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## APPLICATION OF WORKERS' AND UNEMPLOYMENT COMPENSATION STATUTES TO LIMITED LIABILITY COMPANIES

Steven C. Bahls\*

Limited liability companies, according to many experts, are likely to become the entity of choice for many small businesses.<sup>1</sup> Limited liability companies are a new form of business organization uniquely integrating the limited liability of corporate owners with the flexible management and "pass-through" tax advantages enjoyed by partners. As with any new business entity, courts, legislatures, and regulatory agencies have not answered all questions about limited liability companies. Several questions remain to be resolved before limited liability companies gain widespread acceptance by the business community. One significant question in Montana is how regulatory agencies and courts should treat members of limited liability companies for purposes of the Montana Workers' Compensation Act and the Montana Unemployment Compensation Act. If agencies and courts treat members of limited liability companies as employees, members are eligible for benefits provided by the Acts, but limited liability companies must pay the necessary premiums and payroll taxes.

Neither of the Acts expressly defines how limited liability company members are classified. The Montana Legislature is not alone in failing to clarify by statute how limited liability companies are treated for workers' and unemployment compensation purposes.<sup>2</sup> The operative issue is whether members and managers of

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1. See Steven C. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43, 44-53 (1994); Richard L. Parker, *Corporate Benefits Without Corporate Taxation: Limited Liability Company and Limited Partnership Solutions to the Choice of Entity Dilemma*, 29 SAN DIEGO L. REV. 399, 469 (1992); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 417 (1992).

2. At least 36 states authorize limited liability companies. 1 MICHAEL A. BAMBERGER & ARTHUR J. JACOBSON, *STATE LIMITED LIABILITY COMPANY LAWS* v-xi (1994). Only a few state legislatures, however, have enacted statutory guidance classifying limited liability companies for workers' compensation and unemployment compensation purposes. See *infra* note 40.

these businesses are employees, subject to workers' and unemployment compensation. The Montana Acts mandate different treatment of partnerships and corporations. As a general rule, corporate officers and directors are considered employees.<sup>3</sup> Working partners of partnerships are excluded from coverage under both Acts; hence, partners are not considered employees.<sup>4</sup> Since limited liability companies have corporate and partnership characteristics, one must determine which legal entity is most similar to limited liability companies for the Acts' definitional purposes.

The Montana Workers' Compensation Act allows both partnerships and corporations to modify, in part, the statutory scheme.<sup>5</sup> The Act permits partnerships and sole proprietorships to elect to include members of the partnership and owners of the sole proprietorships as employees.<sup>6</sup> Similarly, officers of private corporations may elect not to be bound as employees.<sup>7</sup> According to the Montana Administrative Rules, officers may elect not to be bound only if they own twenty percent or more of the corporation's stock.<sup>8</sup>

This Article discusses the ambiguities in the Acts and how courts and regulatory agencies treat limited liability companies. The Article first discusses the salient attributes of limited liability companies that are relevant to the workers' and unemployment compensation schemes. Next, this Article explores how tax agencies have answered similar definitional questions about limited liability companies. The Article proposes how limited liability companies should be treated for purposes of workers' and unemployment compensation. Specifically, for workers' and unemployment compensation purposes, courts should presumptively treat member-managed limited liability companies as partnerships. In contrast, manager-managed limited liability companies should be presumptively treated as corporations. Finally, the Article concludes with suggestions for legislatures to resolve this issue.

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3. MONT. CODE ANN. §§ 39-71-118(1)(a), 39-51-203(1) (1993).

4. MONT. CODE ANN. § 39-71-118(4)(a)-(b) (1993) (working partners are not considered employees unless employer expressly elects coverage).

5. MONT. CODE ANN. §§ 39-71-401(2)(d), 39-51-204(1)(n) (1993).

6. MONT. CODE ANN. § 39-71-118(4) (1993). If sole proprietors or partners elect coverage, all income they receive from the business, including net profits, is considered wages. MONT. CODE ANN. § 39-71-123(1)(d) (1993).

7. MONT. CODE ANN. § 39-71-401(4) (1993).

8. MONT. ADMIN. R. 24.29.705(1)(c) (1987). An officer may also opt out if "the officer is not engaged in performing the ordinary duties of a worker for the corporation and the officer does not receive any pay from the corporation for performing the ordinary duties of a worker for the corporation." MONT. ADMIN. R. 24.29.705(1)(a) (1987).

## I. ATTRIBUTES OF LIMITED LIABILITY COMPANIES

Confusion about how courts and agencies should treat limited liability companies for workers' compensation and unemployment compensation purposes stems from the fact that limited liability companies share both corporate and partnership attributes under state law. A close examination of limited liability companies, however, leads one to conclude that limited liability companies possess partnership operational characteristics and corporate liability characteristics.<sup>9</sup> Operational characteristics, this Article proposes, are more relevant to classifying limited liability companies under the Acts than liability characteristics.

Limited liability companies, like partnerships, lack the corporate continuity-of-life operational characteristic.<sup>10</sup> As such, if an owner of a limited liability company dies, resigns, or files bankruptcy (and the member's interest is not purchased by the limited liability company within ninety days), the limited liability company is dissolved.<sup>11</sup> Similarly, interests in limited liability companies, unlike corporate stock, are not freely transferable.<sup>12</sup> As with partnership interests, owners of limited liability companies who seek to transfer their interests transfer only interests in any distributions from the limited liability companies.<sup>13</sup> The transferees do not gain the right to manage or vote.

Limited liability companies, like partnerships, are generally managed by members, not by managers or a board of directors.<sup>14</sup>

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9. The operational characteristics of a limited liability company should be distinguished from the liability characteristics. The characteristics governing liability of limited liability company members are based on the corporate model. For example, the Montana Limited Liability Company Act provides that members and managers of limited liability companies are not liable to creditors solely because they serve as members or managers of the limited liability company. MONT. CODE ANN. § 35-8-304 (1993).

10. Compare MONT. CODE ANN. §§ 35-10-616, -624 (1993) (relating to dissolution of partnerships) with MONT. CODE ANN. §§ 35-8-802, -901 (1993) (relating to dissolution of limited liability companies).

11. MONT. CODE ANN. § 35-8-802(1) (1993).

12. Compare MONT. CODE ANN. § 35-1-628 (1993) (relating to corporate shares being transferable unless transfer is restricted) with MONT. CODE ANN. § 35-8-704 (1993) (limiting assignability of partnership interests).

13. Compare MONT. CODE ANN. §§ 35-8-704, -706, -801 (1993) (restricting transfers of interests in limited liability companies) with MONT. CODE ANN. §§ 35-10-508, -510 (1993) (restricting transfers of interests in partnerships).

14. Compare MONT. CODE ANN. §§ 35-10-301, -401 (1993) (relating to partners managing partnerships) with MONT. CODE ANN. §§ 35-8-301, 401 (1993) (stating that as a general rule limited liability companies are managed by members). The Montana Limited Liability Company Act provides that as a default rule, limited liability companies are member-managed. MONT. CODE ANN. §§ 35-8-301, 401. Limited liability companies may be managed by managers, but only if the articles of organization so provide. See MONT. CODE ANN. §§ 35-8-202(1)(e)(i), -401 (1993).

Limited liability companies managed by their owners are called member-managed limited liability companies. Those managed by a person or persons other than the owners are called manager-managed limited liability companies. Unless the organizational documents provide otherwise, as partnerships, each limited liability company member has one vote.<sup>15</sup> Limited liability company management is flexible like a partnership. Unlike corporations, no rigid requirements for meetings or for a board of directors exist. Instead, the operation of a limited liability company is governed by an operating agreement, which is quite similar to a partnership agreement.<sup>16</sup>

Professor Larry Ribstein, who was instrumental in drafting the ABA Prototype Act, noted the striking operational similarity between partnerships and limited liability companies. Because of these operational similarities and the added benefit of limited liability for members of limited liability companies, he predicts that over time "the partnership form of business will greatly diminish in importance" and that "after a transitional period, partnership will survive, if at all, as a residual form" of doing business.<sup>17</sup>

Although the liability aspects of limited liability companies resemble corporations, the operational aspects are the most relevant for workers' compensation and unemployment compensation purposes.<sup>18</sup> The Workers' Compensation and Unemployment Compensation Acts govern the relationship between a business and its employees. Because working partners are, in a sense, both employer and employee, it is difficult to classify them as either employees or employers. In examining how members of limited liability companies should be classified, the operational aspects of limited liability companies define the relationship between limited liability companies and their members. Because the operational aspects of member-managed limited liability companies are nearly identical to partnerships, a presumption arises that courts and regulatory agencies should classify limited liability companies as partnerships under the Acts.

## II. TAX TREATMENT OF LIMITED LIABILITY COMPANIES

Examining how other agencies treat limited liability compa-

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15. MONT. CODE ANN. § 35-8-403 (1993).

16. See STEVEN C. BAHL, MODEL BUSINESS ORGANIZATIONS FORMS (State Bar of Mont. 1993) (compare Form I with Form J).

17. Ribstein, *supra* note 1, at 417.

18. The liability aspects of limited liability companies, which focus on the rights of third-party creditors, are largely irrelevant to workers' and unemployment compensation.

nies is instructive in determining how to classify limited liability companies. The Nevada State Industrial System, for example, examined how the Internal Revenue Service (IRS) classifies limited liability companies and decided to follow the IRS classification.<sup>19</sup> The Internal Revenue Code, like the Montana Workers' Compensation Act, does not expressly state whether limited liability companies are treated like partnerships or corporations. The IRS has, in regulations, described the attributes of a business taxed as a corporation.<sup>20</sup> The IRS states that these are the fundamental attributes that distinguish a corporation from a partnership: (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interest.<sup>21</sup> The business organization must have three of the four corporate characteristics to be a corporation. Member-managed limited liability companies, formed under the default provisions of the Montana Limited Liability Company Act, have only one of the four characteristics—the attribute of limited liability.<sup>22</sup> The IRS has consistently and uniformly ruled member-managed limited liability companies are partnerships when formed with characteristics provided by the default provisions of the Montana statute.<sup>23</sup>

The regulations from which the IRS rulings are derived have their source in the seminal United States Supreme Court case of *Morrissey v. Commissioner*,<sup>24</sup> which identified several characteristics that distinguish corporations from other business organizations. The relevant regulations recognize that determining whether a business organization is a corporation or a partnership is a question of substance rather than form. State agencies and courts should not adopt a policy of determining that limited liability companies are corporations without first considering a standard similarly sophisticated to that found in the IRS regulations.

The Montana Department of Revenue has proposed regula-

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19. Nevada State Indus. Ins. Sys., Opinion for SIIS Policyholder Services re LLC (undated) (on file with author).

20. Treas. Reg. § 301.7701-2 to -3 (1993).

21. Treas. Reg. § 301.7701-2.

22. See Bahls, *supra* note 1, at 53.

23. Rev. Rul. 88-76, 1988-2 C.B. 360 (Wyoming limited liability companies); Rev. Rul. 93-5, 1993-1 C.B. 227 (Virginia limited liability companies); Rev. Rul. 93-6, 1993-1 C.B. 229 (Colorado limited liability companies); Rev. Rul. 93-30, 1993-1 C.B. 231 (Nevada limited liability companies); Rev. Rul. 93-53, 1993-26 C.B. 7 (Florida limited liability companies); Rev. Rul. 93-49, 1993-25 C.B. 11 (Illinois limited liability companies); Rev. Rul. 93-50, 1993-25 C.B. 13 (West Virginia limited liability companies). The IRS is reviewing the Montana Limited Liability Company Act for a possible ruling.

24. 296 U.S. 344 (1935).

tions regarding the treatment of limited liability companies.<sup>25</sup> Like the Internal Revenue Code, Montana tax law does not expressly address whether limited liability companies are treated as partnerships or corporations. The Montana Department of Revenue has properly avoided the temptation to reinvent the wheel with definitions inconsistent from those used for federal tax purposes. The department's proposed rules correctly state that the "taxation of a limited liability company in Montana depends upon its federal classification as a corporation or a partnership as determined by the Internal Revenue Service."<sup>26</sup>

While the federal tax law approach provides an instructive and useful starting point, tax law does not definitively answer the question of how limited liability companies should be treated for purposes of workers' and unemployment compensation. The purposes of tax law and the law of workers' and unemployment compensation are not identical. Tax law is designed to raise revenue. Workers' and unemployment compensation law strike a delicate balance between employees' rights and the employers' obligations. Courts and agencies, therefore, while respecting the position taken by the IRS, should examine both the language and the purpose of the definitions found in the relevant statutes.

### III. STATUS OF LIMITED LIABILITY COMPANIES UNDER WORKERS' AND UNEMPLOYMENT COMPENSATION ACTS

As a general rule, courts and regulatory agencies should treat members of member-managed limited liability companies as partners for workers' compensation and unemployment compensation purposes. Four reasons justify this result. First, no statutory authority exists in Montana to treat members of limited liability companies as employees. Second, if the Montana Legislature intended to cover members of limited liability companies for workers' and unemployment compensation, it would have stated its intent. Absent express intent, it should not be implied. Third, members of member-managed limited liability companies, like partners, have both employer and employee attributes. Fourth, failing to treat members of member-managed limited liability companies as partners would defeat the legislative intent to provide a new type of business organization with the operational benefits of a partnership.

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25. Notice of the Proposed Adoptions of New Rules I and II Relating to Limited Liability Companies, 7 Mont. Admin. Reg. 42-2-562 (proposed by Dep't of Rev. Apr. 4, 1994).

26. See Notice, *supra* note 25.

*A. No Statutory Authority Exists to Treat Members of Limited Liability Companies as Employees*

The Montana Workers' Compensation Act specifically states that the term "employee" includes all "officers and members of boards of directors of quasi-public or private corporations while rendering actual service for the corporations for pay."<sup>27</sup> The Montana Unemployment Insurance Act contains similar provisions.<sup>28</sup> Limited liability companies are not chartered as corporations and do not have officers or directors. Both Acts lack language classifying members of limited liability companies as employees. Absent such express language, the legislative intent to treat members of limited liability companies as employees should not be implied.

The Montana Workers' Compensation Act further recognizes that partners and sole proprietors are not covered by the Act, unless the employer affirmatively elects coverage.<sup>29</sup> The Montana Unemployment Compensation Act contains similar provisions.<sup>30</sup> The statutory scheme governing the relationship of a partner to a partnership is nearly identical to the statutory scheme governing the relationship of a member to a limited liability company. The partnership statute states "each partner is an agent of the partnership for the purpose of its business."<sup>31</sup> The limited liability company statute similarly states that "a member is an agent of the limited liability company for the purpose of its business."<sup>32</sup> Just as partners manage partnerships,<sup>33</sup> members (unless otherwise provided) manage limited liability companies.<sup>34</sup> Since the statutes do not expressly provide that limited liability company members are treated as employees, courts and agencies should not imply such intent.

The fact that the Montana Workers' and Unemployment Compensation Acts exempt sole proprietors and working members of partnerships from coverage, but not members of limited liability companies, is not determinative. Since members of limited liability companies are not included in the definition of "employee" or "worker" in either Act, there is no need to exclude them from coverage. Members of limited liability companies do not fall within the statutory definition of employee because they are not "in ser-

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27. MONT. CODE ANN. § 39-71-118(1)(a) (1993).

28. MONT. CODE ANN. § 39-51-203(1) (1993).

29. MONT. CODE ANN. §§ 39-71-118(4), -401(2)(d) (1993).

30. MONT. CODE ANN. § 39-51-204(1)(n) (1993).

31. MONT. CODE ANN. § 35-10-301(1) (1993).

32. MONT. CODE ANN. § 35-8-301(1) (1993).

33. MONT. CODE ANN. § 35-10-401(6) (1993).

34. MONT. CODE ANN. § 35-8-401(1) (1993).



vice of an employer.”<sup>35</sup> Members, instead of being “in service” of limited liability companies, manage the affairs (and employees) of the limited liability company.<sup>36</sup>

If courts and administrative agencies were, judicially or by administrative interpretation, to add members to the definition of employee, they would violate the prohibition against liberally interpreting the Workers’ Compensation Act. The Montana Code expressly states that the Workers’ Compensation Act “must be construed according to its terms and not liberally.”<sup>37</sup> The legislature expressly stated officers and directors of corporations are employees. To judicially or administratively add the words “members of limited liability companies” to the definition of employee would, at best, be a prohibited liberal interpretation. At worst, it would be a rank misinterpretation of the Act.

*B. If the Legislature Intended to Cover Members of Limited Liability Companies, It Would Have Expressly Stated Its Intent*

The Montana Limited Liability Company Act<sup>38</sup> is a lengthy and comprehensive piece of legislation. The legislation not only created limited liability companies, but made appropriate revisions regarding limited liability companies in the assumed business name statute, the Montana Trademark Act, the Montana Business Corporations Act, the Montana Nonprofit Corporations Act, the Montana Professional Corporations Act, and the Montana Limited Partnership Act.<sup>39</sup> If the legislature intended to treat limited liability company members as employees or corporate officers or directors for purposes of workers’ compensation, the legislature would have expressly stated its intent, just as it expressed its intent with respect to amending the statutes mentioned above.

In a few states, members of limited liability companies are treated as corporate officers for purposes of workers’ compensation. In these states, legislation authorizes (and requires) such treatment.<sup>40</sup> The Montana Department of Labor and Industry and the

35. MONT. CODE ANN. § 39-71-118(1)(a) (1993).

36. MONT. CODE ANN. § 35-8-401(1) (1993).

37. MONT. CODE ANN. § 39-71-105(4) (1993). Courts and agencies should give this section of the Montana Code particular force. Prior to 1987, the Montana Code stated just the opposite. It stated the courts should liberally construe the Workers’ Compensation Act. MONT. CODE ANN. § 39-71-104 (1985).

38. MONT. CODE ANN. tit. 8, ch. 35 (1993).

39. 1993 Mont. Laws 304-11.

40. See, e.g., COLO. REV. STAT. ANN. § 8-41-202(4)(b) (West 1990 & Supp. 1993); KAN. STAT. ANN. § 44-703(h)(9)(i)(1)(C) (1993); MD. CODE ANN. LAB. & EMPL. § 9-206(a) (1991 &

State Compensation Insurance Fund had every opportunity to request that the Montana Legislature follow the statutory approach of these states but did not do so. In the absence of specific legislation requiring the department or courts to treat limited liability companies as corporations, the department and courts should decline to adopt a categorical rule that limited liability companies are not treated as partnerships.

*C. Members of Limited Liability Companies, Like Partners, Occupy the Dual Relationship of Employer and Employee*

The Workers' and Unemployment Compensation Acts treat sole proprietors and working partners in a special way, because they are business owners. Corporate officers and directors are not owners, but managers are subject to the shareholders' ultimate powers. Like partnerships and sole proprietorships, limited liability company members are business owners and should be distinguished from corporate officers and directors.

Professor Arthur Larson states the public policy reason for not treating partners as employees. He notes that in partnerships, "each partner has by law an equal share in management, and is, therefore, in actual possession of the powers of the employer."<sup>41</sup>

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Supp. 1993).

41. 1C ARTHUR LARSON, *THE LAW OF WORKMEN'S COMPENSATION* § 54.32 (perm. ed. rev. vol. 1993). Larson's position is supported by Schneider, who correctly notes:

The general rule is that a partner cannot recover compensation as an employee from the partnership of which he is a member, on the theory that the Act contemplates a relation between two opposite parties, of whom one is an employer and one is an employee, and a person cannot occupy the dual position of employer and employee at one and the same time. This is the general rule when the person in question is paid for his services by a share in the profits.

3 WILLIAM R. SCHNEIDER, *WORKMEN'S COMPENSATION* § 812, at 153 (1943); see also *Brinkley Heavy Hauling Co. v. Youngman*, 264 S.W.2d 409, 410 (Ark. 1954); *Cooper v. Industrial Accident Comm'n*, 171 P. 684, 685 (Cal. 1918); *Metro Constr., Inc. v. Industrial Comm'n*, 235 N.E.2d 817, 818 (Ill. 1968).

The other classic justification for not treating partners as employees is also described by Larson:

[A] partnership is not, except for a few specific purposes, an entity separate from its members. Therefore, since the partnership is nothing more than the aggregate of the individuals making it up, a partner-employee would also be an employer. The compensation act cannot be supposed to have contemplated any such combination of employer and employee status in one person.

1C LARSON, *supra* § 54.31, at 9-275 to -276.

The position that a partnership is an aggregate, not an entity, is no longer applicable to either partnerships or limited liability companies. In Montana, partnerships are entities. MONT. CODE ANN. § 35-10-201 (1993). Limited liability companies are also entities. MONT. CODE ANN. tit. 35, ch. 8, compiler's cmts. (stating that "[a]s a general rule, a Montana LLC should be considered as a separate entity").

That limited liability companies are entities is not determinative. Larson makes it clear

Professor Larson states that a partner is "as much employer as anyone can be, not as a matter of conceptual reasoning, but as a matter of actual function and rights."<sup>42</sup> Larson properly observes that partners are obligated to manage the partnership, without remuneration.<sup>43</sup> Sometimes, however, partnerships pay a salary to a partner who contributes more services than another partner. According to Larson, courts should consider the salary not "as pay for something [the partner] would not be bound to do, but rather merely as an adjustment between the partners to offset the failure of the other partner to furnish the normal services required of a partner."<sup>44</sup>

The proposition that partners are not employees for purposes of workers' compensation is well accepted by courts. Larson notes that "with the exception of Oklahoma and Louisiana, every state that has dealt judicially with the status of working partners or joint venturers has held that they cannot be employees."<sup>45</sup>

Critical to the definition of employee is that an employee is subject to the employers' control.<sup>46</sup> Courts have repeatedly recognized that for workers' compensation purposes, partners are not subject to the partnership's control.<sup>47</sup> Instead, partners control the partnership. As a result, it is inappropriate to characterize partners as being in an employer-employee relationship.<sup>48</sup>

The well-accepted analysis that partners do not have an employer-employee relationship with their partnership applies with equal force to members of member-managed limited liability companies. Members of member-managed limited liability companies have an equal share in management and, as such, have the powers of an employer.<sup>49</sup> Just as partners in partnerships do not have a

that the most important reason not to treat partners as employees is the partners' inherent share in management. He states: "Even if the conceptual difficulty of lack of legal entity in the partnership could be surmounted, there would remain a more stubborn obstacle, which is the fact that in any ordinary partnership each partner has by law an equal share in management." 1C LARSON, *supra* § 54.32, at 9-280.

42. 1C LARSON, *supra* note 41, § 54.21, at 9-281; *see also* Brinkley Heavy Hauling Co. v. Youngman, 264 S.W.2d 409, 410 (Ark. 1954); *In re* W.A. Montgomery & Son, 169 N.E. 879, 880 (Ind. App. 1930); *Hays v. Wyoming Workers' Compensation Div.*, 768 P.2d 11, 14-15 (Wyo. 1989).

43. 1C LARSON, *supra* note 41, § 54.32; *see* MONT. CODE ANN. § 35-10-401(6), (8) (1993).

44. 1C LARSON, *supra* note 41, § 54.32, at 9-282; *see also* Cooper v. Industrial Accident Comm'n, 171 P. 684, 686 (Cal. 1918).

45. 1C LARSON, *supra* note 41, § 54.30, at 9-268.

46. *See, e.g.*, Loos v. Waldo, 257 Mont. 266, 849 P.2d 166 (1993).

47. *See supra* notes 41-44.

48. *See, e.g.*, MONT. CODE ANN. § 35-10-401 (1993).

49. *See supra* text accompanying notes 9-16.

statutory right to compensation (other than a share of profits) for their management services, members of limited liability companies do not have a statutory right to compensation. Both the Montana Uniform Partnership Act and the Montana Limited Liability Company Act assume that distributions will be made to the owners by profit distributions, not wages.<sup>50</sup> As a result, Larson's well-reasoned analysis of the status of partners compels a similar conclusion that the members of member-managed limited liability companies are not employees.

*D. Failing to Exempt Members From the Compensation Acts Would Frustrate Public Policy*

The legislature enacted limited liability company legislation to facilitate formation of small Montana businesses. Saddling members of limited liability companies with the burdens of being classified as employees for purposes of workers' and unemployment compensation will have the opposite impact. This author stated in his testimony before the legislature:

Montana business deserves the same opportunity and advantage afforded to business in neighboring states. To remain competitive, Montana should provide this opportunity immediately. Not only will LLCs provide an exciting alternative to more conventional forms of business organizations in our state, but legislation will facilitate a welcome improvement in Montana's business image. LLCs are pro-economic development, at virtually no cost. And as Montana strives to be a leader, not a follower, in providing for small business, it makes great sense that Montana seize this opportunity now.<sup>51</sup>

Treating working members of member-managed limited liability companies as employees would not only fly in the face of legislative intent, it would be a step backwards for Montana business.

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50. MONT. CODE ANN. §§ 35-8-601, 35-10-401(8) (1993).

51. *Montana Limited Liability Company Act: Hearings on SB 146 Before Judiciary Committee of Montana State Senate*, 53d Mont. Leg., Reg. Sess. (1993) (statement of Steven C. Bahls at 7). Professor Singer has observed that:

Legislative purpose may also be a valuable guide to decision in cases where the effect of a statute on the situation at hand is unclear either because the situation was unforeseen at the time when the act was passed, or the statutory articulation of the rule or policy is so incomplete that it cannot be clearly said to speak to the situation in issue.

2A NORMAN J. SINGER, *STATUTES AND STATUTORY CONSTRUCTION* § 45.09, at 42 (5th ed. 1992). Courts have recognized that testimony at legislative committee hearings can be used to aid in ascertaining legislative purpose. *Id.* § 48.10, at 342-44. According to Singer, if draftspersons' views about a bill are communicated to a legislative body, there is reason to attach weight to their views. *Id.* § 48.12, at 353.

In the author's view, the legislature did not intend members of member-managed limited liability companies to be treated as employees.<sup>52</sup> The legislature intended to create a business organization that had the partnership advantages and limited liability. Treating limited liability company members as employees potentially defeats those advantages and frustrates legislative intent.

#### IV. SUGGESTED TREATMENT OF LIMITED LIABILITY COMPANIES

To foster formation of limited liability companies, they should be, to the extent practicable, treated consistently from state agency to state agency. Just as the Montana Department of Revenue follows the well-reasoned IRS policy of treating most limited liability companies as partnerships, the Department of Labor and Industry and the State Workers' Compensation Fund should adopt a policy that is as consistent with the IRS policy as possible.<sup>53</sup> Fortunately, the Department of Labor and Industry has adopted a well-reasoned interim policy regarding the treatment of limited liability companies for unemployment insurance and workers' compensation coverage. The policy states: "Limited Liability Companies who have filed with the Secretary of State with 'member managers' will be presumed to be like partnerships."<sup>54</sup> The policy also states: "If the Limited Liability Company has filed with the Secretary of State as a 'manager only' entity, it will be presumed to be like a corporation."<sup>55</sup>

The interim policy treating member-managed limited liability companies as partnerships should be adopted by the courts and made permanent by the Department of Labor and Industry. The policy is justified by both the statutory language and the policies behind the treatment of partnerships for workers' compensation

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52. Legislative intent, of course, is not absolutely clear. There is evidence, however, that the legislature intended that administrative agencies treat limited liability companies as partnerships. While not expressly addressing workers' or unemployment compensation issues, the Subcommittee that drafted the Act submitted the following Comments during the legislative hearings on the Montana Limited Liability Company Act: "It is expected and intended that the Montana Department of Revenue apply the same analysis as that applied in Revenue Ruling 88-76 to determine that [limited liability companies] are taxed as *partnerships* in Montana." LIMITED LIAB. CO. SUBCOMMITTEE OF THE STATE BAR OF MONT., COMMENTS TO THE MONTANA LIMITED LIABILITY COMPANY ACT 2 (1993) (emphasis added).

53. I do not mean to suggest that courts or agencies should always apply the four-prong test promulgated and used by the IRS. See *infra* text accompanying notes 59-60.

54. Montana Department of Labor & Industry and State Compensation Insurance Fund Press Release, *State Agencies Announce Interim Plan for Limited Liability Companies* (May 19, 1994). The policy is an interim policy, pending the outcome of a lawsuit filed for a declaratory judgment on the issue.

55. *Id.*

purposes. The interim policy properly takes into account the economic realities of member-managed limited liability companies. It also properly creates some degree of certainty for businesses, employees, and insurers.

The proper treatment of working members of manager-managed limited liability companies is a more difficult issue. Many of the arguments that members of limited liability companies are the functional equivalent of partners holds less weight when applied to both members and managers of manager-managed limited liability companies. In manager-managed limited liability companies, working members do not possess the powers of both an employer and an employee. With manager-managed limited liability companies, managers are the functional equivalent of a corporate board of directors. If working, nonmanaging members of manager-managed limited liability companies receive compensation for services (as distinguished from a share of profits), a much stronger argument can be made that such compensation is subject to the Workers' and Unemployment Compensation Acts. Presumably these members are subject to the managers' control and, as such, are employees because they are "in the service of an employer."<sup>56</sup>

An even more difficult issue is classifying managers of manager-managed limited liability companies. Managers of manager-managed limited liability companies are the functional equivalent of officers or the members of a board of directors. Just as members of corporate boards of directors are elected and removed by the shareholders,<sup>57</sup> managers of manager-managed limited liability companies are elected and removed by members.<sup>58</sup> Payment to managers (many of whom may be nonowners) of manager-managed limited liability companies may not fairly be argued to be adjustments to owners' capital accounts. As such, in most cases, managers are similar to directors or officers and may be more easily classified as employees for the purposes of both workers' and unemployment compensation. Once again, the department's interim policy is correct. Treating manager-managed limited liability companies as corporations reflects the economic reality of manager-managed limited liability companies.

## V. SUGGESTED LEGISLATIVE APPROACHES

In order to eliminate uncertainty found in the current Mon-

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56. MONT. CODE ANN. § 39-71-118(1)(a) (1993).

57. MONT. CODE ANN. §§ 35-1-419, -424 (1993).

58. MONT. CODE ANN. § 35-8-402 (1993).

tana Workers' and Unemployment Compensation Acts, the Montana Legislature should amend both Acts to specify proper treatment of limited liability companies. Because the nature of individual limited liability companies varies, the legislature should reject the temptation to treat all limited liability companies similarly. The legislature should consider adopting one of two approaches. The legislature could: (1) use the four-factor test used by the IRS,<sup>59</sup> or (2) adopt the Department of Labor and Industry's interim policy classifying member-managed limited liability companies as partnerships and manager-managed limited liability companies as corporations.<sup>60</sup>

The four-factor test used by the IRS is a sophisticated test developed by the United States Supreme Court.<sup>61</sup> Unfortunately, it is difficult to apply to workers' and unemployment compensation issues, because it does not focus exclusively on the relationship between the business owners and the business. The four-factor test takes into account extraneous factors such as owner liability to third-party creditors. The four-factor test also creates substantial uncertainty. Absent studying a limited liability company's operating agreement and articles of organization, it is difficult to determine whether the factors of continuity of life, free transferability of interest, and centralized management exist. Some uncertainty is tolerable for purposes of income taxation since the only party primarily disadvantaged by the uncertainty is the taxpayer who has ready access to the legal documents to assess which classification is proper. This uncertainty is not acceptable for workers' and unemployment compensation purposes. Insurers and employees do not have ready access to the necessary documents to assess which of the four factors exist. Substantially more certainty is required.

The best alternative for the Montana Legislature is to enact the department's interim policy that treats member-managed limited liability companies as partnerships and manager-managed limited liability companies as corporations. This alternative does not suffer from the uncertainty of the four-prong test used for federal tax purposes. Whether a limited liability company is member-managed or manager-managed is verifiable by reviewing the articles of organization filed with the Secretary of State.<sup>62</sup> New statutory language that focuses on whether the entity is member-managed or manager-managed properly would consider whether

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59. See *supra* text accompanying notes 19-26.

60. See *supra* text accompanying notes 54-55.

61. See *supra* text accompanying note 24.

62. See MONT. CODE ANN. § 35-8-202(1)(e) (1993).

members are effectively both employers and employees. The simplicity of the department's interim rule, combined with the recognition of the historical doctrine that partner-partnership relationships are not employment relationships, justifies the legislature's consideration.

### CONCLUSION

Any new form of business organization, particularly a new form of business organization that is a hybrid of others, is bound to cause some uncertainty. The uncertainties about the classification of limited liability companies for workers' and unemployment compensation purposes should be resolved by the legislature in its next regular session. Prompt resolution of these uncertainties will limit the necessity for costly litigation.<sup>63</sup> As courts, legislatures, and agencies resolve ambiguities about limited liability companies, including those discussed in this Article, limited liability companies will become an even more attractive form of doing business.

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63. The author is aware of one case already pending in district court in Missoula County. *The Gutter Guy, LLC v. State Comp. Ins. Fund*, No. 79138 (Mont. Fourth Judicial Dist. Court, Missoula County, filed Mar. 10, 1994).



