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About the Business Advisor

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READING THE LIMITED LIABILITY COMPANY OPERATING AGREEMENT

by Mary Hanson

Most people don't want to read a detailed legal document unless it is one they will be signing, or it is one that is involved in a dispute. In particular, accountants, bankers, sales people, insurance brokers, real estate agents, loan brokers, and other business people don't really want to read long legal documents to determine whether they are talking to the right person.

My advice for anyone doing anything with a California limited liability company ("LLC") is to get comfortable with the idea of reviewing the documents, including the LLC Operating Agreement.

Because a California LLC can be structured in many different ways, and California law does not impose many requirements on LLCs, anyone dealing with an LLC can only understand the structure of the company by reviewing the Articles of Organization that were filed and reading the signed Operating Agreement. The LLC rules established by California law are very basic, and many or even most of them only cover the particular issue for a particular LLC if not "otherwise provided in the articles of organization or the operating agreement." The only way for individuals involved in an LLC to know how decisions are supposed to be made is by reading the LLC Operating Agreement.

Management by Members or Managers

A California LLC can be managed by

the members of the LLC or by one or more managers. This is a key structural issue and is determined by the choice made in the Articles of Organization filed with the Secretary of State. The Operating Agreement cannot modify the manager selection made in the Articles of Organization. If a change is desired – or a correction is necessary – the Articles of Organization must be amended or corrected by the filing of a Certificate of Amendment or a Certificate of Correction with the Secretary of State.

This statement about who will be managing the LLC is the most important issue to be verified by a third party dealing with an LLC. Without this information one cannot know who has legal authority to execute documents on behalf of the LLC.

Apparent Authority

Although California law establishes some "apparent authority" – signature authority than can be relied upon by third parties for valid, legal execution of documents on behalf of the LLC – I recommend reading the Operating Agreement to be certain of the LLC structure and to be certain that the validity of a particular document is not hanging on the single bare thread of the law on apparent authority.

Under California law, 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

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“Note whether the LLC is to be managed by ‘one manager,’ ‘more than one manager,’ or ‘all limited liability company member(s).’”

member does not have authority to bind the LLC.

If the LLC is managed by managers (as indicated in the Articles of Organization – the LLC-1 filed with the Secretary of State to establish the LLC), then there are several rules about the apparent or legal authority of certain representatives of the LLC.

No member of an LLC managed by one or more managers has any authority to legally bind the LLC, unless the member is also a manager or has some other authority delegated properly by the LLC.

Every manager of an LLC managed by one or more managers is an agent of the LLC for the purpose of its business and affairs and the act of the manager binds the LLC, unless the manager lacks authority and the person dealing with the manager has actual knowledge of the lack of authority.

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

There are also provisions in California law that give certain combinations of officers (“the chairperson of the board, the president or any vice president and any secretary, and assistant secretary, the chief financial officer, or any assistant treasurer”) of an LLC apparent authority to sign the same documents listed above. Since LLCs are not required to have officers, few LLCs have a board, many LLCs do not

have officers, and the appointment and definition of officers is in the LLC Operating Agreement, reliance on this apparent authority would seem misplaced unless the Operating Agreement and other relevant documents are reviewed.

The actions that are validated by law are only those “for apparently carrying on in the usual way the business or affairs of the limited liability company.” In other words, third parties cannot rely on the apparent authority of a member, manager, or officer, if the action taken is the selling of all the assets of the LLC or some obviously errant action. More problematic would be actions that are not clearly for “carrying on in the usual way.”

LLC Checklist

Here are steps to determine what the structure is of an LLC and what actions can be taken (and by whom) on behalf of an LLC:

First, look at the Articles of Organization. Note whether the LLC is to be managed by “one manager,” “more than one manager,” or “all limited liability company member(s).” Make sure to check any attached additional provisions, if additional pages are attached to the Articles of Organization. Such additional pages may cover a broad range of issues. Any additional provisions are likely to relate to management and management authority, so review of these is important.

Next, look at the Statement of Information filed by the LLC (the biennial information form). This form lists the names of all managers or all members, if there are no managers.

Review the executed Operating Agreement. First, make sure the management structure (managed by a

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manager, more than one manager, or by the members) is consistent with the statement in the Articles of Organization. If there is a conflict, rely on the Articles of Organization, but take the Operating Agreement into consideration in deciding how to deal with the LLC.

Next, look for provisions on management, voting, and decision-making that could be important in determining who has decision-making power in the LLC and what limitations there may be on the signature authority of the members or managers. In particular, check for answers to the following questions:

- How many managers is the LLC supposed to have (if the Articles of Organization indicate there will be more than one manager)?
- If the LLC is managed by managers, will the managers serve for a particular term? What is the term, if any?
- Is there a term stated for the LLC? It is not uncommon for an LLC to have a stated term, such as “until December 31, 2020” or some other date. The intention is that the LLC term will be extended by a vote of the members or that the LLC will be dissolved by that date.
- Do any actions require member approval (do the members have any veto power over certain actions by the managers)? What actions require the vote of the members? Is a high level of member approval required? For example, does the sale of real property or key LLC assets require a super-majority or unanimous vote of members?

If the issues above are not covered, California law provides no default treatment. Third parties dealing with an LLC can take comfort that California law provides clear rules on apparent authority and that the

Operating Agreement does not provide some other layer of limitations on authority. But if there are disagreements within the LLC, there may be no answer to a question raised on these issues. California law does provide that, unless otherwise provided in the Articles of Organization or the Operating Agreement the members’ voting shall be proportionate to the members’ interests in the current profits of the LLC, and that a majority vote shall be sufficient. But California law does not impose the requirement of a member vote on any day-to-day management issue or approval of any typical business transaction. California law does impose a members’ right to vote on amendment of the Articles of Organization and on the dissolution or merger of the entity, but these members’ rights are unlikely to be a problem for a third party dealing with an LLC.

If the Operating Agreement requires certain meetings, votes, or written consent by either the managers or the members, be sure that there is adequate documentary evidence that the LLC met the requirement for each particular contract, obligation, or action approved.

Default Provisions from California Law

The default provisions for LLCs under California law deal with issues of concern to members, rather than issues that are likely to cause problems for third parties seeking a valid signature or binding commitment on behalf of the LLC.

There are two default provisions that could create challenges for third parties dealing with an LLC. One is that, unless otherwise provided in the Articles of Organization or the

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“The only way for individuals involved in an LLC to know how decisions are supposed to be made is by reading the LLC Operating Agreement.”



Publisher's Note

The interests of a member of an LLC go far beyond the concerns of third parties. He or she will have many more issues for which the Operating Agreement is required reading. And he or she will want to read all the California default provisions if the Operating Agreement is too brief. A disappointed member who was expecting to receive distributions, obtain advantageous tax treatment, and have the right to sell his or her LLC interest is likely to wish the Operating Agreement had been much longer and more detailed.

Third parties dealing with an LLC will very likely not have problems because of the apparent authority and default provisions of California law. It is the members who will suffer if an LLC Operating Agreement is too brief and either inadequately covers the rights of members or inadequately covers what members thought they were getting.

The flexibility of the LLC really requires that the founders of an LLC put in the time, effort, and expense necessary to create an Operating Agreement that provides a workable structure for the LLC and provides answers to the questions that are likely to arise.

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Operating Agreement, managers may be removed by a majority vote of the members. Another one is that, unless otherwise provided in the Articles of Organization or the Operating Agreement, for an LLC managed by two or more managers, decisions by the managers are to be made by majority vote or by unanimous written consent. If there are conflicts within an LLC, a third party may have to decide whether to rely on the apparent authority of managers or to insist on proof that disputes within the LLC have been resolved.

Generally California default provisions that apply to an LLC unless otherwise provided in the Articles of Organization or the Operating Agreement either relate to meetings of the members or basic rights of members to vote on major structural

changes. Some examples include:

- members' votes are in proportion to their interests in profits in the LLC;
- meetings may be called by any manager or any member(s) representing 10% of the ownership of the LLC;
- the notice of meetings of members shall state the nature of the business to be transacted;
- profits and losses of the LLC shall be allocated in proportion to the contributions of each member; and
- amendment of the Articles of Organization or Operating Agreement require the unanimous vote of all members.

Third parties dealing with LLCs will likely find all the information they need in the Operating Agreement and California law. **BA**

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