Drafting Partnership Agreements
and Operating Agreements:
Selected issues

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In complex business arrangements, drafting the agreement between the members of a joint enterprise - whether in the form of a partnership agreement, limited partnership agreement, limited liability company, or other form of limited liability enterprise - can be a very difficult and time consuming process that challenges the drafting skills of the lawyers involved in the process. The purpose of this presentation is to identify some important issues that lawyers often face in drafting these agreements and to suggest some approaches and techniques that may be useful in resolving these issues.

1. Understanding the Deal

1.1 ***Get the Facts Straight***. Business people often paint with a broad brush, and expect lawyers to define the issues. Frequently, the parties will order up a "joint venture" agreement with little or no consideration about the proper form of entity, or how to handle important matters such as additional capital calls, management control, distribution priorities, level of commitment to the enterprise, rights to compete or not compete, tax effects, securities laws, etc. etc. etc. etc. The list indeed could go on and on. However, *the important point is to get the facts at the beginning; identify and resolve important deal points at the front end*. In appropriately complex transactions, the lawyers for the participants should encourage their respective clients to draw up comprehensive deal sheets or letters of intent that address all issues of material importance and spell out in appropriate detail the intent and agreement of the parties.

1.2 ***Discover the Scope and Purpose of the Enterprise.*** Find out the nature of the enterprise. Key issues to determine at the outset:

1.2.1 What is the purpose of the enterprise? Conduct an operating business? Perform personal services? Invest in real estate or some other asset or assets?

1.2.2 Are there limitations on the business of the enterprise? For instance, will there be limitations on the ability of the enterprise to acquire certain types of assets or businesses? For instance, certain pension fund investors may demand certain types of restrictions, such as businesses or investments that would give rise to UBTI.

1.3 ***Understand the Proposed Capitalization of the Enterprise.*** Key question include the following:

1.3.1 Is all of the capital in the form of cash, or is there other property? What agreements exist with respect to capital account credit for contributed property? How does property get physically transferred into the partnership.

1.3.2 Will there be passive investors in the transaction whose return on their investment will depend on the management skills of the managing group?

1.3.3 Are all of the participants in the enterprise investment the same or proportionate amounts of capital?

1.3.4 Are there any promoted interests - i.e., are any participants in the enterprise participating in the profits on some basis other than their relative contribution to the capital of the enterprise?

1.3.5 What liability do the participants have for future capital needs of the enterprise?

1.3.6 What is the effect of a failure to contribute? Dilution? Leveraged Dilution? Forfeiture issues?

1.3.7 Partner loans in lieu of additional capital?

1.3.8 Ability to admit new investors and provide special priorities and preferences to the new money.

1.4 ***Understand Overall Financial Structure.*** Key issues include:

1.4.1 Will the enterprise finance acquisitions and/or operations with secured debt?

1.4.2 If so, what are the anticipated parameters?

1.4.3 Will the debt drive or influence the venture – *e.g.*, CMBS lenders may require the use of a single member "bankruptcy remote" special purpose entity with extensive covenants and restrictions, and may require the appointment of

independent directors and "springing members."

1.5 ***Management Issues.*** Key questions include the following:

1.5.1 Who will manage the business of the enterprise?

1.5.2 Are there approval rights in favor of the non-managers with respect to certain business issues? If so, what are they? Consider especially non-routine matters such as the sale of all or substantially all of the assets of the enterprise, financing and refinancing transactions, borrowing money and pledging the credit of the enterprise (and perhaps the credit of the partners), prosecuting and defending lawsuits, major expenditures, deviations from an approved business plan, etc.

1.5.3 Are the managers entitled to reimbursement for expenses? Any limitations? Approvals required?

1.5.4 Are management issues impacted by DOL ERISA regulations on operating companies? E.G., ERISA plan asset rules which require ability of the plan investor substantially to influence management.

1.6 ***Restrictions on Participants and Special Covenants.*** Are there any special restrictions or special covenants required of the participants. These covenants can be particularly important in personal services companies and in enterprises that are engaged in an operating business. Key issues to consider:

1.6.1 For law and accounting partnerships, consider the need for covenants and/or restrictions with respect to compliance with insider trading policies and filing of individual tax returns.

1.6.2 Compliance with individual licensing and/or ethical requirements and maintenance of any licenses required for the conduct of the business of the enterprise (e.g., real estate brokerage licenses, liquor licenses, broker dealer licenses).

1.6.3 Covenants to devote full time or specified time to the business of the enterprise, including restrictions on ability to earn "outside" income.

1.6.4 Covenants not to compete.

1.6.5 Confidentiality covenants.

1.6.6 Restrictions and/or limitations on the ability of participants and their affiliates to do business with the enterprise and to charge for goods and services rendered.

1.7 ***Distributions of Cash Derived from the Enterprise.*** Discuss carefully with the

participants the agreement among the parties with respect to distributions of cash derived from the enterprise. ***Avoid confusing concepts of allocation of gain and loss with concepts of cash distributions.*** Allocations of gain and loss (often stated as allocation of profit and loss or income and loss) are accounting concepts that are important for both tax and book accounting purposes. Distributions of cash derived from the enterprise should reflect the basic business deal of the participants about how and when cash gets distributed, the priorities of distribution, and whether any participant or group of participants are entitled to preferences over other participants. The two concepts are obviously related, but the provisions for distribution of cash will ultimately drive the allocations of gain and loss. Key issues to consider and discuss with the participants include:

1.7.1 Are there to be any distinctions between cash derived from the operation of the enterprise (often referred to as cash flow from operations) and cash derived from the sale or other disposition of the assets of the enterprise (i.e., capital events)? If so, what are they?

1.7.2 Are there to be any distinctions in making distributions of cash flow from operations of specified segments of the business or capital events with respect to specified assets?

1.7.3 When does contributed capital get returned? Commonly, capital will be retained in operating business and personal services enterprises until the liquidation of the enterprise or the death, withdrawal, or retirement of the participant. In investment enterprises, however, it is common for the first distributions to be treated as returns of contributed capital to the participants that made the contributions.

1.7.4 Does capital get returned pro rata and *pari passu* to each contributor?

1.7.5 Does any contributed capital earn a preference? If so how much? When does it get paid?

1.7.5 How are preferences measured? Straight annual percentage yield? Are yields to be cumulative? Compounded? Are any preferences to be based on IRR calculations? How will the IRR be measured? Inflation adjusted vs. regular IRR calculations.

1.7.6 After all preferences have been provided for and funded, how is cash then distributed? Percentage Interests? In operating businesses, consider the treatment of fixed Income partners, non-equity partners, etc.

1.8 ***Allocations of Taxable Income and Loss.*** Probably the best way to avoid confusion in drafting those provisions of a partnership agreement or operating agreement relating to tax allocations, is to remember - and communicate to the participants - the fairly simple and straightforward notion that the tax allocations must reflect the actual economic effect of the enterprise on the participants. Or, in the lexicon of the tax lawyers, we can state it this way: The tax allocations

must have *substantial economic effect*. Thus, in drafting the agreement that governs the enterprise, the lawyers and the participants should understand that the tax provisions will be driven by the economics of the deal between the participants. Usually, the provisions are pretty straight forward and do not cause too much confusion or disagreement. However, we occasionally encounter the hated and often misunderstood *negative capital account make up* requirement. Keep in mind that negative capital account make up requirements are required only in those partnerships in which a participant may take the benefit of tax losses where, in the absence of such a make up requirement, the losses would never have an economic impact on the partner - a good example would be disproportionate allocations of depreciation losses in excess of the sum of the partners share of partnership liabilities, including qualified non-recourse deductions, and cash contributed or agreed to be contributed to the enterprise. These situations are pretty rarely encountered, and in most real estate investment partnerships, the use of a *minimum gain charge back* and *qualified income offset* provisions will assure that the tax allocations have (or be deemed to have) substantial economic effect. In fact, given the present at risk rules which limit the amount of losses that can be deducted by non-corporate taxpayers, it is quite unlikely that a partner could end up with a negative capital account balance. Additional key points for discussion with the participants include:

1.8.1 Will the enterprise be treated as a "Tax Shelter."

1.8.2 Are there any disproportionate allocations of items of income or loss anticipated?

1.8.3 Is the enterprise one that will be treated as a "Family Partnership" for tax purposes?

1.8.4 Are there any "promoted" partnership interests? Do any of the participants receive an interest in the enterprise in exchange for past or future services?

1.8.5 Will any of the assets of the enterprise include "Hot Assets."

1.9 ***Understanding Percentage Interests.*** It is fairly common for a client to offer this reassuring (or at least well intentioned) observation, "This is really a pretty simple 50/50 deal. We share all profits and losses equally, so it should be a pretty simple job to fill in one of your standard form LLC agreements." Well, maybe yes, maybe no. On further questioning, it often turns out that the participants are not putting equal amounts of capital, they have no intention of foregoing or deferring a return of their capital on at least a *pari passu* basis, the manager expects to get some sweat equity for his efforts, and the money partner expects to get a market rate of return on his money before the manager gets to participate. So, the 50/50 deal is really a last tier split of 50/50, after taking into account all the returns of capital, preferences, etc. Now, it should be clear that the deal is not so simple, and if the tax allocations are have substantial economic effect, then the allocations must reflect what is going on in the enterprise *economically*. The concept of *Percentage Interest* is just one factor in figuring out what is going on economically. In most complex transactions, particularly in the case of investment enterprises such as real estate LLCs and partnerships, *Percentage Interest* does not tell very much, except how the cash is to be distributed

at the last tier of the distribution waterfall. The same is true for tax allocations. Items of taxable income and loss are seldom capable of allocation strictly in accordance with *Percentage Interest*. Keep in mind that the tax allocations must reflect - and track - the actual economic effect of the enterprise on the participants.

1.10 ***Unwinds, Buy Outs, Buy/Sells, Transfer Restrictions.*** In operating businesses (other than personal services companies, perhaps) and investment partnerships and LLCs, the parties should give careful thought to how they will be able to separate in the event they later determine that they no longer want to be engaged in a joint enterprise. This is a difficult issue for some people to deal with, because it requires a negative (although constructive) view of the deal that the participants are all then so positive about. Key issues for consideration and discussion include:

1.10.1 Will there be any put or call options in favor of one of the participants? Timing? Conditions? Kick-in/Kick-out considerations.

1.10.2 Can any of the participants cause an unwinding of the enterprise? For instance, can one participant require the liquidation of all of the assets and the termination of the enterprise? Conditions? timing? Procedure?

1.10.3 Do the parties want to included Buy/Sell provisions? How will they work? Timing? Conditions? Lock-outs? Price? Valuation issues? Should appraisal parameters be spelled out (e.g., no lack of liquidity or minority interest discounts, valuation of the interest and valuation of the assets of the enterprise)? Earnest money requirements? Effect of third party restrictions (e.g., mortgagee due on sale clauses) and related issues of who bears the cost.

1.10.4 Effect on pending capital calls? Existing defaults by a partner?

1.10.5 Rights of first refusal? Drag along? Tag along?

1.10.6 Relationship between buy/sell provisions and other provisions, such as the distribution priorities and preferences?

1.10.7 Redemption rights in favor of the enterprise? How keyed? How is the redeemed interest reallocated?

1.11 ***Defaults and Dispute Resolution.*** Key issues to address:

1.11.1 What will constitute a default? Negligence standards?

1.11.2 Notice and cure rights. What about technical defaults that cannot by their nature be cured?

1.11.3 What about disputes and/or deadlocks that do not involve defaults?