

What Is This Operating Agreement of Which You Speak?

In this, the third installment of “Start Up Week”, we will discuss some aspects of the fundamental document governing the internal operation and rules of a limited liability company (“LLC”). This is referred to in various state statutes as a “Company Agreement” (Texas) or an “Operating Agreement”. Regardless of what you call it, it contains the rules to live by in a LLC. Because of the blurring of the lines between various kinds of legal entities in the past few decades, the Operating Agreement is similar in many ways to the by-laws of a corporation and the partnership agreements in general partnerships, limited partnerships and limited liability partnerships, but the discussion in this post relates only to Operating Agreements.

“Why do I need one?” you might ask. You might tell me that you went on the Secretary of State’s web site and for \$300 and 15 minutes of your time, you formed your own LLC and have not done anything else, so what’s the big deal?

Technically, you don’t even need a written Operating Agreement. An Operating Agreement can be written or oral, although I’m sure you recognize the problem of proof if you try to rely on an oral Operating Agreement. You should have a written Operating Agreement even if you are the only member (owner) of a LLC. The Texas statutes recognize and provide for that situation, even if you are essentially agreeing with yourself. One of the best reasons for forming a LLC is the limited liability feature of such an entity and availing yourself of such limited liability requires that you treat the LLC as an entity separate from yourself in regard to contracting, bank accounts, leases, etc. The failure to make such separation can be that a court (in a situation you don’t want to be in) might say that since you disregarded the separate nature of your LLC, the court will do the same and therefore, you don’t have the limited liability protection. The existence of a written Operating Agreement, while not dispositive of the issue in and of itself, is evidence of your recognition of the separate entity and aids in the defense of any attempt to “pierce the veil” of the LLC.

Even if you don’t have a written Operating Agreement, the state has provided one for you. For example, in Texas the statute says, “To the extent that the company agreement of a limited liability company does not otherwise provide, (these statutes) govern the internal affairs of the company.”

So, if the state is going to write one for you, why not do one that might better suit your needs?

While not exhaustive, the following is a discussion of issues that should be considered in your Operating Agreement. These should be carefully considered and discussed with an attorney and an accountant to determine if they actually achieve the goals that the members have for the LLC and their investment in it. Also, since we have treated the posts during this “Start Up Week” as alpha and omega and “Cradle to Grave”, you can consider the Operating Agreement as a giant pre-nuptial agreement relating to the very real relationship you will be entering into in a multi-member LLC. Therefore, you should provide for how you get into the relationship, how you act during the relationship and how you are going to end the relationship. Good advice in life, good advice in LLCs.

Issues:

1. What happens when you or another member want to sell your interests?

Interests in small LLCs tend to be closely held and not particularly marketable, so this tends to be self-limiting. However, absent some contractual restriction, LLC interests are freely assignable, and you don't want to wake up one morning and find that you are in business with someone that you didn't anticipate, so you should consider restricting the sale in some way. Some methods of doing this are: (i) right of first refusal in favor of the LLC and the other members on the same price and terms as offered by a third party; (ii) exercise of a "stare-down" agreement (also called "push-pull") where a party desiring to sell names a price and the other member(s) can either purchase the interest at that price or sell their interest at that price but one or the other has to occur; and (iii) declaration of intent to sell where a party who desires to sell declares that intent and the terms upon which the party would sell (this is similar to the right of first refusal but there is not a ready buyer at the time).

Other situations that you would possibly want to consider are purchase of a member's interest in the event of divorce, death, disability, bankruptcy, retirement, breach of the Operating Agreement or termination of employment for good cause. The situations in this paragraph would require the establishment of a value for the interest that can either be done in the Operating Agreement (generally forgotten and rarely updated) or by a method established in the Operating Agreement (e.g. third party appraisal).

2. How capital is to be contributed and gains and losses are to be allocated?

In the event that not every member contributes the same amount to the enterprise (e.g. some contribute money, some contribute intellectual property or labor, etc.) the dynamics and results of that non-symmetry needs to be considered. The maintenance of each member's capital account and how that will be affected if different capital contributions are made but gains and losses are passed through in equal amounts should be discussed in depth with a financial advisor. Also, if future capital contributions are to be made, what happens if there is default? Is the defaulting party's interest subject to being bought out at some pre-determined price or is the defaulting party's interest terminated? Other consequences can be set out. One of the values of a LLC is its flexibility. As long as it is not illegal, you can agree to do it in an Operating Agreement.

3. What are other considerations?

Aside from how to capitalize and distribute gains and losses and how to manage a termination of the relationship, other issues to be considered are how to form and manage the enterprise, whether to have the LLC indemnify the members for certain actions and whether to distribute money to pay for tax liabilities in certain situations.

Obviously, any lawyer worth his salt can work one of these agreements into a multi-volume set. However, the time, effort, expense and thought put into this on the front end when people are much more agreeable can avert a number of issues down the road when they might not be so congenial. Avoiding future problems, that's a good thing.