LLC Agreement (Multi-Member, Manager-Managed)

PRACTICAL LAW CORPORATE & SECURITIES

Search the Resource ID numbers in blue on Westlaw for more.

This document features a few sections of the full resource found on Practical Law. This is one example of the thousands of other up to date, available resources like Practice Notes, Standard Documents, Checklists, Toolkits, and more, that can be accessed as part of a subscription to Practical Law.

To learn about our subscription offerings or to request a free trial, visit **TryPracticalLaw.com**.

A long-form US LLC agreement to be used in connection with an investment transaction with multiple members (such as a private equity buyout). This Standard Document assumes an agreement among multiple members with a board of managers controlled by a private equity sponsor. This Standard Document includes integrated notes with important explanations and drafting and negotiating tips.

SAMPLE

DRAFTING NOTE: READ THIS BEFORE USING DOCUMENT

A limited liability company operating agreement (LLC agreement) is an agreement among the members of a limited liability company (LLC) that governs the operation of the LLC, including the members' contractual rights, obligations, and restrictions relating to their membership interests in the company. The LLC agreement, together with the company's certificate of formation, are the basic documents for the formation of an LLC (see Forming an LLC Checklist (2-381-1369)). The principal advantages of forming an LLC and entering into an LLC agreement include:

- The flexibility to describe the entire relationship of the parties, including the economics of the venture and any fiduciary duties, by contract, without being governed by a mandatory statutory scheme. Unlike state corporation statutes, most state LLC statutes primarily contain default provisions that can be altered by agreement among the members (with some mandatory provisions that cannot be altered).
- The liability of members of an LLC is limited like that of a corporation's stockholders. Unlike the partners of a (general) partnership, the members of

the answer company™ THOMSON REUTERS®

© 2020 Thomson Reuters. All rights reserved.

an LLC are generally not personally liable for the debts and obligations of the LLC.

- For US tax purposes, an LLC may be treated as a partnership, or pass-through entity, which is not taxed at the entity level, but passes the company's profits and losses through to the members. For a discussion of the US federal income tax rules that apply to US entities taxed as partnerships, see Practice Note, Taxation of Partnerships (W-000-6885).

For a more detailed discussion of the advantages of LLCs and LLC agreements, see Practice Notes, LLC Agreement Commentary (1-381-0515) and Choice of Entity: Tax Issues (1-382-9949) and Checklist, Choosing an Entity Comparison Chart (7-381-0701).

ASSUMPTIONS USED IN THIS DOCUMENT

This Standard Document is drafted on the basis of several important assumptions. Some of these assumptions relate to the differences between LLC agreements for operating companies and LLC agreements for holding companies. Others are relevant considerations for LLC agreements in any transaction context.

General Assumptions and Drafting Considerations

- **Multiple members.** This Standard Document is an LLC agreement for a company with multiple members. Although the drafting notes frequently describe the different approaches taken by joint ventures and multiple-member LLCs to various issues, the body of the agreement in this Standard Document is not meant to be used for a joint venture between two parties. For an example of an LLC agreement written for a two-party joint venture, see Standard Document, LLC Agreement (Operating Company) (6-520-9727).
- **Delaware law.** This Standard Document assumes that the company has been formed in Delaware. This is an important assumption not only for the use of correct terminology (for example, a "certificate of formation" is filed in Delaware while "articles of organization" are filed in New York), but for substantive issues like the permissibility of limiting the fiduciary duties of managers. It is therefore important to become familiar with the relevant statutory and case law before drafting the LLC agreement and, if necessary, to engage local counsel. This Standard Document is based on Delaware law for the following principal reasons:
  - the Delaware Limited Liability Company Act has a strong influence on LLC statutes in other jurisdictions (6 Del C. §§ 18-101 to 18-1109);
  - the LLCs for large, complex transactions are often formed in Delaware;
  - Delaware has the most developed and most rapidly developing common law regime governing LLCs; and
  - Delaware statutory and common law provides for the greatest freedom of contract.
- **Scope.** This Standard Document sets out most of the terms governing the parties' ownership interests in the company. In some situations, though, the parties may choose to document certain provisions, such as transfer restrictions, in a separate members' agreement. The parties sometimes prefer this approach if certain members are subject to certain benefits or obligations that others are not. However, this Standard Document does not include detailed provisions for registration rights often granted to investors in a private equity deal. This Standard Document assumes that the registration rights are described in a separate registration rights agreement. For a form registration rights agreement, see Standard Document, Registration Rights Agreement (Section 4(a)(2) Private Placement Form (8-500-6936)).
- **Specialist counsel.** Long-form LLC agreements require significant input from tax and employee benefits counsel. The allocations section, in particular, is mostly driven by tax issues and compliance with various Treasury Regulations. The capital accounts and distributions sections also require thorough review by tax counsel. In addition, benefits counsel should be consulted for the drafting of provisions governing the issuance of incentive units

SAMPLE

© 2020 Thomson Reuters. All rights reserved.

and for the drafting of any compensation plan and related award agreements under which incentive units are awarded.

- **Tax-related references.** When discussing certain tax-related provisions, the drafting notes in this Standard Document sometimes refer to the company as a partnership because multiple-member LLCs are generally treated as partnerships for tax purposes. This is done for the sake of accuracy when explaining how the Internal Revenue Code (Code or IRC) and the Internal Revenue Service (IRS) may view certain provisions in the agreement. As an organizational matter, the company is of course an LLC, not a partnership.

Holding Company versus Operating Company Drafting Assumptions

This Standard Document assumes that the company has been formed as a holding company to hold a control investment, such as the investment vehicle formed by a private equity sponsor in a buyout transaction. In a buyout context, the sponsor contributes cash in return for a controlling equity interest in the holding company, while new or existing management often contribute new capital or roll over their existing equity in the acquired target company (or both) in return for equity in the holding company (see Practice Note, Buyouts: Overview (4-381-1368)). This assumption has important implications for this Standard Document and the drafting and negotiating of the LLC agreement, as described below.

Sponsor-Favorable LLC Agreement

In a buyout context, sponsor counsel prepares the first draft of the holding-company LLC agreement, which favors the sponsor. Accordingly, many provisions of this Standard Document are drafted in favor of the sponsor. However, the management team of the target company (and the seller, if it will maintain a stake in the portfolio company following the buyout) and its counsel will commonly review and negotiate the terms of the LLC agreement. (In deals with minority outside investors, significant investors may also be given an opportunity to weigh in on major issues affecting their investment.) As a result, the initial draft of the agreement may undergo several rounds of changes during negotiation. Therefore, this Standard Document aims to be relatively reasonable to reduce the time and expense of lengthy negotiation and contains the provisions most often included in these agreements. The drafting notes in this document, when applicable, identify issues that both the sponsor and management should consider when drafting or negotiating the LLC agreement.

Classification and Ownership of Membership Interests

To preserve the sponsor's control over the company, a holding-company LLC agreement usually designates various classes of membership units, each with different economic and other rights. By contrast, many operating-company LLCs (especially two-party joint ventures) do not designate different classes of units, instead defining the rights of the parties on the basis of their respective percentage ownership interests in the company (and explicitly describing any special voting rights in the agreement).

As described in detail in Article III, this Standard Document assumes the following classification and ownership of membership interests:

- The company issues three classes of units, consisting of a class each of:
  - non-voting preferred units;
  - voting common units; and
  - non-voting incentive units reserved for issuance to management and employees of the target company.
- The sponsor buys both preferred units and common units (though it would typically purchase far more preferred than common units given the liquidation preference of the preferred units) and will hold a substantial majority of each of the two classes.
- Management members acquire a combination of preferred, common, and incentive units, with individual members:
  - co-investing alongside the sponsor by purchasing preferred and common units for cash;

SAMPLE

© 2020 Thomson Reuters. All rights reserved.

  - acquiring common units by rolling over their existing equity in the target company; and/or
  - receiving grants of compensatory incentive units in consideration for their "sweat equity" in managing and growing the business.

Use of Profits Interests

Sponsors often organize holding companies as LLCs because, among other reasons, an LLC provides more tax-efficient equity incentives for the company's management and other employees. These efficiencies are accomplished by qualifying the incentive units as profits interests. A profits interest is an incentive equity interest that gives the recipient the right to receive a percentage of future profits (but not existing capital) from the LLC. Under current law, profits interests can be structured so that the grant is tax-free to the recipient and the issuer, provided certain requirements are met (see Rev. Proc. 93-27 and 2001-43).

The recipient of a profits interest is generally entitled to preferentially taxed, long-term capital gain treatment (a maximum rate of 20% for higher-income individuals, plus a potential additional 3.8% tax for higher-income individuals on "net investment income," which includes gains) on the later sale of its interest in the LLC or on the sale of a capital asset of the LLC, if the holding-period requirements are met. Under changes made by 2017 tax-reform legislation, however, recipients of certain profits interests in an LLC must satisfy a three-year holding period to qualify for long-term capital gain treatment on a sale of the profits interest, or on the LLC's sale of a capital asset (IRC § 1061). This special three-year holding period requirement applies to profits interests received for performing substantial services in an applicable trade or business, which is a business that consists of both:

- Raising or returning capital.
- Either investing in, disposing of, or developing:
  - securities;
  - commodities;
  - real estate held for rent or investment;
  - cash or cash equivalents;
  - options or derivatives on any of the assets listed above; or
  - an interest in a partnership (or LLC taxed as a partnership) to the extent of the partnership's (or LLC's) interests in the assets listed above.

The longer three-year holding period requirement thus generally applies to profits interests granted to private equity managers and other private equity employees. However, a target company employee who receives a profits interest in a holding-company LLC may be able to qualify for the regular one-year long-term capital gain holding-period requirement as long as the employee only provides services to the target company (IRC § 1061(c)(1)). (Assuming a typical five-to-seven-year timeline for private equity investments, the three-year holding-period requirement may not have a significant impact for private equity managers and employees in any event.)

This Standard Document assumes that profits interests are granted to management when the agreement is executed, which for a buyout is typically at the closing. Profits interests are typically issued under a written compensatory plan and individual award agreements. For a summary of the requirements for granting profits interests on a tax-free basis, see Drafting Note, Profits Interests (3-422-4189). For more detailed information about profits interests, see Practice Note, Profits Interests (9-560-6768). For an example of a profits interest plan, see Standard Document, Profits Interest Plan. For an example of an award agreement, see Standard Document, Profits Interest Award Agreement (8-561-5645).

Management Structure

As is common in the private equity context, this Standard Document assumes that the company is board-managed, not member-managed. Although the sponsor is entitled to appoint a majority of the board, minority investors have a say in management if they have a right to appoint a board member. Operating-company LLCs can also be managed by boards, but joint ventures frequently designate one member as the

SAMPLE

© 2020 Thomson Reuters. All rights reserved.

managing member. This is a common structure when a party with operating expertise, who acts as the managing member, brings in an investor to provide much of the capital for the project or venture (often the majority member). In those transactions, the majority member takes a more passive management role, reserving veto rights over major decisions.

For an example of an operating agreement for a member-managed LLC, see Standard Document, LLC Agreement (Operating Company) (6-520-9727).

No Capital Calls

This Standard Document assumes that members are not required to make additional capital contributions following their initial investment. This is common in the buyout context, where the members expect to make their entire required investment at the outset to finance the buyout. If the company requires additional capital, the members expect the company to raise it either with debt financing or new equity securities issuances subject to the LLC agreement's pre-emptive rights (see Article IX).

In contrast, LLC agreements for operating companies frequently give the managing member the right to make capital calls on the assumption that the company will likely need more regular infusions of capital to fund its ongoing business. LLC agreements in the fund-formation context generally contemplate a hybrid approach in which investors make an aggregate capital commitment that can be called in stages over a period of time.

For an example of an operating agreement that contemplates capital calls and additional capital contributions, see Standard Document, LLC Agreement (Operating Company) (6-520-9727).

Major Decisions

Holding-company LLC agreements typically do not require that major decisions be decided with supermajority or unanimous approval because the sponsor expects to control the company through its ownership of a majority of the voting units and its right to appoint a majority of the board members. Special approval rights over major decisions are common in LLC agreements for operating companies and for private equity minority investments where the members expect either equal treatment or specific voting rights. These rights give minority or non-managing members a veto over major decisions of the board or managing member. For more information about private equity minority investments, see Practice Note, Minority Investments: Overview (1-422-1158).

This Standard Document assumes that the minority investors do not have veto rights over specific decisions, which preserves the sponsor's control of the company. To alleviate the minority members' concerns that they have no say if the sponsor chooses to sell its ownership interest, the agreement grants all members tag-along rights (see Drafting Note, Participation).

No Deadlock Procedures

This Standard Document does not include any deadlock procedures. Because holding-company LLC agreements do not usually grant minority approval rights over major decisions, they typically do not include detailed deadlock procedures for resolving conflicts. In addition, in private equity deals the sponsor can usually appoint and remove a majority of the board members at will and under Delaware law, the board members' fiduciary duties can be contracted away (see Drafting Note, Limitation of Liability). This means that the sponsor can ensure that the board will act in the sponsor's best interests.

For a discussion of deadlock procedures generally, see Practice Note, Joint Ventures: Exits and Terminations (8-501-7299). For an example of buy-sell deadlock procedures in an LLC agreement, see Standard Document, LLC Agreement (Operating Company): Section 7.07 (6-520-9727).

Other assumptions adopted in this Standard Document are related to specific sections of the LLC agreement and are discussed in the relevant drafting notes.

COVER PAGE LEGEND

Many LLC agreements include a legend on the cover page of the agreement to notify

SAMPLE

© 2020 Thomson Reuters. All rights reserved.

transferees of any restrictions on the units that are contained in the LLC agreement (see Drafting Note, Legends). An example of this legend used in this context is as follows:

> "THE UNITS REFERRED TO IN THIS AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT ARE SUBJECT TO THE PROVISIONS OF SUCH AGREEMENT. NO TRANSFER, SALE, ASSIGNMENT, PLEDGE, HYPOTHECATION OR OTHER DISPOSITION OF THE UNITS REFERRED TO IN THIS AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT MAY BE MADE EXCEPT IN ACCORDANCE WITH THE PROVISIONS OF SUCH AGREEMENT."
>
> "THE UNITS REFERRED TO IN THIS AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR UNDER ANY OTHER APPLICABLE SECURITIES LAWS AND MAY NOT BE TRANSFERRED, SOLD, ASSIGNED, PLEDGED, HYPOTHECATED OR OTHERWISE DISPOSED EXCEPT (A) PURSUANT TO A REGISTRATION STATEMENT EFFECTIVE UNDER SUCH ACT AND LAWS, OR (B) PURSUANT TO AN EXEMPTION FROM REGISTRATION THEREUNDER."

BRACKETED ITEMS

Bracketed items in ALL CAPS should be completed with the relevant facts. Bracketed items in sentence case are either optional provisions or include alternative language choices to be selected, added, or deleted at the discretion of the drafting party.

SAMPLE

Section 3.01 Units Generally. The Membership Interests of the Members shall be represented by issued and outstanding Units, which may be divided into one or more types, classes, or series. Each type, class or series of Units shall have the privileges, preference, duties, liabilities, obligations, and rights, including voting rights, if any, set forth in this Agreement with respect to such type, class, or series. The Board shall maintain a schedule of all Members, their respective mailing addresses, and the amount and series of Units held by them (the "**Members Schedule**"), and shall update the Members Schedule upon the issuance or Transfer of any Units to any new or existing Member. A copy of the Members Schedule as of the execution of this Agreement is attached hereto as Schedule A.

DRAFTING NOTE: UNITS GENERALLY

Section 3.01 authorizes the company to establish various designations of units. A similar authority is expressly contemplated by the Delaware Act, which allows a company's LLC agreement to designate different classes or series of membership interests with different rights and obligations (6 Del. C. § 18-215(a)). However, the authorization to designate and issue **units** is a concept borrowed from the corporate context. The Delaware Act does not speak of issuing units to members, only admitting persons as members of the company.

The ensuing sections of Article III go on to specify the preferred, common, and incentive classes of units. The particular terminology used to identify the different types of units in the agreement is not as important as accurately defining the different rights and obligations of each class of unit. For example, this Standard Document, like many LLC agreements, uses the terms

© 2020 Thomson Reuters. All rights reserved.

"preferred" and "common" units, even though those terms do not appear in the Delaware Act. The terms are also borrowed from the corporate context because they evoke the common associations that investors have with the terms preferred stock (no voting rights, fixed minimum return, priority on distributions) and common stock (voting rights, unlimited equity upside, distributions after the preferred stock). These units can be categorized as Class A, Class B, and Class C units or with any other naming device that is helpful.

AUTHORIZED NUMBER OF UNITS

Section 3.02 and Section 3.03 do not limit the number of preferred and common units that the company may issue. Some LLC agreements limit the number of units that the company is authorized to issue, similar to limits on authorization in certificates of incorporation. Although this limit on authorization is not contemplated by the Delaware Act for LLCs, a Delaware court will honor the limit if the company attempts to issue more units than it is authorized to under the LLC agreement. The company must amend the LLC agreement to raise the authorized number of units. (See *Zimmerman v. Crothall et al.,* 62 A.3d 676, 692-97 (Del. Ch. 2013).)

MEMBERS SCHEDULE

The Delaware Act requires the company to maintain a current record of the name and last known business, residence or mailing address of each member and manager (6 Del. C. § 18-305(h)). Any member of the company can request this record (6 Del. C. § 18-305(a)(3)).

SAMPLE

Section 7.02 Priority of Distributions. After making all Distributions required for a given Fiscal Year under Section 7.04 and subject to the priority of Distributions pursuant to Section 13.03(c), if applicable, all Distributions determined to be made by the Board pursuant to Section 7.01 shall be made in the following manner:

(a) first, to the Members pro rata in proportion to their holdings of Preferred Units, until Distributions under this Section 7.02(a) equal the Preferred Unpaid Yield in respect of all the Preferred Units owned by the Members as of the time of such Distribution;

(b) second, to the Members pro rata in proportion to their holdings of Preferred Units, until Distributions under this Section 7.02(b) equal the aggregate amount of Capital Contributions attributable to the Members in respect of their acquisitions of Preferred Units;

(c) third, to the Members pro rata in proportion to their holdings of Common Units, until Distributions under this Section 7.02(c) equal the aggregate amount of Capital Contributions attributable to the Members in respect of their acquisitions of Common Units; and

(d) fourth, any remaining amounts to the Members holding Common Units and Incentive Units (subject to Section 7.03) pro rata in proportion to their aggregate holdings of Common Units and Incentive Units treated as one class of Units.

DRAFTING NOTE: PRIORITY OF DISTRIBUTIONS

Section 7.02 sets out the economic consequences of the members' investment or the business deal by describing the priority for distributions of cash and property out of the company (known as the distribution waterfall) on a sale of the company or the underlying operating company or out of normal operating earnings.

The distribution waterfall in this Standard Document is common to most sophisticated

© 2020 Thomson Reuters. All rights reserved.

multi-member LLC agreements. Each tier of the waterfall receives its full distribution before the next tier receives any proceeds. The layering of waterfall tiers and the apportionment of distributions among them are matters of negotiation and come in a wide variety of options, though certain approaches prevail among certain types of companies. Even these standard approaches, however, can have multiple variations, the choice of which can have an important impact on the distribution of proceeds on a sale or other liquidation of the company.

The layering of waterfall distributions in this Standard Document is a common approach for private equity buyouts with investment-holding companies. The sponsor in a buyout is typically the principal source of the equity financing for the transaction, while management receives profits interests (see Practice Note, Buyouts: Overview: Equity Financing (4-381-1368) and Drafting Note, Profits Interests). The sponsor in a buyout (and in other private equity investments) typically structures the equity financing to guarantee a return of invested capital, often together with a minimum return, before any distributions are made to other equity holders (such as founders, management, and previous investors).

The sponsor commonly accomplishes this by making the bulk of its equity investment (75% to 90% of the dollar amount) in preferred equity and using the remainder to acquire common equity. The preferred equity has a liquidation preference as reflected in the waterfall used in this Standard Document, receiving a priority return of the invested capital as well as a preferred yield (or hurdle) on the preferred investment (similar to the dividend that accrues on preferred stock in a C-corporation (see Practice Note, Preferred Stock: Overview (2-504-1419))). As a result, the sponsor's new equity investment is subject to the least risk of nonpayment.

Common units are next in priority for the waterfall in this provision. Common units have a right to receive a return of invested capital before the management incentive unitholders participate in any distributions. Unlike the preferred units, however, the common units do not typically earn any yield on the invested capital. This is a sponsor-friendly structure as it ensures that the sponsor gets back its entire investment (for both its preferred and common units) plus a hurdle before the incentive units receive any distributions.

In many other buyout waterfalls, the common unitholders have no priority over the incentive units to receive a return of invested capital. In those cases, the waterfall provides for the common units to immediately share any proceeds with the incentive unitholders after the preferred unitholders have received their liquidation preference. For this type of a waterfall, simply remove Section 7.02(c).

Finally, as drafted here, once the common unitholders receive a return of their capital contributions, they share in any remaining proceeds with the incentive units (subject to the vesting and profits interest hurdle limitations for the incentive units described in Section 7.03). Whether in this structure or in the waterfall described above in which the common units share all proceeds with the incentive unitholders, the sponsor gives itself an opportunity to participate in the company's growth potential by apportioning some of its investment toward the acquisition of common units. The trade-off for the sponsor is that it foregoes a first-priority return on that portion of its investment that otherwise would have been invested in preferred units.

In some waterfall provisions, prior to the final pro rata split of distributions between the common units and the incentive units, the incentive units receive catch-up distributions until the aggregate distributions to the incentive units relative to the aggregate distributions to all units (including the incentive units) equals the same ratio of outstanding incentive units to outstanding common units (see Drafting Note, Non-Participating Preferred Structure). In a successful deal, this type of non-participating waterfall results in the sponsor and management receiving the economics implied by their respective equity ownership percentages, as discussed in greater detail in Drafting Note, Alternative Waterfalls below.

SAMPLE

© 2020 Thomson Reuters. All rights reserved.

For a more complete discussion of the various approaches to waterfall provisions, see Practice Note, Structuring Waterfall Provisions (8-506-2772).

ALTERNATIVE WATERFALLS

The distribution waterfall in this Standard Document allows a sponsor or other investor in a private equity transaction to achieve the two primary goals of receiving:

- A liquidation preference for a priority return of at least the bulk of its capital investment (with a possible preferred yield).
- A pro rata share of any remaining residual value following the priority payments on the preferred units through the ownership of common equity.

Sponsors using LLC investment-holding-company structures can also achieve these dual goals through an alternative distribution waterfall that assumes the sponsor owns a single class of preferred units with characteristics of both preferred units and common units, rather than owning a combination of preferred units and common units. The advantage of this single preferred class structure is that the sponsor receives a liquidation preference (plus a preferred return, if desired) on its entire equity investment, while preserving its pro rata share of the company's future growth.

There are two basic single-preferred-class structures that appear in private equity deals in:

- A non-participating preferred class.
- A participating preferred class.

Both types of preferred units share pro rata in the company's residual common equity value. The difference between the two types turns on whether they allow the incentive units to catch up on their distributions before the preferred units re-enter the waterfall.

Non-Participating Preferred Structure

With this alternative waterfall, the sponsor makes its entire equity investment in preferred units that have a liquidation preference to receive a distribution of the entire capital value (as well as any preferred yield) before the holders of incentive units receive any distribution proceeds. After the liquidation preference distribution, the incentive units have a catch-up to receive distributions until the aggregate distributions to the incentive units relative to the aggregate distributions to all units (including the incentive units) equals the same ratio as the aggregate ownership split between the sponsor and the holders of incentive units (based on the total outstanding preferred and incentive units). The balance of distributions, if any, are then split pro rata between the preferred units and the incentive units based on the same ownership split.

If using this kind of equity structure, modify the waterfall in Section 7.02(a) through Section 7.02(d) as follows:

"(a) first, to the Members pro rata in proportion to their holdings of Preferred Units, until Distributions under this Section 7.02(a) equal the Preferred Unpaid Yield in respect of all the Preferred Units owned by the Members as of the time of such Distribution;

(b) second, to the Members pro rata in proportion to their holdings of Preferred Units, until Distributions under this Section 7.02(b) equal the aggregate amount of Capital Contributions attributable to the Members in respect of their acquisitions of Preferred Units;

(c) third, to the Members pro rata in proportion to their holdings of Incentive Units (subject to Section 7.03) until the ratio of the aggregate Distributions to the Members holding Incentive Units hereunder to the aggregate Distributions to the Members holding Units under Section 7.02(a), Section 7.02(b) and Section 7.02(c) equals the ratio of then-outstanding Incentive Units to the then-outstanding Preferred Units and Incentive Units treated as one class of Units; and

SAMPLE

© 2020 Thomson Reuters. All rights reserved.

(d) fourth, any remaining amounts to the Members holding Preferred Units and Incentive Units (subject to Section 7.03) pro rata in proportion to their aggregate holdings of Preferred Units and Incentive Units treated as one class of Units."

To illustrate, assume that the sponsor in a buyout contributed $90 million for 9,000 non-participating preferred units, which have accrued a preferred yield of $10 million, and that an aggregate of 1,000 incentive units was granted to management and have vested (and any strike price has been satisfied). If net equity proceeds of $200 million are available for distribution to the members, the proceeds would be distributed on liquidation under this waterfall as follows:

- The first distribution would go to the sponsor in the amount of $10 million to pay the accrued preferred unpaid yield.
- The second distribution would also go to the sponsor, in the amount of $90 million, to pay the preferred units capital contribution.
- Third, $11.11 million would be distributed to the holders of incentive units to pay the catch-up, equaling the 10% ownership ratio of the incentive units (derived from the algebraic formula X = 0.10 ($10 million + $90 million + X), where X equals the amount in millions of dollars to distribute under this tier of the waterfall).
- The remaining $88.89 million of the $200 million net proceeds would be split to reflect the 90%/10% ownership split:
  - $80 million to the holders of preferred units (for a total distribution of $180 million); and
  - $8.89 million to the holders of incentive units (for a total distribution of $20 million).

If, on the other hand, the net equity proceeds available for distribution to the members are equal to or less than the amount of the accrued preferred unpaid yield plus the preferred units' capital contribution (in this example, $100 million or less), the holders of incentive units receive nothing on liquidation despite their 10% ownership. Finally, if the net equity proceeds are between $100 million and $111.11 million, the incentive units receive all the remaining distributions over $100 million and the sponsor receives no more than $100 million.

Participating Preferred Structure

With this alternative waterfall, as with the non-participating preferred waterfall, the sponsor makes its entire equity investment in preferred units that have a liquidation preference to receive a distribution of the entire capital value (as well as any preferred yield) before the holders of incentive units receive any distribution proceeds. Unlike the non-participating preferred waterfall, however, once the liquidation preference is distributed, the balance of distributions (if any) are then split pro rata between the sponsor and the holders of incentive units (based on the total outstanding units) with no catch-up for the incentive units.

If using this kind of equity structure, modify the waterfall in Section 7.02(a) through Section 7.02(d) as follows:

"(a) first, to the Members pro rata in proportion to their holdings of Preferred Units, until Distributions under this Section 7.02(a) equal the Preferred Unpaid Yield in respect of all the Preferred Units owned by the Members as of the time of such Distribution;

(b) second, to the Members pro rata in proportion to their holdings of Preferred Units, until Distributions under this Section 7.02(b) equal the aggregate amount of Capital Contributions attributable to the Members in respect of their acquisitions of Preferred Units; and

(c) third, any remaining amounts to the Members holding Preferred Units and Incentive Units (subject to Section 7.03) pro rata in proportion to their aggregate holdings of Preferred Units and Incentive Units treated as one class of Units."

SAMPLE

© 2020 Thomson Reuters. All rights reserved.

Assuming the same illustration as above (see Drafting Note, Non-Participating Preferred Structure), the net equity proceeds of $200 million would be distributed on liquidation under this waterfall as follows:

- $10 million to the sponsor to pay the accrued preferred unpaid yield.
- $90 million to the sponsor to pay the preferred units capital contribution.
- The remaining $100 million would be split to reflect the 90%/10% ownership split:
  - $90 million to the holders of preferred units (for a total distribution of $190 million); and
  - $10 million to the holders of incentive units (for a total distribution of $10 million).

As with the non-participating waterfall structure, if the net equity proceeds available for distribution to the members are equal to or less than $100 million (the amount of the accrued preferred unpaid yield plus the preferred units' capital contribution), the holders of incentive units receive nothing on liquidation despite their 10% ownership. Unlike the non-participating waterfall structure, however, if the net equity proceeds exceed $100 million, the proceeds above $100 million are split based on the 90%/10% ownership split, with no additional catch-up distribution to management.

A participating preferred waterfall structure is more favorable to the sponsor. As illustrated in the examples above, the sponsor receives $10 million more in distribution proceeds (and the holders of incentive units $10 million less) than it does in the non-participating preferred waterfall. This is due to the double-dip nature of the participation feature, which includes the preferred yield as well as a pro rata participation in the residual value in the company without a management catch-up. This results in the sponsor potentially receiving more distributions than its membership ownership percentage would indicate.

The non-participating preferred waterfall, on the other hand, provides the sponsor with a priority return of its capital (and possibly a preferred return), but not the same total return, due to the management catch-up. In a successful deal, a non-participating preferred waterfall results in the sponsor and management receiving the returns indicated by their respective membership ownership percentages.

The waterfall structure used in this Standard Document produces similar results to that of the participating preferred structure, except that the two-class ownership structure creates an extra step in the waterfall to account for the return of the common-unit capital contribution before the final residual split. The sponsor receives a priority return of its invested capital along with a preferred return on that capital, and then shares pro rata in the remaining equity value (with no management catch-up).

When structuring LLC agreement waterfalls in a buyout context, it is important to understand the economic effect of different waterfalls and to carefully match the construction of the waterfall to the negotiated business deal. Although sponsors invariably prefer a participating preferred waterfall given the more favorable economics, the type of waterfall selected will depend on the comparative leverage of the sponsor, management, and any other investors when negotiating the terms of the LLC agreement. If using one of these alternative waterfall structures, additional changes must be made to this Standard Document, including deleting all references in the agreement to common units and providing for general voting rights for the preferred units (see Section 4.06). If there is no preferred yield earned on the preferred units, delete Section 7.02(a) and any related definitions.

INCENTIVE UNITS WATERFALL

Some investment-holding-company LLC agreements include a more complicated waterfall for the incentive units themselves. Rather than having all incentive units share equally with the common units at the end of the waterfall, the agreement grants progressively higher distributions to the

SAMPLE

© 2020 Thomson Reuters. All rights reserved.

incentive units depending on the aggregate return to the sponsor from its investment (typically based on the sponsor's internal rate of return or a multiple of its invested capital).

Regardless of the final waterfall structure, distributions on incentive units are subject to Section 7.03(a) and the vesting requirements of each individual manager's incentive units as expressed in the manager's award agreement. Distributions on incentive units are also subject to the limitations in Section 7.03(b) to qualify the units as profits interests (see Drafting Note, Profits Interests).

DISTRIBUTION WATERFALLS AND ALLOCATIONS

The distribution provisions in Article VII of this Standard Document work with the allocation provisions in Article VI to reflect the economic deal struck by the parties as well as the tax consequences to the parties. Some LLC agreements include the distribution waterfall reflected in this Section 7.02 in the allocation article instead, in an effort to meet certain Treasury safe harbor regulations and prevent IRS reallocation (see Drafting Note, Allocation of Net Income and Net Loss).

SAMPLE

ABOUT PRACTICAL LAW

Practical Law provides legal know-how that gives lawyers a better starting point. Our expert team of attorney editors creates and maintains thousands of up-to-date, practical resources across all major practice areas. We go beyond primary law and traditional legal research to give you the resources needed to practice more efficiently, improve client service and add more value.

To see the entire resource, **request a free trial of Practical Law at TryPracticalLaw.com.**

03-20

© 2020 Thomson Reuters. All rights reserved. Use of Practical Law websites and services is subject to the Terms of Use (http://static.legalsolutions.thomsonreuters.com/static/agreement/westlaw-additional-terms.pdf) and Privacy Policy (https://a.next.westlaw.com/Privacy).