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Client Alert

March 2014

Ready or Not, the New California LLC Law is Here

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The California Revised Uniform Limited Liability Company Act was effective January 1, 2014 and is codified as new Title 2.6 of the California Corporations Code starting at Section 17701. The new law incorporates a more robust set of default rules that apply if the LLC operating agreement is silent. It is intended to bring California LLC law more in line with the LLC laws of other states, making it easier for multi-state businesses to operate both inside and outside of California.

The transition provisions of the new law provide that the old law continues to govern all contracts, including operating agreements, entered into by an LLC, its members or managers prior to January 1, 2014, making it seem as if the new law will not affect existing operating agreements entered into prior to that date. However, the new law also provides that any acts taken by an LLC, its members or managers on or after January 1st, will be governed by the new law rather than the prior law. As such, the new law is seemingly unclear as to which law will apply to operating agreements adopted prior to January 1st, but amended after that date. Would just the amendment be governed by the new law? By virtue of amending the operating agreement, does the entire operating agreement now come under the scope of the new law? The answer is that it is unclear. This is the crux of many of the criticisms of the new law as business persons and lawyers try to understand and cope with the changes. As a result, LLC members and managers should consult with their corporate counsel to avoid unwanted consequences that may be brought on by the new law.

The following is a summary that highlights several of the noteworthy changes implemented by the new law.

Operating Agreements Under the new law, if a record filed with the Secretary of State (i.e., Articles or a Statement of Information) conflicts with the operating agreement, the operating agreement controls, with an exception for third parties who rely on the public record. Also, the new law provides that, in addition to an operating agreement being a written and oral agreement, an operating agreement may also be “implied.” Although it is unclear what would be considered “implied,” the significance of this is that an “implied” way of doing things could override the default provisions in the code.

Management The default rule under the prior law stated that an LLC is member managed, unless the Articles provide otherwise. The new law provides that unless both the Articles and the operating agreement state that the LLC is manager-managed, the default rule is that the LLC will be member managed.

With respect to manager-managed LLCs, as a default, absent a contrary provision in the operating agreement, managers have equal rights in the management and conduct of the LLC’s activities and that a majority of managers decide matters in the ordinary course of business except that all members must approve: (1) the sale of assets, (2) an act outside the ordinary course, (3) a merger or conversion, and (4) an amendment to the operating agreement. This is different from the prior law, which provided that as a default all decisions of the manager would be decided by majority vote.

Member Voting Absent a contrary provision in the operating agreement, matters outside the ordinary course of the LLC require the approval of all of the members. So unless a particular action is set forth in the agreement, or unless the agreement expressly disclaims any additional voting rights, a member who does not approve of an action undertaken by a manager could contest that action, claiming it was “outside the ordinary course of business,” and that the member did not consent to it. Accordingly, the operating agreement should specifically list enumerated items for which less than unanimous consent is required, and disclaim all other voting rights with respect to such actions outside the ordinary course actions of the manager. The Code does not define what is meant by outside the ordinary course, so this has the potential to produce disputes between managers and members.

Fiduciary Duties The prior law does not specify the fiduciary duties owed by member-manager or managers, instead stating that they are the same as those of a general partner in a partnership. The new law changes this by providing detailed provisions regarding fiduciary duties. They include the duty of loyalty, the duty of care and the duty of good faith and fair dealing. The new law also provides that, to a certain extent, some of these duties may be varied only by a written operating agreement. The duty of loyalty is limited to enumerated activities as follows:

1. to account to and hold as trustee for the LLC any property or benefit, including the appropriation of a company opportunity,
2. to refrain from dealing with the LLC as or on behalf of a party having an interest adverse to the LLC, and,
3. to refrain from competing with the LLC.

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The duty of loyalty may not be eliminated, but the operating agreement may do any of the following:

1. Identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable, and/or,
2. Specify the number or percentage of members that may authorize or ratify, after full disclosure to all members of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

The duty of care is limited to refraining from grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law. However, the duty of care may be reduced so long as it is not unreasonably reduced. The contractual duty of good faith and fair dealing may not be eliminated.

Capital Contributions The prior law provided that capital contributions can take the form of "money, property or services rendered, or a promissory note or other binding obligation to contribute money or property or to render services." The new law now adds "any benefit" provided by a person to the LLC, which could present a valuation problem.

Tax Allocations Under the prior law, the default rule for tax allocations was that profits and losses were in proportion to the contributions of each member. The new law is silent on the allocation of profits and losses among LLC members for tax purposes. So the operating agreement should specify the method by which profits and losses are to be allocated as the new law does not provide a default rule.

Indemnification The prior default rule provided that an operating agreement may, but is not required to, provide for the indemnification of any person acting on behalf of the LLC. The default rule under the new law is that the LLC must indemnify managing members and managers, so long as they have complied with their statutory duties. If members do not want indemnification to be mandatory, they should amend their operating agreement to override this default rule.

Similarly, the new law also has a default rule requiring an LLC to reimburse members of member-managed LLCs, and managers of manager-managed LLCs, for payments made by them in the course of their activities on behalf of the LLC, provided they have complied with their statutory duties. If members prefer that reimbursement not be mandatory, or that certain conditions be satisfied for members or managers to be eligible for reimbursement (for instance, that the expenses are preapproved or do not exceed certain amounts), they should provide so in the operating agreement to override this default rule.

Disassociation The events described below under the new law are deemed to be member dissociation events, which leave the member with only a “transferee/assignee" status. Dissociated members cannot conduct operations and have no access to records or other information other than the right to an accounting from the date of the LLCs dissolution.

1. Death of member who is an individual;
2. If member managed, the appointment of a guardian or conservator for an individual member;
3. If member managed, a judicial order that the member is incapable of performing his duties;
4. If member managed, a member becomes a debtor-in-bankruptcy.

If members do not want these events to cause disassociation, the operating agreement should so provide.

There are several noteworthy provisions that have remained unchanged by the new law as follows:

1. A California LLC may not perform a professional service that requires a license, registration or certification under the California Business and Professions Code (such as a legal or medical practice);
2. California LLCs will continue to be subject to a gross receipts tax on income from all California sources (S corps are not subject to this tax); and
3. Laws on mergers and conversions are the same for the most part (with the default rule that unanimous member consent must approve a merger).

In light of the notable changes discussed here, members and managers of LLCs should evaluate how the new framework will impact their interests and modify their LLC agreements accordingly.

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