HOW TO DRAFT AN LLC OPERATING AGREEMENT

(Alternatives & Options)

Updated with Discussion of Sweat Equity and Phantom Income

By Donald W. Hudspeth

The Law Offices of Donald W. Hudspeth PC©

Contracts are like shoes. One size does not fit all nor is one pair suitable for all occasions. This is true for a limited liability company operating agreement.[1] One "size" or type is not suitable for every company. Below we discuss content that an operating agreement may contain. Generally, for any LLC with more than one member we would recommend that all three levels be included. But, typically, the company hiring us to do the operating agreement is a start-up which has only limited funds to cover a number of initial expenses, so may not be able to start with what we call the "global" Operating Agreement."

I. Level One, The Basics

A. The Basic Operating Agreement.

LLC Operating Agreements are often treated as a form document, to be printed as part of an LLC package and forgotten. With a single member LLC the Operating Agreement is not critical.[2] But when the limited liability company has more than one member the Operating Agreement becomes essential because it is what I call the "money and power agreement." It states:

1. Who owns what percentage, or number of units,
2. What "consideration", the legal term for payment made or benefit conferred, was given or is to be given,
3. The management structure, i.e. whether the company is to be member managed or manager(s) managed, and
4. The nature and extent of management authority. In a manager managed LLC the Manager may have:
    - (i) Complete "King Tut" authority to do anything, or totally the opposite, be
    - (ii) Subject to the unanimous approval of the members, or most common,
    - (iii) Authority to do acts in the ordinary course of business with unusual acts, e.g. changing the Operating Agreement, borrowing money, pledging company assets, etc. subject to member approval.
5. Standard of Care: As discussed below, in most states the managers, and perhaps the members, have a fiduciary duty (care, loyalty, and not self interest) to the company

[1] For this very reason this article should not be considered or relied on as advice but only as general information to be discussed and applied, as appropriate, to your particular situation.

[2] There is a counter-argument. My understanding based on anecdote is that, although long-accepted in Europe, e.g. as GmbH in Germany, the limited liability company was not widely used in the United States until the 1990's because the Internal Revenue Service had not officially accepted it. I understand that the "Devil's bargain" under which the IRS ultimately accepted LLC's is that the limited liability company documents would contain certain tax law provisions. Thus, early operating agreements contained a number of tax law provisions, including gems such as minimum gain chargeback, qualified income offset and other terms promising compliance with the Internal Revenue Code 704(b). I have wondered, without researching the issue, whether form-like operating agreements lacking these tax law provisions or LLC's without such an operating agreement would satisfy the IRS. If not, then the issue is whether the LLC owners actually have limited liability protection. If I were suing a company without them I might raise the issue.

and themselves as a matter of law. (This means you do not need a contract which says that.) But in Arizona the manager or member only has a fiduciary duty if an agreement, typically the operating agreement, says so. This leads to a strategic choice:

(i) If one is the manager or controlling member in Arizona one may not want a fiduciary duty implied. In this case the standard of care could revert to gross negligence, breach of the business judgment rule or breach of the covenant of good faith and fair dealing, all of which must be proven based on the facts and not a written contract.

(ii) If one is not the manager, or is co-manager, then specifying that the parties have a fiduciary duty to each other and to the company can protect the non-management (or not exclusive management) member.

6. Other common terms and conditions include:

    (i) "Super-Majority" provisions under which certain acts require a higher percentage than majority vote. Typically this percentage is something like 65% or 75% but it can be any percentage the members choose, and the

    (ii) Removal of Manager Procedure, e.g. majority or Super-Majority vote.

These are the basics, the first level of issues to be addressed in the Operating agreement. But though basic the importance of these "Level One" provisions is difficult to exaggerate.

B. LLC Statutes as Default Provisions

One example of the problems caused by the lack of an Operating Agreement – a common situation with do-it-yourself business owners – occurs when the company is Manager-Managed. Limited liability company law is different than traditional corporation law. With corporations the corporate statutes trump, control or strongly influence the corporate documents and private agreements. With LLC's the opposite is true; that is, "the contract rules." The state limited liability company statutes are default provisions which apply only in the absence of an agreement or provision covering the subject matter. Under Arizona law in the absence of an Operating Agreement setting forth the procedures to remove a Manager, the Manager becomes almost impossible to remove. There are arguments and possible legal actions but "arguments aren't answers" and the cost to resolve such issues can be inordinately high. In a nutshell having a well drafted Operating Agreement tailored to your company, its members and management structure can be the difference between routine contract expenses of say, $750 to $2,500 (in unusual cases) and the $10,000 or so which may be required to "walk in the door" in the event of a "partnership" (i.e. membership) dispute or litigation. Total attorneys fees in such litigation typically exceed $100,000, so the maxim "doctor's office, not hospital or emergency room" definitely applies.

C. Members Working for the Company

Here at the firm[3] we often tailor the Level One Operating Agreement to account for employment. Except where it is clearly understood that the member is a "money person" and is

[3] Law Offices of Donald W. Hudspeth, 3200 N. Central, Ste 2500, Phoenix Arizona. 602-265-7997. Azbuslaw.com. This is a good example of the difference between an agreement that looks good and an agreement that works.

to be a passive investor, most business owners assume that the members will also work in the business. This is particularly true with a start-up. But this is a "vision thing" and "partners" like anyone else can have a different view of things. It is not unusual for the Operating Agreement to be silent on the issue of member employment.[4] We have had cases where the member who was supposed to be the Sales Manager was still working somewhere else. Also, it is fairly common to have a member say, in effect, "I am not required to work in the company; I own 25%, so pay me my share of the profits." This of course not only damages the company, but also causes ill will and leads to a partnership dispute and litigation. For these reasons, with the exception of a passive investor[5], we usually require the member to work in the company and may list termination of the member's employment as a triggering event of dissociation, i.e. the process of removing the member from the company with buy-out options by the company or the other members. In the case of members known and accepted as passive investors we may waive the "employment requirement" so that the investors can retain their ownership interest without working in the company. In this case the mandatory buy out for termination of employment would not have to apply.

D. "Sweat Equity"

It is relatively common to have a "money guy" and a "sweat equity guy" in an LLC. The money person pays for his membership interest with cash or property. The sweat equity member pays for all or part of his ownership interest by working in the business. But this leads to a common mistake or important question overlooked: When does the membership interest (i.e. ownership) of the sweat equity partner vest, i.e. become owned with legal rights? Usually, without thinking about it, the parties just treat the sweat equity partner's percentage interest in the company as vested from day one. But this is unfair to the money guy for several reasons:

1. The sweat equity has not yet been "paid," so the person has not yet made the agreed upon contribution and may never do so.
2. The voting and distribution rights would be treated as if the full contribution had been paid.
3. This means the sweat equity member has a claim to his percentage interest of the company's remaining capital in dissolution. You can see the unfairness of this by an extreme example: Consider the hypothetical where one member contributes $100,000 in cash for a 50% interest and the sweat equity member promises to contribute $100,000 in work for his 50% interest, but the limited liability company dissolves the next day (or falls apart within the first year). If the sweat equity member's shares have

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Apparently well drafted operating agreements often contain clauses that are legally correct but make no sense practically: For example, the common provision that the members will meet once a year to determine the value of the company. This almost never happens and the fact that is doesn't can destroy the value of what might have been a $4,000 buy-sell agreement. Here, at the firm we know ways of determining value that work and that can save the client literally tens of thousands of dollars in legal fees spent for dispute resolution.

[4] By employment I mean working in the company. The member typically would not be designated an "employee."

[5] By "passive investor" I mean a person or company investor who does not plan to be actively involved in managing the company. Such an investor is often out of state. Having such investors can raise a number of securities law issues and the reader is strongly advised to seek legal counsel before accepting or even offering to accept money from them. Among other things ask your legal counsel about state and federal Reg. D filings, the Jobs Act, and a private placement memorandum (commonly referred to as the "PPM.").

vested "with no strings attached" (i.e. with no vesting or payment schedule), then he receives a windfall of, say, $50,000 even though he had not yet performed the work.

There are two ways to handle this problem:

1. One way is to give the sweat equity member the full percentage interest now, subject to actual payment, like a loan paid by work. The "payment" might be to work a certain number of years, say five years, providing certain knowledge and skill set of work.
2. Another way is to have the sweat equity vest, i.e. become owned, as it is paid by work over time. For example 20% might vest each year over five years. Or, the vesting could be "staggered," e.g. if the member were to own 50% of the Company then interests could vest as 0% in year one; 5% in year two; 10% in year three; 15% in year four and 20% in year five. Money investors tend to like this plan because the working member actually would have to work before the interest became fully vested. This being so the member may still be treated as owning the full share for purposes of voting and distribution. The only difference then between the money member and the sweat equity member would be in the event of dissolution or buy out.

E. "Phantom Income"

Incidentally, sweat equity shares are taxable. This can lead to a serious tax problem for the recipient. Consider a grant of $100,000 membership interest in return for work. The IRS considers this income but the member has received no cash. At a, say, 35% tax rate the sweat equity member would owe $35,000 in taxes with no money from the company to pay the taxes. The member would need to have other funds to pay the tax. This is why a common provision in operating agreements for companies with a sweat equity member is that the company will at least distribute sufficient funds to cover the tax – $35,000 in this hypothetical.[6]

Problems with "phantom income" are not limited to sweat equity owners. The problem can arise with any member of an LLC or shareholder of a Sub-S corporation. It occurs when the company does not distribute all of its profits, which is fairly typical. Again in this case the owner member would owe taxes with no money from the company to pay the taxes. The member would need to have other funds to pay the tax. This is why a common provision in operating agreements, or the bylaws of a Sub-S corporation, is that where not all profits are distributed the company will at least distribute sufficient funds to cover the tax.

F. Adopting A Corporate Structure

As stated above a business owner may do almost anything she wants with an LLC Operating agreement. In some cases, e.g. where executives are to be hired and the business model contemplates a number of passive investors, we superimpose a corporate structure onto limited liability company operations via the Operating Agreement. In that case the members may be referred to as "shareholders," may vote their "shares," and the company could be governed by

[6] These are things learned from experience but neither I nor this firm practice tax law. So, please consider this as general information to be discussed with your accountant.

a board of directors who appoint the "corporate officers," i.e. the President, V-P, Secretary and Treasurer, etc.

Continuing with the corporate approach the company may form an "Advisory Committee" for the Board. This could serve two purposes:

1. Studies have shown that companies with Advisory Committees are more profitable than those which do not, and perhaps more importantly,
2. Serve as a sales/political tool to woo and assuage investors. It can be a middle ground between active involvement and passive investing.

II. Level Two: Confidentiality, Non-competition and Anti-Piracy Provisions[7]

As discussed above in most states[8] a limited liability company member owes a fiduciary duty (i.e. the duty to act according to the highest standard of honesty, loyalty and integrity) to the company and its members. This fiduciary duty prevents the member from directly competing with the LLC while being a member. But, as a matter of law, and unless the operating or some other agreement says otherwise, the person is free to compete with the company following termination of membership and employment. As members may not be subject to employment agreements it is critical for the company to adopt measures to protect trade secrets and other confidential information and to prevent a former member from targeting the company customers for sales or employees or contractors as agents. Obviously, a former member with inside information about the company's operations and who has few limitations on the right to compete can cause serious damage to the company.

Even without any *contract* limitation on their freedom compete or to target customers and employees, by law the former member may not improperly interfere (called "tortious interference") with his former company's contracts and business relationships.[9] But, "client choice trumps company agreement" and there are ways of competing without violating this prohibition and obvious mistakes can be avoided with the prior advice of counsel as to lawful means to proceed. For example, the firm advised the Arizona General Manager of a Colorado owned engineering company of the proper method to start his own company. As the General Manager was not subject to any employment or other agreement limiting his ability to compete, then at law he was free to do so and he took about $100,000 a month in sales with him. Because a former member can do so much damage to the company we may discuss with the client the option of adding these Level Two provisions to the Operating Agreement.

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[7] Typically, "non-competition" refers to restrictions on the right of the departing member to work for a period of time in the company's trade area or product market. Due to the public policy favoring one's right to work in a chosen trade this period is usually limited, e.g. six months. "Anti-piracy" denotes the restriction by agreement from targeting the company's customers or employees (or agents) for a period of months or years. Here, public policy favors the business right to retain customers, employees and good will, which may have taken years to achieve; thus, this term can be longer, say one year. The law in this area varies by the state which is another reason for a tailored agreement.

[8] This is not true in Arizona. The operating agreement or some agreement must state the fiduciary standard.

[9] "Tortious interference with contracts or business relationships occurs when one knows about and intentionally damages business relationships, e.g. the ex- employee or company owner who uses his inside knowledge about the firm and its customers to approach customers with special deals.

III. Level Three: Buy-Sell Provisions

Earlier we mentioned the possible dissociation, i.e. termination of ownership, of a member with the right of the company or its members to buy out the departing member. Often there is an agreement among the members a) mandating the personal representative of the estate of a deceased member, or a divorced spouse, or a disabled or bankrupt member, to sell the member's interest and b) granting the company or the remaining members the option to buy. With corporations this is called the "Shareholders Agreement" and it is commonly understood what this means. But with LLC's the nomenclature changed. This has caused some confusion because document name adopted, i.e. "buy-sell agreement," is perilously close to the name used for the purchase and sale of businesses, i.e. the "purchase-sale agreement." And, "buy-sell agreement" is often used by laymen to mean a business purchase or sale agreement. Thus, when dealing with "buy-sell" agreements context is important. And when in doubt, ask.

The Level Three option for the company and its members is to adopt buy-sell provisions, specifying:

A. The events triggering dissociation, e.g. death, disability, bankruptcy, divorce or termination of employment.
B. The purchase price, or formula to calculate the value of the interest, e.g. fair market value; a multiple of earnings, EBITDA[10], or net worth; earn-out, i.e. payment of a percentage of profits for a term of years, stipulation, etc. [11]and
C. The terms of payment, typically something like 20% down with 60 month to pay at prime plus one (1) interest.

As shown by item B above, there are a number of ways to calculate the purchase price for the interest. These are negotiable, as are the terms of payment. Instead of financing the purchase the agreement may require "cash, payment in full." Where there is "stock redemption" or "cross purchase" insurance, then in the event of death, and perhaps serious disability, the insurance proceeds may be all or the primary portion of the purchase price.[12] Whatever the particular triggering events, purchase price or terms of payment may be, having these terms agreed to in advance can save literally $10,000's of legal and expert witness costs.

IV. Conclusion

Forming and organizing your company is not a matter of filling out a form. It is well worth it to get a good legal structure, what I have called the "Legal Brickhouse," and advice to go along with it. As the law evolves over time there may be new things to say by the time you read this. A consultation about your particular needs is very important.

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[10] Earnings before, without deducting, or after adding back, interest, taxes, depreciation and amortization.

[11] We have a fairly simple way of doing this which has worked quite well.

[12] Stock redemption insurance is used where the company agrees to purchase the interest of a business owner in the event that her business interest becomes available due to death, disability or retirement. With cross purchase insurance each member would purchase a life insurance policy on each of the other members. Each member would pay the premiums on these policies and they individually, not the company, would be the beneficiaries of the policies. Although cross purchase agreements may have some tax advantages, my clients do not often use them due to the complexity and expense.