



December 15, 2011

WHY EVERY LLC NEEDS A WRITTEN OPERATING AGREEMENT

It is understandably tempting for members of some North Carolina limited liability companies (“LLC”) to not feel the need to have a formal operating agreement laying out the critical rules that will govern the running of the LLC and the specific rights and duties of the members. After all, unlike corporate bylaws, operating agreements are not required under North Carolina law. Additionally, one may be tempted to simply rely on the default rules in the North Carolina Limited Liability Company Act (“Act”) that apply when an operating agreement does not exist. However, this temptation to forgo having a formal operating agreement should be resisted, because a well drafted operating agreement offers significant benefits including (1) a mechanism to resolve member disputes before such disputes become disruptive and expensive, (2) in the context of single member LLCs, a tool to help establish entity status separate from the member personally, and (3) a means to avoid potential undesirable statutory default rules.

Like any agreement addressing important and complex rights and duties between various parties, the primary benefit of having an operating agreement in writing is clarity. While North Carolina does not require operating agreements to be in writing, oral operating agreements run the real risk of misunderstandings and costly “he said, she said” legal disputes. Of course, it is true that even the most carefully crafted operating agreement may not be sufficient to defuse all member disputes, but having an agreement in writing is certainly a huge step towards certainty and clarity which often will help avoid disputes. Additionally, even in the context of a single-member LLC where inter-member conflicts are obviously not an issue, having a written operating agreement is still important in helping establish the LLC as a separate entity apart from the member personally.

Relying on North Carolina statutory default rules also may not be prudent, because there are several notable provisions in the Act that typical LLC members may find undesirable including those highlighted below. First, the Act requires a unanimous vote of the members for (1) adopting or amending the operating agreement, (2) admitting any person as a member, and (3) selling, transferring, or otherwise disposing of all or substantially all of the assets of the LLC prior to dissolution. In contrast, many members would no doubt prefer a lower “majority” or “super majority” voting requirement instead in the interest of more efficient organizational

decision making. Second, the Act obligates members to perform any enforceable promise (read: not just promises in writing) to contribute cash or property or to render services. Considering the significance of capital contributions, it is easy to see how LLC members might prefer capital contribution obligations only be effective if in writing. Third, the Act requires allocations and interim distributions to be made in proportion to the agreed value of contributions made by each member. While basing allocations and distributions on proportionate capital contributions is not necessarily unreasonable, one of the major advantages of LLCs as an entity choice is the flexibility afforded to members in making such decisions. Fourth, the Act provides that membership interests are freely assignable in whole or in part and allows for the pledge of, granting of a security interest, lien or other encumbrance against the member's LLC interest. This unqualified allowance of transfers and encumbrances of membership interests stands in stark contrast to the desire of most LLC members to tightly restrict and manage membership ownership and control.

In conclusion, the benefits of having a well drafted operating agreement are significant in all circumstances, and LLC members should take great care in deciding whether to forgo this important step in entity formation. Please contact Jesse Anderson [(336) 271-5208], Natalie Crenshaw [(336) 271-5220], or another member of the Business & Tax practice group if you have any questions about this article or other LLC operating agreement-related issues.

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