

PART 6. LLC MODEL OPERATING AGREEMENTS

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A. MODEL OPERATING AGREEMENTS—DEFINITION; IMPORTANCE

- 1) Definition. Model operating agreements are, in essence, blank operating agreements. As mentioned in Part 3 of this seminar, there are two main kinds of model operating agreements—general-purpose model operating agreements and special-purpose model operating agreements. In this part, I will discuss only general-purpose model operating agreements.
- 2) Importance. For reasons discussed in greater detail below, good model operating agreements are essential in drafting operating agreements *competently, efficiently* and *profitably*.
 - a) Competence. Good model operating agreements identify all of the issues generally relevant for the type of LLC deal for which they are designed. They thus protect you from overlooking significant issues in the deal.
 - b) Efficiency. Good model operating agreements protect you from having to “reinvent the wheel” in drafting operating agreements.
 - c) Profitability. Good model operating agreements enable you to draft operating agreements efficiently. They thus provide a justification to you to bill clients for all of your time in drafting them.

B. WHAT TYPES OF MODEL OPERATING AGREEMENTS SHOULD YOU HAVE; HOW MANY OF THEM SHOULD YOU HAVE?

- 1) The three key LLC structures.
 - a) The three LLC structures—in general. What types of model operating agreements

should you have? How many of them should you have?

- i) In order to answer these questions, it is useful to understand the basic legal and tax structures of LLCs themselves as they actually exist in the business world.
 - ii) In my experience, LLCs are best characterized for LLC formation purposes on the basis of three main structures—namely:
 - (1) Their *ownership* structure;
 - (2) Their *management* structure; and
 - (3) Their *federal tax* structure.
- b) Using the three structures to choose operating agreements. Whenever you are assisting clients in forming LLCs, you should work with them to determine what LLC ownership structure, management structure and federal tax structure will be best for them. On that basis, you can readily pick the best model operating agreement for them, and this, in turn, will greatly facilitate the rest of the LLC formation process for you and them.
- 2) Other LLC structures don't work in organizing the world of LLCs and LLC model operating agreements for LLC formation purposes. LLCs have many other legal and tax structures—for example, their buy-sell structure, their fiduciary structure and their dispute resolution structure. However, in helping you choose the right model operating agreement for your client, the above three-structure approach *works*; you don't normally have to consider any other structures in making this choice. Empirically, using these other structures in making this choice simply doesn't seem to help. I'm honestly not quite sure why.

C. LLC OWNERSHIP STRUCTURES

There are three main types of LLCs on the basis of ownership structure:

- 1) Single-member LLCs whose members are individuals;
- 2) Single-member LLCs whose members are entities; and
- 3) Multi-member LLCs.

D. LLC MANAGEMENT STRUCTURES

There are 10 types of LLC management structures:

- 4) Management structures of single-member LLCs whose members are individuals. Single-member LLCs whose members are individuals can have any of three main management structures:
 - a) Management by the member;
 - b) Management by the member and an assistant manager (for continuity of management if the member is unable to manage); and
 - c) Management by a third-party non-member manager.

- 5) Management structures of single-member LLCs whose members are entities. Single-member LLCs whose members are entities can also have any of three main management structures, but these management structures are quite different from those of single-member LLCs whose members are individuals. The three structures are:
 - a) Management by a single manager (for a small single-member LLC);
 - b) Management by two or more individuals (who often have traditional corporate officer titles) (for a larger single-member LLC); and
 - c) Management by an internal board of directors and officers (for a large, complex single-member LLC—not generally recommended).
- 6) Management structures of multi-member LLCs. Multi-member LLCs can have any of four main types of management structures:
 - a) General partnership management structures;
 - b) Limited partnership management structures in which the members have broad management rights;
 - c) Limited partnership management structures in which the managers have broad control rights; and
 - d) Corporate management structure.

E. LLC FEDERAL TAX STRUCTURES

The federal tax structures of LLCs depend on their ownership structures.

- 1) Federal tax structures available to single-member LLCs whose members are individuals. Single-member LLCs whose members are individuals can be subject to federal income taxation as “disregarded entities,” C corporations or S corporations.
- 2) Federal tax structures available to Single-member LLCs whose members are entities. Single-member LLCs whose members are entities can be subject to federal income taxation either as “disregarded entities” or as C corporations.
- 3) Federal tax structures available to multi-member LLCs. Multi-member LLCs can have any of three federal income tax structures—that of partnerships, C corporations or S corporations.

F. THE 10 MAIN TYPES OF LLCs; THE 28 MAIN TYPES OF GENERAL-PURPOSE MODEL OPERATING AGREEMENTS

- 1) The 10 main types of general-purpose model operating agreements. On the basis of the above three structures, there are 10 main types of LLCs. See Exhibit 6-1.
- 2) Many of the 10 types of LLCs require more than one general-purpose model operating agreement.
 - a) As shown in the case of Type 1 LLCs, many of the 10 types of LLCs require more than one general-purpose model operating agreement.
 - b) In addition, in the case of multi-member LLCs, an LLC type may need more than

one general-purpose model operating agreement to accommodate the linguistic differences as between agreements for just two members and those for LLCs with three or more members.

- 3) The 28 main types of general-purpose model operating agreements. On the basis of the above three structures, you will need 28 main types of operating agreements. See Exhibit 6-2.

G. METHODS OF SELECTING MODEL OPERATING AGREEMENTS

Obviously, drafting an operating agreement from scratch is not a good method of planning and drafting an operating agreement. There are three potentially sound methods of planning and drafting these agreements:

- 1) The “cut-and-paste” method (the “Skadden Arps” method). Under this method, you base the operating agreement for the LLC that you are forming on an operating agreement in your files for an LLC your firm has previously formed whose structure is similar to that of the current LLC. A partner of the Skadden Arps law firm once noted to me that this is the main method she uses in drafting operating agreements for new LLCs.
- 2) The “set of forms” method
 - a) Under this method, from a set of model operating agreements you possess, you choose the right model operating agreement on the basis of the ownership structure, management structure and federal tax structure of the LLC you are forming.
 - b) The model agreement identifies all key issues and provides ideal starting points for resolving them for the type of LLC in question.
 - c) You make any necessary additions and deletions in the model agreement.
- 3) Document assembly. Under the document assembly method, you follow a digital decision tree and, at the end of the process, the document assembly system gives you a more or less complete operating agreement, including factual particulars such as parties’ names and addresses and the amounts of their contributions.
- 4) Which of the above three methods is best? This depends on the specific circumstances.
 - a) The “cut-and-paste” method.
 - i) Obviously, if you have one or more good operating agreements from previous deals that are reasonably similar to an LLC deal you’re currently handling, you should use those existing agreements as a basis for drafting the operating agreement for your current deal.
 - ii) The potential drawback of the “cut-and-paste” method is that the operating agreement you use on the basis of this method may omit key issues relevant to your current LLC deal.
 - b) The “set of forms” method.
 - i) Among other benefits, good model operating agreements identify all of the

issues likely to arise in deals involving the type of LLC for which they are designed, and they provide optimal starting points for resolving these issues.

- ii) Choosing a form from a set of forms may be better than any other method:
 - (1) For initially defining the issues and possible resolutions in a deal;
 - (2) For drafting operating agreements in situations in which you will not have to extensively revise the model operating agreement.
 - iii) Use of the “set of forms” method can be a very efficient method of drafting operating agreements. In my experience, 70% to 90% of the provisions of operating agreements based on a good model operating agreement will be identical to those of the model operating agreement.
- c) The document assembly method.
- i) To my knowledge, the only document assembly system generally available is the LegalZoom system. Operating agreements produced through the use of this system fail to identify and address many basic LLC issues.
 - ii) My publisher, Wolters Kluwer, is interested in developing an online document assembly system for LLC operating agreements, but the timetable for this project is presently unclear.

H. WHAT CONSTITUTES A GOOD MODEL OPERATING AGREEMENT?

- 1) A good model operating agreement for a particular type of LLC should, to the extent possible, meet all tests applicable in evaluating the soundness of *actual* operating agreements of that type.
- 2) A good model operating agreement should do the following:
 - a) It should identify all issues relevant to the type of LLC for which it is designed.
 - b) It should provide optimal starting points for resolving those issues.
 - c) It should provide an optimal script for negotiating the LLC deal.
 - d) It should provide an optimal template for drafting operating agreements.

I. WHAT CONSTITUTES A GOOD *SET* OF MODEL OPERATING AGREEMENTS?

In order for a set of model operating agreements to be sound:

- 1) It must be complete. In my view, this means it must contain 28 model operating agreements.
- 2) The model operating agreements included in it must be uniform in structure, content, etc.
- 3) The set must be accompanied by guidelines for choosing among the model operating agreements in the set for particular LLC formations and for using these agreements.