



# Business Divorces:

## No Written Operating Agreement Is a Common Pitfall for LLCs

By Stephen A. Pedneault

Attorneys who work with small businesses know that “business divorces” have all the drama and heartbreak of a marital divorce. And, when the “love” dies in a business relationship, the paperwork had better be there or it won’t be pretty.

Consider this fable as an example of an LLC gone wrong: Mary and Susan, friends for years, met one day for coffee to discuss a common interest—health and fitness. Mary, whose kids recently started school, was regaining her daytime schedule, allowing her capacity to get involved in a new business idea. Susan, whose career occupied the largest part of her schedule, had the financial wherewithal to support a new venture. Over the course of their coffee, they forged the idea of starting a health and fitness business targeted towards stay-at-home moms. Mary agreed to be responsible for setting things up including completing required tax forms, establishing a bank account, buying a computer, setting up the books and records for tracking, and starting to look for an appropriate space to house their business. Susan provided a large initial contribution that was used to establish the financial support needed to open. She also set up the company as an LLC herself without consulting an attorney. Neither one of the women even considered the thought of a written operating agreement or by-laws. After all, they were long-time friends with a shared passion of the new venture. What could possibly change that?

For nearly two years the business ran as designed, with Mary running the day-to-day

operations, maintaining the bookkeeping records, recruiting more members, and handling all financial aspects of the business. Susan modified her schedule to be present in the business as frequently as possible, but in reality relied on Mary to ensure the business’ continued success. Over the period, Susan made additional capital contributions to maintain cash flows and pay company vendors. Mary told Susan she, too, was making contributions.

As often happens, the business lost momentum. With declining revenues, it required more and more capital. Susan frequently asked Mary what was happening and sought access to the business records, only to get no response. The relationship between Susan and Mary quickly deteriorated. When Mary changed the locks and security access codes to the building, the business in essence became the sole possession of Mary, leaving Susan out in the cold. Susan retained counsel, and the process to obtain answers for Susan began.

To determine what happened during Mary’s watch and see if she could recover any part of her investment, Susan’s attorney had to commence an action, and subpoena the business’ books, records, bank statements, tax returns, and other financial information. She had to retain someone to recon-

struct the financial transactions to find out the true nature of the activity that occurred. Her goal was to establish credible financial information upon which the matter could be pursued and ultimately resolved. And here’s where Susan ran into her biggest hurdles. There was no written operating agreement that memorialized her understanding with Mary. As a result, she had little to no recourse when she learned that Mary had not made the contributions she claimed she’d been making each time Susan infused the company with capital. Susan also learned that Mary had been using the business funds to pay her personal expenses. The information tracked by Mary within her QuickBooks system was unreliable, and the filed tax returns were based upon manipulated financial information. The reported results as well as the capital accounts on the partnership tax returns and K-1s were incorrect and improperly reflected, concealing Mary’s true activity.

While no business divorce is easy, there are ways to avoid this sort of thing, and it’s largely about the formation that starts the day the parties decide to set up the entity. Due to the ease in establishing an LLC coupled with its flexible form to conduct business, the LLC is one of the most com-

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## President's Message

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cation, with an eye toward the possibility that if we do not regulate this, the legislature may very well do it.

In view of the increased effort by legislative bodies to regulate the profession and invade the attorney client privilege, we should remind ourselves of the importance of self-governance.

To the extent that lawyers meet the obligations of their professional calling, the occasion for government regulation is obviated. Self-regulation also helps

maintain the legal profession's independence from government domination. An independent legal profession is an important force in preserving government under law, for abuse of legal authority is more readily challenged by a profession whose members are not dependent on government for their right to practice.

Preamble, *supra*. With these principles in mind, we have opposed legislative regulation of the legal profession. Although there has been a suggestion from time to time regarding a national bar, we are committed to Connecticut lawyers being regulated by the Connecticut Judicial Branch. I suspect that few among us want our profession to be regulated by the U.S. Congress, which

is a possibility if a national bar existed. We view state legislative regulation of the legal profession with a high level of scrutiny. Although there are narrow situations where the state legislature must pass laws that regulate the legal profession (e.g., the unauthorized practice of law), we believe that the General Assembly generally should stay out of regulating the legal profession.

Self-regulation is a hallmark of our profession. The storied history of our profession underscores the crucial role of our profession in a representative democracy. This role remains secure by self-governance. If we don't do so, the legislature surely will. **CL**

## Business Divorce

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mon forms of entity for small businesses. Unfortunately, all too many individuals discount the importance and value of seeking professional advice and counsel in forming the new business and relationship. These "do-it-yourselfers," such as Susan, often overlook the need for written operating agreements or by-laws. Without these, there is nothing to memorialize their understanding. The members simply apply for federal and state tax identification numbers, complete and file the articles of incorporation with the Secretary of the State, and open a bank account to commence their operations. No one even discusses how things would be wrapped up with the LLC in the event that the business fails. And, without an attorney involved in the set-up, members don't even consider it.

Without a written operating agreement or by-laws, there's a good chance that state law will prevail on issues like equalization of member capital accounts and final distributions. That could result in things getting very complicated during the "divorce" hindering a resolution in the matter.

The federal government does not recognize LLCs for federal income tax purposes.

An LLC is treated as a partnership (Form 1065) unless the entity elects to be taxed as a corporation (Form 8832). However, just because an LLC is treated as a partnership for federal tax purposes, does not translate to the entity being treated by the state as a partnership for operating, capital, and other purposes. Rather, references can be found directing guidance on these issues to the state laws within which the entity exists.

In Connecticut, for example, LLCs are covered within Chapter 613 of the Connecticut statutes. Specifically, Connecticut sections 34-100 to 34-242, inclusive, contain the "Connecticut Limited Liability Company Act." In reading this section, the language within many of the provisions contains references such as "per the operating agreement," "in the manner agreed to in the operating agreement," "unless otherwise provided in the operating agreement," or similar language. Many sections also contain "if the operating agreement does not so provide..." Connecticut defines an operating agreement within the LLC context as "a means any agreement, written or oral, as to the conduct of the business and affairs of a limited liability company, which is binding upon all of the members."

Mary and Susan's business divorce reminds all of us of two valuable lessons. First, when working with new or existing clients involved in LLCs (even those LLCs operated among family members) it is paramount to

discuss the importance of having a written operating agreement along with written by-laws. Second, a process needs to be in place that will ensure that all members have equal access to all financial records of the LLC. Each member needs to be able to make his or her own independent, objective assessment and monitoring of the financial activity. Complacency and delegation often leads to bad outcomes and an uglier divorce than necessary.

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