Why Your LLC Needs A Written Operating Agreement

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The New Jersey Revised Uniform Limited Liability Company Act (the "Revised LLC Act") took effect on March 18, 2013 for LLCs formed on or after that date and on April 1, 2014 for all other New Jersey LLCs. The Revised LLC Act repealed the old New Jersey LLC Act and now provides, among other things, that an operating agreement may be in writing, oral, or implied from the facts and circumstances of how the LLC operates.

Although the Revised LLC Act permits oral or implied operating agreements, common sense and sound business judgment compel the need for your LLC to have a written operating agreement. An operating agreement is the equivalent of a partnership agreement for a partnership. Like partnership agreements, operating agreements can have varying levels of complexity covering activities ranging from a two-person auto body shop to multi-million dollar ventures. The operating agreement functions as the heart and soul of the LLC, and issues concerning members' sharing of profits and losses, timing and sharing of distributions to members, transfer of LLC interests, rights of withdrawing members, and other organic changes to the LLC, which are critical to its continuing existence and prosperity, should be spelled out in writing.

Over time, memories fade and disputes may arise, for example, over what a withdrawing or resigning member is entitled to receive as fair compensation for his or her LLC interest after departing the LLC or what circumstances may constitute "good cause" to force one member out of the LLC. These and other issues, if not spelled out and reduced to writing in a well structured and crafted written operating agreement, will be decided by default under the provisions of the Revised LLC Act or, after litigation erupts, implied from the circumstances of how the LLC in fact has operated, or not covered at all, which may lead to disappointment, the financial detriment to one or more members, or the court-ordered dissolution of the LLC.

Disputing an oral operating agreement only serves to enrich the trial attorneys and proving the existence of such an agreement may well be insurmountable. For example, suppose A and B form the Acme LLC and you contribute thousands of dollars to Acme and help generate revenue for Acme. You believe that you are a member of the LLC but you have nothing in writing to confirm this. Subsequently, A and B transfer Acme's assets to a company solely owned by A and B. You decide to sue for breach of contract and breach of fiduciary duty. The court rules that your oral "agreement" is unenforceable because all the material terms of the agreement were never discussed or finalized. At best, you are only able to show that an agreement was discussed and that the essential terms would be worked out later. Your suit fails because it was not enough to prove breach of contract or fiduciary duty.

Relying on the default provisions of the Revised LLC Act may not be appropriate either. For example, the Revised LLC Act provides that unless the members of an LLC otherwise agree, all distributions of profits shall be shared equally between members. This means that even if one member (A) contributes $90,000 and the other member (B) contributes $10,000 at formation of the LLC, they will equally share in the profits of the LLC. To avoid this result and any potential disputes, A and B should reduce to writing their agreement that they share distributions of profits in proportion to their respective contributions. In the example given, the operating agreement would expressly state that A would receive 90% and B would receive 10% of distributions of profits and losses, subject to any further changes in their respective ownership percentages of the LLC.

By having in place a well structured and crafted written operating agreement, you should avoid much confusion, misunderstanding, and waste of time and resources in operating your LLC and have the freedom to concentrate on maximizing the potential of your business.