

What's the Big Deal? The Importance of Having an Operating Agreement for Your LLC

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So, you've started a business with your buddy. Enthusiasm is high, things look promising, and you've decided to formally register your business as a limited liability company (or, ahem, if you haven't formally registered your business, you plan to do so ASAP). Now, what about that oft-neglected next step after registering as an LLC: creating an operating agreement?

When all is good, well, and exciting in the early days of your business (or, let's be honest, even if all is not good and well), it can seem like a tedious and lower priority task to put together an operating agreement for your company. After all, you and your buddy trust each other, are on the same page about your respective roles in the business, have agreed on how you'll divide future profits, and hey, even if you have a disagreement, you've always been able to work it out in the past. You'll put together an operating agreement later on, if and when things really get rolling.

Don't fall into this trap. Failing to have an operating agreement can jeopardize everything you've been working for. Commit to having an operating agreement in place for your company right from the start. Here are a few reasons why:

1. Default statutory provisions might catch you off-guard. This is perhaps the single most important reason every LLC should have a signed operating agreement in place, even if it's a relatively simple one. Although every state has its own statute governing LLCs, most are extremely deferential to operating agreements and apply certain provisions of the statute only in the absence of an operating agreement that says something different. Big deal, you say; why not just let the statute act as your operating agreement? It sure sounds a lot easier. Well, LLC statutes often contain unexpected provisions that may result in drastically different outcomes than you intended. As just one example, in Michigan, if you don't have an operating agreement specifying how distributions should be divided among the LLC's owners (called members), any distributions of cash or other assets are to be allocated in equal shares to all members. Further, if you haven't specified voting rights in an operating agreement, a "one member, one vote" default rule applies in Michigan. That means, even if your buddy only contributed 5% of the capital to the company, without a written agreement in place he or she could technically claim 50% of the profits and have equal power in making business decisions!

2. An operating agreement brings formality to your business and helps separate the business

from its owner(s). It is no secret that one of the major reasons for operating a business through an LLC is to protect yourself from being personally liable for the debts and liabilities of the business (hence, the limited liability company). But to ensure this liability protection holds up, you should run your business with a level of formality and keep the business operations and assets completely separate from any accounts or activities of the owners. Having a signed operating agreement in place helps show this separation and formality, and provides a "playbook" of sorts by which the members and/or managers are to run the business.

3. Preparing in advance for later misunderstandings can prevent huge headaches (and legal fees) later on. This almost goes without saying, but as with any business relationship, it is important to reduce your understanding with your buddy to writing in order to prepare for future misunderstandings, disputes, or unexpected events. What if one of you becomes disabled and cannot put in as much (or any) time anymore? Or, what if one of you gets promoted at his/her "day job" or finds a new gig and wants out of the business? You'll want to have procedures in place via an operating agreement to address these situations smoothly. If possible, you should solicit the assistance of someone who is experienced with operating agreements, such as a business lawyer. He or she will know what types of scenarios to prepare for and can talk you through unique considerations for your particular situation. You and your buddy could each get your own lawyer if you want to be sure someone is prioritizing your personal interests, but more commonly a lawyer will represent the entity itself and take a neutral stance in preparing a fair and functional operating agreement.

4. Even if you are the sole owner of your LLC, it is still a good idea to have at least a simple operating agreement in place. Not only can an operating agreement help create the separation and formality discussed above, but it can also act as a safeguard against unintended consequences of bringing on additional investors/owners too soon without an agreement. Often, a single-member LLC operating agreement will contain a provision that says a new, more detailed operating agreement (addressing matters such as voting rights, allocations of profit and loss, timing of distributions, and designation of a tax matters member) must be entered into before a new member will have any rights as a member. A single-member operating agreement may also contain a provision describing what happens if the sole member dies or becomes permanently disabled, which your loved ones will appreciate.

You and your buddy may be in the early stages of running your LLC, but don't delay in creating an operating agreement. Although it is better late than never to put one in place, it is best treated as one of the very first steps in setting up your business.

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