

OPERATING AGREEMENTS ONE SIZE DOES NOT FIT ALL

BY GREGORY JOHNSON

“Do I really need an operating agreement for my company? Can I just use one I found online? Can you just send me a form operating agreement to use?”

Many of us receive these questions from clients looking for a quick and easy solution for their operating agreements. While it's true that an operating agreement isn't the be-all and end-all of a partnership, it holds significant importance. It serves as the guiding framework for how a company operates, outlining the rights and responsibilities of its members. And because those rights and responsibilities vary across different members and different businesses, so must the agreements that describe them.

GET TO KNOW YOUR CLIENT

When crafting an operating agreement, it is essential to understand the intricate details of our clients' businesses and aspirations. Understanding how the members intend to conduct business (or how they've done so in the past) will help guide the structure of the operating agreement.

Consider, for instance, a limited liability company owned by a husband and wife, where the sole asset of the business is a rental property. Now, juxtapose that with a seven-member company dedicated to widget manufacturing. Their operating agreements would likely look very different.

The first step to preparing a useful operating agreement for a client is to get to know that client. They may balk at all the questions, but through examination and exploration, you can gain the background information necessary to craft an operating agreement that meets their objectives.

These six questions will give you a good starting point:

- **Number of Members:** How many owners are there? Is everyone aligned (which is more likely in smaller ownership groups), or are there diverse opinions and goals?
 - **Relationships between Members:** Once you know the number of owners, you will want to understand their relationships to one another. Figuring out how they are all associated may prove to be complicated. Are they family members? Are some of the members married to each other? Are they simply strangers who came together for an investment?
 - **Percentage Ownership:** Understanding voting power within the company is critical. Does one person or a specific group of members hold the majority of voting rights? Does everyone have equal voting power? Also consider whether any of the members' relationships may lead them to typically vote as a bloc.
 - **Class of ownership:** Should all members vote? Or should decision-making be left to a few members, with the others just receiving distributions?
 - **Age:** Ask your client to give you a birds-eye view of the membership. What are the demographics of the current ownership? Is anyone looking to retire soon? Have they thought through their succession plan?
 - **Current roles in the Company:** Are all of the members active employees in the company? Are members expected to perform certain functions as a result of being a member? Are there employment agreements for members that perform various roles within the company?
- provisions are right for them.
- **Restrictions on Transferability:** Most operating agreements restrict transfers of ownership by the members, but many will allow some exceptions. One common exception is the ability of a member to transfer his/her interest to a trust for the benefit of the member. Other operating agreements — typically those for family-owned businesses — allow transfer to other family members.
 - **Management Structure:** Many operating agreements address how the company will be managed. Will the day-to-day operations of the company be managed by the members, or will the members appoint a manager? Will the members appoint officers with specific roles and authority? If the company will be operated by a manager, how broad is that manager's authority? What decisions will be made by the members and not the manager? Will some member decisions require majority vote and others supermajority or unanimous consent?
 - **Buy-Out Scenarios:** The operating agreement should contain the triggering events and process for how the buy-out of a member will work under various scenarios. The client should understand and consider which buy-out options would work for their business. These are some common buy-out events to consider:
 - **Individual Sale to a Third-Party:** If a member wants to sell their interest to an unrelated outside party, most operating agreements will give the company a right of first refusal to purchase the offered interest so that the members can avoid doing business with a new or unknown third-party.
 - **Death of a Member:** Many — but not all — operating agreements will require a mandatory buy-out by the company upon the death of a member. Or, in the case of a family business, members might prefer the

ability to transfer to other family members. Generally, a deceased member's interest gets a stepped up basis so the sale back to the company is tax free.

- **Disability of a Member:** Are all members active in the company? Would the disability of a member hurt the company's performance? Some operating agreements provide for redemption of the member's interest upon disability. If the client wants this provision, consider what would count as a disability.
- **Divorce:** Many members only want to do business with their current partners, not the members' spouses. Accordingly, many operating agreements require a buy-out of the member upon divorce so that the company interest is not an asset of the divorce.
- **Tag-Along/Drag-Along:** A client should understand tag-along and drag-along buy-out scenarios to determine whether they are appropriate for their operating agreement. A tag-along right is a right granted to the minority members to "tag along" on the majority members' sale to a third party. A drag-along right is the majority member's right to "drag along" the minority members in a sale. Many operating agreements don't contain these rights. For those that do, the sale price for the forced sale is upon the same terms and conditions as the majority sale.
- **Put/Call Rights:** Without a "put" right, a member typically has no ability to exit or leave the partnership. A "put" right is a member's right to "put" their interest back to the company and require a buy-out. A "call" right is the company's ability to "call" back a member's interest. These are not very common in operating agreements, as a general goal for many operating agreements is to bind all members together until they all decide to sell or dissolve.
- **Purchase Price for Buy-Out:** Even if the client wishes to include some of the

above buy-out provisions in the operating agreement, the purchase prices and terms may differ for each provision. For example, the purchase price for a Third-Party Sale or a Put Right might be at a discount of fair market value (70%-90%) in order to discourage the buy-out. A Call Right buy-out, on the other hand, might be at a premium of fair market value (110%-130%) to compensate the member who didn't ask to be bought out.

- **Payment of Purchase Price:** Consideration needs to be given to how the company will pay the purchase price. Most companies don't have large cash reserves on hand to buy out members. Hence, most operating agreements would structure the buy out over a period of time with a promissory note from the company. Would this time period be the same for each buy out scenario? What if there is key-man insurance to use upon the death of one of the members?
- **Restrictive Covenants:** Should the operating agreement contain non-competition or non-solicitation provisions? What if the membership is made up of active and passive investors? Should the passive investors be prevented from investing in similar operations? Successful drafting relies on understanding the clients and their unique circumstances. By incorporating provisions that address situations like the above, operating agreements can be tailored to the specific needs of the client and provide clear guidance for decision-making, even when not all members are in agreement.

THE ROLE OF AI & ITS LIMITATIONS

While we have all heard about Artificial Intelligence's revolutionary impact on the legal profession, that doesn't mean you should rely on artificial intelligence when drafting an operating agreement.

- **Standardization versus Tailored Solutions:** AI-generated templates may offer convenience and time-saving benefits, but they often provide a one-size-fits-all approach. This

article has highlighted areas of operating agreements that can vary greatly from company to company and the importance of tailoring them to the unique needs of the company in question.

- **Complexities and Nuances:** Operating agreements involve intricate legal concepts and negotiations that require human judgment and experience, along with an understanding of contextual nuances. AI algorithms may struggle to capture the subtleties and complexities of individual cases, potentially leading to oversights or errors.
- **Potential Risks and Liabilities:** Relying solely on AI-generated operating agreements may expose parties to unforeseen risks and liabilities. Drafting lawyers have the opportunity to ensure that the agreement adequately addresses potential legal issues and outlines the agreed-upon terms.

Operating agreements are far from one size fits all; they are intricate documents that require a deep understanding of clients and their businesses. Attorneys who invest the time to learn about their clients' unique circumstances and anticipate various scenarios are able to craft operating agreements that better serve their clients' needs. By addressing key elements, ensuring compliance, and anticipating future contingencies, attorneys can create operating agreements that provide a solid foundation for their clients' success.



Gregory Johnson is Chair of the Business and Real Estate Practice Groups at Schneider Smeltz Spieth Bell. He concentrates his practice on corporate transactions, mergers and acquisitions, and real estate matters. In addition, he is experienced in counseling clients with the formation and disposition of all types of business entities including corporations, limited liability companies, and limited partnerships. He has been a CMBA member since 2006. He can be reached at (216) 696-4200 x1119 or gjohnson@sssb-law.com.