

Limited Liability Company Agreements: Common Pitfalls to Avoid

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General Comments Regarding Pitfalls

- Purpose of presentation
- Common sense

Preamble and Recitals

Pitfall:

- Identification of the members



- No general or limited partners

Pitfall:

- Amending and restating an LLC Agreement
 - Recitals should reference the original LLC agreement
 - Recitals may want to reference new members
 - “Review by a third-party”
 - State that the original LLC agreement is being amended and restated in its entirety

The “Act”

Pitfall:

- “The Company was formed as a Texas limited liability company in accordance with the Texas Limited Liability Company Act”
- For a Texas LLC, the “Act” should mean the Texas Business Organizations Code.
- For a Delaware LLC, the “Act” should mean the Delaware Limited Liability Company Act.

Definitions

Pitfall:

- Capital terms not properly defined and used inconsistently

Pitfall:

- The definition of the term “Affiliate”

Pitfall:

- Cross-references not updated

Purpose; Registered Agent

Pitfall:

- Purpose of the LLC - specific purpose versus generic or broad purpose
- “The purpose and business of the Company shall be to engage in any lawful business activity in which a limited liability company formed under the Act may engage or participate.”

Pitfall:

- Identification of the registered agent

Initial Capital Contributions

Pitfall:

- Failure to state when capital contributions should be made

Pitfall:

- Failure to state the amounts of capital contributed
- “As of the Effective Date, each of the Members has contributed capital to the Company.”

Pitfall:

- Failure to state the value of contributed property
- Failure to clearly state net capital contributions/capital accounts of the members

Initial Capital Contributions

Pitfall:

- Disguised sale issues
- Contribution of property and a related distribution of cash
- Deemed capital contributions

Pitfall:

- Calling reimbursements of expenses “distributions” to a member

Initial Capital Contributions

Pitfall:

- Failure to discuss capital commitments

Pitfall:

- Failure to state percentage interests

Additional Capital Contributions

Pitfall:

- Failure to state how additional capital is called

Pitfall:

- Failure to state whether additional capital contributions are mandatory
- Potential deadlock when entity requires capital

Pitfall:

- Requiring the consent or approval of parties before calling capital

Additional Capital Contributions

Pitfall:

- Failure to consider the deadlines for contributing capital after issuing a call

Pitfall:

- Consequences of a defaulting member
- Failing to discuss repayment of default loan
- Failure to provide a remedy other than a default loan (conversion to capital contribution)
- Complexity of dilution formula

Distributions

Pitfall:

- Definitions of “Cash Flow from Operations” vs. “Cash Flow from Capital Transactions”

Pitfall:

- Ambiguity in distribution waterfall
 - “Cash will be distributed by the Company to the Members until they receive a 12% return”
- Failure to state how return will be calculated
 - Annual versus overall return? Compounding?
 - Multiple capital contributions?
 - Return of capital through distributions?

Distributions

Pitfall:

- “The Company shall distribute cash to the Members in accordance with their respective Sharing Ratios.”
- Reminder to check definitions.
- Impact of penalty dilution on distributions

Pitfall:

- “The Company will distribute cash to the Members at such times as determined by the Manager in its sole discretion.”

Pitfall:

- “The Company will distribute Net Cash Flow to the Members at such time and in such manner as determined by the Manager in its sole discretion.”

Distributions

Pitfall:

- “4.1(a) First, to the Members, pro rata in accordance with their respective Percentage Interests until each Member has received aggregate distributions under this Section 4.1(a) equal to an 8% annual return on its Capital Contributions.”
- “4.1(b) Second, to the Members, pro rata in accordance with their respective Percentage Interests until each Member has received aggregate distributions under this Section 4.1(b) equal to a 12% annual return on its Capital Contributions.”

Pitfall:

- Definition of internal rate of return
- Calculations do not work
- Impact of dilution

Distributions

Pitfall:

- No clawback with respect to the carried interest or promote

Pitfall:

- Failing to provide for tax distributions
- Using the wrong tax rate
- Failing to consider potential recapture of prior deductions or deferred gain

Management

- Member-managed or manager-managed

Pitfall:

- “The business and affairs of the Company shall be managed by its members.”

Pitfall:

- Failure to provide a mechanism for multiple managers
- “The business and affairs of the Company shall be managed under the direction of the Managers.”

Management

Pitfall:

- Impact of major decisions

Pitfall:

- Manager cannot be removed

Pitfall:

- Failure to address conflicts of interest or additional business ventures

Management

Pitfall:

- “To the fullest extent permitted by law, the Company shall indemnify and hold harmless the Manager and its Affiliates from any and all expenses (including reasonable attorneys’ fees), losses, damages, liabilities, charges, and claims of any kind or nature whatsoever incurred by the Manager or its Affiliates arising out of any act performed by the Manager on behalf of the Company in its role as a manager.”

Pitfall:

- “To the fullest extent permitted by law, the Manager shall indemnify and hold harmless the Company, each Member, and their Affiliates from any and all expenses (including reasonable attorneys’ fees), losses, damages, liabilities, charges, and claims of any kind or nature whatsoever incurred by such person as a result of any action of the Manager hereunder.”

Buy/Sell Provisions

Pitfall:

- Defined terms and deadlines

Pitfall:

- Defining the triggering event

Pitfall:

- Failing to account for a defaulting member
- Failing to consider economic events (e.g., distributions, sales of assets, etc.) during a pending buy/sell
- Failing to consider who manages the business during a pending buy/sell

Books and Records

Pitfall:

- “No later than fifteen (15) days after the end of each fiscal year, the Company shall prepare, or cause to be prepared, all tax returns of the Company and deliver copies thereof to each Member.”

Pitfall:

- Timing of financial reports

Transfers of Interests

Pitfall:

- “No Member may Transfer its Membership Interest in the Company except upon the prior written consent of the other Members.”

Pitfall:

- Failing to consider indirect transfers

Pitfall:

- Failing to account for permitted transfers
- Failing to account for the need of specific members to be able to freely transfer interests in such members (e.g., public companies)

Amendments

Pitfall:

- “This Agreement may be amended or modified from time to time only by an instrument in writing signed by the Manager and the Members holding a majority of the Percentage Interests.”

Pitfall:

- Broad amendment powers given to the manager

Dissolution/Termination

Pitfall:

- “The Company shall be dissolved and its business wound up upon the approval of the Manager, in its sole discretion.”

Pitfall:

- “In settling accounts after dissolution, the assets of the Company shall be paid first to third-party creditors and then any remainder shall be distributed 50/50 to the Members.”

Tax Issues

Pitfall:

- “The Company shall be treated as a disregarded entity for U.S. federal income tax purposes.”

Pitfall:

- “The Company shall elect to be treated as an association taxable as a corporation for U.S. federal income tax purposes.”

Tax Issues

Pitfall:

- Tax allocations
- Understanding allocations versus distributions

Pitfall:

- Not having tax counsel review the agreement

Tax Issues

Pitfall:

- “The Manager shall be the “Tax Matters Partner” of the Company as such term is defined in Code Section 6231(a)(7), and it shall serve as such at the expense of the Company with all powers granted to a tax matters partner under the Code.”

Pitfall:

- Discretion given to partnership representative, including over matters related to tax elections

Notices

Pitfall:

- “Any notice required by the terms of this Agreement shall be provided to the Members by mail, facsimile, telex, telegraph....”

Pitfall:

- Addresses not completed or incorrect

Representations

Pitfall:

- Failing to account for identity of the member (natural person versus entity)

Pitfall:

- Failing to include relevant securities representations

Signature Page

Pitfall:

- ABC, LLC

By: _____
Name: John Doe, its general partner

Pitfall:

- Failure to include all parties or to correctly list the parties

Exhibits

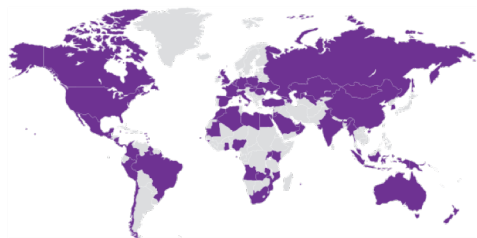
Pitfall:

<u>Name of Member</u>	<u>Percentage Interest</u>
James Smith	25%
Andrea Jones	17%
George Rodriguez	42%
Shelly Miller	15%
Total	100%

Pitfall:

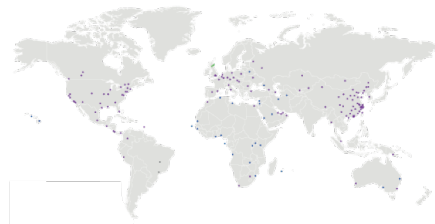
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Dentons by the numbers



Countries

78



Locations

174

Total number of lawyers

9,000+



All timekeepers

11,500+

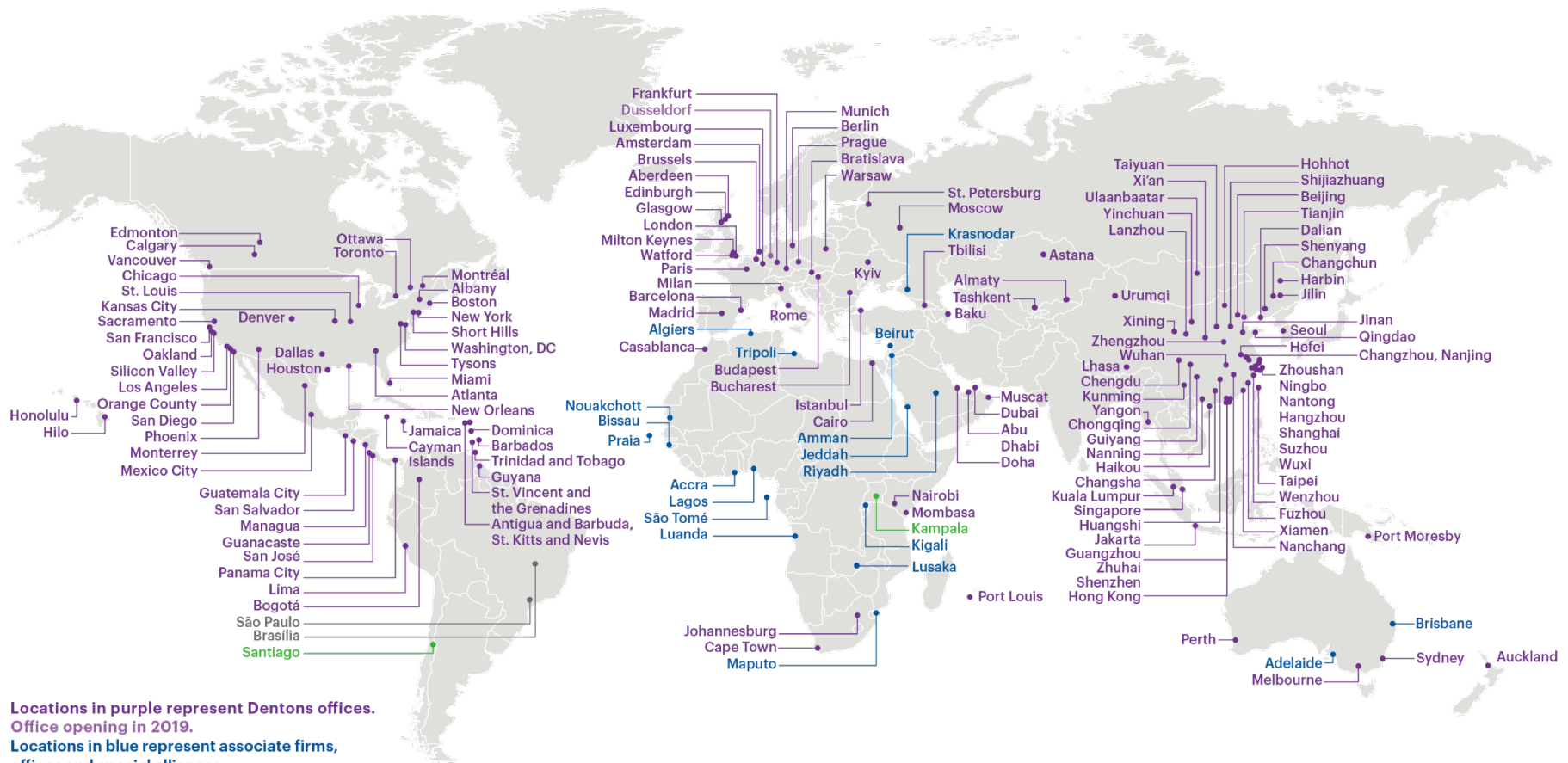


Total number of people

16,000+



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Donald A. Hammett is the managing partner of the Dallas office and has more than 20 years of experience advising clients on tax issues. Don's practice includes the formation and financing of corporate entities, pass-through entities and real estate investment trusts (REITs). He has substantial experience in mergers and acquisitions involving corporate entities and REITS, as well as partnerships, limited liability companies and other pass-through entities. He also has extensive experience in the formation of investment funds, UPREITs, DownREITs and other similar entities.

Don's clients include publicly and privately held companies and REITs, as well as national and regional developers and other companies that finance, own, manage and develop real estate and other assets. He advises clients on the formation of acquisition vehicles and various debt and equity structures, and is a frequent lecturer on related topics.



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Raleigh Johnston is a partner in the Dallas office where he represents public and private companies, including real estate investment trusts (REITs), in a variety of corporate, tax, securities, and real estate matters. His practice includes advising clients in connection with transactions involving mergers and acquisitions, real estate and private equity fund formations, real estate acquisitions and sales (including sale-leaseback transactions and like-kind exchanges), and joint venture formations. He also advises clients on a wide range of federal income tax matters related to transactions involving REITs, corporations, partnerships, and limited liability companies. His experience also includes advising clients that invest in, acquire, develop, and lease real estate assets, including entertainment properties, student housing properties, hospitality properties, mixed-use properties, medical properties, and multifamily properties.

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