MATT DICKSTEIN

Practice Attorney

Making legal matters easy and economical for your practice

39488 Stevenson Place, Suite 100, Fremont, CA 94539
510-796-9144.   mattdickstein@hotmail.com   mattdickstein.com

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Negotiate an Operating Agreement in California

In this article, I explain the basic negotiation points for an LLC Operating Agreement in California. I focus mainly on control and on exit (buy-sell).

Control

Control starts with voting percentages, meaning, who has sufficient votes to control the LLC's decision-making? If the LLC has a board, control means the number of votes on the board. The member with control likes simplicity. Since it already has control, it wants to end the discussion there. An Operating Agreement drafted by the controlling member frequently has a short section on management that states the percentages or votes (i.e. control) and nothing else.

The members without control want complexity, that is, they want the Operating Agreement to have provisions that restrict the controlling member. Minority, non-controlling owners need to protect themselves from majority action. Protection usually comes in the form of veto votes, which give the minority a right to stop a particular action proposed by the majority. Consider these veto rights:

Veto Right	Rationale
Hiring, firing, replacing the manager or officers	Although the minority won't run the operations of the business, they want some control over who will.
Salaries & bonuses for management	Minority owners should prevent control persons from siphoning off substantial salaries and bonuses, leaving no profits for anyone else.
Affiliate transactions	This veto vote guards against the manager entering into sweetheart deals with its affiliates thereby redirecting profits to itself.
Distribution of profits	This veto vote helps minority members ensure some minimum distribution of profits to themselves.
Transfer of ownership interests	If the majority wants to sell their ownership to a third party, the minority might want to reject that third party as their new partner.

Issuing ownership interests to existing or new members	This veto vote guards against the unfair dilution of the minority owners, including when the majority sells ownership to themselves or friends at sweetheart prices.
Selling the business or merging	The minority wants some level of control over its ultimate exit, including to prevent the majority from selling the business in a sweetheart deal that primarily benefits the majority.
Amendments to the Operating Agreement	The minority doesn't want the majority to unilaterally change the terms of the deal.

Exit, a.k.a. Buy-Sell

Every Operating Agreement should have provisions for the buy-back of a member's ownership. I call this the economic divorce; others call it buy-sell. If the business, for whatever reason, needs to remove a particular owner, the Operating Agreement gets you a divorce on terms that are fair to everyone.

Triggers for Buy-Back. Traditional buy-sell involves what I call the 4 D's & 2 B's. The 4 D's are death, disability, divorce and dispute, and the 2 B's are bankruptcy and bad transfers. I talk about these buy-sell trigger events at length on my website.

Other buy-back triggers may include a litany of "for cause" events, and they essentially give the control persons a number of vague and open-ended reasons to remove an owner. Some LLCs just cut to the chase, without need for pretext, and permit the control group, at-will without-cause, to buyback a member's ownership. This latter expulsion can be important to the continued, smooth operations of the business, but it's clearly dangerous to the minority owners who are subject to removal.

Buy-Back Price. The buy-back price is the crucial term for all buy-sell events. A high buy-out price gives the exiting owner a windfall. A low buy-out price is unfair and leads to litigation. The trick is finding a procedure that ensures a fair price – for example, using a neutral appraisal process or accounting formula to fix a price. Next look at payment terms, because payment up-front in one lump sum is much better than payment by promissory note over a long period of time.

Non-Competition Covenant. In California, it's legal to apply a non-competition covenant to a minority owner who has been bought out. Most non-competition clauses are for a period from 1 to 3 years, and cover the region in which the business is active. I have lots of articles on this topic on my website.

Call me if you want to talk more.

Simpsons

- *Marge*: This is the worst thing you've ever done. *Homer*: You say that so often that it's lost all meaning.
- *Bart to Homer*: It's just hard not to listen to TV: it's spent so much more time raising us than you have.
- *Homer*: I hope I didn't brain my damage.