

Legal Risk Management Tip
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CONSIDERATIONS FOR FORMING AND OPERATING A CALIFORNIA LLC: PART 1

The first step in the process of any new business is deciding which entity structure the new company will utilize. However, this process is also riddled with possible pitfalls. Taking the time to understand the pros and cons of any entity structure is vital to the short and long-term success of the company. In this two-part series, we will focus on one such business entity type – the Limited Liability Company (“LLC”), and will describe the entity structure, governing rules in the State of California and some common pitfalls to avoid when registering and operating your company as an LLC.

What is an LLC?

An LLC is a flexible legal entity structure, organized for any legal purpose,¹ whose owners cannot be held personally liable for the company's debts or liabilities. This means an owner's financial liability is limited to a fixed sum, normally equal to the owner's investment in the company. At the same time, LLCs are incredibly flexible, and most statutes governing LLCs allow for the company's Operating Agreement (the governing document of a LLC) to dictate how the company will function. While this is normally a benefit, there are disadvantages to this as well which will be discussed in more detail below. In essence, an LLC is a ‘blended’ entity giving entrepreneurs the limited liability protections inherent in a corporation, with minimal operating costs, governance requirements and the beneficial tax treatment of a sole proprietorship or partnership. Specific rules and regulations governing LLCs differ slightly from one country, or even one state, to the next.

Initial Considerations to LLC Formation

1. Selecting your Entity

Selecting which entity structure should be utilized when starting a new business can be a somewhat daunting task. Certain liability, taxation and record-keeping considerations must be taken into account. The most common types of entities employed by new businesses include sole proprietorships, general partnerships, limited partnerships, corporations and LLCs. While there is no “perfect” entity type, certain characteristics of each entity may lend themselves best to a particular industry and/or business. Going through the advantages and disadvantages of each entity would be far too time consuming for purposes of this article. However, it is recommended that anyone seeking a new entity explore and understand the characteristics of each entity prior to registration.

2. Selecting a Jurisdiction and Registering a “Foreign” LLC

LLCs are now a recognized in all fifty states, Puerto Rico and the District of Columbia. Individuals seeking to establish an LLC have their choice of states for doing so. Deciding which state to organize the LLC typically rests upon such factors as: the nature of the business, the source of funding for the business and the company's long-term business plan. Aspiring entrepreneurs should also consider the tax ramifications of their decision. For instance, if a business operates in the state of California, but

¹ LLCs may not be used for the following business types: banking, trust company and those businesses which issue policies of insurance and assume insurance risks.

decides to organize in another state, the LLC is not going to be able to avoid California state taxes simply due to the fact that it was formed elsewhere. The tax and corporation laws in California require out-of-state, or “foreign,” LLCs to pay taxes regardless of the LLC state of organization. This is of particular importance to small business owners who may organize in other states to take advantage of their lower “corporate taxes” without realizing that they are now in fact subject to taxes in both states.

3. Drafting the Operating Agreement

The single most important document for any LLC is the firm’s operating agreement because it structures the business’ financial and functional decisions. An operating agreement is the agreement among LLC members that governs the LLC’s business, as well as the member’s financial and managerial duties. The operating agreement should always be customized to the particular needs of the LLC to properly govern internal operations of the business in a way that suits the business and its owners. Once an operating agreement is signed by the members, its terms are binding.

Failure to customize the LLC’s operating agreement can lead to a myriad of problems, particularly if provisions are silent, or ambiguously written. For instance, an operating agreement should specify which members may bind the LLC in transactions with third parties, how membership interests may be transferred, what are the voting rights of members, and specify procedures for raising additional capital or making distributions. Unclear terms can all lead to internal strife amongst members, and cause the LLC to operate in a manner other than how its ownership envisioned.

Increased Number of “Default Rules”

As of January 1, 2014, the California Revised Uniform Limited Liability Act (“RULLCA”)² governs the use of LLCs in California, replacing the Beverly-Killea Limited Liability Company Act of 1994 (the “Beverly-Killea Act”). While RULLCA does not require existing LLCs to perform any new filings, these new rules apply to both new LLC formations, as well as local and foreign LLCs *already in existence* at the time of RULLCA’s effective date. There is no ability for existing California LLCs to “opt out” of RULLCA. Of particular importance are the “default” provisions of the new statutes. Such provisions automatically apply if the members have not agreed to more specific terms relating to certain governance matters in a written operating agreement. If an existing (or amended) operating agreement adopts rules for operation that are different from the “default” rules stated in RULLCA, then the terms of the operating agreement will override the default rules of RULLCA.

Although RULLCA does not require existing LLCs to revise their operating agreements or file any new documents, it is important for most LLCs to amend their agreements in writing to reflect the many changes for members and managers. Below are some of the more impactful default provisions of which LLC owners need be made aware:

a. New Rules for Formation

LLCs are now presumed to be member-managed.³ If the firm prefers not be member-managed, the new law requires a written statement in the LLC’s articles of organization and operating agreement designating that the LLC is manager-managed. For existing LLCs, if members intend the LLC to be

² Codified at California Corporations Code sections 17701.01 - 17713.13.

³ California Corporations Code at 17704.07(a).

manager-managed, and the LLC's articles of organization do not include a written statement as such, an amendment to the articles will be required to comply with the new rules.

Formation also has been expanded to include all agreements of the members "whether oral, in a record, implied, or in any combination thereof."⁴ Additionally, "a person that becomes a member of a limited liability company is deemed to assent to the operating agreement," under the new default rules. Therefore, a member can be subject to not only an implied agreement, but also to a written one that is not reviewed or signed. Due to this expansion of LLC formation, it is important for members to thoroughly document all agreements concerning operation of the LLC in writing, and sign them. This will help avoid a situation where an agreement would be implied.

b. Duties Owed by Members

RULLCA expands upon previous rules that made reference to the fiduciary duty of members by specifically requiring members and managers to abide by the duty of loyalty,⁵ the duty of care,⁶ and "any other fiduciary duty." Although RULLCA permits members to modify the duty of loyalty, subject to a "not manifestly unreasonable" and upon full disclosure and informed consent from the members, the duty of loyalty cannot be eliminated altogether.⁷ As such, fiduciary duties should be clearly defined in an LLC's operating agreement.

c. Members' Authority

Another default rule limits a manager's authority to act without approval of all the members on particular matters, including (1) a sale, lease or exchange of all or substantially all of the assets of the company, and (2) any action outside the "ordinary course" of the company's business. RULLCA also requires unanimous member approval for amendments to operating agreements.⁸

The requirement of unanimity means that a member with a minority interest can hold up and potentially defeat the decisions of the majority members. This is particularly important, because a member can have voting rights, or other non-economic rights, without being required to make a contribution to the LLC. Therefore, a member may transfer their economic interest in an LLC while maintaining his voting rights and status as a member.⁹

It is important to review operating agreements to ensure they explicitly state that matters are to be decided by the majority or supermajority instead of unanimously, if that is the intention. If decision making power is not clear, there is a significant risk that the LLC will face questions about whether or not important actions were authorized, within the scope of the manager's authority, or outside the "ordinary course" of the company's activities.

⁴ California Corporations Code at 17701.02.

⁵ Defined in Section 17704.09(b) as preventing a member from engaging in a competing business or taking a corporate opportunity.

⁶ Defined in Section 17704.09(c) as refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law.

⁷ California Corporations Code at 17701.09, 17701.10(c)(4), 17701.10(c)(14)-(15).

⁸ California Corporations Code at 17704.07(c)(4).

⁹ California Corporations Code at 17704.07(c)(4).

d. Ownership Interests

The new default rules now include automatic disassociation for a member in the following circumstances: (1) the death of a member, (2) the appointment of a guardian or conservator for a member in a member-managed LLC, (3) a member is judicially deemed incapable of performing their duties in a member-managed LLC, and (4), a member of a member-managed LLC becomes a debtor in bankruptcy, and/or (5) a membership interest in the LLC is distributed for a member that is a trust. Upon disassociation, the member loses all rights to participate in the LLC's management. If the disassociated member also is serving as a manager, they will be automatically removed from that position.¹⁰

The new default rule codifies the current law where a deceased or incompetent member's family member or guardian steps into the shoes of the dissociated member with respect to receiving distributions from the LLC, but has no other rights as a member. Further, under RULLCA, the remaining members of the LLC could amend the operating agreement to modify or reduce the rights of the dissociated transferee.¹¹ Moreover, an operating agreement may provide that in the case of certain dissociative events of a manager, the manager may continue to manage the LLC. Such issues may be addressed explicitly in the operating agreement so that the new default rule does not apply, and the likelihood of disputes is minimized.

e. Indemnification

Rather than simply permitting indemnification as Beverly-Killea Act had, RULLCA's default rule now requires reimbursement and indemnification of members and managers for any expenses, debt, obligations or other liabilities incurred on behalf of the LLC so long as such members abide by RULLCA.¹² Reimbursement and indemnification is not required if such expenses violate any fiduciary duties. Any LLC that wishes to scale back or clearly delineate the duties of managers or members in order for them to be indemnified should address such concerns in its operating agreement.

Conclusion

In this first part of the series, we laid down the framework of what defines an LLC along with rules that must be considered for LLCs in California. We will be expanding upon this along with other considerations to factor in during next month's Legal Risk Management Tip. While there are distinct advantages to forming an LLC in certain situations, it should not be perceived as the best choice in every situation. Next month's article will further expand upon those considerations.

For more information on this topic, please contact us at (619) 298-2880 or at info@jackolg.com.

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¹⁰ California Corporations Code at 17706.01(b)(2), 17705.02(a)(3), 17706.03(a)(1).

¹¹ California Corporations Code at 17701.12 (b), 17701.12 (d)(1).

¹² California Corporations Code at 17704.08(a), 17701.10(g).