ELEVEN FUNDAMENTAL ERRORS IN DRAFTING LLC OPERATING AGREEMENTS

By John M. Cunningham
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My law practice is focused on limited liability company formations and conversions, and I've written a formbook and practice manual, published by Aspen Law & Business, on how to draft LLC operating agreements. Because of this background, I am often asked by clients or their accountants to review operating agreements written by other lawyers. I have found many of these agreements to be impressive, and I have learned a great deal from them. But many of them, unfortunately, are far less than impressive.

Reflecting comprehensively on this latter category of agreements—the less impressive ones—I have concluded that there are 11 fundamental errors often made by lawyers in drafting LLC operating agreements. In the discussion of these errors that follows, I'll only be talking about operating agreements for multi-member LLCs taxable as partnerships. Agreements for multi-member LLCs taxable as S corporations and for single-member LLCs raise special issues I won't address here.

Error #1: *Failure to Base Operating Agreements on Planning Memos to Clients*. In my view, lawyers should rarely provide their clients with drafts of operating agreements until they have first provided them with planning memos that propose the key contents of these agreements in plain English. If clients are willing to give a careful reading to these memoranda, they will be far more likely to be able to explain to their lawyers what they want in their operating agreement and understand the necessarily lengthy and technical final version of that agreement before they actually sign it. The planning memo should begin with a statement of the relevant facts; it should make recommendations as to the management structure and tax structure of the LLC; and it should briefly summarize and explain all of the agreement's key provisions as the lawyer envisions them.

It is clear to me that all too many operating agreements that I am asked to review would never have been approved by clients even for review by me if the clients themselves had first been able to review the agreement on the basis of a plain-English planning memorandum. We owe our clients these memos.

Error # 2: *Failure to Tailor the Operating Agreement to the Deal*. In negotiating and drafting operating agreements for actual deals, I am a great advocate of using model agreements as starting-points and templates. These model agreements can help you identify the relevant issues; they can provide you with useful guidance in resolving these issues; and they can greatly increase your efficiency in the process of negotiation and drafting.

However, all too often I see operating agreements that are hardly more than photocopies of model agreements with specific names and addresses inserted for the parties. These agreements show little or no awareness of the myriad of specific and unique issues that every LLC deal inevitably involves—for example, special issues regarding dissociation events, buy-sells, fiduciary duties or voting rights.

Error # 3: *Failure to Base the Operating Agreement on the Right Form*. By my count, there are a total of 14 main types of LLCs, each of which is sufficiently different from the other 13 so as to need its own model operating agreement. The model operating agreement you will need for a venture capital deal is very different than the one you will need for an asset protection LLC or an operating LLC for a mom-and-pop convenience store. Slavish adherence to a form is a very bad thing. (See Point 2, above.) Use of the *wrong* form is even worse. I see this "wrong form" error in the case of at least half the operating agreements I am asked to review.

Error # 4: *Failure to Start the Operating Agreement with a Table of Contents*. LLC deals among two or more parties inevitably involve at least a couple of dozen relatively complex legal and tax issues; so most operating agreements worthy of the name should normally be at least 25 pages long. However, you should never ask a client or another lawyer to read an operating agreement of that length unless you start the agreement with a relatively detailed table of contents that will orient the reader to the agreement as a whole and thus make it easier for him or her to digest its specific contents. First the forest, then the trees. And of

course Word and WordPerfect make the creation of such a table of contents effortless. So why, in so many of the operating agreements I am asked to review, do I see no table of contents?

Error # 5: ***Failure to Address Key Issues.*** The master form I use in forming LLCs contains 32 sections and 190 subsections. The 21 specific model agreements I use are modifications of this form. My goal in drafting my master form was to identify every conceivable legal and tax issue that could possibly arise in all but the most esoteric LLC deals, and thus to avoid overlooking any of these issues in actual deals. When I review an operating agreement drafted by another lawyer, my method is essentially to compare his or her agreement with my master form. Very often, this process results in my discovering several and sometimes a dozen or more issues which are obviously of substantial importance to the deal in question but on which the agreement is entirely silent—and often enough, on which the default and mandatory rules of the governing LLC act also provide no guidance.

Among the issues I find to be the most neglected in operating agreements I am asked to review are those regarding (i) members' preformation representations and warranties, (ii) tax distributions, (iii) fiduciary rights and duties, (iv) the specific functional responsibilities and time commitments of members who are to be active in the LLC's business, (v) rules and procedures for member and manager suspensions and expulsions, and (vi) methods of dispute resolution. Failure to address these or other key issues in an operating agreement can lead to intractable conflicts among the members even within a year or two after an LLC's formation.

Error # 6: ***Failure to Override in the Operating Agreement Default Provisions in the Governing LLC Act that Don't Work for the Clients Involved.*** All LLC acts consist principally of mandatory provisions—*i.e.,* statutory provisions that LLC members may not validly alter in their operating agreement; and default provisions—*i.e.*, statutory provisions that the act itself permits the members to alter in these agreements. A key task for lawyers in drafting operating agreements is to ensure that all of the default provisions in the governing act that are not in the best interests of their clients are overridden in the provisions of the operating agreement they prepare for these clients; otherwise, upon the signing of the agreement, these default provisions will automatically govern the deal. In a third or more of the operating agreements I am asked to review, I find at least a handful of default provisions in the governing LLC act that the operating agreement ought to override but does not.

Error # 7: ***Inclusion of Needless Tax Boilerplate in the Operating Agreement.*** At least half of the operating agreements I am asked to review begin with a section consisting of a dozen or more definitions of abstruse federal income tax terms—*e.g.*, partnership minimum gain, partner minimum gain, qualified income offset, etc. In addition, these agreements contain pages and pages of substantive federal income tax provisions that (i) provide safe harbors under Code Sec. 704(b) for the validity of "special allocations" (*i.e.*, allocations of profits and losses disproportionate to contributions); (ii) set forth special rules under Code Sec. 704(c)(1)(A) concerning contributions of appreciated property; and (iii) address other complex federal income tax arrangements among the members.

The problem with all of these definitions and substantive provisions (which, in most cases, have been slavishly copied from model agreements) is twofold: First, the vast majority of operating agreements are written for LLCs that, from a tax viewpoint, are "straight-up partnerships"—*i.e.,* LLCs that will make allocations and distributions to the members that are strictly proportionate to member contributions. For these LLCs, the above tax provisions are entirely unnecessary. Second, the prose in which the above tax provisions are expressed is unintelligible to non-specialists. Why include any such prose in *any* writing unless you absolutely have to?

Error #8: ***Use of Legalese.*** I will be the first to admit that when tax provisions are actually needed in an operating agreement, it's hard to write these provisions in plain English. That is why I think tax provisions of any complexity should generally be relegated to appendices and that clients should be advised not to bother reading them. However, most or all of the *non*-tax terms of an operating agreement can and should be expressed in plain English. Compliance with this plain-English rule is critical for many reasons, but two of the key reasons are these:

First, while the most important function of operating agreements is obviously that of recording the LLC deal in an accurate, comprehensive and legally binding manner, the second most important function

of these agreements is to serve as pre-formation teaching documents that will give all of the prospective members a clear idea of the rights and duties they will have if they sign the agreement. You can't fulfill this function in legalese; you've got to do it in plain English.

Second, an operating agreement should serve as a post-formation user's manual for the LLC in question. This function, too, requires the use of plain English. At least half of the operating agreements I am asked to review are replete with "whereas's," "hereinbefore's" and other ugly archaisms that violate the above plain-English rule.

Error # 9: ***Inclusion of Needless Clutter in the Operating Agreement.*** Most of the key issues in an LLC deal should be addressed in the body of the operating agreement. However, all key issues that require highly customized or detailed treatment—as is often the case, for example, with buy-sell arrangements and contributions of non-cash property or services—should be addressed in separate exhibits, each of which should normally include one or more concrete examples. The inclusion of this type of detailed material within the body of the agreement rather than in exhibits will usually have the effect of hopelessly cluttering the agreement, and this clutter can dull readers' minds to such a degree that they have trouble focusing on even the most basic contractual terms. In at least half of the operating agreements I am asked to review, I see this problem of mind-deadening clutter.

Error # 10: ***Failure to Ensure that the Operating Agreement Flows.*** The provisions of a well-drafted operating agreement, like the paragraphs of a well-drafted essay, should be grouped logically and follow a logical sequence; they should tell a story. In general, this means they should contain, in more or less this order: (i) one or two preliminary sections that address basic issues such as the effective date of the agreement, the name of the LLC, its purpose and its principal place of business; (ii) three or four sections of tax and financial terms (namely, on contributions, allocations, distributions and capital accounts); (iii) a detailed section on member dissociations and related matters; (iv) a few sections about sales and other transfers and issuances of membership rights; (v) a few sections on voting and management issues; (vi) several sections on fiduciary duties; and, finally, sections on (vii) dissolution, (viii) dispute resolution and (ix) boilerplate matters. All too few of the operating agreements I am asked to review reflect this logic; far too many look like crazy quilts.

Error # 11: Failure to Begin Agreements with Recitals When Recitals are Needed. Human understanding is contextual. Many operating agreements can be understood much better—or, at the very least, much faster—if they begin with a series of recitals (which, in my operating agreements, I prefer to call by the plain-English term "statements of background") that succinctly provide the reader with the context and key elements of the deal. At least half of the operating agreements I am asked to review—and especially those that address complex LLC deals—need recitals but lack them. ▲