# Washington's new Limited Liability Company Act

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**On January 1, 2016, the rules are changing for Washington LLCs.**

Washington's new Limited Liability Company Act takes effect on January 1, 2016, bringing with it a number of changes that affect current and future managers and members of Washington LLCs, as well as anyone doing business with Washington LLCs. Below are eight changes that you ought to know about so that you can decide whether you need to take action before the end of the year.

## Limited liability company agreements will no longer need to be in writing.

Under the current Act, an LLC agreement must be in writing. The new Act permits oral or implied agreements and amendments. While this gives businesses an opportunity to organize themselves informally, it also exposes them to the potential for unintended amendments.

> *For example, assume Ann and Betty are members of an LLC, and that Ann and Betty own 80% and 20% of the LLC interests, respectively. The LLC agreement requires a simple majority vote of the percentage interests of the members to take any action, so Ann, with her 80% vote can effectively control the LLC without Betty's agreement. Nonetheless, every time a vote comes up, Ann says, "Betty, you know I would never do anything without your okay." Betty could argue that she and Ann had amended their LLC agreement to require a unanimous vote of the members to take any actions.*

We recommend that all of our clients have written LLC agreements to avoid ambiguity, confusion, and mistake. In addition, in light of this change in the new Act, we encourage all LLC members and managers to confirm that their LLC agreements can only be amended by a written agreement. If you are uncertain whether you are protected from unintended amendments, we invite you to contact us with questions you may have.

## The new Act expressly defines the fiduciary duties owed by managers, and sets clear limits as to the extent to which those duties can be limited or eliminated.

The current Act does not set forth the fiduciary duties owed by those managing the LLC. Lacking statutory guidance, Washington courts have previously analogized the duties owed between managers of an LLC to those owed between partners of a general partnership. This is a less than ideal situation for LLCs, because partners owe very strict duties to one another – often more strict than those that should be owed by managers of LLCs.

The new Act specifies that the following are the only fiduciary duties owed by managers to the LLC and to one another:

- The duty of loyalty, which is limited to:
  - (a) Accounting to the LLC for, and holding in trust for the LLC, any benefits derived:
    - (i) in conducting or winding up the LLC's activities,
    - (ii) from the use of LLC property, or
    - (iii) by appropriating an LLC's company opportunity;
  - (b) not competing with the LLC; and
  - (c) not engaging in conflict-of-interest dealings with the LLC.
- The duty of care, which is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law while conducting or winding up the LLC's activities. Additionally, a manager may rely in good faith on, and does not violate the duty of care by relying on, opinions, reports, or statements by any member, manager, officer, employee, or outside professional if such opinions, reports, or statements are within such person's professional or expert competence.

Under the new Act, members of an LLC can use their LLC agreement to expand or limit the fiduciary duties owed by those managing the LLC, subject only to very few limitations. Specifically, the LLC agreement may not eliminate or limit: (a) the duty to avoid intentional misconduct and knowing violations of law; (b) the duty not to make a distribution in violation of the LLC agreement or which would render the LLC unable to pay its debts as they become due; or (c) the implied duty of good faith and fair dealing (which applies to LLC agreements as it does to all contracts).
**This means that the members of an LLC can enter into an LLC agreement that eliminates the duty of loyalty entirely.**

*For example, assume Bill is a commercial real estate broker with extensive experience in leasing. Bill puts together a group of investors to form an LLC, and the LLC enters into a master lease for a shopping center. Under the master lease, the LLC pays a set monthly rent to the owner of the shopping center, and generates cash flow by sub-leasing the individual suites within the shopping center. The LLC is manager-managed, and Bill is the manager.*

*The LLC agreement provides that the manager's fiduciary duties are waived "to the fullest extent permitted by law." The purpose of this provision was to permit Bill to invest in other commercial buildings, even if they compete with the shopping center for tenants.*

*When the master lease comes up for renewal, Bill decides to bid against the LLC to take over the master lease himself. Do the investors have any recourse?*

*Under the current Act, the investors may have recourse because courts have drawn on partnership law to define the scope of a manager's fiduciary duties. Under Washington's partnership law, the duty of loyalty may not be eliminated. Furthermore, limitations on the duty of loyalty will not be enforced if it is "manifestly unreasonable." The investors can argue that the purpose of the LLC agreement's waiver of fiduciary duties was to allow Bill to invest in other properties, not to allow Bill to compete directly with the LLC with respect to the shopping center itself. Such an interpretation, the investors would argue, is manifestly unreasonable.*

*Under the new Act, however, Bill's duty of loyalty to the LLC can be eliminated entirely. Because the LLC agreement provides that Bill's duties are waived "to the fullest extent permitted by law," Bill may compete directly with the LLC. If the investors wish to avoid this outcome, they should insist that the LLC agreement be amended to address direct versus indirect competition.*

When the new Act becomes effective on January 1, 2016, these duties will be applicable to all existing LLCs. If you are a member or manager of an LLC, this will have a significant impact on your duties or the duties owed to you by others. Are you satisfied with the default duties the new Act will impose? Are they too burdensome? Or are they not stringent enough? We encourage all members and managers of existing and future LLCs to have frank discussions about what duties should be owed amongst them and to update their LLC agreements accordingly.

### Certificates of formation will no longer indicate whether an LLC is member-managed or manager-managed. Although this change provides LLCs with more flexibility to change their management structures without the need to file with the Secretary of State, it decreases transparency for third parties dealing with LLCs.

Under the current Act, an LLC's management structure is determined by its certificate of formation. In contrast, under the new Act, an LLC's management structure is determined solely by the provisions of the LLC agreement. If the LLC agreement vests management of the LLC in one or more managers, then the LLC is manager-managed. Otherwise, it is member-managed. This revision provides more flexibility for LLCs because they may now change how they are managed without having to file anything with the Secretary of State.

With this flexibility, however, comes reduced transparency for third parties doing business with LLCs. Outside parties can no longer look to a public document (the certificate of formation) to determine whether an LLC is member-managed or manager-managed. And although LLCs are still required under the new Act to provide manager information in their annual reports (which can be ordered from the Secretary of State), those reports may be outdated, or not completed correctly. If you are considering doing business with an LLC, we recommend that you request a copy of that LLC's written LLC agreement, and that you insist on a representation that the LLC agreement provided to you remains in effect as presented. Additionally, any agreement with an LLC should include warranties that the person or persons executing the agreement have been properly authorized to do so and to bind the LLC.

### Under the new Act, the default voting scheme is no longer based on equity ownership—the default is now "one member, one vote."

The new Act has changed the default rule for voting by members. Under the current Act, member votes are based on equity ownership unless a different rule is specified in the LLC agreement; the affirmative vote of members who contributed at least 50% of the agreed-upon value of the contributed equity of the company is required for most actions. Under the new Act, however, unless altered by the LLC agreement, members vote on a per capita basis (i.e., one vote per member).

*For example, hearken back to Ann and Betty, who contributed 80% and 20%, respectively, of the value of the LLC. Ann has been relying on the current Act's default voting rule to give her effective control of the LLC with her 80% vote. However, under the new Act, the default voting rule will be one vote per member, so Ann and Betty will have equal votes.*

This new default rule probably flies in the face of most investors' or owners' expectations. Generally, members expect voting power commensurate with their equity ownership – not one vote per person, regardless of contribution. What people may not appreciate, however, is the difficulty in calculating the value of members' contributions, especially where one or more members are putting in sweat equity in lieu of cash.

Our view is that this change to a per capita default voting scheme serves as a reminder to LLC members to directly address voting requirements in their LLC agreements. Most sophisticated parties will elect not to have members vote per capita, choosing instead a negotiated voting methodology. If your current LLC relies on the default voting rules of the current Act, we strongly encourage you to amend your LLC agreement after having frank discussions with your fellow members about how voting ought to take place.

### LLCs will have more, and more complex, obligations to provide LLC members with access to LLC records and information.

The current Act gives LLC members the right to inspect an enumerated list of company records, but does not give members rights to inspect company records (such as accounting records) not on that enumerated list. The new Act functions similarly, but it expands the list by making additional records available to members under specific circumstances.

An LLC must keep at its principal office, *and allow members to inspect for any purpose*, the following records:

- A copy of the LLC's certificate of formation and all amendments thereto;
- A copy of any written limited liability company agreement and any written amendments;
- Unless contained in the LLC's certificate of formation, a written statement of: (a) the amount of cash and agreed value of benefits contributed and to be contributed by each member; (b) the times or events that trigger each member's additional contributions; and (c) any right of a member to receive distributions that include a return of all or any part of a member's contribution; and any events that will trigger the LLC's dissolution;
- The LLC's three most recent federal, state, and local tax returns;
- The LLC's three most recent years' financial statements;
- Copies of any consents or votes of the members for the past three years;
- The LLC's three most recently filed annual reports;
- Any filed articles of conversion or merger; and
- Any certificate of dissolution or certificate of revocation of dissolution.

The list above *cannot* be reduced by agreement.

A member may also inspect the following records if: (a) the member has a purpose reasonably related to the member's interest in the LLC; (b) the member makes proper demand describing the records sought and the member's reason; and (c) the records sought are directly connected to the member's purpose:

- A current and past list, setting forth the full name and last known mailing address of each member and manager;
- Excerpts from any meeting of managers or members, and records of LLC action approved without a meeting;
- LLC accounting records.

After receiving a member's demand, an LLC has just **ten days** to inform the member of (a) what records it will provide; (b) when and where they will be provided; and (c) if the LLC declines to provide any records, the reason for declining.

The new requirement to produce records, especially accounting records, may become cumbersome for LLCs with many members, so LLCs should consider developing internal procedures for handling requests. To this end, an LLC agreement can add procedures for requesting company information, so long as the new procedures do not "unreasonably restrict" a member's right to records or information. LLCs desiring to develop a records request procedure to meet the specific needs of their businesses should contact us to make sure that any tailoring does not constitute an "unreasonable" restriction in violation of the new Act.

### The new Act expressly permits classes of members with no voting rights.

This change falls under the heading of "something that most people just assumed was okay." The current Act says that LLCs may have different classes of members with different rights, powers, and duties. As such, the current Act does not expressly prohibit classes of members with no voting rights, inasmuch as a class of members without voting rights has fewer "relative rights" than a class with voting rights. Accordingly, many practitioners adopted just such a good-faith interpretation of that portion of the current Act.

Apparently, however, there are enough practitioners who have adopted the opposite view – that without a provision expressly permitting classes with no voting rights, such classes could not be created – that the drafters of the new Act decided to include this clarifying provision. If you have avoided creating non-voting classes of members because of this ambiguity, please contact us to discuss how and when such classes may be created.

### Not-for-profit entities can now be formed as LLCs.

Under the current Act, an LLC may carry on "any lawful business or activity" and has the power to "do all things necessary or convenient to carry out its business and affairs." The references to "business" in the current Act have cast doubt on whether LLCs may be formed to carry out not-for-profit activities, and in Washington, nearly all not-for-profit organizations are formed as corporations or trusts.

The new Act makes clear that an LLC can be formed "for any lawful purpose, **regardless of whether for profit**." Because LLCs provide management simplicity and flexibility that corporations do not, an LLC may be a better entity choice for certain not-for-profit enterprises. Moreover, the IRS has determined that LLCs can qualify for 501(c)(3) tax exemption under certain conditions. If you plan to form a non-profit entity, we invite you to contact us to discuss which form best suits your needs.

### The new Act allows an LLC to be managed by a board.

Many attorneys and businesspeople may have assumed that the current Act permits an LLC to be managed by a board or committee because the current Act permits management of an LLC to be vested in one or more managers. However, management by multiple managers is not the same as management by a board. The key difference is that, with a group of managers, each manager is an agent of the LLC, able to act on behalf of the LLC. In contrast, under the new Act, if management is vested in a board or other group, no one individual among that board or group is an agent for the LLC. Instead, the board alone is the agent for the company, and it may act for the LLC only in the manner permitted in the LLC agreement.

A member of a board of managers might represent himself or herself as a manager, perhaps without understanding the difference between management by multiple managers and management by a unitary board. Accordingly, the allowance of management boards under the new Act is yet another reason to require an LLC to disclose its LLC agreement, if you are considering doing business with that LLC.

If your current LLC is governed by a board, we encourage you to review, or have us review, your LLC agreement to ensure that the authority to act is vested in the manner you intended it to be vested. If your current LLC is not governed by a board, but you wish it to be, we invite you to contact us so that we can make appropriate amendments to your LLC agreement.

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