CORPORATE MATTERS:
ANATOMY OF A LIMITED LIABILITY COMPANY AGREEMENT – PART I

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BACKGROUND

When the acquisition structure calls for the formation of a limited liability company ("L.L.C."), we typically recommend Delaware or New York (for clients doing business in New York[1]) as the jurisdiction in which to form the entity.

Once the structure is agreed upon, our clients generally ask us to form the L.L.C. and draft the relevant governance documentation, which in New York is referred to as the "operating agreement" and in Delaware law as the "limited liability company agreement." In practice, however, the terms are used interchangeably, and for purposes of this article, we will use the term "Operating Agreement" as it is more commonly used.

Following formation of the L.L.C., clients frequently request copies of the memorandum and articles of association, bylaws, and stock certificates with respect to the newly-formed entity. None of the above documents are mandatory or common with respect to an L.L.C. The equivalent of all such documents is the Operating Agreement itself. This article is the first in a series explaining what an Operating Agreement is and describing the key provisions one typically sees in an Operating Agreement.

OPERATING AGREEMENT

An Operating Agreement is the L.L.C. equivalent of a partnership agreement, except that the owners are referred to as members when the entity is an L.L.C., or a shareholders' agreement among the owners of a corporation. Although owners of a corporation are not required to enter into a shareholders' agreement, the New York Limited Liability Company Act requires that members enter into a written Operating Agreement.[2] In Delaware, an Operating Agreement is also required, but it may be implied, written, or oral.[3]

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1 Simon H. Prisk, "Corporate Matters: Are You Doing Business New York L.L.C.?," Insights 8 (2015): pp. 35-37.

2 N.Y. Limited Liability Company Law §417(a): Subject to the provisions of this chapter, the members of an L.L.C. shall adopt a written Operating Agreement that contains any provisions, which are not inconsistent with the law or its articles of organization, relating to (i) the business of the L.L.C.; (ii) the conduct of its affairs; and (iii) the rights, powers, preferences, limitations, or responsibilities of its members, managers, employees, or agents, as the case may be.

3 See the definition of "limited liability company" in Delaware Limited Liability Company Act §18-101(7).

FORMATION, PURPOSE, AND POWERS

Most Operating Agreements follow a common form. The initial sections of the agreement deal with the formation of the company. An L.L.C. is not formed by the signing of the Operating Agreement, and typically, the company will have been formed previously by the filing of a certificate of formation or organization with the Secretary of State. The date of formation and the jurisdiction in which it was formed are set forth in the Operating Agreement.

"An L.L.C. may be managed by the members, a manager appointed by the members, a board of managers, or a combination of the three."

The following sections of the Operating Agreement typically cover the purpose for which the company was formed and the powers that the company will possess. Often, these sections are taken from the state statute in the jurisdiction where the company was formed. Alternatively, a generic statement in the Operating Agreement will provide that the company's purpose and powers are as provided in the relevant statue.[4] In other words, the L.L.C. may engage in any business that may be carried on legally by an L.L.C.

If the company is a wholly-owned subsidiary, precisely defining the purpose of the company may not be necessary, as such matters will typically be dealt with between the owners of the parent company. However, if the company is being formed as an entity through which a joint venture will operate, it may be important to accurately define the purpose of the company. To illustrate, if a joint venture is formed to buy real estate, the co-venturers will want to make sure that the entity does not carry on an active program of trading in stocks and securities. Also, if there is a desire to make sure that none of the joint venture partners compete against the company, it is helpful to clearly state purpose of the company so that provision can be made elsewhere in the Operating Agreement preventing members of the company from conducting a competing business or preventing them from being an owner of a business that competes with the company.

MANAGEMENT

An L.L.C. may be managed by the members, a manager appointed by the members, a board of managers, or a combination of the three.

Typically, a single-member L.L.C. or a multiple-member company owning a small business will be managed by the members. This means that all owners share responsibility for the day-to-day management of the entity.

Companies with more substantial businesses and two or more members may want to appoint a manager who need not be a member – particularly if some of the members want to be passive. The members may want to have a say on major decisions, and in this instance, the manager may be given the power to run the day-to-day operations of the company but will be required to seek the approval of the members in order to carry out an atypical action.

A board of managers or an advisory board may also be appointed to oversee the management of the company. In this instance, management would need to consult with the board on certain business decisions outside the ordinary course of business.

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[4] *E.g.*, Delaware Limited Liability Company Act §18-106.

CAPITAL CONTRIBUTIONS

Members of an L.L.C. contribute capital to the company typically, but not necessarily, based on their ownership shares, which can be expressed as a percentage or by the issuance of ownership units. Service providers receiving a so-called profits interest in the L.L.C. are not usually required to contribute capital. Unit certificates can be obtained if desired, but typically the ownership interest in an L.L.C. is set forth as a percentage in an exhibit to the Operating Agreement.

Contributions to capital may be made in the form cash or property. Property contributions are listed and described, and the managing member or members agree on the fair market value of such property.

Each member of an L.L.C. has a capital account, which is credited with the initial capital contribution and any additional capital contributions. A full description of capital accounts will appear in Part II of this article, where allocations and distributions will also be discussed.

This section of the Operating Agreement will also cover additional capital contributions, if any, and set forth how the additional contributions can be called and the consequences of non-payment. Note also that members may loan money to the company, separate from their capital accounts.

TRANSFERS

As in a shareholders' agreement, an important provision in an Operating Agreement is the provision setting out transfer restrictions. A member may be completely prohibited from transferring his or her ownership interest, or a member could be subject to any one of a number of transfer restrictions – as mentioned in previous articles – including right of first refusal or offer, drag-along or tag-along rights, and shotgun buy/sell provisions.

In Part II of this series, we will discuss capital accounts, allocations and distributions, and the standard boilerplate provisions contained in an Operating Agreement.