

OPERATING AGREEMENTS: A CHECKLIST FOR DISCUSSION PURPOSES

Why prepare an Operating Agreement?

- Avoiding misunderstandings and mistaken assumptions
- Prepare for the possibility of intrusion by third parties
- Anticipate failure and success
- Anticipate the end of the relationship

Planning the Business

The Business and the Business Plan. I recommend that you have and maintain a budget, business operating plan and, where applicable, a sales and marketing plan. The process of getting ideas down on paper is very helpful in aligning members and others.

1. How long do the members plan to be involved in the business?
2. Will the members ultimately sell their investment or the business? When? To whom? How will that work? Or, will you simply run it for cash flow for as long as it goes, and then wind it up?
3. Do any members plan or want to pass their interest on to their children or other family members?
4. What is each member's anticipated exit strategy or understanding?

Legal Structure

Members

1. List full names, including corporate names, if corporations or LLCs.
2. Who are the voting members? How many votes will they have? What will they pay for their shares? When?
3. Who are the equity members – same as voting members or economic interest only? What percentages will they own? What will they pay for their interest? When?
4. Will there be any preferred interests? If yes, why, what, and for what purpose?
5. Interest structure - have types and attributes of membership interests been agreed to? Has each member consulted his or her accountant in that regard?

Company Managers

6. How many managers will you have? Who will they be? How will they be selected? What are their full names and home addresses?
7. If multiple managers, how will manager voting work?
8. Will managers receive compensation?

Company Officers. Officers manage the day to day business of the company.

9. How many officers will you have? What titles will they have? How will they be changed or selected? What are their full names and home addresses?

Personal Contribution and Commitment

1. What are the strengths and weaknesses of each member?
2. What risks is each member actually going to take on in relation to the business?
3. Will some members contribute more to the business? What? When? Why? Will some members get greater rewards from the business? What? When? Why?
4. What will the Members contribute to financing the business?
5. What monies or monies worth are the members putting in? When?
6. Is that to be in the form of loans or equity?
7. If loans: Are they going to bear interest? Are they going to be secured? What are the repayment terms? When? How? Who decides?
8. If equity: What kind? What attributes? Preferred return to certain investors?
9. Have you considered return of contribution, as well as return on contribution?
10. What if more money is needed in the future? Who will decide? Where will it come from?
11. Will members be required to participate with more money, guarantees, etc.? If yes, on what terms?
12. What if a member does not come up with their share? Or if you do if you cannot agree on putting in more money? Alternatives include secured loans from parties that want to; forced dilution by the parties that want to; initiate some buyout time procedure by the parties that want to of the parties that do not want to; wind up the company.
13. What else will each member contribute to the business and the company, in both tangibles and intangibles?
14. How will each member participate in business operations, if at all?
15. What time will each member spend in the business, and doing what? For how long? How will they be paid for that?

Members as Employees

1. Will Members be employees? Who? Why? What will they do? Who will they report to?
2. Can they be fired with or without cause? By who? Under what terms?
3. How are member salaries/bonuses/commissions going to be set? What if you cannot agree? (Arbitration? By whom?)

Restricting the Members to Protect the Business

1. What activities will the members be obligated to do together through the business?
2. What will the members be free to do outside of this business?
3. What kind of special covenants will apply to the members while they are members? e.g. noncompetition, non-solicitation, ownership of any inventions
4. What about family members or others who are not members?
5. What kind of special covenants will apply to the members after they cease being members? e.g. non-solicitation, non-competition – What activities? In what territories? For how long?
6. What about family members or others who are not members?
7. Is it different if a member is forced out against their will?
8. Or if they quit or walk away?
9. Is it different if the company is no longer carrying on business?

Member Decision-Making

Decision Making Generally, Strategic and Operational

1. Consider both strategic issues (e.g. new members, buying new businesses, selling the business) and operational (e.g. signing authorities on contracts and bank accounts, ability to make binding commitments on behalf of the company, hiring and firing, purchasing, selling, etc.).
2. Are there any general principles for making decisions you want to see in the membership?
3. Will there be different kinds of decisions that get made in different ways?
4. Who will the decision makers be? In what areas? Why? How will they make decisions?
5. How will voting rights be handled? On day to day issues versus big issues? Is the general rule simple majority vote? 2/3 vote? Unanimous vote? Supermajority? Or something else?
6. How will you handle disagreements? Of the things where minority members can block the majority, or things that have to be unanimous, are there any that you would be willing to have resolved by arbitration etc. to avoid having a deadlock?
7. Of the things where minority members can block the majority, or things that have to be unanimous, are there some that you would be willing to resolve by some kind of “super majority” (e.g. 75%) to avoid a deadlock?
8. If you do end up with things that create a deadlock, what would you do? Just live with it? Arbitration? Third party expert? Some kind of buyout mechanism? Wind up the business? Sell the business?

Distributing Profits

1. Who will decide when to distribute profits to members and how much to distribute?
2. What if they cannot agree? Arbitration? Deadlock?
3. Are there any milestones you want achieved before profits are distributed?
4. Are there any priorities for how profits should be used?
5. Are profits distributed based on shares only or something else too?

6. Is there a distinction between distributions from net income and distributions from a capital transaction?

Company Financial Matters

1. Who will be the Tax matters member? Who will have a say in hiring and firing the company accountant? How will that be handled?
2. What will be the company year end date be?
3. Will you have audited financial statements?
4. Will all members have full access to company books and records? What financial and other reports will be distributed to the members? When and how?
5. Who will have signing authority on the company bank account? With any dollar limits? Who will have a say in changing that? How will that be handled?
6. How will the company be taxed? For example, LLC's can elect to be taxed as an S corporation. Be sure to discuss this issue with your accountant or attorney.

Transferability and Exit Strategies

1. Can members transfer their shares or investment? To whom? Under what conditions? With what approvals? Any time or milestone based limitations? Any rights of first refusal?
2. Can a member get out if they want out? How? Options include: wind up the business; sell the whole business; sell the whole business with rights of first refusal for each member; majority buys out minority member; shotgun buy-sell; find a third-party buyer for your interest; some combination of all of the above.
3. If the others are forced to buy you out: How will the purchase price be determined? What will be the payment terms? Any security? How will they finance that?
4. Will you pay a penalty in the purchase price for leaving the membership?
5. Any restrictions on when or how you get? e.g. cannot withdraw within first two years of starting out?
6. Can the members get rid of a member they no longer want? Who decides? What voting? How will you handle it? Options include: wind up the business; sell the whole business with rights of first refusal for each member; majority buys out minority member; shotgun buy sell; find a third-party buyer for their shares; some combination.
7. If the others are forced to buy out: How will the purchase price be determined? What will be the payment terms? Any security? How will they finance that?
8. Any restrictions on going this way? e.g. when – cannot force out within first two years of starting out?
9. Can some members force a sale of the whole business? With a drag-along?
10. Do you want a shotgun buy-sell? A “shotgun” means one party sets the price and the other chooses whether to buy or sell? Any restrictions, time or otherwise?
Note: shotgun clauses work best where you have members of roughly equal percentage, with roughly equal financial strength, both of whom would probably want the business if the company fell apart. They can produce unfair results in different circumstances.
11. How will you handle a member default? What do you do if a member defaults in their obligations to the LLC? When do you do it? After how long? After what notice?
12. How does it affect their profits? Their votes? Their right to appoint officers?

13. How do you get them out of the company? On what terms? Terms more onerous than forced out when not in default? Options include: wind up the business; sell the whole business with rights of first refusal for each member; non-defaulting member buys out defaulting member at reduced valuation; find a third-party buyer for their shares at reduced valuation; some combination.
14. If the others are forced to buy out: How will the purchase price be determined? What will be the payment terms? Will there be security?
15. How are things different in above scenarios if members are dismissed “for cause”? Or “without just cause”? Or they quit? Or retire?

Disability

16. What will happen if a member is disabled? What if a member becomes sick or disabled for an extended period of time? Difficult issue for managing member.
17. What will happen to their: Salary? Profit share? Shareholdings? - during the disability.
18. What will happen if they have not recovered after a certain period of time (e.g. six months)? Options include: wind up the business; sell the whole business with rights of first refusal for each member; majority buys out minority member; shotgun buy-sell; find a third party buyer for their shares; some combination.
19. If the others are forced to buy out: How will the purchase price be determined? What will be the payment terms? Will there be security? How will they finance that?

Death

20. What happens if a member dies?
This is a complex area that may require input from the company accountant and a life insurance representative.
21. Can the company force their estate to sell out?
22. Can the estate force the company or the other members to buy them out?
23. Can shares be left to children, spouses, etc.? Other Options include: wind up the business; sell the whole business with rights of first refusal for each member; find a third-party buyer for their shares; some combination.

Valuation Issues in Buyout

24. How are shares or investment valued? How is purchase price calculated? What are payment terms? Will there be security? How will the buyer finance it?
25. Do you take the death into account in assessing value?

Use of Insurance to fund Buyout

26. Do you fund this with insurance? How much insurance, and how is that updated?
27. Who owns the insurance? Who pays the premiums? How do the funds flow?
28. What do you do if a member is not insurable?
29. What do you do if insurance is too expensive?
30. What do you do if insurance claim is denied?
31. What if there is not enough insurance money?
32. What if there is “surplus” insurance money?

Judgment Creditors

33. What will you do if a member loses control of their investment to a third party?
34. What do you do if a member loses control of their shares through bankruptcy, marital split up or some other circumstance?
35. How does it affect their profits? Their votes? Their right to appoint officers?
36. How do you get them out of the company? On what terms? Terms more onerous than forced out when in control? Options include: wind up the business; sell the whole business with rights of first refusal for each member; remaining member buys out other member; find a third party buyer for their shares; some combination.
37. If the others have right to buy out: How will the purchase price be determined? What will be the payment terms? Will there be security? How is all that financed?

Other Considerations

1. Is there anything else that is important to you and that you want addressed in your operating agreement?