

# LLC Agreements for Real Estate LLCs - How to Address Five Key Business Organization Law Issues

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Published on [www.lorman.com](http://www.lorman.com) - July 2019

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## **LLC Agreements for Real Estate LLCs – How to Address Five Key Business Organization Law Issues**

### **A. Dissociation events and buy-sell provisions (which should be combined in the same LLC agreement provision)**

- 1) Events of dissociation of LLC members are events, such as deaths, whose occurrence terminate a member's membership.
- 2) LLC agreements need comprehensive and properly tailored provisions for dissociation events in order to establish who is and isn't a member of the relevant LLC at any given times. Many LLC members and managers are careless in documenting changes in the membership of their LLCs.
- 3) Because of the very close relationship between dissociation events and LLC redemptions and cross-purchases of dissociated members, provisions in LLC agreements for dissociation should often be combined with provisions specifying the effects of each listed event of dissociation on the dissociated member, the remaining members and the LLC—e.g., whether each event of dissociation will trigger a redemption or a cross-purchase, and on what price terms and non-price terms (such as closing terms, installment terms, interest terms and terms addressing breaches).

- 4) However, the above issues are in separate sections in Form 6.2 to illustrate a potential array of redemption and cross-purchase terms and because, in particular deals, these terms are likely to need substantial customization.

**B. Fiduciary provisions—in general; their importance; their frequent neglect**

- 1) The fiduciary terms in an LLC agreement set forth the ethical rules governing the members and managers and the “team spirit” of the LLC. In my experience, they are significantly or entirely neglected both in multi-member LLC operating agreements and in the statutes governing them.

**C. Duty of care**

- 1) There are, of course, two main types of fiduciary duties—namely, the duty of care and the duty of loyalty.
- 2) The main duty of care issue is the standard of care. The main standards are ordinary prudence and avoidance of gross negligence.
- 3) However, in many multi-member LLCs, the standard should be competence (properly defined).

**D. Duty of loyalty (with particular attention to non-compete provisions)**

- 1) The duty of loyalty is, with respect to the business and internal affairs of the LLC, to the duty to put the best

- interests of the LLC first and one's own interests second (or at least not in conflict with the best interests of the LLC.)
- 2) The duty of loyalty is intrinsically and unavoidably complex; by its very nature, it includes seven subsidiary duties. Let's look quick at the duty of loyalty provisions in Form 6.2.
  - 3) The Delaware Act permits the complete elimination of fiduciary duties, and managers and majority members may want this elimination.
  - 4) In many real property LLC deals, some or all of the members may want the LLC agreement to permit some or all members to compete against the LLC by investing in competitive real property deals if opportunity arises to do so. But this will raise serious "corporate opportunity" issues.

## **E. Dispute resolution**

- 1) If an LLC agreement is silent about the method by which the members and managers must resolve disputes among themselves and the location where they must do so, these matters will be determined by state law and thus will normally require resolution by litigation in a court of competent jurisdiction under state or federal rules of civil procedure in the relevant jurisdiction (although the statutory law of some states—e.g., New Hampshire—requires mediation or arbitration before litigation).
- 2) The main advantages of arbitration as an LLC's dispute resolution method is that the resolution process will be

confidential and that the parties will have considerable flexibility in determining the location of the arbitration and the rules governing it.

3) However:

- a) Whether the arbitrator will be as competent and impartial as a judge may be a major issue for one or both parties.
- b) Arbitration is often just as expensive as litigation and often more expensive.
- c) Parties who lose litigation will usually have the option of appeal. Under the federal arbitration act, they almost always will not.

4) For many years, I recommended that my LLC formation clients agree in their LLC agreement:

- a) To use their best efforts to resolve their disputes voluntarily and to agree that if a party failed to do so, this would be a significant factor in any related mediation, arbitration or litigation arbitration;
- b) That if they could not resolve their dispute voluntarily, they must seek to resolve it in mediation; but, if mediation failed,
- c) They must resolve it in arbitration.

5) However, New Hampshire has a court whose sole function is to resolve business disputes, the judge in that court is

excellent, and cases in it are generally able to be resolved quickly and fairly. Thus, I am now often recommending to New Hampshire LLC formation clients to provide in their operating agreements for best efforts at voluntary resolution; mediation if voluntarily resolution won't work; and litigation in the New Hampshire business court if mediation fails.

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