



A Good LLC Operating Agreement Can Avoid a Really Bad Court Case

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Limited liability companies (LLCs) are a popular form of entity selection for organizing and operating a business in Michigan, as there are many benefits to forming an LLC. The benefits include having the protection of a corporation, but not paying corporate tax, as well dealing with fewer administrative and legal formalities.

While the popularity and prevalence of this relatively new corporate structure has increased, there is little evidence that LLCs – despite their many positive attributes – have had any discernible impact on reducing one age-old business problem: disputes between business partners.

In my 20 or more years of practicing law, I have litigated disputes between members of LLCs on several occasions. Many of these disputes, and the resulting cost to a business owner, including both financial and stress incurred in the courtroom, could have been avoided by drafting an effective operating agreement. Although I could write an entire book on the terms of an operating agreement, this article is focused on addressing issues that often give rise to disputes between members and how a properly drafted operating agreement can potentially resolve some of these disputes short of litigation.

The Michigan Limited Liability Act can be found at Michigan Compiled Laws (“MCL”) 450.4101 *et al.* The Act allows members of an LLC to draft a written operating agreement pertaining “to the affairs of the limited liability company and the conduct of its business.” MCL 450.4102(2)(r). The operating agreement of an LLC forms the “rules” by which the members and managers of the LLC operate within the LLC. It provides the rights and responsibilities of the members and managers. It can be used as a means of managing the members and managers and, when things go wrong, can allow for the termination and removal of members and managers.

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Most operating agreements address issues such as how individuals will acquire a membership interest in an LLC, make initial and additional capital contributions to the LLC and manage the members' capital accounts. But there are additional provisions that should be included, many of which deal with unexpected, but not infrequent, events and circumstances that require changes to the LLC membership or management structure.

In particular, operating agreements should contain specific terms pertaining to buy/sell arrangements between the LLC's members. Certain "triggering events" can be defined in an operating agreement allowing members or the company to buy out other members in certain circumstances. Typically, the circumstances include death, member withdrawal from the LLC, member bankruptcy, divorce, failure to make capital contributions, or - which commonly results in litigation - where a member who is also an employee of the LLC has his employment terminated.

When a "triggering event" occurs, the value of the membership interest needs to be determined, often done through a fair market value appraisal. Life insurance can be used to fund a buyout in the event of the death of a member. The value of the membership interest can also be discounted depending upon various "triggering events," such as in the event a member or their spouse files for divorce, the member commits some wrongful act against the LLC, withdraws from the LLC voluntarily or is expelled from the LLC because of unwanted conduct.

An operating agreement, drafted properly, should allow members to force out another member at a certain purchase price in the event of member fall-out. This can help avoid protracted and expensive litigation where a judge or jury will determine whether or not a member's conduct constitutes a "triggering event," and in the absence of such language in an operating agreement, what the value of that membership interest should be under a given "triggering event."

The operating agreement can also set forth payment terms for the buyout of a membership interest if it is believed that the LLC or the remaining members will not be able to afford a lump sum payment to the member who is subject to a "triggering event." Terms can range from monthly payments to annual lump sum payments and include interest.

MCL 450.4515 also allows a member of a LLC to file suit against the other members for "willful, unfair and oppressive conduct" toward the member. Anytime a member feels he is being treated unfairly, if the operating agreement has not addressed how to handle the situation, a member can force the other members into court in an attempt to force a buyout, to recover damages, and possibly dissolution of the LLC. This type of headache is expensive and distracting. Therefore, before membership issues become a problem, steps should be taken to address how these issues can be handled through the procedures set forth in the operating agreement. This will save the members and the LLC substantial sums of money and time in the long run.

If you have questions or concerns about your operating agreement and updates to avoid costly litigation, please contact me so we can discuss the terms of your operating agreement before you end up in court asking a judge or jury to address and decide the issues for you.