

Is The West Coast The Best Coast?

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Should You Organize Your LLC in California or Delaware? Part 1- Voting Rights

We are often asked whether a new limited liability company (“LLC”) that will be active in California should be organized in California or Delaware. In the next several posts we will explore different topics relating to this threshold question, since an LLC operating in California may have its internal affairs governed by Delaware law if it is organized and properly maintained under Delaware law. And while the answer depends on the facts of each case, there are important common factors that all parties involved in this decision making process must carefully consider.

One of the most important factors in picking between California and Delaware are the default voting rights given to members in California that cannot be waived or altered by agreement. These fundamental voting rights shift a certain amount of power and control away from the managers, who are often the founders or initial investors, and towards the other members.

The importance of this shift in power, mandated by California statute, depends in large part on the anticipated investor profile of the company, both upon formation and at different stages in the business lifecycle. If it is anticipated that the company will only be owned by a handful of individuals or family members, the voting rights may be of relatively less importance because of the opportunity to seek consensus amongst the members. But if the company may eventually need outside investors or the ability to issue profits interests to key employees, the voting rights become far more important.

The California statute provides that members have the right to vote on the following matters, and the right to vote on these matters cannot be waived or altered by an operating agreement: (i) amending the articles of organization; (ii) dissolving or liquidating the LLC; (iii) converting the LLC into another business entity; or (iv) a merger involving the LLC. In addition, in the absence of an agreement to the contrary the California statute provides that the following matters require the unanimous consent of all of the members: (i) amending the operating agreement; and (ii) selling substantially all of the Company’s property. While many operating agreements we review give members the right to vote on additional company matters, it is imperative that all of the above are addressed in an operating agreement in order to avoid unintentionally giving all members an effective veto power over important events.

The California statute also requires the unanimous consent of all of the managers, which cannot be altered by an operating agreement to the contrary, for the following two matters: (i) converting the LLC into a different type of business entity (whether organized or incorporated in California or a different state); or (ii) a merger of the company. These two matters require the unanimous consent of all of the managers presumably because the conversion or merger of the LLC into an entity in a different state may change the rights or obligations of those managers.

The Delaware statute, on the other hand, does not have such unalterable voting rights. In Delaware you can limit the right of members to vote absolutely, making it a more attractive venue for those businesses seeking outside investors.

Depending upon the type of business and the number of anticipated third-party investors, these unalterable voting rights in California may or may not pose much of a deterrent to organizing an LLC that will operate in



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California under the law of that state. However, careful consideration of the appropriate state law – California vs. Delaware – coupled with careful drafting is absolutely necessary in order to make sure all members are not effectively given a veto power over events that will be important in the life of the business.

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