



Anatomy of an Operating Agreement for Investment Vehicles

The heart of an LLC is the “Operating Agreement,” a term that many entrepreneurs have heard but rarely understand. Simply put, it is a partnership agreement that can be engineered to speak to the unique facets of the partners’ relationship. And since every venture is unique, the Operating Agreement provides tremendous flexibility to translate those facets into a pragmatic economic and management framework. When speaking of partners, as in multiple partners, the Operating Agreement can and should be the blueprint for the relationship between them.

Secondly, under New York law, the Operating Agreement is one of the few statutorily imposed requirements that a LLC must observe (Section 417 of the New York LLC Act). And while the NY LLC Act provides some default rules on how the LLC should operate, it is a fairly poor baseline and in many instances may run contrary to the actual wishes of the partners. Worse still, many of the default provisions are very imprecise, which can lead to costly litigation in partner disputes. Hence, it makes sense for the partners to take the time to properly craft an Operating Agreement to fill in these significant gaps.

Also a key term: “Partners” in an LLC are called “Members.”

An Operating Agreement’s Common Provisions:

The following is a summary breakdown of some of the most critical Operating Agreement provisions. These provide a window into its key functions.

- Ownership Interests
- Purpose
- Allocation and Distribution of Profits and Losses
- Special Duties and Restrictions
- Voting Rights and Mechanics
- Managers
- Admission of New Members; Transfer of Membership
- Meetings
- Dissolution of the Company

Ownership Interests. One of the most overlooked functions of the Operating Agreement is to set forth the actual ownership stakes that the members have in the LLC. This is commonly achieved by a “Schedule” in the rear of the Operating Agreement that breaks down the member names, the initial amount of capital they invested into the LLC, and the percentage interest each member actually owns in the LLC. Unlike a corporation that often has share certificates evidencing ownership, LLC’s can and often do rely on the schedule in the Operating Agreement to set forth the relative interests of the members.

Purpose. Most startups have broad statements as to the LLC’s purpose. Usually, an Operating Agreement states that the LLC can engage in any “lawful” purpose. However, there are times when specificity is called for. For example, if the LLC is being used as a fundraising vehicle for the development of one real estate property, that may be specified in the Operating Agreement. Hence, in particular cases, it may make sense to limit the activities in which the LLC is permitted to engage.



Allocation and Distributions of Profits and Losses. Unlike a corporation, the equity a member has in the LLC and the amount of profits or losses that member is entitled to receive can be different. In contrast, in a corporation, a 50% shareholder would usually receive 50% of the profits of the corporation automatically. However, in an LLC, a member with a 50% Membership Interest could be configured to receive only 10% of the LLC's profits/losses, which is something that can be specified and agreed to in the Operating Agreement.

This allows for various creative structures to incentivize and facilitate a variety of deals. For example, a member who is contributing labor as opposed to capital may have an escalating profits share against certain milestones, despite having a fixed amount of company equity. Often, the Operating Agreement will also specify timing of member cash distributions as well as distribution minimum amounts.

Special Duties and Restrictions. The Operating Agreement may address the unique arrangements between the members or between the members and the LLC. For example, members may be obligated to work for the LLC on a full time basis (or the reverse, the members may be expressly permitted to work in and for other ventures). In addition, the Operating Agreement may provide for a member "Non-Compete" during and after membership in the LLC. Confidentiality may also be required of the members during and after membership in the LLC. These provisions can all carry penalties for breach, including expulsion, reduction in membership interest, etc.

Voting Rights and Mechanics. While the members often informally work out their issues, sometimes more formal process is needed. Hence voting process should be addressed in the Operating Agreement. LLCs can be designed to facilitate voting in a variety of ways, unlike corporations, which generally have voting rights that track the number of shares a shareholder has.

One approach is the partners have a voting stake equal to their membership interest in the LLC. So for example, a member with a 51% stake, would be able to trump the vote of the member with 49%. In addition, members can vote on a "per capita" basis, where each member is entitled to one vote irrespective of the amount of equity the members hold in the LLC, as well as other approaches.

Managers. LLCs can have a dedicated management team, whose powers can be proscribed in the Operating Agreement. Managers are often a hybrid between a CEO and a Director overlooking the "big ticket" strategic decisions affecting the LLC and its day to day operations. LLCs that have managers often delegate those roles to the managers, while the non-managing members have a passive role in the LLC. The Operating Agreement will, among other things, set forth the Manager selection and removal procedure as well as procedures that govern their management practices.

Admission of New Members; Transfer of Membership. One of the core functions of an Operating Agreement is to set out the mechanics and restrictions for the transfer of equity members ownership interests. One of the common approaches is the so called "right of first refusal" which grants the LLC and other members the opportunity to match any offer obtained from any third party by a member wishing to sell his or her Membership Interest. In addition, the Operating Agreement can address so called "involuntary transfer" situations such as death, bankruptcy, disability or termination of employment by the company, as triggers that require a Member to sell, or the LLC to buy, a Membership Interest. In these situations, the Operating Agreement should also lay out a procedure and formula for determining valuation and buyout.



Meetings. Unlike corporations, which usually have statutory obligations to have meetings at multiple levels, LLC's in NY have a default annual meeting rule, unless the members agree otherwise. The Operating Agreement often sets out a basic framework for the members to call meetings to address LLC business or call a vote on certain matters. In addition, the Operating agreement will also commonly set forth how the meeting is actually called and how participation takes place (e.g., in person and/or telephone).

Dissolution of the LLC. Few want to address the possibility of having to “dissolve”. However, relying on State law alone can be disastrous. Rather, the partners should make sure the Operating Agreement sets forth the scenarios in which the LLC can or should be dissolved and the timing and mechanism to do so. Often the two major triggers are the unanimous consent of the Members or by application to a court for a judicial decree. However, many ventures have unique needs that may demand a different approach, which should also be dictated in the Operating Agreement.

Summary. An Operating Agreement is an essential LLC component. In the short term, developing one will assist the partners in identifying and articulating their particular concerns. In the long term, an Operating Agreement will be the reference guide for many if not all of the scenarios that may impact the partners' relationship.