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Governance of Limited Liability Companies— Contrasting California and Delaware Models

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Organizers of limited liability companies need to choose the formation state with awareness of differing standards for management's duties to the limited liability company and its members and the ability to change the standards by contract.

Awareness of the differences in laws regulating LLC governance is critical for persons participating in management whether as an owner or an independent manager. A manager of a limited liability company (LLC) owning, for example, a real estate asset faces many significant management decisions, such as selection of a property manager, terms for renting to major tenants, when to sell or refinance the asset and whether or not to include the members in a similar investment opportunity. What are the constraints imposed on managers in making these decisions? The answer is – it depends on the governing documents of the LLC and the state law where the LLC was formed. The following discussion focuses on contrasting the dramatic differences in governance of an LLC formed under Delaware and California law. The laws of these two states reflect opposite extremes for regulating LLC governance. California has a strict statutory regime for governance of LLC management using statutory standards of fiduciary duties while Delaware allows governance in accordance with contractual standards contained in the LLC agreement.

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Governance Post-Enron

Much has been written and discussed recently about governance of corporate entities in the aftermath of the major corporate scandals involving Enron, Worldcom, Global Crossing and Tyco. Corporate governance is regulated by state and federal law and market forces. The resulting regulation provides fairly common standards applicable to corporate governance across state boundaries. In contrast at least three models have emerged for governance of LLCs including one model based on partnership standards, a second model based on standards similar to corporate standards applied to conduct of directors and officers and a third model where standards are left to contractual agreement among the parties.¹

Corporations are rarely used for ownership of investment real estate due to the current tax structure that imposes double taxation on disposition of real estate assets and that limits the availability to pass through tax deductions to the owners. LLCs possess the advantage of being taxed as pass through entities. Under the IRS "check the box" regulations an LLC may be taxed as a partnership or a disregarded entity. Like a corporation, an LLC features limited liability protection for the owners and managers. Limited partnerships, formerly the entity of choice for ownership of real estate invest-

ments, need a general partner who is exposed to unlimited liability for limited partnership obligations. Limited partners cannot participate fully in management without exposing themselves to the risk of being classified as general partners with attendant unlimited liability. Owners and managers of an LLC can actively participate in management without losing this limited liability protection. These factors make LLCs the entity of choice for ownership of real estate. These advantages also encourage use of an LLC as the single asset entity demanded by lenders for ownership of real property used as collateral for loans.

Management and ownership of an LLC may be unified or may be in separate hands. Even if management and ownership are unified in the same persons, if more than one person participates in ownership or management, conflicts of interest may arise. Resolution of these conflicts will require reference to the governing documents of an LLC as well as state law.

A Word About Corporations

A natural conflict of interest exists between corporate management and corporate shareholders. Management is perceived to have an interest in the protection, preservation and compensation of itself sometimes in conflict with the interests of shareholders. Recent discussions over corporate governance centers around mechanisms to oversee management to provide assurance that the interests of the shareholders will be promoted. The real power to control policy in a corporation is vested in the board of directors elected by the shareholders. Advocates of good corporate governance assert that corporate boards should be composed of a majority of independent directors, directors who have no personal stake in the outcome of management decisions, other than providing benefits to shareholders. Active participation of independent directors is perceived as the solution to keeping the conflicting interests of management in check.

The Limited Liability Company Model

LLCs do not usually have a management structure equivalent to a board of directors although flexibility of the LLC laws would permit this structure. Control of significant decision making for an LLC is rarely vested in independent persons. The usual models for LLC management include management by one or more managers, management by a managing member or management by consensus of the members. The most common management structure is for management by one or more managers. Regardless of the management model, LLC management is subject to the same legal constraints imposed by state law. The managers may or may not have a significant equity investment in the LLC at the outset of the investment. A significant portion

of the equity investment may come from passive investors.

To form an LLC, a charter is filed with the state of formation and the members adopt a written or oral LLC agreement. Management is empowered or constrained by the terms of the LLC agreement. Management frequently undertakes to form the LLC and put together the investment. As a result, management itself makes most of the significant decisions concerning the content of the LLC agreement. Management is usually vested by the LLC agreement with broad powers to control the LLC and to make most significant management decisions.

California Constraints

Managers of an LLC formed under California law are subject to strict statutory constraints notwithstanding broad powers provided by an LLC agreement. In 1994, California adopted the Beverly-Killea Limited Liability Company Act.² The California LLC act provides that managers owe fiduciary duties to the LLC and its members to the same extent as a partner owes fiduciary duties to a partnership and the other partners.³ Standards for fiduciary duties among partners were originally developed by California case law. At the time of enactment of the California LLC act, these standards generally meant that partners owed each other duties of honest disclosure, good faith and fair dealing and to account for partnership profits. An agreement between the partners could change the scope and nature of the duties owed to one another. For example, most partnership agreements pertaining to real estate investments contained a broad and simple provision allowing a partner to invest in similar ventures without offering the investment to the other partners. Partnership agreements frequently provided that active partners could receive fees and compensation from the partnership on terms that may or may not be arms length. Similar provisions appear in many LLC agreements. Applying the same standards as partners of a partnership to managers of an LLC made common sense.

A dramatic but little noticed change in the nature of fiduciary duties applicable to managers of California LLCs occurred in 1996 when California adopted the Uniform Partnership Act of 1994⁴ ("1994 UPA"). The 1994 UPA specifies statutory fiduciary duties owed by partners including a duty of loyalty and a duty to exercise rights consistent with the duty of good faith and fair dealing. Those statutory standards also apply to California LLCs and the California LLC act constrains the ability of organizers to modify these standards. The duty of loyalty specifically includes duties to account to the partnership and not appropriate a partnership opportunity, not engage in any conduct adverse to the interests of the partnership and to refrain from competition with the partnership.⁵ While the 1994 UPA allows some flexibility by specifying that a partner does not violate the duties merely by engaging in trans-

actions furthering a partner's own interest,⁶ the 1994 UPA applies in effect a fairness test for interested party transactions.⁷ A partner may lend money to, or transact business with a partnership on the same terms as a non-partner.

At first look, the standards of fiduciary duties outlined by the 1994 UPA do not significantly differ from the original standards developed by case law. The dramatic difference is that the statutory provisions now restrict the ability of the organizers to vary the duty of loyalty and the duty of good faith and fair dealing by the partnership agreement.⁸ Offering some flexibility, the 1994 UPA allows the partnership agreement to identify specific types or categories of transactions that do not violate the duty of loyalty.⁹ A partnership agreement may also specify that all or a specific number or percentage of partners may approve a transaction that would otherwise violate the duty of loyalty.¹⁰ The 1994 UPA provides that standards of good faith and fair dealing cannot be eliminated by the partnership agreement but measurement standards may be specified in the partnership agreement as long as the standards are not manifestly unreasonable.¹¹

While the 1994 UPA affords some flexibility to alter the statutory standards of fiduciary duties for partners, the California LLC act further constrains modification of fiduciary duty standards applied to managers of a California LLC. The California LLC act requires that any alteration of the fiduciary duties must be contained in a written LLC agreement obtained with the "informed consent" of the members.¹² A parallel requirement for an "informed written consent" is contained in the California Code of Professional Conduct applicable lawyers who seek a waiver of a conflict of interest from a client.¹³ If the strictness of the ethical standard applicable to attorneys is carried over to the standards applicable to modification of fiduciary duties applicable to managers of LLCs, then it will be very difficult to draft effective provisions modifying fiduciary duty standards in an LLC agreement. An LLC agreement would need to set out with particularity a disclosure of all of the facts and foreseeable consequences applicable to changing the statutory fiduciary duty standard. Over time, with changing facts and circumstances, this can be very difficult.

The practical effect of the 1994 UPA combined with the California LLC act is to apply the same strict fiduciary duties to managers of California LLCs with little or no effective flexibility to change the standards by agreement. Broad provisions in California LLC agreements excusing managers from liability and providing for indemnification of managers may not be effective. Simple provisions allowing managers to engage in other investments without offering the investment to the other members may be subject to challenge as lacking the specificity necessary to provide the informed consent needed to make such provisions effective.

Delaware Laissez Faire

The Delaware Limited Liability Company Act¹⁴ establishes

the opposite extreme with respect to fiduciary duties. No mention is made in the Delaware LLC act of the standards applied to duties owed by a manager to the entity or to the members. There is no clear case law from the Delaware Supreme Court addressing the issue. In unpublished opinions lower court judges presume that common law principals of fiduciary duties, similar to the common law principles originally established in California case law, would be applied in absence of contractual provisions in the LLC agreement.¹⁵

The overriding principal of the Delaware LLC act is to give maximum effect to the affected parties' freedom to contract and the enforceability of LLC agreements.¹⁶ The duties and liabilities of managers and members to a Delaware LLC or to each other may be expanded or restricted by the LLC agreement.¹⁷ In discharging those duties specified in the LLC agreement, managers and members are free from liability to the LLC or the other members as long as they rely in good faith on the terms of the LLC agreement.¹⁸ The Delaware LLC act further provides that the LLC agreement may specify the standards and restrictions for indemnification of managers and members.¹⁹

The practical effect of the Delaware LLC act is that organizers of a Delaware LLC are free to draft the standards that govern the duties of managers to the LLC and to the members in any manner short of permitting egregious acts of reckless, fraudulent or criminal behavior. Organizers of a Delaware LLC are free to draft the level of duty owed by the managers to exclude the traditional partnership concepts of fiduciary duties. The LLC agreement for a Delaware organization may provide broad and extensive exclusions of managers from liability and may provide generous defense and indemnity protections for managers.

There are no significant limitations under California law for a Delaware LLC to operate in California or to have California residents as members. A Delaware LLC must register with the California Secretary of State to conduct business in California.²⁰ Ownership of active investment real estate in California by a Delaware LLC will trigger the requirement to register the entity. Lenders frequently ask for legal opinions that such registration has occurred. If more than 25 percent of the membership of a Delaware LLC resides in California, then the California resident members are permitted to exercise the information and inspection rights specified in the California LLC act.²¹ This includes a requirement to provide an annual statement to the members of a LLC with more than 35 members.²² Aside from these information and inspection rights, the California LLC act specifies that the internal affairs and liability and authority of the managers and members of a foreign LLC are governed by the law of the state of its formation.²³ A Delaware LLC operating in California and having California residents as members is free to determine the rights and liabilities of its managers and members in accordance with its LLC agreement under the principles of freedom of contract granted by the Delaware LLC act. This freedom allows organizers of a Delaware LLC to select a

range of duties from high fiduciary duties to relaxed contractual standards depending on their needs and perception of the nature of the LLC's business.

Conclusion

Organizers of LLCs have a choice in most states to select their own state law or a foreign jurisdiction to govern the affairs of the entity. The Delaware LLC act offers the advantage of applying supremacy of the contractual provisions in the LLC agreement. Using this advantage, organizers may avoid restrictive provisions of their own state LLC law. Armed with knowledge of the significant differences in approach to governance between state laws, an organizer of an LLC can rely on a statutory construction of governance or can contractually craft governance standards.

Notes:

- ¹ California adopts partnership standards from the Uniform Partnership Act of 1994. New York follows a corporate model that seems to be non-waivable. The New York model is not discussed in this article. Delaware permits standards set by contract.
- ² Cal. Corp. Code §17000 et seq.
- ³ Cal. Corp. Code §17153.
- ⁴ Cal. Corp. Code §16100 et seq.
- ⁵ Cal. Corp. Code §16404.
- ⁶ Cal. Corp. Code §16404(c).
- ⁷ Cal. Corp. Code §16404(f).
- ⁸ Cal. Corp. Code §16103(b).

- ⁹ Cal. Corp. Code §16103(b)(3)(A).
- ¹⁰ Cal. Corp. Code §16103(b)(3)(B).
- ¹¹ Cal. Corp. Code §16103(b)(5).
- ¹² Cal. Corp. Code §17005(d).
- ¹³ Cal. Rul. Prof. Conduct, Rule 3-310.
- ¹⁴ 6 Del.C. §18-101 et seq.
- ¹⁵ VGS, Inc. v. Castiel, 2003 WL 723285 (Del. Ch., 2003)
- ¹⁶ 6 Del.C. §18-1101(b).
- ¹⁷ 6 Del.C. §18-1101(c)(2).
- ¹⁸ 6 Del.C. §18-1101(c)(1).
- ¹⁹ 6 Del.C. §18-108.
- ²⁰ Cal. Corp. Code §17451.
- ²¹ Cal. Corp. Code §17453.
- ²² Cal. Corp. Code §17106(c).
- ²³ Cal. Corp. Code §17450(a).



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