

**GREINER**  
& ASSOCIATES PLLC

## OPERATING AGREEMENTS

AN OUNCE OF PREVENTION OVER A POUND OF CURE



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## CHAPTER 1 / THE BASICS OF OPERATING AGREEMENTS



Imagine this, your business is your life's work. You've put in years of blood, sweat, tears and sleepless nights into developing it. Then one day, something unexpected happens. Your business partner wants out, a client wants to sue, or maybe you're getting an offer for a buyout. How do you navigate these situations? If other owners are involved, how do you ensure that the best interests of your company will be met?

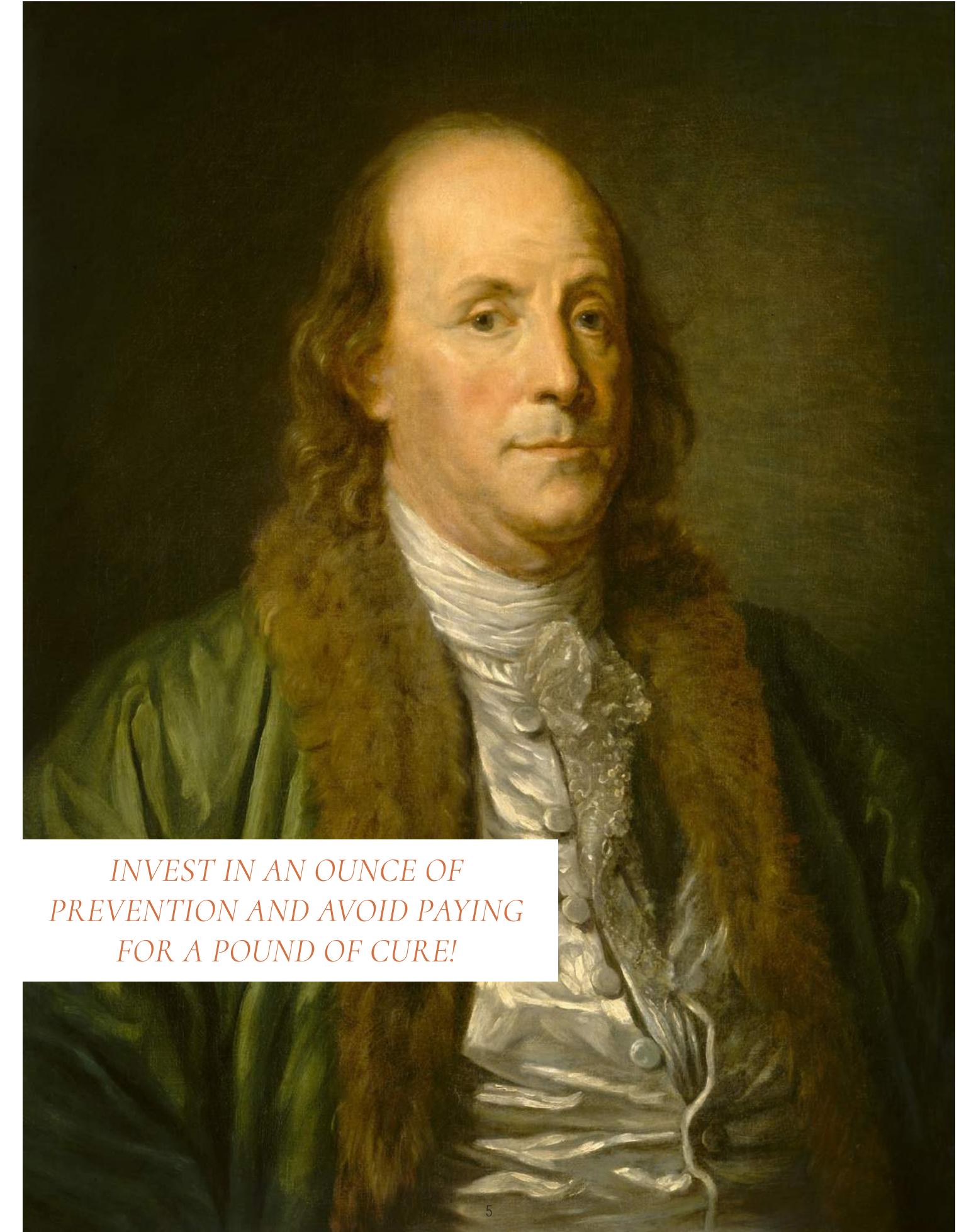
The answer is to follow the processes defined by your business' operating agreement. Operating agreements help deal with many possible situations including allocation of liability, distribution of profit and losses, voting and decision making authority, duties owed to the company and other parties, and more.

Every business should have a company agreement. The state of Texas has a default set of rules that governs how your business will operate absent a separate operating agreement. If you did not take the time to

consult with a lawyer and develop a custom operating agreement, it's likely you will find yourself falling back on the default set of rules to navigate these business-altering situations.

You wouldn't trust a doctor to perform the same operation on everyone, regardless of their illness – so why would you trust an operating agreement that was written for someone else's business.

Custom operating agreements provide cures. Cures that you, the other owners and your lawyer have previously discussed and agreed to, eliminating headaches during what are often stressful and scary situations. The default rules provided by the state of Texas could do your business more harm than good. To ensure a healthy and productive future, it is recommended you make the time and financial investment to develop a custom company agreement tailored to your business' needs.



*INVEST IN AN OUNCE OF  
PREVENTION AND AVOID PAYING  
FOR A POUND OF CURE!*

## CREATING A COMPANY AGREEMENT



OPERATING AGREEMENTS CAN BE AS FLEXIBLE  
OR AS UN-FLEXIBLE AS NEEDED.



It is recommended that you sit with a lawyer that is passionate about your success to develop a customized operating agreement. A reputable lawyer will spend the time to get to know you and your business needs. Businesses small and large have several layers, unique organizational structures and often ambitious growth goals. Each of these pieces can be protected and better defined by an operating agreement.

For example, your operating agreement can outline your organizational structure. This includes what types of roles parties assume and what each role can operationally do within the company. Often times these roles are shareholders, directors, officers and general employees, though they can go by many other names.

A great business lawyer will also help you understand the importance of preventative measures. Together, this process will result in a company agreement that helps achieve better results. Better results may look like settling disagreements quietly and avoiding court or feeling confident about big decisions that drive the company's direction forward.

There are particular pieces of Texas' default operating agreement that cannot be altered. For example, every business registered with the Secretary of State must have a registered agent. There's no way around this. However, a smart combination of what can and what cannot be changed will mean the difference between having the odds stacked in or against your favor.

## CHAPTER 2 / BUSINESS FORMATION & ENTITY TYPES, HOW TO PROTECT YOUR PERSONAL ASSETS FROM BUSINESS LIABILITY

- There are many different entity types available to new businesses. Which one you select will determine all aspects of how your business operates, including how liability and responsibility is divided amongst your company. It is highly recommended that you involve a lawyer in the entity exploration process taking into consideration issues such as taxes, liabilities, management and duration of the company, ownership interests and transferability and formality of operation. Each entity type has a list of pros and cons and only a reputable business lawyer can help ensure what you select will truly serve your business best. A few of the more common entity types are discussed on the following page.



### 1. SOLE PROPRIETORSHIP

Sole proprietorship is the oldest and most common type of business entity. It represents man's entrepreneurial desire, giving the individual who conducts the business full ownership of all the assets. A single individual engages in business and does not require formal organization by filing with the Secretary of State. It also does not include any personal liability protection; your personal assets are treated as a part of your business and vice versa. This includes any debts that the business incurs. This can be a dangerous choice because of the lack of liability protection. However, the ease of formation and operation can be appealing for business owners who plan on solely managing the business.

*Do you need to pay for filing?* No

*Do you need an operating agreement?* No

### 2. GENERAL PARTNERSHIP

General partnerships were created to serve two or more people who agree to operate a business together. This is often a popular choice for married couples who go into business together. It is recommended that the partnership operate in accordance with a partnership agreement, but there is no requirement of a formal written agreement. Like the sole proprietorship, a general partnership does not require formal organization by filing with the Secretary of State. Notable characteristics of this business entity include its informality and great flexibility on the terms of the business agreement. There is still no protection against personal liability and you can be held accountable for the actions of your partner. If your partner builds up debt or makes a poor business decision, you can be held equally responsible.

*Do you need to pay for filing?* No

*Do you need an operating agreement?* No

### 3. LIMITED PARTNERSHIP (LP)

A limited partnership is a partnership formed by at least two people having one or more limited partners with one or more general partners. This entity can be traced back to medieval times, it was developed by the common wealth merchants. In this entity, the limited partners can receive liability protections. These limited partners are typically just equity partners that do not serve in a management role, therefore eliminating their liability for any results from company management. The general partner takes responsibility for managing the business and unlimited liability for the debts of the business. In this type of partnership, the limited partners are often kept from receiving the benefit of tax losses generated by the business.

*Do you need to pay for filing?* Yes

*Do you need an operating agreement?* Yes

### SELECTING THE RIGHT BUSINESS ENTITY

Selecting the right business entity will help ensure you and your personal assets are protected and that the right people are managing the business. There is no 'one size fits all' approach to selecting a business entity. Working with a reputable business lawyer with experience will help ensure you make the right choice because of logical, objective business reasons – not knee-jerk reactions to what you believe might be best. Owning and operating a business is a large picture project that requires having the skill to envision and predict the importance of each moving part.

Businesses also have the ability to change their entity type if needed. This largely occurs once business grow and develop different needs. Motivations behind changing entity types may be tax savings, operational restructuring, merging with or acquiring another company.

### 4. LIMITED LIABILITY PARTNERSHIP (LLP)

In Limited Liability Partnerships, the liability of partners for obligations of the partnership is substantially limited. LLPs have three requirements. First, the name must include "limited liability partnership" or the letters "LLP". These letters inform others that there are liability safety nets in place. Second, you must file with the secretary of state with an additional per partner filing fee. Finally, you must carry liability insurance. Typically, you are required to carry at least 6 figures or more in insurance.

*Do you need to pay for filing?* Yes, additional fees are charged per partner

*Do you need an operating agreement?* Yes

### 5. LIMITED LIABILITY LIMITED PARTNERSHIP (LLLP)

Limited liability limited partnerships are similar to LLPs, except in these entities a general partner also receives liability protection from the debts of the business. It is not widely used in Texas, especially because Texas does not distinguish between an LLP and an LLLP.

*Do you need to pay for filing?* Yes

*Do you need an operating agreement?* Yes

### 6. CORPORATION

Corporations have been around for close to 500 years, inspired into creation by the need to organize large public-facing operations such as universities. A corporation is a legal entity characterized by limited liability, centralization of management, perpetual duration, and ease of transferability of ownership interests. In a corporation, owners are shareholders and the company is managed by a board of directors that are elected by these shareholders. From here, the company organization often includes chief officers, managers and general employees. Shareholders typically have very little control over the management of the business.

*Do you need to pay for filing?* Yes

*Do you need an operating agreement?* Yes

### 7. LLC

A Limited liability company (or LLC) is neither a partnership nor a corporation. LLCs are popular among start-ups because of three main characteristics. They allow for limited liability, partners have the ability to participate in business management and they receive favorable income tax treatment. This is the newest form of business entity. Business owners can choose the best parts of different entity types to create a very tailored form of business organization. Many startups and new businesses exist solely because of the formation of LLCs and how great of an entity option they can be for the right business.

*Do you need to pay for filing?* Yes

*Do you need an operating agreement?* Yes



## CHAPTER 3 / LIMITING YOUR LIABILITY, PROTECTING YOUR ASSETS

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Let's say a client sues the company and wins. The court awards them **\$500,000.00**, but the company is only worth **\$300,000.00**. Can you be held personally responsible for the remaining **\$200,000.00**? The answer is dependent upon the type of entity you choose and what role you play within that entity. The extent of liability protection you (*as a business owner*) can enjoy is a major factor to consider when selecting an entity.

It often depends on the goal you wish to accomplish and where your money is coming from. Falling back on a sole proprietorship or a general partnership can leave your personal assets unprotected from business liabilities. If you don't wish to be responsible for debts or obligations of the company we recommend working with a business attorney before selecting an entity type.



## LIMITED PARTNERSHIP (LP) LIABILITY

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The limited partnership is the first step above the general partnership in terms of liability protection. General partners in a limited partnership, are not afforded liability protection, meaning they can be personally responsible for debts and obligations of the company. (*This is why you will usually find that the general partner in a limited partnership is another business entity rather than an individual.*) Limited partners of the limited partnership enjoy liability protection as long as they do not participate in the management of the company. Limited partners only stand to lose the capital already invested in the company. Creditors cannot go after their personal assets.

## LIMITED LIABILITY PARTNERSHIP (LLP) LIMITED LIABILITY LIMITED PARTNERSHIP (LLLP) LIABILITY

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The feature that distinguishes an LLP from a partnership not properly registered as an LLP is the limitation on the personal liability of partners. Partners are afforded protection from the liabilities incurred by the business or other partners. A partner will not, however, be protected from liability in situations where the partner personally guarantees a contractual obligation or personal misconduct.



## LIMITED LIABILITY COMPANY

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Like a Corporation, an LLC provides its members and managers a full liability shield. You are protected from any debts or obligations while maintaining the ability to participate in the management of the company. As is always the case in law, the liability protections of an LLC are not absolute. Certain circumstances or actions could open you up to personal liability. For example, members of an LLC who personally participate in wrongful acts cannot hide from punishment behind their LLC.



## CORPORATION

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The liability limits of a corporation are similar to that of an LLC (see above). Corporations are well known for their complete liability shield, which is why they have long been such an attractive option for business owners. Like an LLC, unless a shareholder, director or officer abuses the privilege of operating a corporation they will have no liability for the debts and obligations of the company. Officers and Directors can also incur liability for breach of duties owed to the company. As managers of the company, they are charged with acting in the best interest of the company. Generally, Shareholders have no liability because they don't participate in the management decisions. If shareholders were held accountable it would be as if after someone purchased stock off the stock market they also became liable for management decisions they had no control over. Honestly, that's just not fair. A corporation is what people typically chose when they want a strict division of liability.

CONGRATULATIONS

DON'T PANIC!

**CHAPTER 4 / HOW TO ALLOCATE THE PROFITS/LOSSES  
BETWEEN MEMBER TYPES**



IT'S HARD TO BELIEVE WE ARE  
THIS FAR INTO A WRITING ABOUT  
COMPANY AGREEMENTS, ENTITY  
TYPES AND LIABILITY OPTIONS  
AND WE HAVEN'T STOPPED  
TO CONGRATULATE YOU ON  
WANTING TO START A BUSINESS. ►►

►► It's understandable that by chapter 4 you may be feeling a bit overwhelmed. This can be a lot of information to digest, try to organize and understand enough to plan your next steps. After all, this is just one more piece of the puzzle.

Your passion is your business, our passion is law. Take a deep breath and really think about the value a creative, bright business attorney could provide you.

How to allocate liabilities and profits between members depends on two things: the business entity type and the operating agreement. Again, to reinforce the theme of this paper, it is critical that you start with an attorney who is knowledgeable in business law from the very beginning.

A great lawyer who does their job well, will be able to create a combination of what you need and what you want. It's important that your business lawyer understands the difference between your wants and needs – both are critical to the success of your business and to building trust. Ultimately, the sky is the limit when it comes to options on allocating liabilities and profits. For example, with the right operating agreement these allocations can differ even within the same entity type.

It's difficult to wrap up this chapter without placing disclaimers at the end of each sentence. Each situation is different and each solution has the potential to be different. Thankfully, that's the beauty of working with a business lawyer during this process.

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*ULTIMATELY, THE SKY IS THE  
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OPTIONS ON ALLOCATING  
LIABILITIES AND PROFITS.*





## CHAPTER 5 / HOW TO SELECT YOUR FEDERAL TAXATION TYPE

Determining how your entity will be taxed is very important. Choosing the wrong entity type or selecting the wrong type of taxation within your entity can eat into those profits you have worked so hard to earn. Taxation is such a specialized area of practice that we actually recommend you involve a tax attorney or tax specialist in the process of setting up your business. As business attorneys ourselves, we have a handful of great tax specialists that we rely upon for these types of matters; this is especially true when you consider how frequently our tax code is changed by the Legislature (*every year*). That being said, the tax treatment you can expect, again, depends upon the entity type you select.

**►► 1. SOLE PROPRIETORSHIP**

In a sole proprietorship the business owner and the entity are treated as one and the same. The IRS does not view the business as a separate taxable entity so all assets and liabilities of the business are included and taxed directly with the owner's personal taxes.

**2. GENERAL PARTNERSHIP**

A general partnership works much the same as the sole proprietorship. The IRS does not consider the business to be a separate entity from the owners, so the income from the partnership is treated as belonging to the individual owners who will be taxed on said income at their own individual tax rate. This is what is generally referred to as "pass-through" taxation.

**3. LIMITED PARTNERSHIP (LP)**

LPs, LLPs, and LLLPs, are taxed the same as a general partnership. They enjoy the benefits of "pass through" taxation. No tax is paid by the partnership itself. Instead, each owner will be taxed based upon their individual share of the company in relation to their earning bracket and any tax deductions utilized.

**4. LIMITED LIABILITY COMPANY (LLC)**

While LLCs are considered to be a separate legal entity apart from their owners for purposes of liability protection, they are generally treated like general partnerships for federal tax purposes. LLCs, however, are unique in that the owners have the ability to elect to be treated as a corporation for tax purposes. Whether this election is right for a particular business requires a discussion with your business attorney and tax specialist.

**6. CORPORATION**

There are two types of corporations as far as federal income tax is concerned, a C Corp and an S Corp. C Corps are subject to a corporate income tax and the owners will pay taxes on any distributions from the company. This is commonly referred to as "double taxation". If a Corporation meets specific requirements it can file a special election to be an S Corp. This allows the corporation to be treated more like a partnership for federal tax purposes and avoid the "double taxation" of a C Corp.



## FINAL NOTE

► Starting a business can be one of the most rewarding experiences of your life. It comes with its own unique set of challenges and demands that no one can predict; but, with the help of a trusted business attorney you can be protected and well educated on your options along the way.

It is our hope that this eBook has inspired you to move forward with collaborating with a business attorney when creating an operating agreement and selecting an entity type. If you have questions or want to talk about your options, give us a call. We'll be happy to help you.

Until then, enjoy the journey of starting a business. You are living the American Dream!



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