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FORMATION, OPERATION AND LEGAL ISSUES CONCERNING A LIMITED LIABILITY COMPANY IN THE STATE OF CALIFORNIA

by

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A Limited liability company or "LLC" offers the simplicity and flexibility of a sole proprietorship, while at the same time, affording to company members the limited liability enjoyed by corporate shareholders and the pass through tax advantages of a partnership without the restrictions imposed upon limited partnerships and Subchapter S corporations. Limited liability companies may engage in any lawful business activity except banking, insurance, trust company business, or certain service professions which require a license and which are governed by the Business & Professions Code or the Chiropractic Act. Certain professionals such as lawyers, accountants, doctors and registered nurses are precluded from conducting business in the LLC form.

The LLC is not a partnership or a corporation, but a hybrid of the advantages offered by both, and offering the business person a new alternative. Because it is a separate legal and distinct business entity, it is capable of suing and being sued, and having rights, obligations, powers and privileges accorded to it by state statute. A LLC must be organized through the filing of a document called "Articles of Organization" with the Office of the Secretary of State. Filing fees must be paid and thereafter, the LLC must pay a minimum yearly franchise tax fee of \$800.00. However, taxes due each year are based on the LLC revenues, and a tax scale has been created by the Franchise Tax Board which may increase the overall taxes owed to not less than \$800 and not more than \$2,500 per year.

The laws concerning the organization, operation and management of a Limited Liability Company are codified in the California Corporations Code Section 17000 et seq.

Choice of Appropriate Entity

A LLC will often be a desirable form of business entity for business ventures that are closely held or which involve a relatively small number of participants. Some suggested businesses include:

Restaurants

Consultants

Venture Capital Transactions

Real Estate Projects

Outbound Investments from the United States

Joint Ventures

Estate Planning

Any Small Business requiring limited liability

It is important to note that currently, the law as stated in Cal Corp Code Section 17375 does not allow a LLC to render professional services as defined by Cal Code Code Section 13401(a). Said businesses not allowed to operate as a LLC include those personal service businesses which can only be lawfully rendered pursuant to a license, certification or authorization as set forth in the Business and Professions Code or Chiropractic Act. **Therefore, persons performing personal services such as architects, lawyers, doctors, dentists and chiropractors may not provide said personal services as an LLC.**

Advantages of an LLC

1. Pass-Through Taxation

If the LLC is set up to be taxed as a partnership rather than a C corporation, earnings of an LLC are taxed only once, and otherwise treated like the earnings of partnerships, sole proprietorships and most Subchapter S corporations.

2. Limited Liability

A member's interest is generally limited to only the amount of money which the member has invested in the LLC. The member is entitled to have his/her/its other personal assets shielded from the creditors of the LLC.

3. Flexible Management Structure

LLC's are free to establish any management structure agreed upon by its members and as set forth in the Operating Agreement. LLC's are not required to hold meetings on any kind of annual basis, not required to file yearly forms to maintain status, and may separate profit interests from voting interests.

Disadvantages of an LLC

1. Organization

LLC's are required to be organized pursuant to state statute, thus requiring some paperwork, as opposed to a partnership or sole proprietorship.

2. Improperly Organized

If the LLC is not properly organized, the members could lose the right to passive taxation of profits.

Organizational Issues

In order to form a LLC, there must be **at least one (1) member** to hold membership interest in the LLC. (See California Corporations Code Section 17050(b) which was amended effective January 1, 2000). There may be more than one (1) member if appropriate. The membership interests are not required to be held on a pro rata basis, but may be held in any percentage not to fall below a 99-1 threshold. Married persons qualify as two separate persons and may participate as members in the LLC on an individual basis, and corporations may hold membership interests as well.

The name given to an LLC must include either the phrase "Limited Liability Company," or the letters, LLC or L.L.C.

A LLC is owned by its members. They are analogous to partners in a partnership or shareholders in a corporation. Members may participate in the day-to-day operations of the business or designate managers to operate the business. The members receive share certificates which represent their respective "ownership" or "membership interest" in the LLC.

In order to properly organize, a document named the "Articles of Organization" must be filed with the Office of the Secretary of State together with a filing fee of \$70.00. Unless the Articles are filed over the counter, it will take approximately 4 weeks for the Articles to be processed. Effective the date of organization, the business entity is free to conduct business and make contracts. Within four months after the beginning of its initial tax year, the LLC must pay a minimum franchise tax fee to the Franchise Tax

Board of \$800.00.

As soon as possible after organization, it is advisable to obtain a federal tax identification number, open a new bank account in the name of the business, and hold an organizational meeting for the purpose of adopting a membership agreement and appointing officers. If employees are to be paid, then the LLC must apply with the EDD for a state payroll number.

LLC Management

A LLC may be managed by its members (owners) or by selected managers. If the LLC will be managed by its members, each member will have an equal vote in the decision making process of the company. If the members choose, they may elect a manager or managers to act in a capacity similar to a corporation's board of directors. The elected manager(s) will be in charge of the daily affairs and operations of the business.

It is advisable for the LLC to operate under the terms of an "Operation Agreement." This agreement allows for maximum flexibility in the formation and management of the LLC. Members and their respective interest(s) are identified, provisions made be made for the sharing and distribution of profits and losses, and allocations made for capital investment and expenses. Further, the operating agreement constitutes the complete understanding between the members on how the members will be treated in certain events.

Members always have a fiduciary duty to each other distinct from the issues of standard of conduct for managers or members who act as managers. The Operating Agreement may provide for express fiduciary duties in addition to those provided by statute and those duties which are inherent given the nature of the legal relationship between and among the members and the LLC.

In the absence of an Operating Agreement, the statute controlling Limited Liability Companies provides for management of the company and the treatment of members. Limited Liability Companies are governed by California Corporations Code Section 17000 et seq., to the extent that an Operating Agreement does not control the field.

Non-Tax Considerations

1. Advantages Over Other Forms of Business Entities

A. Corporations

1. LLC's are not subject to the same formalities as corporations, such as the requirements for calling and conducting meetings, and annually electing directors and officers.

2. The rights, duties, privileges and preferences of the members may be defined in the operating agreement, which is a private document not required to be

filed with the state. In contrast, the rights, privileges and preferences of shareholders may be provided by the Articles of Incorporation, which are filed with the Secretary of State, and/or Bylaws.

3. Amendments regarding the class can be made subject to the provisions of the Operating Agreement and not by a majority vote of the shareholders.

4. There is no cumulative voting for the election of managers.

5. Managers of the LLC may be removed in accordance with the terms of the Operating Agreement. It is more difficult to remove the directors of a corporation.

6. There are not as many restrictions concerning a distribution to LLC members as there are to stockholders of a corporation.

B. General Partnerships

1. Partners are personally liable for the debts of the partnership. Members are not personally liable for the debts of the LLC.

2. A partner always has the authority to bind the partnership. A non-managing member has no authority to bind the LLC to contracts or obligations.

3. A partner may independently cause the dissolution of the partnership. A member does not have the statutory right to dissolve the LLC, however, such right may be provided for in the Operating Agreement.

2. Disadvantages Over Other Forms of Business Entities

A. Corporations

1. In certain transactions, the business community at large is much more familiar with the structure of a corporation and may be uncertain about a LLC, and the authority of its officers.

2. LLC are relatively new, having been authorized by the State of California in

1994, therefore, there is very little state case law concerning transactions with LLCs.

B. General Partnerships

1. General Partnerships may be preferable to a LLC in the event that there is a nonjudicial foreclosure of real property. In California, there is a statutory law which provides that a lender may not seek a deficiency judgment against the owners of real property if that lender forecloses on the property under its deed of trust (nonjudicial foreclosure instead of foreclosure by virtue of a judicial action.) The court's will not allow a deficiency judgment against partners. However, it is unknown at the time of this writing whether or not the court's would allow a deficiency judgment against members of a LLC.

2. There are no filing requirements with the Secretary of State.

Tax Considerations

An advantage of the LLC is its tax flexibility. The members of the LLC are allowed to select how the entity will be taxed. The IRS will presume that an LLC will be taxed as a partnership unless the LLC seeks corporation taxation status. Partnership taxation allows for passive, flow through taxation to the individual members. Thus, there is no separate entity level tax.

The LLC has the option to elect to be taxed as a C corporation. To preserve this election, the LLC is required to file a Form 8832 with the IRS. If this election is made, the LLC will be required to file its own separate tax return and pay a independent entity level tax. The only financial reason to elect C corporate taxation status is to retain profits in the LLC to have them taxed at the corporate rather than the personal rate.

In order to be taxed as a partnership, the LLC must lack two out of the four corporate characteristics:

1. Continuity of Life
2. Free Transferability of Interest
3. Centralized Management
4. Limited Liability

The variations must be set forth in the Operating Agreement. If the LLC does not have an Operating Agreement, the Limited Liability Company default statute classifies all California LLCs as a partnership.

If the LLC is classified as a partnership for federal income tax purposes, it may specially allocate income and loss to its members in accordance with IRC Section 704(b). Further, an officer-member of an LLC will never have their salary or a portion thereof disallowed by the IRS as unreasonable compensation.

Unlike Subchapter S corporations, LLCs are not restricted on the number and type of members that it may have. LLCs may have any number or variety of classes or series of membership interests. A member of a LLC may include in his/her/its basis on the membership interest that member's share of the LLC's debt under IRC Section 752, even though the debt is nonrecourse to the member.

Sale of Membership Interest is the Sale of a Security

The sale of a membership interest in an LLC is a sale of a "Security", and therefore regulated by state and federal laws concerning the sale of securities. This memorandum is not intended to review the laws with respect to the sale of securities which would be a very long discussion. However, it should be noted that before the sale of any membership interest in an LLC, the founders should obtain from the investor a subscription and investment representation letter/agreement which sets forth that that investor recognizes that there are restrictions on the sale of the membership interest and which also reduces the exposure to the LLC. The Company is also required to make certain written disclosures to potential investors which allow the investor to appreciate and understand the risks of making and/or losing his/her investment.

The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney, please call Jennifer J. Hagan or James Hagan at The Hagan Law Firm (650) 322-8498.

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