



Mary Hanson

About the Business Advisor

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She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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LLCS: WHY FLEXIBILITY CREATES UNCERTAINTY

by Mary Hanson

Flexibility was the key feature that made limited liability companies (“LLCs”) popular throughout the United States when this new structure was first introduced. Investors in real estate and owners of businesses quickly made use of the new structure because it provided limited liability to owners and investors without the restrictions and complexity of then-existing entity choices with similar tax treatment. As the 50 states adopted new laws for forming LLCs, each state adopted its own approach to the new structure, and each state made its form of LLC more flexible than existing entity structures. Consequently, someone dealing with an LLC should not make assumptions about how the LLC he or she is dealing with is structured and who has authority to act on behalf of the LLC.

Most states’ LLC laws provide a default structure of management by the members, which applies if an LLC does not adopt a different structure. Most states allow an LLC to select and create the structure the LLC prefers. To understand who has authority to act on behalf of an LLC it may be necessary to review applicable state law, the information filed with the state by the particular LLC, and the internal documents of the LLC (such as the Operating Agreement and records of actions taken naming managers or delegating authority to a particular person).

The key roles in an LLC are the members and the managers.

Members

Throughout the 50 states the term “Member” consistently refers to an

owner of an interest in an LLC. Because of the variations in the states’ law, and because of the choices available in most states, the term may or may not indicate a right to act on behalf of the LLC.

Because of the flexibility typical of LLCs, a “Member” may be (depending on state law) an individual, a foreign citizen, a corporation, a trust, a partnership, or some other type of organization.

Unlike a corporation, in which the owners (shareholders) have no management authority based on their status as shareholders, many LLCs are structured, by default or by choice, so that members are the managers of the LLC. If an LLC is managed by managers rather than members, then one should assume that the members have no management authority unless the LLC Operating Agreement or other documents confirm the authority of a member.

Managers

The term “Manager” is used in state laws to describe an individual or entity that is responsible for management and conduct of the LLC. Like the flexibility allowed for LLC membership, the flexibility with regard to management means that, depending upon applicable state law, managers of an LLC may be a corporation, a partnership, a foreign citizen, or some other organization. The Manager of an LLC need not be an owner (Member) of the LLC.

Because state laws do not require that members be the managers of an LLC, it is necessary to determine whether the members are the managers or if some other format has been selected or designed by the LLC.

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If an LLC is managed by more than one member or more than one manager, it is necessary to determine who those members or managers are. Then it is necessary to determine what constitutes approval of a proposed action, such as approval by the majority (typically by percentage ownership) of the manager-members or a majority of the stated managers.

Some actions by an LLC, such as a sale of assets, may require a particular level of approval based on either state law or the LLC Operating Agreement. An LLC should expect a buyer of assets to ask for proof of compliance with the applicable requirements.

Members of an LLC as well as third party outsiders dealing with an LLC will want confirmation that a contract or commitment by an LLC is valid and enforceable. It may be necessary to determine whether there are limitations on the authority of the Members or Managers acting on behalf of the LLC, and whether a certain percentage approval is required by state law or the Operating Agreement of the LLC.

California Law

In California the formation documents filed with the state require an indication of whether the LLC will be managed by the members or by managers. Under California law a California LLC is managed by the members unless the Articles of Organization and the Operating Agreement provide for management by one or more managers. If a California LLC is managed by managers, the members have no statutory authority to act on behalf of the LLC. Any authority of a member to represent the LLC would have to be created by managers delegating authority to the member.

LLCs in California must file a Statement of Information every two years. That Statement of Information reports the managers (or members, if the LLC is member-managed) and the Statement is available to the public on the California Secretary of State’s website. The Operating Agreement of an LLC is an essential document for understanding the structure of a particular LLC. However, no state requires or even provides for the filing of operating agreements with the state.

A party trying to determine who has authority to act on behalf of a California LLC should take the following actions:

- review the Articles of Organization filed with the California Secretary of State. This document can be viewed on and downloaded from the Secretary of State’s website at: <https://businesssearch.sos.ca.gov/> The choices for “Management” in the form are: “One Manager,” “More than One Manager,” and “All LLC Members.”
- review the Statement of Information filed by the LLC with the Secretary of State listing the Managers or Members of the LLC. If the LLC is manager-managed, this listing is of the Managers. If the LLC is member-managed, the listing is of the Members of the LLC. This filing is also available on the Secretary of State website.
- review the Operating Agreement of the LLC to identify requirements for the Managers (or Members as Managers) to approve actions and whether there are limitations on the authority to act. The management provisions of the Operating Agreement may establish a requirement for a certain level of approval – by a majority or some stated

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percentage approval – for certain actions or for expenditure over a certain dollar amount. In addition, provisions in the Operating Agreement on the rights of Members may set out Members' rights to vote on certain actions.

- review California law for default requirements that apply in the event the LLC Operating Agreement does not address a particular issue. Section 17704.07 of the California Corporations Code sets out default requirements for LLC members' approval of certain actions. If a California LLC is manager-managed, the default requirement is 100% member approval of certain major actions, including the sale or other disposal of all the property of the LLC and other acts outside ordinary course of business of the LLC. If an LLC is member-managed, there is still a default requirement for approval of acts outside the ordinary course of business.

Other States

In many states information about the structure of an LLC and names of managers or managing members is not readily available from a state agency as it is in California. Additional information may be available by mail and with payment of a fee, but the information is likely inadequate to confirm the authority of managers or members to act on behalf of the LLC.

Some states, including Texas, have no default type of management imposed on LLCs. The only way to confirm the management structure for an LLC created under such state laws is to review the LLC's internal documents.

Lenders, buyers, agencies, businesses and parties entering into contracts

with LLCs in any jurisdiction are best advised to make no assumptions about the authority of a particular person to sign contracts on behalf of the LLC or to represent the LLC in other ways. A review of both public and internal documentation is necessary to obtain adequate information about the authority of particular individuals. Representations made regarding the structure of an LLC or the accuracy of information provided should be backed by independent evidence and contractual commitments adequate to provide protection against a misrepresentation of authority.

Agent for Service of Process

Every state requires that an LLC registered with the state (either formed in the state or formed in another state but registered to do business in the state) has an agent designated as a contact for the LLC. This "Agent for Service of Process," "Registered Agent," "Resident Agent," or "Statutory Agent" is the required contact for the purpose of valid service of process for initiation of a lawsuit or notice of other legal action against the LLC.

An Agent for Service of Process has no authority to act on behalf of the LLC or commit the LLC in any way. Such an agent represents the LLC only to the extent that the service of process is valid when made upon the named agent. The authorized agent is established by the information filed with the state. Internal documents or correspondence with regard to the agent have no effect. The role of an agent for service of process is more important than it might seem, because the service of process is valid when made upon the company or individual identified as the Agent or Representative, whether or not

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Publisher's Note

In the past year many state agencies added technical capabilities and changed filing requirements to facilitate on-line filing of required information and on-line payment of fees. With agency employees working from home and fewer people at state offices, on-line filing offered the advantages of faster processing by fewer staff members and the ability to process digital filings from any location. The same advantage applies to entities filing annual reports and other documents.

An unfortunate disadvantage of digital filing by one person (e.g., an LLC employee) entering information and making payments on a state agency website is the loss of a second set of eyes on the information. Without the separate steps of document preparation, document signing, copying, and mailing, there is no proofreading and often no opportunity to catch obvious errors. Typos, erroneous information, wrong documents, unauthorized submittals, duplications, overpayments, and underpayments proliferate in the digital environment. Errors may not be discovered until money is owed, penalties applied, or transactions delayed due to a mismatch in filed information.

Businesses need to be aware of the risks posed by technology and the ability of one person to make mistakes and even wreak havoc. New approaches to authority, approvals, redundancy, and internal controls need to be considered.

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Attorney/Publisher

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the documents served are delivered to the LLC.

An LLC doing business in other states should have the role of agent for service of process performed by a business that is set up to handle documents and legal notices served on it. The best firms have technology and 24/7 staffing that assure that the LLCs they represent are promptly informed of the receipt of any legal notices. Having a friend, employee, or contact that is not in the business of acting as an agent for an out-of-state entity increases the risk of legal hassles and even a default judgment in the event the company is not notified expeditiously. An out-of-state LLC needs prompt notice and delivery of documents to the right people at the LLC to assure a timely response to a lawsuit or other legal matter.

Annual Reports

Most states require the filing of an annual or biennial report (in California it is a biennial Statement of Information) that provides the current address, the agent, and the managers, or members, or an officer of an LLC registered with the state. The deadlines for filing, fees, terminology, report forms, and information required vary widely from state to state. Failure to file a required report can create problems including late fees, penalties, and even termination of the entity. I recommend using a calendar with reminder functions, and tasking a particular person with responsibility for calendaring due dates and for timely filing of the required forms.

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