NOTES BEARING INTEREST

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Protecting Real Estate Developers

Expect the Unexpected in Drafting LLC Operating Agreements

by Christopher E. Hannum & Stanton P. Geller

Do these words, which were commonly used when times were good for real estate developers, sound familiar?

- "Here is an operating agreement we used for another project. Let's just use this and change the names."

- "This is an operating agreement my buddy used. I want to use this form." or

- "I just want a simple agreement since this is a simple deal."

A basic, boilerplate operating agreement (or even no operating agreement) may be fine for your real estate developer client when the client and the client's family, projects, and business are healthy and prosperous. However, as the popular television commercial says, "life comes at you fast."

Consider the following (abbreviated) story, based on an actual case: Developer client ("Client") raised capital from investors to develop condo properties on the coast, each held in a separate limited liability company (LLC) controlled and owned in part by Client and Client's family. Each project also had 3rd party financing guaranteed by Client and some of Client's family members. Client's development company, which employed family members, earned management fees from each deal. Client lost his life in a tragic accident at a time when the projects were at various stages of development and the economy started its downturn. Without competent successor leadership and getting caught in an unfavorable real estate market, the projects stalled. Property values plummeted, creditors lost confidence, and investors were angry.

At a time when solid documentation was needed the most, operating agreements that should have protected the Client's family failed them in a number of critical areas.

1. Client's family lost all control over the projects;

2. Client's family lost all rights to participate in LLC member and management meetings, despite having the most knowledge about the projects and in some cases the most equity;

3. Operating agreements did not accurately reflect Client's equity stake;

4. Client's development company was immediately cut off from all revenue from the projects;

5. The fate of the projects (and Client's equity) became dependent upon disgruntled, inexperienced, previously uninvolved investors;

6. Operating agreements did not contain protective language that, along with other

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offering documents, could have helped shield Client's estate from securities laws claims; and

7. Client's family did not have "put" rights triggered upon death, or any other liquidity or exit options.

Many of these challenges could have been avoided with careful planning and comprehensive operating agreements. This article generally reviews the flexibility of an operating agreement and some of the issues and pitfalls to consider when crafting an operating agreement for developer clients.

Without a doubt, the tax and accounting terms and conditions of an operating agreement are critical in drafting operating agreements and preparing for the unexpected. However, in the authors' opinion, there are several outstanding articles that address tax and accounting pitfalls in preparing an operating agreement.[1] The authors have therefore focused on other hazards to be aware of when drafting an operating agreement.

Freedom of Contract

North Carolina provides tremendous freedom for members of an LLC to set the terms and conditions of owning, operating, and governing the LLC through a contract called an operating agreement. N.C.G.S. Section 57C-10-03(e) provides, "[e]xcept as otherwise provided in this Chapter, it is the policy of this Chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements." In fact, there are very few minimum requirements associated with LLCs under North Carolina law (*See* N.C.G.S. Section 57C 3 32 on restrictions on limiting or eliminating personal liability of a manager, director, or executive of an LLC).

The obvious benefit of this freedom of contract is the flexibility in drafting an operating agreement to suit your client's needs. You have the opportunity to draft an operating agreement for your client that meticulously addresses the issues and threats that your client could face as a member or manager of an LLC. Relying on outdated forms, generic forms, default statutes, and/or common law may have unintended and disastrous consequences.

Pre-drafting Planning

Know the Role of the Members and Managers. Discuss and understand the role of each member and manager and who ultimately drives the success of the operations. Generally in a real estate development deal, there are "know-how" developer member(s) and the investor member(s). Without question, the financial backing of a development deal is important; however, the developer member will be primarily responsible for the ultimate success or failure of the venture. Once it is clear who will be making the decisions that drive the success of the venture, you can draft provisions that give such persons the freedom and flexibility to make decisions without unreasonable impediments.

Management. The Operating Agreement should not only set forth current management responsibilities, but also set forth a succession plan to ensure seamless continuation of operations. It is imperative to "game out" the various scenarios.

i. Removal and Replacement of Managers. Carefully walk through the process of removing and/or replacing a manager under various circumstances, including the death or disability of a manager. If your client controls removal and replacement decisions, removing and replacing a manager should be a simple and clearly stated process that does not require unnecessary meetings, minority approval, or quorum requirements. Also consider the use of development entities to act as managers that can continue to act in the event that an individual principal is unable to serve the project.

If your client will manage but not control the LLC, consider restricting any removal of your client as manager to narrowly defined "cause" events, such as embezzlement or conviction of a crime involving the LLC. This can create a sense of stability for the project and ensure that management will remain in competent hands. It also protects against disgruntled investors who may lose confidence in your client or wish to take control of the project.

ii. Managers v. Members. Think carefully about dividing power among the managers and members. Again, knowing your client is critical. If your client controls the project, keep decisions requiring member approval to a minimum and make sure investor/passive members cannot easily remove and replace the manager. In addition, review the process of allowing an assignee to become a substitute member, since assignees generally do not have any voting power, and, therefore, cannot participate in voting for or against removing and replacing a manager. Not allowing an assignee to become a substitute member could be a backdoor method of keeping voting rights out of the hands of intended successors and assignees of members.

iii. Deadlocked Management. If management deadlock is a potential issue, think about creating a management committee with an uneven number of members to avoid deadlock. Obviously, you want your client to control a majority of the management committee members. Also, beware of automatically making members the managers of the LLC (a member-managed LLC). This could create unintended shifts in management power and create management deadlocks. It could also give passive members unintended management power.

Know the Securities Laws. If there will be outside investors not involved with the project, be careful to review and analyze state and federal securities laws. The definition of a "security" is broad and unsettled, especially when it comes to investing in real estate through an LLC. A discussion on securities law is beyond the scope of this article; however, know that an investor who purchases a security (assuming the interest is a security) may have civil remedies against the offeror of the security, including, without limitation, the right to rescind or undo the purchase and get his or her money back or recover damages. An investor's remedy may be in addition to state and/or federal criminal penalties (or worse).

Capital Contributions. If your operating agreement provides for mandatory capital contributions, review the following ques-

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- Notice provisions,
- Financing terms,
- Terms and conditions of a forfeited option,
- The time period to exercise and close on the option, and
- Purchase price and how the purchase price is determined.

Review the practical aspects of the time, cost, and difficulty of exercising and closing on a purchase option. Also review methods of dealing with an uncooperative offering member to help provide a seamless transition. In most cases, time is of the essence for real estate development, so a timely transition of membership interest can mean the difference between a profitable and non-profitable transaction.

Insurance. Purchase options do not help if you do not have the means to exercise them. Establishing and maintaining key-man insurance (life and disability) policies to fund certain purchase options may be the most important practical step to ensure that the parties actually close on the purchase. An important decision is determining if the members, LLC, or a combination thereof should own the insurance policy(ies). Insurance trusts can also be used in appropriate situations. There are various tax issues involved in establishing and holding key-man insurance policies, so consult a professional well versed in this area before drafting your operating agreement.

Transfer Restrictions. Many boilerplate transfer restrictions in operating agreements generally provide that no member can voluntarily or involuntarily transfer their membership interest without the written consent of all disinterested members. This blanket approach may have unintended results. For example, even the smallest membership interest holder could block or unduly delay a transfer of membership interest that would otherwise be beneficial to the LLC.

Identify situations where your client may want the freedom to transfer his or her membership interest without going through the approval process, such as a transfer to the member's estate or heir, a transfer to an affiliate company, or a gift to a family member or trust. For instance, many development companies are family run businesses with multiple generations owning and operating the development company. The success of the development company may depend on ownership and management of the company remaining in the family if the older generation is unable or unwilling to continue. Though estate planning issues and opportunities are outside the scope of this article, you should reconcile the ownership and management of the LLC with your client's estate plan. Also, consider drag-along rights, tag-along rights, and related concepts in drafting these provisions.

A comprehensive discussion of the interaction of bankruptcy law with transfer restrictions and purchase rights and obligations in an operating agreement is beyond the scope of this article; however, be mindful that bankruptcy and other insolvency laws may trump certain transfer restriction provisions. There are, however, drafting techniques that will put your operating agreement in a better position to be respected by a bankruptcy judge. For example, an operating agreement that is treated as an "executory contract"[2] under bankruptcy law may place the debtor/member's membership interest under Section 365 of the Bankruptcy Code (which gives the debtor the option of assuming or rejecting an executory contract) instead of Section 541 (which covers property of the estate). If an operating agreement could be an executory contract and the transfer restrictions could be held invalid under the "ipso facto" rules of Section 365 of the Bankruptcy Code, review the personal services exception and determine if you can draft the operating agreement in order to fall under this exception. If you are not an expert in this area, it is naturally advisable to bring in co-counsel to advise on such matters.

Assignee v. Substitute Members. North Carolina statutes generally provide that an assignee of a membership interest may become a member by meeting the requirements provided in the articles of incorporation or operating agreement. (*See* N.C.G.S. 57C-5-04). Furthermore, the North Carolina statutes generally provide that an assignment entitles the assignee to receive, to the extent assigned, only the distributions and allocations to which the assignor would be entitled but for the assignment. (*See* N.C.G.S. 57C-5-02). Assignees generally only have basic economic rights and, therefore, do not have voting, management, or other important member rights; therefore, it is important to review the process how an assignee becomes a substitute member.

Frequently, in an attempt to thwart any judgment creditors[3] or other unwanted persons from obtaining voting or management powers, operating agreements contain numerous hoops that an assignee must jump through before becoming a substitute member. This strategy can backfire. Be aware that there are situations where your clients will be best served if an assignee automatically becomes a substitute member. For instance, in the scenario above, the estate was blocked from becoming a substitute member by other investors, even though family members had the expertise to run the development company. The estate may have had a winning equitable argument in court to achieve substitute member status, but the cost could be years of expensive litigation.

Defining "Net Cash Flow"

Generally, members of an LLC receive distributions of net cash flow. Though basic accounting rules dictate how this "net cash flow" is defined, the managers often play a significant role in determining this amount. Carefully review the powers that the managers have in controlling of net cash flow, such as control over expenses, setting reserves, and accelerating loan payments.

Exit Strategy

Contrary to the popular saying, failure is an option. So what happens if the business is failing or being mismanaged, or members cannot agree in which direction the business should go? What is your client's exit strategy? One strategy may be to give certain members put rights to the LLC. Another strategy may be to provide purchase obligations upon certain triggering events. Review key issues, such as valuation of membership interests and funding put rights and purchase obligations. The right exit strategy can turn out to be a lifeline that your client will desperately need.

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tions:

- Who may make capital calls? May your client access additional capital from the investors if circumstances warrant? If not, may your client secure outside financing without member approval?;

- How are capital calls enforced? What remedies are available to the LLC and other members for failure to make capital contributions? Consider dilution, "squeeze down," loan, and other equitable structures to deal with members who fail to contribute; and

- What the contingency plan is if members do not contribute enough capital? Again, may your client loan funds to the LLC? May your client secure outside financing? May additional LLC units be issued to secure financing?

If your operating agreement has a "squeeze down" provision (other contributing members dilute non-contributing members), you may want to incorporate a member power-of-attorney to help facilitate the consummation of the squeeze down.

Loan Documents and Guarantees. For a real estate development, outside financing is typically guaranteed by some or all of the members. The operating agreement should have a clear course of action if the LLC cannot make loan payments, a lender forecloses against the LLC, or a lender enforces personal guarantees of members. You may also want to have cross-reimbursement obligations in the event some members become liable for guarantees in excess of their proportionate share. This economy has made it painfully clear that some personal guarantees have value while others do not.

In addition, determine whether any spouses of members have made personal guarantees. Obviously, it is best to keep personal guarantees to members. There are various planning strategies and legal protections available to preserve and protect marital estates. For example, in North Carolina, tenancy by the entirety real property is generally subject only to the joint creditors of the couple and not the sole creditors of one spouse.

Contingency Plans. There should be a contingency plan if certain members or managers cannot fulfill their duties and responsibilities. As drafters of operating agreements, we have the opportunity to craft a flexible agreement that covers unexpected events.

An important test of the adequacy of your operating agreement is to actually play out events, such as the death of a key member, and carefully review whether your operating agreement sufficiently addresses these situations. You may have to step in the shoes of an estate or heir to the deceased member and ask some of the following questions:

- Is a purchase right or obligation triggered?

- If so, what are the mechanics of the purchase right or obligation?

- Does the LLC have key-man insurance to fund any purchase rights or obligations?

- Will the estate or heir maintain control over the LLC? What happens to voting rights and management participation rights?

- Who will take over the management of the LLC?

Purpose of the LLC. Frequently, real estate developers will own investment property along with property they are developing (inventory). The importance of the distinction is that gain on inventory is taxed at ordinary income rates (currently the top federal marginal rate for individuals is 35%) and long-term capital gain (held for more that one year) is taxed at capital gains rates (currently the top federal marginal rate for individuals is 15%). Though there is case law that provides that LLCs can own real estate as inventory and investment property, combining the two in one LLC is generally not a good idea.

One way of documenting a separation of investor and developer activities is to clearly distinguish the two in the purposes and powers section of the operating agreement. For instance, when drafting an operating agreement for an investment company, be sure to limit the purposes of the LLC to those involving investing in real estate. Though actions speak louder than words, your well-drafted operating agreement will put your clients in a better position to distinguish gains from inventory and investments if they are ever in question with the IRS or the North Carolina Department of Revenue.

Transfers of Membership Interests

Options to Purchase Membership Interest. What happens if the developer member's membership interest is involuntarily transferred, whether due to death, disability, divorce, or otherwise? What happens if a manager, who is also a member, is removed? Many operating agreements provide members an option to purchase another member's membership interest upon certain triggering events, such as the death, disability, divorce, or termination of employment of a member. However, your developer client may or may not want such events to trigger a purchase option. The purchase option could backfire and allow other members to buy out your client's membership interest at your client's (or client's heirs') great surprise and dismay. In certain cases, on the other hand, your client may want a mandatory purchase obligation that requires the LLC and/or remaining members to buy out a member or his successors in certain situations. Again, knowing the intentions and desires of your client is critical.

The actual mechanics of exercising a purchase option are frequently provided in overly general language, which creates confusion and uncertainty. An operating agreement should provide at the very least the following information for a purchase option:

- The person or persons who has the option,

- Events that trigger the option,

- The amount or proportion of membership interest subject to the option,

- Whether the option is "all or nothing,"

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Respect the Operating Agreement

This concept seems basic, but it is amazing how many times no one can find an operating agreement and/or signature pages to an operating agreement, or tax returns are prepared in direct contradiction to the operating agreement. If you want creditors, investors, lawyers, judges, and the IRS to respect your clients' operating agreement, your clients must respect it. Create a checklist for drafting an operating agreement, make sure everyone appropriately executes it, keep hard and electronic copies of all organizational and governing documents, and respect their terms. Also, your clients should be well advised regarding required meetings, notice requirements, voting, and other formalities required under their operating agreement.

Conclusion

As lawyers, we cannot control such matters as the death, disability, or incompetence of our clients, or the ebb and flow of the economy and real estate market; however, we can control to some degree the legal and business consequences of extraordinary events. You will serve your clients and their families well by taking the time to walk through the potential pitfalls associated with real estate development and advising your clients on how to address those issues in their operating agreements. ■

End Notes

1. Kean, Warren P., "Common Mistakes and Oversights When Drafting and Reviewing LLC Operating Agreements." Journal of Passthrough Entities. January-February 2008: 23-48.

2. "Executory contract" is undefined under bankruptcy law but generally means a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other. (Countryman, Executory License Agreements in Bankruptcy, 57 Minn. L. Rev. 439, 446 (1973).)

3. *See* N.C.G.S.A. § 57C-5-03 (Judgment creditors have only the power to charge the membership interest of a member with payment of the unsatisfied amount of the judgment with interest, and to the extent so charged, the judgment creditor has only the rights of an assignee of the membership interest).

Christopher E. Hannum is a partner and Stanton P. Geller is an associate at the law firm of Culp Elliott & Carpenter, P.L.L.C. in Charlotte, North Carolina.