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About the Business Advisor

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STRUCTURING A LIMITED LIABILITY COMPANY: Why the Operating Agreement is a Key Document

by Mary Hanson

The formation of a California limited liability company (“LLC”) takes more time and effort than the formation of a corporation. This is not surprising when you consider the nature of an LLC.

The flexibility offered by the California LLC requires the business founders to consider many options in structuring the company. California law provides very little structure and few limitations.

An LLC can be managed by its members (owners), by a single manager (which need not be an individual), by two managers, or by a board of managers. Management decisions can be made by the manager(s) in almost any way that is decided upon in structuring the LLC. In comparison, a corporation has a set structure imposed by law – shareholders elect a Board of Directors, the Board of Directors name the required officers (President, Secretary, and Treasurer) and meetings are called and held and voting on business issues is done in accordance with corporation law.

California corporation law answers almost any question that might be asked regarding the rights, duties, and obligations of the shareholders, officers, and directors and regarding the structure and the procedures to be used in management of a corporation. This is NOT the case with a California limited liability company.

The flexibility of the LLC allows

the business owners to devise a structure with the type of management they want and the type of tax treatment they want. However, this flexibility to “make your own structure” means that the founders of an LLC must put in the time, effort, expense, and negotiation necessary to determine the desired structure for the particular LLC and get that structure established in a written operating agreement.

Risks of a Brief Operating Agreement

Some LLCs attempt to solve the time and expense problem of the LLC by using a very brief operating agreement. This approach saves time and money in establishing the LLC, but will eventually cause problems for the members (the owners of an LLC are “members” rather than “shareholders”) or the managers of the LLC.

The managers and members of a California LLC must have a thorough operating agreement in order to know what the structure of the LLC is, and what their roles, rights, and responsibilities are. Many issues, including some important ones, are not covered by California law.

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If the operating agreement of a California LLC is incomplete, when

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an important question arises there may be no answer to the question posed by members or managers of the LLC. The members and managers must try to determine what the rights, roles, and responsibilities of the members and managers are as each issue arises, and must try to work out any conflicts and disagreements on their own.

California statutes do cover some limited liability company issues, but the statutes are not adequate to provide the structure and management guidance for an LLC in the absence of a written operating agreement adopted by the members of the LLC. First, most of the statutes set out what an operating agreement MAY provide as structure for an LLC. Without an operating agreement, these provisions have no effect on a particular LLC.

Other statutes apply to a California LLC unless “otherwise provided” in an operating agreement. These California LLC statutes actually set out requirements that apply in the absence of an operating agreement or failure of an operating agreement to cover an issue. However, these are basic issues, and the founders of an LLC will often wish to modify the treatment set out in the statutes to suit the circumstances of the particular LLC. Some of these basic issues include:

- members’ voting being in proportion to their interests in profits;
- required majority vote of the members;
- meetings held at the principal office of the LLC;
- meetings called by any manager or any member(s) representing 10% of the ownership of the LLC;

- minimum 10 day notice for meetings and notice of action to be taken;
- election and removal of managers;
- fiduciary duty of managers;
- the right of the LLC to purchase insurance covering managers;
- decisions of managers (if more than one) being made by at least majority vote;
- broad powers of members to make commitments binding the LLC (if members are managers); and
- broad powers of managers to make commitments binding the LLC (if the LLC is managed by managers).

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, the Articles of Organization must be amended by an amendment of the Articles filed with the Secretary of State. To determine WHO has the right to amend the Articles of Organization, it is necessary to review the operating agreement, which is the document that establishes the rules for the LLC, including the right to amend the Articles of Organization.

If the operating agreement does not cover the issue of amending Articles of Organization, for example, by requiring a vote of a majority of the members according to their percentage interests, then California law does cover the issue, requiring a

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unanimous consent of all the members. One hold-out can prevent the amendment of the Articles of Organization. Covering this issue in a complete operating agreement could save an LLC from being unable to file an amendment.

Day-to-Day Management

Whether the LLC is managed by members or by one or more managers, there are many issues that should be set out in the operating agreement.

The following are some of the issues that must be covered by the operating agreement in order to provide structure to day-to-day management:

- Who will make management decisions for the LLC? How will they be made? With formal meetings or informally? What records will be kept regarding decision-making?
- What issues will require an opportunity for ALL members to vote?
- Will some issues require a UNANIMOUS vote of members? For example, should the sale of real property or key assets require a super-majority or unanimous vote of members?
- How will voting be done? Will you have regular meetings? How will meetings be called? Who can call a meeting?
- Who will have the authority to sign contracts on behalf of the LLC?
- If the LLC is managed by managers, will the managers serve for a particular term like one year or will they serve until replaced? How will successor managers be elected?

- If you are the manager, do you wish to restrict the members from removing you as the manager?
- Will members be required to contribute additional funds to the LLC after initial contributions? Will members or managers have the ability to require additional contributions by the members?
- Will distributions of income be required or will distributions be at the discretion of the managers or members? Who will determine when distributions will be made and how much they will be?

Transfer of Membership Interest

One of the important issues to cover in an LLC operating agreement is whether a member is restricted from assigning or transferring his or her (or its) interest in the LLC to another party without the consent of the other members (or the managers) of the LLC. The few statutory provisions covering the transfer of an LLC membership interest provide that, unless otherwise set out in the operating agreement, a member may assign his or her interest in the LLC to another party only if a majority (in percentage ownership) of the other members vote in favor of the transferee's admission as a member. Unless admitted as a member, an assignee is entitled to distributions of profits, but is not entitled to vote or exercise other rights of ownership.

An operating agreement may take a different approach, allowing free transfer of membership interests, or may provide greater restriction, such as restricting members from using membership interests as collateral on loans, and requiring members to offer their membership interests to the other members for purchase

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Publisher's Note

A California limited liability company is not "simple." A limited liability company formed under another state's laws may have a "standard" form, but, as described in this article, the California LLC is not limited by many statutory requirements. Because the operating agreement can structure the LLC in so many ways, and can even modify the provisions of most of the LLC statutes, the founders must put in time and effort to define the LLC structure.

In addition to management flexibility, the LLC also allows flexibility in tax treatment, which is beyond the scope of this article. A tax specialist should draft the tax provisions of the operating agreement if special tax allocations or particular tax treatments are objectives in structuring an LLC.

Each manager and member of a California LLC needs to keep a copy of the operating agreement handy. Only the operating agreement will provide answers to questions about his or her rights, roles, and liability regarding the LLC.

Mary Hanson
Attorney/Publisher

before any valid transfer can be made.

California law does nothing to cover buyout rights, such as the right of the LLC or other members to buy the interest of a member in the event of death, disability, or retirement. Any such agreement must be covered in the operating agreement or some other agreement among the members.

Dissolution

If an operating agreement does not cover the issue of dissolution for a California LLC, the only basis for dissolution may be vote of a majority of the members. Especially for an LLC with few owners, it is important to have a number of bases for dissolution. If there are conflicts in management, the dissolution of the LLC upon the expiration of a set term may be a valuable "exit

strategy" for getting out of the LLC investment.

The best time to structure the roles of the members and managers, and set out the rules by which the LLC will be operated, modified, and dissolved, is at the beginning, when all interested parties are working together to establish the LLC. The terms of the operating agreement should be worked out as part of the formation of the LLC.

Because the operating agreement of a California LLC actually establishes the structure of the company for decision-making, tax issues, and the roles of the members and managers, each member, each manager, the attorney, and the accountant for the LLC each needs to have a copy of the operating agreement. **BA**

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