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A Summary of the New California LLC Law

Effective January 1, 2014, the existing limited liability company (LLC) statute in California (the “Old Act”) will be replaced by the California Revised Uniform Limited Liability Company Act (RULLCA). Actions taken by managers and members prior to January 1, 2014, will remain governed by the Old Act but RULLCA will apply to all LLC actions commencing as of that date. Many of the default and mandatory rules of the Old Act will be replaced by different default and mandatory rules of RULLCA. These changes may significantly alter the rights and expectations of members and managers in a way that conflicts with or overrides their written operating agreements. Some key changes to California LLC law and the practical implications of those changes for members and managers are discussed below.

- I. **Management Authority.** RULLCA creates new rules for forming manager-managed LLCs. The new law requires a written statement designating the LLC a manager-managed LLC in the LLC’s articles of organization and written operating agreement.¹ Under the Old Act, establishing a manager-managed LLC could be accomplished by a statement to that effect in the articles of organization only. Under RULLCA, if members intend their LLC to be manager-managed, they should ensure that the intention is expressed in both of the LLC’s formation documents. If members intend their LLC to be manager-managed, and the LLC’s articles of organization do not include a statement to that effect, an amendment to the LLC’s articles of organization will be required. Otherwise, RULLCA will treat the LLC as a member-managed LLC subject to its rules for member-managed LLCs, notwithstanding the members’ intentions.²
- II. **Scope of Managerial Powers.** A new RULLCA default rule limits a manager’s authority to take certain actions without approval of all the members, including, among other things, (i) a sale, lease or exchange of all or substantially all of the assets of the company,³ and (ii) any action outside the “ordinary course” of the company’s business. These rules can be overridden by the terms of the operating agreement. Many LLCs are organized to own real property and include a number of members. For administrative convenience, the members often delegate management authority to a manager who is empowered to sell or lease the property without consulting the members. The lease or sale of such property would constitute a sale of substantially all of the assets of the company. If the operating agreement does not expressly grant those powers to the manager, or relies on the default voting rights of members under applicable LLC law (which would require unanimous member consent under RULLCA but not the Old Act),

¹ Note that RULLCA requires all operating agreements to be written. This is a change from the Old Act which permits both written and oral agreements.

² See Section 17704.07(a) of RULLCA.

³ This is a change from the Old Act, which includes mandatory approval of members in connection with a statutory merger but is otherwise silent on member approval in connection with non-statutory business combinations.

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effective January 1, 2014, unanimous member consent would be required for such actions. RULLCA's default requirement of unanimity means that a member with a small LLC interest can hold up any such lease or sale and defeat the will of the majority. Members and managers should review their operating agreements to ensure that it is explicit in the powers granted to the manager and/or the standard for member approval of these matters is majority or supermajority instead of unanimous, if that is their intention. In addition, the standard "ordinary course" of the company's business is vague and potentially sweeping. We recommend that the delegation of powers to a manager and the limitations on those powers requiring member approval be clearly articulated in the operating agreement. If the delegation and limitations are not clear, there is a significant risk that the company will face questions about whether or not important actions have been authorized or were within the scope of the manager's authority or outside the "ordinary course" of the company's activities.

- III. **Fiduciary Duties.** The Old Act makes a general reference to the fiduciary duties of members and managers but it does not specify the nature or scope of such duties. The RULLCA specifically states that the fiduciary duties of members and managers include the duty of loyalty, the duty of care, and "any other fiduciary duty." RULLCA permits members to modify (but not eliminate) the duty of loyalty, subject to a "not manifestly unreasonable" standard. The new rules also require full disclosure and the informed consent of the members in connection with any modification of members' and managers' fiduciary duties. We strongly recommend that parties seeking to modify fiduciary duties specifically define the duty of loyalty and the duty of care and specifically authorize certain actions that might otherwise be viewed as conflicting with the duty of loyalty (e.g., engaging in a competing business or taking a corporate opportunity) or the duty of care (e.g., allowing the manager to be involved in other businesses and activities or the delegation of power by the manager to other officers or agents of the company). Modifications of fiduciary duties should be targeted, to avoid running afoul of the "not manifestly unreasonable" standard and facilitate showing informed consent of the members. The statute is explicit that the "informed consent" standard will not be satisfied merely by the members' execution of an Operating Agreement including such fiduciary duty modifications or waivers.
- IV. **Amendments – Timing Matters.** While many of RULLCA's new default rules may be overridden by the terms of the operating agreement, when the operating agreement is amended may matter significantly because of the new default rule requiring unanimous member approval for amendments to operating agreements. Under the Old Act, if an LLC agreement was silent on the voting threshold for amending the agreement, the rule was the vote of a majority of LLC interests. In addition, actions taken by members prior to January 1, 2014, will remain governed by the Old Act. If the operating agreement is not clear or relies on default rules of the Old Act, after effectiveness of RULLCA, each member, even members with small LLC interests, will have veto power over the will of the majority. If the voting standard for an amendment of the LLC agreement is not clearly specified in such agreement, it should be. Amending the operating agreement while the Old Act remains effective, i.e., prior to January 1, 2014, will minimize the likelihood of problems in accurately reflecting the members' intent.
- V. **Application to Foreign LLCs.** Section 17713.04(a) of RULLCA provides that the new law will apply to both domestic and foreign LLCs commencing January 1, 2014. However, Section 17708.01(a) of RULLCA provides that the law of the state in which an LLC is formed governs, among other things, the "internal affairs" of the LLC and the "management authority" of members and managers of the LLC. Section 17713.04(a) can be read as conflicting wholly with Section 17708.01(a). However, the two sections can be harmonized as California law governs those aspects of the LLC's operations not specifically carved out in Section 17708.01(a) (i.e., internal affairs, etc.). In any event, it is not clear which specific aspects of the LLC would be governed by California law, i.e., which aspects of the LLC's operations constitute "internal affairs" and which aspects do not. In its current iteration, RULLCA is ambiguous about its application to foreign LLCs. This discrepancy, if not rectified, will create confusion about what law governs the operations of foreign LLCs. This could be significant with respect to the scope of the manager's authority and limitations on that authority requiring approval of the members and limitations or eliminations of fiduciary duties, both of which are areas where parties tend to gravitate to Delaware as a jurisdiction that has a robust statute and case law that is premised on freedom to contract with respect to governance and fiduciary duties for LLCs. Section 17713.04(a) of RULLCA appears to be in the same vein as Section 2115 of the California Corporations Code which establishes "Pseudo-California Corporations," although Section 2115 is more specific about which provisions apply and requires a threshold of contacts be exceeded to justify the extension of California law to foreign corporations.

VI. **Conclusion.** The RULLCA makes significant changes to the law governing LLCs in California. To guard against any potential inconsistency between an LLC agreement adopted under the terms of the Old Act and RULLCA, members of existing California LLCs should consult legal counsel to review such agreements, determine the potential impact of RULLCA, and make appropriate changes prior to RULLCA taking effect.

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