

## ***Form 2.3***

# **Operating Agreement for Member Managed LLC with Straight-Up Allocations**

*Revised January 1, 2009*

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## OPERATING AGREEMENT

**DATE:** *[date]*

**PARTIES:** *[name of member 1], [name of member 2], and [name of member 3]*

### RECITAL:

The parties to this agreement (the “members”) are entering into this agreement for the purpose of forming a limited liability company (the “company”) under the Limited Liability Company Act of the state of *[name of state of creation]* (the “act”).

### AGREEMENTS:

#### 1. Formation

- 1.1 **Name.** The name of the company is *[name of company]*.
- 1.2 **Articles of Organization.** Articles of organization for the company were filed with the secretary of state for the state of *[name of state of creation]* on *[date]*.
- 1.3 **Duration.** The company will exist until dissolved as provided in this agreement.
- 1.4 **Principal Office.** The company’s principal office will initially be at *[address]*, but it may be relocated by the members at any time.
- 1.5 **Designated Office and Agent for Service of Process.** The company’s initial designated office will be at *[address]*, and the name of its initial agent for service of process at that address will be *[name of initial agent for service of process]*. The company’s designated office and its agent for service of process may only be changed by filing a notice of the change with the secretary of state for the state in which the articles of organization of the company were filed.
- 1.6 **Purposes and Powers.** The company is formed for the purpose of engaging in the business of *[type or description of business]*. The company has the power to do all things necessary, incident, or in furtherance of that business.
- 1.7 **Title to Assets.** Title to all assets of the company will be held in the name of the company. No member has any right to the assets of the company or any ownership interest in those assets except indirectly as a result of the member’s ownership of an interest in the company. No member has any right to partition any assets of the company or any right to receive any specific assets on the winding up of the business of the company or on any other distribution from the company. Assets of the company may not be commingled with those of a member or any other person.

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## 2. Members, Contributions and Interests

**2.1 Initial Members.** The names and addresses of the initial members of the company, the amounts of their initial capital contributions and their initial ownership interests are:

<u>Name and Address</u>	<u>Contribution</u>	<u>Ownership Interest</u>
<i>[name of member 1] [address]</i>	<i>[dollar amount]</i>	<i>[percentage]</i>
<i>[name of member 2] [address]</i>	<i>[dollar amount]</i>	<i>[percentage]</i>
<i>[name of member 3] [address]</i>	<i>[dollar amount]</i>	<i>[percentage]</i>

Each member's ownership interest at any time will be determined by the ratio of the member's aggregate capital contributions to the aggregate capital contributions of all members.

**2.2 Initial Capital Contributions.** The capital contributions of *[name of member 1]* and *[name of member 2]* must be paid to the company, in cash, immediately after all the members have signed this agreement. The capital contribution of *[name of member 3]* must be made by *[name of member 3]*'s transferring the assets listed on the attached Exhibit A to the company, and the members agree that the value of those assets is equal to the amount of *[name of member 3]*'s capital contribution set forth in the section relating to initial members. Immediately after all members have signed this agreement, *[name of member 3]* must execute and deliver to the company all documents necessary to transfer the assets to the company free and clear of all liens and encumbrances. The transfer documents must include warranties of title and good right to transfer.

**2.3 Additional Members.** Except as otherwise provided in the section of this agreement relating to substitution, additional members of the company may be admitted only with the members' unanimous approval.

**2.4 Additional Contributions.** Except as otherwise provided in the act, no member is required to contribute additional capital to the company without the member's consent. Additional capital contributions may be made only with the members' approval. If the members approve additional capital contributions, they must set a maximum. Members will then have the right, but not the obligation, to contribute pro rata shares of the maximum based on their ownership interests. If any member elects to contribute less than his or her pro rata share, the other members may contribute all or part of the difference on

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a pro rata basis in accordance with their ownership interests or on any other basis they may agree on.

**2.5 No Interest on Capital Contributions.** No interest will be paid on capital contributions.

**2.6 Capital Accounts.** An individual capital account must be maintained for each member. A member's capital account will be credited with all capital contributions made by the member and with all income and gain (including any income exempt from federal income tax) allocated to the member. A member's capital account will be charged with the amount of all distributions made to the member and with all losses and deductions (including deductions attributable to tax-exempt income) allocated to the member. Members' capital accounts must be maintained in accordance with the federal income tax accounting principles contained in Treasury Regulations §1.704-1(b)(2)(iv).

### **3. Allocation of Profits and Losses**

**3.1 Net Profit or Loss.** The net profit or loss of the company for each fiscal year will be determined according to the accounting principles employed in the preparation of the company's federal income tax information return. The profit or loss, as well as any items thereof that must be separately stated under IRC §703(a), will be allocated to the members in proportion to their ownership interests.

**3.2 Allocations Solely for Tax Purposes.** In accordance with IRC §704(c), income, gain, loss, and deduction with respect to any property contributed to the capital of the company must be allocated among the members to take into account any variation between the adjusted basis of the property for federal income tax purposes in the hands of the company and the agreed value of the property as set forth in this agreement, or in any document entered into at the time additional property or other capital is contributed to the company. Any elections or other decisions relating to the allocations to be made under this section will be made by the members. The allocations to be made under this section are solely for income tax purposes and will not affect any member's capital account, allocable share of the net profits and net losses, or right to distributions.

**3.3 Prorates.** If a member has been a member of the company during only part of a fiscal year, or if a member's ownership interest changes during a fiscal year, the net profit or net loss for the year will be allocated to the member based only on the period of time during which he or she was a member or held a particular ownership interest. Net profit or loss for the fiscal year may be allocated ratably between the persons who were members on a daily basis using the company's usual accounting methods. Except as otherwise provided in IRC § 706(d)(3), the company's fiscal year may, in the alternative, be divided into two or more segments, and the net profits or losses for each segment allocated among the persons who were members, or who held particular ownership interests, during the segment. Decisions about the method of prorating profit or loss will be made by the members.

\* \* \* \*

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## 10. Miscellaneous Provisions

- 10.1 Amendment.** The members may amend or repeal all or part of this agreement by unanimous written agreement. This agreement may not be amended or repealed by oral agreement of the members.
- 10.2 Binding Effect.** The provisions of this agreement are binding on and will inure to the benefit of the heirs, personal representatives, successors, and assigns of the members. This section is, however, not a modification of any restriction on transfer set forth in this agreement.
- 10.3 Notice.** Except as otherwise provided in other sections of this agreement, any notice or other communication required or permitted to be given under this agreement must be in writing and personally delivered or mailed by certified mail, return receipt requested, with postage prepaid. Notices addressed to a member must be addressed to the member's address listed in the section of this agreement relating to initial members, or if there is none, the address of the member shown on the records of the company. Notices addressed to the company must be addressed to its principal office. The address of a party to which notices are to be mailed may be changed by the party's giving written notice to the other parties. All mailed notices and other communications will be deemed to be given at the expiration of three days after the date of mailing unless the recipient acknowledges receipt prior to that time.
- 10.4 Litigation Expense.** If any legal proceeding is commenced for the purpose of interpreting or enforcing any provision of this agreement, including any proceeding in the United States Bankruptcy Court, the prevailing party is entitled to recover reasonable attorneys' fees in the proceeding, or any appeal, to be set by the court without the necessity of hearing testimony or receiving evidence, in addition to the costs and disbursements allowed by law.
- 10.5 Additional Documents.** Each member must execute all additional documents and take all actions as are reasonably requested by the other members in order to complete or confirm the transactions contemplated by this agreement.
- 10.6 Counterparts.** This agreement may be executed in two or more counterparts, which together will constitute one agreement.
- 10.7 Governing Law.** This agreement is governed by the law of the state in which the articles of organization of the company were filed and must be construed in accordance with the law of that state.
- 10.8 Third Party Beneficiaries.** The provisions of this agreement are intended solely for the benefit of the members and create no rights or obligations enforceable by any third party, including any creditor of the company, except as otherwise provided by applicable law.

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**10.9 Authority.** Each individual executing this agreement on behalf of a corporation or other entity warrants that he or she is authorized to do so and that this agreement constitutes a legally binding obligation of the corporation or other entity that the individual represents.

**10.10 Counsel.** This agreement has been drafted by *[name of attorney]* (the “attorney”), who represents *[name of represented member]* in connection with the creation of the company. *[name of unrepresented member]* and *[name of unrepresented member]* each understand that the attorney can represent only one party in connection with this matter and that the attorney represents *[name of represented member]* and does not represent them. *[name of unrepresented member]* and *[name of unrepresented member]* acknowledge that they have been advised by the attorney that they should retain attorneys of their own choice in connection with this matter.

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*[name of member 1]*

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*[name of member 2]*

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*[name of member 3]*

**EXHIBIT A**

*[List of assets that are to be contributed to the capital of the company by the member contributing property]*

## ***Commentary***

### **Form 2.3: Operating Agreement for Member Managed LLC With Straight-Up Allocations**

This is a basic form of operating agreement for a member managed limited liability company. The form is based on a partnership model of management and operation and is appropriate for use if there are a limited number of members of the LLC, all of whom are actively involved in the business. The form is designed to be used in a situation in which each member of the LLC will contribute money or property in an amount proportionate to the member's share of the profits and losses, and no member will contribute services for his or her interest.

Because state LLC statutes vary, the applicable state LLC statute should always be consulted to verify the appropriateness of the provisions contained in this form. In some cases, modifications will be necessary.

## 1. Formation

*1.1 Name.* The name of the company is to be inserted in this section. State LLC statutes typically require that the name contain the term “limited liability company” or an abbreviation of the term. In addition, the name generally may not be the same as, or deceptively similar to, the name of any LLC, corporation, limited partnership, or limited liability partnership that is organized under the law of the state or is qualified to transact business in the state.

*1.2 Articles of Organization.* The date of filing of the articles of organization for the company is to be inserted in this section. If the operating agreement is being signed before the articles of organization are filed, this section should be modified to so indicate. In that case, it is important to include language prohibiting the company from engaging in business before the articles are filed.

*1.3 Duration.* This section assumes that the company will continue until the occurrence of an event causing its dissolution. If the company is to exist only for a specified period of time, as may be the case if the company is formed as a joint venture to complete a single project, this section will need to be modified to so indicate. The limited duration should also be set forth in the articles of organization. If the company has a limited duration, the section relating to causes of dissolution will need to be modified to reflect the limited term.

*1.4 Principal Office.* The address of the company’s principal office is to be inserted in this section. Since the principal office is typically the place where the applicable state LLC statute requires the books and records to be maintained, this provision should identify the location of the company’s business office rather than the location where its operations are conducted, if those locations are different.

*1.5 Designated Office and Agent for Service of Process.* This section specifies the location of the company’s designated office and the identity of its agent for service of process. The agent for

service of process is called a registered agent in many states. This section reminds the members that the designated office and agent for service of process can only be changed by a state filing.

*1.6 Purposes and Powers.* The business of the company is to be identified in this section. While it is possible to state that the company is authorized to engage in all businesses in which an LLC may be lawfully engage, this is usually undesirable if a member managed LLC has more than one member. Each member can act as an agent for the company and bind it to obligations incurred in the ordinary course of business. Unless the LLC’s business is defined precisely, the authority of members may be broader than intended.

*1.7 Title to Assets.* The company is a separate entity that owns its own assets. Failure to maintain a separation between the company’s assets and those of the members might provide a court with a justification to hold the members personally liable for liabilities and obligations of the company under the doctrine of piercing the corporate veil. This section also reminds members that they own interests in the company, not the assets of the company.

## 2. Members, Contributions and Interests

*2.1 Initial Members.* It is desirable to include the names and addresses of the members and the amounts of their contributions in the operating agreement because many LLC statutes require this information to be maintained as part of the company’s books and records at its principal place of business. In addition, it is well to document the fact that the company was adequately capitalized at the time of its creation to forestall possible attacks on the limited liability of members under the doctrine of piercing the corporate veil.

If the names or addresses of all members, or the amounts of their contributions, are not known at the time the operating agreement is prepared, this information can be moved to an exhibit to

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facilitate its completion at the time the operating agreement is signed.

This form has been prepared for an LLC in which all members make capital contributions that are proportionate to their profit and loss sharing ratios—a so-called “straight up” arrangement. For example, if there are three members and one member contributes \$15,000 in cash, another member contributes \$45,000 in cash, and the third member contributes property worth \$40,000, the members’ ownership interests will be 15 percent, 45 percent, and 40 percent, respectively. If any member’s capital contribution is disproportionate to his or her profit and loss percentage, because, for example, the member is contributing past or future services, there will be a special allocation of profits and losses for federal income tax purposes. In this case, the operating agreement should contain provisions supporting the special allocation that are not included in this form.

*2.2 Initial Capital Contributions.* This form provides that one member is contributing property as the member’s capital contribution. The initial capital contribution of this member will be the fair market value of the property, as agreed to by the members. The agreed value is used to establish the member’s ownership interest, which determines the member’s profit and loss sharing ratio and proportionate voting rights. The agreed value is also used to establish the member’s capital account, which will affect the amount the contributing member is entitled to receive on liquidation of the company.

A contribution of property to the company will ordinarily be a tax-free exchange of property for an interest in the company under IRC §721. The member’s tax basis in his or her interest in the company and the company’s tax basis of the contributed property will both be equal to the member’s adjusted tax basis in the property at the time of the contribution under IRC §§722 and 723. If the company’s tax basis in the contributed property is different than its agreed value, special allocations of depreciation, depletion, gain, and loss must be made with respect to the contributed

property for federal income tax purposes under IRC §704(c)(1). Provision for these allocations is made in the section relating to allocations solely for tax purposes.

*2.3 Additional Members.* Because this member managed LLC functions like a partnership, members have a strong interest in being able to approve the admission of new members. New members not only have the right to participate in the management of the company but also have authority to act as agents of the company. In addition, the admission of new members will affect existing members’ ownership interests, and therefore their profit and loss sharing ratios. In view of the members’ strong interest, this provision requires that all members approve the admission of any new member.

*2.4 Additional Contributions.* The issue of how to address additional capital needs is often knotty. It can be difficult to anticipate the capital needs of a business, and members may not have the resources or desire to commit substantial capital in addition to their initial contributions. At the same time, if members’ profit and loss sharing ratios depend on their capital contributions, additional capital contributions can change the members’ respective profit and loss shares, so members may be reluctant to allow others to make capital contributions.

This form provides that additional capital contributions can be made only if the members approve. Members then have the right to make any additional capital contributions in proportion to their initial capital contributions, but they are not required to do so. If any member does not make his or her proportionate additional contribution, the others may make the contribution and increase their percentage ownership interests.

*2.5 No Interest on Capital Contributions.* Capital contributions represent equity investments in the company and therefore do not bear interest. If a member wishes to receive interest on part of the member’s contribution, that part should be structured as an interest bearing loan.

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In some situations where one member contributes capital and another contributes services or expertise, or one member contributes substantially more capital than the others, the member contributing capital is entitled to a preferred return on the member's contribution. A preferred return differs from a loan because it is payable only if the profits of the company are sufficient. A number of additional provisions, including provisions supporting special allocations, are required in an LLC's operating agreement if any member is entitled to a preferred return.

*2.6 Capital Accounts.* This provision requires the members' capital accounts to be maintained in accordance with the regulations under IRC §704(b). Those regulations contain rules specifying how capital accounts must be accounted to insure that any special allocation of income, gain, loss, deduction, or credit is recognized for tax purposes. Although this operating agreement is for an LLC with straight-up allocations, the capital account maintenance rules of the Treasury Regulations are consistent with the partnership accounting rules of general application.

#### 200000003. Allocation of Profits and Losses

*3.1 Net Profits and Losses.* This form assumes that the company will be taxed as a partnership in accordance with Treasury Regulation §301.7701-3(b)(1)(i). As a result, its net profits and losses will pass through for reporting the member's individual tax returns.

The taxation of some items making up the company's profit or loss, such as capital gains and charitable contributions, will depend on each member's particular tax situation. As a result, IRC §703(a) provides that these items pass through to the members and retain the character they had in the company's hand. They are not included in computing the company's net income or net loss that passes through to the members.

Both the company's net profit or net loss and its separately stated items are allocated between the members based on their ownership interests. This is a "straight up allocation" because each member's share is proportional to his or her capital contribution. If the allocation were made in another manner, it would be a "special allocation" and additional provisions would need to be included in the operating agreement in order to be certain that the allocation will be respected for income tax purposes.

*3.2 Allocations Solely for Tax Purposes.* IRC §704(c)(1) requires that tax items, such as depreciation and gain, on property contributed to an LLC taxed as a partnership be allocated between the members so as to take into account any difference between the agreed value of the property for purposes of establishing capital accounts and the member's adjusted basis in the property. The income tax regulations permit the allocation to be made in more than one way, and this section leaves the selection of the method to be used to a decision of the members.

Because the allocation method can have a material impact on members from an income tax standpoint, members contributing substantial amounts of property may want to consult with their tax advisors and enter into an advance agreement with the other members about how the allocation will be made.

*3.3 Prorates.* If ownership interests change in the middle of a taxable year, profits and losses for the year must be allocated between members under IRC §706(d)(1). Such a change will occur if all or part of a member's interest is transferred, a new member is admitted, or a member's interest is redeemed by the company. The allocation can be made by either closing the company's books on the date of the ownership change or by prorating the gain or loss for the year of the ownership change. This section of the agreement allows the members to decide which method to use, subject to IRC §706(d)(2), which requires certain expense items to be allocated using the proration method if an LLC uses the cash method of accounting. This requirement prevents shifting

the company's income or loss between members by prepaying expenses or postponing their payment.

\* \* \* \*

## 10. Miscellaneous Provisions

*10.1 Amendment.* The operating agreement may be amended only by unanimous agreement of the members. This provision is consistent with a partnership model and protects the interests of minority members, whose rights might otherwise be subject to change without their consent.

*10.2 Binding Effect.* This agreement binds the successors in interest of the members and may, for example, require the successor in interest of a member to tender the interest for sale to the company under the buy-sell provisions of the operating agreement.

*10.3 Notice.* This section specifies the means by which notice is to be given to the members and the company.

*10.4 Litigation Expense.* This provision, which provides for the recovery of attorneys' fees in any action involving this operating agreement, can be deleted at the option of the drafter. Some drafters prefer to substitute an arbitration provision.

*10.5 Additional Documents.* The members may need to sign additional documents to complete the organization of the company or to complete contributions to capital, and this section requires them to do so.

*10.6 Counterparts.* This provision permits the members to sign separate copies of the operating agreement.

*10.7 Governing Law.* The law controlling the organization and operation of an LLC is that of the state in which the company is organized.

*10.8 Third Party Beneficiaries.* This provision seeks to prevent creditors of the company or of members from seeking to enforce the terms of the operating agreement.

*10.9 Authority.* This provision attests to the authority of any person signing the agreement on

behalf of an entity that is a member of the company. If all members are individuals, this section can be omitted.

*10.10 Counsel.* This provision seeks to address the conflict of interest issues that may be present if counsel for one member prepares the operating agreement. It can be omitted if the attorney drafting the operating agreement represents the company and has not represented any of the individual members in the past.