Creating an LLC Operating Agreement

Like corporate bylaws, operating agreements govern the workings of an LLC

An LLC operating agreement allows you to structure your financial and working relationships with your co-owners in a way that suits your business. In your operating agreement, you and your co-owners establish each owner's percentage of ownership in the LLC, his or her share of profits (or losses), his or her rights and responsibilities, and what will happen to the business if one of you leaves.

Why an Operating Agreement Is Necessary

While many states do not legally require your LLC to have an operating agreement, it's foolish to run an LLC without one (even if you're the sole owner of your company).

An operating agreement helps your LLC by guarding your limited liability status, heading off financial and management misunderstandings, and making sure your business is governed by your own rules -- not default rules created by your state.

Protecting Your Limited Liability Status

The main reason to make an operating agreement is as simple as it is important: It helps ensure that courts will respect your limited personal liability. This is particularly key in a one-person LLC where, without the formality of an agreement, the LLC will look a lot like a sole proprietorship. Having a formal written operating agreement will lend credibility to your LLC's separate existence. For an operating agreement for a single-owner LLC, see Nolo's Legal Forms for Starting & Running a Small Business, by Fred Steingold, or Quicken Legal Business Pro.

Defining Financial and Management Structure

Co-owned LLCs need to document their profit-sharing and decision-making protocols as well as their procedures for handling the departure and addition of members. Without an operating agreement, you and your co-owners be ill-equipped to settle misunderstandings over finances and management. What's more, your LLC will be subject to the default operating rules created by your state law.

Overriding State Default Rules

Each state has laws that set out basic operating rules for LLCs, some of which will govern your business unless your operating agreement says otherwise. (These are called "default rules.")

Many states, for example, have a default rule that requires owners to divide up LLC profits and losses equally, regardless of each member's investment in the business. If you and your co-owners did not invest equal amounts in the LLC, it's doubtful you'll want to allocate profits equally. To avoid this, your operating agreement must spell out how you and your co-owners want to split profits and losses.

By writing an operating agreement, you can choose the rules that will govern your LLC's inner workings, rather than having to follow default rules that may or may not be right for your LLC.

What to Include in Your Operating Agreement

There's a host of issues you must cover in your LLC operating agreement, some of which will depend on your business's particular situation and needs. Most operating agreements include the following:

- the members' percentage interests in the LLC
- the members' rights and responsibilities
- the members' voting powers
- how profits and losses will be allocated
- how the LLC will be managed
- rules for holding meetings and taking votes, and
- buyout, or buy-sell, provisions, which establish a framework for what happens when a member wants to sell his or her interest, dies, or becomes disabled.

While these items may seem fairly straightforward, each requires important details. Make sure you fill out the particulars in the following key areas.

Percentages of Ownership

The owners of an LLC ordinarily make financial contributions of cash, property, or services to the business to get it started. In return, each LLC member gets a percentage of ownership in the assets of the LLC. Members usually receive ownership percentages in proportion to their contributions of capital, but LLC members are free to divide up ownership in any way they wish. These contributions and percentage interests are an important part of your operating agreement.

Distributive Shares

In addition to receiving ownership interests in exchange for their contributions of capital, LLC owners also receive shares of the LLC's profits and losses, called "distributive shares." Most often, operating agreements provide that each owner's distributive share corresponds to his or her percentage of ownership in the LLC. For example, because Tony owns only 35% of his LLC, he receives just 35% of its profits and losses. Najate, on the other hand, is entitled to 65% of the LLC's profits and losses because she owns 65% of the business. (If your LLC wants to assign distributive shares that aren't in proportion to the owners' percentage interests in the LLC, you'll have to follow rules for "special allocations."

Distributions of Profits and Losses

In addition to defining each owner's distributive share, your operating agreement should answer these questions: How much -- if any -- of the LLC's allocated profits (the members' distributive shares) must be distributed to LLC members each year?

Can members expect the LLC to pay them at least enough to cover the income taxes they'll owe on each year's allocation of LLC profits? (An LLC owner, like a partner in a partnership, has to pay income taxes on the full amount of profits that are "allocated" to him or her, not just on profits that are actually paid out. When profits are plowed back into the business instead of being paid out, they are still treated as income to the owners, in the proportions allocated.)

- Will distributions of profits be made regularly or are the owners entitled to draw at will from the profits of the business?
- Because you and your co-owners may have different financial needs and marginal tax rates (tax brackets), the allocation of profits and losses is an area to which you should pay particular attention.
- You may want to run the allocation part of your operating agreement by a tax professional, to make sure it achieves the overall results you had in mind.

Voting Rights

While most LLC management decisions are made informally, sometimes a decision is so important or controversial that a formal vote is necessary. There are two ways to split voting power among LLC members: Either each member's voting power corresponds to his or her percentage interest in the business, or each member gets one vote -- called "per capita" voting. Most LLCs mete out votes in proportion to the members' ownership interests. Whichever method you choose, make sure your operating agreement specifies how much voting power each member has, as well as whether a majority of the votes or a unanimous decision will be required to resolve an issue.

Ownership Transitions

Many new business owners neglect to think about what will happen if one owner retires, dies, or decides to sell the owner's interest in the company. These concerns may not be on your mind now, but such situations crop up frequently for small business owners, and it pays to be prepared. Operating agreements should include a buyout scheme -- rules for what will happen when a member leaves the LLC for any reason.

How to Create an Operating Agreement

Obviously, you'll need help beyond this article to make your own operating agreement. There are many sources for blank or sample LLC operating agreements, but you must be sure that your operating agreement is drafted to suit the needs of your business and the laws of your state.

Software that helps you create your own LLC may be your best alternative. For example, LLC Maker (from Nolo) will use your input to customize an operating agreement that suits the needs of you and your co-owners and meets the requirements of your state's laws.

You can also pay a business lawyer for assistance -- in fact, we recommend this for LLCs with more than five owners, and also for those that opt to have a special manager or management group run the LLC. Lawyers typically have several types of standard agreements on hand that can be customized for your LLC. Although using a lawyer can get pricey, the peace of mind you'll gain from knowing that your LLC is protected -- and has adopted operating rules that will best serve its interests -- may well be worth the cost.