

Show Me the Money Operating Agreement: Key Provisions in Organizational Documents to Consider Before Making an Investment



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They say “knowledge is power.” If so, then the best way to have power over your investments is to know the business you are investing in. Limited liability companies (commonly referred to as “LLCs”) are common vehicles for businesses to operate under, especially in Oklahoma. An Operating Agreement is the primary document an LLC will have that sets forth the terms of how an LLC operates. There are many aspects of a business that an investor should examine before making an investment, but carefully reviewing the Operating Agreement

should be at the top of any investor's "to-do" list. While each provision of an Operating Agreement is important for an investor to understand the terms of their investment, below is a summary of the key provisions that investors should carefully consider before making an investment in an LLC.

Classes of Securities

The "Units" or "Membership" section in an Operating Agreement should specify whether the membership interests in the LLC are divided into separate classes. Membership interests can be broken out into multiple different classes, each with different economic, voting, and management rights. If the Operating Agreement specifies different classes of membership interests, it will be especially important to know what class of membership interests an investor is purchasing and what rights that specific class of members has under the Operating Agreement.

Capital Contributions

While the "Capital Contribution" section in an Operating Agreement may not seem noteworthy at first glance, investors should pay close attention to any subsection titled "Additional Capital Contributions" or "Capital Calls." Operating Agreements often have provisions regarding the circumstances in which the LLC can require members to contribute additional cash to the business. When making an initial investment in an LLC, an investor may not realize that they could be obligating themselves to continue to put cash into the LLC in the future. If a member is required to make an additional capital contribution under the Operating Agreement and refuses or fails to do so, Operating Agreements often punish those members by diluting their interest or, in some instances, expelling them from the LLC (potentially at a discounted valuation). It is especially important for an investor to fully understand in what instances the LLC can require members to make additional capital contributions and

the potential risks associated with failing to do so before making any investment.

Distributions and Allocations

The “Distribution” and “Allocation” sections in an Operating Agreement detail the economic terms regarding an investment in an LLC. Typically, net income and loss are allocated to each member’s capital account based on the percentage of ownership each member has in the LLC. However, there are often special allocation provisions in Operating Agreements that allocate a disproportionate amount of net income and loss to specific members, especially when there are different classes of membership interests. Distributions of cash are also usually made in proportion to each member’s percentage of ownership in the LLC; however, there are often different tiers (commonly referred to as a “waterfall”) where certain members are entitled to receive specific amounts of cash distributions made by the LLC. These disproportionate levels of distributions could be made on a perpetual basis, or they could be triggered by certain events occurring. A careful review of these sections is essential in determining the economic terms of any investment.

Management

The “Management” section of an Operating Agreement will describe who is responsible for managing the business and affairs of the LLC and what restrictions there are on such person’s or entity’s management authority. If an investor is purchasing a significant amount of the membership interests in an LLC, they may want to negotiate one or more seats on any “board” of managers or restrict the manager(s) from making certain decisions without their approval. Investors of all sizes should carefully review the Operating Agreement to determine if the manager(s) are prohibited from taking certain actions without receiving a certain level of consent from the members (or certain members). Such restricted actions could

include selling a significant amount of the LLC's assets, making purchases over a certain amount, or dissolving the LLC. This section is especially important in evaluating the level of control an investor will have over the LLC.

Transfers

The "Transfer" section of an Operating Agreement can often have the most impactful provisions regarding an investor's investment in an LLC. Frequently, members are prohibited from assigning their membership interests in an LLC to a third party without first either obtaining the manager's and/or other members' consent or offering their membership interests to the existing members pursuant to a "Right of First Refusal" clause. Members may also be forced to sell their membership interests (or may force other members to sell their membership interests) in certain instances pursuant to any "Drag" and "Tag" provisions found in the Operating Agreement. The "Transfer" section may also include certain buy-out provisions which set forth the terms on which a member can be forcefully bought out of the LLC by either other members or the LLC itself. Investors should read the "Transfer" section of an Operating Agreement carefully to determine what restrictions exist on their ability to transfer their membership interests in the LLC and in what instances they may be forced to sell their membership interests.

While an investor and their attorney should closely read each section of an Operating Agreement, the foregoing sections contain the terms that will likely have the most impactful provisions on any investment. Before making any investment in an LLC, investors should be certain that they fully understand the terms of their investment and their rights and obligations under the Operating Agreement.

About the author:

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