



# The LLC Operating Agreement Demystified

January 6, 2020 / By Jeremy Waitzman

## Creating Company Rules with an LLC Company Agreement

One of the most common entity types when starting a business is what is known as a limited liability company, or LLC. Like corporations, LLCs are principally governed by the law of the state in which the LLC is formed.

In general terms, an LLC is similar to a corporation for the asset protection provided to its owners. However, unlike a corporation, an LLC may utilize a flexible [governance structure](#) and adopt the flow-through tax treatment of a partnership. While a comparison of corporation vs. LLC vs. partnership vs. other entity types is beyond the scope of this article, the concepts discussed below are the same or have a close corollary outside of LLCs.

Any company can be formed as an LLC, but the way any particular LLC operates will depend largely on whether the LLC is being formed by:

- Someone going into business by herself,
- People seeking to go into business with each other, or
- One or more people [looking for passive investors](#).

Because of the flexibility permitted by the LLC structure, the owners (known as “members”) of most LLCs adopt what is known as an operating agreement or limited liability company agreement to document the “rules” for the company.

## If You Form an LLC, You Need an LLC Operating Agreement

While not required by law, an operating agreement is usually a good idea. Though, this recommendation is slightly tempered for single member LLCs, since it is not necessary to deal with issues that may arise among the members.

If your company does not have an operating agreement, then state statutes, regulations and case law will govern your company to a degree they would not if you had an operating agreement. An analogy is the difference between dying with a will and dying without a will. Just as all states have laws that dictate what happens to your property if you die without a will, states also have default laws and rules that apply absent agreement among the members of an LLC. Since it is almost never a good result to let politicians decide who will get your wedding ring when you die, you similarly do not want them to tell you how to run your business.

The members of an LLC are generally aligned in at least one goal: they want the company to succeed. But regardless of how the business does, the desires and needs of all the members will never be perfectly aligned. Such differences can be based on risk tolerance, personal wealth, [family dynamics](#), business goals or any number of other factors.

This divergence in viewpoints is usually more evident in the situation where one member is an operator of the business and the other is a passive investor, but each member likely has her own views on many issues even where both are working in the business. The process of preparing the operating agreement [brings these conflicts to light](#), allows each member to express her respective viewpoint and document the collective agreement within the operating agreement. While discussing certain issues may be uncomfortable, failing to do so on the front end may result in significant expenditure of time, money and energy on the back end.

Even if you (and your partners or investors, if you have any) decide that an operating agreement is not needed for your company's internal purposes, you may nevertheless be required to prepare one for something as simple as opening a bank account, because banks commonly include an operating

agreement on their account opening checklists in order to confirm proper authority. Note that if the only reason you decide to adopt an operating agreement is because a bank is forcing you to, you may be able to obtain a simple “bank form” from the bank itself.

## **An Operating Agreement is Like a Corporation’s Bylaws + Shareholders Agreement**

By statute, all corporations are required to adopt what are known as bylaws. Bylaws are a set of rules that govern certain corporate affairs, such as the [election of directors and officers](#), when and how shareholder meetings are to be held and other governance issues. Bylaws are sometimes required to be provided to third parties to establish corporate authority.

While not required by statute, shareholders of a corporation also commonly adopt what is called a shareholders’ agreement. A shareholders’ agreement addresses issues related to ownership of equity, economics among the shareholders and other matters that commonly arise among owners. Shareholders agreements are internal corporate documents that are only utilized for intra-shareholder relations.

An operating agreement is the functional equivalent of both these documents in an LLC context. It can address all of the issues that a corporation would address in both its bylaws and shareholders’ agreements.

## **Common Provisions in an LLC Operating Agreement**

Since operating agreements are a product of contract, they may address most anything the members of an LLC wish to cover. Depending on your state of formation, however, there are a small number of matters that are dictated by statute and which cannot be changed by agreement of the members. For example, Illinois has 11 distinct items that may not be modified in an operating agreement (examples include (i) members information rights, (ii) certain rights to expel members, (iii) certain wind-up processes, (iv) right to distributional interests (except in limited circumstances), (v) right to approve merger where personal liability may arise, etc.).

Operating agreements typically include provisions addressing the following

subjects:

- **Equity Structure**—These provisions address the number of equity classes and the rights of each class, which may include voting rights, management rights, preferred economic terms or any other distinctions among the classes of equity.
- **Member Ownership**—Items include the percentage interest in the company or the number of units owned.
- **Capital Contributions**—Provisions may outline the amounts and nature of such contributions. Contributions typically are in the form of cash, but they may also include assets.
- **Profit and Loss Allocations**—How are the company’s profits and losses divided up among the owners? This usually follows percentage interest or is based on the respective number of units owned, but it may be allocated differently.
- **Distributions**—When and how are distributions made? Distributions may be mandatory (meaning a certain amount of funds may be required to be distributed out - e.g. to cover tax obligations) or permissive (at the discretion of the managers or members). Distinctions may also be made as to operating profits vs. funds received in connection with a liquidation event (most often the sale of the company).
- **Management**—This provision outlines the type of management structure (e.g. member vs. manager managed), the rights of management vs. the rights reserved for owners and the method of selecting managers (e.g., majority vote, special appointment rights, etc.). If the LLC is Member-Managed, it means that the members are making the management decisions on behalf of the company. If the LLC is Manager-Managed it means that the members have appointed one or more managers who will be the decision makers (like directors of a corporation). A company may want to have the owners approve a major decision (e.g. borrowing money, entering into a new line of business, merging with another party, etc.) even if the company is otherwise Manager-Managed.

- **Compensation**—This provision determines how officers and employees will be compensated.
- **Restrictions on Outside Activities/Competition**—This includes prohibitions on activities of members or managers other than for the benefit of the company.
- **Transferability of Ownership**—The rules around when and if equity can be transferred from owners of equity and to whom.
- **Purchase Rights and Obligations**—This may include the rights of existing members to acquire additional equity or the rights or obligations of remaining members or the company to purchase the equity of a member that is dissociating from the company on either a voluntary (e.g. selling units to a third party) or involuntary (e.g. death) basis.

## A Good Operating Agreement Anticipates Issues

Operating agreements are (and should) usually be drafted to permit the members of the LLC to change it as circumstances change. However, it is best to create an operating agreement that anticipates common scenarios and addresses them in a fair, equitable manner. The good news is that most issues that will arise in your business have already arisen in other businesses, so drafting a flexible operating agreement is not difficult.

### Example:

Two college roommates agree to form a company and that the company should be an LLC. Each of the roommates contribute \$10,000 on formation, agree that each will own 50% of the company, and then agree further that if either of them stops working in the business, the member who does not stop working may buy the non-working member's interest for the amount of her capital contributions.

As it so happens, the company immediately becomes profitable, thereby requiring no additional capital infusions in order to operate. Five years later, the company has a fair market value of \$1,000,000, but one of the former roommates (they can now afford their own apartments) suffers a stroke and can no longer work in the business. Under the operating agreement, the continuing

member would have the right to buy out the ailing member's interest for \$10,000.

In this example, the continuing member could decide that the company will pay \$500,000 (or at least something greater than \$10,000) notwithstanding the provision in the operating agreement stating that the buyout would be for \$10,000, but there would be no contractual obligation to do so and it's unclear where the money would come from to pay it (after all, it is unlikely that there is \$500,000 just sitting in the company's bank account).

The roommates' agreement at the birth of their company appears to have been shortsighted. An experienced lawyer would have anticipated the issue and helped them to create a more equitable arrangement (i.e., one that would have adjusted for company growth and differentiated for buyout circumstance).

## **Don't Be Penny Wise and Pound Foolish**

Drafting a good operating agreement is unfortunately not as easy as simply downloading a template from Google and changing a few names. That is often far worse than not having one at all.

If you intend to build your business to last, part of its foundation must be a good legal structure. Legal and accounting fees are always less for drafting good documents than they are for fighting over bad ones.

### **About Jeremy Waitzman**

Jeremy chairs the Corporate Group at the Sugar Law Firm (Sugar Felsenthal), a national boutique serving the affluent and the companies they own or otherwise control. He advises his clients on significant transactions and operational issues in their businesses. Described by clients as "an essential business advisor" and "a partner in the success of my business," Jeremy has substantial experience representing businesses of all types and sizes from inception, guiding them through significant growth, and often through ownership's exit. His clients include privately-held middle market and emerging growth companies, family offices/funds, investors, C-level executives, boards of directors, family-owned businesses and entrepreneurs. Jeremy counsels clients in the areas of corporate law, mergers & acquisitions, private placements, and general contract law. He represents individuals, closely held businesses, start-up companies and serves as outside counsel to several large corporations. His work with companies often includes strategies for the creation of enterprise value.

[The LLC Operating Agreement Demystified](#) originally published by Financial Poise, reprinted here with permission.