

**PART 5. OPERATING AGREEMENTS UNDER THE NEW ACT—
INTRODUCTION, DEFINITION, PURPOSES, EVALUATIVE
CRITERIA**

OVERVIEW

A. INTRODUCTION.....	1
B. WHAT FUNCTIONS SHOULD OPERATING AGREEMENTS PERFORM?.....	1
C. STRUCTURE AND STYLE OF OPERATING AGREEMENTS—OVERVIEW; FORM 3.1.....	2

EXHIBIT

EXHIBIT 5-1 General-purpose Form 3.1

A. INTRODUCTION.

- a) The centrality of operating agreements in LLC formation practice.
 - i) For reasons I’ll describe below:
 - (1) The key document in forming any LLC under the New Act is the LLC’s operating agreement; and
 - (2) The key skill of any LLC formation lawyer is that of knowing how to plan and negotiate operating agreements effectively.
- b) Purpose of this Part. In this part of the seminar, I will provide a general definition of the term “operating agreement” and I will define what I believe are best practices in creating the *formal* features of LLCs—i.e., their structure, their format, their prose style, and their visual appearance.
- c) Parts 6 through 9. In Part 6, I’ll discuss the topic of *model* operating agreements—often referred to by LLC lawyers as LLC “forms.” In respectively, Parts 7 and 8, I’ll discuss issues concerning the substantive issues that should be addressed in planning and drafting of operating agreements for, respectively, single-member LLCs whose members are individuals and single-member LLCs whose members are entities; and in Part 9, I’ll discuss the substantive issues that should be addressed in drafting operating agreements for multi-member LLCs..
- d) Definition of operating agreement. An operating agreement is a contract among the members of an LLC (or, in the case of a single-member LLC, between the member and the LLC) that defines the purpose of the LLCs, its legal and tax structure, and the rights and duties of its members and managers.

B. WHAT FUNCTIONS SHOULD OPERATING AGREEMENTS PERFORM?

In my view, operating agreements should perform three main functions for the LLCs and the LLC members and managers for which it is drafted.

- 1) Issue identification.
 - a) First, these agreements should identify all of the legal and tax issues important to the LLC and its members.
 - b) In particular, they should identify every legal and tax issue that may eventually become contentious among the members and managers.
- 2) Issue resolution.
 - a) Secondly, they should resolve these issues in a manner that accords with the parties' negotiations and that legally binds the parties.
 - b) In general, operating agreements will be binding to the extent they are clear and that none of their provisions conflicts with a mandatory act of the governing LLC act or with general principles of contract validity.
- 3) Teaching documents and users' manuals.
 - a) Third, they should serve the parties to the operating agreement as pre-formation teaching documents before they enter the LLC deal and as users' manuals thereafter.
 - b) In general, they will fulfill these functions if they are properly structured, if they are written in plain English and if they meet the standards of structure and style summarized below.

C. STRUCTURE AND STYLE OF OPERATING AGREEMENTS—OVERVIEW; FORM 3.1.

- 1) Introduction. To achieve the above goals:
 - a) Operating agreements must have a good structure;
 - b) Obviously, they must contain all provisions that are needed by the LLC in question;
 - c) These provisions must be set forth in an appropriate sequence;
 - d) They must be written in an appropriate style;
 - e) They must have an appropriate visual appearance.

The guidelines concerning operating agreement structure and the other guidelines in this Part are aptly illustrated, I hope, in General-Purpose Form 3.1, which is set forth in Exhibit 5-1 of this Outline. Form 3.1 is a form for an LLC that has two equal members and a general partnership management structure and that is taxable as a partnership.
- 2) Structure. To structure an operating agreement properly means to include in it all of the parts and provisions that it needs and to do so in the proper order.
 - a) Parts. To be well structured, an operating agreement should the following parts:
 - i) A title page. This page is useful in providing the agreement with an appropriate formality and dignity.

- ii) A summary table of contents. Most people are better able to understand the details of agreements if they can first obtain a general understanding of them. To provide this understanding, you need a summary table of contents.
 - iii) A detailed table of contents. Detailed tables of contents are useful as further introductions to the contents of operating agreements and as tools for finding specific provisions.
 - iv) A table of exhibits. This table, too, can be indispensable to readers in gaining a solid basic understanding of the agreement.
 - v) The body of the agreement. This part of the agreement contains its actual provisions.
 - vi) The texts of all of the exhibits in the agreement.
- b) Provisions. Overview of the key provisions that should be contained in operating agreements for, respectively, single-member LLCs whose members are individuals, single-member LLCs whose members are entities and multi-member LLCs are addressed in, respectively, Parts 7, 8 and , 9 of this Outline.
- c) Sequence of provisions. In general, the provisions of an operating agreement should flow in a logical order. This means the order mostly likely to be useful to the members and managers. The order of provisions should generally be as follows:
- (1) Preliminary provisions about the LLC—e.g., provisions concerning its name, management structure, federal tax regimen structure, taxable year and method of accounting (Form 3.1, Section 1);
 - (2) Preliminary provisions about the operating agreement, including a provision concerning its effective date (Form 3.1, Section 2);
 - (3) Financial provisions—i.e., provisions concerning contributions, allocations, distributions, and capital accounts (Form 3.1, Sections 3-6);
 - (4) Provisions concerning events of dissociation (Form 3.1, Section 7);
 - (5) Provisions concerning transfers of membership rights (Form 3.1, Sections 8 through 11);
 - (6) Management provisions (Form 3.1, Sections 12-15);
 - (7) Fiduciary provisions and related provisions (Sections 16-21);
 - (8) Record-keeping provisions (Form 3.1, Section 22);
 - (9) Dissolution provisions (Form 3.1, Section 23);
 - (10) Provisions concerning the termination of the operating agreement (Form 3.1, Section 24);
 - (11) Dispute resolution provisions (Form 3.1, Sections 25 through 27) ; and
 - (12) Boiler plate provisions (Form 3.1, Section 28).

3) Style. Operating agreements should meet appropriate standards of:

a) *English* prose; and

b) *Contract* prose.

In general, this means they should be written in plain English, not in legalese.

4) Visual appearance.

a) The visual appearance of the agreement should such help readers to understand its content. To achieve this goal, the agreement should contain plenty of white space. Crowded pages confuse the brain.

b) More generally, the agreement should *look good* to prospective readers from even a purely aesthetic viewpoint. This means not only lots of white space but also graceful font types and sizes and graceful formatting .