# Common Mistakes and Oversights When Drafting and Reviewing LLC Operating Agreements

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At the 2007 Fall Meeting of the LLCs, Partnerships and Unincorporated Entities Committee of the American Bar Association's Business Law Section, the Model Real Estate Limited Liability Company Operating Agreement (which is based on the Delaware Limited Liability Company Act) was presented for publication (the "Model Agreement").[*] During the course of drafting that agreement and its extensive commentary, the joint task force of the LLCs, Partnerships and Unincorporated Entities Committee and the Taxation Committee of the ABA Business Law Section responsible for the project (the "ABA Joint Task Force") discussed many common mistakes and oversights that frequently are encountered when negotiating and reviewing operating agreements. This article describes some of those miscues and oversights, all of which, and others, are discussed in more detail in the commentary to the Model Agreement.

## I. Economic Matters

**A. <u>Membership Interests</u>.** Each member of a limited liability company ("LLC") has one, and only one, membership interest. One never owns "membership interests."

Unlike the law for business corporations that mandate that shares of capital stock of the same class or series convey identical rights and preferences, there is no comparable concept or requirement under LLC statutes. Instead, membership interests (even those that are described in the operating agreement as being comprised of "units" or "shares") may, and frequently do, on a per-unit or per-share basis, have different interests in the management, capital, profits, losses, and tax attributes of the LLC. A common mistake is to forget to take those differences into account when drafting the buy-sell, preemptive rights, co-sale rights, drag-along rights, put and call options, liquidating distribution, etc. provisions of the operating agreement.

For example, under the hypothetical facts presented in the Model Agreement, the Financial Investor pays $10 million for 4,000 Units ($2,500 per Unit), but the Developer

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[*] The Model Agreement was published in the February, 2008 issue of *The Business Lawyer*. Unless otherwise indicated, all references to the "Code" are to the Internal Revenue Code of 1986, as amended, and all references to "Sections" or "Secs." are to sections of the Code.

pays nothing for its 4,000 Units. Upon the sale or refinancing of the LLC's assets, the Financial Investor is to be repaid its $10 million plus a preferred return on that capital contribution before any residual cash is shared on the basis of the number of Units each member owns. Obviously, one would pay a much higher price for one of the Financial Investor's Units (entitling the holder to a liquidation preference of $2,500 plus a preferred return on that $2,500) than one would pay for one of the Developer's Units. These types of economic differences (as well as tax, e.g., Code Sec. 704(c) differences) between the attributes of units or shares of different members are frequently overlooked or neglected in operating agreements (e.g., in the buy-sell provisions). Many operating agreements make the mistake of treating the membership interests (and the units or shares in which they are divided) of the LLC's members as if they were fungible when they are not.

**B. <u>A "Limited Liability Company Interest" under the Delaware LLC Act</u>.** The Delaware Limited Liability Company Act does not use the term "membership interest." It does, however, use the term "limited liability company interest." But, as defined in the Delaware Limited Liability Company Act, a member's limited liability company interest is only that member's economic interest in an LLC.

This is another example of a term of art that some drafters use without fully understanding what it means. The consequence of such a misunderstanding is failing to recognize that the conveyance of a "limited liability company interest" alone will not include any management or voting rights that the selling member may have had under the operating agreement. Instead, the assignment of that interest must be drafted to specifically include those and other rights (as well as providing for the required approval under the operating agreement for the transfer of that interest). Because if it does not, then someone who thought they were buying a controlling interest in the LLC may later be informed that technically they did not acquire any control, management, or voting rights.

**C. <u>Failing to Understand Tax and Accounting Nomenclature, Concepts, and Consequences</u>.** An LLC with two or more members is treated for federal tax purposes as a partnership unless IRS Form 8832 is filed with the IRS to cause the LLC to be taxed as a corporation. Being treated as a partnership means that the members of the LLC (and not the LLC itself) are taxed on their distributive shares of the LLC's income. Accordingly, there are very intricate allocation and tax-monitoring rules that intrude into the drafting and application of the economic provisions of the operating agreement.

Tax and accounting concepts that pertain to partnerships and LLCs must be understood, with thoughtful provision made for their application, or potential application, in the operating agreement. These include concepts such as "capital shifts," "liability shifts," "Section 704(b)" capital accounts (as contrasted from "tax" or "GAAP" capital accounts), "substantial economic effect," the correlation between tax and economic losses, "partners' interests in the partnership," "deficit restoration obligations," "Section 704(c)" and "reverse Section 704(c)" elections, income and allocations, "disguised-sale" of assets and membership interests, "anti-mixing bowl" transactions, different tax treatment of different types of income and loss, "nonrecourse deductions," "minimum gain" and "minimum gain chargebacks," "qualified income offsets," state withholding and composite return issues (and comparable concepts with respect to in-bound and out-bound investments), the design under the federal tax law (i.e., Subchapter K) for maintaining symmetry between inside and outside bases of the members' membership interests and the LLC's assets and, contrasted from corporations, the primacy of outside basis, the limitations on the ability to deduct the LLC's losses that are allocated to a member, the need for "book ups" and "book downs" for the members to receive their correct shares of the LLC's net worth, Code Sec. 708(a)(1)(B) "technical" terminations, "hot assets," different tax treatment for different payments (i.e., Code Sec. 707(a) payments, "guaranteed payments," distributions in general, distributions of "marketable securities," retained character of contributed and distributed (and purchased and sold) property under Code Secs. 707(b), 724 and 735, special basis adjustments under Code Sec. 743(b) and common basis adjustments and Code Sec. 734(b).

These tax concepts are dynamic and have different import and consequences depending on the particular facts and circumstances of the parties' agreement and the LLC's business or businesses and often require the modeling of different structures or the order in which a series of transactions should take place. Accordingly, a "one-size-fits-all" set of boilerplate provisions is not possible, and it is important that the drafter not delude himself or herself that there is or that these issues can otherwise be summarily avoided or dismissed.

There can be significant adverse economic (not just "tax") consequences to, and collateral conflict between, the members if due regard is not given to these "tax" concepts when drafting the operating agreement. For example, all too often, the drafter of an operating agreement will include both (i) boilerplate "tax provisions" stating that "notwithstanding anything to the contrary in the operating agreement," the agreement is to comply with the substantial economic effect rules of Code Sec. 704(b) and (ii) irreconcilable allocation and, more importantly, distribution provisions that do not attempt to comply with those rules. There may be substantial differences in the members' shares of the LLC's net worth or their income tax liabilities depending on which of these two different regimes are to be applied. Quite simply, someone who does not fully understand the tax and accounting concepts that apply to LLCs has no business drafting or negotiating the terms of an operating agreement without the assistance of a colleague who does.

**D. <u>The Difference Between Allocations and Distributions</u>.** Allocations are made of the LLC's income and losses. Distributions are made not only from the LLC's earnings but also from its contributed capital. The drafter should view each member as having a separate investment account (i.e., capital account), which is credited with that member's capital contributions and is increased by that member's share of the LLC's earnings and reduced by that member's share of the LLC's losses. It is from that investment or capital account that distributions are made. That correlation between allocations and distributions often is misunderstood with the allocation provisions not yielding the result contemplated by the distribution waterfall or, for agreements with either no allocation provisions or allocation provisions that do not have substantial economic effect -- the distribution provisions unintentionally creating taxable capital shifts or misallocating taxable income to the detriment of one or more of the members.

In addition, many, if not most non-tax lawyers, fail to understand that two sets of allocations must be made and maintained for an LLC: one for allocating taxable income and losses (so-called "Section 704(c) allocations" and "reverse Section 704(c) allocations") and one for determining or accounting for the members' economic interests in the LLC (so-called "Section 704(b) allocations").

Members with otherwise identical membership interests may have significantly different tax liabilities due to the manner in which income and deductions are allocated under Code Sec. 704(c). For example, assume two persons organize an LLC. One member contributes $1 million in cash to the LLC and the other member contributes a depreciable or amortizable asset having a fair market value of $1 million but an adjusted tax basis of only $500,000 that is to be recovered on a straight-line basis over five years. Under these simple facts, and assuming the LLC elects to use the "traditional method" under Code Sec. 704(c), the member who contributed the $1,000,000 of cash would be allocated $500,000 more of the built-in gain asset's tax depreciation or amortization deductions over that asset's remaining five-year recovery period than what would be allocated to the member who contributed that asset to the LLC. While that result may be perfectly appropriate, in that the member who contributed the cash presumably has already paid tax when that money was earned (i.e., that money is an after-tax asset, while the in-kind property contributed to the LLC, at least in the amount of the built-in gain, is a pre-tax asset), the members and their counsel should discuss the manner in which that built-in gain (including the related depreciation and amortization deductions) will be allocated for tax purposes and the impact that those allocations may or should have (or not have) on distributions (including tax distributions).

**E. Tax Distributions.** While in the abstract, requiring distributions to be made to the members to cover the tax liability that they must pay on their shares of the LLC's taxable income seems fair and reasonable, tax distributions may become unduly burdensome and distort the members' agreed-upon returns. The parties should agree on the frequency that distributions are to be made (annually or quarterly). If quarterly, the drafter should keep in mind that estimated payments for the first three quarters of a calendar taxable year are due on April 15, June 15 (not July 15), and September 15 (not October 15), and the estimated payment for the fourth quarter is due on December 15 for corporations and January 15 for individuals.

The parties also should understand that questions such as the following need to be considered and answered. What imputed tax rate is to be applied? Should it be the "maximum combined federal and state rate"? What if a member is a citizen and resident of a foreign country? What adjustments should be made for deductions on the federal return for state income taxes? What should be done about the reduction of that benefit due to the floor under Code Sec. 67, the haircut under Code Sec. 68, and the alternative minimum tax? How is the different rate for long-term capital gains for individuals to be factored into the determination of the imputed tax rate? Should provision be made for non-income taxes, e.g. self-employment taxes? Should distributions for taxes be made on the basis of the allocation of the LLC's taxable income or the parties' agreed-upon, economic sharing percentages? How should past losses and distributions be factored into the determination of the amount of the tax distributions that should be made (or whether those distributions should be made)? Should members be required to repay over-paid tax distributions (e.g., when income for one year is offset by losses in a subsequent year)? To what extent, if at all, should the tax distributions paid to a member affect the amount of other current or future nonliquidating distributions that otherwise would be paid to that member? How should tax distributions be factored into an investor's internal rate of return (IRR) or preferred return calculations (i.e., as current payments or treat them, for compounding purposes, as not having been paid until the remainder of the return is paid)? How is the requirement for tax distributions under the operating agreement reconciled with the negative covenants against distributions in the LLC's credit agreements? What happens when the LLC does not have enough cash flow from operations to make the required distributions? One of the most important and most frequently overlooked issues is whether, or to what extent, tax distributions should be made for taxable income attributable to built-in gains (so-called Code Sec. 704(c) and reverse Code Sec. 704(c) income) and the non-*pro rata* manner in which those allocations of taxable income are made.

For an example of the problems, distortions, confusion, and adverse economic consequences to one or more members that tax distributions may cause for members of an LLC and their lawyers, see *Interactive Corp. v. Vivendi Universal, S.A.*, C.A. No. 20260, 2004 WL 1572932 (Del. Ch. 2004). In that case an apparent mistake in the drafting of the tax distribution provision caused the preferred return for one of the members to yield an after-tax return rather than a pre-tax return, causing that member potentially to receive more than $600 million over what the other member thought was to be paid on the preferred return.

## II. <u>Capital and Services</u>

**A. <u>Difference Between Debt and Equity</u>.** Some drafters make the mistake of incorporating loan repayments to one or more members in the operating agreement's distribution waterfall rather than in promissory notes or loan agreements. The repayment of a loan is not a "distribution" for income tax purposes or under any LLC Act.

**B. <u>Failing to Understand How Different Laws Apply to LLCs and Their Members</u>.** A member may not be both a "partner" in and an "employee" of an LLC for federal tax purposes. Accordingly, one should receive either a Schedule K-1 or a Form W-2, but not both.

Whether someone is a "partner" for federal tax purposes depends on the intention of the parties as demonstrated by their actions. *Commissioner v. Culbertson*, 337 U.S. 733 (1949). If someone is described in different contracts, and is reported in different filings with the IRS, to be both an "employee" and a "member" of, or "partner" in an LLC, an IRS agent may take the position that, based on that inconsistency, he or she is free to choose whether to treat that person as an employee or a partner for tax purposes, possibly on the basis of what the agent believes will result in the government receiving the most tax revenues.

In addition, whether a payment made to a member is treated as a "distribution" under Code Sec. 721, a "guaranteed payment" under Code Sec. 707(c) or a payment that was made in that person's "capacity as a member" under Code Sec. 707(a) likely will have different consequences to both the LLC and the recipient. *See, e.g.*, Rev. Rul. 2007-40, 2007-25 I.R.B. 1426 (a partnership recognizes the built-in gain of property used to make a guaranteed payment to a partner when, as a general rule, that gain would not be triggered if the payment had been a "distribution").

Also, a person who is treated as a "partner" for state law and tax purposes will not necessarily be treated as a "partner" under federal employment laws. *See*, *e.g.*, *EEOC v. Sidley Austin Brown & Wood*, 315 F.3d 696 (7th Cir. 2002).

**C. Unduly Restraining Access to Capital.** Inadequate capitalization is a leading cause for businesses, particularly start-up businesses, to fail. The parties should take that risk into account when negotiating the restrictions and limitations that are to be placed on the LLC's ability to access additional financing. This can be a delicate negotiation between allowing the LLC to obtain the capital it needs when it needs it and not subjecting the members to a potential black hole of capital calls or undue dilution. That discussion should be part of broader negotiations of the relative rights and duties of majority and minority owners.

**D. Providing Representations and Warranties for Contributed Property.** The parties likely have the same expectations for property that is contributed to an LLC as they have for property that they purchase. Accordingly, in most cases, representations and warranties concerning property (other than cash) that is contributed to an LLC are just as appropriate as if that property had been purchased by the LLC.

**E. Failing to Take Full Advantage of the Flexibility of LLCs.** The parties to an operating agreement have considerable freedom to customize when, and in what manner, they will share in the LLC's different revenue streams and losses. While, generally speaking, simplifying their economic structure is worthwhile, in many cases a simple structure does not best achieve the parties' risk, return, and other economic objectives.

For example, the Model Agreement provides for two sets of non-liquidating distribution waterfalls: one for cash flow from operations (in which the promoted or carried interest participates before the contributed capital is repaid) and the other for cash flow from sales and refinancings (which requires the contributed capital to be repaid before the promoted or carried interest may participate). The Model Agreement also provides that contributed capital is to be paid a preferred return to compensate the investors' cost of carry. Of course, the manner in which the cash flow from an LLC is shared by the members may be, and often is, more sophisticated and customized than what is provided in the Model Agreement.

## III. Management

As with the manner in which profits, losses, and cash flow may be shared, the parties to an operating agreement have considerable flexibility when devising the LLC's management structure. This is another case of one size not fitting all situations. Examples of common management structures include the member-managed, manager-managed, and board-managed arrangements.

Just as in the member-managed structure, the manager-managed and board-managed arrangements allow the parties to deviate from the traditional one-man, one-vote (i.e., per capita) standard. In many situations it may be more appropriate to give a board member more than one vote than to require that member to appoint more than one board member to have the agreed-upon board representation. Doing so could help avoid situations such as the one encountered by the majority owner in *VGS, Inc. v. Castiel*, C.A. No. 17995, 2000 WL 1277372 (Del. Ch. 2000), *aff'd* 781 A.2d 696 (Del. 2001), in which an appointed manager switched allegiances to marginalize the member who appointed him.

Whatever management structure is adopted, each member likely will want to make sure that the voting and management rights that member has extend to the LLC's subsidiaries and other affiliates.

## IV. Fiduciary and Other Duties, Exculpation, Indemnification, and Equitable Remedies

Only the tax treatment of LLCs and their members has engendered more discussion and confusion than the duties, and potential liability for the breach of those duties, that managers and other decision makers of an LLC have to the LLC and its members. At one end of the spectrum are those who believe that those duties and liabilities are as transfixed and immalleable as they historically have been in the trust or corporate context. Chief Justice of the Delaware Supreme Court, Myron Stelle, correctly points out that "although current judicial analysis seems to imply that fiduciary duties engrained in the corporate law readily transfer to limited partnerships and limited liability companies as efficiently and effectively as they do to corporate governance issues, that conclusion is flawed." Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L 1, 4 (2007). Instead, a distinction must be made between duties that are based on "status" or "dependency" relationships (such as, the duties owed by a trustee to a beneficiary) and those that are based on "contractual" relationships (such as partnerships and limited liability companies). *Id.* at 13.

At the other end of the spectrum are those who believe that the duties and liabilities of managers and other control persons can be summarily eliminated. Many have the misunderstanding that if an LLC Act, such as the Delaware LLC Act, states that fiduciary and other duties and liabilities may be eliminated in the operating agreement, they may be, and if the LLC Act does not expressly provide that they may be "eliminated," they may not be. This generally is not the case. Compare, for example, the applicable provisions of the Delaware LLC Act § 18-1101(a) and those of the North Carolina LLC Act §§ 57C-3-22, and 57C-3-30 through 57C-3-32. Although the

Delaware Act does state that the operating agreement may eliminate a person's duties to the LLC and its members (other than the implied contractual covenant of good faith and fair dealing), one may not stop there. The Delaware case law, as succinctly stated by Vice Chancellor Strine, demands that "[w]ith the contractual freedom granted by the LLC Act comes the duty to scrivin with precision." *Willie Gary LLC v. James & Jackson, LLC*, 2006 WL 75309 (Del. Ch. 2006), *aff'd* 906 A.2d 76 (Del. 2006).

Many drafters of operating agreements are not as precise as they should be, particularly when describing the duties that the various parties to the operating agreement have and the consequences that they will suffer if they breach or violate those duties. For example, after decisions such as *Gelfman v. Weeden Investors, L.P.*, 859 A.2d 89, 117 (Del. Ch. 2004); *R.S.M. Inc. v. Alliance Capital Mgmt. Holdings, L.P.*, 790 A.2d 478, 497 (Del. Ch. 2001); and *Miller v. American Real Estate Partners, L.P.*, C.A. No. 16788, 2001 WL 1045643 (Del. Ch. 2001), one should not expect that simply stating in an operating agreement that "fiduciary duties are eliminated" or "to the fullest extent permitted by law, fiduciary duties are eliminated" will be given effect by the courts. Instead, the drafter of an operating agreement needs, to the extent permitted by the applicable LLC Act, to clearly state what duties the members/managers have and do not have, including the extent to which traditional, common-law fiduciary duties are modified or supplanted.

This then begs the question: What are fiduciary duties? Many throw those "vague" words around as if they have a well-settled and generally understood meaning, particularly with respect to the manager of an unincorporated or other business entity. *See Cantor Fitzgerald, L.P. v. Cantor*, C.A. No. 18108, 2001 WL 1456494 at *5 (Del. Ch. 2001). This, unfortunately, is not the case. In fact, the Delaware courts (as well as the courts of other jurisdictions) have struggled with trying to define what are the fiduciary duties of the managers of a business entity.

For a number of years, the Delaware courts indicated that in addition to the duties of care and loyalty, fiduciary duties include the duty of "good faith" (not to be confused with the implied contractual duty of good faith and fair dealing), which proved to be a very murky, in-the-eyes-of-the-beholder concept and led to a "fog of . . . hazy jurisprudence." *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 754 (Del. Ch. 2005), *aff'd* 906 A.2d 27, 64 (Del. 2006). The Delaware Supreme Court ultimately backed away from it in its 2006 decision of *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006), returning "good faith" as a component of the fiduciary duty of loyalty.

Whether in Delaware, North Carolina, or any other state having an LLC statute that generally defers to the parties' contract, the only way to "modify" or "eliminate" duties is to state what those duties are and, thereby, supplant what the default duties would otherwise be. Thus, the operating agreement should state what the duty of care is for the managers or other persons in control of the LLC. Should it be negligence or gross negligence? Should there be no duty of care, or no personal liability in the case of a transgression (i.e., an anti–*Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), elimination of personal, financial liability for breach of the duty of care), which, when adopted for a business entity, have caused courts to sometimes be receptive to expanding the duty of loyalty/duty of good faith to allow recovery for conduct that arguably would otherwise constitute a breach of the duty care (i.e., intentional nonfeasance or malfeasance)?

Likewise, the operating agreement should describe what the parties' duties of loyalty are, including the circumstances under which a member or manager of an LLC may compete against the LLC and, frequently overlooked, whether controlling members/managers may enter into noncompetition agreements in other transactions that could impact what the controlled (i.e., "affiliated") LLC might be able to pursue in the future. Other duties of loyalty that the operating agreement should address include the circumstances under which members or managers may transact business with the LLC, take advantage of a business opportunity that arguably should be considered or undertaken by the LLC, engage in other transactions or activities for which they have, or may have, a conflict of interest with (or divided loyalties with those of) the LLC or the other members. What duties of disclosure/candor should the manager and other control persons have? What type of information (e.g., reports, business plans, budgets, and financial statements) must be provided or made available to the LLC's members (and under what circumstances and within what period of time must that information be provided, e.g., in connection with a major transaction or the exercise, or response to the exercise, of the LLC's buy-sell provisions)? What method or methods of accounting must be used in preparing financial statements and reports that are to be provided to the LLC's members? To what extent must control persons of an LLC treat members even-handedly? To what extent may members and managers take into account their own self interest when making decisions, or voting on matters, affecting the LLC? The operating agreement should provide how each of these and other duties are to apply and be regulated and enforced. For example, to what extent should scienter control or otherwise affect the outcome? Should one be liable only for intentional misconduct? Should an objective or subjective standard of knowledge or intent be used? What should the consequences be if a particular duty is breached? Should one have the right to cure their transgressions? If so, under what terms?

Because an LLC is a contract-based entity, one must also contend with the implied covenant of good faith and fair dealing and the extent to which it may be applied to achieve the presumed reasonable expectations of the parties. This duty often is described as a "gap filler." *See, Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 440 (Del. 2005). That is, what the parties may reasonably expect is to be derived from, and therefore is dependent on, the terms of the operating agreement. The more precise the agreement is, the less this concept may come into play.

The North Carolina LLC Act generally employs standards for allowing the LLC's governing documents to absolve the managers from liability to the LLC and its members except for "(i) acts or omissions that the manager . . . knew at the time of the acts or omissions were clearly in conflict with the interests of the limited liability company" or "(ii) any transaction from which the manager . . . derived an improper personal benefit." N.C. Gen. Stat. § 57C-3-32(b). For comparable standards, see the Delaware General Corporation Act Section 8-102(b)(7) and Model Business Corporation Act (3d ed.) Section 2.02(b)(4). While these essentially are the same words used under Section 55-2-

02(b)(3) of the North Carolina Business Corporation Act for absolving directors under the corporation's articles of incorporation, they have a different application in the LLC (contract-based) context because what is in "conflict with the interests of the limited liability company" or an "improper personal benefit" can only be determined from the parties' contract – the operating agreement. Thus, there should be no difference in result in determining what the duties of the managers and other decision makers are (or, more accurately, the consequences for breaching those duties) whether the operating agreement is governed by the North Carolina LLC Act or the Delaware LLC Act, but the parameters contained in the North Carolina LLC Act may help to provide context.

To simplify the above discussion, the scope of a manager's duties and the potential liability if the manager breaches those duties were treated as if they were one and the same. What good is a duty if there are no financial consequences if one breaches that duty? How can one obtain an injunction against negligent or grossly negligent conduct? The answer is that while it may be perfectly understandable and reasonable for the parties to agree that a manager of an LLC should not be personally liable for his or her mistakes, members should be able to enforce their rights under the operating agreement.

For example, the members may provide in the operating agreement that certain transactions or other actions require their prior approval. The manager, however, may forget, or misread, the applicable terms of the operating agreement before entering into such a transaction without the necessary authorization from the members. Even if the operating agreement absolves the manager from personal, financial liability for any losses suffered by the LLC as a result of that unauthorized transaction, the members should be able to enforce their rights under the agreement by, for example, seeking to rescind that transaction. They can do so only by demonstrating that the manager's actions were not authorized. If, however, the manager had no "duty" under the operating agreement, then the operating agreement would seem to have conflicting directives: one requiring the prior vote of the members before the manager could enter into prescribed transactions, and the other stating that the manager has no duty to comply with that requirement.

Thus, while it may be appropriate for the operating agreement to limit the circumstances under which a manager may be personally liable for money damages, that does not mean that the members should agree to surrender their equitable remedies (e.g., rescission, disgorgement, and injunction) to redress other missteps by the manager. See, e.g., the difference between Model Business Corporation Act (3d ed.) Sections 2.02(b)(4) (ability to limit the liabilities of directors) and 8.56(a) (ability to limit the liabilities of officers) and Sections 8.30 (duties of directors) and 8.42 (duties of officers); and North Carolina Limited Liability Company Act Section 57C-3-22 (duties of managers) and Section 57C-3-32 (ability to limit the liabilities of managers).

## V. <u>Direct and Indirect Changes in Ownership and Member Bankruptcies</u>

Unlike corporate statutes, most, if not all, LLC statutes clearly permit the parties to the LLC operating agreement to restrict transfers of membership interests and to limit the rights conveyed to certain transferees by operation of law (e.g., death) to the economic rights in the membership interest that is transferred, and not its management and voting rights. With that being the case, the parties to an operating agreement should consider whether a right of first refusal that one might include in a shareholders' agreement adds anything to the requirement that transfers of membership interests be approved under the operating agreement. In that regard, however, operating agreements also frequently provide that members/managers may approve or prohibit transfers in their "sole and absolute discretion" without realizing that case law has narrowly construed those terms to not allow one to unreasonably or arbitrarily restrict another from transferring their membership interest. *See*, *Fitzgerald v. Cantor*, No. 16297-NC, 1999 WL 182571 (Del. Ch. 1999).

If there are to be restrictions on transfers of membership interests, should those restrictions effectively be pushed up (through change-of-control provisions) to the owners of entities that are members of the LLC? Also, to what extent will those restrictions be overridden by bankruptcy and insolvency laws? The few bankruptcy cases that have considered this issue seem to split in their analysis of factors such as (1) the type of bankruptcy (e.g., liquidation under Chapter 7 or reorganization under Chapter 11 of the U.S. Bankruptcy Code); (2) whether the operating agreement is to be treated as an "executory contract" under Section 365 of the Bankruptcy Code; (3) if an executory contract, the extent to which the restrictions may be held to be invalid under the "*ipso facto*" rules of Section 365(e)(1) of the Bankruptcy Code; (4) which then requires a determination of whether the personal services exception of Sections 365(e)(2) and 365(c)(1) of the Bankruptcy Code apply; and lastly, (5) whether the bankrupt member is the only member of the LLC.

The limited case law indicates that a Bankruptcy Court likely will hold that the transfer restrictions in a single-member operating agreement, will not prevent the transfer of management rights to the bankruptcy trustee of the bankrupt member. *See, e.g.*, *In re Modanlo*, 2007 WL 2609470 (Bankr. D. Md. 2007), *In re A-Z Electronics, LLC*, 350 B.R. 886 (D. Idaho 2006), and *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003). That case law also indicates that a Bankruptcy Court likely will hold that the transfer restrictions in a multi-member operating agreement will not prevent the transfer in a bankruptcy proceeding of the information rights, and perhaps limited voting rights, of a bankrupt member who has little or no management rights or remaining obligations or other responsibilities to the LLC (including, for example, obligations to contribute additional capital). *See, e.g.*, *In re: Baldwin*, 2006 WL 2034217 (10th Cir. BAP (Okla.), July 11, 2006) and *Meiburger v. Endeka Enterprises, L.L.C. (In re Tsiaoushis)*, 2007 WL 186536 (Bankr. E.D. Va. 2007).

## VI. Miscellaneous "Boilerplate"

Many lawyers become fatigued by the time they get to the final set of provisions of the operating agreement dealing with miscellaneous matters, but when there is a dispute, many of these provisions become very important in determining the outcome of that dispute.

**A. Dispute Resolution and Exit.** Perhaps the most important provisions in the operating agreement are those that come into play when there is a disagreement, including the circumstances under which members may liquidate their membership interests or, more generally, when there is an impasse or larger breakdown in the relationship between one or more of the decision makers of the LLC. There are numerous approaches that should be considered for dealing with those potential situations, including put and call options, co-sale or tag-along rights, drag-along rights, registration rights, rights of first offer or refusal, forced sell of the Company, auction or appraisal buy-sell provisions, etc. Because of the scrutiny that these provisions will receive when they are activated, they should be drafted with particular care. *See, e.g.*, *Haley v. Talcott*, 864 A.2d 86, 92 (Del. Ch. 2004), in which a buy-sell provision that neglected to address the personal guaranties of the members of the LLC was held to be ineffective; and therefore, the court required the LLC to be judicially dissolved.

**B. Amendments.** Care should be given to drafting the amendment provisions of the operating agreement because it is not always clear whether a decision is made in accordance with the operating agreement or constitutes an amendment to the operating agreement. This distinction becomes important when a different standard or vote would be required (i.e., the possible difference between a manager or majority-member decision vs. a member super-majority or unanimous approval required for amendments to the operating agreement). Also, consideration should be given as to how abstentions and other failures to vote are to be treated. Should they be counted effectively as votes for or votes against the proposal? Should it make a difference depending on whether the manager or the board of directors was the one that proposed that amendment or other action to be taken?

**C. Coordination with Other Agreements and Anti-Reliance.** The drafters should determine what other documents contain other aspects of the parties' arrangement or that may effect the application of certain provisions of the operating agreement. Care should be given to coordinate the application of those different agreements, including contribution and subscription agreements, noncompetition agreements, purchase and sale agreements, loan agreements, etc. Also, the operating agreement should state what documents and other information the members may rightly claim they relied upon when purchasing their membership interest in the LLC and executing the operating agreement.

**D. Remedies, Choice of Law, and Jurisdictional Issues.** One should keep in mind that parties who perceive that they have been aggrieved, likely will assert both contract and tort (e.g. fraud) claims for recovery. A decision should be made as to what law is to apply to those different claims and what forum or forums should (may) those claims be brought. *See*, *e.g. Gloucester Holding Corp. v. U.S. Tape and Sticky Products, LLC*, 832 A.2d 116, 123-25 (Del. Ch. 2003), that recognized that tort claims may be litigated in one state, while contract claims are litigated in another.

**E. Member Disclosures and Further Actions.** At a minimum, the parties to an operating agreement should be required to provide information that may be necessary for the LLC to comply with applicable law (e.g., Patriot Act, OFAC, and tax disclosures).

## VII. Conclusion

LLCs are extraordinarily flexible, efficient, and effective vehicles for organizing, financing, and operating privately-owned enterprises and ventures. They require a unique, blended application of business, tax, agency, and contract law. By necessity, "corporate" and other traditional business, tax and other commercial lawyers have expanded their practices to include organizing, and advising their clients with respect to, LLCs. In doing so, it is important for one to truly understand the extent of their knowledge in these areas of law and reach out for assistance from others as one nears the edge of their competencies. The ABA Joint Task Force hopes that the Model Agreement and its commentary will be of assistance in this regard and will be a useful tool for identifying and resolving the types of issues that are unique to, or have a different application or otherwise have special import for, unincorporated, contract-based entities in general, and LLCs in particular.