

Do You Have an LLC? Your Operating Agreement Is a Vital Document

In the absence of an operating agreement, the LLC will be governed by the rules set forth in Arizona's statutes, which are silent on what will happen in many situations.



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Because of its simplicity and low cost (compared to incorporation) and its ability to protect owners from legal liability, the limited liability company (LLC) is the legal entity of choice for many business owners.

In Arizona, an LLC is formed by filing articles of organization with the Arizona Corporation Commission. While the articles are necessary in the creation of an LLC, when it comes to protecting the company and its owners from expensive litigation, the most important document in an LLC's legal arsenal is its operating agreement.

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An operating agreement governs how the LLC will be run. In the absence of an operating agreement, the LLC will be governed by the rules set forth in Arizona's statutes. Because the statutes are silent on what will happen in many situations, having an operating agreement from the outset is an important tool for avoiding legal confusion and exposure later on.

Here are some examples of key issues usually governed by an operating agreement.

THE MEMBERS

An operating agreement should identify the "members" (the LLC equivalent of "shareholders"), what percentage of the company each member owns, and how each member will be paid for his share. It may allow the company to have members with and without voting rights. It governs whether the LLC can call on its members for additional capital contributions. It also defines how profits will be shared, how decisions will be made, and how disputes will be settled.

CHANGES IN MEMBERSHIP

An operating agreement should define whether and how members may be added, whether a member can transfer his interest, and under what circumstances a member can be terminated. The agreement can give the LLC a right of first refusal if a member dies or chooses to sell his share. The agreement can restrict a member's ability to transfer his shares and can protect the business from having to accept someone as a member, even if that person buys an existing member's share.

KEEPING OUTSIDERS OUT OF YOUR BUSINESS

An operating agreement can provide that, if a member becomes insolvent or is threatened with a divorce action, the member must sell his interest back to the business for a predetermined, reduced price. This protects the company from being forced to open up its records to the courts and other outside parties and keeps creditors and ex-spouses out of the business.

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PROTECTING YOUR ASSETS

The main reason for creating an LLC is to protect the members' assets – home, car, cash, etc. – from the risks of doing business. The LLC can shield individual members from personal liability for the company's debts. However, if the LLC has not carefully kept its affairs separate from the affairs of its members, a creditor may be able to "pierce the corporate veil" and reach the assets of individual members. A written operating agreement and other written records of actions taken by the LLC go a long way toward proving that the LLC has observed "corporate formalities" in conducting its business, such that the court should respect the shield the LLC provides its members.

SINGLE MEMBER LLCs

Though many people do not realize it, an operating agreement may be even more important to an LLC with only one member (a "single-member LLC") than it is to an LLC with many members. Because a sole owner may tend to conduct business without using many formal documents, a single-member LLC can look a lot like a sole proprietorship – therefore exposing the owner to possible personal liability. An operating agreement may be important proof that a single-member LLC has observed "corporate formalities" such that the LLC's separate existence, and the shield it provides its members, should be respected. In addition, a simple operating agreement may allow a sole owner to protect the longevity of his business, by specifying a person authorized to make business decisions in the event of the owner's incapacity or death. Without a written agreement of this type, the LLC may not have authority to continue business and may terminate after the death or disability of its only member.

CRITICAL SITUATIONS

There are a few situations in which an operating agreement is absolutely critical. For example –

If the company has non-member investors, the business owners will want a clear understanding with the investors as to what their role will be, who will make decisions, how their share of profits will be determined and how profits will be distributed. Having a clear understanding about these sorts of issues from the outset can help avoid lengthy (and costly) disputes in the future. That is why these issues are typically addressed in an operating agreement.

An operating agreement is also essential for employers who plan on rewarding employees by providing them with a small ownership interest in the business. An operating agreement can give the majority owners absolute discretion regarding compensation matters, including distributions to minority owners. On the other hand, the operating agreement can give minority owners a limited right to profits that is not affected by distributions to majority owners.

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GET HELP

A good operating agreement can be an extremely useful tool for managing your business affairs. If you think you might benefit from such an agreement, contact Ron Adams (480-345-8845 or [email](#)) or your business attorney.
