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About the Business Advisor

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STRUCTURING AN LLC UNDER CALIFORNIA LAW

by Mary Hanson

The limited liability company (“LLC”) is an entity with features that differ from those of corporations, limited partnerships, and other types of entities. The key attraction to LLCs is that the law provides protection from personal liability for the members and managers and yet allows greater flexibility in the ownership, management, and tax treatment than other entities. The owners (“members”) can be individuals, trusts, corporations, or other LLCs. An LLC can be managed by one or more managers (who may or may not be members) or by the members of the LLC. An LLC can design its own methods for management, rather than being required to have a board of directors or a general partner. An LLC can choose from a variety of types of tax treatments that are broader than the options available to corporations or limited partnerships.

A California limited liability company is formed by the filing of a one-page form (“Form LLC-1 Articles of Organization”) with the California Secretary of State or filing on-line on the Secretary of State’s website. The form and the on-line filing require the name of the LLC, the street address and mailing address of the LLC, the name and address of the LLC’s Agent for Service of Process, and an indication of whether the LLC is to be managed by “All LLC Members,” “One Manager,” or More than One Manager.”

Although an operating agreement is not filed with the state, a thorough

operating agreement is needed to provide a structure for management, decision-making, voting, distribution of profits, and authority to act on behalf of the LLC. Since California law does not impose a required structure for LLCs and allows a great deal of flexibility in defining an LLC’s structure and management, the creators of an LLC should take steps to establish the desired features in an operating agreement that binds the members and the LLC.

Because the California Revised Uniform Limited Liability Company Act (“RULLCA”), which has been in effect since 2014, includes a number of default provisions imposed on LLCs if not overridden by the terms of an operating agreement, a California LLC needs an operating agreement that addresses the default provisions of RULLCA. Some provisions imposed by RULLCA on the LLC may not be desired by the LLC members or managers. An operating agreement should modify unwanted default provisions and also recite provisions of RULLCA that affect the LLC so that members and managers are aware of the provisions that are imposed by law whether covered in an agreement or not.

Management Authority

Under RULLCA there is a presumption that an LLC is **member-**managed unless both the Articles of Organization (LLC-1) and the operating agreement state that the LLC is **manager-**managed. Many LLCs will prefer to be managed by

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one or more managers and will need to make sure both the LLC-1 and the operating agreement state that the LLC will be managed by managers. A family business or investment operated by parents and children as members will often prefer to have the LLC managed by one or both parents as the managers.

Under RULLCA, when an LLC is managed by the **members**, each member is an agent of the LLC and the act of any member binds the LLC unless the other party to the transaction knows that the particular member does not have authority to bind the LLC.

If the LLC is managed by one or more **managers** no member of the LLC has any authority to legally bind the LLC, unless the member is also a manager or has some other authority actually delegated to that member by the LLC.

An LLC needs the authority of managers to be clearly set out in the LLC operating agreement so that banks, lenders, vendors, and others doing business with the LLC can easily confirm the authority of individuals to make legal commitments on behalf of the LLC by reviewing the operating agreement.

A provision of RULLCA states that a “note, mortgage, evidence of indebtedness, contract, certificate, statement, conveyance or other instrument in writing” between the LLC and another party is deemed valid if signed by at least two managers (by one manager if the LLC is managed by just one manager), unless the other party has actual knowledge that the manager or managers do not have authority to execute the document.

The authority of managers is limited, however, by certain provisions of the California law that require the consent of ALL members for certain actions by the LLC unless the provisions are modified by the operating agreement.

Approval of Members. Whether an LLC is member-managed or manager-managed, RULLCA imposes the requirement of unanimous approval of members for acts “outside the ordinary course” of business of the LLC, unless the operating agreement of the LLC covers the issue with a different treatment or standard. For LLCs managed by managers, the California law lists specific actions that require the approval of all members, including the sale, lease or other disposition of all or substantially all of the LLC’s property.

Other provisions of RULLCA impose a requirement of unanimous member approval for amendment of the operating agreement of the LLC.

Because any requirement of unanimous consent gives each member an effective veto power over actions that may be greatly desired by other participants in the LLC, it is often desirable to establish a lower threshold for approval in the LLC operating agreement. If an LLC has members with small percentage interests, the LLC may wish to set an approval level that does not require the consent of members owning small percentages. The member approval level should make sense for a particular LLC based on its ownership structure.

In any event the requirement of member approval for extraordinary actions and for amendment of the operating agreement should be

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recited in order to make members and managers aware of the treatment imposed by California law. Members and managers reviewing a draft operating agreement would have the opportunity to consider the impact of a unanimous vote requirement and agree instead on approval percentages appropriate for the particular LLC.

Voting Power of Members. RULLCA provides that “if no voting provision is contained in the articles of organization or written operating agreement ... the members ... shall vote in proportion to their interests in current profits.” RULLCA provides for allocation of profits and losses of an LLC among its members in proportion to the value of the contribution of each member in the event an operating agreement does not cover allocation of profits and losses.

In order to avoid confusion and disagreement about allocation of profits and losses and about the voting power of members, an operating agreement should very clearly define and establish these rights. An attachment to the operating agreement should list all the members of the LLC, their contributions, and their percentage ownership for the purposes of distributions, tax treatment, and voting power.

Default Provisions and Mandatory Provisions

RULLCA contains a number of default provisions on a range of issues that should be addressed in the LLC operating agreement. Before an operating agreement is signed, the members and managers may wish to either accept the default

provisions or modify the default provisions as desired for that LLC.

Removal of Managers. Under default provisions of RULLCA, managers of a manager-managed LLC can be removed at any time by the consent of a majority of the members (by percentage ownership) without cause and without notice. An operating agreement should either include a statement to this effect or include a different provision on removal of managers that is preferred by the participants in the LLC.

Transfer and Inheritance of Membership Interest. Unless otherwise provided in the operating agreement, an LLC member requires the unanimous consent of all other members for the transfer of a membership interest. A member may make a transfer of the economic interest, but full membership, with the right to vote, is subject to the approval of other members.

An LLC operating agreement should provide an alternative, if desired, by defining permissible transfers, procedures for admitting a transferee to membership status, and the percentage approval required for such admission, such as the vote of a majority in interest of the other members in favor of the admission of a transferee as a full member.

Similarly, RULLCA limits the rights of a deceased member’s estate or heir to the limited rights of a “transferee” and not a full member. A member in a multi-member LLC who wishes his or her heirs to inherit a voting role as a member needs to make sure the LLC operating agreement clearly provides for full membership for heirs.



“An issue on which an operating agreement is silent can lead to disagreements among members or managers of the LLC.”

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Publisher's Note

In addition to planning based on the provisions of California law on limited liability companies, tax law and securities laws must be considered. The tax treatment of the particular type of business and circumstances of individuals who will earn income from the business must be considered even before the LLC is chosen as the type of entity to be used for the business endeavor.

The impact of securities laws needs to be considered for any type of entity used for business or investment purposes. A good general rule is that any time individuals or entities will be putting effort into a business or investment activity in reliance on the management skills of others, it is most likely an investment and a security under the law. Steps must be taken to comply with applicable securities laws.

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RULLCA also contains mandatory provisions that cannot be changed in the articles of organization or the LLC operating agreement. Most mandatory provisions of RULLCA deal with structural issues, such as mergers, conversion, dissolution, and legal action by a court or an LLC member. Mandatory provisions prohibit an LLC in California from eliminating the fiduciary duties imposed on members and managers, including the duty of loyalty and the obligation of good faith and fair dealing. In addition, a mandatory provision of RULLCA requires that more than 50% of the membership interests approve any amendment of the articles of organization of the LLC. I recommend reciting mandatory provisions in an LLC operating agreement so that members and managers reviewing

the agreement get a better picture of provisions that may be important to them.

Issues Not Covered in an Operating Agreement. If a particular issue is not covered by an LLC's operating agreement or by the mandatory or default provisions of RULLCA, there may be no legal guidance on the issue at all. LLCs are new enough that the background of legal interpretations from lawsuits and other resources is limited. An issue on which an operating agreement is silent can lead to disagreements among members or managers of the LLC. Verbal promises and various understandings could become the basis for claims and disputes if the LLC operating agreement does not adequately cover the issues that may later arise.

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