



# CONSIDERATIONS FOR OPERATING AGREEMENTS

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# INTRODUCTION

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Operating agreements – whether in the form of a partnership agreement, corporate bylaws, or LLC operating agreement – may be thought of as the contract both among the members of an entity with each other and with the entity itself. As a result, a thorough and thoughtful discussion of the economics of the enterprise, the dynamics among the present and potential members of the entity, and the goals of the entity is vital to crafting an operating agreement that will serve the business well. Indeed, the discussion surrounding the development of the operating agreement may provide almost as much value as the agreement itself; such discussions enable all of the entity’s members to think about potential problems that may arise and their solutions before they even become issues.

There are many books and treatises containing myriads of operating agreement samples, terms, and clauses. Any time an operating agreement is to be drafted, you should always engage licensed legal counsel with experience in both entity formation issues and in the industry within which your entity will operate. However, to start the conversations that will develop your operating agreement, the following outline includes some suggestions to get you started.

## Formation and capital contribution issues

- Capital contributions by members:
  - When a member contributes land, equipment, or cash to an entity, what types of membership or ownership interest is given to the member making that contribution? Should a member be given shares, or simply paid for their contribution?
  - Contributions could be recognized by issuing new membership units. For example, if a family member wanted to enter a business, their contribution could be recognized by issuing new units; this would be a way of bringing in new family members.
    - If new membership units are issued, one should also consider whether there will be multiple types of units – for example, voting and non-voting units, or “preferred payment” units (units that receive fixed payments or payments before other distributions are made).
  - Where property is being contributed to an entity, is *title* to the property or the right to *use* the property being granted?
    - Generally, the presumption is that when someone contributes property to an entity, they transfer the title to the entity and no longer hold it themselves.
      - That means that the entity now owns the title. The consequence of this is that no member of the entity can claim direct title to the property themselves – they only own membership units in the entity that holds the title. This furthers the objective of keeping the “integrity” of land titles and not having them fractionalized.
      - This arrangement usually means the property cannot be withdrawn from the entity. Exceptions can be written into operating agreements for certain circumstances. For example, if the entity is terminated, the person contributing the property could be given preference in receiving it back.
      - If only use of the property is granted, but the contributor retains the title:
        - What are the terms of the property’s use (including payment to be made

for its use)? In many circumstances, a simple lease may be preferable to this kind of arrangement?

- When can use of the property be terminated by the contributor?
- Does the entity have the right to require additional capital contributions (*i.e.* make “capital calls”) in the future?
  - For example, if the entity wants to acquire a major asset, or encounters debt pressure, could the entity require all the members to contribute additional capital to aid in the financing of the purchase?
  - An important consideration with capital calls is the voting margin required to approve them. One way to handle this issue is to require a unanimous vote before a capital call can be made. This has the effect of making sure some members cannot force another member to contribute capital if they cannot afford it. On the other hand, one should also consider a unanimous vote can have the effect of blocking a capital call when one is needed to maintain the financial viability of the business.



## MANAGEMENT & DECISION-MAKING ISSUES

- Identity of managers; compensation and limitations on powers
  - “Manager” is the term used for someone authorized to act on behalf of the entity.
    - This means the person can sign contracts, make payments, etc. and the entity is bound to the obligation created by the manager’s action, so long as the manager’s action was within the scope of the manager’s authority in the operating agreement.
    - If it is intended that one or two people will be handling many of the day-to-day operational issues for an entity, designating that person (or people) as manager(s) gives them the ability to handle those issues without having to take a vote of the members.
  - LLCs can be “member managed” wherein *all* members are also managers, or they can be “manager managed” meaning only one of the members serves as a manager.
    - Member-managed entities generally work well where there is a very small number of owners; the larger the number of members, the more complications having multiple managers can cause.

- Limits can be set on what managers can and cannot do without approval of the other members. Common examples of this include dollar limits on expenditures or the ability to encumber LLC assets.
  - For example, the manager can make purchases without having to conduct a vote so long as the purchase is less than \$X,000.
  - Another example would be that the manager cannot secure a loan with entity property as the collateral without a vote of the members.

Managers can receive compensation for their services in the form of direct payments or the purchase of benefits; if this is something that is desired, it should be explicitly authorized in the operating agreement.

- What activities and responsibilities are to be assumed by specific members – is it desirable to have certain members assume specific assigned responsibilities?
  - Many entities will not assign specific duties to members, but this can be done if certain roles are specifically suited to members.

## MEMBERSHIP, MEMBERS' RIGHTS & RESTRICTIONS

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- Will there be different classes of membership for the entities?
  - Different classes of membership units with different voting rights are common among family-owned farm businesses where a gradual transfer of ownership and management authority is anticipated. Over time, voting units can be transferred by gift, sale, or by estate transfer from the from one generation to the next.
  - Different classes of ownership units may also be used to bring in new members. For example, children might purchase or be given non-voting units as they begin their active involvement in the farming operations, and once they have reached specified goals, be granted voting units.
- Is active participation or passive investment anticipated and permitted?
  - Will there be different classes of membership for active and passive members, and what will be the rights of those classes?
    - “Active engagement” has a specific technical definition for FSA regulations. If Farm Bill program payments through FSA are important, it also may be important to require anyone who is a member to meet the definition of “active.”
    - Beyond eligibility for Farm Bill program payments, some operations may desire a requirement that future new members of operation be “actively” engaged in the farm, with “active” determined by the members. An objective definition of what “active” means can reduce the opportunity for conflicts in this determination.
    - Active engagement might also be defined by a family employment policy that is separate from the entity’s operating agreement.
  - Can a member switch from active to passive membership and what are the consequences of such a switch?
    - For example, if one must be “active” to have voting membership units, does a switch from active to non-active status trigger a requirement to buy back the member’s existing

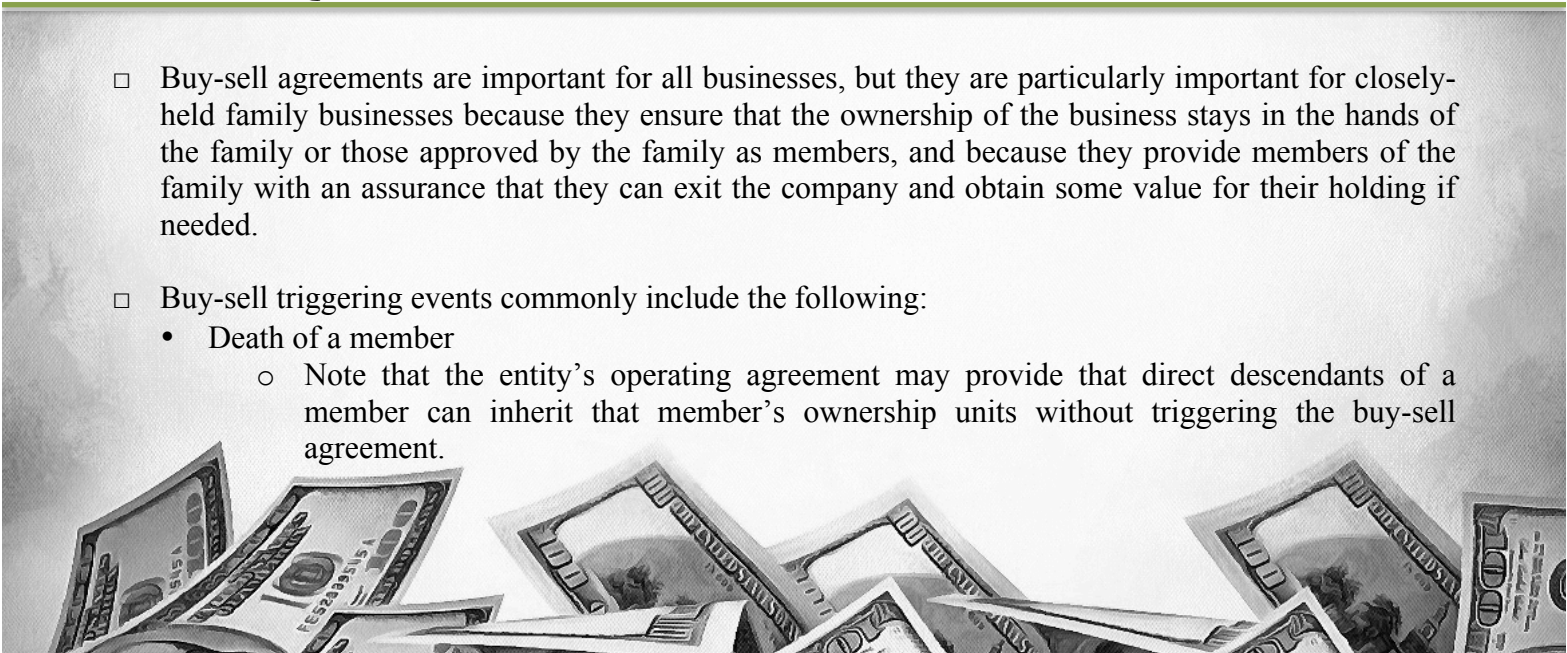


units and issue them non-voting units? Again, this is only a consideration for an entity that would be receiving FSA payments.

- What restrictions will be placed on the right to assign or transfer a membership interest?
  - Some operations hold that membership should be tightly controlled and restricted to lineal descendants (children, grandchildren, etc.) and their spouses. Others wish to create opportunities for employees or others to become members as well.
  - Some restrictions on transferability of ownership will be required in the operating agreements of the entities to secure the “limited marketability” discount on the valuation of the entity for estate tax purposes (if management of estate tax liability is one of the goals of the entity).
  - Restrictions on transfers are usually incorporated in the provisions of the buy-sell agreement within the operating agreement. Some buy-sell provisions are included in the discussion below.
- What is the anticipated need for regular meetings of the members?
  - Meetings should be held at least annually for all entities, but one may want to include a requirement for meetings to be held more frequently (semi-annually, quarterly, etc.).
  - Is it desirable to specify a default meeting location with a provision that the meeting location can be moved with the consent of the members?
- Will all or some of the members will be allowed to participate in outside activities?
  - This is sometimes referred to as a “competition” or “non-compete” requirement.
  - For example, family members may have farming operations outside the entities and/or might want to purchase land for their own operations rather than offering that opportunity to the family farm entities first. Alternatively, the operation may want a clear requirement to provide such opportunities to the larger farm entity first, giving it something akin to a “right of first refusal” before the individual members can pursue the opportunity.

## BUY-SELL TRIGGERS & REQUIREMENTS

- Buy-sell agreements are important for all businesses, but they are particularly important for closely-held family businesses because they ensure that the ownership of the business stays in the hands of the family or those approved by the family as members, and because they provide members of the family with an assurance that they can exit the company and obtain some value for their holding if needed.
- Buy-sell triggering events commonly include the following:
  - Death of a member
    - Note that the entity’s operating agreement may provide that direct descendants of a member can inherit that member’s ownership units without triggering the buy-sell agreement.



- A common use of the death of a member trigger is to give the entity the opportunity to purchase the deceased's member's ownership units from a spouse who was part of the family by marriage.

- Divorce of member who was part of the family by marriage
- Permanent disability of a member
- Bankruptcy or insolvency of a member
- The removal of a member
- The voluntary withdrawal of a member

Other events can also be included

- Buy-sell agreements commonly take one of three approaches once a triggering event occurs:
  - The entity may be given the right to purchase the member's ownership units, or it may be required to purchase them if it can. When the company purchases the units, it is called "redemption."
  - The other members can be given the right to purchase the member's ownership units, or they may be required to purchase them if they can. This is called "cross-purchase." In either case, the purchase is usually made on a "pro-rata" basis – that is, if another member holds 75% of the entity, they are allowed or required to purchase 75% of the exiting members' ownership units.
  - A "hybrid" approach involves a combination of redemption and cross-purchase requirements. For example, a common approach is that the exiting member must first offer his or her ownership units to the company, and if the company declines to purchase them, the remaining owners are required to purchase their units.
- Requirements for either company purchases (redemptions) or pro-rata cross-purchases are used to minimize the effect the triggering event has on the proportions of ownership held by the other members; that is, they are used to reduce the chance that one member's triggering event will significantly shift ownership of the entity.
- An important tool for minimizing conflicts when a triggering event occurs is a provision that defines how the exiting member's ownership units will be valued; this means that everyone has agreed in advance to a valuation method as being fair.
  - Regular appraisals of the business as a valuation tool can provide that the valuations are never too far out of date and provide important information to managers, but they can also be expensive. Some agreements provide that a triggering event also triggers an appraisal.
  - Valuations based on a formula tied to the book value of the business can be very fast and inexpensive, but they can also lead to inflated results if the business has been doing very well in recent times, or can lead to deflated results if the business has been going through a difficult period.
  - Some buy-sell agreements specify an appraisal at the time a triggering event occurs, but also specify a discount, such as 80% of the entity's fair market value.
- The purchase of a member's ownership units can be an expensive event for the company and/or the other members, depending on whether a redemption or cross-purchase approach is selected. A funding mechanism should be established either in the company's operating agreement or by a separate company policy to determine what assets should be used to fund the purchase if sufficient liquid assets are not available.

- Life insurance held by the company on the lives of its members is a common financial instrument used to fund purchase obligations, but death is only one triggering event.
- Other insurance policies may be available to fund the purchase of membership units if a triggering event other than the death of a member occurs.

## DISTRIBUTIONS, PAYMENTS & BENEFIT ISSUES

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- Is it desirable to pay salaries and/or purchase benefits such as health insurance, life insurance, or retirement investments for members?
  - Is it desirable to pay a salary to the managing members, if a manager-managed model is used?
  - If a salary is paid, will it be deducted from the company's profits prior to the calculation of all the partners' shares? Alternatively, will it be deducted from the manager's share of those profits?
  - It should also be noted that the deductibility of salaries and benefits is largely influenced by the type of entity (partnership, C corporation, and LLCs opting to be taxed as either partnerships or C corporations). If salaries and benefits are an important factor, the need to consult with a tax professional before choosing an entity form is vital.
- Is it desirable to pay a salary to non-managing members if they provide specific services or play certain roles for the company? If so, are salaries deducted from profits generally or from the shares of the individual member?
- Is the company permitted to make loans to its members, and if so, what are the terms of those loans?
- How will the entity make cash distributions? Is it required to make distributions or can it retain cash? Note that this may be better suited to a policy than being included in an operating agreement.
- How will profit and loss be allocated among the members? Can members be allocated items of gain and loss out of proportion with their ownership interest in "disproportionate allocations"?
  - These can be made under certain circumstances, but this requires very carefully crafted language to be included in the operating agreement and close consultation with the company's accounting professionals. Disproportionate allocations must be given "substantial economic effect" meaning they must have an impact on the members' respective capital accounts.



# TERMINATION & DISSOLUTION ISSUES

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- What events should (or might) trigger the dissolution of the entity?
  - Note this is different from trigger events for the buyout of a member – this point refers to what events could or should result in the complete dissolution of the entity.
  
- What are the rights of the members upon liquidation of the entity?
  - As mentioned above, should the entity be instructed to return property contributed by a member back to that same member (if that can be accomplished)?
  
- Is there an option to continue the company upon the withdrawal or one or more members? The most likely answer is “yes” given that one of the objectives of all of the family farm entities is continuity of the farm and preservation of its asset base, but it is an option to wind up an entity once a member or a threshold amount of members withdraws or leaves the entity.

# CONFLICT RESOLUTION

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- Is there a prescribed means of resolving disputes (*e.g.*, requirements to submit to mediation before seeking litigation; binding arbitration is another possibility).
  - Requiring mediation as a step before litigation can be important to quickly resolve conflicts while providing the best opportunity to preserve family relationships through the conflict.
  
- Is there a right to expel a member; if so, on what basis? Should there be a power to expel members for any cause whatsoever or only for what is sometimes called “just cause” (wrongdoing or negligence of a member)?