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# Delaware LLC Agreements: Planning and Drafting Approaches

## Evaluating and Leveraging the Contractual Flexibility Afforded by the Delaware LLC Act; New 2018 Amendments

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# Delaware LLC Agreements:
## Planning and Drafting

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# Anatomy of LLC agreement

# LLC Statistics

- According to the IRS statistics, as of 2017, there were about 20 million LLCs, out of which 70% were single-member LLCs, 25% were two-member LLCs and only about 5% had three of more members.
- Two-member LLCs are most susceptible to inter-member disputes.
- LLC agreements must address all issues relevant to the LLC members.

# Purpose of an LLC Agreement

- Prepare a comprehensive and binding contract that parties can use as a manual going forward
- Identify every issue potentially important to the members
- Avoid ambiguities
- Members should be able to find answers to their issues in the agreement

# Anatomy of the LLC Agreement

- The LLC Agreement must address:
  - Ownership structure
    - Multiple members
    - Various classes of interest
  - Management structure
    - Member-managed
    - Manager-managed
    - Corporation-like structure with a BOD, officers
  - Tax structure
    - Partnership taxation or Subchapter S taxation

# Anatomy of the LLC Agreement

- Member contributions; capital accounts
- Allocations / distributions
- Management
- Deadlock provisions
- Transfers, redemptions
- Duties of managing members, managers
- Dissociation provisions
- Dissolution; dispute resolution

# Drafting Tips

- Start with a terms sheet
- Use a comprehensive formation checklist
- Get the facts right
- Identify all significant legal and tax issues
- Discuss with client how to best address these issues

# Drafting Trips

- Guiding principle:
  - §18-1101(b): It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements

# Mandatory Provisions

- Know all mandatory provisions of the DE LLC Act
- LLC Agreement does not need to repeat them, but cannot be inconsistent
- Example: §18-101(7) – members and managers are bound by the LLC operating agreement even if they do not execute it.

# Default Provisions

- You can override in the operating agreement
- Do not mention them if they support your client's interest
- Seek to override them in the LLC agreement if they do not
- Typically begin with "unless otherwise provided in a limited liability company agreement …."

# Default Provisions

- Example: §18-107 permits both managers and members to enter into business transactions with the LLC to the same extent as third parties
- Example: §18-108 provides that an LLC may indemnify members, managers and others from "any and all claims and demands whatsoever"

# Default Provisions

- Example: §18-204(b) permits the LLC agreement and other documents to be executed by an agent for the party. The authorization need not be in writing.
- Example: §18-407 provides that both managers and members have full authority to delegate their rights and powers to manage and control business and affairs of the LLC.

# Default Provisions

- Example: §18-402 places management in its members (unless the members designate a manager) in proportion to their percentage ownership. Each member and manager (if any) has the authority to bind the LLC.
- Voting control: More than 50% establishes control (§18-402). Same applies to a merger (§18-209(b)), a change of state of organization (§18-213(b)), and a conversion (§18-216).
- BUT: §18-301(b)(1) requires the consent of all members for the admission of members after the LLC formation.

# Default Provisions

- Example: §18-301(d) permits a member to be admitted into an LLC without acquiring an LLC interest and without making or being obligated to make a contribution.
- Example: §18-301(e) provides that a member has no preemptive rights to subscribe for add'l interest in the LLC or any other company.
- Example: §18-302(d) and §18-404(d) provide members and managers with ability to take action without meetings, prior notice, or a formal vote, so long as the action is verified by subsequent written consent.

# Default Provisions

- Example: §18-305 provides for statutory right to obtain certain information from the LLC.
- Example: §18-602 permits a manager to resign by giving a written notice to the members and other managers, even if restricted by the LLC Agreement.
- Example: §18-603 does not allow a member to resign before the dissolution or winding up of the LLC (if formed after 1996)

# Default Provisions

- Example: §18-702 provides that a member that assigns its entire interest will cease to be a member, but this does not apply to pledge or a grant of a security interest or a lien in the interest.
- Example: §18-1104 provides that managers and managing members have traditional fiduciary duties.

# Enabling Provisions

- Permit you to include a particular provision (but you have to provide for it expressly)
- Example: §18-302(a) – LLC may have multiple classes. Unless you specifically so state in the LLC agreement, your LLC will not have multiple classes.
- Example: §18-210 permits an LLC agreement to provide for contractual appraisal rights for any class or group of members in the event of merger, consolidation or sale of assets.

# Enabling Provisions

- Example: §18-215 permits the LLC to create a series LLC and establish separate rights and obligations in connection with each series.
- Example: §18-306 permits the LLC agreement to provide for remedies and penalties in case of a member's breach of its obligations; §18-405 (managers); §18-502(c) (in the case of failure by a member to make required contributions)

# Fiduciary Duties

# Fiduciary Duties

- The DE LLC Act assumes that managing members and managers have fiduciary duties, but does not specify what they are
- Section 18-1104 was amended in 2013 to provide as follows:
  - In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern.
- Default provision: if the LLC agreement is silent about it, managing members and managers of a DE LLC owe fiduciary duties

# Fiduciary Duties

- Fiduciary duties in an LLC are different from a corporation because in a corporation duties are based on "status" or "dependency" relationship, whereas in an LLC they are based on a "contractual" relationship
- Serious disputes among LLC members – especially those with only two members – are very common

# Fiduciary Duties

- Duty of Care:
  - Requires managers and managing members to inform themselves "prior to making a business decision, of the material information reasonably available to them" and to act with the level of care that ordinary careful and prudent person would use in similar circumstances

# Fiduciary Duties

- Duty of Loyalty:
  - Prohibits managing members / managers from using their "position of trust and confidence to further their private interests"
  - Duty to put the interests of the LLC first and one's own interests second (or at least not in conflict)
  - Avoid self-dealing
  - Act in good faith in the best interests of the company and its members
- It consists of multiple sub-issues, each of which needs to be addressed in the comprehensive LLC agreement

# Address All Possible Duty of Loyalty Issues

- Can members compete against the LLC?
- Can members take advantage of a business opportunity of the LLC?
- Is there a duty to avoid self-interested transactions?
- Are there duties of disclosure / candor?
- To what extent must managers treat members even handedly?
- Can managers take into account their own interests when making decisions for the LLC?
- Should members use LLC property only for LLC purposes? (IP assignment provisions)
- Is there a duty of confidentiality?

# Modification of Fiduciary Duties

- Section 18-1101(c) of the DE LLC Act allows the operating agreement to increase, decrease or eliminate a person's duties to the LLC and its members
- Exception: cannot eliminate the implied contractual covenant of good faith and fair dealing

# Section 18-1101(c)

- "To the extent that, at law or at equity, a member or manager or other person has duties (**including fiduciary duties**) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be **expanded or restricted or eliminated** by provisions in the limited liability company agreement; **provided that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing**."

# Modification of Fiduciary Duties

- Must be done clearly, expressly, and unambiguously in the LLC agreement
- Example: "To the fullest extent permitted by law, the [Manager] shall owe no fiduciary duties to the Company or the Members; provided that the [Manager] shall act in accordance with the implied contractual covenant of good faith and fair dealing."

# Modification of Fiduciary Duties

- Another example: "This Agreement is not intended to, and does not, create or impose any fiduciary duty on any Covered Person. Furthermore, each of the Members and the Company hereby waives any and all fiduciary duties that, absent such waiver, may be implied by Applicable Law, and in doing so, acknowledges and agrees that the duties and obligation of each Covered Person to each other and to the Company are only as expressly set forth in this Agreement. The provisions of this Agreement, to the extent that they restrict the duties and liabilities of a Covered Person otherwise existing at law or in equity, are agreed by the Members to replace such other duties and liabilities of such Covered Person."

# Elimination of Fiduciary Duties

- Elimination of fiduciary duties may make sense:
  - In a family LLC where senior members don't want "palace revolutions" by junior members
  - Where an elimination of fiduciary duties is necessary to attract a particular manager who doesn't want to be potentially liable in litigation by unhappy members
  - When representing investors that are majority unitholders

# Implied Covenant of Good Faith and Fair Dealing

- The purpose of the covenant is to meet the reasonable expectations of the parties to the agreement when a situation arises that is not contemplated by the agreement
- Fill-in the gap
- "The implied covenant only applies to developments that could not be anticipated, not developments that the parties simply failed to consider…"
- Must be apparent what the parties would have expressly agreed to provide had they anticipated the event
- Only "rarely" used by DE courts

# Miller v HCP & Company, 2018 WL 656378 (Del. Ch. Feb 1, 2018)

- Sale of Trumpet Search LLC
- Co-founder / minority investor in an LLC challenged sale to a third party
- Sale resulted in 200% to the majority investor (HCP) but little to the minority investor
- Plaintiff claimed breach of implied covenant of good faith b/c distributions waterfall did not give the right incentive to maximize the sale price

# Miller v HCP & Company, 2018 WL 656378 (Del. Ch. Feb 1, 2018)

- Court of Chancery dismissed the case
  - LLC agreement waived all fiduciary duties
  - LLC agreement had no gap for the implied covenant to fill
  - LLC agreement gave the board (controlled by the majority investor) the sole discretion to sell to an independent third party, and that was the only pre-requisite

# Delaware LLC Agreements: Planning and Drafting

November 14, 2018

douglas park law

# Drafting Issues

1. Capital Contributions of Members
2. Relationship between Members and Managers
3. Deadlock Resolution Procedures
4. Distribution & Allocation
5. Dissociation & Transfer Restrictions

# Drafting Issue No. 1 – Members' Contributions

Section 18-301(a) - In connection with the formation of a limited liability company, a person is admitted as a member of the limited liability company upon the later to occur of:

(1) The formation of the limited liability company; or

(2) The time provided in and upon compliance with the limited liability company agreement or, if the limited liability company agreement does not so provide, when the person's admission is reflected in the records of the limited liability company.

Section 18-301(b) - After the formation of a limited liability company, a person is admitted as a member of the limited liability company: (1) in the case of a person who is not an assignee of a limited liability company interest, including a person acquiring a limited liability company interest directly from the limited liability company and a person to be admitted as a member of the limited liability company without acquiring a limited liability company interest in the limited liability company at the time provided in and upon compliance with the limited liability company agreement or, if the limited liability company agreement does not so provide, upon the consent of all members and when the person's admission is reflected in the records of the limited liability company;

Section 18-305(h) of the Delaware Act requires the LLC to maintain a current record of the name and last known business, residence or mailing address of each member and manager.

Section 18-305(a)(iii) of the Delaware Act provides that each member of an LLC has the right to request access to the member schedule subject to reasonable standards as may be set out in the LLC agreement (e.g. during regular working hours) or otherwise established by the LLC's manager (or if there no manager, by the members).

# Capital Contributions - Valuation

For any non-cash contributions, the parties should agree upon how the assets will be contributed (e.g. outright transfer, license) and how the value of the non-cash contributions will be determined.

Valuation mechanisms:

"price that a willing buyer having all relevant knowledge would pay a willing seller for such asset in an arm's length transaction, as determined in good faith by the Managers . . ."

"as determined by mutual agreement of the contributing member and the Managers . . "

Dispute resolution mechanism for engaging an independent appraiser.

# Contributions of Services

If a party contributes services in exchange for a membership interests, consider the tax consequences. If the service-provider receives a capital membership interest, it is subject to tax upon receipt.

If the service-member receives a profits-only interest in exchange for services, if properly structured there is no tax event upon the issuance.

A capital membership interest is one in which the member would have a right to receive assets if the company were to liquidate immediately after granting the capital interest.

Should also address what happens in the event the services are not rendered in an acceptable manner:

- Vesting schedule;
- Repurchase rights.

# Additional Capital Contributions - Permissive

If additional capital contributions are not required by the operating agreement, what is the process to allow them in the event one or more Members wish to make additional capital contributions. Consider the following factors:

1. Consent of other members;
2. Dilution; and
3. Pre-emptive Rights.

Failure to agree on additional capital contribution may also be a trigger for a deadlock – to be discussed later.

# Additional Capital Contributions - Required

Key Issues:

1. Can the manager make a capital call at any time, or is the manager's right limited by a pre-approved budget?

2. Can the capital call only be made for certain purposes e.g. development of real estate? What about for unforeseen events?

3. Do a percentage of the members have to approve a capital call, or can the manager automatically initiate a capital call?

4. How much must each member contribute?

# Additional Capital Contributions - Required

What happens when a member fails to make a required additional capital contribution? Potential remedies include:

1. Company suing defaulting member for breach of contract.

2. Requiring the Company to return additional capital contributions made by other members.

3. Charging interest on the delinquent capital call.

4. Causing the delinquent member to lose voting, distribution and other membership rights.

5. Other members who have made their capital contributions may make the capital contribution on behalf of the delinquent member. This can be structured in the following ways:

   a. A loan to the company (can include recourse against the defaulting member; also can be secured by the defaulting member's interests in the company);

   b. A payment in exchange for the LLC interests of the defaulting member to the non-defaulting member; or

   c. Initially a loan, but with a provision to convert the loan into a transfer of the delinquent member's LLC interests after a period of time.

# Additional Capital Contributions – Cram-Down

Defaulting Member loses some of its percentage ownership in the LLC and the contributing member increases its ownership. To incentivize each member to make the additional capital contribution, however, this modification is may be greater than the modification what would have occurred based upon the cumulative capital contributions of the parties.

Example of a Cram-Down clause:

The non-Defaulting Member may make a Capital Contribution to the Company in the amount of the Additional Capital which the Defaulting Member failed to contribute, together with the amount of the Additional Capital which the non-Defaulting Member was to contribute (collectively, a "Shortfall Contribution" )

"the Percentage Interest of the non-Defaulting Member shall automatically be increased (and the Percentage Interest of the Defaulting Member shall automatically be correspondingly decreased), to equal the percentage equal to a fraction, the numerator of which is the sum of: (i) 1.5 times the amount of such Shortfall Contribution; and (ii) the amount of the Actual Capital of the non-Defaulting Member (not counting the amount in clause (i) immediately preceding) and the denominator of which is the sum of the Actual Capital of the Members contributed to the Company."

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# Additional Capital Contributions – Cram-Down

Example: two members each make a $400,000 contribution and each has a Percentage Ownership of 50% . The operating agreement requires that each Member make an additional $100,000 contribution. Members 1 makes the additional contribution, Members 2 does not. Member 1 then makes a contribution on behalf of Member 2 of $100,000.

Using the formula on the prior slide, Member 1's Percentage Ownership is increased to equal the percentage equal to (1.5 * $200,000 + $400,000)/$1,000,000 = $700,000/$1,000,000 = 70%. Notice that Member 1 has contributed 60% of the capital to the company, (the initial $400,000 plus the $200,000 of additional capital contributions), but has a higher Percentage Ownership in the Company as a result of the cram-down calculation.

# Drafting Issue No. 2 – Management

Section 18-402 - Unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members in proportion to the then current percentage or other interest of members in the profits of the limited liability company owned by all of the members, the decision of members owning more than 50 percent of the said percentage or other interest in the profits controlling; provided however, that if a limited liability company agreement provides for the management, in whole or in part, of a limited liability company by a manager, the management of the limited liability company, to the extent so provided, shall be vested in the manager who shall be chosen in the manner provided in the limited liability company agreement. The manager shall also hold the offices and have the responsibilities accorded to the manager by or in the manner provided in a limited liability company agreement. Subject to § 18-602 of this title, a manager shall cease to be a manager as provided in a limited liability company agreement. A limited liability company may have more than 1 manager. Unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company.

# Checks on Management

1. Consent Rights
2. Removal of Management
3. Dissolution

# Veto Rights for Members

Actions that commonly require the consent of Members:

1. Amend or modify the certificate of formation
2. Amend the operating agreement – often allow manager to make technical amendments (e.g. updates to the member schedule). Less frequently, allows amendment of operating agreement in a manner not adverse to a member's interests
3. Issuance of additional membership interests
4. Make any material change to the "Business" of the Company
5. Incur debt, grant liens, make loans or guarantee debt – typically allow for baskets or conformity with a pre-approved budget

# Veto Rights for Members (continued)

1. Amend or modify any affiliate contract:
   a. Exception for arm's length contracts or
   b. Approval by disinterested managers
2. Acquisitions and dispositions of assets outside ordinary course
3. Joint Ventures and other investments
4. Liquidation & Bankruptcy

# Removal of Manager

18-405. A limited liability company agreement may provide that:

(1) A manager who fails to perform in accordance with, or to comply with the terms and conditions of, the limited liability company agreement shall be subject to specified penalties or specified consequences; and

(2) At the time or upon the happening of events specified in the limited liability company agreement, a manager shall be subject to specified penalties or specified consequences.

# Drafting Concerns for Removal of Manager

Percentage of members that have to agree to removal. Frequently in multi-class operating agreements, each class has a right to appoint a member of a board of managers. Usually, only the class that appointed the manager can remove the manager.

Triggers: manager's breach of a duty under the operating agreement or affiliate contract. Typically requires written notice.

Trigger based upon the manager's declaration of bankruptcy.

Death and disability of manager.

Method for appointing a replacement manager.

# Dissolution of Company

Potential Triggers:

1. Breach of Manager of obligation under the operating agreement;
2. Failure to meet specified financial or operational targets;
3. Deadlock.

# Drafting Issue No. 3 – Deadlock

First Issue: Definition of Deadlock. Should be limited to issues that are so crucial to the operation of the company that failure to agree makes the continued operation of the company impracticable.

Deadlocks can occur in different contexts:

1. Deadlock between Manager and Members over actions requiring member consent. You may want to limit the deadlock resolution mechanisms to only a subset of these items though (e.g. if change of the Company's Business requires member's consent, failure to obtain such consent does not trigger a deadlock – the company just continues operating consistent with past practices.)
2. Deadlock between Managers (or member for member-managed companies). There should be a defined term of "Fundamental Issues" that trigger deadlock procedures. These fundamental issues are usually similar to the consent items discussed previously.

# Deadlock – Mediation Procedures

Typically there is a requirement that the deadlocked parties attempt in good faith to resolve the deadlock for a period of time. If the parties cannot resolve the issue, it may be referred to another party for resolution.

1. Deadlock between managers may be referred to the members for resolution.
2. Third-Party mediator.

Results of mediator are binding upon the parties.

# Deadlock - Mediation

The governing document should address how the company is operating during the pendency of the mediation procedures. Typically, the requirement is that company operates consistent with past practices or in accordance with a budget (which may allow for annual increases).

Drawbacks of requiring third-party mediation – time consuming, costly and may not result in a satisfactory resolution.

# Deadlock – Buy-Sell

If the parties cannot resolve the deadlock after a defined period of time, consider utilizing buy-sell provisions.

Pricing Methodologies:

1. Fair Market Value as determined by an independent third party.

2. Each party sends a minimum price at which it will sell its interests to an independent third party. Whoever set the highest price has to purchase the interests of the other members at that price.

3. Each party sends to an independent third party a bid setting forth the maximum price it would be wiling to buy-out the other members. Highest bid wins.

4. One member gives a notice to the other party setting forth a price. The receiving member can either sell its interests at that price or buy the sending member's interest at that price with the only changes be pro rata adjustments to reflect different percentage ownerships.

5. Auction procedures.

The agreement should also address what happens if a party with an obligation to buy fails to do so.

# Deadlock – Buy-Sell

Issues that can make buy-sell provisions problematic:

1. A disparity in the members' financial resources;
2. Large disparities in the percentage ownerships;
3. Different classes of membership interests.

Potential solutions – third party valuation; put/call rights; dissolution.

# Deadlock – Dissolution

Section 18-802. “On application by or for a member or manager the Court of Chancery may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement.”

“The text of Section 18-802 does not specify what a court must consider in evaluating the “reasonably practicable” standard, but several convincing factual circumstances have pervaded the case law: (1) the members' vote is deadlocked at the Board level; (2) the operating agreement gives no means of navigating around the deadlock; and (3) due to the financial condition of the company, there is effectively no business to operate.”

*Fisk Ventures, LLC v. Segal*, 2009 WL 73957 (Del. Ch. Jan, 13, 2009).

# Drafting Issue No. 4 – Distributions and Allocations

Section 18-601 “Except as provided in this subchapter, to the extent and at the times or upon the happening of the events specified in a limited liability company agreement, **a member is entitled to receive from a limited liability company distributions** before the member's resignation from the limited liability company and before the dissolution and winding up thereof.”

# Distributions

§ 18-607 Limitations on distribution.

(a) A limited liability company shall not make a distribution to a member to the extent that at the time of the distribution, after giving effect to the distribution, all liabilities of the limited liability company, other than liabilities to members on account of their limited liability company interests and liabilities for which the recourse of creditors is limited to specified property of the limited liability company, exceed the fair value of the assets of the limited liability company, except that the fair value of property that is subject to a liability for which the recourse of creditors is limited shall be included in the assets of the limited liability company only to the extent that the fair value of that property exceeds that liability. For purposes of this subsection (a), the term "distribution" shall not include amounts constituting reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program.

(b) A member who receives a distribution in violation of subsection (a) of this section, and who knew at the time of the distribution that the distribution violated subsection (a) of this section, shall be liable to a limited liability company for the amount of the distribution. A member who receives a distribution in violation of subsection (a) of this section, and who did not know at the time of the distribution that the distribution violated subsection (a) of this section, shall not be liable for the amount of the distribution. Subject to subsection (c) of this section, this subsection shall not affect any obligation or liability of a member under an agreement or other applicable law for the amount of a distribution.

(c) Unless otherwise agreed, a member who receives a distribution from a limited liability company shall have no liability under this chapter or other applicable law for the amount of the distribution after the expiration of 3 years from the date of the distribution unless an action to recover the distribution from such member is commenced prior to the expiration of the said 3-year period and an adjudication of liability against such member is made in the said action.

# Distributions

Drafting Concerns:

1. Permissive vs. Mandatory.

2. If Mandatory – calculation of amount of distribution (e.g. excess cash flow after establishment of reasonable reserves).

3. If Permissive – consider tax distributions.

# Distributions - Waterfall

Waterfalls are often structured to provide a return of invested capital plus a minimum return on investment before distributions are made to other equity holders. Individuals who receive units in exchange for services frequently are lower on the waterfall.

Non-Participating Preferred – first, to minimum yield on investment, second to return of investment, third to incentive unit holders to true them up to their percentage ownership, fourth to members pro rata.

Participating Preferred – first to minimum yield on investment, then to investment, then to all members pro rata on percentage ownership.

# Allocations

§ 18-503 Allocation of profits and losses.

The profits and losses of a limited liability company shall be allocated among the members, and among classes or groups of members, **in the manner provided in a limited liability company agreement**. If the limited liability company agreement does not so provide, profits and losses shall be allocated on the basis of the agreed value (as stated in the records of the limited liability company) of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned.

# Allocations

Internal Revenue Code § 704. Partner's Distributive Share.

(a) Effect of partnership agreement.--A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

(b) Determination of distributive share.--A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if--

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

# Substantial Economic Effect Requirement

Main idea is that the tax consequences should follow the economic reality of the member's interest in the company.

There is a safe harbor set forth in Treasury Regulation § 1.704-1(b).

Three requirements: (i) maintain capital accounts, (ii) liquidation distributions are made in accordance with capital account balances and (iii) capital account deficit restoration provision or a qualified income offset.

If your waterfall doesn't provide that liquidation distributions be made in accordance with capital account balances, you are not within the safe harbor.

# Allocation Techniques

Layer Cake approach – multiple tiers of allocations to reflect the business deal.

Target Capital Account approach – each member has a target capital account allocation based upon what it would receive in a theoretical liquidation of the company. This is generally the preferred approach as the waterfall is easier to understand and better matches the parties intent, but technically does not fall within the substantial-economic-effect safe harbor.

The Target Capital Account may still be respected as the partner's interest in the partnership test

# Dissociation & Transfer

§ 18-304 Events of bankruptcy.

A person ceases to be a member of a limited liability company upon the happening of any of the following events . . . a member:

a. Makes an assignment for the benefit of creditors;
b. Files a voluntary petition in bankruptcy . . .

No analogous provision for death of a member, but the assignment provisions to be discussed later still apply.

# Dissociation & Transfer

§ 18-801(b).

Unless otherwise provided in a limited liability company agreement, the death, retirement, resignation, expulsion, bankruptcy or dissolution of any member or the occurrence of an event that terminates the continued membership of any member shall not cause the limited liability company to be dissolved or its affairs to be wound up, and upon the occurrence of any such event, the limited liability company shall be continued without dissolution.

# Dissociation & Transfer

§ 18-702 Assignment of limited liability company interest.

(a) A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement or, unless otherwise provided in the limited liability company agreement, upon the vote or consent of all of the members of the limited liability company.

(b) Unless otherwise provided in a limited liability company agreement:

(1) An assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member;

(2) An assignment of a limited liability company interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned.

# Dissociation & Transfer

Bifurcation of rights to protect the choose your own partner principle. Also applicable in the event of a divorce where the divorced member's spouse obtains a membership interests.

Frequently, disassociation triggers a buy-out right on behalf of the Company or the other members.

One issue: triggering a buy-out upon the bankruptcy of the member is a violation of the *ipso facto* rules of the bankruptcy code.

# Provisions of Limited Liability Company Agreement – Transfer Provisions

Operating Agreements frequently have detailed provisions addressing manner in which interests may be transferred.

Various Approaches:

- No transfers at all except for certain permitted transfers (e.g. estate planning transfers, transfers to other members);
- No transfers to certain types of persons (e.g. competitors)
- Procedural restrictions on transfers (e.g. right of first refusal).

# Right of First Refusal

Company gets the first right. Often, this does not provide the other members with sufficient protection because (a) company may not have the resources or (b) company management may not wish to exercise its right.

If Company does not exercise its right, each member has a right to purchase its pro rata share of the transferred interests.

If the interests is still under-subscribed, then exercising members can purchase unsubscribed portion.

Only when all of these procedures have been satisfied can the sale take place, and then only on the same terms and within a set time frame.

Pay attention to the time frames for notice, counter-notices, etc. and make sure they work.

# Joinder Provisions

Even if a transfer is permitted, an LLC Agreement typically does not allow the transferee to become a member until the transferee has joined the limited liability company agreement in some manner (signing LLC Agreement, signing a joinder agreement).

Until joinder is executed, transferee only has the economic rights in the company.

# Questions?

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# New Developments in DE LLC Act

# 2018 Amendments

- Signed into law on July 24, 2018
- Became effective as of August 1, 2018 (except that amendments relating to registered series will become effective August 1, 2019):
  - Use of blockchain technology
  - Division of LLCs
  - Formation of statutory public benefit LLCs
  - Cancellation of LLC upon abuse of powers

# Use of Blockchains

- Section 18-104(g) of the DE LLC Act has been amended to expressly allow DE LLCs to use electronic networks or databases (including one or more distributed electronic networks or databases, e.i., blockchains) for maintenance of company records and for certain electronic transmissions (such as a vote or a proxy)
- Correspond to 2017 amendments to the DGCL

# Use of Blockchains

- Blockchain is a decentralized ledger network in which transactions (blocks) are recorded chronologically using cryptography
- Examples of potential distributed ledgers:
  - Ownership ledger
  - Record of UCC filings and other financial instruments
  - Other corporate recordkeeping

# Division

- New Section 18-217 allows DE LLCs to divide into two or more DE LLCs
- Such a division is effective pursuant to:
  - (a) the adoption of a plan of division
  - (b) the filing with the Secretary of State of a certificate of division and a certificate of formation of each new LLC
- The division does not constitute a dissolution of the dividing LLC: it may survive the division

# Division: Plan of Division

- The plan of division needs to allocate all assets, property, rights, obligations, and duties of the dividing company among the division companies
- Does not need to specifically identify each asset and liability
- Is not required to be filed with the DE Secretary of State

# Division

- If the LLC agreement of the dividing LLC does not specify the manner of adopting a plan of division and does not prohibit a division, then Section 18-217(c) will act as a default provision providing rules with respect to the division.
- Section 18-217(e) allows the interests in the dividing company to be exchanged for or converted into cash, property, or interests in the surviving company or any other business entity

# Creditor Protections

- Any unallocated debts and liabilities will be joint and several debts and liabilities of all division companies
- Certificate of Division needs to specify the name of a division contact who must provide any creditor with the name and address of the division company to which such creditor's claim was allocated for six years following the division

# Division

- For LLCs formed prior to Aug 1, 2018: any contractual restrictions or prohibitions on mergers, consolidations or asset transfers will apply to a division if it were a merger, consolidation or asset transfer
- For LLCs formed after Aug 1, 2018: any such restrictions or prohibitions must be expressly stated in the LLC agreement

# Public Benefit LLCs

- New Subchapter XII
- Similar to public benefit corporations
- A public benefit LLC is "a for-profit limited liability company formed under and subject to the requirements of the Act that is intended to produce a public benefit or public benefits and to operate in a responsible and sustainable matter"

# Public Benefit LLCs

- A statutory public benefit LLC must balance the members' pecuniary interests, the best interests of those materially affected by the LLC's conduct, and the public benefit set forth in its certificate of formation.

# Public Benefit LLCs

- Unless otherwise provided in the LLC agreement, there is no personal liability for monetary damages for failure to balance such interests. 18-1204(a).

# Public Benefit LLCs

- Section 18-1204(b) addresses the fiduciary duties of managers and members and states that they will not owe any duties to any person on account of any interest of such person in the public benefit set forth in the certificate of formation or any interest materially affected by the LLC's conduct.
- With respect to the decision implicating the "balance" requirement, such person's fiduciary duties will be satisfied if such person's decision is both informed and disinterested and not such that no person of ordinary, sound judgment would approve.

# Public Benefit LLCs

- Section 18-1203 imposes a two-third member voting requirement for a statutory public benefit LLC seeking to amend its certificate of formation in order to revise the statement of its public benefit, merge into an entity that is not a statutory public benefit LLC (or similar entity) or otherwise cease to be a statutory public benefit LLC.

# Public Benefit LLCs

- Public benefit LLCs will be subject to all provisions of the DE LLC Act, except to the extent that Subchapter XII imposes additional or different requirements (and which cannot be altered in the LLC agreement).

# Judicial Cancellation of Certificate of Formation

- New Section 18-112
- The DE Attorney General may file a motion in the Court of Chancery to cancel the certificate of formation of any LLC for abuse or misuse of its powers, privileges or existence.

# Questions?

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