Operating Agreements Today

The Foundation to Avoid Controversy Tomorrow

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Perilous Journeys in the Undocumented World

Melvin, a developer and investor who owned a modest real estate portfolio with his partner, Susan, asked his attorney, Maggie, to form a limited liability company to own a new strip shopping center the company was purchasing.

“Please form the entity, but don’t spend much time on it. Keep it simple; we don’t want to pay legal fees. Susan and I have been doing this for a long time. We just agree on everything, and we’re really tight,” he told Maggie.

Famous last words? Maggie knew that any partners in business could at some point have a falling out, but she was going to follow her client’s instructions and would not do more detailed legal work without getting paid. And maybe Melvin was right, as he had been so many times before.

What Melvin did not understand was that, just because he was tight with his partner, that did not mean he would be tight with his partner’s executor.

Two years after the company acquired the new property, Susan died following a sudden illness. She was survived by two children, Martin, who was appointed the executor of her estate, and Lois. Neither child was involved in or had any interest in the business. Martin initially demanded that Melvin pay half the value of the company to the estate in cash, but backed off when advised that this was not realistic. Among other assets, Martin was focusing on the new shopping center, which by this time had been fully leased, primarily as a result of the marketing and leasing skills of Melvin’s son and daughter, Louis and Karen, who were working in the business.

It did not take long for tension to arise. Instead of his trusted colleague Susan, who knew the real estate business and was committed to the company’s future, Melvin had to deal with Susan’s executor, who knew nothing about real estate and would have been happy to break up the company. Unfortunately, all

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of the real estate assets were in single-purpose partnerships or limited liability companies governed by four-page partnership or operating agreements. All of the agreements said that Melvin and Susan would make all decisions jointly, with all costs and benefits split 50/50, and each agreement included a clause saying that neither could withdraw or transfer his or her interest (except to family members) without the other's consent.

With the new shopping center fully leased, and covering its operating expenses and debt service, Melvin turned to the center's backlog of needed repairs and capital expenditures necessary for re-leasing when leases started to roll over. But where would the money come from? A modest capital contribution would cover the repairs, and he asked Martin to provide Susan's 50% share. But Susan's children were determined not to put another penny into the business, and there was no provision in the operating agreement requiring a capital contribution to cover costs necessary for the company's operations. When the local building department placed a violation on the property that required immediate attention, Melvin offered to loan the money to the company or advance it as an additional contribution. But the operating agreement did not provide any mechanism for providing additional funds. So Martin told him, "Please do so, but we're not giving you anything for it; thank you for the gift." And they would not agree to pay Melvin interest on a loan or allow him any preferred rights for an additional contribution. So the violation remained of record and the repairs were deferred.

The situation could not continue indefinitely. Melvin went to the bank that financed the purchase with a request to increase the mortgage loan. The bank was happy to do so, provided that someone provide a limited guaranty to maintain the loan-to-value ratio. Melvin was willing; he had no choice. But the bank also required the customary "non-recourse carve out guarantees" from all beneficial owners having an interest of 20% or more, including Susan's children.

Martin's response was predictable. "Melvin, you cannot have the company borrow money without our consent, and we're not consenting. And you expect us to provide guarantees? Are you serious? And even if we were willing, don't think that we would let you do any tax allocations that would give you any benefit for providing a payment guaranty by yourself." So the money was not borrowed, and the situation continued. By now, the bank was aware of the violation and demanded it be cured, as the mortgage required.

In the meantime, the property was beginning to generate a small cash flow as lease rents began to increase and more expenses were covered by tenants under escalation clauses. Martin suspected this might be happening and requested operating financial statements and the opportunity to review the company's books and records. But the company had no agreement giving the owners the right to financial information or inspection rights, and Melvin, who was running the business, turned down their requests. Neither Melvin nor Martin was aware of a state law provision providing members of a limited liability company access to records for a proper purpose. Thus, the estate, which owned 50% of the company, was unable to obtain information about the company's affairs.

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The estate's attorney, Eugene, contacted Melvin and said that if he did not provide the requested information and allow the inspection of books and records, he would go to Probate Court and obtain an order to that effect from the probate judge on the ground that the information not only had to be provided under state law but also was necessary for the administration of a decedent's estate. Melvin reluctantly complied. And when Martin saw there was a small cash flow, which Melvin was applying to repairs, he demanded that the company instead distribute cash to the owners. The operating agreement, however, said nothing about when cash is to be distributed, whether distributions could be suspended while the company requires cash for other purposes, and who decides. So Melvin used the funds for repairs, cured the violation, and made no distribution to the owners. When Melvin advised Martin that he was hiring legal counsel to have the violation removed of record, at the company's expense, matters got worse.

For Susan's children, dealing with Melvin was just not worth it. They wanted out, and they wanted cash. They would take less than 50% of value just to be rid of it. Eugene introduced them to Vulture Investors, Inc., which purchased ownership interests in companies at a steep discount. Vulture's business model was to purchase interests in companies cheaply and maximize its own value by demanding quick liquidations and harassing management if management did not go along. Since they were fed up at this point, Martin, as executor, made a deal to sell Susan's interest to Vulture. In the course of Vulture's due diligence, its attorney, Henry, discovered that Melvin had an approval right over the transfer. At Henry's suggestion, the estate and Vulture entered into a contract for the sale of Susan's interest, subject to obtaining Melvin's approval. Melvin refused. He could not agree to have an opportunistic investor like Vulture as his business partner.

Martin and Lois went back to Eugene and asked how they could get out of the business and get some cash in the process. The attorney advised them, "The operating agreement does not give you any mechanism to get out. There is no exit strategy. You cannot even withdraw."

A friend advised Martin, "Hire the nastiest litigator you can. Then you'll get what you want." Martin hired a trial lawyer, Peter, who had a reputation for aggressiveness. Peter brought a claim in Probate Court accusing Melvin of fraud and mismanagement. To make it more unpleasant, Melvin's children, Louis and Karen, were added as defendants. The allegations were false, and everyone knew that, but this might be a way to force the issue.

It did force the issue, but not in the way that was expected. Martin received a rude awakening when Peter sent him an engagement letter setting forth his hourly rates for legal services and demanding a large retainer. Melvin, trying to run a real estate business but terribly distracted by the dispute, asked Maggie to represent him. Maggie could not; as counsel to the company, representing one owner against the other would be a conflict of interest. Melvin, unable to use his long-term attorney, hired a more expensive attorney he did not really know.

With both sides facing large legal bills and the dispute beginning to interfere with the company's day-to-day operations, the parties had no choice but to reach a settlement that would please nobody. Susan's estate would receive an agreed amount of cash, significantly less than the beneficiaries expected, and

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would transfer Susan's interest to members of Melvin's family. To raise the cash, a sufficient number of the company's properties would be put up for sale, regardless of the strength of the market or the adequacy of sales prices. Melvin would end up with a smaller company, one that might not be able to generate sufficient income to provide long-term employment for his children at reasonable levels of compensation. And it all would be subject to review by the Probate Court.

Clearly, when Melvin and Susan were conducting business together, they never would have expected an outcome like this. What could have been done differently to protect the parties in the event of an unexpected occurrence like the death of an owner?

The LLC: A Vehicle for Maximum Flexibility

Given the differing outlooks between Melvin and the next generation on Susan's side in the above example, it was inevitable that there would be tension regardless of whether the parties had a detailed agreement on paper. But proper planning in forming the limited liability company to conduct the business, and a good operating agreement describing what would happen if the unexpected arose would have made a big difference.

Limited liability companies became common in the United States in the 1990s as an alternative to corporations and partnerships. Offering the benefit of simplified structures, with owners called "members" and management by either members or "managers," at the owners' selection, limited liability companies combined corporate benefits like perpetual existence and limited liability of the owners, with the ability to achieve pass-through taxation as in a partnership. Except for matters expressly governed by state statutes, which generally are limited, members of a limited liability company are free to set up whatever business relationships they want in their operating agreements.

Limited liability companies have been used for a generation, and practitioners have worked hard to make this a desirable structure for business. They are used for such diverse business purposes as:

- two or more family members owning a family business,
- two or more unrelated parties joining to engage in a business venture,
- a single-purpose entity created to satisfy the technical requirements of securitized financing, and
- a two-member company composed of a real estate developer and a financial institution providing most of the equity for a project.

This article will discuss some of the key issues to address when forming the company and drafting its operating agreement to minimize problems down the road.

Formation and Structuring of the Company

Forming a limited liability company is simple enough; it involves filing a certificate with minimal information, usually called a certificate of formation or articles of organization, with the secretary of state or other officer under state law, and drafting an operating agreement to set forth the relevant business arrangements.

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The first question for determination is where to form the company. Most companies are formed in the state where the business is located or the key principals reside. The state of formation's laws will govern the internal affairs of the company. Formation in the home state is a common practice in smaller deals in which it would be impractical or uneconomical to go elsewhere to resolve internal disputes, even in home state jurisdictions having laws more favorable to creditors or where cases will be determined by non-expert judges or jurors. In larger deals, banks and sophisticated investors often require the use of a company formed in Delaware, where limited liability company law is highly developed and predictable and permits maximum flexibility in structuring. Further, the Delaware court system is respected for resolving legal disputes competently and efficiently.

Some lenders require their borrowers in securitized financings to be organized in Delaware or to have a Delaware managing member, or they impose additional burdens if the borrower is organized elsewhere. Anyone contemplating this type of financing, whether initially or in the future (such as on the completion of construction of a real estate project), should seriously consider forming the company in Delaware. Should the company be doing business elsewhere, it can become authorized to do business as a "foreign limited liability company" in the relevant jurisdiction.

Another key question is whether to have all persons with an economic interest in the company owning the investment directly as members, or whether ownership should be held indirectly and structured through the use of parent company members or tiered entities. For example, in a limited liability company owned by two families, there may be one member for each family that is a separate company, with individual family members owning interests in the separate company. Also, members may be organized into groups for decision-making purposes. Decision-making rights would belong to the group, acting through a designated representative, rather than the members directly.

In forming a limited liability company, specific state statutory provisions must be reviewed. These will govern the specific contents of the filed certificate, annual requirements for filing reports and the payment of fees and taxes (such as the $300 annual Delaware franchise tax), and other formalities.

Most state statutes say little about operating agreements, but the statutory provisions are important. Some states require a written operating agreement to be adopted within a specified time period; others permit oral agreements. In a state like Delaware that permits oral or implied agreements, it is critical to have the written agreement drafted and signed quickly to avoid a claim that an oral agreement existed before the parties entered into a written agreement.

Attorneys should be careful to review certificates filed by others, such as the clients themselves, accountants, or formation agents such as corporate service companies. Service companies are experts on the mechanics and are a great source of guidance and assistance in forming companies, but are not always aware of legal quirks. For example, New York permits a choice of management by either members or managers, but requires a statement in the articles of organization (that is, the filed certificate) to elect management by managers. See N.Y. Ltd. Liab. Co. Law § 401(a). If the right to be manager-managed is only in the operating agreement, but not in the articles, the law will prescribe the result and it may not be the one that is desired.

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Tax Treatment of the Company

The tax treatment of the company depends on how many members it has and whether it has made any elections with the IRS relating to its tax status on Form 8832.

A single member LLC is treated as a disregarded entity for federal tax purposes. Treas. Reg. § 301.7701-3(b)(1)(ii). The taxable income, gain, loss, and deductions are reported directly on the sole member's income tax return. There is no requirement for the company to file any tax return or obtain a federal employer identification number (EIN) unless the company has employees and must withhold taxes from wages. Nonetheless, obtaining an EIN is often helpful in dealing with banks and other persons.

If the company has two or more members, then the company is classified as a partnership for federal income tax purposes. Treas. Reg. § 301.7701-3(b)(1)(i). A partnership must file annually with the IRS Form 1065, which reports the taxable income, gain, loss, or deductions of the company.

A partnership, however, is not a taxable entity. Its taxable income and other items flow through to its partners who are then responsible for paying the taxes on any resulting income or gain on their allocable share of such income or gain. IRC § 701. In addition, tax losses or deductions allocated to a partner may be able to offset other income of that partner, but subject to many tax law limitations (such as the at-risk and passive loss rules), which can serve to make it very difficult to use those losses or deductions except to offset future income or gain from that same partnership. IRC §§ 465, 469.

A partner's allocable share of the partnership's taxable income, gain, loss, or deductions is set forth on IRS Schedule K-1, which is issued by the partnership to each partner and is attached to the partnership's annually filed Form 1065. The partnership's ability to freely allocate such items among its partners is limited by IRC § 704(b), which requires that partnership allocations of such items must have substantial economic effect (SEE). If SEE is lacking, then the IRS can re-allocate such items among the partners based on the partners' interests in the partnership.

The Treasury has published detailed guidelines on when allocations will have SEE. Treas. Reg. § 1.704-1. The key requirements are that the partnership must maintain capital accounts for its partners and those capital accounts must generally be used to determine how cash or other property distributed by the partnership to its partners is distributed when the partnership liquidates. Treas. Reg. § 1.704-1(b)(2). In fact, the tax regulations have many nuances that show up in detailed tax allocation provisions contained in most operating agreements. For a more detailed discussion of these rules, see Philip R. Hirschfeld, *Deciphering Tax Allocation Provisions in a Partnership Agreement*, Prob. & Prop., Jan./Feb. 2016, at 36.

The tax treatment of the company also can be changed to that of a corporation if a timely election is made with the IRS on Form 8832. Treas. Reg. § 301.7701-3(c)(1). As a practical matter, such corporate election is generally undesirable because it will convert the company into a taxable entity. If the company is formed under non-U.S. laws, then a different set of classification rules needs to be reviewed. In contrast to the treatment of U.S.-formed companies, a company formed under foreign law may be clas-

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sified as a corporation and thus may desire to file an election with the IRS to be treated as either a partnership if it has two or more members or a disregarded entity if it has only one member. Treas. Reg. § 301.7701-3(b)(2).

Management—Delegated Management and Major Decisions

By providing for management by members or by managers in accordance with an operating agreement, the limited liability company structure provides more flexibility for management than do corporations or partnerships.

Management is simple in situations such as a single-member limited liability company or small family company in which all members are involved in management. But usually management by everyone is not feasible, and management responsibilities must be delegated to one or more managing members or managers. In this case, the operating agreement should specify the scope of such persons' management responsibilities.

Of course, it must be anticipated that a person with management responsibilities may die, move away, or become incompetent. If a specific person or group of persons is expected to be a successor decision maker, then that should be stated. If the remaining members are to determine the successor, the necessary vote should be set forth, and consideration given to whether any member has a veto over the decision. If the requisite ownership percentage (whether it be a majority, a supermajority, or a unanimous vote) cannot agree on a successor, then what happens? Similarly, the operating agreement should address when and how a person with management responsibility can be removed, including the reasons, if any, that would permit removal and who can vote on that decision.

When management is delegated, the operating agreement can reserve certain significant decisions to the members or provide for approval of specific items by members. These items are often called "major decisions."

Examples of major decisions customarily found in operating agreements include decisions concerning sale of the property, financing, operating and capital budgets (and how much a managing member or manager can deviate from an approved budget without approval), major leases, major capital expenditures, new business ventures, and decisions regarding bankruptcy or insolvency. Other examples concerning the entity itself include admission of new members or dilution of the interests of existing members.

As set forth in the operating agreement, a particular major decision may require approval by a majority of the members, a supermajority approval such as two-thirds, 75%, or a higher percentage, or approval by all members. It is common for decisions regarding bankruptcy or insolvency of the company to require a higher percentage of member approval than other major decisions, often 90% or 100% of the members.

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Management also has fiduciary duties to the members. Some states allow these to be expanded, reduced, or eliminated through the operating agreement. Even if fiduciary duties are eliminated by agreement, in many states (including Delaware), the implied covenant of good faith and fair dealing is not waivable.

In situations involving joint management, the possibility of deadlock exists if the managing members or managers do not agree. The operating agreement should anticipate this possibility and specify means of addressing it. Some deadlocks, however, are not susceptible to resolution. In those cases, it may be necessary to end the relationship. Different exit strategies that may be applied in the case of deadlock are described below.

Capital Contributions—What Happens When You Need Cash?

Members are required to contribute capital to a limited liability company only in the amounts they agree to contribute in the operating agreement, at the times specified in the operating agreement. But like any business enterprise, a limited liability company may have unexpected or unquantifiable needs for capital in the future.

To the extent the members desire that future capital needs be satisfied by borrowing from third-party lenders, such preference can be set forth in the operating agreement, which may contain provisions covering how much can be borrowed, who makes the decision (or who has a right to consent to it), and how the terms of the loan will be determined. Similarly, if the members desire that future capital needs be satisfied by admitting new equity investors, provisions to that effect can be put into the operating agreement, together with any desired limitations on how much can be raised in this manner and how the terms of the new investments will be determined.

In any case, an operating agreement should cover how additional capital needs will be satisfied if third-party sources are not available at all or on acceptable terms. The key issues are:

- What needs justify a mandatory additional contribution from the members?
- Who decides that additional funds are needed, and who may make a capital call for such funds?
- What happens if a member fails to contribute the required additional capital?

An operating agreement may provide that members must contribute additional capital to meet nondiscretionary cash needs for the conduct of the business. Examples include amounts needed to pay taxes, amounts needed to pay debt service on loans, amounts needed to comply with legal requirements, amounts needed to eliminate safety hazards or make necessary repairs, and amounts needed to discharge liens on the company's property, to pay bills from contractors and suppliers, or to pay cost overruns.

An operating agreement may provide that members must contribute additional capital in accordance with a budget that may be established in the future. Because budgets may be exceeded, the agreement may provide for contributions up to an agreed variance, such as 5% or 10% in excess of budgeted amounts.

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If the operating agreement calls for fees to a member or an affiliate of a member for services (such as construction or management fees), and the fees cannot be paid from the company's cash flow, then the operating agreement should state whether or not the members must make mandatory contributions to fund such fee obligations or pay for these services from amounts that otherwise would be distributed to them.

Who Decides That Additional Funds Are Needed, and Who May Make a Capital Call?
Typically, the managing member(s) or manager(s) make this decision and are authorized to make a capital call for the needed funds.

If there is more than one managing member or manager, the operating agreement should provide what happens if there is a disagreement, particularly if the decision makers are deadlocked. Some operating agreements provide that any managing member or manager may make a call for mandatory funds. Others provide for dispute resolution by arbitration. It should be kept in mind that a dispute regarding mandatory capital contributions will need to be resolved quickly to avoid default on the company's obligations or loss of its property.

What Happens If a Member Fails to Contribute the Required Additional Capital?
Generally, operating agreements will give the members a period of time to make required contributions, with notice and cure rights if they do not, but provide consequences if the contribution is not made within the applicable cure period.

Many operating agreements provide that the failure of a member to contribute required capital will permit the performing members to withdraw their contributions. This remedy is illusory, however, because it will deprive the company of required funds and may lead to defaults on third-party obligations. To prevent this result, an operating agreement should permit the performing members to provide the contribution of the defaulting member, with a penalty to the defaulting member.

One option is to permit the performing members to make a loan to the company of the defaulting member's share, with a high rate of interest. The loan would be repaid, with interest, from the next distributions that would otherwise be payable to the defaulting member. In drafting the operating agreement, it is important to provide that repayment of a penalty loan be payable from the defaulting member's distributions, and not by the company before the making of distributions. Otherwise, repayment would be made in part from funds that belong to the performing members, who in essence would be paying themselves.

Another option is to provide for a reduction in the interest of the defaulting member in the company with a corresponding increase to the performing members who provide the defaulting member's share of capital. This is sometimes called a "squeeze-down" or a "cram-down." A squeeze-down can be computed by crediting the performing member with additional capital contributions and recalculating each member's share based on the total capital contributed by each member, both previously and in connection with the present capital call, as a percentage of the aggregate capital contributed to the company.

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Many squeeze-down formulas have a penalty factor to penalize the defaulting member and reward the performing members. In recalculating the members' percentage interests in the company, the performing members may be credited with, for example, 125% or 150% of the defaulting member's share of required capital when they provide the deficiency.

What Is the Tax Treatment of Cash or Property Contributions?

The contribution of cash or property to a limited liability company taxed as a partnership can generally be done in a tax-free manner. IRC § 721. As a result, no taxable gain will generally be recognized on the contribution by a member to the company of appreciated property that has built-in gain. Built-in gain is the excess of the property's fair market value (FMV) over the adjusted tax basis or cost of such property to the contributing member.

In the past, some advisors have combined a contribution of property with related mandatory cash distributions by the company to the contributing member as a way to avoid having a taxable sale even though the contributing member ends up economically in the same position as if there was a taxable sale. In response, there are now detailed Treasury Regulations that can sometimes reclassify a tax-free capital contribution of property to a limited liability company or partnership into a taxable disguised sale of property if there may be related company distributions or other actions. Treas. Reg. § 1.707-3. A more detailed discussion of these rules can be found in Philip Hirschfeld, *Partnership Property Contributions: The Good, the Bad and the Ugly*, Real Est. J. (BNA) (Feb. 3, 2016).

If a contribution of property is tax-free, then IRC § 704(c) requires that the company's allocation of taxable income, gain, loss, or deduction take into account any built-in gain for the contributed property or built-in loss, which exists if the FMV of the property is less than the tax basis of the property. Most operating agreements also will refer to these rules in the tax section. These rules require the company to choose one of three methods in allocating company items to take into account any built-in gain or built-in loss for the property. The methods are (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial allocation method. Treas. Reg. §§ 1.704-3(b), (c) & (d). In general, all methods re-allocate depreciation deductions and gain or loss on sale of the contributing members among the members to try to replicate the effect on the noncontributing members to what it would have been had the property been purchased by the company for its FMV rather than contributed. The remedial method uses that approach but supplements it further. The effect of each method is different on the contributing member compared to the other members, so the best choice depends on which you are. These methods are very complex. A detailed discussion of these rules is set forth in Hirschfeld, *Deciphering Tax Allocation Provisions*, supra.

Distributions: Pro Rata or Not

Limited liability companies usually are formed for one reason: to make money. Sometimes the return can be in the form of a contractual arrangement, such as a salary paid to a key person involved in the business or fees to a member or its affiliate for services (such as development, leasing, or management fees). Most of the time, however, members realize the return on their investment through distributions from the company.

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An operating agreement should specify when distributions will be made and who decides. Any operating agreement should specify if, and under what circumstances, the persons with management authority can elect not to distribute available cash but instead use it for future operations, capital expenditures, and reserves. This can be a major area of controversy if the members (or their descendants who succeed to the interests of deceased members) have different views of the company or different investment time frames. An investor that is an investment vehicle such as a fund, which has its own investment goals and anticipated duration, might require mandatory distributions and less discretion to use funds for other purposes. A company owned by young family members in a family business might have the opposite view and require flexibility not to distribute available cash but instead keep it in the business.

Distribution provisions are contained in the operating agreement and may provide for distributions in proportion to invested capital, agreed percentages (which may or may not be based on contributed capital), or for distributions based on more complicated formulas. One advantage of the limited liability company structure taxed as a partnership is that it permits distributions to be made in a manner that is not proportionate to the members' investments or ownership. A common example is a provision for distributions to members of funds that will permit them to pay income taxes on their income derived from the company.

Operating agreements often provide that when members make capital contributions that are not proportionate to their percentage ownership interests, the members contributing extra amounts will get a return, called a "preferred return," on their extra contributions, that will be distributed to them before payments are made to the members on a pro-rata basis. In addition to receiving a preferred return *on* their excess capital, they may receive a return *of* their excess capital before other distributions.

Operating agreements often have separate provisions regarding distributions of operating cash flow and distributions of proceeds of "capital transactions," such as a sale or financing. The distribution priorities may be different in the separate categories. For example, preferred returns on capital may be payable from distributions of both operating cash flow and proceeds of capital transactions, but preferred returns of capital may be payable only from the proceeds of capital transactions.

Sometimes a limited liability company will have various classes of members with different distribution priorities. For example, in a real estate transaction, equity investors and managers may participate in distributions based on the company's performance. It is not unusual to have the promoters or managers of a project receive, as an incentive, generous distributions if the project exceeds expectations because although they may contribute less capital, they contribute more intangible skills or knowledge, "sweat equity," and add value by creating synergies through introducing parties to each other and managing the relationships. Sometimes these persons have the last distribution priority (after other investors are paid) and receive a disproportionate share of the return in the event of a runaway success.

A manager or promoter of a real estate project can sometimes be rewarded by having the partnership or limited liability company grant that person a carried interest in the company. A carried interest entitles the manager or promoter to a share of profits (usually 20%), but only after the investors have received (1) a preferred return on their invested capital, which is equal to a specified percentage of their invested

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capital, (2) a return of their invested capital, or (3) a combination of both factors. The first tax goal of issuing a carried interest is that it will be treated as a profit interest in the partnership so that the manager or promoter is not subject to tax on receipt of the carried interest. Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191. The second tax goal is that, when the company sells its property, such person's share of the taxable gain is treated as long-term capital gain, which, for individuals, is subject to preferable tax treatment (maximum tax rate of 20%).

Carried interests have been receiving bad press over the last few years with many politicians and others recommending changing their tax treatment. E.g., John D. McKinnon, *Liberal Senators Urge Treasury to Limit Carried Interest Tax Break*, Wall St. J. (Sept. 22, 2015), www.wsj.com/articles/liberal-senators-urge-treasury-to-limit-carried-interest-tax-break-1442928663. There have been legislative proposals to tax the manager or promoter on the grant of the interest or treat all income from the interest as ordinary income not eligible for favorable tax treatment. E.g., H.R. 2889, Carried Interest Fairness Act of 2015, 114th Cong., 1st Sess. As a result, it is possible that the treatment of carried interests may change after the 2016 elections and a new Congress comes into office next year.

For tax purposes, a member can generally receive a distribution of cash from the company without incurring any tax as long as the distribution does not exceed the basis for such member's interest. IRC § 731(a)(1). The member's tax basis for its membership interest is increased by the member's share of the company's taxable income or loss, any cash contributions and the tax basis of any property contributions made by the member to the company, and that member's share of the company's liabilities. IRC §§ 705, 722 & 752. The member's tax basis is also decreased by its share of the company's loss or deductions and additional reductions arise from the company's distributions. If the company distributes property (other than cash) to the member, that distribution can generally be made in a tax-free manner to both the member and the company. IRC §§ 731(a) & (b). The member's tax basis for its membership interest does not act as a limit on the nonrecognition tax treatment of property contributions.

The major caveat to these rules was discussed above in the "Capital Contributions" section. Special disguised sale rules can apply if a member makes a capital contribution of property to a limited liability company, and the company then makes related distributions to that member. If those disguised sale rules apply, then the distribution can become taxable. Treas. Reg. § 1.707-3.

Transfers of Interests— What Are the Concerns?

An operating agreement must cover the issues of when interests in a limited liability company can be transferred and by whom and with what restrictions. In companies involving a small number of members in a common business enterprise, the operating agreement should restrict transfers to ensure the parties will continue to do business with the same people, and not strangers. Restrictions on transfers of interests by small passive investors are less common.

When a group of owners holds their interests through one member entity, the operating agreement will have to address the transferability of indirect interests in the single member.

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Even when transfers are restricted, it is common for estate planning purposes to permit transfers to family members of direct or indirect interests owned by individuals, or on death. These restrictions often, but not always, require that the transferee be another family member or a trust for his or her benefit.

Sometimes, transfers are not restricted so long as the management of a member or a group does not change. This provision may take the form of a requirement that a key individual or individuals remain in a management position.

Operating agreements cannot prohibit transfers resulting from death, even of a key person. Therefore, an operating agreement should permit the designation of a substitute managing individual and indicate who may be the substitute person and whether other members have approval rights with respect to that person.

An operating agreement may provide for redemption of the interest of a deceased member for a price to be determined by appraisal or by a formula. In that case, the operating agreement should specify the source of the funds for the redemption.

Regardless of what the operating agreement says, transfers may be restricted by third-party requirements, usually loan documents. In government-sponsored projects, there may be limitations on transfers or requirements for particular persons to remain. Legislation such as the Patriot Act effectively prohibits direct or indirect transfers to persons on the "Specially Designated Nationals" list and residents of countries on the Office of Foreign Assets Control list. Accordingly, the operating agreement should prohibit transfers that are not permitted by third-party requirements, unless any necessary consents are obtained.

If the company owns property in a jurisdiction that applies transfer taxes or other taxes to transfers of interests in entities, the operating agreement should set forth who is responsible to pay the tax.

A transferee of an interest in a limited liability company does not automatically become admitted as a new member unless the operating agreement so provides. Otherwise, the transferee will acquire only the economic interest of the transferor without other rights of a member, such as voting rights. Therefore, the operating agreement should specify when a transferee becomes a member in place of the transferor and the requirements for becoming a member. At the least, this should include an agreement in writing to be bound by the terms of the operating agreement.

A member that sells a membership interest must pay tax on any resulting gain. But, does that transfer affect the other members?

For tax purposes, the transfer of 50% or more of the company made by one or more members in a 12-month period can cause a technical tax termination of the company. IRC § 708(b)(1)(B). A tax termination does not result in the recognition of taxable gain or loss by the remaining members, but it does

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adversely affect the depreciation deductions claimed by the company in the future by requiring the company to re-start the clock for computing its depreciation deductions. IRC § 168(i)(7). The effect is that future depreciation deductions expected will now be stretched over a longer time period.

A person purchasing a membership interest from an existing member also will want the company to make a tax election under IRC §§ 754, 743(a), if the value of the company's properties has gone up. This election will work only for the benefit of the purchaser and will not affect any other member (except for the need to pay an accountant to keep track of this election). The election allows the company to increase the tax basis of its properties allocable to the purchaser to the price paid for the membership interest. The effect of that election is to increase future depreciation deductions allocable to the purchasing member and lower any gain (or increase a loss) arising from a later sale by the company of its properties. If the value of the properties has declined, the election may not be advisable but may be mandated if the drop in value reflects a substantial built-in loss (generally, more than $250,000). IRC §§ 743(a), (d).

Member Exit Strategies

Operating agreements can restrict transfers for periods of time, but parties should not be forced to continue in a business enterprise forever. This is particularly true when the members are deadlocked on decisions necessary to conduct business. As an alternative to dissolution, members bound by transfer restrictions should have an exit strategy.

Some methods used in operating agreements are as follows:

- • Allowing transfers subject to a buy-out right of the other members. A buy-out right could take the form of either a right of first refusal, in which the selling member must get a third-party offer that could be matched by the other members, or a right of first offer, in which the interest (or the underlying property) would be valued and the buy-out price would be based on that valuation. The buy-out should set forth the appraisal method to avoid valuation disputes.
- • Allowing a member to put the company's assets up for sale, with the other members having a buy-out right based on the sale price of the assets, adjusted to reflect the members' percentage interests. In this case, the buy-out price would be the price the selling member would receive if the property were sold and the sales proceeds distributed to the members. The price may or may not be adjusted to reflect closing costs of the hypothetical sale. The operating agreement could either require the member desiring to sell to get a third-party offer to start the process, or cause the property to be valued with the buy-out price based on the valuation.
- • The so-called "buy-sell" provision, in which any member can invoke the process by giving a notice to the other members and providing a number that is supposed to represent the value of the company's assets. The other members can elect to either sell their interests or buy the interest of the proposing member based on the number, with an appropriate adjustment for the members' percentage interests. If there are more than two members, the operating agreement must state what happens if the nonproposing members do not agree on whether they will buy or sell; presumably they all will be required to either buy or sell, as set forth in the operating agreement. The buy-sell provision is based on the premise that all members have financial strength, so if the procedure is

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invoked, they can make a rational decision to either buy or sell based on their view of the valuation. In cases of disparity in financial condition, the buy-sell provision may be less effective, particularly if the stronger member invokes the procedure thinking the other members will have to sell because they lack the resources to purchase. This problem could be mitigated by requiring that the selling member provide purchase money financing, with a long repayment period, to the purchasing members. But a party going into a business enterprise thinking it may lack the resources to buy out another member will resist a buy-sell provision in the operating agreement and argue for another exit strategy.

- • "Drag-along rights," in which a majority member desiring to sell its interest can force minority members to join in the sale.
- • "Tag-along rights," in which minority members can elect to join in a sale of the majority member's interest.

These exit strategies can have time limitations in the operating agreement. For example, in a development project, the operating agreement may provide that the exit strategy does not apply during construction, or for some period after construction is complete, to permit the property to be leased and operate without losses. This is particularly true in cases in which one member has special construction or leasing expertise and needs to remain in the project during the initial stages.

The availability of these strategies is limited, of course, by the provisions of loan documents to which the company is subject. If the loan documents do not permit transfers among members, or require a lender's consent to the transfer, the mechanisms will not be reliable exit strategies. Similarly, if the loan documents do not permit a transfer by a prospective selling member because the seller's principals are required to stay in the deal for management purposes or as guarantors, the mechanisms will not work. Therefore, in negotiating loan documents, it is important to make the loan documents consistent with the company's designated exit strategies.

Books and Records— Who Needs What?

Operating agreements typically provide for the delivery of specified reports and financial statements to the members. In companies with large institutional investors or investment funds as members, the scope of reporting to members, and whether annual statements are audited, will be driven by member needs. In any case, members will require a customary Form K-1 to prepare their tax returns.

The operating agreement will usually require the maintenance of books and records, but who has access to them? Clearly large institutional members will require access for their own audits. The need is no less for individual investors in a small closely-held company, who may have more at stake in protecting their own investments. It should be noted that some limited liability company laws, such as the Delaware Limited Liability Company Act, provide for rights of access to information for members, which may be expanded or restricted by the operating agreement.

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Limited Liability Companies in Sophisticated Financings

Owners of income-producing real estate projects can seek competitive interest rates and other favorable terms by seeking financing in the capital markets, where mortgages can be packaged and sold to investors in the form of commercial mortgage-backed securities (CMBS). CMBS financing has special requirements, and limited liability company structures have had to adapt to meet CMBS requirements.

CMBS financing depends on uninterrupted cash flow from the mortgaged properties supporting the securities sold to investors. The greatest risk to this is bankruptcy, of course, and while it is possible that bankruptcy may result from a failure of the mortgaged property itself, CMBS will not work if the owner of a mortgaged property goes into bankruptcy because of something else, and the assets of the borrower are consolidated into the bankruptcy estate. Hence, limited liability companies must be structured as "single purpose entities" (SPEs) that are "bankruptcy remote," meaning that the entity is not going to be brought into a bankruptcy or insolvency proceeding affecting related entities such as the company's principals, parent company, or affiliates. "Bankruptcy remote" does not mean "bankruptcy proof" because bankruptcy can still occur if the SPE's own business fails, although, as discussed below, lenders seek protections even in this instance. For tax purposes, these single member SPE limited liability companies are often treated as disregarded entities so that they do not add an extra layer of possible tax exposure or tax reporting for the parties involved.

For these reasons, a typical SPE in a CMBS transaction is subject to a long list of restrictions intended to assure that its business is kept separate and discrete from all other activities, particularly those of its affiliates. Although these restrictions will appear as covenants in loan documents, the CMBS market requires that they also be included in the borrower's organizational documents, and possibly in those of a managing member, which also must be structured as an SPE. As inclusions in the operating agreement, they prohibit not only acts that constitute a loan default but also acts beyond the company's authority. Therefore, the operating agreement for a limited liability company structured as an SPE will prohibit any activity or ownership of assets outside the scope of the particular activity and real estate being financed, require dealing with its affiliates on an arm's-length basis, and provide that the company not hold itself out as part of a larger organization. These restrictions are expressly for the benefit of the lender and can be removed only when the loan is paid in full or otherwise refinanced, and they cannot be amended without the lender's consent.

Furthermore, lenders have required other modifications to the traditional limited liability company structure to minimize the risk that an SPE could file for bankruptcy even as a result of its own activities. For example, the company may be required to have a "special member," which has no economic interest and has a voting right only if the single equity member experiences a triggering event, such as a bankruptcy, or which can vote only on limited matters relating to bankruptcy or insolvency. Alternatively, the operating agreement of an SPE may provide for an "independent director" or "independent manager" whose authority is limited to voting on specific matters like bankruptcy and dissolution. In such a case, the operating agreement will typically provide that such decisions cannot be made without the vote of the independent director or independent manager. The special member, independent director, or independent manager will be independent of the other members and typically is a designee of a corporate service company that provides these persons as part of its services for a fee. Sometimes, special

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members are referred to as “springing members” because they have no ordinary management functions until the triggering event occurs. In large transactions, there may be two such persons to assure the lender that a bankruptcy filing will not be made without the involvement of two independent individuals. Significantly, the operating agreement will expressly provide that these independent persons will take into account the interests of creditors when considering these matters.

Conclusion

The limited liability company operating agreement is not unlike a prenuptial agreement. No matter how close the company’s members may be at the outset, their interests, or the interests of their successors, may diverge over time. A complete operating agreement may prevent problems later-paper is cheap and lawsuits are expensive. n

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