

Preparing LLC Documentation - Selected Checklist Issues-

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The Client

- Identify who is client
 - The Company
 - The Manager
 - One or more Members

- Consider
 - Multiple client representation issues (Rule 1.6(a))
 - Conflict waivers (Rule 1.7)
 - Engagement Letter language (Exh. B)

Manager-Managed Issues

- Identification required in company's articles of organization (15 Pa. C.S. § 8913(5))
- Who appoints manager?
 - Pa statutes do not include default rules for appointment of managers – must be set forth in operating agreement (15 Pa. C.S. § 8941(c))
- Qualifications of manager
 - Individual? Member?
 - Entity?

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Manager – Managed Issues

- How can manager be terminated/removed?
 - Change of control (if entity)
 - Bankruptcy
 - Conflicts
 - Who determines?
 - Who replaces?
- Consider specific issues as to which members retain control/voting rights

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Fiduciary Duty Issues

- Pennsylvania refers to the corporate statutes (§§ 1711, et seq.) to import corporate – like fiduciary duties on managers of manager-managed LLCs, while members in such entities have no duties to each other (solely by reason of acting in his capacity as a member). 15 Pa. C.S. § 8943(b).
- An operating agreement may not relax (but may increase), the above-described duties of representatives of the company to its members. 15 Pa. C.S. § 8943(b).
- In a member-managed LLC, the only circumstance in which a duty is imposed is where such member engages in any transaction (including a winding up of the company) without consent of the other members and then such member must account to the company and hold in trust proceeds of such activity. 15 Pa. C.S. § 8943(a). This requirement may not be modified by an operating agreement.
- Compare to Delaware, in which an operating agreement may expand, restrict or eliminate any fiduciary duties a member or manager otherwise has to another member or manager (or the company), other than the implied contractual covenant of good faith and fair dealing. 6 Del. C. § 18-1101. See also RULLCA § 110(d) (may reduce the duty of care, if not manifestly unreasonable).

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Fiduciary Duty Issues

- Note: An operating agreement is a contract, and as such incorporates an implied duty of good faith and fair dealing. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 205 (“every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement”).
 - In Pennsylvania, the standard of care applicable to a manager is derived from 15 Pa. C.S. § 1712:
 - good faith
 - in a manner reasonably believed to be in the best interests of the company
 - Such care, including reasonable inquiry, skill and diligence as a person of ordinary prudence would use under similar circumstances
 - Under RULCA, § 110(c)(5), an operating agreement may not eliminate the obligation of good faith and fair dealing, set forth expressly in that Act in § 409(d), but the operating agreement may prescribe the standard by which the performance of the obligation of good faith and fair dealing will be measured. RULLC § 110(d)(5).

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Good Faith

- There is, however, significant distinction as to the meaning of “good faith.”
 - E.g. - Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006), the Delaware Supreme Court determined that good faith is a “subsidiary element” of the duty of loyalty. The scope of what constitutes good faith or the absence of bad faith is recognized as being murky at best. In the Disney decision in which the Delaware Chancery court acknowledged that it likely is impossible to articulate a broad enough definition to capture the “universe of acts that would constitute bad faith.”
- Disney decision - case law in this area is a “fog of . . . hazy jurisprudence,” but “[t]o act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation,” which includes not intentionally disregarding his or her duties as a fiduciary.
- The phrase “acts or omissions not in good faith” is “easily susceptible to widely differing interpretations, especially retroactively” and was determined to be too imprecise a standard or duty to be barred from being waived in a corporation’s certificate of incorporation. Instead, the breadth of what might constitute nonwaivable bad faith has been narrowed under the Model Business Corporation Act to include acts or omissions (i) with respect to which the director derives a financial benefit to which he or she is not entitled or (ii) that are either intentionally criminal or intentionally designed to harm the corporation.
- Must carefully draft applicable standards in operating agreement

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Duties of Loyalty

- Operating Agreement should describe what the parties’ duties of loyalty are. Consider, e.g.,
 - Obligation to refer business opportunities
 - Right to compete with, or otherwise have conflict of interest with, the LLC
 - Ability and circumstances under which manager/ members may engage in business with the LLC
 - Duties of candor/disclosure
 - Obligations of “control” persons
 - Standards for breach:
 - reckless/negligent/gross negligence
 - scienter
 - objective or subjective knowledge
 - Consequences of breach
 - Requirement of prior approval of certain actions

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Transfer Issues

- Two features of an LLC interest may be transferred:
 - the full membership interest - or
 - the economic interest only.
- Operating agreements typically restrict transfer of LLC interests to preserve partnership tax status or to reflect the intent of the parties to be able to veto new members.
- Transfer of the economic interest only in an LLC is generally permitted as it does not affect the operations of the LLC.
- The transfer of an interest merely transfers the member's right to receive distributions (the economic interest), and the assignee does not have an automatic right to become a member or to participate in the management of the LLC without a further vote or consent. See 15 Pa. Stat. § 8924(a).
- Consider estate planning issues – e.g., right to transfer to permitted transferees (e.g., spouse or children), particularly if transfers otherwise trigger rights of first refusal or other similar provisions.
- Consider enforceability of remedies – in particular, those involving forfeiture of rights and/or property if transfer is absolutely prohibited even in involuntary situations.

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Transfer by Operation of Law

- It generally is preferable for the operating agreement to provide that upon the death of a member, only the member's economic interest in the LLC, and not specific LLC property or voting rights, passes to the member's estate.
- But see 6 Del. C. § 18-705 (providing the deceased member's personal representative with the right to exercise all of the member's rights, including "any power under a limited liability company agreement of an assignee to become a member").
- See also 15 Pa. Stat. § 8971(a)(4) (death of a member triggers dissolution).
- Consider similar issues for divorce of spouses; bankruptcy (transfer to trustee); receivership

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Voting/Consent/Amendment

- In determining the appropriate level of consent for specific actions/amendments of the operating agreement, consider
 - how best to effect
 - (1) avoiding unfairness or excessive bias against a minority member by requiring a large enough approval;
 - (2) ensuring that the agreement is sufficiently flexible to be practical.
 - Methodologies: (Section V.A. of checklist)
 - Meetings with formal rules
 - Informal consent^[1]
 - Unanimous of the members
 - Vote of members otherwise sufficient to act
 - Other:
- [1] Alternatives include permitting consent to be by a unanimous written consent, by the vote of the members sufficient to pass on the matter in question at a convened meeting of the members, or by a threshold higher than that required at a convened meeting but below unanimous.
- To accord the varying degree of protection needed, or concert achieved, it may be desirable to require a higher percentage or even a unanimous vote for certain types of amendments or on certain voting issues, e.g.:
 - Sale of all/substantially all assets; merger
 - Dissolution
 - Bankruptcy
 - Incurrence of significant debt
 - Reorganization/recapitalization
 - To avoid deadlock, the operating agreement should include exit provisions including the economic ramifications thereof. Any exit provision should require the departing member's interest to be completely separated from the LLC (mandatory purchase provisions; covenant not to compete; admission of new members).
 - N.B. - Members and managers leaving an LLC may continue to have fiduciary duties to the company through the winding up of the company.

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Levels/Thresholds of Consent (Section V.B. of checklist)

If Member Managed:

- [A] Majority of Members
- [B] Supermajority of Members ____%
- [C] Unanimous consent of Members
- [D] Managing Member(s)
- [E] Management Committee
- [O] Other: _____

If Manager-Managed:

- [A] Single Manager if there is only one manager
- [B] Majority of Managers
- [C] Supermajority of Managers ____%
- [D] Unanimous consent of Managers
- [E] Ratification required by majority/supermajority of Members
- [F] Majority of Members
- [G] Supermajority of Members
- [H] Unanimous Consent of Members
- [O] Other: (e.g., "managing partner")

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Types of Actions Requiring Consent

- Opening bank accounts
- Signing checks [> \$ _____]
- Employment of professionals and other agents
- Maintain records
- Borrowing of funds [> \$ _____]
- Cause the LLC to guarantee/pledge property to secure the obligation of any person
- Lend money of the LLC to any person
- Investment of funds [> \$ _____]
- Acquisition of property [with a value > \$ _____]
- Other capital expenditures [> \$ _____]
- Other LLC expense [> \$ _____]
- Cause the LLC to call capital from its Members
- Determine the time and amounts of distributions to Members
- Admission of new member and modification of Members' economic relationships in connection therewith
- Approve reimbursement of expenses of Managers/Members
- Determining to expel Member for cause
- Admission of an assignee as a Member
- Making tax elections
- Commence litigation in the name of the LLC
- Cause the LLC to reorganize
- Voluntarily dissolve the LLC
- Instituting an action for judicial dissolution and winding up
- Sell all or substantially all of the property of the LLC outside of the ordinary course of business
- Cause the LLC to commence an action in bankruptcy

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Consent Level for Amendments

- Unanimous consent of the members for all amendments
- Consent of _____% of the members is required for all amendments other than:
 - those that adversely affect less than all members or all classes, or disparately affect some members or members within a class, as to which _____ is required
 - those that change the rights to appoint managers
 - certain financial rights, as to which _____ is required
 - liquidity events, as to which _____ is required
 - Other:
- If Manager Managed, consent of Manager required for:
 - any amendment affecting rights, duties, obligations, liability of Manager
 - the following actions:
 - _____
 - _____
 - _____

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Dispute Resolution

- Arbitration – if so, which issues, what law, specific procedures
- Mediation (binding/non-binding)
 - As a condition to certain suits
- Choice of governing law/venue/submission to jurisdiction
- Prevailing party fee provisions
- Waiver of jury trial

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Exits

- Circumstances – e.g., no remaining members, dissociation, impermissible transfers, deadlock or impasse, sale of all assets
- Who determines (if consent required)
- Mechanisms:
 - Put/call
 - Co-sale or tag-along rights
 - Drag-along rights
 - Registration rights
 - ROFO/ROFR
 - Auction or forced sale
- Process/timing
- Funding
 - Insurance
 - Notes – payment over time

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