Insights: Publications

8 Key Takeaways | Navigating Operating Agreements: Material Terms and Best Practices

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At a recent **Association of Corporate Counsel (Charlotte Chapter)** event, Kilpatrick's **Mikail Clark** presented on the topic of "**Navigating Operating Agreements: Material Terms and Best Practices**."

Mr. Clark provides the following key takeaways from the discussion:

1. Ownership and Governance. A manager is responsible for the governance of the business and the affairs of the LLC, including the operation of the LLC in the ordinary course of its business (e.g., hiring employees, entering into contracts, etc.) and the making of major decisions on the LLC's behalf (e.g., a sale of the LLC). Typically, managerial powers and authority is exclusive: except as set forth in the operating agreement, the members have no right to govern the affairs of the LLCs. Generally, such exceptions are limited to negative controls over major decisions and the election, removal, and replacement of managers. A member is a holder of equity in an LLC which entails both economic rights (i.e., right to receive profits and incur losses) and governance/voting rights. Like shares of a corporation, membership may exist in classes, each of which may. contain distinct preference, rights, and privileges. In member-managed LLCs, members have the power and authority to govern the affairs of the LLC; however, in manager-managed LLCs, members' governance rights are typically very limited. Persons other than members may hold equity or quasi-equity rights in an LLC in a variety of ways, all of which are generally devoid of any meaningful governance rights.

2.Voting Rights. In manager-managed LLCs, members typically have little (if any) voting rights, and voting is limited to required consent for major decisions and the election, removal, and replacement of managers. Although the consent threshold is usually a simple majority for both members and managers, the consent threshold with respect to such decisions is usually higher (e.g., a supermajority). In member-managed LLCs, members have broad voting rights, but such rights may vary based on classes of equity (if any) and the members' respective ownership percentages. Voting may occur at a regular or special meeting of the members or managers, but typically just occurs via written consent.

3. Negative Controls/Protective Provisions. In both manager-managed and member-managed LLCs, it is common for certain major decisions to require the consent of at least a majority of the members. Examples of such decisions include amendments to the Operating Agreement or Articles of Organization; a sale, merger or other business combination of the LLC; the LLC's entrance into a joint venture or partnership; the issuance or redemption of equity in the LLC; the incurrence of major expenses such as capital expenditures; the incurrence of debt and the any disposition thereof in a manner inconsistent with the terms of the applicable loan agreement, note, etc.; the LLC's dissolution, wind-up, and liquidation; the LLC's bankruptcy or judicial insolvency; the LLC's change of tax status; the LLC's change of its principal line of business, jurisdiction of formation, or type of legal entity; transactions between the LLC and members or affiliates thereof; and capital calls.

4. Tax Statuses. An LLC is a flexible entity that can be classified as either a pass-through entity (PTE) or a c-corporation for federal and state tax purposes. PTE status is the default status of LLCs and includes a disregarded entity or "DRE" (one member) or a partnership (members). PTE status simply means that, unlike a C-corporation, an LLC is not taxed on its income; rather, the income is deemed to be "passed through" to its members, who are each taxed on their respective portions of the LLC's income. Alternatively, an LLC can elect to be taxed as a S-corporation or a C-corporation by filing IRS Form 2553 or 8832, respectively. In addition, an LLC taxed as an S-corporation must comply with all rules generally governing S-corporations: it must have 100 or fewer equity holders, all of its equity holders must be individual U.S. citizens or residents (or grantor/settlor trusts), and it can only have 1 class of economic equity.

5. Distributions. Commonly referred to as the "waterfall", distributions are simply any cash or other LLC property (less Company expenses and reserves) distributed to an equity holder with respect to its equity. Like the declaring of a corporation's dividends, distributions usually require manager consent. Although distributions are typically pro rata to each equity holder in accordance with the percentage of equity held by such equity holder, an LLC's waterfall can incorporate a wide variety of nuances and iterations such as preferred returns, carries, hurdles, and catch-ups. To avoid the issue taxes resulting from "phantom income" (i.e., a member being assessed taxes based on LLC income that is not actually received by or distributed to the member, such as cancellation of debt), Operating Agreements typically require the LLC to make distributions in such instances in an amount equal to the estimated tax liability resulting from the phantom income.

6. Transfer Restrictions. Transfers and encumbrances of an LLC's equity are prohibited and require the consent of the managers and/or a majority in interest of the members. Such transfers may also require compliance with securities laws and the proposed substitute member's execution of a joinder to the LLC's operating agreement. Common exceptions to this prohibition include transfers to an entity owned/controlled by the transferring member (or an affiliate thereof), transfers for estate planning purposes, transfers to immediate family members upon a member's death, and transfers to other members. In the private equity acquisition context, it is also common that transfer restrictions be limited to the investment horizon (e.g., 3-5 years).

7. Buy-Sell Events. A buy-sell event is an event affecting a member that gives the LLC and/or other members a right to repurchase the member's equity. Buy-Sell triggers are very common in closely-held LLCs with individual members. Examples of buy-sell events include a member's death, legal incompetency, bankruptcy, dissolution/liquidation, breach of contract, and divorce (particularly in a community property state). Buy-sell procedures should be through and should provide for, among other things, the manner and period in which the buy-sell option may be exercised, the manner in which the purchase price is determined, the interim powers of the subject member, and the closing of the transaction.

8. Exit Rights. Operating Agreements typically include drag-along, tag-along (co-sale), and right of first refusal provisions. A drag-along right grants members holding a certain percentage of an LLC's equity (usually a majority) the right to force the other owners to sell the LLC, whether through a sale of equity, assets, a merger or other business combination in which the LLC does not survive, an equity exchange, or otherwise. A tag-along is a reciprocal right granted to minority members: if the majority wants to sell the LLC, the minority can join in the sale. A right of first refusal grants the LLC and/or the members to right to purchase the equity of a member who receives a bona fide offer third party to purchase the equity, but is subject to any drag-along rights and cannot be exercised along with any tag-along rights. Other exit rights may include optional puts or calls after a holding period or upon the

occurrence of a certain event (e.g., LLC valuation at certain EBITDA multiple, achievement of certain sales revenue) and the right the force a sale of the LLC upon the occurrence of such an event. Provisions governing exit rights that are frequently negotiated include the threshold for dragging, the scope of the dragged members' indemnity and post-closing obligations, and the process for determining the fair market value of the LLC's equity.

For more information, please contact
Mikail Clark, moclark@ktslaw.com.

www.ktslaw.com

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Mikail O. Clark
t 704.338.5286
moclark@ktslaw.com