



Mary Hanson

About the Business Advisor

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The Trouble with Brief LLC Operating Agreements

by Mary Hanson

Limited liability companies (“LLCs”) have become more popular than corporations, limited partnerships, and other types of entities because of the flexibility available in structuring an LLC. LLCs provide insulation from personal liability for the members while offering flexibility in the ownership, management, and tax treatment that other entities can’t provide.

The owners of an LLC (called “members” rather than “shareholders” or “partners”) can be individuals, trusts, corporations, or other LLCs.

An LLC can be managed by one or more managers or by the members of the LLC. An LLC can design its own methods for management decision-making, rather than being required to have a Board of Directors (as a corporation does) or a General Partner (as a limited partnership does). LLCs can have officers (a president, secretary, and treasurer) or no officers. Officers or managers are not legally required to be members of the LLC but the LLC can require them to be members.

LLCs can be taxed in a number of ways. A single member LLC is taxed as a disregarded entity (the income of a single member LLC is reported on a Schedule C included in the single member’s tax return). Multiple member LLCs can choose to be taxed as partnerships, C corporations, or S corporations.

Members’ contributions to an LLC can be tangible or intangible property, money, services performed, services to be performed in the future, promissory notes, or other agreements to contribute property or money. There is no legal

requirement that members contribute capital to an LLC.

The profits and losses of an LLC can be allocated among the members in various ways. Allocations do not need to be proportionate to the ownership interests or voting power of members.

Voting by members – or managers – may be on a per capita, proportionate to share of profits, percentage stated, ownership interest, or any other basis. The LLC can set a very high vote requirement for any particular matter.

Gaining an understanding of the alternatives and the many features and limitations associated with the alternatives is important. To take advantage of the flexibility offered by an LLC, the alternative approaches need to be understood, well chosen, and well drafted in the LLC operating agreement that establishes the rules for the particular LLC.

An operating agreement should address, among other things:

- Obligations to contribute capital,
- Allocations of profit and loss,
- Distributions of profits, and the percentages to use for distributions,
- Management responsibilities and authority,
- Voting rights of members, indicating whether voting rights are determined by members’ percentages of profit distribution or another percentage or arrangement,
- Member approval needed for particular actions by the LLC,
- Decision-making by managers,

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- Authority to act on behalf of the LLC,
- Admission of new members,
- Restrictions on transfers of ownership and permissible transfers of ownership, and
- Rights to buy out the membership interests of other members.

A poorly planned LLC operating agreement (or a verbal or non-existent operating agreement) leaves the business without guidance or legal clarity on many important issues. Members and managers of an LLC with an inadequate operating agreement will eventually encounter some issue that is open for resolution, negotiation, or dispute because the operating agreement fails to address it.

California law (and probably most state laws) do not provide rights, duties, structure, guidance, or definitions that are adequate for operation of an LLC. The intended flexibility of LLCs means that states do not define rights, duties, roles, and requirements for LLCs as state corporation laws do for corporations.

California law provides default terms that apply when an LLC operating agreement is silent on the subject matter. The California default terms are not a substitute for an operating agreement tailored for a particular LLC. Most LLCs will want to adopt operating agreement terms that override California default provisions.

The Default Provisions of California Law

The California Revised Uniform Limited Liability Company Act (“RULLCA”), which became effective in 2014, was made applicable to all LLCs registered

in California, whether formed in California or in another state, and whether formed prior to 2014 or after 2014.

An LLC lacking a robust operating agreement will be subject to the definitions and requirements of RULLCA on any matter not otherwise addressed in the operating agreement. Only a few of California’s statutory provisions are mandatory and most can be modified (and often should be modified) in an operating agreement. In the absence of different treatment in an operating agreement, the default provisions apply to a California LLC whether or not the participants have any knowledge of the provisions and whether or not the provisions work well for the particular LLC.

Here are some of the default provisions of California law that apply to an LLC registered in California if the issue is not addressed in a different manner in an operating agreement:

- 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 member does not have authority to bind the LLC.
- In a member-managed LLC each member has equal rights in the management and conduct of the LLC’s activities including equal voting rights.
- Voting by members shall be in proportion to their interests in current profits of the LLC.
- A difference arising among members in a member-managed LLC shall be decided by a majority of the members.
- “Majority of the members” means “more than 50 percent of the interests

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of the members in current profits of the limited liability company.”

- If an LLC is managed by one or more managers no member of the LLC has any authority to legally bind the LLC, unless the member is also a manager or has authority actually delegated to that member by the LLC.

- If the LLC is managed by one or more managers, consent of **all** members of the LLC is required to sell, lease, exchange, or otherwise dispose of all, or substantially all, of the LLC’s property outside the ordinary course of the LLC’s activities, and except for actions involving mergers and conversions, to take any other action outside the ordinary course of the activities of the LLC.

- If the LLC is managed by one or more managers, LLC decisions are made exclusively by the managers.

- If the LLC is managed by one or more managers, each manager has equal rights in the management and conduct of the activities of the limited liability company and a difference arising among managers as to a matter in the ordinary course of the activities may be decided by a majority of the managers.

- “Majority of the managers” means “more than 50 percent of the managers of the limited liability company.”

- Profits and losses shall be allocated in proportion to the value (as stated in the LLC’s records) of the contributions by each member to the LLC.

- Distributions of money or property to members shall be on the basis of the value of the contributions to the LLC from each member.

- For both member-managed and manager-managed LLCs the operating

agreement may be amended only with the consent of **all** members.

- In all other matters in which a vote is required but the statutes do not require a unanimous vote, a vote of a majority of the members shall be sufficient.

- In a manager-managed LLC, a manager may be chosen at any time by the consent of a majority of the members and remains a manager until a successor has been chosen. A manager may be removed at any time by the consent of a majority of the members without cause.

- A meeting of the members may be called by any manager or by any member or members holding more than 10% of the interests in current profits.

- The transfer of a membership interest of an LLC member requires the unanimous consent of all other members.

- A “note, mortgage, evidence of indebtedness, contract, certificate, statement, conveyance or other instrument in writing” between the LLC and another person is presumed valid if signed by at least two managers (one manager if the LLC is managed by just one manager), unless the other party has actual knowledge that the manager or managers lack the authority to execute the document.

- The vote of 50% or more of the voting interests of the members is required to dissolve an LLC.

- An LLC must maintain specified documents and records, make them available for inspection and copying, and provide copies of some documents to members upon request. Required documents and records include:

- A list with the current name and address of each member, together

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Publisher's Note

An LLC operating agreement downloaded from the Internet is extremely unlikely to serve a particular LLC well. A one-size-fits-all form can include provisions that are inconvenient or wrong for a particular LLC.

The key feature of LLCs is flexibility, and the only way to properly structure an LLC is to confront the issues of management, voting, tax treatment, accounting, distributions, authority to act on behalf of the LLC, and other issues that need to be covered and craft an LLC operating agreement that serves the interests of the LLC participants.

When participants in an LLC don't read or take the time to understand the terms of the operating agreement, they are likely to eventually encounter an LLC problem for which there is either no provision established for the LLC or the provisions adopted – or imposed by law – are not helpful.

An LLC operating agreement may not be a good "do it yourself" project. If LLC participants need a set business structure that doesn't require research and drafting, they may be better served by using an S corporation, if they are eligible to use it.

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- with each member's contribution and share in profits and losses,
- The name and address of each manager in a manager-managed LLC,
 - A copy of the articles of organization and all amendments,
 - Copies of the LLC's federal, state, and local income tax or information returns for the six most recent years,
 - A copy of the LLC's operating agreement with any amendments,
 - Copies of the LLC's financial statements, if any, for the six most recent fiscal years.
 - The LLC's books and records related to the internal affairs of the LLC for at least the current and past four fiscal years.
- An LLC is obligated to send tax information necessary to complete tax

returns to each member within 90 days after the end of each taxable year.

Many members and managers of LLCs may be surprised to discover that these default provisions apply to their LLCs. Many of the provisions are not what a particular LLC wants or needs.

A good example of a problematic default term is the requirement of unanimous member consent for LLC actions. The requirement of unanimous approval gives each member an effective veto power over the particular action that might be taken by the LLC.

A well-planned written operating agreement is needed to set voting requirements at an appropriate level for a particular LLC, to provide the LLC with a structure tailored to the LLC, and to establish the position of the LLC on the many issues affecting the LLC.

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