# Advanced LLC Issues

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# WALKING THE ETHICAL LINE

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# WALKING THE ETHICAL LINE

By Edward Gartenberg[1]

## A. Ethical Standards and Civil Liability

1. Source of Law Governing Ethical Standards.

The California Rules of Professional Conduct govern the practice of law in the State of California. A lawyer who violates any of the Rules may not only be subject to professional discipline, but may also be civilly liable for malpractice. The remainder of this section will highlight some of the key ethical issues faced by a lawyer who represents LLCs. It should be noted, however, that this is only a survey and is by no means, an exhaustive list of California's ethical rules.

2. Ethical Standards

(a) Competence. An initial issue for any lawyer agreeing to represent a LLC in some capacity, is whether that attorney meets the required level of competence. Under the California Rules, an attorney owes every client a duty of competence.

(i) Rule 3-110.

(1) A member shall not intentionally, recklessly or repeatedly fail to perform legal services with competence.

(2) For purposes of this rule, "competence" in any legal service shall mean to apply the (1) diligence, (2) learning and skill, and (3) mental, emotional, and

[1] The author wishes to gratefully acknowledge the assistance of Fawn Wright (admission pending) in the preparation of this article.

physical ability reasonably necessary for the performance of such service.

(3) If a member does not have sufficient learning and skill when the legal services are undertaken, the member may nonetheless perform such services competently by associating with or , where appropriate, professionally consulting another lawyer reasonably believed to be competent.

(ii) When must an attorney consult a specialist?

(1) The Rules tell us that an attorney has a duty to consult a specialist when a *reasonable* practitioner would do so under the circumstances. If the attorney fails to consult the specialist, he or she will be subject to review under the same higher standards as those applicable to specialists in that area. See *Horne v. Peckham* (1979) 97 Cal. App. 3d 404, 414 (Court approved the following jury instruction: "It is the duty of an attorney who is a general practitioner to refer his client to a specialist or recommend the assistance of a specialist if under the circumstances a reasonably careful and skillful practitioner would do so. If he fails to perform that duty and undertakes to perform professional services without the aid of a specialist, it is his further duty to have the knowledge and skill ordinarily possessed, and exercise the care and skill ordinarily used by specialists in good standing in the same or similar locality and under the same circumstances. A failure to perform any such duty is negligence.").

(2) A practitioner may subject to discipline or malpractice for failing to consult a specialist if that practitioner lacks the necessary knowledge or experience required for the representation. See *Lewis v. State Bar* (1981) 28 Cal. 3d 683.

(iii) Special Considerations for the Attorney Representing a LLC.

(1) Offering advice to a client about organizing or operating a business entity requires that the lawyer be competent not only in the area of business organization, but also in other areas of law. These may include familiarity with formation and dissolution of a LLC; state and federal securities regulations; real property transactions; federal, state and local tax laws; and intellectual property.

(2) The Rules permit that in a situation where referral or consultation with another lawyer is impractical for some reason, the attorney can give limited advice or assistance in a matter in which he or she does not have the skill that is ordinarily required of him or her.

(b) Communication. Effective communication between an attorney and his or her client is essential to fostering a successful attorney-client relationship. Communication, however, is more than just a good business practice; it is also required by the California Rules of Professional Conduct.

(i) Rule 3-500.

(1) A member shall keep a client reasonably informed about significant developments relating to the employment or representation, including promptly complying with reasonable requests for information and copies of significant documents when necessary to keep the client so informed.

(2) The discussion to Rule 3-500 adds that the rule is not intended to change a member's duties to his or her clients. It is intended to make clear that, while a client must be informed of significant developments in the matter, a member will not be disciplined for failing to communicate insignificant or irrelevant information [see also California Business and Professional Code, § 6068(m)].

(ii) Frequency of Communication

(1) Gauge the client's comfort level in communication. If you are uncertain, it is generally better to communicate, than not to do so. As a good rule of thumb—if you even question whether it is a significant development in the representation, communicate with your client about the matter.

(2) But, as the discussion to the Rule makes clear, an attorney does not have to keep the client informed of every development relating to the representation—only those that are important. An attorney who fails to inform his or her client of irrelevant and insignificant matters need not worry about being disciplined.

3. Disciplinary Proceedings.

An attorney who breaches any of the California Rules of Professional Conduct can be the subject of disciplinary proceedings brought by the State Bar.

4. Civil Liability.

In addition to professional discipline, however, that attorney may also face civil liability for his or her misconduct if that misconduct amounted to professional negligence.

(a) Professional Negligence or Malpractice. Professional negligence is the most common cause of action brought by clients against attorneys. Others causes of action may, but less frequently, include breach of contract and breach of fiduciary duty.

(b) To determine whether an attorney has breached his duty of care to the client, and was therefore negligent, courts apply an objective "reasonable attorney" standard. An attorney must possess a degree of learning and skill that is ordinarily possessed by attorneys of good standing, practicing in the same or similar localities, and under similar circumstances.

(c) Effective Client Communication as a Means of Avoiding Civil Liability. Effective communication can play a role in avoiding civil liability.

## B. The Role of the Attorney as Advisor in LLC Formation

When an attorney agrees to undertake representation of a LLC, or any business entity, there exists a complex set of issues defining the attorney's role in the representation. These include, but are not limited to: (1) whether it is appropriate for that attorney to represent the client on the matter, (2) identifying who is the actual client—whether it is the promoter, the entity, or someone else involved in

the transaction, (3) knowing the client's plans and goals for the business, and (4) advising the client accordingly.

1. Determining Whether Representation is Appropriate

(a) This requires that the attorney gather enough information from the prospective client to enable him or her to make an informed and ethical decision. The necessary information may include facts regarding the identities, biographies and business affiliations of the principals and people that will have material relationships with the potential organization, a summary of the business plan, and trade names that will be used.

(b) This information may also be helpful to the attorney in discovering any potential conflicts of interest. Identifying conflicts early on will prevent the attorney from sharing any confidential information with the potential client.

2. Identifying the Client

(a) It is especially important for an attorney representing a LLC, or any business entity, to clearly identify his or her client.

(b) The client is often the entity itself, but it can also be the person who first approached the attorney about the matter, his or her business partner, or any combination thereof. For this reason, it is essential for the business attorney to know the identity of his or her client at the very beginning of the representation.

(c) While it is important that the attorney be able to clearly identify his or her client, it is equally important that the parties are able to do so. The attorney should make sure the parties understand his or her role in the formation of the entity. The attorney should also make clear to the parties who he or she actually represents and

what will happen if in the future the parties enter into a dispute over the business.

3. Becoming Familiar with the Client's Business Plan

(a) After determining that representation is appropriate (i.e. the attorney is competent and no actual conflicts of interest exist), the attorney needs to become familiar with the client's business plans. This will enable the attorney to effectively advise the clients as to the proper form of business entity.

(b) The attorney may find that a LLC is the best entity to meet the client's objectives. However, the attorney should always consider each type of business entity in relation to his or her client's needs before advising the client on a particular one.

4. Advising the Client

(a) The attorney may be called upon to offer the client advice on a variety of different matters. As discussed above, this usually will include the most appropriate business entity given the client's needs, as well as how to structure and organize the business.

(b) The attorney may also be required to advise the client on the specific statutory scheme for formation of the entity, general contract matters, tax issues, and securities laws.

(c) Clients may also request advice from the attorney on matters relating to the business in general.

(d) The attorney must always keep in mind his or her ethical duties. If the advice sought by the client exceeds the scope of the attorney's expertise, he or she must refrain from giving advice on the issue until after consulting with some authority on the matter.

## C. Avoiding Conflicts of Interest

Conflicts of interest and potential conflicts of interest are inherent in the representation of business entities. While the possibilities for conflicts are numerous, this outline will focus on three situations where most of a business lawyer's conflicts will arise. These include: (1) conflicts among parties; (2) conflicts that arise when the organization is the client, and (3) conflicts that occur between the practitioner and his or her client.

1. Conflicts and Potential Conflicts among Parties

(a) Multiple Clients. A lawyer engaged in representing a business venture is often asked to represent more than one of the involved parties. It is common for these parties to have varying interests. If the attorney agrees to represent multiple parties, he or she must be cautious of the fact that potential conflicts may arise at any point during the representation.

(i) Written Consent. Rule 3-310(C) makes it unethical for the attorney to represent multiple parties with conflicting interests unless he or she has informed consent from each party.

(1) Rule 3-310(B) provides that a member shall not accept or continue representation of a client without providing written disclosure to the client where:

a) The member has a legal, business, financial, professional, or personal relationship with a party or witness in the same matter; or

b) The member knows or reasonably should know that: 1) the member previously had a legal business, financial, professional, or

personal relationship with a party or witness in the same matter; and 2) the previous relationship would substantially affect the member's representation; or

c) The member has or had a legal, business, financial, professional, or personal relationship with another person or entity the member knows or reasonably should know would be affected substantially by resolution of the matter; or

d) The member has or had a legal business, financial or professional interest in the subject matter of the representation.

(2) Rule 3-310(C) provides that a member shall not, without informed, written consent of each client:

a) Accept representation of more than one client in a matter in which the interests of the clients potentially conflict;

b) Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict; or -

c) Represent a client in a matter and at the same time in a separate matter accept as a client a person or entity whose interest in the first matter is adverse to the client in the first matter.

(3) Rule 3-310(D) provides that a member who represents two or more clients shall not enter into an aggregate settlement of the claims of or against the clients without the informed written consent of each client

(4) Rule 3-310(E) provides that a member shall not, without the informed written consent of the client or former client, accept employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment.

(5) Rule 3-310(F) provides that a member shall not accept compensation for representing a client from one other than the client unless:

a) There is no interference with the member's independence of professional judgment or with the client-lawyer relationship; and

b) Information relating to representation of the client is protected as required by California Business & Professions Code §6068, subdivision (e); and

c) The member obtains the client's informed written consent, provided that no disclosure or consent is required if: 1) such nondisclosure is otherwise authorized by law; or 2) the member is rendering legal services on behalf of any public agency

which provides legal services to other public agencies or the public.

(6) Multiple representation may be inappropriate and not subject to waiver.

a) Counsel may *not* represent two clients at a hearing or trial if there is an existing, actual conflict between them. Any consent by the clients to such representation is considered neither intelligent nor informed as a matter of law. See *Tsakos Shipping & Trading, S.A. v. Juniper Garden Town Homes, Ltd.* (1993) 12 CA 4th 74, 97.

b) The Court may refuse a client's waiver where it justifiably finds an actual conflict of interest.

c) Waiver will not be permitted if the new client insists that the representation be kept confidential, thus making disclosure of the conflict impossible. [See California Bus. & Prof. Code § 6068(e)--attorney's duty "to maintain inviolate the confidence, and ... to preserve the secrets of his or her client"].

d) Waiver is also impermissible where an attorney's continued representation of multiple clients in a matter would result in violation of the CRPC or State Bar Act. [See CRPC 3-700(B)(2)].

e) If the attorney believes that multiple representation is inappropriate due to conflicting interests, the attorney may choose to represent only the entity or only one of the parties to the formation of the LLC. In doing so, the attorney must inform all parties (including the one he represents) of the following information:

i) Whom counsel will and will not represent in formation of the LLC;

ii) The nature of the existing and any foreseeable conflicts among participants (to the extent appropriate);

iii) That the attorney cannot undertake to advise other parties or protect their interests and that the other parties must seek separate counsel for any legal advice; and

iv) The proposed terms, if any, under which the attorney would represent the entity itself upon completion of the entity's organization.

(b) Special Considerations for the Attorney Representing a LLC

(i) If an attorney who has agreed to form a LLC for his clients is asked to represent more than one of the parties involved, a potential conflict could easily arise if the parties have a

disagreement over any aspect of the business. Thus, the attorney must pay careful attention to Rule 3-310(c).

(ii) The practitioner has to determine whether it is possible, or even advisable, to represent parties as a group or if separate representation is necessary due to conflicts. If the practitioner determines that all the parties have generally the same interests, the attorney may accept joint engagement. If there is any potential for a conflict of interest, however, the attorney must first obtain written consent from each party.

(iii) Managers and Non-managers. There exists an inherent conflict in LLCs between the interests of members that are active managers and those who are passive members or investors. A lawyer representing a LLC must be aware of this relationship and prepared to manage the potential conflicts that may arise from it.

(1) Managing members usually seek compensation based on a share of profits and separate salaries or fees for specific services.

(2) Passive, non-managing members, on the other hand, usually rely on a share of the profits for a return on their investment.

(iv) Before the attorney proceeds with the representation, each party should acknowledge, in writing, receipt of the above information as well as their understanding of the matters.

(c) Throughout the entire representation, the attorney must be on alert for any possible conflicts of interest that may arise.

(d) Under some circumstances, an attorney may have originally deemed multiple representation appropriate, but later interests diverge or material conflicts arise. If that occurs, the attorney should again advise the parties to obtain independent counsel, regardless of any prior consents from the parties. If conflicts do arise, such that clients' separate interests can no longer be fairly represented, the attorney may be required to discontinue any representation of the business entity, unless independent counsel is obtained. See Rule 3-310.

2. The LLC as the Client

Conflicts of interest can also present themselves when the organization, or the entity itself, is the attorney's client. In this situation, the attorney does not represent the party that approached him or her on the matter, or any of the organization's members. The attorney represents only the business entity itself.

(a) Organization as the Client: Rule 3-600.

(i) Rule 3-600(A) provides that in representing an organization, a member shall conform his or her representation to the concept that the client is the organization itself, acting through its highest authorized officer, employee, body, or constituent overseeing the particular engagement.

(ii) Rule 3-600(B) provides that if a member acting on behalf of an organization knows that an actual or apparent agent of the organization acts or intends or refuses to act in a manner that is or may be a violation of law reasonably imputable to the organization, or in a manner which is likely to result in substantial injury to the organization, the

member shall not violate his or her duty of protecting all confidential information as provided in California Business & Professions Code §6068, subdivision (e). Subject to California Business & Professions Code §6068, subdivision (e), the member may take such actions as appear to the member to be in the best lawful interest of the organization. Such actions may include among others:

(1) Urging reconsideration of the matter while explaining its likely consequences to the organization; or

(2) Referring the matter to the next higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest internal authority that can act on behalf of the organization.

(iii) Rule 3-600(C) provides that if despite the member's actions in accordance with paragraph (B), the highest authority that can act on behalf of the organization insists upon action or a refusal to act that is a violation of law and is likely to result in substantial injury to the organization, the member's response is limited to the member's right, and, where appropriate, duty to resign in accordance with rule 3-700.

(iv) Rule 3-600(D) provides that in dealing with an organization's directors, officers, employees, members, shareholders, or other constituents, a member shall explain the identity of the client for whom the member acts, whenever it is or becomes apparent that the organization's interests are or may become adverse to those of the

constituent(s) with whom the member is dealing. The member shall not mislead such a constituent into believing that the constituent may communicate confidential information to the member in a way that will not be used in the organization's interest if that is or becomes adverse to the constituent.

(v) Rule 3-600(E) provides that a member representing an organization may also represent any of its directors, officers, employees, members, shareholders, or other constituents, subject to the provisions of rule 3-310. If the organization's consent to the dual representation is required by rule 3-310, the consent shall be given by an appropriate constituent of the organization other than the individual or constituent who is to be represented, or by the shareholder(s) or organization members.

(b) If the LLC's management, investors, employees, members, or other constituents develop interests that are or may become adverse to the organization, the attorney should explain the client's identity to the adverse party. But, as, the attorney should limit his or her representation to the client's best interests, if it becomes clear that the client's best interests and the individual director or manager's interests are adverse and illegal, the attorney may not disclose the information. The attorney must resign from representation. [See Rule 3-600(B), (C) and Rule 3-700.]

3. Conflicts and Potential Conflicts between the Attorney and the Client

Disclosure Requirements. Conflicts of interest are not limited to those between the various clients of the attorney and the business organization. Many conflicts of interest may also arise from the lawyer's own dealings with the business he or she represents, or in dealings with others. These

conflicts are thus described as those that exist between the attorney and the client, or potential client.

(a) Frequent scenarios for these conflicts of interest include, but are not limited to, the following:

(i) When an attorney invests in a client's business,

(ii) When an attorney accepts an economic interest in the business in lieu of fees; or

(iii) When the attorney enters into a transaction to provide goods or non-legal services to a client.

(b) If the attorney enters into a business transaction with a client, or knowingly acquires a pecuniary interest that is adverse to the client, the attorney must do the following:

(i) Provide the client with a full, written disclosure of the transaction;

(ii) Ascertain the fairness of its terms;

(iii) Advise the client to seek independent legal advice;

(iv) Provide the client with a reasonable opportunity to seek such advice;

(v) Obtain the client's informed written consent. [See Rule 3-300; see also ABA Model Rules 1.8, and 1.13]

(c) It also may be necessary, under some circumstances, for the attorney to disclose the transaction to the members of the LLC and obtain their informed written consent.

(d) If an attorney has a financial interest in a business, he or she should be very cautious about providing that business with legal advice. This is because the attorney's financial stake in the business creates the potential for many conflicts of interest.

(e) Serving as Both Counselor to and Officer of the Entity. Clients, for various reasons, may request their attorney to serve in managerial capacities to the LLC. Potential conflicts can exist when the attorney serves as both counselor of and officer to a business entity.

(i) When the attorney offers both legal and managerial services to the entity, he or she is serving the entity in dual roles. The attorney's activities can no longer be truly independent. This creates a greater likelihood for conflicts of interest.

(ii) It is also important to note that an attorney serving a managerial role is held to a higher standard of conduct than a non-attorney in the same role.

(iii) Other members of the business may find it difficult to distinguish the attorney's legal advice from statements made in a managerial or business context.

(iv) Economic benefits resulting from the attorney' managerial role are also subject to the California Rules of Professional Conduct. See Rule 3-300.

## D. Confidentiality: Information Derived from an Earlier Representation

1. The Duty of Confidentiality

The California Rules of Professional Conduct and the Business and Professions Code place strict confidentiality requirements on practicing attorneys. The

combination of these provisions prohibit attorneys from revealing any confidential client information, with only a few very limited exceptions.

(a) Rule 3-100.

(i) Rule 3-100(A) provides that a member shall not reveal information protected from disclosure by Business and Professions Code section 6068, subdivision (e)(1) without the informed consent of the client, or as provided in paragraph (B) of this rule.

(ii) Rule 3-100(B) provides that a member may, but is not required to, reveal confidential information relating to the representation of a client to the extent that the member reasonably believes the disclosure is necessary to prevent a criminal act that the member reasonably believes is likely to result in death of, or substantial bodily harm to, an individual.

(iii) Rule 3-100(C) provides that before revealing confidential information to prevent a criminal act as provided in paragraph (B), a member shall, if reasonable under the circumstances:

(1) Make a good faith effort to persuade the client: (i) not to commit or to continue the criminal act or (ii) to pursue a course of conduct that will prevent the threatened death or substantial bodily harm; or do both (i) and (ii); and

(2) Inform the client, at an appropriate time, of the member's ability or decision to reveal information as provided in paragraph (B).

(iv) Rule 3-100(D) provides that in revealing confidential information as provided in paragraph (B), the member's disclosure must be no more than is necessary to prevent the criminal act, given the information known to the member at the time of the disclosure.

(v) Rule 3-100(E) provides that a member who does not reveal information permitted by paragraph (B) does not violate this rule.

(b) Business and Professions Code, Section 6068(e)(1)

(i) Business and Professions Code, Section 6068(e)(1) provides that it is a duty of a member:

(1) To maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client.

(2) A member's duty to preserve the confidentiality of client information involves public policies of paramount importance. See *In Re Jordan* (1974) 12 Cal.3d 575, 580.

(ii) Comparison to the attorney-client privilege.

(1) The attorney-client privilege as codified in California Evidence Code 952 is an evidentiary privilege.

(2) The duty of confidentiality under Section 6068(e) is broader than that imposed by the confidentiality requirements of the attorney-client privilege.

(3) Attorney-client privilege protects information obtained from the client. Section 6068(e) may apply to information received from other sources.

(iii) Duty to challenge a trial court order to make disclosure?

(c) Attorney-Client Privilege. The attorney-client privilege as codified in California Evidence Code Section 952 is an evidentiary privilege.

(d) Work-Product Doctrine.

(e) Special Confidentiality Considerations for LLCs

(i) Business attorneys are required to give repeated attention to the problem of client confidences and conflicts of interest each time a new client becomes part of the relationship.

(ii) Confidentiality issues often arise when an initial client tells the attorney about confidential business plans, personal goals and objectives, or other information that the client does not want disclosed to others. The attorney may find that in a later transaction, this confidential information is a material fact that has to be disclosed to the potential new client. Before the attorney agrees to represent the new clients, the attorney should discuss these concerns with the original client. Further, the attorney should obtain the informed written consent of both the new and former client.

(iii) Another scenario for potential conflicts occurs when an attorney withdraws from representation and subsequently is

offered the opportunity to represent another client in a transaction with the original client. In this case, the attorney will have to obtain the informed, written consent of the original client if confidential information relevant to the new representation was obtained in the former representation.

# UNDERSTANDING THE WORLD OF MINORITY RIGHTS AND FIDUCIARY OBLIGATIONS

**Edward Gartenberg**

# UNDERSTANDING THE WORLD OF MINORITY RIGHTS AND FIDUCIARY OBLIGATIONS

By Edward Gartenberg[2]

## A. The Source and Nature of Fiduciary Obligations in LLCs

### 1. Limited Liabilities Companies Act

(a) Limited liability companies combine aspects of both corporate and non-corporate entities. Due to the hybrid nature of a LLC, there are still uncertainties as to the fiduciary duties owed by their members. Additionally, these duties often vary depending on the particular state whose law applies.

(b) California LLCs are governed by the Beverly-Killea Limited Liability Company Act (Cal. Corp. Code Section 1700, *et seq.*) (the "LLC Act").

### 2. Articles of Organization

The principal source for determining the relations among members of LLCs is the operating agreement. The LLC Act recognizes this at Cal. Corp. Code Section 17005(a) which provides:

> Except as provided in subdivisions (b) and (c), relations among members and between the members and the limited liability company are governed by the articles of organization and operating agreement. To the extent the articles of organization or operating agreement do not otherwise provide,

[2] The author wishes to gratefully acknowledge the assistance of Fawn Wright (admission pending) in the preparation of this article.

this title governs relations among the members and between the members and the limited liability company.

3. Types of LLCs

The obligations a members are subject to different analyses depending upon the type of LLC.

(a) Manager-Managed LLCs

(i) The California LLC Act provides that managers owe the same fiduciary duties of care and loyalty to the LLC and all of its members as are owed by a partner to a partnership and its partners Cal. Corp. Code Section 17153.

(ii) This Act allows for these duties to be modified in a written operating agreement with the members' informed consent Cal. Corp. Code Section 17005(d). But the extent to which these duties can be modified remains uncertain.

(iii) The California LLC Act does not specifically address the fiduciary duties of non-managing members of a manager-managed LLC.

(iv) The LLC Act does state, however, that any member may lend money and transact other business with the LLC and "subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a member." Cal. Corp. Code Section 17004(a).

(b) Member-Managed LLCs

(i) The LLC Act states: "Unless the articles of organization include the statement referred to in subdivision (b) of section 1751 vesting management of the limited liability company in a manager or managers, the business and affairs of a limited liability company shall be managed by the members subject to any provisions of the articles of organization or operating agreement restricting or enlarging the management rights and duties of any member or class of members. If management is vested in the members, each of the members shall have the same rights and be subject to all duties and obligations of managers as set forth in this title." Cal. Corp. Code Section 17150.

(ii) The duties of loyalty and care are incorporated into the provision that the members shall be "subject to all duties as set forth in this title" because Cal. Corp. Code Section 17153 provides:

> The fiduciary duties a manager owed to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership.

(iii) It may be reasoned that good faith is also encompassed either as an "obligation" incorporated by Corp. Code Section 17153 or on the theory that the operating agreement is a contract which would include an implicit covenant of good faith.

4. Members and Managers' Fiduciary Duties

California case and statutory law directly related to fiduciary duties of LLC members and mangers is limited. Since the language in the California Limited Liability Companies Act seems to incorporate the fiduciary duties of partners at least for LLC managers, it is relevant to review the fiduciary duties owed by general partners under California law. The two duties recognized by statute are the duties of care and loyalty.

(a) Duty of Care. Members of member-managed LLCs and managers of manager-managed LLCs owe a duty of care to the LLC and to its other members in all conduct and winding up of the LLC business. The duty of care is limited, however, to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law. See Cal. Corp. Code Section 16404(c).

(b) Duty of Loyalty. The California Partnership Act divides the duty of loyalty into 3 components: (1)the duty to account, (2) the duty to refrain from self-dealing, and (3) the duty not to compete.

(i) Duty to Account.

(1) A member of a member-managed LLC or a manager of a manager-managed LLC owes a duty to account to the LLC and hold as trustee for it any property, profit, or benefit derived by the member/manager in the conduct and winding up of the LLC business or derived from the member/manager's use of the LLC property or information, including appropriation of a business opportunity. See Cal. Corp. Code Section 16404(b)(1).

(2) Pursuant to this rule, the LLC can recover from a member or manager any money or property that can be traced back to the LLC.

(3) This rule prohibits a member of a member-managed LLC or a manager of a manager-managed LLC from appropriating benefits from the LLC without the members' consent and may not usurp a business opportunity.

(ii) Duty of to Refrain from Self-Dealing

(1) The duty to refrain from self-dealing requires that member-managers or managers refrain from dealing with the LLC in the conduct or winding up of the LLC business as or on behalf of a party having an interest adverse to the LLC. See Cal. Corp. Code Section 16404(b)(2).

(2) This rule does not prohibit a LLC member-manager or manager from lending money or transacting other business with the LLC. See Cal. Corp. Code Section 16404(f).

(3) Similar to the duty to account, this duty is also time sensitive. Once a member/manager of a LLC has fully withdrawn, he or she is free to deal in a manner that is adverse to the LLC. See Cal. Corp. Code Section 16603.

(c) Duty Not to Compete

(1) Member-managers and managers of a LLC have a duty to refrain from competing with the LLC in the

conduct of the business before the dissolution of the LLC. See Cal. Corp. Code § 16404(b)(3).

(2) It is important to note that this duty only applies to the conduct of the LLC business, and not to its winding up. In this respect, this duty differs from the others.

(3) This duty not only ends as soon as the LLC is dissolved, but it also ends as soon as a member or manager withdraws from the business. While a dissociated member/manger can freely compete with the LLC, he or she must refrain from using any confidential information after his or her dissociation. See Cal. Corp. Code § 16603(2).

5. Obligation of Good Faith and Fair Dealing.

The obligation of good faith and fair dealing is related to fiduciary duties, but analytically distinct. The California Partnership Act also provides that partners owe an obligation of good faith and fair dealing in the discharge of his or her duties, as well as in the exercise of any rights, under the statute and under the partnership agreement. See Cal. Corp. Code § 16404(d).

The law is not entirely clear on whether this obligation applies to LLC members and managers. The duty of good faith may be applicable based on the California LLC Act's reference to "obligations" under the Partnership Act. Alternatively, it may apply to members and managers of LLCs through general rules of contract law.

## B. Identifying and Protecting the Rights of Minority Interest Holders

1. The Rights of LLC Minority Interest Holders

Every member or holder of an economic interest in a LLC has certain rights with respect to the operation and management of the organization, regardless of whether the LLC has adopted a member-managed or manager-managed structure. These rights include:

(a) Information Rights

(i) Every member, or holder of an economic interest in a LLC has the right to demand prompt delivery of copies of any written operating agreements and/or any copies of information required to be maintained under the California Corp. Code Section17058(a)(1)-(2), (4). See Cal. Corp. Code Section 17106(a).

(ii) A member or economic interest holder may only exercise this right for purposes that are reasonably related to his or her ownership interest.

(iii) Upon such a request by the member or interest holder, management must also deliver any amendments to the articles or operating agreements. See Cal. Corp. Code Section 17106(d).

(iv) All copying expenses must be paid by the LLC. See Cal. Corp. Code Section 17106(a).

(b) Inspection Rights

(i) Pursuant to California Corp. Code, Section 17106(b)(1), any LLC member or economic interest holder has the right to make a reasonable request to inspect and copy during

normal business hours any record required to be maintained at the principal office of the LLC.

(ii) Additionally, Cal. Corp. Code Section 17106(b)(2) provides that any member or economic interest holder has the right to obtain and copy the LLC's federal, state and local income tax or information returns for each year.

(iii) Inspection requests must be for a purpose that is reasonably related to the interest of the requesting member or interest holder. See Cal. Corp. Code Section 17106(b).

(c) Additional Reporting Required for LLCs With More Than 35 Members.

(i) In addition to the above requirements, any LLC with more than 35 members must meet additional reporting obligations.

(ii) Managers of these LLCs must send an annual report to each member within 120 days of the close of each fiscal year. Cal. Corp. Code Section 17106(c)(1) requires these reports to contain an income statement, a balance sheet, and a statement of any changes in financial position over the fiscal year.

(iii) Cal. Corp. Code Section 17106(c)(2) provides that members representing at least 5% of the voting interests of members, or three or more members, may make a written request to a manager for an income statement of the LLC for the initial three-month, six-month, or nine-month period of the current fiscal year ended more than 30 days prior to the date of the request, and a balance sheet of the limited liability company as of the end of that period. The

statement shall be delivered or mailed to the members within 30 days thereafter.

(d) Other Information and Inspection Rights.

(i) Pursuant to Cal. Corp. Code Section 17106(b) and (e), the LLC must send each member and economic interest holder the information necessary to complete that member or interest holder's income tax returns.

(ii) The LLC must mail the foregoing information no later than 90 days after the end of each taxable year. Further, any financial statements sent to the LLC members must include reports by any independent accountants engaged by the LLC or a manger's certificate that the statements were prepared without audit. Cal. Corp. Code § 17106(c).

(e) Member Meetings Are Not Required.

The LLC Act does not require LLC members to hold meetings. If the articles or the operating agreement, however, create requirements for when member meetings are to occur, then the LLC will be obligated to meet these procedures.

(f) Voting Rights.

The LLC's articles of organization or its operating agreement should set forth the extent to which members have voting rights. Cal. Corp. Code Section 17103(a). The LLC Act restricts certain limitations on voting rights.

(g) Amendment of the Articles or Operating Agreement.

Cal. Corp. Code Sections 17005(b)(3) and 17103(b) provide that the articles of organization or operating agreement can only be

amended following approval by at least a majority in interest of the members. If, however, the articles or agreement do not contain a voting provision regarding amendment, then the unanimous consent of all the members is required. Cal. Corp. Code Section 17103(a)(2).

(h) Members' Rights that Cannot Be Modified by Agreement. A LLC can, to an extent, contract as to its internal operations and management. The LLC Act, however, limits this freedom by specifying certain members' rights that cannot be modified. See Cal. Corp. Code § 17005. These rights include, but are not limited to, the following:

(1) The right to assert that a provision in the operating agreement governing the termination of that member's interest and the return of that member's contribution was unreasonable under the circumstances existing at the time the agreement was made. Sections 17005(b)(2) and 17100(c).

(2) The right, by the vote of a majority in interest (or such greater percentage of the voting interests as may be specified in the articles of organization or written operating agreement), to dissolve the LLC. Sections 17005(b)(3), 17103(c) and 17350(b).

2. Protecting and Enforcing the Rights of Minority Interest Holders

Options to enforce minority rights include:

(a) Litigation or, if provided for by agreement, arbitration. This may include derivative actions brought by members who were record or beneficial members at the time of the transaction at issue or by

their successors in interest. The plaintiff in a derivative action may be required to post a bond to cover anticipated litigation expenses.

(b) Regulatory organizations including the SEC or the State attorney General.

(c) The LLC Act also provides members with dissenter's rights when their approval is required by the operating agreement or articles of organization for the LLC to participate in certain actions.

(i) These actions include:

(1) Mergers,

(2) The acquisition of all or substantially all of the assets of another LLC or business entity, in exchange in whole or in part for one or more of the following:

a) The acquiring LLC's membership interests;

b) The membership interests or equity securities of the entity controlling the acquiring LLC;

c) The debt securities of the acquiring LLC that are not adequately secured and that have a maturity date beyond five years after the acquisition closes;

d) The debt securities of the entity controlling the acquiring LLC that are not adequately secured and that have a maturity date beyond five years after the acquisition closes.

(3) The acquisition of membership interests of another LLC or business entity in exchange in whole or in part for the acquiring LLC's membership interests, if immediately after the acquisition, the LLC has some control of the other LLC or business entity.

(ii) Cal. Corp. Code Section 17601, *et seq.* provides for a member's right to require the LLC to purchase dissenting interests.

## C. Restrictions on Fiduciary Obligations: Waiver

1. The Extent to which LLC Members and Managers Can Waive their Fiduciary Duties

(a) Managers. Pursuant to the Cal. Corp. Code Section 17005(d), a manager can only modify his or her fiduciary duties with a written operating agreement and the "informed consent" of the members.

(i) The Code, however, does not define "informed consent" and it is not entirely clear what consent would be considered "informed". One possibility may be that informed consent requires the following: (1) a clear explanation to the members of what the unmodified duty is under the Act, (2) what modification is proposed, and (3) a summary that is as objective as possible of the advantages and disadvantages to the LLC and its members of the modification. Regardless of the actual definition of informed consent, it is important that the managers of the LLC evidence the members' consent by a separately signed writing which confirms both the consent and the disclosure.

See BALLANTINE AND STERLING, CALIFORNIA CORPORATION LAWS § 905.

(ii) Section 17005(d) is difficult to reconcile with Cal. Corp. Code Sections 17153 and 16103(b). On their face, sections 17005(d), 17153, and 16103(b) of the California Corporations Code appear to conflict with one another. Section 17005(d) permits managers to limit their duties with the informed written consent of the members. Section 17153 incorporates the duties of a general partnership to those owed to the LLC and its members. Section 16103(b) limits a partner's ability to waive certain fiduciary duties in the partnership agreement. There is little statutory guidance on how a court should reconcile these provisions of the law. It may be argued that section 17005(d), which provides that one can waive fiduciary duties by agreement, should be applied to the LLC context because section 17005(d) is part of the LLC Act. It may also be argued that the more specific provisions of a rule govern over the less specific. Based on this rationale, it could again be argued that section 17005, allowing for the waiver of fiduciary duties by agreement, should apply to LLCs.

(b) Members. It may be reasoned that given the LLC Act's lack of statutory inclusion of duties by non-managing members and the lack of a statutory prohibition on waiving the duties, there is no prohibition of explicitly waiving any potential fiduciary duties of non-managing members to each others.

## D. Securities Law Considerations

1. Source of Law

The offer and sale of securities in California must comply with both the federal securities laws and the California Corporate Securities Law of 1968 [see Cal. Corp. Code , Section 25000, *et seq.*]

2. Treatment of LLCs Under California and Federal Law

(a) Under the federal Securities Act of 1933 and the Securities Exchange Act of 1934, a security is defined broadly to include, among other things, a "certificate of interest or participation in any profit-sharing agreement" and an "investment contract." The latter term is defined broadly under case law. See, e.g.. *SEC v. Howey,* 328 U.S. 293 (1946) (Identifying a four factor test: (1) investment of money, (2) in a common enterprise, (3) with expectation of profits, (4) "solely" from the efforts of others.)

(b) While each situation is subject to its own analysis, a member's ownership interest in a LLC is often considered a security for federal purposes.

(c) Under the California Corporate Securities Law, the term "security" is also defined broadly, but it does not include membership interests in LLCs when the person claiming the exception can demonstrate that all of the members are actively engaged in the management of the LLC. However, evidence of members voting, or having the right to information concerning the business and affairs of the LLC, or the right to participate in management does not establish, without more, that all of the members participate in Members.