REAL ESTATE LAW

by Loryn Dunn Arkow

The NEW LLC

RULLCA's default provisions must be considered when drafting operating agreements for real estate LLCs

WITH THE START of the new year, the California Revised Uniform Limited Liability Company Act[1] (RULLCA) has replaced the Beverly-Killea Limited Liability Company Act (Beverly-Killea).[2] Because limited liability companies are often the entity of choice for closely held businesses, including many real estate-related enterprises, the recasting of California's limited liability company laws has widespread and significant consequences for businesses in California.

RULLCA is modeled upon the Revised Uniform Limited Liability Company Act (Model Act) published by the National Conference of Commissioners on Uniform State Laws in 2006. The California Legislature, in enacting RULLCA, cited the benefit of consistency with the limited liability company laws of other states.[3] While California's enactment of RULLCA brings its limited liability company laws more in line with the seven other states that have adopted the Model Act[4] and others that incorporate select provisions, it reaffirms the gap between California's law and the Delaware Limited Liability Company Act[5] (Delaware Act), which is the preference of many operators, lenders, and institutional investors. An examination of various provisions of RULLCA, as compared to the Delaware Act, highlights reasons why sponsors organizing limited liability companies in California may opt to form their entities in Delaware and be governed by the Delaware Act rather than RULLCA.

Delaware has long been a state of choice for entity formation because of its overriding commitment to uphold freedom of contract, as embodied in the Delaware Act,[6] in addition to Delaware's generally business-friendly body of law. In accordance with the Model Act, RULLCA pays homage to freedom of contract: "It is the policy of this title and this state to give maximum effect to the principles of freedom of contract and to the enforceability of operating agreements."[7] Nonetheless, RULLCA enumerates more than

Loryn Dunn Arkow is a partner in the Los Angeles office of Kelley Drye and Warren LLP, where she counsels real estate investors, lenders, developers, and sponsors.

20 restrictions on what members of a limited liability company can agree upon. Further, RULLCA provides new default standards (i.e., provisions that apply in the absence of the parties' providing otherwise in the operating agreement) that may complicate company operations, creating a potential trap in the event that members 1) fail to address such matters in their operating agreements, or 2) in the case of existing companies, had relied either on prior default rules that are now supplanted by RULLCA or on the absence of the extensive array of default rules that appears in RULLCA.

Limits on Contractual Variation

Among other things, RULLCA prohibits an operating agreement from varying any provision relating to mergers and conversions provided for in Articles 10 and 12 of RULLCA.[8] The restrictions also limit the ability to vary applicable law and the power of the court in certain contexts.[9] However, the restrictions on contractual flexibility set forth in RULLCA particularly emphasize limitations on the ability of the operating agreement to modify fiduciary duties and related obligations, with no less than nine subsections of RULLCA Section 17701.09 pertaining to these issues.[10]

Addressing a previously existing ambiguity under California law, RULLCA states that an operating agreement is prohibited from eliminating the duty of loyalty, the duty of care, or any other fiduciary duty.[11] Nor may an operating agreement eliminate the contractual obligation of good faith and fair dealing consistent with which a member is required to perform its duties and exercise its rights with respect to the limited liability company.[12]

Ambiguity remains, however, with respect to the extent to which fiduciary duties may be modified. For example, RULLCA lists what the duties of loyalty that a member in a member-managed limited liability company (or of a manager in a manager-managed limited liability company) are:

> (1) To account to a limited liability company and hold as trustee for it any property, profit, or benefit derived by the member in the conduct and winding up of the activities of a limited liability company or derived from a use by the member of a limited liability company property, including the appropriation of a limited liability company opportunity.
>
> (2) To refrain from dealing with a limited liability company in the conduct or winding up of the activities of a limited liability company as or on behalf of a party having an interest adverse to a limited liability company.
>
> (3) To refrain from competing with a limited liability company in the conduct or winding up of the activities of the limited liability company.[13]

While Section 17701.10(c)(14) of RULLCA prohibits elimination of these duties, it specifically allows an operating agreement to qualify them by 1) identifying specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable, or 2) specifying the number or percentage of members that may authorize or ratify, after full disclosure to all members of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.[14] This statute raises some questions.

First, does the inclusion of these specifically authorized modifications preclude any other type of modification of the duty of loyalty? Second, could typical provisions included in operating agreements potentially be found by courts to be "manifestly unreasonable"? For example, many operating agreements, including operating agreements of real estate-related companies, authorize the members and managers to participate in activities that may be competitive with the company, without incurring any obligation to offer any interest in these activities to the company or to the other members. This provision could be read as negating the duty of a member to refrain from competing with the company, making it "manifestly unreasonable."

Further, how do managers completely avoid situations in which they would be acting on behalf of parties having an interest adverse to the company when, for example, very often the manager's affiliate is the property manager of the company's property, the guarantor of the company's debt, or a stakeholder in a community where the company owns property? Inevitable divergences of interest are difficult to identify in advance without describing them in a manner so overly broad it becomes "manifestly unreasonable."

Given these challenges, the right under Delaware law to contractually eliminate fiduciary duties[15] appeals to sponsors as a way to mitigate unexpected liability not contracted for by the sponsor. The Delaware Act cautions that, while fiduciary duties may be contracted away, the operating agreement "may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."[16] The requirement of good faith and fair dealing, also inviolable under RULLCA,[17] arguably sufficiently protects passive investors from true bad acts of managers, as merited by public policy.

When proceeding under RULLCA, sponsors should precisely craft limitations on fiduciary duties tailored to the specific business plan and scope of the enterprise accounting for RULLCA's limitations and should further consult California case law for guidance in interpreting what actions constitute a

When proceeding under RULLCA, sponsors should precisely craft limitations on fiduciary duties tailored to the specific business plan and scope of the enterprise accounting for RULLCA's limitations and should further consult California case law for guidance in interpreting what actions constitute a breach of fiduciary duty.

MCLE Test No. 231

The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education credit by the State Bar of California in the amount of 1 hour.

1. The limited liability company law of which state has a policy of giving maximum effect to the principles of freedom of contract and enforceability of operating agreements?

A. California.
B. Delaware.
C. Both.
D. Neither.

2. The California Revised Uniform Limited Liability Company Act (RULLCA) permits elimination of the fiduciary duties of the manager.

True.
False.

3. The Delaware Limited Liability Company Act (Delaware Act) permits elimination of the fiduciary duties of the manager.

True.
False.

4. RULLCA allows an operating agreement to eliminate the contractual duty of good faith and fair dealing of the members.

True.
False.

5. The Delaware Act allows an operating agreement to eliminate the contractual duty of good faith and fair dealing of the members.

True.
False.

6. Under RULLCA, one element of the duty of care that a manager in a manager-managed LLC has is to refrain from competing with the LLC in the conduct or winding up of the activities of the LLC.

True.
False.

7. Under RULLCA, one element of the duty of loyalty that a manager in a manager-managed LLC has is to refrain from acting on behalf of a party having an interest adverse to that LLC.

True.
False.

8. RULLCA allows an operating agreement to qualify the duty of loyalty by identifying specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable.

True.
False.

9. Under RULLCA, a member is bound by a provision in the operating agreement modifying the fiduciary duties of the manager even if the member has not signed the operating agreement.

True.
False.

10. Unanimous consent of the members of a manager-managed, California LLC is required for the sale of all or substantially all of the property owned by the company:

A. Under all circumstances.
B. Even if the operating agreement allows for the sale upon majority approval.
C. If the operating agreement does not specify what vote is required.

11. Pursuant to RULLCA, unless otherwise specified in the operating agreement, taking of any action outside the ordinary course of the LLC's activities by the manager requires unanimous consent of the members.

True.
False.

12. RULLCA defines activities in the "ordinary course" as the day-to-day activities of the company.

True.
False.

13. The default rule for the percentage vote required to amend the operating agreement under RULLCA is the same as it was under Beverly-Killea.

True.
False.

14. In a manager-managed LLC, the members can remove the manager without cause upon a majority vote.

True.
False.

15. A charging order is available as a remedy for judgment creditors of members of an LLC in:

A. California.
B. Delaware.
C. Both.
D. Neither.

16. California law permits foreclosure on membership interests in a multimember LLC as a remedy against a judgment debtor.

True.
False.

17. California law permits foreclosure on membership interests in a single-member LLC as a remedy against a judgment debtor.

True.
False.

18. Delaware law permits foreclosure of membership interests in a multimember LLC as a remedy against a judgment debtor.

True.
False.

19. Delaware law permits foreclosure of membership interests in a single-member LLC as a remedy against a judgment debtor.

True.
False.

20. Under RULLCA, a merger must be approved by unanimous consent of the members of each constituent LLC involved in the merger.

True.
False.

MCLE Answer Sheet #231

THE NEW LLC

Name ______________________

Law Firm/Organization ______________________

Address ______________________

City ______________________

State/Zip ______________________

E-mail ______________________

Phone ______________________

State Bar # ______________________

INSTRUCTIONS FOR OBTAINING MCLE CREDITS

1. Study the MCLE article in this issue.
2. Answer the test questions opposite by marking the appropriate boxes below. Each question has only one answer. Photocopies of this answer sheet may be submitted; however, this form should not be enlarged or reduced.
3. Mail the answer sheet and the $20 testing fee ($25 for non-LACBA members) to:

   Los Angeles Lawyer
   MCLE Test
   P.O. Box 55020
   Los Angeles, CA 90055

   Make checks payable to Los Angeles Lawyer.
4. Within six weeks, Los Angeles Lawyer will return your test with the correct answers, a rationale for the correct answers, and a certificate verifying the MCLE credit you earned through this self-assessment activity.
5. For future reference, please retain the MCLE test materials returned to you.

ANSWERS

Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.

1.	☐ A	☐ B	☐ C	☐ D
2.	☐ True		☐ False	
3.	☐ True		☐ False	
4.	☐ True		☐ False	
5.	☐ True		☐ False	
6.	☐ True		☐ False	
7.	☐ True		☐ False	
8.	☐ True		☐ False	
9.	☐ True		☐ False	
10.	☐ A	☐ B	☐ C	
11.	☐ True		☐ False	
12.	☐ True		☐ False	
13.	☐ True		☐ False	
14.	☐ True		☐ False	
15.	☐ A	☐ B	☐ C	☐ D
16.	☐ True		☐ False	
17.	☐ True		☐ False	
18.	☐ True		☐ False	
19.	☐ True		☐ False	
20.	☐ True		☐ False	

breach of fiduciary duty.[18] RULLCA also provides that the fiduciary duties of a manager of a limited liability company may only be modified in a written operating agreement with the informed consent of the members.[19] Accordingly, care should be taken that the original members, as well as any transferees, whether by operation of law or otherwise, provide their written informed consent to these provisions. In addition, the operating agreement perhaps should include recitals regarding the informed consent of the members. When proceeding under the Delaware Act, it is also necessary to explicitly specify if the parties have agreed to eliminate fiduciary duties rather than attempt to contract them away by omission. The Delaware Supreme Court pointed out in 2012 that whether the Delaware Act imposes default fiduciary duties was unsettled,[20] and in response the Delaware Act was amended to specify that the rules of law and equity relating to fiduciary duties apply by default.[21]

Default Voting Specifications

RULLCA necessitates that an operating agreement also address the percentage vote of members, if any, required for a company to take particular actions. A lack of specification regarding whether a vote of members is required in a manager-managed limited liability company, without affirmative language that a manager can act without a vote of members on any unspecified matters, likely results in application of RULLCA's new default rule requiring approval by a vote of members. This default rule, set forth in Section 17704.07(c)(4), requires unanimous consent of all members of the limited liability company to do any of the following:

> (A) Sell, lease, exchange, or otherwise dispose of all, or substantially all, of the limited liability company's property, with or without the goodwill, outside the ordinary course of the limited liability company's activities.
> (B) Approve a merger or conversion.…
> (C) Undertake any other act outside the ordinary course of the limited liability company activities.
> (D) Amend the operating agreement.

The prior default rule under Beverly-Killea imposed a lower hurdle for decisions not otherwise addressed in the operating agreement, requiring the vote of a majority in interest of the members for "matters in which a vote is required," except in the case of amendment of the operating agreement or articles of organization, which specified unanimous consent as the default rule.[22] In the absence of a contrary provision in the limited liability company agreement, the Delaware Act default rule similarly calls for unanimous consent for amendments, unless otherwise provided by law, such as in the context of a merger wherein only a majority in interest is required for an amendment.[23]

However the Delaware Act does not impose a hurdle of unanimous consent or any particular voting requirement for actions by the limited liability company that fall outside of an undefined "ordinary course," including sale, lease, exchange, or other disposition of the company's property, as does RULLCA.[24] Under RULLCA, it is not clear what constitutes the "ordinary course," including whether financings or other transactions are within the ordinary course. Providing for unanimous consent of the members to authorize actions of the manager confers upon minority members a disproportionate power over the destiny of the company.

Further, RULLCA includes a default provision that a majority of the members can choose a manager or, with or without notice or cause, remove a manager at any time.[25] The Delaware Act has no similar provision. In the absence of express requirements regarding appointment and removal of managers, very different results would arise with respect to removal of the manager of a California limited liability company versus a Delaware one. In California, a manager can easily be ousted from control unless alternative arrangements appear in the operating agreement.

Accordingly, an operating agreement should set forth with specificity that certain enumerated actions require a specific threshold of consent (less than that set forth in RULLCA) and that the manager can act without the vote of any other member except as explicitly constrained by the operating agreement. The operating agreement should also specify appropriate requirements for appointment and removal of managers, which may include removal of the manager only with cause. Note that the adoption of RULLCA also behooves lenders to require unanimous written consents of members up the chain of ownership if the relevant limited liability company agreements are not completely clear that the manager of the company has authority to bind the company in a loan transaction without such consent.

Rights of Judgment Creditors

Also of concern to sponsors, lenders, and investors in limited liability companies are the rights of judgment creditors against membership interests in the limited liability company. In closely held companies, it would be problematic if a judgment creditor could interfere in the operations of a limited liability company or in any way supplant the intended members of the company. In addition, owners of membership interests are loath to forfeit the entire value of an interest in a limited liability company due to foreclosure of a judgment lien against the interest (which may be for a judgment of a much lesser value) because liquid funds to pay the creditor are scarce.

RULLCA provides that a court can issue a charging order as a lien on the transferrable interest of the judgment debtor in a limited liability company and require that any distributions that would otherwise be paid to the member be paid instead to the judgment creditor. RULLCA further allows for the foreclosure of the lien on the membership interest upon a showing that distributions under the charging order will not pay the judgment debt within a reasonable time.[26] In Delaware, on the other hand, the ability to foreclose in this context has been squarely rejected.

In fact, the Delaware legislature amended the Delaware Act in August 2013 to firmly establish that a charging order is the exclusive remedy that a judgment creditor can pursue with respect to the judgment debtor's interest in a limited liability company. The amendment states explicitly that attachment, garnishment, foreclosure, or other legal remedies are not available to the judgment creditor. Further, the amendments also codified that the result will be no different if the judgment debtor is a single member or a multimember limited liability company.[27] This declaration is significant, given that some courts have viewed foreclosure by a judgment creditor against the interests in a single member limited liability company as more equitable.[28] In contrast, RULLCA provides that foreclosure is available upon a showing that distributions will not pay the judgment debt in a reasonable time, which is particularly suited to allow for a foreclosure in the context of a single-member limited liability company.

Delaware Law in California

A question remains as to whether a California court would enforce the choice of Delaware law to govern the remedies available to the judgment creditor. According to the Delaware statute, "a limited liability company agreement that provides for the application of Delaware law shall be governed by and construed under the laws of the State of Delaware in accordance with its terms."[29] However, RULLCA states that the law of the jurisdiction of formation governs 1) the organization of the company, its internal affairs, and the authority of its members and managers, 2) the liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of the company, and 3) the authority of the members and agents of a limited liability company.[30] It is unclear whether these categories are exclusive of all other matters addressed by RULLCA, and Section 17713.04 exacerbates this ambiguity, declaring that RULLCA applies to all foreign limited liability companies registered in California.[31] Perhaps the scope of application is meant to be limited to the provisions of RULLCA that specifically address foreign limited liability companies (such as registration, merger, and conversion), or perhaps instead the section makes a far-reaching attempt to override the choice of any other state law except for very limited purposes. While a California court may attempt to assert its domestic law regarding the rights of judgment creditors in the case of a Delaware limited liability company operating in California, especially considering Section 17713.04, it is certain that forming a California limited liability company will result in the availability of foreclosure for judgment creditors.

The Issue of Practicality

In light of the changes in the California limited liability company statute, some have counseled that limited liability companies amend their operating agreements to ensure that there are no unintended consequences of omissions from existing operating agreements. However, given that such amendments would likely be unpopular with those whose fiduciary duties or approval rights are sought to be altered, as well as that lender consent in most cases would be required to amend the operating agreement if a lender is involved, amendment of existing agreements seems impractical. California limited liability companies may want to consider conversion to Delaware limited liability companies, which generally requires only a majority in interest approval,[32] although in many instances conversion will also require lender consent, if applicable.

The emphasis of RULLCA on fiduciary duties and rights of nonmanaging investors as well as its grant of foreclosure rights to judgment creditors when a charging order seems insufficient is reflective of California's public policy. Those who prefer the public policy of Delaware, which proclaims itself the corporate capital of the world,[33] may alternatively opt for organization of their limited liability companies in Delaware. ■

---

[1] Corp. Code §§17701.01 *et seq.*

[2] Corp. Code §§17000 *et seq.*

[3] SB 323 Bill Analysis, Senate Rules Committee, Jan. 13, 2012.

[4] Florida, Idaho, Iowa, Nebraska, New Jersey, Utah, Wyoming, and the District of Colombia. *See* SB 323 Bill Analysis: Senate Judiciary Committee Hearing (Jan. 10, 2012) *and* National Conference of Commissioners on Uniform State Laws, Legislative Fact Sheet: Limited Liability Company (Revised), *available at* http://www.uniformlaws.org.

[5] Del. Code Ann. tit. 6, §§18-101 to 18-1109.

[6] Del. Code Ann. tit. 6, §18-1101.

[7] Corp. Code §17701.07.

[8] Corp. Code §§17701.10(c)(10) and (12). Note that while Corp. Code §17704.07(c)(4)(B) provides for a default rule of unanimous consent for a merger absent any other provision in the operating agreement, Corp. Code §17710.12(a), which cannot be modified, indicates that the agreement of merger shall be approved by all managers and a majority in interest of each class of membership interests of each constituent limited liability company, unless a greater approval is required by the operating agreement of the constituent limited liability company (subject to additional requirements if any member becomes personally liable for any obligations as a result of the merger).

[9] Corp. Code §§17701.10(c)(2), (3), and (7).

[10] Corp. Code §§17701.10(c)(4), (5), (14), (15), (16), (d), (e), (f), and (g).

[11] Corp. Code §17701.10(c)(4). It is unclear what is meant by "any other fiduciary duty." *See* §17704.09.

[12] Corp. Code §§17701.10(c)(5), 17704.09.

[13] Corp. Code §17704.09.

[14] Corp. Code §§17701.10(c)(14), 17704.09.

[15] Del. Code Ann. tit. 6, §18-1101(e).

[16] *Id.*

[17] Corp. Code §17101(10)(c)(16).

[18] Beverly-Killea referenced that fiduciary duties a manager owes to the company and the members are those of a partner. Corp. Code §17153. *See also* Corp. Code §§15904.08, 16404.

[19] Corp. Code §17101(10)(e).

[20] Gatz Props., LLC v. Auriga Capital Corp., 59 A. 3d 1206 (Del. 2012).

[21] Del. Code Ann. tit. 6, §18-1104.

[22] Corp. Code §§17103(a)(2), (3). Beverly-Killea provided a minimum threshold, unalterable by the operating agreement, of a majority in interest for votes on the amendment to articles or operating agreement, dissolution, and merger. Corp. Code §§17103(b), (c), 17350, 17551(a).

[23] Del. Code Ann. tit. 6, §18-302(f).

[24] The Delaware Act creates a default requirement of unanimous consent for admission of new members and a two-thirds vote for dissolution. Del. Code Ann. tit. 6, §§18-301 and 18-801.

[25] Corp. Code §17704.07(c)(5).

[26] Corp. Code §17705.03. Beverly-Killea allowed foreclosure "at any time" without requiring a showing that distributions under a charging order will not pay the judgment debt within a reasonable time. Corp. Code §17302.

[27] Del. Code Ann. tit. 6, §18-703.

[28] *See* In re Albright, 291 B.R. 538, 539 (Bankr. D. Colo. 2003); Olmstead v. FTC, 44 So. 3d 76 (Fla. 2010). The Florida legislature subsequently amended its statute to provide for a charging order as the sole and exclusive remedy for a judgment creditor, except that if the interest charged is an interest in a single member limited liability company and the judgment creditor makes a showing that distributions under a charging order will not satisfy the judgment within a reasonable time, the creditor has the option to foreclose and become the sole member of the company. Fla. Stat. §608.433.

[29] Del. Code Ann. tit. 6, §18-1101(i).

[30] Corp. Code §17701.06.

[31] Corp. Code §17713.04.

[32] *See* Corp. Code §17540.3(b) (until Dec. 31, 2013) *and* Corp. Code §17710.03(b)(1) (from and after Jan. 1, 2014); Del. Code Ann. tit. 6, §18-214. A higher threshold of approval is required if any of the members becomes personally liable for the obligations of the converted entity as a result of the conversion.

[33] *See* http://sos.delaware.gov.