

LLC - OPERATING AGREEMENT

OPERATING AGREEMENT (SLIDE 2)

The LLC operating agreement (“OA”) is a comprehensive outline of the internal policies and procedures of the company. Like any contract, the operating agreement can be amended, the process by which should be outlined in the agreement itself. But because this is the cornerstone of the company’s operations, it is a good idea to work with legal professionals to ensure the original agreement is comprehensive.

The operating agreement should cover the following:

- General company information: name, purpose and governance
- Term of life
- Capital contributions
- Accounting
- Recordkeeping
- Allocations and distributions
- Member’s rights and responsibilities
- New members, assignment or transfer of ownership
- Membership termination
- Dissolution

Let’s go over these items individually. A transcript of this portion of the presentation will be available to read as well.

OPERATING AGREEMENT CONT. (SLIDE 3)

General company information. All operating agreements express the company’s name and purpose. The purpose statement can be as broad or narrow as the entrepreneurs choose. The purpose of the LLC acts as a boundary; the company cannot act outside of its purpose. Any act that falls outside of the company’s purpose is an *ultra vires* act and is invalid.¹ Because of this, many operating agreements articulate a broad business purpose to allow flexibility for company growth. New York LLC law permits entrepreneurs to form an LLC for “any lawful business purpose.”² The purpose, therefore, can be as broad as “to perform any lawful business.”

The OA should also express how the LLC will be governed. There are two types of LLCs: member-managed and manager-managed.³ Member-managed LLCs are owned and operated by the members themselves. A manager-managed LLC is owned by members, but managed by individuals listed in the operating agreement. If the articles of organization do not provide that

¹ See *Ultra Vires Acts*, INVESTOPEDIA, <http://www.investopedia.com/terms/u/ultra-vires-acts.asp> (last visited Oct. 31, 2016).

² See N.Y. LTD. LIAB. CO. LAW § 201 (Consol. 2013).

³ See *Id.* §§ 401, 408.

the LLC will be managed by managers, it is assumed the LLC is member-managed.⁴ Founders may agree that only some members should have management rights. If this is the case, the OA would list which members have management authority for the LLC.

No matter who is set to manage the LLC, all managers must perform their duties in good faith and with due care.⁵ Should a manager act in a way that harms the business, members may sue the manager and he or she will be judged based on an “ordinarily prudent person” standard; meaning, if the manager(s) did not act as an ordinarily prudent person would have in the same circumstances, the manager(s) could be liable for damages he or she caused the company.⁶

Term of life. Limited liability companies can exist “at will” or founders can limit the term of existence to a specific date or event that would trigger the dissolution of the company.⁷ If an LLC is to have a term, the start and end date must be articulated in the operating agreement. If there is a term of life articulated in the operating agreement, members may extend that term by amending the operating agreement.

Capital contributions. The operating agreement should contain a schedule of capital contributed by each member. Capital can be cash, property, services or a promissory note for any of those items.⁸ The schedule is important because the figures reflect each member’s investment in the LLC. The operating agreement outlines how to treat the capital accounts, including whether a member can withdraw money from his or her capital account and how capital contributions are repaid.

Accounting. A comprehensive operating agreement covers accounting and financial reporting policies to be followed by members and managers. This includes setting the LLC’s fiscal year, assigning an accountant to audit the company’s finances, policies to maintain the books, any procedures to be followed in an audit, and an explanation about how financial information will be shared.

OPERATING AGREEMENT CONT. (SLIDE 4)

Recordkeeping. All companies keep a record of their business actions. For example, meeting minutes are documented and saved, contracts are stored, payments are documented, certain communications are archived, and so on. The policies about what items should be recorded, how to record them, and where to store records should be outlined in the operating agreement.

Allocations and distributions. Allocations and distributions refer to two different things. Profits and losses are allocated to the members according to their investment shares in the LLC

⁴ See *Id.* § 401.

⁵ See *Id.* § 409.

⁶ *Id.*

⁷ See *Id.* §§ 203, 701.

⁸ See *Id.* § 501.

or another formula articulated in the operating agreement. Capital allocated to members can be distributed in whole or in part according to the procedure outlined in the operating agreement. An allocation of a profit or loss is not necessarily permission to withdraw the amount allocated; that is decided by the distribution procedures in the operating agreement.⁹

New York law prohibits a distribution that exceeds the fair market value of the company.¹⁰ When creating the distribution process consider the following: when should distributions take place, are there circumstances where a distribution can happen outside of any fixed date, when would members receive 100% of their distribution or less than 100%, and are there any restrictions on distributions for some members over others.

Members' rights and responsibilities. Members should be listed in the LLC operating agreement. Members receive rights and liabilities in regard to their ownership of the LLC. The operating agreement should outline the responsibilities held by all members and establish an appropriate standard of care for internal management of the LLC and external business activities that could affect the LLC. The operating agreement should at least articulate voting power, personal obligations or expectations to support the business, and compensation (if any). As a default, members have a proportional share of voting power according to their ownership interest in the LLC.¹¹ The operating agreement must express a different voting scheme if founders intend otherwise.

Members of an LLC are beholden to a duty to act in good faith and in the best interests of the company as well as a duty of care to act prudently and reasonably with sound business judgement.¹² Generally stated, these duties obligate members to work toward the success of the LLC and restrict members' actions so that they cannot act in a way that harms the LLC either through internal management or external obligations. Violating these duties would expose an offending member to liability for wrongdoing.

OPERATING AGREEMENT CONT. (SLIDE 5)

New members, assignment and transfer of ownership. There may come a point where the founders may want to add members to the LLC. The operating agreement should outline how to add new members. If the OA does not outline a process, New York law allows the addition of new members upon a majority vote of current members.¹³

Membership interests are personal property.¹⁴ Because of this, it is possible to assign membership benefits, in whole or in part, to third parties. The operating agreement can restrict

⁹ See, e.g., Beth Laurence, *The LLC Operating Agreement*, NOLO, <https://www.nolo.com/legal-encyclopedia/llc-operating-agreement-30232.html> (last visited Oct. 31, 2016).

¹⁰ See N.Y. LTD. LIAB. CO. LAW § 508 (Consol. 2013).

¹¹ See *Id.* § 402.

¹² See *Id.* § 417.

¹³ See *Id.* § 602.

¹⁴ See *Id.* § 601.

this practice.¹⁵ Assigning a membership interest gives a third party the ability to receive distributions and allocations on behalf of the member.¹⁶ It does not give the third party full membership rights, like voting.

Should a member wish to sell his or her interest in the LLC, the operating agreement can outline the process under which a member may do so. Most startups ask for a right of first refusal. The right of first refusal requires members wishing to leave a company to offer their ownership stake first to the startup for purchase before selling to a third party.¹⁷ The operating agreement would outline all aspects of this transaction: price for purchase, deadlines for purchase, and notice requirements.

Membership termination. At some point during the life of the business, a member may wish to exit the company or other members may wish to terminate a member's ownership interest in the LLC. The operating agreement should identify the circumstances under which membership can be terminated or withdrawn. If the operating agreement does not outline how a member can withdraw his or her membership, members will not be allowed to withdraw until after the dissolution and winding up of the LLC.¹⁸

This section of the operating agreement should take into consideration the following instances:¹⁹

- Voluntary withdrawals or retirement;
- Expulsion;
- The disability of a member; and the
- Death of a member.

Dissolution. Dissolution is the closing down of the LLC. It is always accompanied by the “winding up”: a process by which all financial aspects of the company are dissolved, debtors and creditors are paid, capital contributions are reimbursed (as per the operating agreement), and leftover money is distributed to the members.²⁰ The operating agreement can outline the instances under which an LLC can dissolve. Events that can trigger the dissolution and winding up of an LLC can include: death of a member, bankruptcy of a member, retirement of a member, or the criminal conviction of a member.

A template operating agreement is included in this resource. As you can see from the template, this list is not exhaustive. That is why it is important to work with a professional when drafting an operating agreement.

¹⁵ See N.Y. LTD. LIAB. CO. LAW § 603 (Consol. 2013).

¹⁶ *Id.*

¹⁷ See, e.g., Andrew Steen, *Keeping Ownership in the Family: Part I, Rights of First Refusal*, FAMILY BUS. RES. CTR. (Dec. 8, 2014), <http://www.familyownedbusinessadvisors.com/2014/12/keeping-ownership-in-the-family-part-i-rights-of-first-refusal/>.

¹⁸ See N.Y. LTD. LIAB. CO. LAW § 606 (Consol. 2013).

¹⁹ Alan Guterman, Business Transactions Solutions § 60:43 (Westlaw 2016).

²⁰ See N.Y. LTD. LIAB. CO. LAW §§ 703–704 (Consol. 2013).