Take Time for Caution When Forming an LLC

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Many people who form a limited liability company with family members, friends or acquaintances do so without taking the time to follow some important formalities. One such formality is the creation of a well-thought-out, written operating agreement that clearly sets forth the various rights and responsibilities of the members and managers of the entity. Unfortunately, many who forego the effort and expense to prepare an operating agreement in the beginning learn to regret their failure to do so later.

Within the Colorado Revised Statutes, the Colorado Limited Liability Company Act is designed to provide those who wish to form an LLC with extensive flexibility. In fact, the statute regarding LLC operating agreements states: “It is the intent of this article to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements.”

To reinforce the “freedom of contract” ideal, the act, at §7-80-108(1)(a), C.R.S., further provides that, with very few exceptions, the provisions set forth by the parties to an operating agreement “shall control over any provision of this article to the contrary…” However, while the act does permit such extensive flexibility, if an LLC lacks an operating agreement prepared by the members of that LLC, or to the extent that the operating agreement of the members fails to address certain issues covered in the act, that same section states that the provisions of the act “shall control.”

The provisions of the act are not always in conformity with the expectations and preferences of the LLC’s members. The provisions regarding the selection of a manager and regarding the transfer of interests in the LLC provide good examples of this problem.

Regarding the selection of the manager, in most LLCs the manager is chosen based on a vote of the members. In most LLCs, the operating agreement would provide that voting rights of the members are allocated based upon the relative percentages of the membership interests owned by the LLC’s members. This is similar in principle to how the voting rights of shareholders in a corporation are dependent upon the number of shares each shareholder owns. For example, if the three members of an LLC own 80 percent, 15 percent and 5 percent of the respective membership interests, those members would be allocated 80 percent, 15 percent and 5 percent of the respective votes in any matter requiring a vote.

But not under the Colorado statute. The act provides, “Managers may be designated and removed by the consent of a majority of the members.” This provision is based solely on the number of persons who are members in the entity, without reference to their relative interests.

In the above example, assuming the member with 80 percent of the membership interest in the LLC is the manager, the result of this default provision in the act would be that the two members holding only a combined 20 percent of the membership interest in the LLC can remove the one owner of the 80 percent membership interest from his manager position. Even though they have a comparatively small combined membership interest, this provision in the act gives the two minority-interest owners control simply because they outnumber the one 80 percent owner.

Regarding the transfer of interests in the LLC, most written operating agreements place restrictions upon the ability of members to transfer their respective interests in the LLC. Understandably, because LLCs tend to be smaller entities, the members wish to exercise some control over who owns interests, and thus who they are willing to work with in the LLC. Some transfer controls can be placed in a written operating agreement.

The act provides that "[t]he interest of each member in a limited liability company constitutes the personal property of the member and may be assigned or transferred." This provision in the Act places no limits on the transferability of LLC interests, a circumstance that can lead to undesirable results if a disgruntled or otherwise uncooperative member decides to sell or otherwise transfer his or her interest in the LLC to someone with whom the other members have no interest in working.

For these reasons, among many others, it is in the best interests of the members of an LLC to execute a thorough, written operating agreement carefully tailored to meet their needs, expectations, and preferences. The absence of such an agreement can result in the increased likelihood of future misunderstandings and disputes. While the act provides that an operating agreement need not be in writing, an unwritten operating agreement can seem like no agreement at all when uncertainties arise, and can lead to misunderstandings and litigation because there is no roadmap for how to settle a dispute or unexpected circumstance. A written operating agreement is the most effective way for the members of an LLC to clearly set forth their understanding of their respective rights and responsibilities.

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