What You Need in Your Business LLC Operating Agreement

A Checklist of Items to Discuss with Our Firm Attorneys©

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A. The Basics

1. First, under the new Arizona Limited Liability Company Act ("Act"), after September 2020 an Operating Agreement is both required and highly recommended.

2. Under the Act the members owe a fiduciary duty to the company and other members unless the members opt out of this default rule by inserting a provision to that effect in the operating agreement. In a nutshell a "fiduciary duty" is the requirement not to act out of self-interest to the detriment of the company or the other members. An example of this would be misusing company funds, or stealing a company idea or opportunity for personal use. Because a fiduciary duty is the highest duty of care and loyalty prescribed by law, a claim for breach of fiduciary duty can be the "knock-out punch" against a partner in a partnership dispute.

3. Under the new Act funds from dissolution are divided equally, regardless of percentage ownership. Thus, in the dissolution of a four member LLC, a 60% member may still receive one-fourth of the proceeds from sale of the company assets.

4. The requirements for the right of inspection of books and records are limited to a proper purpose. This was the case law before but now it is by statute.

5. Do the members vote their "percentage interest?" Unless the operating agreement specifies percentage voting, voting defaults to the statute which is a vote *per capita*; that is one-person-one-vote. With *per capita* voting a 60% member would get one vote, the same as a 10% owner.[1]

5. If the company is Manager-managed, the Agreement needs to define the Manager's authority: (a) virtually unlimited "King Tut" authority, (b) unanimous approval for every decision, or (c) Manager authority for ordinary course of business transactions, then the majority or unanimous vote of the members for transactions outside the ordinary course of business, like borrowing money, pledge of assets, sale of company, etc.

6. Contribution given for ownership interest, whether money, property or services ("sweat equity") and for what percentage.

7. Decision whether members' share of profits is according to their percentage interest or some other basis. For example, a 60% member could receive 85% of the profits or 10%, whatever is the mutual agreement.

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[1] This little-known principle of law can be a major surprise, e.g. where the majority owner plans to "rule the roost" but finds herself outvoted by the other members under the one person one vote rule.

Note: Given the difference in state law, and company ownership and circumstances, using a form document from say, Rocket Lawyer or Legal Zoom, probably will not satisfy the statutes. In any case the statute and good practice require consideration and discussion of the questions raised by the new Act. If it ever was, an operating agreement can no longer be a form one-size-fits all document. This should preclude a universal form template from online document services.

B. Beyond the Basics to What Really Matters for Business Partnerships, like LLC's

I have written about this before.[2] I know of no legal document, otherwise well drafted by an attorney according to normal practice standards, which is as inadequate as the standard operating agreement. Reasons are explained in my article How to Draft an Operating Agreement, cited in the footnote below. As the reasons are provided elsewhere, here is a bare checklist of things needed:

1. Vesting for sweat equity over time, e.g. five years of work done, rather than all at once at the beginning. There is also the issue that if the sweat equity member is being paid for work or takes a full distribution, what work pays for the equity.

2. If the company wants to require it, a statement that Active Participation, i.e. continuous, active, and significant services to the company, are a requirement for membership. A member not actively participating may be expelled.

3. A provision allowing withdrawal or expulsion of a member[3] and specifying on what grounds.

4. Mandatory or optional buy-out requirement upon withdrawal or expulsion. Without this provision there is neither the duty to buy nor the duty to sell.

5. A formula or method for determining the buyout price. (Without provisions 4 and 5 an extended legal dispute between the parties is likely.)

6. The "restrictive covenants" of non-competition, non-solicitation, non-disparagement and confidentiality. Otherwise a member may walkout and immediately compete against the company.

7. Perhaps arbitration because it is a private proceeding not part of the public record unless and until the arbitration award is entered as a judgment. And although arbitration has high upfront fees it tends to be faster and cheaper overall.

[2] How to Draft an Operating Agreement, available at azbuslaw.com/Publications/Articles.

[3] An expelled member becomes a "dissociated member." Something often not fully understood is that the dissociated member still has a financial or "economic" interest in the company and right to inspect the books. He or she would receive distributions along with the regular, full status members. What the expelled member loses is the right to vote or have any say in company management.