December 10, 2018

The Top Three Provisions for Every LLC Operating Agreement

One of the great things about limited liability companies (LLCs) is the flexibility they provide. Unlike a corporation, you don't need boards of directors, bylaws or annual meetings. You also have a lot more flexibility in the kind of equity you can offer. The management, economic and ownership terms can all be set forth in one agreement, called an "operating agreement" or "LLC agreement."

Because operating agreements are so central for LLCs, it's critical to carefully think through the agreement to make sure it works for your start-up and that you aren't missing anything important. In that vein, we've summarized below the three broad areas that should be addressed in every operating agreement.

- **Governance**: An operating agreement should clearly detail how decisions are made and who gets to make them. Generally speaking, LLCs have two types of management structures: "*manager managed*," in which managers are appointed by the members and have primary decision-making responsibility and "*member managed*," in which the members have primary decision-making responsibility.

  If the LLC is "manager managed," the founders should think about what types of decisions should require member approval. These would typically be "fundamental" decisions – like whether to sell the LLC, merge with another entity or shut down and dissolve. Members might also want to approve important decisions like admitting new members, borrowing money (more than a threshold amount) or hiring or firing key employees. Some LLCs have officers; others don't.

  The responsibilities and powers of the different actors – members, managers (if any) and officers (if any) should all be clearly set forth in the operating agreement. The operating agreement might also address deadlock resolution, if members disagree.

- **Economics**: LLCs provide flexibility when it comes to both capital investment and profit distributions. Membership interests can be issued for cash, for assets (including a going business) and for services to be rendered. Members can negotiate preferred returns, special allocations of tax benefits and complex "waterfall" distributions. Distributions need not be based on ownership percentages. But these provisions can be tricky with important tax consequences, so be sure to consult your tax professional to avoid future tax surprises.

  We generally recommend that the operating agreement include mandatory tax distributions to avoid "phantom income," that is, allocations of taxable income to members who will want the LLC to pay out enough cash to the members so they can pay their income taxes on LLC profits.

- **Exit**: The LLC's members need to know when they can get their capital back or sell their interest. Generally, an LLC won't let you get your money back until the LLC is sold. Capital is needed for business purposes, not for return to the members.

  You may be able to sell your interest, however. That might create a conflict because the continuing members want to know (and approve) everyone who has an ownership interest. In a start-up or a family business, people will likely be working closely together and they may not want "strangers" participating in the business. For that reason, and because of technical legal issues on limits on transferability, the operating agreement often provides for rights of first refusal. The company and the other members can purchase the interest of a member who wants to sell to an outsider, either for the outsider's price or perhaps for a pre-agreed price.

  Operating agreements will often include an exception to the rights of first refusal to allow members to make transfers to family members or for tax planning.

  Many start-up LLCs choose to include purchase rights on an "event of dissociation," that is, an event (e.g., death, disability, resignation) that means the member will no longer be participating in the venture. These provisions may give the company and the other members the right to purchase the departing member's shares or perhaps just result in the loss of voting rights by the dissociated member.

  The payment terms should also be addressed in the operating agreement. The last thing an LLC wants is an obligation to spend its needed cash to pay out former members rather than invest in the business. The operating agreement may require payment over time, perhaps five or 10 years or more, with the payment obligation secured by pledge of the purchased interest.

Each of these issues requires careful thought among the owners of a new LLC. There are few right or wrong solutions. Candid discussions at the start of the new venture can help avoid misunderstandings or disputes as the business grows.

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