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Corporate Law

ALERT

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New California LLC Law May Significantly Impact Existing Operating Agreements

A new California law governing limited liability companies takes effect Jan. 1, 2014. This new law may adversely affect existing California limited liability companies by effectively rewriting the terms of their operating agreements. To avoid potential disputes among members and/or managers, the members of California limited liability companies should review – and where appropriate amend – their operating agreements.

The California Revised Uniform Limited Liability Company Act (the New Law) will replace existing California LLC law, which has been in place since 1994, significantly changing the law governing LLCs as of January 1, 2014. The transition provisions of the New Law provide that the 1994 law continues to govern all contracts, including operating agreements, entered into by an LLC, its members or managers, prior to January 1, 2014, as well as any vote or consent by members or managers prior to that date, making it seem as if the New Law will not affect existing operating agreements or actions taken in reliance on those agreements.

The New Law also provides, however, that any acts taken by an LLC, its members or managers on or after January 1, 2014, will be governed by the New Law rather than the current law. This implies that, as of that date, the New Law will govern any vote or consent by members or managers. As a result, the New Law not only supplements pre-2014 operating agreements, but also in many cases may materially change the rights and obligations of the members and managers by subjecting any of their actions taken after January 1, 2014, to the requirements of the New Law. In addition, if any one member seeks to enforce the provisions of the New Law in a way that is contrary to the terms or intent of an existing operating agreement, disputes – and

litigation – among members or between a member and manager are likely to result.

While a technical corrections bill, intended to lessen the impact of the New Law on pre-2014 LLCs and to correct a number of poorly drafted provisions, is currently pending, the state legislature will not consider the bill until several months after the New Law has gone into effect. There is also no guarantee that the corrections bill will become law or will eliminate all potential areas of dispute.

To protect against potential disputes and litigation, members of existing California LLCs should review their operating agreements to determine the potential impact that the New Law may have and should make appropriate amendments prior to January 1, 2014.

The following are examples of how some of the provisions of the New Law may materially change the rights and obligations of members or managers of an LLC:

■ **Material Change in Nature of Default Rules**

One reason for the popularity of LLCs is that LLC law generally provides members with a great deal of flexibility in drafting their operating agreement. The current LLC law has only a limited number of mandatory provisions and instead provides “default rules,” which will apply only if the operating agreement does not override them. As a result, one focus in drafting an operating agreement is to make certain to override any default rules in the law that do not reflect the business arrangement among the members.

If the default rules change or the number of default rules increases, an existing operating agreement may no longer override a new or modified default rule, and the LLC and its

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members then would be subject to a default rule even if it is contrary to the intent of their business arrangement. The LLC's members would only be able to nullify the applicability of the new default rule through an amendment to their operating agreement.

The New Law greatly expands the number of default rules, and pre-2014 operating agreements likely have not addressed all these new or modified rules. Because of the language of the transition provisions, members are at risk that the new default rules will be grafted onto their agreements and will change the nature and intent of their business relationships. Below are examples of how these new default rules may affect pre-2014 operating agreements.

■ **Management Authority**

The current law contains only a few rules regarding when a manager would need to obtain the consent of members prior to taking action. Members could agree, in the operating agreement, to expand the number of actions for which a manager needed their consent or to keep the consent rights to a few important actions, such as making changes to the articles or the operating agreement, or entering into a merger. Because the 1994 law contains only a handful of default consent rules, operating agreements are often drafted to specify the limitations on the ability of a manager to act without the approval of members, rather than to simply state that members had no voting rights other than those specified. In many other agreements, the language may provide that "except as provided in the LLC law" members have no voting rights.

While these types of provisions were fine in the context of the current law, the New Law greatly expands the consent rights of members. Depending on the language in the operating agreement, the New Law may effectively limit the authority of a manager to take actions that the manager could have taken prior to 2014. For example, a new default rule is that if an LLC is managed by managers, the manager may not take any action "outside the ordinary course of business" without obtaining the consent of all the members. A similar default rule exists in the New Law for an LLC managed by its members. If a pre-2014 operating agreement provides that approval by members holding a majority of the membership interests is required only for acts enumerated in the agreement, this new rule would not apply and the manager would continue to have the authority described in the operating agreement.

If the operating agreement does not disclaim any additional voting rights, or refers to members having voting rights under the LLC law, however, under the New Law, any

member who does not approve of an action undertaken by a manager could contest that action, claiming that it constituted an action "outside the ordinary course of business" and that the member had not consented to it.

As many operating agreements were drafted with the intent of giving the manager (who often is the member with the greatest interest) absolute decision-making control over actions both in and outside the ordinary course of business, the New Law could materially change the control rights and give a minority member a veto right where the members did not originally so intend. In addition, as the New Law does not provide an express definition of acts that are outside the ordinary course of business, this issue likely will be the subject of many disputes between managers and members.

Members can eliminate these potential problems by amending the operating agreement to reflect the intended scope of the members' voting rights and to specify any limitations on a manager's authority.

■ **Impact of Operating Agreement Amendments on Transferees**

Under the current LLC law, the person to whom any portion of a membership interest is transferred is referred to as an "assignee." Unless admitted as a member, the assignee would not have any of the rights of a member other than to receive distributions associated with the assigned portion of the membership.

The New Law maintains this concept, using the term "transferee" instead of "assignee," but includes a new default rule that may result in litigation between members and transferees.

The New Law expressly states an unstated presumption in the prior law – that the obligations of an LLC and its members to a transferee are governed by the operating agreement. The New Law goes on to include a new default rule, however. An amendment to the operating agreement made after a person becomes a transferee is effective with regard to any obligation of an LLC or its members to the transferee.

Because the transferee would not have a right to approve an amendment (unless that right is stated in the operating agreement), this new default rule seems to give members the ability to amend an operating agreement to modify, reduce or eliminate obligations owed to transferees.

The right to amend may be tempered by the members' obligation of good faith and fair dealing, but if members make any amendments that change the obligations owed to transferees, they should be prepared for disputes with transferees.

Members might eliminate this potential area of dispute by amending their operating agreements to provide that the obligations owed to transferees cannot be modified without the consent of the transferee.

■ ***Unintended Change in Status and Loss of Member Rights***

Under the New Law, certain events can result in the “dissociation” of a member, changing the member’s status to that of a transferee. As a result, the member no longer enjoys the statutory rights of a member, but only the more limited rights of a transferee. As the current law did not contemplate a change in the status of a member (other than following an assignment of a membership interest), pre-2014 operating agreements likely do not contain language maintaining a member’s status upon the occurrence of dissociation events or negating the default rules relating to dissociation.

■ ***Certain Dissociation Events***

Dissociation events under the New Law include the following: (1) the death of a member who is an individual; (2) if the LLC is managed by its members, the appointment of a guardian or conservator for an individual who is a member; (3) if the LLC is member managed, a judicial order that a member who is an individual is incapable of performing the member’s duties; and (4) if the LLC is member managed, a member becomes a debtor in bankruptcy.

If the members do not want any of these events to result in the dissociation of a member, they should amend their operating agreement to prevent these results.

■ ***Impact of Transferee Status on Dissociated Members***

Under the New Law, a dissociated member is subject to the same risk as a transferee – that the members may amend the operating agreement to modify the obligations owed by the LLC or its members to the dissociated member. In addition, a dissociated member, by reason of its transferee status, no longer has the right to participate in the management or conduct of the activities of an LLC. A dissociated member also no longer has a right to have access to records or other information concerning the activities of the LLC other than the right to an accounting from the date of the LLC’s dissolution.

While the New Law expressly states these limited rights, poor drafting relating to these issues, including the use of inconsistent terminology, could result in disputes over whether the loss of the right to participate in the management of the LLC includes the loss of voting rights. Similarly, although the New Law expressly states that transferees do not have the right to access information,

another provision states that “a holder of a transferable interest” does have these rights.

Because these issues all arise from the application of the default rules, the best way for members to avoid disputes is to amend their operating agreement to address these issues in the manner desired by the members.

■ ***Unintended Change in Manager Status if Member-Manager Dissociates***

If a member who serves as a manager becomes a dissociated member, the New Law provides that the member is removed as a manager. If the members would prefer that the dissociation of a member would not automatically result in the removal of that member as a manager, they should amend their operating agreement.

■ ***Change in Rights of Personal Representatives of Deceased Members, and Guardians and Conservators of Incompetent Members***

The current LLC law provides that the personal representative of an estate of a member may exercise the deceased member’s rights for purposes of settling the estate and administering the member’s property, including any power the member had under the operating agreement to give an assignee the right to become a member. The current law also provides these same rights to a guardian, conservator or other legal representative of a member judged incompetent.

Under the New Law, no rights are granted to representatives of an incompetent member. While the personal representative of a deceased member is entitled to all information that a member is entitled to, the representative otherwise only possesses the rights of a transferee.

If the members intend to provide representatives with the rights available under the 1994 law, they should amend their operating agreement to reflect those rights.

■ ***Indemnification***

The current LLC law provides the default rule that an operating agreement may – but is not required to – provide for the indemnification of any person acting on behalf of the LLC. Pre-2014 operating agreements tend to deal with indemnification in a variety of ways – some do not address indemnification, some permit indemnification under certain conditions that may include member or manager approval, and some require indemnification for certain persons or under certain conditions.

The default rule under the New Law is that the LLC must indemnify members of member-managed LLCs and managers of manager-managed LLCs, so long as the member or manager has complied with its statutory duties.

If members do not want indemnification to be mandatory under these circumstances, they should amend their operating agreement to override this default rule.

■ **Reimbursement**

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 that they have complied with their statutory duties.

If members would prefer that reimbursement not be mandatory, or that certain conditions be satisfied for members or managers to be eligible for reimbursement (that the expenses are preapproved or do not exceed certain amounts, for example), they should amend the operating agreement to override this default rule.

The above discussion is intended to serve only as a summary of certain matters relating to the New Law and its potential impact on existing operating agreements for California LLCs. The New Law may affect your operating agreement in ways that are not discussed above or to a greater or lesser extent than described. We recommend that you contact your attorney to discuss how the New Law may impact your existing operating agreement and whether amendments may be necessary to avoid any material changes to your operating agreement.

For questions about the new California LLC law or assistance evaluating your current LLC agreement, please contact your Loeb & Loeb attorney or [Allan Duboff](mailto:Aduboff@loeb.com) at 310.282.2141 or aduboff@loeb.com.

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