Drafting Considerations Under RULLCA

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INTRODUCTION

Let us assume that, a few years ago, a California limited liability company (LLC) was organized. Its three members were enthusiastic about their future success. They engaged an experienced attorney to file the articles of organization and opted for a plain-vanilla operating agreement to set out the economic terms of the LLC, its management structure, and how distributions to the members were to be made. Through hard work and a little bit of luck, they succeeded in growing the LLC's business. In January 2014, the members received a substantial offer to buy all of the LLC's assets. Two of the members, who held an aggregate of 85 percent of the membership interests in the LLC, were thrilled with the opportunity, but the other 15-percent owner was not. They decided to put it to a vote. The operating agreement was silent concerning the approval required to sell the LLC's assets. As expected, the two members voted in favor of the proposed sale, and the member holding the minority interest voted against it.

Since the members holding a majority of the membership interests of the LLC approved the sale, they assumed that they had obtained the necessary approval under California law and proceeded with the sale against the minority member's wishes. The two members were later sued by the minority member. The minority member claimed that the sale had not been approved in accordance with California law. If the sale had occurred before 2014, the lawsuit would certainly have been dismissed because the approval obtained would have been sufficient under the law governing LLCs in California before January 1, 2014. Now, however, unless the operating agreement provides otherwise, the law requires consent of all members for sales outside the ordinary course of the LLC's business. Corp C §17704.07(b)(4).

It has been a little over a year since California's Revised Uniform Limited Liability Company Act (RULLCA) (Corp C §§17701.01–17713.13) went into effect. RULLCA, which became effective on January 1, 2014, has brought in its wake significant changes to the governance of LLCs by implementing new mandatory and default rules. These changes affect all LLCs under California law (see Corp C §17713.04(a)), including LLCs that were formed under the prior LLC statute, the Beverly-Killea Limited Liability Company Act (Beverly-Killea) (former Corp Code §§17000–17656), which had been in effect since 1994. The retroactive application of RULLCA to LLCs formed under Beverly-Killea, as described in the above hypothetical, may have detrimental, unintended results to unwary LLC members and managers.

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RULLCA, in form, is similar to Beverly-Killea in that both statutes provide a set of default rules to govern an LLC in the event that the LLC's operating agreement fails to address certain issues sufficiently. Under Beverly-Killea, the default provisions were generally broad or did not have any direct, substantive effect on the LLC's business or operations. RULLCA, on the other hand, institutes both unalterable, mandatory provisions and specific default provisions that can directly control the way in which an LLC is operated. Along with the new default provisions came ambiguities and new, untested interpretations, resulting in a world of uncertainty for California LLCs and foreign LLCs that may be subject to California law. As a result, RULLCA has forced practitioners to update their operating agreement forms and modify standard operating provisions to avoid unwanted or unintended outcomes.

In view of the lack of guidance concerning the adoption and implementation of RULLCA, this article provides a practical discussion of some of the more significant operating agreement drafting issues arising under RULLCA. For purposes of context, where applicable, the authors have provided short summaries of the differences between RULLCA and Beverly-Killea, but this article is not intended to cover all distinctions between RULLCA and Beverly-Killea or provide an exhaustive comparison between the two Acts. Although this article may provide a starting point for review of counsel's current practices, operating agreements are unique to each company and should always be carefully reviewed in their entirety before execution.

ESTABLISHING AN OPERATING AGREEMENT

RULLCA expressly states that its policy is to give maximum effect to the principles of freedom of contract and to the enforceability of operating agreements. Corp C §17701.07. RULLCA further clarifies that in the event of a conflict between an LLC's operating agreement and its articles of organization, the operating agreement prevails as to members, disassociated members, transferees, and managers. See Corp C §17701.12(d)(1). In other words, the operating agreement governs all terms concerning management and operation of an LLC, even if the LLC's articles of organization filed with the California Secretary of the State provide otherwise.

One of the most common issues that arise in this regard relates to the establishment of an LLC's management structure. The California form of Articles of Organization (Secretary of State Form LLC-1) requires that the organizers specify whether the LLC will be managed by one manager, more than one manager, or all LLC members. See Form LLC-1 Item 5. Under Beverly-Killea, the designation of an LLC as manager-managed in the LLC's articles of organization would be sufficient to determine that the LLC was in fact managed by a manager. However, under RULLCA, notwithstanding the provisions of an LLC's articles of organization, if the operating agreement is silent on the issue or states otherwise, the LLC will be deemed to be member-managed. See Corp C §17704.07(a). This can lead to unintended results and mislead members (or those who believed they were managers) regarding their rights and authority with respect to the LLC.

This potential for conflict can be easily remedied by including in the operating agreement language stating that the LLC is or will be (1) managed by a manager; (2) managed by more than one manager; or (3) managed by all LLC member(s). See Corp C §§17702.01(b), 17704.07(a). Any existing LLC that has been relying on its articles of organization to state its management structure (*e.g.*, that the LLC is manager-managed) is advised to amend its operating agreement to eliminate any potential conflicts with its articles of organization, as appropriate. It should be noted, however, that §17701.12(d)(2) of RULLCA allows the filed articles of organization to govern as to third persons (who are not members or managers).

Thus, in situations where an LLC's articles of organization state that the LLC is managed by a manager, the LLC would still be bound by contracts entered into by a manager on the LLC's behalf even if it is later discovered that the operating agreement did not specify that the LLC is manager-managed.

From a policy perspective, RULLCA's focus on freedom of contract is consistent with Beverly-Killea. However, RULLCA takes a more paternalistic approach in guiding the construction of operating agreements by further providing what an operating agreement is and what it may or may not contain. On one end of the spectrum, RULLCA has an extremely low threshold to establish an operating agreement. It provides that an operating agreement can be oral, in a record, implied, or any combination of those forms. The terms of an agreement may be as simple as an agreement among all members to organize an LLC. Moreover, the agreement need not even be referred to as an operating agreement. See Corp C §17701.02(s) (definition of "operating agreement").

While these provisions make it easy to establish an operating agreement, they also create a risk that parties may unknowingly implement an undesired, implied operating agreement. Without a clear written operating agreement, an implied agreement could be forced on unsuspecting members. In situations where no formal operating agreement exists, as with most oral contracts, the exact details of the agreement are often difficult to prove. As a result, those LLCs will likely be subject to some or all of RULLCA's default provisions even though those provisions may be contrary to the original intent of the parties. It seems probable that any LLC failing to establish a formal written operating agreement is ripe for litigation among its members, managers, and possibly its employees in the event a material dispute arises. A formal written operating agreement should be adopted by LLCs to reduce the likelihood that disputes will result in litigation.

Under RULLCA, operating agreements can be established before or after the formation of the LLC as an entity. See Corp C §17701.11(b). Having an operating agreement in place before the formation of the business entity would help members solidify their business relationship and the management of the venture before assets and liabilities of the company are acquired. In many cases this would be preferable to establishing an operating agreement for a business already in operation because, in the process of drafting an operating agreement, members often may disagree on the specifics of their relationship or management of the business. Some members could argue that any oral discussions by the members, even if the discussions occurred prior to formation, may have already created an enforceable operating agreement. The ensuing negotiations or possible conflicts can disrupt or endanger the business's operations. If it is not possible to establish an operating agreement before formation, one should take care to explicitly state that any discussions or suggested terms are of a nonbinding nature and do not constitute an operating agreement as defined by RULLCA.

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RULLCA AND FOREIGN LLCS

RULLCA applies to both domestic and foreign LLCs existing on or after January 1, 2014, to all foreign LLCs registered with the California Secretary of State before January 1, 2014, whose registrations have not been canceled as of January 1, 2014, and to all foreign LLCs registered with the California Secretary of State on or after January 1, 2014. Corp C §17713.04(a). However, RULLCA also provides that the law of the state or other jurisdiction under which a foreign LLC is formed governs (1) the organization of the LLC, its internal affairs, and the authority of its members and managers, and (2) the liability of a member as a member and a manager as manager for the debts, obligations, or others liabilities of the LLC. Corp C §17708.01(a)(1)–(2). Sections 17713.04(a) and 17708.01(a), read together, could be interpreted to mean that RULLCA applies to all matters involving an LLC not otherwise covered in §17708.01(a). In other words, RULLCA potentially could govern all LLC activities that are not "internal affairs" (which is not a defined term under RULLCA) and all issues relating to member and manager liability regardless of where the LLC was formed or whether an operating agreement states that the LLC is governed by the laws of a foreign jurisdiction.

In view of RULLCA's broad and ambiguous provisions, it is conceivable that foreign LLCs with operations or substantial assets in California could be subject to lawsuits where courts may apply RULLCA to disputes involving certain operations of the LLC that do not qualify as the LLC's internal affairs. Accordingly, if parties elect to form an LLC in a state other than California, but the LLC is registered to do business in California as a foreign LLC, it is important that RULLCA, and the possible scope of its application to the LLC, be carefully considered when drafting the operating agreement or determining whether an amendment to the operating agreement is appropriate.

OPERATING AGREEMENT REQUIREMENTS: RULLCA'S MANDATORY PROVISIONS

As discussed above, establishing an operating agreement under RULLCA is easily accomplished, perhaps too easily. However, drafting an operating agreement that adequately reflects the members' intentions can be much more difficult. Corporations Code §17701.10 sets forth the matters that may be governed by an operating agreement and also sets forth the RULLCA provisions that may not be altered by an operating agreement. These restrictions are often referred to as "mandatory provisions" as opposed to the "default provisions" of RULLCA, which apply only if they are not modified by the operating agreement.

When setting out to draft an operating agreement for a newly formed LLC or amending an existing operating agreement that may have been established under Beverly-Killea, it is important to distinguish mandatory RULLCA provisions from the default provisions that may be modified. This distinction may not be readily apparent, and it is advised that practitioners avoid simply using existing Beverly-Killea operating agreement precedents, as their terms may not correspond to RULLCA's changes or may even contain provisions that are void under RULLCA.

Generally, under RULLCA's §17701.10(c), an operating agreement may not, among other things (1) vary an LLC's right to sue or be sued; (2) vary the power of the court to order the signing of certain documents to be delivered to the Secretary of State; (3) vary the applicability of California law; (4) vary the court's power to enter a decree of dissolution; (5) unreasonably restrict the right of a member to maintain certain legal actions; (6) eliminate the contractual obligation of good faith and fair dealing; or (7) eliminate the duty of loyalty or unreasonably reduce the duty of care. The above list is a sampling of the lengthy restrictions that RULLCA places on operating agreements. Many subsections of §17701.10(c) refer to other sections of RULLCA that significantly broaden their scope. Moreover, RULLCA provides little to no guidance as to what is meant by terms such as "unreasonably reduce" or "unreasonably restrict." As a result, RULLCA is mired in mandatory-provision landmines, and it is reasonable to believe that §17701.10(c) will be a source of litigation in the years to come.

RULLCA's mandatory provisions are an issue that all practitioners should take heed of, but they are by their nature mandatory and unmodifiable. Hence, this article instead focuses on certain RULLCA default rules. Specifically, this article discusses potential issues raised by the more substantive default rules and the ways in which one could approach those issues by tailoring an LLC's operating agreement.

MANAGEMENT AND CONTROL

An LLC may be either manager-managed or member-managed. As discussed above, an LLC will be, by default, member-managed under Corp C §17704.07(a) unless the articles of organization and the operating agreement provide that the LLC is or will be manager-managed. RULLCA also made significant changes regarding how both member-managed and manager-managed LLCs are managed and controlled. Particular attention should be paid to (1) rights of member-managers, including voting rights and requirements, and (2) manager authority.

Member-Managers

By default, each member of a member-managed LLC has equal rights in the management and conduct of an LLC's activities. Corp C §17704.7(b)(2). If an issue or difference of opinion between the members arises in the "ordinary course of the [LLC's] activities," a majority vote is required to proceed. Corp C §17704.7(b)(3).

Section 17704.07(b)(4) of RULLCA provides that any act "outside of the ordinary course of activities" of the LLC, such as the sale of all of the LLC's assets, or any amendment to the operating agreement, must be unanimously approved by the members. This is a significant change from Beverly-Killea, which had a default rule requiring only majority approval of the members for the LLC to undertake these activities. Under RULLCA, by default, each member must consent to any activity outside the normal course of business before the LLC can take action. This new default rule gives substantial power to minority members (as illustrated by this article's opening hypothetical). Importantly, the voting requirements and authority granted by the default rules in Corp C §17704.07(b) can be modified only by a written operating agreement.

It is recommended that an operating agreement provide for specific voting requirements tailored to the LLC. Before execution of the agreement, members should consider their needs and voting requirements for future non-ordinary-course activities that may arise, such as acquisitions or a sale of the business. Because of RULLCA's possible retroactive application, many operating agreements adopted before 2014 may not be specific enough to avoid application of these default rules. It is important when reviewing or amending a pre-RULLCA operating agreement to ensure that the agreement provides the necessary voting threshold for the LLC's business activities and the specific voting rights of the members. Failure to do so could subject the LLC to default provisions that could inadvertently require unanimous consent of the members for certain business transactions.

An additional consideration in the drafting of voting provisions is the modification of RULLCA's default rule in §17704.7(b)(2), which provides that each member of a member-managed LLC has equal voting rights. Section 17704.07(r) allows the articles of organization or a written operating agreement to allocate "to all or certain identified members of a specified class or group of members the right to vote separately or with all or any class or group of members on any matter." This exception allows for voting by the members to be done by a group or a class on a per capita, numerical, financial-interest, or any other basis. A member or a group of members can be granted authority under the operating agreement, or under the articles of organization if not contradicted by the operating agreement, to vote on specific LLC decisions. For example, a group may be given the authority to enter into a specific material agreement without requiring the consent and vote of all members.

Manager Authority

An alternative to the member-managed LLC is to appoint one or more managers. In a manager-managed LLC, the managers decide on matters relating to the activities of the company. If there are more than one manager, each manager has equal rights in the management and conduct of the activities of the LLC. Corp C §17704.07(c). If a conflict or difference of opinion between the managers arises relating to the ordinary-course activities of the LLC, a majority vote of the managers may decide how to proceed. Corp C §17704.07(c)(3).

Although managers have operational control of a manager-managed LLC, unless otherwise expressly provided in the operating agreement their authority is still subject to certain limiting default rules. One of the more substantive changes from Beverly-Killea is Corp C §17704.07(c)(4), which requires the consent of all of the members to (1) amend an operating agreement; (2) approve a merger or conversion under Article 10 (Corp C §§17710.01–17710.18); (3) undertake any other act outside the ordinary course of the company's activities, or (4) sell, lease, exchange, or otherwise dispose of all, or substantially all, of the LLC's property, with or without goodwill, outside the ordinary course of the LLC's activities. Practitioners should note that although §17704.07(c)(4) can be modified by an operating agreement, it does not necessarily allow an operating agreement to modify any of the internally referenced provisions. Article 10, for example, is referenced as part of §17704.01(c)(4)'s default provisions but the actual requirements of Article 10 are prohibited from modification by §17701.10(c)(12).

The unanimous-vote requirement under §17704.07(c)(4) allows for minority blocking rights, which could prevent the company from entering new markets, impede the LLC's ability to raise capital, or generally restrain and restrict the LLC's ability to react to business opportunities. Although every business is unique and minority rights should be discussed by the members before entering into an operating agreement, practitioners should give their clients practical guidance in modifying the default rules to allow flexibility for future non-ordinary-course LLC activities. Practitioners should also note that operating agreement provisions relating to management and control by members and managers drafted prior to RULLCA may be insufficient. To avoid unexpected deadlocks or added complexity in future transactions, a prompt review and update of an existing LLC's operating agreement should be undertaken.

LIABILITY AND INDEMNIFICATION PROVISIONS

Before 2014, Beverly-Killea provided LLCs with the option to indemnify members, managers, officers, agents, and other persons involved with an LLC. See former Corp C §17155. Section 17704.08(a) of RULLCA has drastically changed this approach. Indemnification is now mandated, by default, to members and managers and may be provided to others under the operating agreement. Section 17704.08(a) requires an LLC to reimburse any payment made and to indemnify for any debt, obligation, or other liability incurred on behalf of the LLC by a member of a member-managed LLC or the manager of a manager-managed LLC, provided that the member or manager complied with all fiduciary duties owed to the LLC, whether by default under Corp C §17704.09 or by specific provisions in the operating agreement.

As with many other provisions under RULLCA, an operating agreement may alter or eliminate the indemnification for a member or manager and may eliminate or limit a member or manager's liability to the LLC or members for money damages. See Corp C §17701.10(g). Under §17701.10(g), however, an operating agreement cannot limit liability for (1) breach of the duty of loyalty; (2) a financial benefit by the manager or member to which the manager or member is not entitled; (3) intentional infliction of harm on the LLC or a member; (4) intentional violation of criminal law; or (5) a member's liability for excess distributions under §17704.06. Fiduciary duties are discussed in more detail below.

As noted above, indemnification may be provided to more than just the members or managers of the LLC. In fact, RULLCA §17701.05(*l*) allows an LLC to indemnify or hold harmless "any person." This permits the indemnification of officers, employees, or other agents of the LLC. The specific indemnification of nonmembers and nonmanagers should be sufficiently described and accounted for in the LLC's operating agreement.

One common way for LLCs to cover their indemnification liabilities is for the LLC to buy D&O insurance. Under RULLCA §17704.08(b), an LLC is authorized to purchase and maintain insurance, including insurance on behalf of any member or manager against liability asserted against or incurred by the member or manager in that capacity or arising from that status, even if the operating agreement could not eliminate or limit the person's liability to the LLC for conduct giving rise to the liability.

FIDUCIARY DUTIES

Beverly-Killea referred to the fiduciary duties of members and managers of an LLC by cross-referencing the general partnership law, but it did not specifically describe the nature or scope of these duties. See former Corp C §17153. RULLCA, however, specifically provides that members of a member-managed LLC owe fiduciary duties to the LLC and to the other members of the LLC, and that managers of a manager-managed LLC owe fiduciary duties to the LLC and the members of the LLC. See Corp C §17704.09.

RULLCA states that the fiduciary duties of members (*i.e.*, in a member-managed LLC) and managers (*i.e.*, in a manager-managed LLC) include the duty of loyalty and the duty of care. Corp C §17704.09(a). Further, Corp C §17704.09(d) provides that the members are subject to the obligation of good faith and fair dealing. Finally, Corp C §17701.10(c)(4) mentions "any other fiduciary duty." RULLCA does not allow the parties to an operating agreement to eliminate fiduciary duties. See Corp C §17701.10(c)(4). However, RULLCA permits the modification of fiduciary duties in a written operating agreement, subject to certain important limitations discussed below.

Duty of Loyalty

Under Corp C §17704.09(b), the duty of loyalty is limited to the following:

- To account to the LLC and hold as trustee for it any property, profit, or benefit derived by the member or manager, as applicable, in the conduct and winding up of the LLC's activities or derived from the use by a member or manager of LLC property, including the appropriation of an LLC opportunity;
- To refrain from dealing with the LLC in the conduct or winding up of the LLC's activities as or on behalf of a party having an interest adverse to the LLC; and
- To refrain from competing with the LLC in the conduct or winding up of the LLC's activities.

Members may alter the duty of loyalty by identifying in the operating agreement specific types or categories of activities that do not violate the duty, subject to a "not manifestly unreasonable" standard. See Corp C §17701.10(c)(14)(A). Members may also specify in the operating agreement the members' approval required to authorize or ratify acts or transactions that otherwise would violate the duty of loyalty, so long as all material facts relating to such acts or transactions are fully disclosed to all members. See Corp C §17701.10(c)(14)(B).

Duty of Care

The duty of care is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law. Corp C §17704.09(c). The duty of care may be altered in the operating agreement so long as the duty is not "unreasonably reduce[d]." Corp C §17701.10(c)(15).

Obligation of Good Faith and Fair Dealing

The operating agreement may specify the standards by which performance of the obligation of good faith and fair dealing is to be measured, so long as the standards are "not manifestly unreasonable." Corp C §17701.10(c)(16).

Informed Consent Requirement

It is important to note that, although RULLCA permits fiduciary duties to be modified in a written operating agreement to the extent described above, these modifications may only be made with the "informed consent" of the members. Corp C §17701.10(e). This probably means that there must be full disclosure. However, assenting to the operating agreement in accordance with Corp C §17701.11(b), as a person admitted to an LLC as a new member is deemed to do, does not constitute "informed consent" under Corp C §17701.10(e). Therefore, so-called joinder agreements that a person to be admitted as new member of an LLC signs should be drafted in a manner, and other actions should be taken, to satisfy the "informed consent" requirement if any fiduciary duties of members or managers are modified in the operating agreement.

Application of Duties

Assume Oil Inc. is a manager of several LLCs organized to explore, develop, and produce crude oil and natural gas in Santa Barbara County, California. Each LLC has different members. Oil Inc. identifies a valuable interest in land and producing properties that it seeks to acquire and is in the process of determining which of the LLCs it will select to undertake the acquisition process. Oil Inc. is aware that this situation presents a conflict of interest. In accordance with its duty of loyalty under RULLCA, Oil Inc., as manager of the LLCs, must refrain from competing with, and appropriating an LLC opportunity from, the LLCs, and must act in good faith in its dealings with the LLCs in connection with the acquisition process.

The foregoing example highlights the importance of, and the challenges involved in, anticipating potential conflicts of interest and drafting satisfactory provisions in the LLC's operating agreement that modify fiduciary duties under RULLCA.

TRANSFERS OF INTEREST AND DISSOCIATION

One of the more sweeping changes implemented by RULLCA is the way in which interests can be transferred and how members may become dissociated from an LLC. Under RULLCA, common transfers of interest, *e.g.*, on death of a member, may cause a member or his or her successor to be stripped of his or her rights. See Corp C §17706.02(f)(1). Before RULLCA, the concept of withdrawal of a member from an LLC (now termed "dissociation" under RULLCA; see Corp C §§17706.01–17706.03) was a general concept and Beverly-Killea did not specify default rules. Now, under RULLCA, if an operating agreement is silent on dissociation, members or their successors can be involuntarily dissociated. See Corp C §17706.02. The default rule causes dissociation in the event of (1) resignation or withdrawal of a member; (2) death of an individual member; (3) bankruptcy of a member (in a member-managed LLC); (4) appointment of a guardian or conservator for an individual member (in a member-managed LLC); (5) distribution of a transferrable interest by an estate or trust; or (6) dissolution or termination of a legal entity acting as a member. Corp C §17706.02. Moreover, RULLCA also allows members to expel another member by unanimous written consent if a member transfers its entire transferable interest (which often encompasses only the member's economic interest) to another party. See Corp C §17706.02(d)(2). There is no exception in the statute that would cover transfers to a family trust, which are often made for purposes of estate planning.

The end result of these new provisions is that members could be subject to dissociation. See Corp C §17706.03(a). As a consequence, dissociated members will have only economic rights and will lose the more expansive statutory rights of a member. Although some of the default dissociation events may make sense for a business, the new dissociation rules are not mandatory provisions and can be modified or excluded in the operating agreement by including additional provisions or exceptions relating to a member's dissociation.

The operating agreement need not address all of the triggering events listed in Corp C §17706.02. It may be more appropriate for an operating agreement to list the events that members wish to cause dissociation and then exclude any additional or inappropriate default events set forth in §17706.02. A reference in the operating agreement specifically excluding dissociation events under §17706.02, except those expressly provided in the operating agreement, should be sufficient.

CONCLUSION

In view of the significant changes to the law governing LLCs in California, members and managers of LLCs should consult legal counsel to review and draft their operating agreements carefully and to consider whether any amendments are needed to effectuate the intent of the parties.

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