Boutin Jones INC
ATTORNEYS AT LAW

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LLCs Take Note: An Individual Who is Not a Manager or a Member Can Bind Your Company in Contract

In *Western Surety Co. v. La Cumbre Office Partners, LLC*, 8 Cal. App. 5th 125 (Cal. Ct. App. 2d Dist., Feb 2, 2017), a limited liability company was subjected to claims for $6.07 million under an indemnity agreement even though the agreement was signed by an individual with no authority to bind the LLC and the agreement bore no relationship to the LLC's business. The court determined that third parties benefit from a statutory safe harbor whereby an agreement is binding on an LLC even if the "manager" signing has no authority to sign, as long as the third party does not have actual knowledge of the manager's lack of authority. Further, the court stated that third parties have no duty to conduct due diligence to ensure a signer is in fact an authorized signer.

Background:

La Cumbre Office Partners, LLC, a California limited liability company (the LLC), was managed by Melchiori Investment Companies, LLC (the Sole Manager). Mark Melchiori (Melchiori) was the managing member of the Sole Manager and the president of a separate corporation named Melchiori Construction Company, Inc. (Construction).

The purpose of the LLC was to hold and operate a single medical office building. The purpose of Construction was to engage in the construction business. Melchiori signed an indemnity agreement covering Construction's projects. Even though the LLC received no benefit from, and had no relation to, the bonds underlying the agreement, the agreement included a signature block for the LLC to sign as an indemnitor. Melchiori signed the agreement in his individual capacity as the "managing member" of the LLC. Melchiori had no authority to sign the agreement and the agreement was not approved by any of the members of the LLC or by the Sole Manager.

The underwriter for the surety that prepared the agreement did not undertake any due diligence to determine whether or not Melchiori was authorized to sign the agreement on behalf of the LLC. Melchiori testified that when he signed the agreement he did not notice that he was signing on behalf of the LLC as its managing member, or that the LLC was listed as an indemnitor. He also testified he had no idea why the LLC was named as an indemnitor.

Construction defaulted on the contracts and the surety paid claims guaranteed under the bonds totaling $6.07 million. When the LLC refused to reimburse the surety for any of its losses or expenses, the surety filed a claim against the LLC.

555 Capitol Mall
Suite 1500
Sacramento, CA 95814

Tel / 916.321.4444
Fax / 916.441.7597
BOUTINJONES.COM

Court's Findings:

Despite the LLC receiving no benefit from, and having no relation to, the bonds, and despite the fact that an individual without any legal authority signed on behalf of the LLC, the court found that the LLC was bound by Melchiori's signature on the agreement.

The court's decision was based on Section 17157(d) of the California Corporations Code which provides as follows:

> "[A]ny… contract… or other instrument in writing… executed or entered into between any limited liability company and any other person, when signed by at least two managers (or [as here] by one manager in the case of a limited liability company whose articles of organization state that it is managed by only one manager), is not invalidated as to the limited liability company by any lack of authority of the signing managers or manager in the absence of actual knowledge on the part of the other person that the signing managers or manager had no authority to execute the same."[1]

This rule provides third parties with a statutory safe harbor whereby a written contract signed by an LLC's manager is valid, even if the manager, without the knowledge of the third party, did not have authority. The court noted that the LLC did not claim that the surety had actual knowledge that Melchiori lacked authority to sign on behalf of the LLC. Thus, pursuant to the statutory rule, the LLC would be bound by the Agreement if it was found to have been signed by the LLC's manager.

The LLC argued that the LLC's manager did not sign the Agreement because the LLC's manager was the Sole Manager, not Melchiori. The court found that a similar statutory rule applies to corporations. A prior case interpreting the rule held that corporate officers who sign on behalf of a corporation are not required to specify the office or offices they hold with their signature for the statute to apply, provided the signer is the person he or she is statutorily required to be (e.g., a president and CFO or secretary). In light of that case, the court found that had Melchiori signed his name without any official position, the LLC would have been bound by the agreement. Thus, the fact that the agreement mistakenly designated Melchiori as the managing member was a distinction without a difference. The actual manager of the LLC was a legal entity and therefore could sign the agreement only through the signature of a natural person. The natural person authorized to sign on the Sole Manager's behalf was its managing member, Melchiori, and Melchiori did, in fact, sign the agreement. Therefore, the LLC was bound by the agreement despite the mistaken identification of Melchiori individually as its sole manager.

[1] Even though this case was governed by the older LLC law, the Beverly-Killea Act, the court pointed out that identical language is contained in Corporations Code section 17703.01(d) of the California Revised Uniform Limited Liability Company Act, the current law governing LLCs formed on and after January 1, 2014.

Lastly, the court found that whether a third party exercises due diligence to ensure a signer is in fact an authorized signer is irrelevant. The statutory rule does not require due diligence by third parties.

Does the LLC Have Recourse?

The LLC could sue Melchiori in his individual capacity for losses to the LLC sustained as result of his negligence or breach of fiduciary duty. However, any recovery would necessarily damage the relationship between the LLC and its manager and any recovery would be limited to the extent of Melchiori's personal assets or insurance coverage, if any.

The Right Result?

This case appears to support the ability of a person (any person) to sign an agreement as the manager of a limited liability company (any limited liability company), causing the limited liability company to be legally bound in contract. This doesn't seem like the right result.

The court's decision did not address two defenses the LLC might have made in this case: Without the LLC receiving any value or benefit by entering into the indemnity agreement, there wasn't any legal consideration supporting the contract as between the surety company and the LLC. Without consideration, there is no binding contract. Further, because Melchiori testified he didn't notice he was signing on behalf of the LLC, an argument based on the defense of mistake also might have avoided this result. Because the court did not discuss these defenses, it appears they were not raised by the LLC in the litigation. Perhaps the court would have come to a different result had these defenses been asserted by the LLC.

A petition for review by the California Supreme Court has been filed in this case by the LLC. This Article will be updated to reflect whether review was granted and, if so, the end result.

Nevertheless, the court's decision currently stands and presents a risk for limited liability companies.

How Can a Limited Liability Company Avoid this Scenario?

A limited liability company could expand the indemnification provisions in its operating agreement to make the manager of the limited liability company liable for losses resulting from the negligence of its officers or agents. Since Melchiori was an officer of the Sole Manager, such a provision could have been relied upon by the LLC to seek recovery of the $6.07 million from the Sole Manager. However, such a provision would be unusual, in that most operating agreements contain provisions aimed at *limiting* the liability of the manager of the limited liability company. It may be difficult to find an entity that would be willing to serve as the manager if you insist on including such a provision in the operating agreement of your limited liability company.

Perhaps the better course of action is to take measures designed to ensure that this scenario never applies to your limited liability company. For example, you may wish to communicate the findings of the *Western Surety* case with the members, managers and officers of your limited liability company. Remind those who regularly bind your limited liability company to be vigilant about what agreements they are signing and whether they are being executed properly on behalf of your limited liability company. All material agreements should be reviewed by counsel to your limited liability company *before* they are signed.

We're here to help. Please contact Andrea Bacchi, Iain Mickle or any other member of the Boutin Jones Corporate and Securities Group if you have any questions regarding this article.