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# THE TOP SIX REASONS TO HAVE AN LLC OPERATING AGREEMENT

For many new business owners, one of the first questions they need to tackle is what type of business entity to form. From multiples types of corporations and partnerships (or sole proprietorships for individuals) to limited liability companies, the choices are many. But, these days, for typical entrepreneurial types starting typical businesses like ecommerce sites or professional services, the most common entity is the limited liability company, or LLC.

Legally creating an LLC is pretty simple. All that is required is the filing of Articles of Organization with the state and payment of fees (of course). But, that's just the beginning. See, legally forming the LLC is one thing, but making sure that it does everything you want and need it to do is another thing entirely.

Commonly, business entities are formed for a number of reasons, from limiting liability of the owners to simply projecting a more professional image to clients and customers. But, what any new business owner needs to realize is that, without some additional business planning, they run the risk that their LLC won't function how they thought it would.

That's because LLCs, like every other type of business entity are governed by state statutes (and case law). Those statutes contain default rules for how an LLC must be operated. They act as fall back rules for every LLC that doesn't decide their business should be operated in a different manner. And, sometimes, what the statute requires is at odds with what the business owners intended. So, how do new business owners, specifically those that have formed LLCs make sure their businesses are going to operate in a way that works for them?

Enter the Operating Agreement.

An Operating Agreement is a document drafted by the members of the LLC that lays out the rules for how the business is going to operate. For those familiar with corporate structures, it is similar to corporate bylaws.

There is no formal structure required for an operating agreement, and the topics it can touch on are practically endless. And, for the new business owner who hasn't thought much past how he is going to sell his product, taking the time to draft an operating agreement can be one of the best startup decisions of his entrepreneurial life.

Why have an Operating Agreement?

Well, a number of reasons, but here are six:

## 1. Death of a Member

If you start a business with a partner or a few other individual, have you thought about what should happen if one of you dies? It's safe to assume that, as the business grows, each partner's interest is the business will become a substantial personal asset that he or she will expect to be able to leave to a spouse or children should something happen. But what does that mean for a business that is all of a sudden forced to deal with the family instead of the founding member? Will the deceased member's spouse now "step into his shoes" and serve as a voting member of the LLC? What if the spouse doesn't want to continue on with the business and demands to be bought out? What if the business doesn't have enough liquid assets to buy back the deceased member's interest?

These are some very real questions that commonly face the members of LLCs. An operating agreement can set forth how the situation should be handled should something happen to one of the members so that the remaining members can continue to run the business.

**2. Divorce**

Something like 50% of marriages in this country end in divorce, so if you start an LLC with two other married members, the chances are better than not that one of you will be getting divorced. An unfortunate situation, no doubt, but one that can be made far more stressful for the divorcing couple and the other business owners when it comes time to figure out what the divorce means for the business.

Like the case of a member dying, a divorce is likely going to have a substantial impact on the LLC as the divorcing member's spouse may end up acquiring an interest in the member's interest (business interests are commonly characterized as marital property without additional estate planning). What does that mean for the business? Well, depending on the state's LLC statute, the member's estranged spouse may now be considered a member as well, meaning that it's possible he or she will all of a sudden have the ability to vote as a member of the business.

An operating agreement can anticipate divorce of a member and set forth an appropriate plan in order to prevent that sort of situation from occurring.

**3. Disagreements**

At the onset, the relationship between the founding members of a new business is no doubt rosy. But, as the toll of operating a business begins to take its toll relationships can sour. Members can develop very different visions for the future of the business. Similarly, business interests are valuable and members may vary on if or when the company should be sold. An operating agreement can set forth how disagreements between members will be resolved. By setting rules for how to handle conflicts upfront, business owners can reduce the chance that animosity towards each other will develop down the road.

**4. Secures Limited Liability**

Forming an LLC by filing Articles of Organization with the state is one thing, but it does not guarantee that the business will shield the members from personal liability. If an issue arises, courts have been known to disregard the LLC if it appears from the facts of the situation that the owners of the business failed to really separate the business operations from themselves personally. Things like treating personal and business accounts as one-on-the-same can lead a court to determine that the business was never really a separate entity from the individual in anything but name. Like opening separate business bank accounts, creating an operating agreement with formal rules about how the business operates (and actually following those rules) can show a court that, in fact, the business was operating independently of its owners. That can be a huge determination from a liability standpoint should certain problems arise.

**5. Allows for Future Growth**

For a new business owner, simply earning a profit can sometimes be enough of a challenge, but once the business gains some traction most owners naturally think about how to maximize its growth. An operating agreement can anticipate that growth and structure the business with enough flexibility to permit it to happen without changing the management or voting structure.

For example, two partners stating a new business may see an opportunity down the road to open a number of additional locations if only they had the resources to do so. Bringing on a friend or family member with deep pockets would be an ideal situation, but the partners don't want to give up any control over the direction of the business. Without an operating agreement, the rules may default to that new partner getting a voice (and it could even be proportionate to his ownership in the company, meaning he could potentially take control). But, with an operating agreement, the owners can contemplate future growth from the beginning and structure their business in a way that enables them to take on additional investors without giving up and managerial control.

**6. Clarifies Expectations**

At the end of the day, one of the most important things an operating agreement does is it clarifies expectations.

As I mentioned, the topics an operating agreement can cover are practically endless. Making sure to set forth rules for things like voting, termination, assignment, accounting, allocations of profit and loss, dispute resolution, and a host of other topics ensures that every member of the business has a clear understanding of how the business will operate when presented with specific situations.

That can go a long way towards ensuring success as a growing business.

*Michael F. Brennan is an attorney at the Virtual Attorney™ a virtual law office helping clients in Illinois, Wisconsin, and Minnesota with estate planning and small business legal needs. He can be reached at michael.brennan@mfblegal.com with questions or comments, or check out his website at www.thevirtualattorney.com.*



By Michael Brennan