Little Noticed, Radical Changes in California's LLC Act

By: Bruce Givner and Owen Kaye**

New LLC Act.

On January 1, 2014, the California Revised Uniform Limited Liability Company Act (*California Corporations Code* §§17701.01–17713.13) became effective. (The effective date had been the subject of some discussion, but that matter was settled by *Kennedy v. Kennedy*, 235 CA 4th 1474 (2015)). The new law replaced California's original LLC law—the Beverly-Killea Limited Liability Company Act—which had allowed for the organization of California LLCs beginning in 1994.

New Features.

The RULLCA has features unavailable under the old law. For example, a party opposing an LLC dissolution can now seek a buyout even if the dissolution is dismissed. *California Corporations Code* §17703(c)(6). Under provisions signed by Governor Brown in October 2015, if a member dies or the interest is being administered by a third party under a valid power of attorney, the executor, administrator, guardian conservator, attorney-in-fact, or other legal representative may step into the member's shoes with all powers the member had under the articles of organization. This means greater protection of lenders' rights as a lien holder on a borrower's LLC membership if the loan documents include a power of attorney.

Relationship To Estate Tax Planning.

Family Business Entities.

As tax attorneys, our perspective on LLCs relates to their use as closely held business entities for estate tax planning purposes. Assume Mom and Dad have $20,000,000 of income producing real property in a $30,000,000 estate. The potential estate tax on the surviving parent's death is $30,000,000 minus (a rounded) $11,000,000 = $19,000,000 × 40% = $7,600,000. A standard approach to reducing the estate tax has been to transfer the income producing real property to a family business entity and transfer a 25% non-controlling interest to an irrevocable trust for the children.

Prior Use of Family Limited Partnerships.

Before 1994 we used family limited partnerships, which required the use of a corporate general partner owned by the children's trust. In other words, two entities paying a minimum franchise tax were needed. That is why, when the Beverly-Killea Act allowed LLCs in California, we switched to using family LLCs instead of family limited partnerships.

Valuation Discounts.

The gift to the children's trust would be eligible for discounts for (i) lack of marketability (interests in the family entity do not trade on a stock exchange) and (ii) lack of control (the interest is a minority and non-managing). The combined discounts are often as high as 40%. Therefore, the gift would be valued at $20,000,000 × 25% × 60% (to allow for a 40% discount) = $3,000,000. That saves the parents $2,000,000 of their lifetime transfer tax exclusion. However, there is an even bigger savings is on the surviving parent's death. Each parent had a 37.5% interests. (The IRS is unable to add the two together. *Harriet R. Mellinger*, 112 T.C. 26 (1999), A.O.D. 1999-006.) Each 37.5% interest will be valued as follows: $20,000,000 × 37.5% × 60% = $4,500,000. In other words, by having the parents create the family business entity and give away 25%, the estate tax value has been reduced by 55%!

Important Non-Tax Motive.

The IRS dislikes structures that achieve excellent estate tax planning results. Therefore, it has always been important to show significant non-tax motives for establishing these family business entities. One important non-tax motive has been, and continues to be, that the family business entity provides a high degree of protection for the assets from currently non-existent plaintiffs. California law, in the past, provided an opportunity to maximize that protection when using an LLC. Former *California Corporations Code* §17302 read as follows:

> §17302.
>
> (a) On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the assignable membership interest of the judgment debtor to satisfy the judgment. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect to the LLC and may make all other orders, directions, accounts, and inquiries that the judgment debtor might have made or that the circumstances of the case may require.
>
> (b) A charging order constitutes a lien on the judgment debtor's assignable membership interest. The court may order a foreclosure on the membership interest subject to the charging order at any time. The buyer at the foreclosure sale has the rights of an assignee.
>
> (c) At any time before foreclosure, a membership interest charged may be redeemed in any of the following manners:
>
> (1) By the judgment debtor.

> (2) With property other than property of the LLC by one or more of the other members.
>
> (3) With property of the LLC by one or more of the other members with the consent of all of the members whose membership interests are not so charged.
>
> (d) This section does not deprive any member or assignee of a membership interest of the benefit of any exemption laws applicable to the membership interest in the LLC.
>
> (e) This section provides the exclusive remedy by which a judgment creditor of a member or of a member's assignee may satisfy a judgment out of the judgment debtor's membership interest in the LLC.

This law suggested two different ways to draft the operating agreement to maximize the discount for lack of marketability. First, the operating agreement might have provided that the membership interests were nontransferable. Were that approach followed the creditor would be unable to get a foreclosure since “The court may order a foreclosure on the membership interest subject to the charging order….” The creditor would be forced to ask the court to appoint a receiver for the membership interest. If the closely held entity did not make distributions (designed to frustrate the creditor), the receiver’s existence would not help. That, presumably, would force the creditor to ask the court to appoint a receiver for the LLC itself.

The alternative way for the operating agreement to maximize the discount for lack of marketability was for it to have provided – subsection (c)(2) – that another member could buy the charged member’s interest. Note the statute does not specify the price or the terms for the purchase. Therefore, the agreement might have provided for an appraisal which would consider valuation adjustments (discounts for lack of marketability and lack of control). The agreement might also have provided for a lengthy installment note at an attractive (to the buyer) interest rate. So, for example, using the figures from our example, the children’s trust might have purchase the parent’s interest for $\$20,000,000 \times 75\% \times 60\% = \$9,000,000$ in the form of a 30 year interest only installment note at 3% interest. Of course that note has value. However, that is not as attractive as owning a 75% interest in the underlying real property.

New California LLC Act Regarding Creditors.

Now consider the RULLCA’s comparable provisions:

§ 17705.03.

(a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor.

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subdivision (a), the court may do any of the following:

> (1) Appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made.
>
> (2) Make all other orders necessary to give effect to the charging order.
>
> (3) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a member, and is subject to §17705.02.

(c) At any time before foreclosure under paragraph (3) of subdivision (b), the member or transferee whose transferable interest is subject to a charging order under subdivision (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.

(d) At any time before foreclosure under paragraph (3) of subdivision (b), a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.

(e) This title does not deprive any member or transferee of the benefit of any exemption laws applicable to the member's or transferee's transferable interest.

(f) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment from the judgment debtor's transferable interest.

The same first approach—making the membership interest non-transferable—is still available. However, the second approach – providing that another member can buy the charged member's interest on terms that are unattractive to the creditor – seems to be circumscribed. Former §17302(c) simply provided that the charged membership interest "may be redeemed… With property other than property of the LLC…." There was no specification about the price and terms. New §17705.03(d) provides that the LLC or another member must pay "the full amount due under the judgment". Although that may not specify the terms, it certainly specifies the price (and seems to prevent the use of valuation adjustments). This makes the creditor protection aspects less attractive and, as a result, the lack of marketability discount, smaller.

Limited Partnerships Retain Old Creditor Format.

By contrast, the comparable provision for limited partnerships is virtually identical to former *California Corporations Code* §17302(c)(2):

§ 15907.03.

(a) On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the transferable interest of the judgment debtor with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of a transferee. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the limited partnership and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances of the case may require to give effect to the charging order.

(b) A charging order constitutes a lien on the judgment debtor's transferable interest. The court may order a foreclosure upon the interest subject to the charging order at any time. The purchaser at the foreclosure sale has the rights of a transferee.

(c) At any time before foreclosure, an interest charged may be redeemed:

(1) by the judgment debtor;

(2) with property other than limited partnership property, by one or more of the other partners; or

(3) with limited partnership property, by the limited partnership with the consent of all partners whose interests are not so charged.

(d) This chapter does not deprive any partner or transferee of the benefit of any exemption laws applicable to the partner's or transferee's transferable interest.

(e) This section provides the exclusive remedy by which a judgment creditor of a partner or transferee may satisfy a judgment out of the judgment debtor's transferable interest.

(f) No creditor of a partner shall have any right to obtain possession or otherwise exercise legal or equitable remedies with respect to the property of the limited partnership.

As a result of this change in the law, family entities created for estate tax planning benefits will no longer be LLCs: they will be limited partnerships. This increases the on-going costs to our estate tax planning clients. But it leaves the door open to continuing, large valuation adjustments.

Conclusion.

This radical change in California's LLC law is not going to impact entities created among strangers. So, most litigators and experts in remedies will not notice a change. However, this change will be noticed by the most skilled estate tax planning lawyers and will be considered when drafting closely held business structures. In our practice, we have never had a family member with an interest in a family business entity face a serious creditor issue. However, the possibility remains. So practitioners should be aware.

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