

WHY YOUR LIMITED LIABILITY COMPANY NEEDS AN OPERATING AGREEMENT

The limited liability company has become one of the most popular ways of doing business. Owners of a limited liability company enjoy the same protection from personal liability for business obligations as shareholders in a corporation. However, a limited liability company has the advantage of fewer required legal formalities and more flexibility. For example, in most states, corporations are required to have stock certificates, by-laws or regulations, annual meetings, boards of directors, and officers. In many states, none of these requirements exist for limited liability companies.

While some states require limited liability companies to have a written document called an "operating agreement," many states only require that the owners file very simple organizational documents with the state. Whether or not your state requires an operating agreement, you should consider having one.

An operating agreement is simply an agreement among the owners (usually called the "members") that documents how the business will be run. It usually describes who is in charge, how decisions will be made, how profits will be shared, how disputes will be settled, and how a member can get out of the business. The agreement can restrict the member's ability to transfer his share in the business and can protect the business from having to accept someone as a member, even if that person buys the interest of an existing member.

There are a few situations where an operating agreement is absolutely critical. For example, many growing businesses will look to raise money from outside investors who are not going to be involved in the day-to-day operation of the business. The business owner will want to have a clear understanding with the investors as to what their role will be. Typically, the business owners will not want the investors to be involved in decision-making. The investors, on

the other hand, will want some assurances that their investment is going to be protected. They will also want agreement regarding how their share of profits will be determined and how profits will be distributed. These are the sorts of things are typically included in the operating agreement.

If you are going to be borrowing money from a bank, the bank might look favorably on the existence of an operating agreement that reflects a good business structure and specific rules regarding how the business will be run.

If you plan on rewarding employees by providing them with a small ownership interest in the business, an operating agreement is absolutely critical. Most state laws provide special protection to minority owners and hold the majority owners to a special standard of conduct with respect to those minority owners. As a result, there are numerous court cases where minority owners have successfully challenged the compensation, benefits or perks paid to the majority owners. To avoid these types of problems, an operating agreement can provide the majority owners with absolute discretion regarding compensation matters. Alternatively, the operating agreement can provide minority owners with a limited right to profits that is not affected by the profits paid to majority owners. Additionally, the operating agreement can provide that the minority owners do not have a vote in business matters or only have a vote in limited circumstances.

Even family-owned businesses can benefit from an operating agreement. Many operating agreements provide that if a member enters into bankruptcy or is subject to a divorce action, then the member must sell his interest back to the business for a pre-determined price. Frequently, the price in these circumstances is lower than it might be otherwise. This has several advantages. It protects the business from having to open up its records to the courts and outside parties. It

eliminates controversy regarding the value of the member's interest, since the value of the interest is written right into the agreement. It also is a good way of keeping creditors and ex-spouses out of the business.

If you are the sole owner of the limited liability company, and operating agreement is less important. However, you could use a simple operating agreement to give someone the authority to make business decisions in the event of your incapacity or death. Without a written agreement of this type, the representative of your state may have to go to probate court to get permission to operate the business.

A good operating agreement can be a useful tool for running your business. If you think you might benefit from such an agreement, contact your legal advisor for help.

Michael P. Coyne

Copyright © 2007 HVACR Business. Reprinted with permission.