

# FORMATION AND OPERATION OF AN LLC IN CALIFORNIA

This LLC corpus contains informational documentation provided as a service to help people understand California LLCs.

Forms and instructions for many of the matters discussed on this page can be obtained by downloading the documents at [the California Secretary of States' website](#)

## **Starting and running a California llc**

This article provides an outline of key considerations regarding forming and operating a California llc. Features are similar in other states.

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## INTRODUCTION

The limited liability company entity is a relatively new form of business organization in California. The authorization of the LLC form of business under state statutes is intended to give flexibility to businesses in meeting their tax and business objectives.

A limited liability company ( LLC ) combines some of the best characteristics of the partnership and corporation while eliminating some of their less desirable characteristics. The owners (called "members") of a limited liability company, like shareholders of a corporation, are not generally liable for the debts of the business. Yet, like a partnership, double taxation is avoided because the profits of an LLC are not subject to income tax liability imposed upon the company. Furthermore, unlike limited partners in a limited partnership, members of a limited liability company may actively participate in management without becoming subject to unlimited personal liability. The members of a limited liability company enjoy significant freedom under California law to fix their rights and obligations by agreement as to most matters.

## ORGANIZATIONAL FORMALITIES

One or more persons may form a limited liability company by signing and filing articles of

organization with the California Secretary of State. If the members conduct business prior to filing the articles of organization, they run a substantial risk of having the LLC treated as a general partnership with liability of all members for all obligations incurred prior to filing the articles.

The articles of organization must disclose basic information about the limited liability company for public inspection, including, among other items:

- The name of the California LLC;
- The name and address of an agent for service of legal process on the limited liability company. (This agent may be an individual, a California limited liability company or corporation, or a foreign limited liability company or corporation authorized to do business in California);
- Either of the following statements:  
Management of the limited liability company is vested in a manager or managers, or  
Management of the limited liability company is reserved to the members.  
If management is vested in a manager or managers, each person who is a manager of the limited liability company, and each person who owns a 20% or greater interest in the company.  
If management is reserved to the members, each person who is a member of the limited liability company.
- The latest date, if any, on which the limited liability company must dissolve.
- The articles of organization may include any other legal provisions.

A limited liability company articles of organization are amended by filing an amendment with the California Secretary of State. An LLC must amend its articles of organization if there is a statement in the articles that is false when it was made, or if facts described in the articles have changed, making the articles inaccurate in any respect. For example, an amendment is required if the membership changes and management has been reserved to the members.

If management has not been reserved to the members, an amendment is required after any change in managers or in the members holding 20% or greater interest in the LLC.

The members in a limited liability company customarily enter into an operating agreement at

the time the articles of organization are filed. The purpose of the operating agreement is to describe the members' financial responsibilities, management rights, and profit and distribution shares. As with general partnerships and limited partnerships, if the members do not define their rights and obligations in an operating agreement, California law will supply any missing rights or obligations in a manner which may or may not be consistent with the members' expectations.

## CAPITALIZATION AND DEBT FINANCING

As in general partnerships and limited partnerships, California law permits the members of an LLC broad discretion to determine among themselves how cash, other property, or services will be contributed to the limited liability company by each member at the time of formation or at any time thereafter.

A limited liability company is permitted in California to borrow money from its members or from third parties. The financial condition of a member is not normally taken into account by a lender, except to the extent that the lender is relying upon the member's initial or future capital contribution commitment as a source of repayment of the debt. Members will sometimes be asked by a lender to the limited liability company to sign promissory notes payable to the limited liability company in the amounts of their future contributions.

The promissory notes are then assigned as collateral to the lender to secure the loan to the LLC.

An LLC may also raise additional capital by creating and issuing additional interests in the LLC to new members. Unless the operating agreement provides otherwise, the consent of all members is required to issue new interests in the limited liability company. Because the issuance of additional interests to new members almost always will dilute the profit shares of the existing members, operating agreements that give the LLC the authority to issue additional interest usually impose conditions, such as requiring a minimum capital contribution for any new member or that any additional interests be offered first to the existing members.

## MANAGEMENT AND CONTROL

California permits a limited liability company to divide management rights and responsibilities among the members or to grant management rights and responsibilities to "managers" designated or elected by the members. Unlike a limited partner in a limited partnership, a member does not become personally liable for limited liability company debts if the member participates in the control of the limited liability company's business. In the absence of an

operating agreement to the contrary, California law permits members to vote on certain specific management matters, such as the approval of a plan of merger or consolidation or the issuance of a new interest in the LLC.

If the members delegate management responsibilities to managers, the members will not be involved in the day-to-day management of the company's business. If a member becomes concerned that the managers may not have taken the necessary steps to enforce a claim of the limited liability company against a third party, each member has a special right to bring a legal action (called a "derivative action") to obtain a judgment in the name of the limited liability company against the third party.

#### LLC PROFITS AND LOSSES

The members in an California LLC have significant freedom to divide limited liability company profits and losses LLC distributions in any manner they choose.

If the members do not allocate distributions in their operating agreement, California law provides that distributions will be shared by the members in proportion to their actual contributions to the limited liability company and, after all contributions have been returned, distributions will be shared equally by the members.

#### EXTENT OF OWNERS' LIABILITY

Any member, manager, employee, officer, or agent of a limited liability company is not liable, solely by reason of being a member, manager, employee, officer, or agent, for the debts of the limited liability company. This is different than the liability of general partners in a general partnership or of the general partners in a limited partnership, who have 'joint and several' liability for partnership obligations. It is also different from the liability of limited partners in a limited partnership. In a limited partnership, each limited partner's liability for partnership debts is generally limited to the contribution that the limited partner has made or agreed to make to the partnership. However, if a limited partner participates in the control of the partnership's business, the limited partner will also become liable for all partnership debts.

#### TRANSFERABILITY OF LLC INTERESTS

A member cannot sell or assign his or her interest in an California LLC to another person and make that person a member without the consent of all other members, unless all of the members

have previously agreed in their operating agreement that such consent is not necessary. As noted above, compliance with state and federal securities laws may be required in connection with any such transfer of rights.

If a member desires merely to sell or assign the member's economic rights to receive distributions, without giving the buyer or assignee any management or voting rights as a member, California law permits the transfer of these economic rights, unless the transfer is prohibited by the LLC operating agreement.

#### CONTINUITY OF LIMITED LIABILITY COMPANY EXISTENCE

An LLC in California is dissolved by the consent of all the members unless all of the members have previously agreed in their operating agreement that such consent is not necessary, at the time of a member's withdrawal, removal, bankruptcy, death, or, if the member is a corporation or other legal entity, upon termination of the member's legal existence unless otherwise provided in the operating agreement. Absent other agreements among the members, if an LLC is dissolved, the limited liability company's business must be wound up and liquidated.

In order to prevent an unwanted liquidation of an California LLC following its dissolution, the members may continue the business of the limited liability company pursuant to a right in the operating agreement or, if the operating agreement does not provide such a right, by agreement or consent of all of the remaining members. The company may be involuntarily dissolved if the LLC fails to amend its articles as required by law or if the company has failed to make a required publication.

If the LLC's business is not continued following a dissolution, the proceeds of liquidation must first be used to pay existing limited liability company obligations other than liabilities for distributions to existing or former members. If the proceeds of liquidation exceed the limited liability company's obligations, the remaining proceeds are distributed in whatever manner the members' operating agreement provides. In the absence of a provision in the operating agreement for distribution of liquidation proceeds, the remaining proceeds must be distributed, first, to satisfy unpaid obligations to members who withdrew from the limited liability company prior to dissolution; second, to existing members until they have received a return of their contributions; and, third, to the members in equal shares.

#### TAX CONSIDERATIONS FOR AN LLC IN CALIFORNIA

The income tax treatment of a limited liability company and its members is generally the same under U.S. and California tax codes as the treatment of limited partnerships. A LLC is not required to pay income tax on its net income, but simply reports each member's share of limited liability income or loss to be included in the member's individual income tax return. Like a limited partnership, an LLC is required to pay a withholding tax on behalf of a foreign member characterized as a nonresident alien for federal income tax purposes.

Similar to limited partnerships, a limited liability company in California may elect to be taxed as a corporation. In such case, the LLC and its members are treated in the same manner as a corporation and corporate shareholders.

#### CALIFORNIA RECORD KEEPING REQUIREMENTS

A California limited liability company must file annual federal and state informational tax returns that reflect the limited liability company's income or loss for the year and each member's share of the limited liability company's taxable income or loss. The LLC must maintain copies of a current list of the names and addresses of its members, the original articles of organization, and all written operating agreements and amendments. An LLC must also maintain correct and complete financial records, which may be inspected by any member. No annual activity reports need to be filed with any state agency.

#### CONCLUSION

The principal benefit available with use of an California limited liability company is the protection against the personal liability of the members. A member's risk associated with the LLC is generally confined to the amount contributed or required to be contributed to the limited liability partnership. Other benefits arising from use of a limited liability company include the significant freedom of the members to allocate the sharing of profits, losses, and distributions and the single level of taxation resulting from the treatment of an California LLC as a nontaxable partnership for income tax purposes.