

DRAFTING LLC AGREEMENTS

Michael Bloom, Esq.

Dan Straga, Esq.

Stephanie Molyneaux, Esq.

November 2019

OUTLINE OF MAIN TOPICS

1. *Structure of LLC*
2. *LLC Information*
3. *Capitalization and Distributions*
4. *Tax Provisions*
5. *Management and Membership*
6. *Transfer Rights*
7. *Fiduciary Duties*
8. *Miscellaneous Provisions*

STRUCTURE OF LLC

Choice of Entity



Fundamental Principle of LLCs

Freedom of Contract

Single vs. Multi-Member LLCs

Single Member LLCs

- May not need an LLC Agreement, but banks or other organizations may require it

Multi-Member LLCs

- Drafting an LLC Agreement is strongly recommended
- Types of Multi-Member LLCs
 - Holding company vs. operating company
 - Two members (e.g., joint venture)
 - Several members (e.g., startup)
 - Investment fund

Tax Elections

- Single-Member LLCs
 - Default: disregarded for income tax purposes
 - May elect to be treated as an S-corporation or C-corporation
- Multi-Member LLCs
 - Default: treated as a partnership for income tax purposes
 - May elect to be treated as an S-corporation or C-corporation
- Elections
 - Members indemnify LLC if their actions invalidate S-election

LLC INFORMATION

LLC Information

- Name of the Company
 - Requirements by jurisdiction for naming the company with “LLC” or “L.L.C.”, etc.
- Formation
 - Delaware is very common for established corporate legal framework
 - Foreign qualification in states of operation/etc. – depends on jurisdiction
- Principal office
 - Location of office (usually tied to state of formation or foreign qualification)

LLC Information

- Registered Agent
 - Typically the Manager, a Member, or a third party service
- Purpose
 - Can generally be for any lawful purpose under state law
 - Tied to non-competition provisions
- Bank Accounts

CAPITALIZATION AND DISTRIBUTIONS

Capitalization

- Form of Contribution
 - Cash
 - Property
 - Services (i.e., sweat equity)
- Initial Contributions
 - Make upon formation of LLC
 - Ownership percentage typically determined by amount of contributions
 - Contributions are not required upon formation
- Additional Contributions
 - Preemptive rights (permissive)
 - Capital calls (mandatory)
 - Ability of members to loan funds for working capital purposes
 - Authorization to incur indebtedness

Capitalization – Sample Language

- Initial Capital Contribution
 - Each of the undersigned Members hereby covenants and agrees to contribute to the capital of the Company the property set forth after the name of such Member in Exhibit A attached hereto.
- Preemptive Rights
 - In the event that the Manager determines that additional funds are necessary or advisable for the continued operation of the Company's business, the Manager shall deliver written notice to the Members and each Member shall have the right to contribute in pro rata portion (determined in accordance with the Members' respective Ownership Percentages) of the additional funds sought.
- Capital Calls
 - The Commitment of each Member is set forth opposite such Member's name on Schedule I. The Manager shall be permitted to draw down on the Commitments from time to time as it determines necessary or advisable by delivering to each Member a written notice specifying the aggregate amount of such draw down and such Member's pro rata portion of such amount (which shall be determined based upon the respective Commitments of the Members). Each Member shall, within ten Business Days following receipt of any such notice, fund its pro rata portion of such amount.
- Working Capital Borrowings
 - The Manager may cause the Company to accept from one or more members short term loans of not more than ninety (90) days in duration to be used for working capital purposes; provided that such loans are at no more than prevailing interest rates and otherwise on market terms and conditions.
- Authorization to Incur Indebtedness
 - The Manager shall have the right to cause the Company to incur indebtedness; provided that (i) the maximum aggregate principal amount of indebtedness of the Company outstanding at any time shall not exceed a Debt-to-Value Ratio of fifty percent (50%) and (ii) the Manager shall not permit the Company to issue any guarantees that extend beyond the term of the Company.

Distributions

- Timing
 - At the discretion of the Manager
 - Quarterly / Bi-Annually / Annually
 - Promptly following receipt
- Cash Flows Available for Distribution
 - Gross revenue less operating expenses
 - Reserves for future expenses
 - Reserves required by indebtedness covenants or regulatory requirements
- Distributions
 - One waterfall for all cash flows
 - Different waterfalls for different types of cash flows
 - Preferred Returns / Hurdles / Carried Interest
 - Tax distributions
 - Reallocation Principle

Distributions – Sample Language

- Timing of Distributions

- The Manager shall cause the Company to distribute all Promote to the Members within thirty (30) days following receipt by the Company of such Promote.
- The Manager may (but shall not be required to) cause the Company to make distributions to the Members of any Available Cash Flows from time to time; provided that, at a minimum, the Manager shall use commercially reasonable efforts to make distributions of Available Cash Flows to the Members at least once per calendar year.

- Available Cash Flows

- “Available Cash Flows” means (a) all cash funds derived from the operations of the Company (other than Capital Contributions) and cash previously held as a reserve (including interest received on reserves) less (b) cash funds which are reinvested or used to pay current operating expenses or establish reasonable reserves for future expenses, debt and liability payments, capital improvements and replacements, as determined in the reasonable discretion of the Manager, less (c) cash funds used to establish required regulatory reserves.

Distributions – Sample Language

- Waterfall
 - The Manager shall cause any Available Cash Flows to be distributed to the Members as follows: (1) first, one hundred percent to Member A until it has received total distributions equal to its previously unpaid Capital Contribution, (2) second, one hundred percent to Member A until it has received a return of eight percent (8%) on its Capital Contribution, and (3) thereafter, to the Members on a pro rata basis in accordance with their respective Percentages.
- Reallocation Principle
 - In the event that any Capital Proceeds arising from a Capital Event are disbursed by the purchaser(s) or financing source(s) in the applicable Capital Event directly to the Members rather than to the Company, the Members shall promptly (and in any event within five (5) days following the receipt of such Capital Proceeds) make such transfers of such Capital Proceeds between the Members as are necessary to result in each Member receiving the amount of Capital Proceeds from such Capital Event that such Member would have received if all Capital Proceeds from such Capital Event had been disbursed directly to the Company and distributed by the Company to the Members in accordance with this Section 4.2(c).

TAX PROVISIONS

Structure / Taxation of LLCs

- Why choose an LLC from a tax perspective?
 - Not subject to a Federal entity-level tax.
 - Individual members are tax directly on the LLC's income at normal graduated rates:
 - 37% (highest marginal rate)
 - *New deduction* -- 199A deduction equal to 20% of QBI (subject to limitations)
 - **Effective tax rate: 29.6%**
 - Corporations:
 - Federal entity-level tax of 21%
 - Plus 23.8% tax on shareholder dividends (20% capital gains rate + 3.8% NIIT).
 - Effective tax rate:
 - \$21 of corporate tax ($\$100 * 21\% = \21)
 - \$18.8 of individual tax ($\$79 * 23.8\% = \18.8)
 - **Effective tax rate: 39.8%**

Structure / Taxation of LLCs

- LLCs serve an accounting function.
- Profit and loss are calculating at the entity level and then allocated among members.
- Members pay tax on their allocated profit and loss each year from an LLC -- even if it is not actually distributed to them.
- Example:
 - Michael Jordan and Tiger Woods form “VR Golf LLC” (a virtual reality golf game).
 - Each contribute \$5M to the Company and agree to split profits 50/50.
 - In 2020, the company earns income of \$2M and expenses of \$600,000.
 - Each will be allocated \$700,000 of taxable income in 2020
 - their capital accounts will go up from \$5M to \$5.7M

Schedule K-1 (Form 1065) 2018
 Department of the Treasury Internal Revenue Service
 For calendar year 2018, or tax year beginning / / 2018 ending / /

651118
 OMB No. 1545-0045

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

Part I Information About the Partnership

A Partnership's employer identification number XXXXXXXX

B Partnership's name, address, city, state, and ZIP code
 VR Golf LLC

C IRS Center where partnership filed return

D Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number XXXXXXXX

F Partner's name, address, city, state, and ZIP code
 Michael Jordan

G General partner or LLC member-manager Limited partner or other LLC member

H Domestic partner Foreign partner

I1 What type of entity is this partner?

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here

J Partner's share of profit, loss, and capital (see instructions)

	Beginning	Ending
Profit	%	50 %
Loss	%	50 %
Capital	%	50 %

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	\$	0
Qualified nonrecourse financing	\$	0

L Partner's capital account analysis:

Beginning capital account	\$	\$0
Capital contributed during the year	\$	\$5,000,000
Current year increase (decrease)	\$	\$700,000
Withdrawals & distributions	\$(\$0)
Ending capital account	\$	\$5,700,000

Tax basis GAAP Section 704(b) book
 Other (explain)

M Did the partner contribute property with a built-in gain or loss?
 Yes No
 If "Yes," attach statement (see instructions)

For Paperwork Reduction Act Notice, see Instructions for Form 1065. www.irs.gov/form1065 Cat. No. 11204R Schedule K-1 (Form 1065) 2018

Final K-1 Amended K-1 OMB No. 1545-0045

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	15	Credits
	\$700,000		
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions

L Partner's capital account analysis:

Beginning capital account	\$	\$0
Capital contributed during the year	\$	\$5,000,000
Current year increase (decrease)	\$	\$700,000
Withdrawals & distributions	\$(\$0)
Ending capital account	\$	\$5,700,000

Tax basis GAAP Section 704(b) book
 Other (explain)

M Did the partner contribute property with a built-in gain or loss?
 Yes No
 If "Yes," attach statement (see instructions)

For Paperwork Reduction Act Notice, see Instructions for Form 1065. www.irs.gov

Structure / Taxation of LLCs

- Tax allocations must reflect the economics of the underlying business deal for the IRS to respect the tax allocation.
- In other words: must have “substantial economic effect”
- The regulations under Section 704(b) provide a safe harbor by which tax allocations will be treated as having “substantial economic effect.”
- In general, these regulations require that “tax follows book”.
- LLC agreements drafted to comply with this safe harbor will:
 - Require that capital accounts be maintained in accordance with Treas. Reg. 1.704-1(b)(2)(iv); and
 - Liquidate in accordance with the positive balances in the member’s capital account.

Structure / Taxation of LLCs

“Capital Account” means the account maintained by the Company for each Member in accordance with the following provisions:

(i) a Member’s Capital Account shall be credited with amount of cash and the fair market value of other property contributed to the Company by the Member, the amount of any Company liabilities assumed by the Member, the Member’s distributive share of Profit and any item in the nature of income or gain specially allocated to such Member pursuant to the provisions of Section IV [Allocations];

(ii) a Member’s Capital Account shall be debited with the amount of cash and the fair market value of any Company property distributed to the Member, the amount of any liabilities of the Member assumed by the Company (or which are secured by property contributed by the Member to the Company), the Member’s distributive share of Loss and any item in the nature of expenses or losses specially allocated to the Member pursuant to the provisions of Section IV [Allocations]; and

(iii) if any Interest is Transferred pursuant to the terms of this Agreement, the transferee shall succeed to the Capital Account of the transferor to the extent the Capital Account is attributable to the Transferred Interest.

It is intended that the Capital Accounts of all Members shall be maintained in compliance with the provisions of Regulations Section 1.704-1(b), and all provisions of this Agreement relating to the maintenance of Capital Accounts shall be interpreted and applied in a manner consistent with that Regulation.

Structure / Taxation of LLCs

- LLC Agreement drafted to comply with this safe harbor for will also require that the LLC liquidate in accordance with each Member's positive capital accounts:

“. . . if the Company is liquidated, after making any allocations of Profit or Loss pursuant to Section 4.2, the assets of the Company shall be distributed to the Members in accordance with their positive Capital Accounts.”

- Tax allocations are driving the economics.
- Often times include a “savings clause”.
- Target approach?

Structure / Taxation of LLCs

- Target Allocations:
 - Target allocations focus on those provisions in the partnership agreement dealing with cash flows (e.g., distributions)
 - Simply state that the taxable income and loss of the LLC shall be allocated among the members as necessary to cause their capital accounts to be the amount that each member would receive if the LLC were liquidated and all cash proceeds were distributed in accordance with the distribution provisions (i.e., the economic arrangement).

“. . . all Profits and Losses shall be allocated to the Members' Capital Accounts in a manner such that, as of the end of such taxable year or other relevant period, the Capital Account of each Member (which may have either a positive or negative balance) shall equal, as nearly as possible, (a) the amount of distributions that would be received by each such Member if the Company were liquidated and all of its assets were sold for their Adjusted Book Values. . . and all remaining amounts (after satisfaction of such liabilities) were distributed in full pursuant to [the Distribution Provision].”

Structure / Taxation of LLCs

- Tax Distributions:
 - Income is allocated (even if cash is not received).
 - Creates a “phantom income” problem.
 - Tax distributions require the LLC to make distributions to Members to cover the taxes owed on allocable income.

Tax Distributions. Notwithstanding anything to the contrary in this Agreement (except [Section 4.4] and Section 4.5.4), the General Manager [shall/may/shall make commercially reasonable efforts to] distribute to each Member an amount of cash sufficient to pay such Member’s federal, state and local income taxes (calculated on the assumption that such Member is subject to the highest combined effective federal, state and local income tax rate applicable to an [individual residing in [●]/to any Member (or in the case of any Member which is a pass-through for federal income tax purposes, the ultimate taxable owner or owners of such Member)] for such calendar year, but taking into account (i) any reduced tax rates applicable to long-term capital gains or qualified dividends [and (ii) the tax imposed under Section 1401 and Section 1411]) on the taxable income allocated to each such Member pursuant to this Agreement for each taxable year; would be adjusted for § 743(b) special basis adjustments (probably not).

Structure / Taxation of LLCs

- Tax Distribution Issues:
 - To what extent compelled? (“shall”, “may”, “use reasonable efforts”, etc.)
 - Does the provision cover state and local taxes – in addition to Federal?
 - If so, what state and local tax rate is being assumed?
 - How do we account for losses allocated in prior years?
 - Is there an obligation to borrow to pay the tax?
 - How are the distributions treated?
 - Priority distribution.
 - Advance against future distributions.

Structure / Taxation of LLCs

- Profits Interests
 - Interest in a partnership that has a right to share in future profits – but no current liquidation value.
 - If there was a liquidation, profits interest holder would not receive any proceeds.
 - Receipt of profits interest is tax free provided:
 - LLC is not publicly traded.
 - No predictable or substantially certain stream of payments.
 - Interest not sold w/in 2 years.
 - Sample distribution waterfall w/ profits interest:
 - 100% to Capital Partner until receives X% Preferred Return
 - 100% to Capital Partner until receives Return of Capital
 - 20% to Service Partner and 80% to the Capital Partner

Structure / Taxation of LLCs

- Distribution Threshold:

“... no Distributions shall be made with respect to any Profit Interest Unit unless and until the aggregate amount that is distributed pursuant to Section 7.2.1 (Net Proceeds from Capital Transactions) and Section 10.3 (Liquidating Distributions) since the issuance of such Profits Interest Unit equals the Distribution Threshold for such Profits Interest Unit, with such amounts distributed instead to the other Holders who are eligible for Distributions under this Section in accordance with Percentage Interests.”

Structure / Taxation of LLCs

- Profits Interest Features:
 - How is Distribution Threshold Determined?
 - Vested or Unvested
 - Catch-Up Allocation
 - Buy-Out Upon Termination of Service
 - Tax Distributions?

END OF FIRST HOUR – QUESTIONS?

MANAGEMENT AND MEMBERSHIP

Member-Managed vs. Manager-Managed

- Who controls the management of the company
 - Member-Managed (decision-making and economics are linked)
 - Managing Member
 - Major Decisions left to Members
 - Manager-Managed (decision-making and economics are not linked)
 - Single Manager
 - Board of Managers
 - Major Decisions left to Members
 - Investment Committees (binding authority on limited scope of matters)
 - Advisory Boards (non-binding authority)
- Manager-managed is typically preferred (logistics, fiduciary duties)
- Members not personally liable, but managers can be liable as bad actors

Appointment of Managers – Sample Language

- Appointment of Manager:
 - *The Company shall have one manager to manage the affairs of the Company in accordance with this Article III (the “**Manager**”). A Manager may, but need not, be a Member of the Company. The initial Manager of the Company shall be [_____].*
- Appointment of Board of Managers:
 - *“Board” shall mean and refer to the Board of Managers of the Company, which shall be comprised of the Managers. As of this date, the Board shall consist of (i) [_____] and (ii) [_____] , each in his or her respective capacity as a Manager.*
 - *It is the intention and desire of the Members, as parties to this Agreement, that the Members (in their capacity as members of the Company) shall have no voting rights or decision-making authority with respect to the Company. Except as otherwise expressly provided in this Agreement, all voting rights and decision-making authority with respect to the Company, regardless of the matter being voted upon or decided, shall be vested in and exercised exclusively by the Board acting on the vote of a majority of the Managers on a per capita basis; provided, however, that in the event of a tied vote of the Managers, a decision of the majority of the Members based on Percentage Interests shall be required to approve any actions of the Company, including, but not limited to...*

Appointment of Managers – Sample Language

- Succession:

- *Each of the Managers (or their respective personal representative, executor, estate and/or successors and assigns) may appoint a successor Manager, who shall have the right, power and authority to manage, oversee and administer the business and affairs of the Company in accordance with the provisions of this Agreement in the event of the death, adjudication of insanity or incompetency, resignation or retirement of any of the Managers designated hereunder. No Person designated to serve as a Manager hereunder is required to be either a Member of the Company or a resident (or domestic corporation) of the State of Maryland.*

- Appointment Right Contingent on Equity Interest:

- *For so long as the Minority Member and its Affiliates collectively hold at least fifty percent of the Interests held by the Minority Member as of the Effective Date, the Minority Member shall have the right to appoint one member to the Board of Managers.*

Major Decisions

- Sample introductory language:
 - *Notwithstanding anything to the contrary contained herein, the following actions and/ or decisions with respect to the management and operation of the Company and the Company business shall require the prior unanimous written consent and approval of the Members, which consent and approval may be granted or withheld in the sole and absolute discretion of each of the Members, but shall not be unreasonably delayed: ...*
- For the non day-to-day items
 - Specific to industry
 - Materiality
 - Monetary Thresholds
- Consider approval thresholds by Members:
 - Simple majority
 - Supermajority (depending on capitalization)
 - Unanimous consent
 - Veto power

Sample Major Decisions

- effecting a material change in the business of the Company, including, without limitation, acquiring or establishing another product or service line of business of the Company;
- hiring or terminating any key management employee;
- materially modifying or altering the compensation package for any key management employee or otherwise materially modifying the employment agreement of any key management employee;
- paying (on behalf of the Company) any fees, expenses, commissions or other compensation to any Member or Affiliate thereof or other intercompany transactions between the Company and its Affiliates;
- selling, exchanging, conveying or otherwise disposing of all or substantially all of the Company Assets or one or more lines of business of the Company;
- infusing additional equity, financing, refinancing, modifying or restructuring any indebtedness of the Company, other than trade payables paid or payable in the Company's ordinary course of business;
- admitting additional Members to the Company through an equity offering under the provisions of the Agreement or otherwise;
- adopting, approving, modifying and/or supplementing the annual operating budget and, if applicable, the annual capital budget of the Company; provided, however, that, in the event an annual operating budget cannot be agreed upon by the Members, the prior year's operating budget (adjusted for the applicable consumer price index) shall apply;

Sample Major Decisions (Cont.)

- adopting, approving, modifying and/or supplementing the annual business plan of the Company;
- merging, consolidating or otherwise reorganizing or restructuring the Company;
- voluntarily commencing a case with respect to the Company, as debtor, under the Federal Bankruptcy Act or any similar Federal or state statute or taking any other action (such as, but not limited to, consenting to a confess judgment) that could result in the termination of the Company;
- expending Company funds, or undertaking any obligations by or on behalf of the Company, where such expenditures incurred (or to be incurred) exceed [_____ Dollars (\$_____)] in the aggregate during any calendar year and are not otherwise authorized under the applicable budget with respect to the line item attributable to such expenditure(s);
- establishing cash reserves on behalf of the Company which exceed amounts authorized under the applicable budget;
- modifying, amending, extending or terminating any management agreement (or any successor management agreement);
- amending the Articles or this Agreement, except in the manner expressly provided for hereunder;
- selecting or changing the auditors of the Company; and
- commencing, settling or otherwise initiating or disposing of an action or other legal proceeding.

Governance: quorum, voting, etc.

- Meetings for Managers
- Meetings for Members
- Quorum for Meetings
 - Default: Majority of directors/members required
 - Can specify different threshold (subject to minimum requirements of state law)
- Voting requirements
 - Default: Majority of directors/members required
 - Can specify different threshold (subject to minimum requirements of state law)
 - Different voting rights for different classes of interests (e.g., supermajority interests)
 - Examples
 - majority or supermajority voting based on membership interest percentages
 - voting on a per-capita basis

Board/Member Deadlock

- Even vs. Odd-Numbered Board
- Resolution of Deadlock
 - Escalation to Members
 - Escalation to executive team
 - Non-binding mediation
 - Binding arbitration
 - Forced liquidation
 - Forced or optional buyout
- Sample language:
 - *In the event that the Members fail to agree to pursue or not pursue any Member Approval Matters and such failure shall continue through two (2) consecutive duly-convened meetings of the Members (a “**Member Deadlock**”), the Members shall, upon the request of any Member, pursue an escalation process as follows, and during the pendency of such escalation process no action with respect to such matter shall be taken: (i) first, such Member Deadlock shall be escalated for consideration and negotiation by the chief executive officers of each Member for a period of 15 days, (ii) second, if such Member Deadlock has not been resolved by such negotiation, [a non-binding mediation process][binding arbitration process] shall be initiated by the Members for completion within 30 days, (iii) third, in the event that such Member Deadlock has not been resolved upon the completion of the foregoing escalation process, either Member shall have the right to [initiate the buyout process set forth herein][initiate the termination of the Company and the liquidation of the Company’s assets].*

Buy-Sell / Russian Roulette

- Concept: Member A sets price and Member B determines whether to sell its interest or buy the interest of Member A at such price
- Theory vs. Practicality
 - Only works with two members
 - Only works where both parties have resources
- Sample language:
 - *Notwithstanding anything to the contrary contained in this Agreement, in the event, and only in the event, of a dispute or deadlock between the Members which they are unable to resolve themselves after using their best efforts to do so within thirty (30) days after written notice from one Member to the other Member citing such dispute or deadlock, either Member (hereinafter in this Article XVI referred to as “**Offeror**”) may send written notice (such written notice being hereinafter referred to as a “**Buy-Sell Notice**”) to the other Member (hereinafter in this Article XVI referred to as “**Offeree**”), stating Offeror’s willingness to purchase the entire Interest of Offeree for the fair market value of all of the Company Assets, net of all liabilities of the Company, multiplied by the Percentage Interest owned by Offeree (the “**Purchase Price**”), and Offeree shall have the option to do either of the following...*

Forced Sale

- Concept: Pre-determined that one member will buy out other member
- Sample Language:
 - *In the event of a dispute or deadlock between the Members which they are unable to resolve themselves after using their best efforts to do so within thirty (30) days after written notice from one Member to the other Member citing such dispute or deadlock, Member A shall have the right to purchase all of the Interests held by Member B at the fair market value of such Interests. Such fair market value shall be determined by a qualified appraiser of national standing with expertise in the industries in which the Company operates.*
- Instructions to Appraiser
 - Minority interest discount
 - Lack of marketability discount

Indemnification

- Managers, officers, directors, and other agents may be indemnified parties
- Important to consider scope of indemnification
 - Fraud, gross negligence, or willful misconduct generally not covered
 - Types of costs covered by indemnity
 - Reasonable attorneys' fees or other expenses incurred in connection with settlement or in any finally-adjudicated legal proceeding
 - the removal of any liens affecting any property of an Indemnified Party
- Satisfaction of Indemnification Obligations
 - Typically limited to the extent of LLC's available funds
 - D&O insurance policy
- Consider state law and applicable statutes

Termination/Resignation

- Manager usually has the option to resign
- Manager automatically removed upon ceasing to be a member
- Manager may be terminated for “Cause”
- Sample definition for “Cause”
 - *“Cause” means any of the following: (i) commission of a willful act of dishonesty in the course of such Member’s duties hereunder, which is reasonably likely to cause material injury to the Company, (ii) conviction of such Manager by a court of competent jurisdiction or a nolo contendere plea with respect to a crime constituting a felony, or conviction or a nolo contendere plea in respect of any act involving fraud, dishonesty or moral turpitude, (iii) performance by such Manager under the influence of non-prescription controlled substances, or continued habitual intoxication, during working hours, (iv) any breach of this Agreement that is not cured within thirty (30) days of notice of any such breach, or (v) any material non-compliance with any of the policies and procedures of the Company that is not cured within thirty (30) days of notice of any such non-compliance.*

Transfer of Interests

- Restrictions – interests are usually not freely transferable
- Permitted Transfers – sample language:
 - *The provisions of Article XIII-1 shall not apply to any transfer or assignment by any Member of all or any portion of its Company Interest to any of the following (each, a “**Permitted Transferee**” and, any such transfer to a Permitted Transferee, a “**Permitted Transfer**”):*
 - *Such Member's spouse, parent, siblings, descendants (including adoptive relationships and stepchildren), and the spouses of each such natural persons (collectively, “**Family Members**”);*
 - *A trust under which the distribution of Company Interests may be made only to such Member and/ or any Family Member of such Member;*
 - *A charitable remainder trust, the income from which will be paid to such Member during his or her life;*
 - *A partnership or limited liability company, the partners or members of which are only such Member and/ or Family Members of such Member;*
 - *By will, or, by revocable (or living) trust or by the laws of intestate succession, to such Member's executors, administrators, testamentary trustees, legatees, distributees or beneficiaries; or*
 - *Any of such Member's Affiliates.*

Transfer of Interests

- Put Right
 - Member's ability to "put" interest to Company under certain circumstances
 - Examples:
 - Failure to attain performance milestones
 - Expiration of certain time periods
 - Bad acts of other members
- Call Right
 - Company's ability to "call" interest under certain circumstances
 - Examples:
 - Member fails to meet capital call,
 - Member commits certain bad acts
 - Member resigns or is fired as an employee of the LLC
- Pricing Considerations

TRANSFER RIGHTS

Right of First Refusal / Right of First Offer

- Right of First Refusal – triggered by a bona fide third party offer
- Right of First Offer – triggered by interested member wishing to sell
- Primary and Secondary Rights
 - Primary – the Company has the right to exercise the ROFR / ROFO
 - Secondary – to the extent the Company does not exercise its primary right, the Members have the right to exercise the ROFR / ROFO
- Allocation among Members
 - Pro Rata (either to all or a defined subset of Members)
 - Overallotment Rights
- Failure of the Company and Members to fully exercise ROFR / ROFO
- Permitted Sale Period
 - Length of Period: 60-180 days (subject to extensions to obtain governmental authorizations)
 - No less than the price stipulated by the selling Member
 - On terms no more favorable [in the aggregate] to the transferee

Right of First Refusal / Right of First Offer

- ROFR – Sample language:

- If a Member (the “**ROFR Transferor**”) proposes at any time to accept an offer to purchase all or any portion of its Interest (the “**Transfer Interest**”), such ROFR Transferor shall provide to each other Member (the “**ROFR Members**”) a written notice (the “**ROFR Transfer Notice**”) specifying the Transfer Interest and containing an irrevocable offer to Transfer the Transfer Interest to the ROFR Members at the price (the “**Transfer Price**”), and upon the other material terms and conditions, specified in the ROFR Transfer Notice. The Transfer Price shall be equal to the price offered (the “**Purchase Offer**”) to the ROFR Transferor by a bona fide third party offeror (the “**Third Party Offeror**”), the identity of which shall be specified in the ROFR Transfer Notice together with the ROFR Transferor’s good faith reasonable estimation of the cash value of any non-cash consideration offered by the Third Party Offeror, the terms of payment of the Purchase Offer and all other material matters relating to the Third Party Offeror’s offer to purchase the Transfer Interest. The written proposal containing the Purchase Offer shall be provided with the ROFR Transfer Notice.

- ROFO - Sample language:

- In the event that a Member desires to sell, assign, transfer, convey, pledge, or encumber all or any portion of its Membership Interests to a purchaser (a “**Purchaser**”), such Member (the “**Offeror Member**”) must first give to the other Members (the “**Offeree Members**”), notice of the Offeror Member’s intention to make such Disposition, which notice shall specify the purchase price and payment terms upon which the Offeror Member is willing to sell its Membership Interests to the Purchaser (the “**Offer**”). For a period of thirty (30) days from the receipt of such notice (the “**Election Period**”), the Offeree Members shall have the option (but not the obligation) to elect to purchase the Offering Member’s Membership Interests (or portion thereof) at the same price and upon the same terms and conditions as are set forth in the Offer.

Tag-Along

- Concept – non-transferring Members can participate (“tag”) in sale by transferring Member
- Each non-transferring Member may participate on a pro-rata basis with the transferring Member
- Pro rata cut-back of transferring Member participation
- Restrictions on Sale Terms:
 - All members receive consideration pro rata
 - Option to receive different forms of consideration is allocated pro rata
 - General indemnification obligations are only several and allocated pro rata
 - No non-competition covenants
- Permitted Sale Period
 - Length of Period: 60-180 days (subject to extensions to obtain governmental authorizations)
 - No less than the price stipulated by the transferring Member
 - On terms no more favorable [in the aggregate] to the transferee
- Transfers in Violation of Tag-Along

Tag-Along

- Sample Language:
 - *In the event of a proposed Transfer by a Member (a “Transferring Member”) to any Person of all or a portion of such Member’s Interest, and subject to prior compliance with the Right of First Refusal, each other Member (a “Tag-Along Member”) shall have the right to participate in such proposed Transfer. Each Tag-Along Member may, subject to the limitations set forth in this Section 7.3(c), Transfer to the Tag-Along Transferee up to such portion of its Interest equal to the aggregate Interest held by such Tag-Along Member multiplied by the Transferring Member Tag-Along Percentage.*

Drag-Along

- Concept: Gives controlling member(s) ability to sell the entire company
- Minority members are required to participate (“drag”) in the sale as long as certain requirements are satisfied:
 - All members receive consideration pro rata
 - Option to receive different forms of consideration is allocated pro rata
 - Dragged members required to only give limited reps
 - General indemnification obligations are only several and allocated pro rata
 - No non-competition covenants
- Key Concept – power of attorney

Drag-Along

- Sample Language:

- *In the event that (i) the Offeree Members waive or fail to exercise the option set forth in Section 6.01(a)(ii) above, (ii) the Offeree Members waive or fail to exercise the option set forth in Section 6.01(b) above and (iii) the Offeror Member owns more than fifty percent (50%) of the Interests, the Offeror Member shall have the option to require the Offeree Members to sell all or a portion of its Membership Interests to the Purchaser, as directed by the Offeror Member, at the same price and upon the same terms and conditions as are set forth in the Offer (the “**Drag-Along Right**”); provided, however, that if the Purchaser, pursuant to the terms of the Offer, is purchasing less than all of the outstanding Interests, then the Offeror Member and the Offeree Members shall sell to the Purchaser the specified portion of Interests on a pro rata basis in accordance with their respective Percentage Interests. The Offeror Member shall have ten (10) days after the expiration of the Tag-Along Period in which to notify the Offeree Members in writing of the Offeror Member’s election to exercise the Drag-Along Right.*

Interaction of Transfer Rights

- Transfer Rights do not apply to Permitted Transfers
- Order of Transfer Rights
 1. Right of First Offer
 2. Exercise of Drag-Along (if applicable)
 3. Right of First Refusal
 4. Tag-Along Right
- Carveout any special transfers (e.g., put right, call right)

FIDUCIARY DUTIES

Fiduciary Duties

- Duty of Care
 - Manager must fully inform themselves
 - Gross negligence standard
- Duty of Loyalty
 - Managers must have the interests of the LLC and members ahead of their own
 - Implied covenant of good faith and fair dealing within this duty
 - Conflicts of Interest
 - Business Opportunities Doctrine
- What Does the Agreement Say?
 - No disclaimer
 - Duty of loyalty disclaimer only
 - Full disclaimer
 - Expansion

Fiduciary Duties

- Sample language to disclaim the duty of loyalty:
 - *Except as expressly provided in this Agreement, nothing contained herein shall be construed to limit in any manner the Members in the carrying on of their own respective businesses or activities. Any Member may engage in and/or possess any interest in other business ventures of every nature and description, and neither the Company nor the other Members shall have any rights in or to any such independent ventures or the income or profits derived therefrom. In furtherance of the foregoing, no Member shall be obligated to bring any business opportunity or investment to the Company, and each Member shall be exonerated from any claim which may arise from a business opportunity.*

Non-Competition and Non-Solicitation

Non-Competition

- Prohibition from competing with the company
- Can bind members or managers
- Drafting the definition of the “Business” narrowly
- Prohibition disappears upon achievement of certain milestones

Non-Solicitation

- Employees – prohibition from soliciting employees of the company
- Clients – prohibition from soliciting clients, customers, or suppliers of the company or a subsidiary
- Must also be reasonable to be enforceable

MISCELLANEOUS PROVISIONS

Dissolution

- Process governed by state statute
- Sample language in DC:
 - *The Company shall be dissolved, the Company Assets shall be disposed of, and its affairs wound up, upon the earliest to occur of the following events (an “**Event of Dissolution**”), it being understood and agreed that the death, resignation, retirement, expulsion, termination or Bankruptcy of a Member, or other event that terminates the continued membership interest of a Member in the Company under the Act, shall not constitute an Event of Dissolution:*
 - *the unanimous written consent of the Members; or*
 - *the entry of a decree of judicial dissolution under §29-1348 of the Act.*

Legal Title to Company Assets

- Assets are held in the name of the Company
- Important to discuss between Members and attorney, as well as accountant

Confidentiality

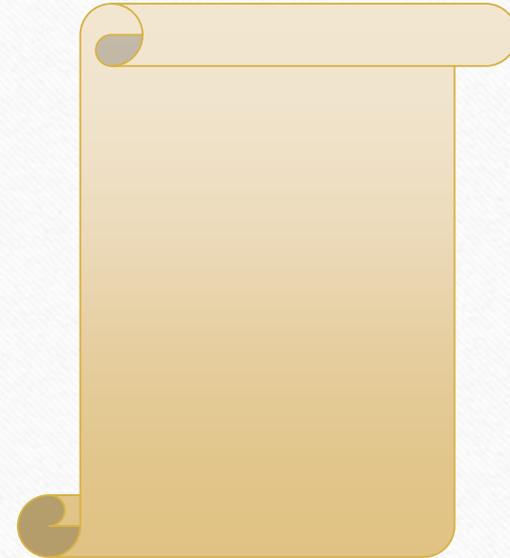
- Consider type of information the Company will handle
- Example: trade secrets and intellectual property should be kept confidential
- Do you need to protect it against third parties?
 - Consider separate, mutual non-disclosure agreements

Governing Law, Jurisdiction, Venue

- Governing Law and Jurisdiction
 - Law of which state will govern for breach/disputes?
- Venue
 - Location for dispute resolution
- Consider location of LLC, its Members, and Managers for all

Amendment

- Requirement for modification
 - Signature(s) of Manager(s)
 - Signature(s) of Member(s)
- Consider approval:
 - Simple majority
 - Supermajority
 - Unanimous consent
 - Disproportionate economic detriment



Boilerplate Provisions

- Beneficiaries, successors, and assigns
- Severability
- Counterparts
- Headings

END OF SECOND HOUR – QUESTIONS?