

## **OUTLINE OF PROVISIONS AND SUBJECTS TO DISCUSS FOR INCLUSION IN A LLC OPERATING AGREEMENT**

A limited liability company (“LLC”) offers pass-through income tax treatment like a partnership but with limited liability protection like a corporation. In recent years the LLC has become one of the most – if not the most – popular business entity chosen to operate a business or investments, such as real estate. It is one of the easiest business entities to form.

The LLC formation document is the most important one for an LLC because it establishes the LLC’s existence. In New Jersey, an LLC is formed by filing a “Certificate of Formation” with the state. It’s a very simple and short document, usually one page, perhaps two pages of basic information.

The LLC Operating Agreement is the second most important document for an LLC. This document is not filed with the state, but rather, is a private agreement among the LLC and its members that governs the LLC ownership and operating structure. Think of the LLC Operating Agreement as an operating manual for the LLC. It establishes the owners and their rights, responsibilities and obligations. In addition, it creates procedures and rules for what the LLC can and cannot do, and how the LLC can operate and act as its own separate legal entity.

Not only is the LLC easy to form, it is one of the most flexible business entities to use – the parties are generally free to structure their economic and business relationship in any manner they see fit. However, with such flexibility comes greater complexity – because the parties are free to contractually structure their Operating Agreement, there are numerous issues for the

parties to think through and determine. There is no “one size fits all” or “off-the-shelf” Operating Agreement. Each Operating Agreement has to be tailored specifically for each situation. And while an Operating Agreement for a 2-Member LLC managed by the Members (typically structured with equal votes, allocations and capital contributions) will often be simpler than an Operating Agreement for a 3-or-more Member LLC managed by the Members, there are still many issues for the parties to decide upon, especially events triggering buy-out provisions and how to structure those buy-outs. A “simple” Operating Agreement for a 2-Member LLC managed by the Members could run approximately 25-30 pages, letter-sized, double-spaced.

The following sets forth an outline of relatively standard provisions and subjects to discuss for inclusion in the LLC Operating Agreement when structuring the parties’ agreement. It’s just a sample of the items that the parties need to consider and resolve, but, of course, it is not an all-inclusive listing. We’ve noted key items that need to be dealt with in some manner.

## **1. Organization**

- (a) Formation
- (b) Name
- (c) Registered Office and Registered Agent
- (d) Principal Place of Business
- (e) Purposes – should the purposes be narrowly defined or broad?
- (f) Duration – perpetual or limited term?
- (g) Title to Company Assets
- (h) Banking – who signs the checks?
- (i) Borrowing

- (h) Large Expenditures – what is a threshold amount to be considered “large” and should checks above that threshold be signed by all Members
  - (i) Reimbursement of Expenses
  - (j) Payments to Related Parties
- 2. Capital Contributions** – how much is each Member contributing to the LLC?
- (a) Initial Capital Contributions
  - (b) Additional Capital Contributions
  - (c) Additional Capital Required - yes or no, and who makes the decision?
- 3. Capital Accounts** – compliance with technical and complicated Internal Revenue Code statutory and regulatory rules
- (a) Increases
  - (b) Decreases
  - (c) Transferee
  - (d) Compliance with IRC Section 704(b)
  - (e) Revaluation of FMV
  - (f) No Withdrawal or Return of Capital Account
  - (g) No Interest Paid on Capital Accounts
- 4. Allocations** – what are the profit and loss allocations and how are they determined?
- (a) General
  - (b) Change of Membership Interest
  - (c) Special Allocations - compliance with technical and complicated Internal Revenue Code statutory and regulatory rules
    - (i) Minimum Gain
    - (ii) Qualified Income Offset
    - (iii) Deficit Capital Account
    - (iv) Deficit Creation

- (v) Deficit Balance
  - (vi) Nonrecourse Deductions
  - (vii) IRC Section 704(c)
  - (viii) Curative Allocations
- (d) Family Partnership Savings Provision

**5. Distributions**

- (a) Discretionary or mandatory?
- (b) How often made?
- (c) Mandatory in an amount sufficient to pay federal and state income taxes relating to each Member's share of LLC income?

**6. Members**

- (a) Single class or multiple classes of membership interests?
- (b) Membership Units – total to be issued and how many to each Member?
- (c) Member Authority and Limitations
- (d) Voting Rights – one vote per Member (per capita) or voting rights based on number of Membership Units issued to each Member (based on capital contributions)?
- (e) Member Meetings
  - (i) Frequency?
  - (ii) How many votes needed to call a meeting?
- (f) Action by Written Consent
- (g) Admission of Additional Members – by all Members or a lesser percentage?

**7. Management**

- (a) Member-Managed or Manager-Managed?
- (b) Member Powers
- (c) Manager Powers (if applicable)

- (d) Actions Outside Ordinary Course of Business – by unanimous vote; super-majority; majority vote?
- (e) Officers? Not really necessary in a LLC

**8. Standards of Conduct for Members**

- (a) Duty of Loyalty
- (b) Duty of Care
- (c) No personal liability for certain acts, debts or liabilities
- (d) Identifying Acts of Members – carve out for a Member engaging in other activities that may compete with LLC, etc.?
- (e) Authorization or ratification by other Members if an act violated the duty of loyalty after full disclosure of all material facts?

**9. Disposition of Membership Interests** – the parties need to decide if a buy-out will occur upon certain events. Not all of the provisions below need to be included within an Operating Agreement – it’s up to the parties.

- (a) Transferability of Membership Interests – general rule is no transfers, except as otherwise provided
- (b) Exception for Family Member Transfers – gifting/sale permitted for lifetime transfers. Most standard Operating Agreements restrict the transfer of Membership Units by members to others without the approval of at least some percentage vote of all Members. However, in some cases, the Members may want to at permit each Member to be able to transfer his or her Membership Interests to a family member without requiring the approval of the other Members. This provision permits this.
- (c) Deadlock in 2-Member LLC – this provision forces the acquisition by one Member of the Membership Units of the second Member as a method for resolving a deadlock. The provision only applies if there are 2 Members in an LLC and they have equal ownership and control or the LLC Operating Agreement otherwise requires the approval of both Members for an LLC decision. The provision is known as the “Texas shotgun” provision because one Member can initiate a forced sale by offering a price to buy-out the other Member. The other Member then has the option to sell his or her Membership Units at the offered price or to purchase the other Member’s Membership Units at the offered price.
- (d) Right of First Refusal – upon the occurrence of a bona fide third party offer. This gives the Members and then the LLC the right to step in the shoes of a buyer who is interested in buying the Membership Units of a Member desiring to sell his or her Membership Units. A standard provision in an LLC Operating Agreement

requires that Members need to vote on the ability for a Member to transfer his or her Membership Units to a third party. This is the most common provision because it is reasonable for the existing Members to control who owns and has rights in the LLC (i.e., Member compatibility). However, some LLCs want to balance this concern regarding Member compatibility with the need of the Members for liquidity (i.e., the ability to sell their Membership Units to obtain cash). This balance is usually addressed with a Right of First Refusal Provision.

- (e) Tag-Along Rights – this provision permits any Member to require that his or her Membership Units be included in the sale by another Member pursuant to a bona fide third party offer
- (f) Drag-Along Provision - this provision permits Members holding more than a majority of the Membership Units to require the other Members to sell their Membership Units to a third party. This provision is relevant if there is an intent to later sell the LLC to a third party. If the majority of LLC Members want to sell, this provision allows them to require that the other Members sell their Membership Units so that the entire LLC can be sold to a prospective buyer of the LLC.
- (g) Death of a Member – there are 3 alternatives to consider. One alternative is for the decedent’s estate and then his or her successors (beneficiaries/heirs) to step into the shoes of the Member upon his or her death. Therefore, the deceased Member’s beneficiaries and heirs keeps all economic and voting and management rights held by the deceased Member prior to death. A second alternative is for the deceased Member’s heirs and successors to only get the economic rights (distributions and income and loss allocations) attributable to the Membership Units of the deceased Member (but no voting and management rights). We don’t recommend that second alternative. The third alternative is for a mandatory buy-out of the deceased Member’s Membership Units by the LLC and/or other Members, with purchase price and payment terms to be decided upon in the Operating Agreement (appraisal method? Installment note over a period of years?).
- (h) Termination for Tax Purposes – no transfer if it would cause the LLC to terminate under Code Section 708
- (i) Compliance with Securities Law – all transfers must comply with federal and state securities laws

## **10. Disassociation**

- (a) Meaning of Disassociation – unless a buy-out occurs of a disassociated Member, he or she retains economic rights attributable to his or her Membership Units, but loses the right to vote and participate in management. We don’t recommend this. Instead, we recommend a buy-sell provision upon disassociation of a Member. Such a provision is used to ensure that the members remain ones that are active

and in good standing as it is commonly agreed upon by Members that a disassociation event is a reasonable event to trigger a buy-sell provision. In that situation, purchase price and payment terms need to be decided upon in the Operating Agreement (appraisal method? Installment note over a period of years?).

- (b) Events Causing Disassociation (e.g., encumbrance, bankruptcy/insolvency, guardianship, dissolution of a business entity that is a Member, expulsion by judicial order)
- (c) Charging Order – sole remedy of a Member’s creditor

**11. Indemnification** – should such a provision be included?

- (a) Against Expenses Incurred in a Proceeding
- (b) Against Debts and Liabilities
- (c) Insurance
- (d) Definitions (e.g., Company Agent, Other Enterprises/Another Enterprise, Expenses, Liabilities, Proceeding)

**12. Tax Matters Member** – who to appoint?

**13. Accounting, Records and Tax Matters**

- (a) Accountant – whom to designate?
- (b) Books and Records
- (c) Fiscal Year and Accounting Method – to decide upon
- (d) Reports
- (e) Code Section 754 election – to make? Unanimous consent or majority vote?
- (f) Code Section 704 Matters – to determine methods

**14. Rights of Members and Disassociated Members to Information**

- (a) Inspection and Copying
- (b) Furnishing of Information to Members
- (c) Information to Disassociated Members
- (d) Copying Charges

- (e) Exercise through Agent or Representative
- (f) Transferee
- (g) Imposition of Reasonable Restrictions and Conditions

**15. Dissolution and Winding Up**

- (a) Term
- (b) Dissolution – to determine events (e.g., unanimous vote/consent of Members, as set forth in Certificate of Formation, judicial order)
- (c) Winding Up
- (d) Distribution of Assets
- (e) No Recourse Against Members or Transferees – if assets insufficient to return capital contributions

**16. Power of Attorney**

- (a) Designating Other Members as Agent for Specific Purposes
- (b) Execution of Documents
- (c) General Power of Attorney
- (d) Consent

**17. Miscellaneous**

- (a) Entire Agreement
- (b) Amendment
- (c) Severability
- (d) Waivers
- (e) Binding Effect
- (f) No Third Party Beneficiary
- (g) Construction
- (h) Headings
- (i) Notices



- (j) Governing Law
- (k) Jurisdiction
- (l) No Partition
- (m) Attorney Fees
- (n) Partnership
- (o) Counterparts