

You've Got the LLC – Do You Need an Operating Agreement?

by David S. Rintoul

Management of a multi-member LLC is governed by statute unless the members agree otherwise. When can you rely on the statutory provisions, and when do you need a separate agreement?

Choice of Entity: There is little debate regarding the best type of business entity for small consulting firms: a limited liability company, or “LLC,” is the best choice. Like a corporation, it protects its “members” or owners from individual liability for the obligations of the entity. Unlike a corporation, however, the members can decide how it will be taxed, whether as a corporation, S-corporation or as a partnership, which most LLCs choose to avoid entity-level taxation.

How Will Your Company Be Run? The choice of entity is just the start of figuring out how your business will be run, who's going to run it, and what rights and obligations each owner will have. This article discusses some of these factors, particularly whether you should enter into an operating agreement regarding your LLC. An operating agreement is simply a written agreement among the members regarding how the LLC will be managed on a day-to-day basis and what the members' rights and obligations are. An operating agreement is optional; the LLC is formed when you file the form with the appropriate state agency, usually the Secretary of State.

When do you need an operating agreement? The decision to enter into an operating agreement can be significant. You will incur \$750 to \$3000 in legal fees, depending on how active the negotiations are. Costs will be higher if some or all the members hire their own attorneys, which may be necessary depending on how contentious the negotiations become. Negotiating an operating agreement also tends to bring any simmering tensions among the members to the surface, as the members discuss who deserved to get what when. Entering into an operating agreement, however, provides a sound basis for the business to move forward, with every member having a better idea of what his or her rights and obligations are, and provides a structure for avoiding disputes, and resolving them promptly if they do arise.

To be able to discuss this topic in a short article, I have made some assumptions: all the members of the LLC will be employees of the Company, or otherwise actively involved in the management and business of the Company; and that you chose the “member-managed” LLC, where, like a partnership, all members are basically peers. The other form of LLC, the “manager-managed” LLC, is closer to the corporate model, with one or more CEO-types running the company with other members as passive shareholder-type owners or otherwise not involved in management. State laws vary widely on some important points regarding governance of LLCs, so you need to consult with a lawyer in your state before deciding what to do.

If you don't have an operating agreement, the LLC will be managed as provided in the LLC statutes. The statutory provisions which govern in the absence of an agreement

among the members basically create a partnership where the majority rules. This article discusses some of the areas in which you may wish to alter the statutory scheme.

Majority Rules: Under the statute, the majority rules, either the majority of members, or the holders of the majority of the percentage interests in the LLC, depending on the state. The majority, therefore, could increase their own salary, sell all or any part of the company's assets, dissolve the company, fire another member, enter into contracts and admit new members, depending on the state. The only exceptions to majority rules, depending on the state, are a merger or consolidation, amendment to the written operating agreement or taking an action that contravenes a written operating agreement. These require either unanimous approval or approval by two-thirds of the member interests, depending on the state.

If you want to limit these powers in a meaningful way, you need to have a written operating agreement. In deciding who will vote on what, you may want some major decisions, such as whether to sell the company or fire a member from employment, to be voted on by each member having one vote, regardless of their respective percentage interests.

Even without an operating agreement, there are some limits on what a majority can do. They are subject to fiduciary duties to the other members not to unreasonably exploit their position for their personal benefit and to the detriment of the company. The scope of the duties and how they apply to specific circumstances is uncertain. Better to deal with it in the operating agreement than to try to guess what a court is going to order once a dispute arises.

Individual Power: In a member-managed LLC, each member has the right on his or her own to conduct all ordinary business activities of the company, such as signing contracts, buying equipment, hiring employees, etc. If you want to require consent by more than one member for significant actions or expenditures in excess of certain amounts, you need to have a written operating agreement.

Distributions – Share and Share Alike: Under the statute, each member has an equal right to share in any distributions from the LLC in proportion to the value of their capital contributions to the company. If the members want compensation to be determined by some other factor, such as hours billed, business originated, or revenue generated, this needs to be dealt with in the operating agreement.

Withdrawal:

Voluntary: A member has a right to voluntarily withdraw from an LLC, though the withdrawing member may have to pay damages to the LLC if the withdrawal violates the operating agreement. Some states provide that a withdrawing member is entitled to be paid the fair market value of his or her interest, while in others like Connecticut, the withdrawing member is not entitled to be paid anything for the member's interest unless the company dissolves or otherwise makes a distribution to members. You therefore

cannot force the person out as a member, even if they no longer work for the company. An operating agreement can provide for a compulsory buy out.

Involuntary: A member cannot be expelled involuntarily from an LLC unless the member is insolvent, unless the operating agreement provides otherwise. If you want the right to remove a non-productive member, you need to put that in the operating agreement. For instance, you could provide for a forced expulsion and buyout with the vote of all the members but the affected member.

Buyout Price: When the statute gives a withdrawing member the right to be bought out, or if the members decide to provide for a buyout, how will the buyout price be determined? By the withdrawing member's capital account? The member's proportionate share of the book value of the company? Will the value of goodwill and receivables be included? Will the value be discounted for lack of marketability or for being a minority interest? Unless you deal with this in the operating agreement, a court will decide these issues.

Competition: If a member successfully withdraws from the company, the former member may be able to compete with the company so long as the former member can show that he or she is not using company secrets. If you want to restrict competition post-withdrawal, you need a written operating agreement.

Other Businesses: In some LLCs, the members envision that the company will be their full-time occupation. They expect that each member will devote his or her full time and energy to the company, and if any member becomes aware of a potential business opportunity, the member will give the company the option to pursue it before pursuing it by him or herself. Alternatively, other LLCs are set up with the idea that they will only be one of many of the business activities of the members. No one expects that business opportunities will be offered to the company first, and may even be willing to have the members compete with the company. If you don't address these issues in the operating agreement, the common law corporate business opportunity doctrine will apply, with all the uncertainty and expense involved in getting a court to make a decision.

Arbitration: If you want any intra-company disputes to be arbitrated, rather than settled in court, you have to have a written operating agreement.

Conclusion

This article has space only to discuss some of the issues that should be addressed in an operating agreement. Most LLCs probably should have a separate operating agreement, and not rely on the statutory default management provisions. Without a separate agreement, you will be guessing about how a court will rule if some dispute arises. By entering into an operating agreement, the members can decide what works best for them and the company, rather than depending on litigators and courts to work it out.

David S. Rintoul practices with the firm of Brown, Paindiris & Scott in Glastonbury Connecticut, and represents many independent consultants in addressing the legal and business issues arising from a professional consulting practice. I need feedback! Let me know what you think about this article or the others I have written. Feel free to send any comments or legal or business questions that you confront in your practice to drintoul@bpslawyers.com and they may be the subject of a future column.

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