rights and remedies of the applicant. For example, a court should not grant involuntary dissolution of an at-will company if the applicant member has the right to dissociate and force the company to purchase that member's distributional interest under Sections 701 [35-8-808] and 702 [35-8-809]. In other cases, involuntary dissolution or some other remedy such as a buy-out might be appropriate where, for example, one or more members have (i) engaged in fraudulent or unconscionable conduct, (ii) improperly expelled a member seeking an unfair advantage of a provision in an operating agreement that provides for a significantly lower price on expulsion than would be payable in the event of voluntary dissociation, or (iii) engaged in serious misconduct and the applicant member is a member of a term company and would not have a right to have the company purchase that member's distributional interest upon dissociation until the expiration of the company's specified term.

[14] Thomas Rutledge and Elizabeth Fenton, *Piercing the Unincorporated Veil*, ABA section of Business Law Annual Meeting (2014) pg. 13-20.

[15] *Gordon v. Kuzara*, 2012 MT 206, ¶ 20, 366 Mont. 243, 248, 286 P.3d 895, 899.

[16] *Id.* at 35-8-902(2).

Another area were LLCs can be unintentionally dissolved is if it is no longer reasonably practical to carry on the business. As Mont. Code Ann § 35-8-902(1) states:

> (1) On application by or for a member or a dissociated member, a district court may order dissolution of a limited liability company, or other appropriate relief, when:
>
> > (c) it is not otherwise reasonably practicable to carry on the company's business in conformity with the articles of organization and the operating agreement;

The Mississippi Supreme Court, in a case of first impression, recently interpreted this same statutory language when an LLC member asked for judicial dissolution of the LLC.[17] In *Venture Sales, LLC v. Perkins*, some LLC members argued that it was reasonably practicable for the LLC to continue operating because it was solvent and could wait for the overall economy to improve, at which point it could carry on with its business purpose. However, the court found that merely being solvent was not an adequate reason to continue the LLC given the lack of a plan to meet the LLC's purpose. The court accordingly held that the chancellor's order dissolving Venture Sales LLC was supported by substantial evidence and was not an abuse of dissolution, and affirmed the order of dissolution. This case provides an example of judicial dissolution based on the member's ability to carry on with the purpose of an LLC. This case is relevant to Montana because it shows the necessity to respect the articles of organization and operating agreement of an LLC. Members must respect the purpose that those documents set out, or be subject to an unintended dissolution.

In determining whether and what type of relief to order in involuntary dissolution suits, a court should take into account other rights and remedies of the applicant. For example, a court should not grant involuntary dissolution of an at-will company if the applicant member has the right to dissociate and force the company to purchase that member's distributional interest under Mont. Code Ann. § 35-8-808, which provides:

[17] *Venture Sales, LLC v. Perkins*, 86 So.3d 910, 914 (Miss. 2012).

(1) A limited liability company shall purchase a distributional interest of a:

(a) member of an at-will company for its fair value determined as of the date of the member's dissociation if the member's dissociation does not result in a dissolution and winding up of the company's business under 35-8-901; or

(b) member of a term company for its fair value determined as of the date of the expiration of the specified term that existed on the date of the member's dissociation if the expiration of the specified term does not result in a dissolution and winding up of the company's business under 35-8-903.

(2) A limited liability company shall deliver a purchase offer to the dissociated member whose distributional interest is entitled to be purchased not later than 30 days after the date determined under subsection (1). The purchase offer must be accompanied by:

(a) a statement of the company's assets and liabilities as of the date determined under subsection (1);

(b) the latest available balance sheet and income statement, if any; and

(c) an explanation of how the estimated amount of the payment was calculated.

(3) If the price and other terms of a purchase of a distributional interest are fixed or are to be determined by the operating agreement, the price and terms so fixed or determined govern the purchase unless the purchaser defaults. If a default occurs, the dissociated member is entitled to commence a proceeding to have the company dissolved under 35-8-902(1)(d).

(4) If an agreement to purchase the distributional interest is not made within 120 days after the date determined under subsection (1), the dissociated member, within another 120 days, may commence a proceeding against the limited liability company to enforce the purchase. The company, at its expense, shall notify in writing all of the remaining members and any other person that the court directs of the commencement of the proceeding. The jurisdiction of the court in which a proceeding is commenced under this subsection is plenary and exclusive.

(5) The court shall determine the fair value of the distributional interest in accordance with the standards set forth in 35-8-809, together with the terms for the purchase. Upon making these determinations, the court shall order the limited liability company to purchase or cause the purchase of the interest.

(6) Damages for wrongful dissociation under 35-8-804(2) and all other amounts owing, whether or not currently due, from the dissociated member to a limited liability company, must be offset against the purchase price.[18]

In other cases, involuntary dissolution or some other remedy such as a buy-out might be appropriate where, for example, one or more members have (i) engaged in fraudulent or

[18] OFFICIAL COMMENTS of Mont. Code Ann. § 35-8-808: This section sets forth default rules regarding an otherwise mandatory company purchase of a distributional interest. Even though a dissociated member's rights to participate in the future management of the company are equivalent to those of a transferee of a member, the dissociation does not forfeit that member's right to enforce the Article 7 [35-8-808, 35-8-809, 35-8-811, and 35-8-812] purchase right. Similarly, if the dissociation occurs by reason of death, the decedent member's successors in interest may enforce the Article 7 [35-8-808, 35-8-809, 35-8-811, and 35-8-812] rights. See Comments to Sections 503(e) [35-8-707(5)] and 603(b)(1) [35-8-805(2)(a)].

An at-will company must purchase a dissociated member's distributional interest under subsection (a)(1) [subsection (1)(a)] when that member's dissociation does not result in a dissolution of the company under Section 801(a)(1) [35-8-901(1)(a)]. The purchase price is equal to the fair value of the interest determined as of the date of dissociation. Any damages for wrongful dissociation must be offset against the purchase price.

Dissociation from a term company does not require an immediate purchase of the member's interest but the operating agreement may specify that dissociation is an event of dissolution. See Section 801(a)(1) [35-8-901(1)(a)]. A term company must only purchase the dissociated member's distributional interest under subsection (a)(2) [subsection (1)(b)] on the expiration of the specified term that existed on the date of the member's dissociation. The purchase price is equal to the fair value of the interest determined as of the date of the expiration of that specified term. Any damages for wrongful dissociation must be offset against the purchase price.

The valuation dates differ between subsections (a)(1) and (a)(2) [subsections (1)(a) and (1)(b)] purchases. The former is valued on the date of member dissociation whereas the latter is valued on the date of the expiration of the specified term that existed on the date of dissociation. A subsection (a)(2) [subsection (1)(b)] dissociated member therefore assumes the risk of loss between the date of dissociation and the expiration of the then stated specified term. See Comments to Section 801 (dissociated member may file application to dissolve company under Section 801(a)(4) [35-8-902(1)]) [35-8-901 and 35-8-902].

The default valuation standard is fair value. See Comments to Section 702 [35-8-809]. An operating agreement may fix a method or formula for determining the purchase price and the terms of payment. The purchase right may be modified. For example, an operating agreement may eliminate a member's power to withdraw from an at-will company which narrows the dissociation events contemplated under subsection (a)(1) [subsection (1)(b)]. See Comments to Section 602(a) [35-8-804(1)]. However, a provision in an operating agreement providing for complete forfeiture of the purchase right may be unenforceable where the power to dissociate has not also been eliminated. See Section 104(a) [35-8-110(1)].

The company must deliver a purchase offer to the dissociated member within 30 days after the date determined under subsection (a) [subsection (1)]. The offer must be accompanied by information designed to enable the dissociated member to evaluate the fairness of the offer. The subsection (b)(3) [subsection (2)(c)] explanation of how the offer price was calculated need not be elaborate. For example, a mere statement of the basis of the calculation, such as “book value,” may be sufficient.

The company and the dissociated member must reach an agreement on the purchase price and terms within 120 days after the date determined under subsection (a) [subsection (1)]. Otherwise, the dissociated member may file suit within another 120 days to enforce the purchase under subsection (d) [subsection (4)]. The court will then determine the fair value and terms of purchase under subsection (e) [subsection 5]. See Section 702 [35-8-809]. The member's lawsuit is not available under subsection (c) [subsection (3)] if the parties have previously agreed to price and terms in an operating agreement.

unconscionable conduct, (ii) improperly expelled a member seeking an unfair advantage of a provision in an operating agreement that provides for a significantly lower price on expulsion than would be payable in the event of voluntary dissociation, or (iii) engaged in serious misconduct and the applicant member is a member of a term company and would not have a right to have the company purchase that member's distributional interest upon dissociation until the expiration of the company's specified term.

F. Rights of Judgment Creditors.

LLC members are often sued and the issue arises as to the liability of the LLC assets to satisfy the judgment creditor an individual LLC member and, in the case of a majority interest in the LLC or a single member limited liability company, the possible liquidation of the LLC. Montana law provides that any judgment creditor may obtain a court approved charging order against the "distributional interest of the member" for payment of the unpaid amount of the judgment. The judgment creditor has only the rights of "an assignee of the distributional interest." Mont. Code Ann 35-8-705(2015). The charging order is a lien on the judgment debtor's distributional interest and is subject to foreclosure and transfer and may be redeemed before foreclosure by the judgment debtor, or the other members of the LLC with property other than the company's, or with the company property if so permitted by the LLC's operating agreement. Mont. Code Ann 35-8-705(4) (2015). The foregoing provide for the exclusive remedy by which a judgment creditor of a member or its transferee may satisfy a judgment out of the judgment creditor's distributional interest in the LLC. Mont. Code Ann 35-8-705(5) (2015). But a disgruntled creditor may also seek standing to liquidate the LLC.

G. Piercing the Corporate Veil

Prior to the widespread adoption of LLC legislation in all states in the early 1990's, corporations were the most widely used form of business entity. But corporations began to have some glaring issues in accomplishing the essential mission of limiting personal liability. Over the years, courts tended to weaken the corporate liability shield under a variety of legal theories. Many cases on these issues have been decided and broad rights have developed for those seeking to "pierce the corporate veil" and hold the owners personally liable.

1. Corporate Formality Liability

One legal ground for piercing the corporate veil is failure to follow corporate formalities. For example, corporations have certain legal formalities which must be adhered to, such as issuing shares, holding annual meetings, preparing minutes, and creating and maintaining governing bylaws.[19] In cases where these formalities are not properly followed, courts have held that the legal liability protection of the shareholders was effectively waived and the personal assets of the owners could be reached by the plaintiff. This result usually occurs in smaller, closely-held businesses, which tend to be less diligent in maintaining the corporate records than larger companies with the resources and staff necessary to meet the formal requirements.

2. Alter Ego Liability

A second rational for piercing the corporation veil is based on what is known as "alter ego" liability. This used when an individual and a company are so closely linked that they should not be viewed as separate entities for legal purposes, the shield against personal liability will not be applied. Over the years, courts have provided many of factors that should be considered in making this determination:

- Absence or inaccuracy of corporate records;

[19] *Id.* at 35-1-215 *et seq.*

- Concealment or misrepresentation of members;
- Failure to maintain arm's length relationships with related entities;
- Failure to observe corporate formalities in terms of behavior and documentation;
- Failure to pay dividends;
- Intermingling of assets of the corporation and of the shareholder;
- Manipulation of assets or liabilities to concentrate the assets or liabilities;
- Non-functioning corporate officers and/or directors;
- Significant undercapitalization of the business entity (capitalization requirements vary based on industry, location, and specific company circumstances);
- Siphoning of corporate funds by the dominant shareholder;
- Treatment by an individual of the assets of corporation as his/her own;
- Was the corporation being used for a shareholders personal dealings;[20]

In making the determination under the alter ego test, the law is that no single factor is determinative, and instead a court must examine all the circumstances to determine whether to apply the doctrine. In reality, what this means is that in almost any situation, a finding of alter ego liability can be made depending on the outcome that the court would like to produce. Small businesses sometimes treat corporate formalities, written minutes and banking in a more casual manner than larger companies with staff and resources. Since there are so many factors which can be considered and the proper weight to be given to any particular factor is left entirely to the courts discretion, it is often the case that a court can shape its own result. A reading of the cases demonstrates that similar fact patterns produce dramatically different results based on the particular conclusion which the court is attempting to shape. Sometimes the outcome depends less on the conduct of the parties than it does on the courts view of what is a fair result.

H. Piercing the LLC Veil

Case law in Montana generally permits piercing of the LLC veil to much the same extent as corporations. Although LLC formalities are sometimes not as strict as those of corporations,

[20] *Meridian Minerals Co. v. Nicor Minerals, Inc.*, 228 Mont. 274, 283, 742 P.2d 456, 462 (1987).

when the alter ego doctrine is asserted, a failure to hold annual meetings and maintain adequate company records may influence the court's decision on personal liability protection.

Instead of the corporate formality rule courts have begun to use the "instrumentality rule" or the "identity rule" for LLC piercing.[21] The instrumentality rule of LLC piercing requires proof of three elements. First control, not just majority or ownership control, but complete domination of the finances, policies and business practices so that the entity has no separation or existence of its own. Second, the control must have been used to commit a fraud or wrong-doing. Finally the control and breach of duty must be the proximate cause of the injury or unjust loss. [22] This rule was essentially used in *White v. Longley*, a 2010 Montana case that dissolved an LLC as a result of fraud on the part a controlling member.[23]

In *White v. Longley*, A contractor deceived homeowners about his credentials, his experience, and the work he would perform. The contractor proceeded to build the Whites' home in his capacity as general manager of Castle Homes, LLC. The contractor's work was so substandard that the house was rendered unlivable. The district court held the contractor jointly and severally liable with Castle Homes, LLC for damages incurred by the Whites because the contractor's own misconduct would subject him to personal liability. The court stated:

> "The Limited Liability Company Act does not offer blanket protection from liability to a member of an LLC for the member's own conduct, and there are not "decades" of precedent establishing any such protection. Section 35–8–304, MCA, merely provides that a member or manager may not be personally liable based "solely" upon being a member or manager . . . Longley could be held liable to the Whites because his own conduct would have exposed him to liability. . . We therefore construe § 35–8–304, MCA, to allow personal liability against a member or manager of an LLC based upon contract or tort if the member or manager would be liable if acting in an individual capacity.
>
> In the present case the District Court found ample evidence that Longley's own acts or omissions in the construction of the Whites' house damaged them and were

[21] Phillip L. Jelsma and Pamela Everett Nollkamper, *The Limited Liability Company*, § 8–160 (2015).
[22] *Id.*
[23] *White v. Longley*, 2010 MT 254, 358 Mont. 268, 244 P.3d 753 (2010).

> actionable against him individually in both contract and tort. Under § 35–8–304, MCA, this removes any protection from liability that Longley might otherwise have based upon the organization of Castle Homes as a limited liability company."

(Curiously, the Montana court expressly refused to characterize what it was doing as piercing the corporate veil in footnote no. 2 of the decision, which confuses its analysis.)

Absent personal liability on a contract, fraud or other tortious conduct the court still provides LLCs limited liability protection. A 2013 Montana case *Weaver v. Tri-County Implement, Inc.*, held that LLCs that operate as empty shells to avoid personal liability will be subject to veil piercing. In *Weaver v. Tri-County Implement, Inc.*, Smith and Weaver formed an LLC. Smith opened a line of credit for the LLC with Tri- County Implements, Inc. ("Tri-County"), and requested that Tri-County perform certain work on a truck on the LLC's account. The truck was titled in the name of Weaver, and when the invoice was not paid and Tri-County would not release the truck, Weaver sought return of the truck.

The trial court held Weaver personally liable to Tri-County for the charges owed for work on the truck. On Appeal, the Montana Supreme Court reviewed the statutory liability protection provided to members and managers of an LLC under the Montana LLC statute, which states that a member or manager is not liable for an LLC's debt, obligation, or liability solely by reason of being a member or manager.

> "[T]his Court has recognized [LLCs] as legal entities distinct from their members, with obligations separate from their members." (Citations omitted). LLCs provide their members and managers with "a corporate-styled liability shield . . . However, this liability shield is not absolute and does not provide immunity to a member for his own wrongful conduct."[24]

[24] *Weaver v. Tri-Cty. Implement, Inc.*, 2013 MT 309, ¶ 12, 372 Mont. 267, 271, 311 P.3d 808, 811.

The court stated that Weaver's liability as a member depended on whether he engaged in conduct that would give rise to contract or tort liability if he were acting in his individual capacity.

Although the trial court concluded that Weaver was liable on the contract with Tri-County, the Montana Supreme Court found no basis on which to hold Weaver liable on the contract. The agreements with Tri-County for work on the truck were between Tri-County and the LLC, Weaver did not guarantee the LLC's payments or make any other promise. The Montana Supreme Court distinguished the facts of White from the facts of Weaver. In White, the contractor's own misconduct removed any protection from liability that he might otherwise have based upon the organization of Castle Homes as a limited liability company. The facts of Weaver did not establish a basis for personal liability in contract or tort. Weaver was a not a party to the contracts for work performed on the Freightliner or the Volvo, and Weaver's personal conduct towards Tri-County did not constitute an actionable tort. *"If a member or manager operates an LLC as an empty shell to perpetuate fraud and avoid personal responsibility, that situation would be different, but those are not the facts here."* In the absence of personal misconduct that would itself be actionable, a member or manager of an LLC cannot be held individually liable for the obligations of the LLC.

The court reversed the portion of the district court's judgment that imposed joint and several liability on Weaver for the cost of the work performed on the two vehicles and the attorney fees and costs.[25]

The identity rule for LLC piercing relates to a unity of interest and ownership. Under this theory an attacker must show that there was such a unity of interest and ownership that the independence of the LLC never existed at all. In this rule, the adherence to the fiction of separate

---

[25] *Weaver v. Tri-County Implement, Inc.*, 311 P.3d 808 (Mont. 2013).

identity would serve only to defeat justice and equity by permitting the LLC member to escape liability from and event arising out of an operation conducted by the LLC for the benefit of the member.[26] This rule is shown in the case of *In re Storer*, a 2007 case that that applies Montana corporate veil piercing principles to an LLC and concluded that the LLC was alter ego of one of its two members based on fact that a member listed creditors of the LLC as his creditors on his bankruptcy schedule, but holding that the member did not use LLC as subterfuge to perpetrate fraud, as follows:

> **As a general rule, members of a limited liability company are not subject to personal liability for corporate obligations. However, in certain instances, courts in Montana have disregarded the corporate form, and the general immunity attendant thereto, by imposing personal liability on controlling shareholders. *Flemmer v. Ming*, 621 P.2d 1038, 1042, 190 Mont. 403 (1981). In such instances, the courts have "pierced the corporate veil." In discussing the doctrine of "piercing the corporate veil," the Montana Supreme Court instructs:**
>
>> **Piercing the corporate veil is an equitable remedy used to curb injustices resulting from the improper use of a corporate entity. Because the remedy is equitable, no concrete formula exists under which a court will disregard the separate identity of the corporate entity. Use of this remedy depends entirely upon the circumstances of each case. See Comment, *Piercing The Corporate Veil in Montana*, 44 Mont.L.Rev. 91, 92–93 (1983). However, this Court has previously required two general factors to be present before a court will disregard the separate and distinct identity of a corporation: (1) The corporation must be a mere agent or alter ego of the parent company; and (2) the corporate cloak must have been used to defeat public convenience, justify wrong, perpetrate fraud, or to defend crime. *State ex rel. Monarch Fire Ins. Co. v. Holmes* (1942), 113 Mont. 303, 307–08, 124 P.2d 994, 996.**
>
> ***Hando v. PPG Indus., Inc.*, 771 P.2d 956, 960, 236 Mont. 493 (1989). In discussing the first prong of the above two-prong test articulated by the Montana Supreme Court, the Ninth Circuit Court of Appeals identified six factors which may show whether a corporation is a mere alter ego of its shareholders:**
>
> **[18] The factors relevant to a finding of alter ego include, but are not limited to:**
>
> **1. Whether the individual is in a position of control or authority over the entity;**
>
> **2. Whether the individual controls the entity's actions without need to consult others;**
>
> **3. Whether the individual uses the entity to shield himself from personal liability;**
>
> **4. Whether the individual uses the business entity for his or her own financial benefit;**
>
> **5. Whether the individual mingles his own affairs in the affairs of the business entity;**

[26] *Id.*

6. Whether the individual uses the business entity to assume his own *234 debts, or the debts of another, or whether the individual uses his own funds to pay the business entity's debts.

See generally Hando, 771 P.2d at 960; *Drilcon, Inc. v. Roil Energy Corp., Inc.,* 230 Mont. 166, 749 P.2d 1058, 1063–64 (1988); *Meridian Minerals Co. v. Nicor Minerals, Inc.,* 228 Mont. 274, 742 P.2d 456, 462 (1987); Jody J. Brewster, *Piercing the Corporate Veil in Montana,* 44 Mont.L.Rev. 91, 95–97 (1983); *see also Valley Finance[, Inc. v. U.S.],* 629 F.2d [162] at 172–73 [(D.C.Cir.1980)].

Towe Antique Ford Found. v. Internal Revenue Serv., 999 F.2d 1387, 1391 (9th Cir.1993).

[19] In the instant case, it is undisputed that Lynxx was a closely-held limited liability company and at all times relevant to this case, Doug and Mike owned 100% of Lynxx and were the only two individuals who had any dominion or control over Lynxx' activities. Thus, the first two elements discussed by the Court in *Towe* would weigh in favor of the Businger and a finding that Lynxx is the alter ego of both Doug and Mike. This Court could conclude similarly on factors 3 and 4. However, factors 5 and 6 weigh in Doug and Mike's favor. Doug testified that his and Mike's personal affairs were not mingled with Lynxx and Lynxx did not assume any of Doug or Mike's personal debts. Nevertheless, the Court is troubled by the fact that Doug has included the Busingers as a creditor having an "unknown" unsecured claim on Doug's Schedule F. Moreover, Doug's Schedule F includes all the vendors referenced in Exhibit 11 as creditors having unsecured claims in amounts that are identical to the amounts set forth on Exhibit 11. Doug certainly would not have listed the Busingers, American Appliance, Billings Insulation Service, Treasure State Electric, D and L Construction, R Crew and Bloedorn Lumber as creditors on his Schedule F if he believed he was not personally liable for the obligations of Lynxx. The Court thus concludes that Lynxx was Doug's alter ego.

[20] The Court's next inquiry is whether Doug used Lynxx as a subterfuge to defeat public convenience, justify wrong, perpetrate fraud, or to defend a crime. As noted in one case, " 'public convenience' refers to something fitting or suited to the public need." *Drilcon, Inc. v. Roil Energy Corp., Inc.,* 230 Mont. 166, 749 P.2d 1058, 1063 (1988). The Busingers did not present any evidence to suggest that Lynxx was used as a subterfuge by Doug to defeat public convenience. In addition, no evidence exists in the record that Lynxx was used to justify a wrong or to defend a crime. Thus, the determination of Doug's personal liability hinges on whether Lynxx was used as a subterfuge to perpetrate a fraud.

[21] In the case of *Drilcon,* the Court recognized "that something less than a positive showing of fraud is needed to pierce the corporate veil." *Id.,* 749 P.2d at 1064 (citing *E.C.A. Envtl. Mgt. Services, Inc. v. Toenyes,* 208 Mont. 336, 679 P.2d 213, 219 (1983)). Additionally, when addressing the issue of fraud in the context of corporate liability, the Court in *Drilcon* notes that it is not necessary to "distinguish between the acts of an alleged corporate agent ... as opposed to the acts of the party sought to be held liable[.]" After considering the testimony and exhibits presented at trial, and as will be discussed more thoroughly below, the Court concludes that Lynxx was not used by Doug as a subterfuge to perpetrate a fraud.

Because Lynxx was not used by Doug to defeat public convenience, justify wrong, perpetrate fraud, or to defend crime, this *235 Court concludes that under the standard articulated by the Montana Supreme Court in *Hando,* it is not appropriate in this case to disregard the separate and distinct identity of Lynxx. Therefore, the Busingers' Complaint against Doug must fail. However, even if the Court were to pierce the corporate veil, the Court concludes that the Busingers have failed to satisfy the elements of their fraud claim under § 523(a)(2)(A).

[22] Under § 523(a)(2)(A), the Busingers must first establish by a preponderance of the evidence that Doug induced the Busingers, either through the use of false pretenses, false representations or actual fraud, into letting Lynxx build the Busingers' home. While Doug

certainly missed the mark with his bid on the Busingers' home, no evidence exists in the record to suggest that Doug crafted the bid with the intent of defrauding the Busingers. Rather, the evidence establishes that while Doug may fashion himself as a professional homebuilder, he got more than he bargained for with the Busingers' home. According to the Busingers, Lynxx simply was not qualified to perform the extensive type of work necessary to complete the Busingers' home. However, Doug's inability to accurately estimate the costs of construction, and later, Lynxx' inability to do the necessary work simply does not rise to a level which would allow a party to prevail under § 523(a)(2)(A). In sum, the Busingers failed to present any evidence that Doug or Lynxx intentionally set out to harm the Busingers by providing them with a bid, which in hindsight, was understated.

[23] After carefully considering the record, the law and the testimony of the parties, the Court finds that the Busingers have not sustained their burden of proof. In particular, the Busingers have not established, by a preponderance of the evidence, that Doug or Lynxx intended to defraud the Busingers or that Doug and Lynxx intentionally provided a false estimate for the cost of construction. The record in this case illustrates that the Busingers might have a breach of contract action, and nothing more, and breach of contract actions do not give rise to an action in fraud. As stated in *Leeb v. Guy (In re Guy)*, 101 B.R. 961, 978 (Bankr.N.D.Ind.1988):

> **[A] mere breach of contract by the debtor without more, does not imply existence of actual fraud for purposes of the exception to discharge under § 523(a)(2)(A). *In re Emery*, 52 B.R. 68, 70 (Bankr.E.D.Pa.1985).**

CONCLUSIONS of LAW

3. The Busingers have failed to satisfy their burden under 11 U.S.C. § 523(a)(2)(A) by showing that Doug made any type of false representation to the Busingers.

IT IS THEREFORE ORDERED a separate Judgment on the merits shall be entered in this adversary proceeding in favor of the Defendant, Alan Frank Storer, and against the Plaintiffs, John R. Businger and Katherine J. Businger; and the Plaintiffs' Complaint against the Defendant under 11 U.S.C. § 523(a)(2)(A) is DISMISSED.

In Re Storer 380 B.R. 223 (Bankr. Dist. MT) 2007.

One of the unfortunate byproducts of the uncertainty surrounding the application of the law is an inevitable increase in the number of cases filed against LLCs and their owners. Creditors can exploit this uncertainly by naming the owner as a co-defendant in litigation against the LLC. This move immediately places the owner's personal assets in jeopardy since they are threatened with large legal costs as well as a real loss of personal assets if the plaintiff is successful. Depending on the size of the claim and the amount of the defendant's available wealth, plaintiffs may be tempted to settle to avoid litigation costs as well as the possibility of an unfavorable outcome in the case. When a legal outcome is uncertain, as it is in most veil piercing cases, plaintiff's start from a strong bargaining position to attack the assets of a LLC.[27]

I. Foreign LLCs operating in Montana

1. Recognition of Foreign LLCs.

Montana courts and the Secretary of State's office do not automatically recognize LLCs that were formed in other states. The Montana LLC act requires registration of a foreign LLC before they may enter into certain business transactions in Montana.[28] This registration is completed with a Certificate of Authority meeting the statutory requirements and filed with the Secretary of State, a Certificate of Authority form can be found on the Secretary of State's website.[29] Montana Code Annotated § 35-8-1001(2) provides a list of actions a foreign LLC can take in Montana without filing a certificate. If a foreign LLC conducts business without registering, the LLC cannot maintain an action in any court in Montana until a Certificate of

[27] Thomas Rutledge and Elizabeth Fenton, *Piercing the Unincorporated Veil*, ABA section of Business Law Annual Meeting (2014) pg. 13-20.

[28] Mont. Code Ann § 35-8-1001.

[29] *Id*. at 35-8-1003

Authority is filed. Additionally, the foreign LLC will be subject to a civil penalty of $5 each day until a certificate is filed.[30]

2. <u>Choice of Law</u>

Choice of law is another possible factor that could come up in litigation involving a foreign LLC; Montana courts may not apply a foreign state's law, even if the operating agreement so requires, if the application is contrary to a fundamental policy of the state; a Montana resident LLC member requesting a Montana court to liquidate a closely held LLC "found within" Montana to consider fraud, constructive fraud, or veil piercing claims will likely involve such a "fundamental policy." Montana has adopted the Restatement (Second) Conflict of Laws § 187 and 188, which provides:

> Restatement (Second) of Conflict of Laws § 187 (1971):
>
> (1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.
>
> (2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, *unless* either
>
>> (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, *or*
>>
>> (b) *application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issu*e and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.
>
> (3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.
>
> Restatement (Second) of Conflict of Laws § 188 (1971):

[30] *Id.* at 35-8-1002.

> (1) The rights and duties of the parties with respect to an issue in contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties under the principles stated in § 6.
>
> (2) In the absence of an effective choice of law by the parties (see § 187), the contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include:
>
> > (a) the place of contracting,
> > (b) the place of negotiation of the contract,
> > (c) the place of performance,
> > (d) the location of the subject matter of the contract, and
> > (e) the domicile, residence, nationality, place of incorporation and place of business of the parties.
>
> These contacts are to be evaluated according to their relative importance with respect to the particular issue.
>
> (3) If the place of negotiating the contract and the place of performance are in the same state, the local law of this state will usually be applied, except as otherwise provided in §§ 189- 199 and 203.

The restatements essentially state that when a claim is based on a foreign LLC's operating agreement, courts will likely abide by any choice of law provision in the agreement, unless the court has reason to look outside of the agreement as evidence in the cases below. It is important to remember that fraud is a claim not based in contract but rather in tort. Therefore, contracts entered into fraudulently could be subject to the tort choice of law rule, which is generally the place the injury occurred or the fraudulent contract was executed.[31]

Restatement (Second) of Conflict of Laws § 145 (1971):

> (1) The rights and liabilities of the parties with respect to an issue in tort are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the occurrence and the parties under the principles stated in § 6.
>
> (2) Contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include:

[31] Restatement (Second) Conflict of Laws § 145 and *Phillips v. Gen. Motors Corp.*, 2000 MT 55, ¶ 21, 298 Mont. 438, 445, 995 P.2d 1002, 1007.

> (a) the place where the injury occurred,
> (b) the place where the conduct causing the injury occurred,
> (c) the domicile, residence, nationality, place of incorporation and place of business of the parties, and
> (d) the place where the relationship, if any, between the parties is centered.
>
> These contacts are to be evaluated according to their relative importance with respect to the particular issue.

It is also important to note that a state or federal court in Montana will likely have jurisdiction over the members of the LLC, the LLC itself, and its Montana based assets if the LLC is "found within" the state of Montana.[32] This will result in a Montana court deciding whether to apply Montana law or the law of another jurisdiction, with the likely result that Montana law will be applied if state law liquidation issues or other substantive equity issues are asserted.

The Delaware Chancery Court has recently decided a case in which an LLC member did not have statutory standing to dissolve an LLC but the court found that there was equitable standing nonetheless.[33] In the case of *In re Carlisle Etcetera LLC*, an assignee of a membership interest in an LLC did not have statutory authority to petition for dissolution of the LLC, as the other member had not consented to the assignment as required under their operating agreement. The court explained that there was equitable standing because entities are not purely contractual. Because an entity takes advantage of the benefits that a state has provided, the state retains an interest in the entity. The interest preserves the ability of a state to oversee and potentially dissolve an entity. Simply put, LLC operating agreements are not just between members because the LLC has powers only the state can give to the LLC.[34]

[32] *Harrington v. Energy W. Inc.*, 2015 MT 233, ¶ 14, 380 Mont. 298, 356 P.3d 441, 445.
[33] *In re Carlisle Etcetera LLC*, C.A. No. 10280-VCL, 2015 WL 1947027 (Del. Ch. April 30, 2015).
[34] *Id*.

In an earlier iteration of the *Gordon v. Kuzara* case cited above, the Montana Supreme Court was tasked with a question regarding the enforcement of an arbitration clause. The court had to decide if a binding arbitration clause prevented an LLC member from submitting a dissolution petition to a court, instead of submitting the petition for arbitration. The court reasoned, "the scope of the arbitration clause in the OA is explicit. The only actions subject to arbitration are those (1) challenging the agreement, (2) based on activity conducted pursuant to the agreement, or (3) challenging an interpretation of the agreement. The OA does not contain any provision addressing judicial dissolution. Thus, we cannot conclude that the parties ever agreed to arbitrate in the event of, or in lieu of, judicial dissolution pursuant to § 35–8–902, MCA."[35] The court ultimately decided judicial dissolution was appropriate.

In sum, LLCs that are formed in other states and operate in Montana are not free from the possibility of unintended dissolution and equitable remedies. Members and Managers of an LLC formed in any state must respect formal requirements and operations to protect against an unintended dissolution.

J. Practical Pointers for Protection against Personal Liability and Unintended Dissolution

The first step to avoiding personal liability for an LLC is to comply with the legal requirements concerning LCC formalities and operations as described in the cases and legislation. This means that the initial organizational filings, IRS compliance and operating documents and procedures for the LLC are correct and properly maintained. The LLC should be adequately capitalized for its purpose and commingling of accounts, and undocumented contributions and distributions should be avoided. Compliance with legal requirements is the point at which experienced lawyers should be consulted to prevent a client from the imposition

[35] *Gordon v. Kuzara*, 2010 MT 275, ¶ 8, 358 Mont. 432, 435, 245 P.3d 37, 39

of personal liability or an unintended dissolution. The following are some recommended records to be kept:

1) Account records
2) An Annual Report: This is a statutory requirement under Mont. Code Ann. § 35-8-208. Unlike many states Montana does not require a statement of the capital, property and assets belonging to the LLC.
3) Annual Financial Statements: Sometimes an operating agreement requires an LLC to furnish members with annual financial statements upon request.
4) Minutes of Meetings: Allow not required by statute records of majors decisions can protect managers and answer questions during a potential veil piercing attempt.[36]

Another step to avoid personal liability is for LLC management and majority owners to adhere to the fiduciary duties imposed on them by their operating agreement. Generally, these duties include, disclosure of information and data, non-competition, confidentially, candor, care loyalty and good faith.[37] LLC misuse or abuse by majority owners can lead to personal liability. However, Montana does take the minority position that a manager is only liable for gross negligence or bad faith, rather than the majority of states using the prudent person standard.[38]

Management authority granted by both the articles of organization and the operating agreement can have a significant impact on a dissolution or veil piercing event. Therefore, it is always important to be aware of the way different LLC operations are to be conducted. Specifically, what is the voting percentage necessary to for operations, amendments, liquidation and assignments within an LLC? And what type of ownership interest does each member hold for example membership units, shares, or percentage. Special attention should be placed on any event which creates an event of disassociation, which can quickly lead to a required purchase of the membership interest or liquidation. A disgruntled, dissociated member will likely want to "plead liquidation" in order to access underlying assets if there is any question that the remaining members and the LLC can feasibly purchase the membership interest.

[36] Phillip L. Jelsma and Pamela Everett Nollkamper, *The Limited Liability Company*, § 8–330 (2015).
[37] *Id.* at § 8–190.
[38] Mont. Code Ann § 35-8-402

As was discussed in previous sections choice-of-law provisions are an area where close attention needs to be paid. Choosing the desired state law to apply will generally be given deference by courts absent a showing of fraud or tortious conduct. A provision applying another state's law within Montana courts is a valid choice-of-law provision that can have desirable results. Additionally, is mandatory arbitration applicable? If so, is it defined generally or specifically, as we saw in the *Gordon v. Kuzara* case, courts will read arbitration clauses narrowly to allow certain events to escape arbitration if possible and increase judicial oversight.

As an additional safety measure, it may be necessary to use heightened asset protection planning to insulate and shield personal assets through the use of "imbedded" trusts and single member LLC's which are themselves members of the principle operational LLC to protect liquid assets such as savings and investments, but those "embedded" entities must maintain formalities and have independent business purchase. Any known or foreseeable claims existing against the individual creating the embedded entity may be successful under fraudulent conveyance statutes or the reach of a bankruptcy trustee, for up to 10 years after its creation under 11 USC 548. Taking the proper steps to minimize the risks of a client's business makes sense for those who have accumulated savings and investments and may require establishing a self settled asset protection trust in Wyoming, South Dakota, Nevada or one of 13 or so other states which have established these asset protection devices.

K. Single Member Liability Protection

Aside from the liability protections mentioned above. Single member LLCs require additional protection considerations. In general, single member LLCs are a good vehicle for lability protection. However, the single member LLC that has a no employees has no liability protection from the member's tortious conduct. The single member is always the actor thus, will never have protection from tortious conduct. The viability of single member LLCs as an asset protection entity has been brought into question as a result of *In re Albright*, 291 B.R. 538 (2003). In *Albright*, the court allowed a creditor to directly attach and secure an interest in the assets of a single member LLC. The normal remedy would be a charging order, but the court reasoned that a charging order was not appropriate because it was intended to protect the other owners of a LLC from creditors. In this case, there were no other members to protect via a charging order and as such the assets of the LLC could be directly attached and secured. Therefore, using multiple members affords an additional protection. Including an additional minority member with little or no management ability may be an effective way to avoid the result found in *Albright*.

L. Bankruptcy Cases involving LLCs

***In re Ehmann (Movitz v. Fiesta Investments, LLC)* 334 B.R. 437 (Bankr. D. Arizona, 2005).**

The asset protection benefits afforded by an LLC, may be further restricted when the debtor is in bankruptcy. Critical to avoiding a trustee's access to LLC's assets is whether the LLC membership interest is an asset of the bankruptcy estate under 11 USC 541 or whether trustee must reject or perform under the operating agreement because there are future performance obligations under the operating agreement as an "executory contract" under 11 USC 365 of the Bankruptcy Code. The *Ehmann* case is a detailed analysis of when an LLC operating agreement is or is not an "executory contract." In *Ehmann*, the taxpayers were a married couple who formed Fiesta Investments, LLC, and transferred interests in the LLC to their son. Later, the son filed a voluntary bankruptcy petition, and his creditors attempted to force Fiesta Investments to make distributions to them.

Although no formal distributions had been declared or paid to members of Fiesta Investments, cash was lent to members and amounts were paid to certain members to redeem part of their interest. The bankruptcy trustee demanded information and distributions from the LLC. In response, Fiesta Investments moved to dismiss the bankruptcy trustee's demand, based on its operating agreement, which provided that a trustee's acquisition of a member's interests would not dissolve the company or entitle an assignee to participate in the management of the business and affairs of the company unless such assignee is admitted as a member. The operating agreement stated that unless an assignee has become a member, the assignee is only entitled to receive the share of distribution to which a member would otherwise be entitled.

Additionally, Fiesta Investments argued that the limitations on the rights of assignees were specifically authorized by Arizona state law and that the trustee was similar to a judgment creditor, whose exclusive remedy would be a charging order. The trustee responded that he was not a mere assignee of the son's membership interest, but that he acquired all of the son's right, title, and interest of the membership interest under 11 USC 541.

The bankruptcy judge held that the son's managing membership interest in an LLC could be the property of his bankruptcy estate, and so pass in full to his bankruptcy trustee. The court was influenced by the fact that the son, other Fiesta members, and even non-members had borrowed funds from Fiesta, LLC, and that although the loans were fully repaid with interest and did not harm the LLC, they were made in violation of the operating agreement. The judge's order stated that 11 USC 365, the "executory contract" provision of federal bankruptcy law determined the interests of the trustee, rather than the more restrictive Arizona law, because a non-management membership interest does not require the non-managing member to do anything of substance; therefore, the bankruptcy trustee became a full member of the LLC even though the operating agreement provided otherwise.

Having established that federal bankruptcy law, rather than Arizona law, applied to the son's membership interest, the bankruptcy trustee moved for a summary judgment to establish that the bankruptcy estate was a full member of the LLC and to appoint a receiver to take charge of the LLC so that proper distributions could be made and so that the members' creditors' claims could be satisfied. The bankruptcy court agreed, issued the trustee a summary judgment, and ordered the appointment of a receiver. The court stated that the receiver could, if necessary, cause the dissolution and liquidation of the LLC in order to satisfy the son's creditors.

***In re JNS Aviation, LLC,* 376 B.R. 500, 530 (Bankr. N.D. Tex. 2007).**

A creditor, which had obtained default judgment against Chapter 7 debtor-limited liability company (LLC) for breach of contract relating to creditor's purchase of aircraft, established a claim of veil-piercing under the “sham to perpetrate a fraud” strand of corporate disregard and, thus, could hold debtor's non-debtor owners liable for the judgment debt; owners' overriding purpose in closing down debtor and continuing operations under the shield of a different entity was to isolate creditor's default judgment in a worthless shell, and debtor's owners caused debtor and/or the successor entity to perpetrate an actual fraud for their personal benefit, as the stated reason for the successor entity's formation, to avoid ad valorem taxes, was not legitimate, debtor's owners provided no formal notice of debtor's closing to creditor, and creditor suffered injury in the form of increased attorney’s fees due to the subject transactions.