CORPORATE MATTERS:
LIMITED LIABILITY COMPANY AGREEMENTS

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In a previous issue, we discussed shareholder agreements and set out items that one should look for in such an agreement.[1] A related topic, but one with subtle differences – particularly on the tax side – concerns the agreements used to govern the management and operation of limited liability companies. In the Delaware Limited Liability Company Act,[2] these agreements are referred to as "limited liability company agreements," and in the New York Limited Liability Company Law,[3] they are referred to as "operating agreements." In practice, however, the terms are used interchangeably. For purposes of this article, we will use limited liability company agreement ("L.L.C. Agreement"), as Delaware is the state most frequently used for limited liability company formation.

STATE REQUIREMENTS

Although many states do not require a limited liability company to have an executed L.L.C. Agreement, it is prudent to outline the internal governance procedures of the entity in a legal document. There really is no reason why the members of a limited liability company should not have a functioning governing document. An L.L.C. Agreement does not necessarily have to be a long or complicated document; it will allow you to effectively structure your financial and working relationship with your co-owners in a way that is suited to the type of business you are engaged in. Furthermore, having an agreement will help protect your limited liability status, particularly for single-member limited liability companies, as well as prevent management disagreements and ensure that the business is governed by rules of your making, rather than as stipulated by a particular state statute.

Care should be taken in drafting the agreement, however, as although many statutes provide a lot of discretion for members of a limited liability company to define the terms of their relationship – state statutes contain fundamental governing provisions that members of a limited liability company can contract out of – courts have relied on the plain language contained in the contracts and have resisted creating ambiguities based on extrinsic evidence.[4]

Oral contracts could lead to uncertainty if the relationship deteriorates, as a court may look to the applicable state statute to provide terms for the parties' L.L.C. Agreement with the possibility that the court-imposed terms will differ from any oral agreement settled between the parties.

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1 See *Insights* Vol. 1 No. 3, "Corporate Matters: Shareholder Agreements."

2 6 *Del*. C. §18-101 *et seq*.

3 N.Y. Ltd. Co. Law § 101 *et seq.*

4 *In re Nextmedia Investors, LLC,* C.A. No. 4067-VCS (Del. Ch. May 6, 2009)

AGREEMENT

Ownership Interest

Ownership interest is typically expressed as a percentage interest and usually determined by the initial capital contribution to the company. Capital contributed in return for an ownership interest can be in the form of cash, property, services, or promissory note. If assets other than cash are contributed, a value is usually attributed to the asset; this can be negotiated between the parties. In most cases, ownership certificates will not be issued and a member's interest is evidenced by the executed L.L.C. Agreement. However, ownership "units" can be created and unit certificates obtained which give a limited liability company more of the look and feel of a corporation.

The ownership interest comprises an economic interest and a management interest in the company. Interests can be non-voting and different classes of ownership can be created, such as convertible and preferred, etc.

Capital Accounts

Each member of a limited liability company has a capital account, which essentially keeps a record of a member's equity investment in the partnership determined by reference to the principles or practices of the financial accounting method used by the partnership. Additionally, for allocation of partnership income, gain, loss, or deduction to have "substantial economic effect" under applicable federal tax rules, such amounts must be reflected as debits or credits to capital accounts in a manner described in the Treasury Regulations. It is therefore possible for a partner to have two different capital accounts if the partnership maintains a set of financial accounting books and also maintains proper capital accounts for tax allocation purposes. Note that both types of capital accounts must be carefully distinguished from a partner's "outside" tax basis in his partnership interest. There is an important and useful mathematical relationship between a partner's tax capital account and his adjusted tax basis in his partnership interest: Generally, a partner's tax basis in his partnership interest is equal to the sum of his tax capital account and his share of partnership liabilities.

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Tax Allocations and Distributions (in Liquidation or Otherwise)

The "economics" of the limited liability company are reflected in its tax allocation and distribution sections. As indicated above, an allocation to a member of his or her share of profits or losses of the limited liability company under the terms of the L.L.C. Agreement will be respected for tax purposes if it has "substantial economic effect" or if it is in accordance with the members' "interests" in the limited liability company. There are several approaches to drafting these important provisions. In many if not most agreements, a member's share of capital contributions, profits, losses, and cash flow will be the same. In such cases, these provisions are fairly straightforward and, generally, are based on the member's percentage interest in the limited liability company.

Not all distributions to members are "straight up" distributions based on percentage interests. Often, there are so-called "waterfall" distribution provisions. Under such provisions, the anticipated distributions are set forth in the agreement in order of priority, with the tax allocations adjusted to be consistent with the cash distributions to the members. In other cases, a member may be granted a so-called "carried

interest," which offers that member the right to future profits without a commensurate capital contribution (often in connection with services rendered or to be rendered to the limited liability company). In this case, the tax allocations drive the distributions because the carried interest member is not entitled to share in pre-admission profits or "value."

"Tax law mandates certain allocations."

Tax law mandates certain allocations. For example, §704(c) of the Internal Revenue Code provides that income, gain, loss, or deduction attributable to property contributed to a limited liability company by a member must be allocated to the contributing member solely for tax purposes. This prevents the shifting of tax consequences among members with respect to pre-contribution gain or loss. A limited liability company is required to allocate income, gain, loss, and deduction for contributed property so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.

It is common for the L.L.C. Agreement to provide for preferred returns to some members, to distinguish between operating profits and profits from extraordinary "capital" events, and to include a provision that delays the payment of equity capital until the liquidation and dissolution of the limited liability company. Many agreements provides for tax distributions, recognizing that members will be taxed on limited liability company profits whether they are distributed or not. It is important to read and draft the tax allocations and distribution provisions in a manner so that these provisions work consistently.

MANAGEMENT

Management of a limited liability company can be by the members, a managing member, or a board of managers. If a managing member is selected, care should be given to stipulating in the agreement the range of activities he can conduct for the company. Limits on his or her authority can also be important and a common way of doing this is to include a list of actions that can only be undertaken following a super-majority vote or the authorizing vote of an identified member. If a board of managers is appointed, the agreement should lay out how it is appointed, how members are removed, and how to replace members.

TRANSFER

Limited liability companies often have the same transfer restrictions as partnerships and corporations. The most typical transfer restriction is a right of first refusal. Depending on the industry, a list may be prepared of individuals or companies to which an ownership interest cannot be transferred. Members may also have a veto right on transfers. Often, permitted transferees are identified, enabling members to transfer interests to affiliated entities or for estate planning purposes.

LIQUIDATION AND DISSOLUTION

Most L.L.C. Agreements provide the procedures for dissolving the limited liability company and liquidating (and distributing) its assets. In the absence of procedures set forth in the L.L.C. Agreement, the law of the state in which the limited liability company is organized will provide default procedures. L.L.C. Agreements often require dissolution upon the occurrence of one or more specified events, such as the sale of substantially all the assets of the company, or may provide for a fixed term.