SMALL BUSINESS
KNOWLEDGE AND
TRAINING PORTAL

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AMERICA'S SBDC TENNESSEE

PARTNERSHIP AND OPERATING AGREMENTS

LESSON TOPICS

1. Common structures

-Partnership: Involves more than one person and can be operated under a general partnership agreement.
-Limited Liability Company: Can have one or more owners and operates under an operating agreement.
-It is highly recommended that both LLC's and Partnerships need to have signed agreements before starting their business. This allows all owners, even if they are family members, to be on the same page and know all rules for the business.

2. Basics of Operating Agreements

The owners of a LLC are called members and in a partnership, they are called partners. The operating agreement will state who is a part of the LLC and what interest do they have in it. Ownership interest can be expressed in percentage or unit format. This interest has two attributes that are governance rights, or the right to vote on LLC decisions, and financial rights, or the owners' right to receive distribution of cash of the company.

3. Management Options

-Member Managed: Managed by the members. This type is great for small businesses since the members are all active.
-Manager Managed: Managed by one or more managers.
-Board or Director Managed: Managed by a board of directors like a corporation.

4. Passive Ownership

If some of the members are passive then a board or manager set up would be optimal. A passive member would be someone who is not active in the day to day decision making of the business but more of just a passive investor. This type of member does have certain approval rights over actions in the company. These rights include selling new securities and ownership interests for admitting new members, whether or not they have to make capital contributions, and the ability to approve a budget. They also have approval of transfer of ownership interests, amendments made to the operating, agreement, and finally whether or not to dissolve the company and distribute the assets to the owners.

5. Capital Accounts

Partnership and Operating agreements both have capital accounts, which is a calculation of how much money an owner puts in minus what they get out. LLCs are taxed by default either as a partnership, with more than one member, or a disregarded entity, with only one member. However, an LLC can elect to be taxed as an S Corp or a C Corp. If these types of taxes are elected, then the operating agreement should not contain any tax provisions.

Another attribute of a partnership and operating agreement is allocating the profit and loss of the LLC among the members. This is done for tax purposes. This is reported on a K1 each year to the members.

PARTNERSHIP AND OPERATING AGREMENTS

LESSON TOPICS CONT.

6. Money

One of the most important parts of an agreement is money. There are many types of distributions that partnerships and LLCs make. The first is a tax distribution, which will require the company to distribute money to its' owners every year, incase there is a gain that is taxable to the members. Gain and loss inside an LLC and the money you get out of an LLC, are two completely different things. If the LLC gains profit then the earnings with be allocated to its' members in accordance with their membership interests percentages. To the extent that a member is allocated a tax gain that is not offset by a loss, often times the operating agreement will provide that they distribute money to that member, to fund that member's tax liability.

Second, are distributions of available cash flow. If the company has cash, the company will distribute it in accordance with the mechanism in the operating agreement for making those distributions.

The third type of distribution is called capital events. examples of this would be the company sells an asset, sells all the assets, or the company refinances debt and distributes to owners.

A lot of times a passive investor will have a preferred return, which means that that member gets the first money that is distributed. They will get their money before the promoters of that deal even. They will also get a return on that investment before the rest of the owners get their share.

7. Transfer of Ownership Interest

When can a member transfer their own membership interests in the company and to whom? In general most operating agreements will restrict transfers in some way, shape, or form. Many LLCs are small businesses that have business partners that do not want the identity of their partners to be an unknown. This results in the restriction of the sale or trade of interests to someone else. These restrictions can be determined in many different ways in the operating agreement. The agreement can also provide for compelled or optional purchases by the company and other members. The operating agreement will allow the company or members to buy the interest of a deceased member, disabled member, or member subjected to an involuntary transfer. This will be doe with a formula that is pre-determined either through an evaluation mechanism or a number given in the agreement. You run the risk of choosing to do this through an agreed upon number, because values change over time, and that number may end up being too small or too big.

PARTNERSHIP AND OPERATING AGREMENTS

LESSON TOPICS CONT.

8. More Purchase/sale Options

Put right allows a member to compel the company or other members to buy them out at a certain price over time. Usually, the put price is able to be financed by the company so that the company does not have to pay a large amount in a lump sum.

A tag along provision allows one member, who wants to sell their interest, to have other members tag along to that buyer with at the same time with the same price.

A drag along provision is when a member wants to sell to a third party and compel other members to do the same at the same price and time.

9. Withdraw and Dissolve

Another item that should be in an agreement is a restriction on a member's ability to withdraw from the company. Withdraw means that a member just leaves the company at any time. However, the LLC Act requires the company to pay the fair value of that member, who wants to withdraw, interest in a lump sum. This can be problematic for a company that has little cash flow. Operating agreements will require its' members to waive their rights to withdraw and waive their rights to receive fair value for their interests. Instead that value will be determine by an evaluation mechanism or a pre-determined number.

Operating agreements will also provide for what happens when the company wants to dissolve . Who will make that decision? Who liquidates those assets and distributes them to the members? Is it a board or member decision? This is all determined in the operating agreement. When this decision is made, the company will file an articles of dissolution with the Secretary of State, someone affiliated with the company will liquidate the assets, and then the assets will be distributed, with a set formula, to the members.