California's Revised LLC Statute Could Have Profound Effects on Entertainment Industry Limited Liability Companies

The use of limited liability companies, or LLCs, is pervasive in the entertainment industry. Writers, actors, directors and other "talent" often render their creative services through single-member "loan-out" LLCs. Providers of a wide range of film and television production-related services (such as visual and special effects, post-production services, payroll services, catering and equipment rentals) operate as LLCs.

Film and television production joint ventures commonly are entered into by holders of content rights, financiers and producers for the purpose of financing and producing one or more films or television series, and such joint ventures are often operated as LLCs. Many film distribution companies are also organized as LLCs. Major and mini-major studios typically form "one-off" LLCs in connection with the production of specific movies and television series. Musical groups frequently organize and operate as LLCs as well.

While many such entertainment entities are formed under the laws of other states, such as Delaware and New York, the number of entertainment industry-related LLCs that have been formed under California law is truly staggering. A recent search of the California Secretary of State's online database reveals that the number of registered LLCs whose names contain the terms "Entertainment," "Production(s)," "Distribution(s)," "Television," "Studio(s)" or "Film(s)" exceeds **33,000**.

Those in the entertainment industry who conduct business through California LLCs should be aware that, effective January 1, 2014, California's existing limited liability company statute (Corporations Code §§ 17000 – 17656) was replaced by the California Revised Uniform Limited Liability Company Act (Corporations Code §§ 17701.01 – 17713.13). Actions taken by LLC managers and LLC members prior to January 1, 2014 will remain governed by the old statute, but the new statute will apply to all LLC actions taken on or after that date. Many of the default and mandatory rules established by the old law will be replaced by new and different default and mandatory rules under the new law.

While some of these changes are likely to have more of an impact on multi-member LLCs (such as joint ventures and musical groups) than on single-member LLCs (such as "loan-out" companies and one-off production entities), all of the changes to the law could result in significant and unintended consequences to entertainment LLCs. LLC members and non-member managers of entertainment LLCs could discover that the new law significantly alters their rights and expectations in ways that conflict with or override their written operating agreements. Accordingly, all members and managers of California LLCs should consider whether revisions to their formation documents may be necessary. Some of the more potentially impactful changes to California's LLC law are discussed below.

Who Manages the Company?

California's revised LLC law creates new rules for forming manager-managed LLCs (i.e., LLCs that are run by only one of its members, or by someone other than an LLC member). For example, the new law requires *both* the LLC's articles of organization *and* its written operating agreement to include a written statement designating the LLC a manager-managed LLC. Under the former statute, a manager-managed LLC could be established by a statement to that effect *only* in the articles of organization. Accordingly, if the members of an existing California LLC intend their LLC to be manager-managed, they should ensure that the intention is expressed in *both* of the LLC's formation documents. Otherwise, the new statute will treat the LLC as a member-managed LLC, and subject to different rules.

Consider, for example, a film production joint venture organized as an LLC with the members comprising a holder of content rights, a financier and a production company. It is not unusual for the daily and routine operations of such entities to be delegated to a single manager rather the all the members (usually the production company-member since it has the most relevant experience necessary to operating a film production company). However, if the LLC's articles of organization and written operating agreement do not *both* include a statement to that effect, an amendment to one of the LLC's formation documents would be necessary in order for the LLC to continue to be treated as manager-managed under the new law. Otherwise, the manager will find that the new law treats the LLC as a member-managed entity subject to its rules for member-managed LLCs. Such a result would, among other things, require member consent (including unanimous member consent in some circumstances) for otherwise routine actions that the members intended the manager to take in its sole discretion, which may lead to unnecessary and costly business delays.

What is the Scope of the Manager's Powers?

By default under the new law, a manager's authority to take certain actions without approval of *all* the members is limited, unless such limitations are expressly waived. Absent a waiver of these limitations, a manager must obtain approval for any actions that would be considered to be outside of the "ordinary course" of the company's business. The new statute does not define "ordinary course" or provide any guidelines for what actions generally would be considered to be outside of the ordinary course. Such ambiguity can readily lead to disputes should a manager take some action without the members' consent that one or more members believe required their consent.

Consider a musical group organized as an LLC, where the organizer is also the lead singer and/or creative force behind the band. It is not unusual for the organizing member, given his particular interest and investment in the band, to retain sole management authority. If the operating agreement does not expressly grant specific powers to the manager, or clearly define certain actions as being "in the ordinary course" of the LLC's business, the band member-manager may find his or her authority restricted under the revised statute.

This issue is not unique to music band LLCs and the same concern applies to any LLC where management is vested in one or more managers rather than the members. Unless appropriate amendments to the operating agreement are made, the band member-manager must seek unanimous (rather than majority or supermajority) member consent before taking such action. To avoid future disputes, members and managers should review their operating agreements to ensure that it is explicit in: (i) the powers granted to the manager; (ii) outlining those specific activities deemed within ordinary course of the company's business; and/or (iii) the standard for member approval of certain matters (i.e., majority or supermajority instead of unanimous), if that is their intention.

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In addition, the standard "ordinary course" of the company's business is vague and potentially sweeping. We recommend that the delegation of powers to a manager and the limitations on those powers requiring member approval be clearly articulated in the operating agreement, as is the common practice where the members are concerned about having certain veto rights or approval rights. If the delegation and limitations are not clear, there is a significant risk that the LLC will face questions about whether or not important actions have been authorized or were within the scope of the manager's authority.

What Rights Do Transferees of LLC Interests Have?

Multi-member entertainment LLCs usually intend to limit membership to the founding members and certain permitted affiliates. Thus, the operating agreements of these LLCs may restrict the rights of any non-permitted transferee of an LLC interest. For example, such a transferee may be limited to an economic interest in the company (i.e., distributions of profits) but have no voting or information rights (i.e., access to books and records of the LLC). The old law referred to such a transferee as an "assignee." While the new law maintains the same concept, it refers to such a person as a "transferee" and not an "assignee." Because the new law does not use the term "assignee" in the same way as the old law, members to pre-2014 operating agreements may find that certain transferees, who are intended to own only a limited economic interest, may have broader rights in the LLC under the new law.

For example, in connection with an unpermitted transfer of LLC interests, some operating agreements automatically convert the transferred membership interest to a limited economic interest. If the underlying operating agreement includes language such as "a non-permitted transferee shall have the rights of an assignee, as defined in the Act," or otherwise relies on the default rules of the old law to accomplish this conversion, the transferee may actually have broader rights under the new law than intended. Members and managers should consult their operating agreements to ensure the limited economic rights of certain transferees are clearly worded using the nomenclature of the new law.

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What Fiduciary Duties Are Owed?

Members in a member-managed LLC owe fiduciary duties to each other; managers in a manager-managed LLC owe fiduciary duties to the LLC's members. The old law made general reference to the fiduciary duties of members and managers but did not specify the nature or scope of such duties. The new

law specifically states that the fiduciary duties of members (in a member-managed LLC) and managers (in a manager-managed LLC) include the duty of loyalty, the duty of care, and "any other fiduciary duty."

While the new law permits the modification (but not elimination) of the duty of loyalty, any alteration of this duty is subject to a "not manifestly unreasonable" standard. The new rules also require full disclosure and the informed consent of the members in connection with any modification of fiduciary duties. We strongly recommend that parties seeking to modify fiduciary duties specifically define the duty of loyalty and the duty of care and specifically authorize certain actions that might otherwise be viewed as conflicting with the fiduciary duties. Modifications of fiduciary duties should be targeted to avoid running afoul of the "not manifestly unreasonable" standard and facilitate showing informed consent of the members. It is not sufficient for purposes of establishing informed consent to rely upon the fact that the modifications of fiduciary duties are in the operating agreement and the members signed the operating agreement.

What Should You Do?

California's revised LLC law is a potential trap for the unwary. To guard against any potential inconsistency between an operating agreement adopted under the provisions of the old law and the revised statute, members of existing California LLCs should consult legal counsel to review such agreements, determine the potential impact of the new law and make appropriate changes.

About the Author

Ekong Udoekwere's practice focuses on mergers and acquisitions, private equity (including investments in public entities), corporate finance, credit/loan transactions, corporate governance, entertainment and media and securities law. His experience in M&A includes public and private M&A, mergers of nonprofit entities, joint ventures, venture capital and private equity investments, acquisitions and sales of business (as well as purchases and dispositions of significant equity interests in businesses), and equity/venture fund formations.

Ekong represents clients in a broad range of industries including agriculture, Internet-based businesses, financial services, nonprofits, retail and real estate. His entertainment and media work includes acquisitions and sales of intellectual property libraries and licensing of media content matters involving major brands. Ekong has represented companies in connection with registration and reporting obligations under the Securities Act and Exchange Act, and advised corporate governance clients on the compliance obligations of boards of directors, audit, compensation and other board committees under the rules and regulations of Sarbanes-Oxley, Dodd-Frank and the national securities exchanges. In credit or lending transactions, he has experience on both the lender and borrower side of the deal. Ekong has also worked with nonprofit entities in connection with mergers and reinstatements of 501(c)(3) status.

Ekong is an annual guest lecturer on entity selection for the independent entertainment production professional at UCLA Extension.

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