LINER LLP

STRUCTURING WATERFALL PROVISIONS IN LLC AND PARTNERSHIP AGREEMENTS

January 26, 2016

LINER LLP

Unless otherwise determined by the Manager, all Available Cash shall be distributed to the Members on the first day of each Fiscal Quarter in accordance with the following:

1. First, to the Members holding Class A Units, pro rata in proportion to the amount of any Accrued 5% Preferred Return as of such date in respect of each such Unit as of the date of distribution, until the Accrued 5% Preferred Return of each Class A Unit is reduced to zero;
2. Second, to the Members holding Class A Units and Class B Units, pro rata in proportion to the Unreturned Capital of each such Unit, until the Unreturned Capital of each such Unit is reduced to zero;
3. Third, 80% to Members pro rata in proportion to the number of Class A Units and Class B Units held by each Member and 20% to the Members pro rata in proportion to the number of Class C Units held by each Member until a 20% IRR has first been achieved with respect to the A Units; and
4. Thereafter, 70% to the Members pro rata in proportion to the number of Class A Units and Class B Units held by each and 30% to the Members pro rata in proportion to the number of Class C Units held by each.

Overview

I. Waterfall Provisions Generally

II. Determining and Drafting Waterfalls

III. Specific Waterfall Considerations

IV. Coordinating Tax with Waterfalls

V. Q & A

LINER LLP

I. Waterfall Provisions Generally

A. Provide for distribution of money and property from the entity to the owners

B. Specify when distributions can be made or must be made

C. Describe the relative priorities of the owners to distributions

D. Usually are of the most important business consideration for the owners

E. Same issues for partnerships and limited liability companies

II. Determining and Drafting Waterfalls

A. Relative economic rights of the owners
B. Relative control rights of the owners over distributions
C. Tax considerations
D. Drafting

II. Determining and Drafting Waterfalls

A. Relative Economic Rights of Owners

1. More flexibility in partnerships and LLCs than in corporations
2. Identify owner goals:
   a. Do owners share in all distributions equally?
   b. Do some owners have priorities over others?
   c. Is there an accruing preferred return or IRR?
   d. Should sharing change as economic goals are met?
   e. Does the type of distribution matter?
      - Cash flow, capital events, liquidation, tax, in-kind

II. Determining and Drafting Waterfalls

B. Relative Control Rights of Owners

1. When do owners expect distributions?
   a. Specific times – Quarterly, Annually, Estimated Taxes
   b. Specific events – Capital Events, Receipt of Cash
2. Will certain owners or managers have control over the timing of distributions?
3. Will certain owners or managers have control over the amount of distributions?
4. Are there preconditions to making distributions?
   - Repayment of debt, payment of fees, reserves, etc.

LINER LLP

II. Determining and Drafting Waterfalls

C. Tax Considerations

1. Allocating tax items consistently with the economic arrangements
2. Addressing potential taxable "capital shifts"
3. "Tax distributions" to allow owners to pay taxes associated with allocations of tax items
4. Should tax allocations drive economics or vice versa?

II. Determining and Drafting Waterfalls

D. Drafting

1. Provisions should address
   a. when distributions are made
   b. allocation of distributions among owners
   c. form of distributions (cash v. other property)
2. Provisions should only address distributions, <u>not</u> payments of fees, liabilities, etc.
   a. Obligations to make payments before distributions should instead be conditions to distributions
   b. Priorities of other payments can be separately stated

II. Determining and Drafting Waterfalls

D. Drafting (Cont.)

3. Ensure a provision addresses every possibility
    a. Avoid orphaned money
    b. Which "waterfall" has the "catch-all" rules?
4. Make sure tag-along, drag-along, change of control provisions are consistent with waterfall
    a. Different interests have different relative values
    b. Remember that interests will remain outstanding after sales of equity (v. sale of assets by entity)
    c. Allocate proceeds in accordance with liquidation values or waterfall?

II. Determining and Drafting Waterfalls

D. Drafting (Cont.)

Allocation of Proceeds Example

A, *B*, and *C* are members of *ABC*. The distribution waterfall says that *A* and *B* split the first $100 50-50, and any additional distributions go 40-40-20. 50% of the company is sold for $100 to the buyer, *D*, implying a value of $200 for the entire company. Each of *A*, *B*, and *C* sells 50% of its interest in the company to *D*.

➢ After the sale, distributions will go as follows:

- *A*, *B*, and *D* will split the first $100 25-25-50
- Thereafter *A*, *B*, *C* and *D* split 20-20-10-50

LINER LLP

II. Determining and Drafting Waterfalls

D. Drafting (Cont.)

Allocation of Proceeds Example

- Prior to sale, if the company is worth $200, the equity values of *A*, *B*, and *C* are as follows:

Member	Step 1	Step 2	Total
A	$50	$40	$90
B	$50	$40	$90
C	$0	$20	$20
Total	$100	$100	$200

- After the sale, distributions will go as follows:
  - *A*, *B*, and *D* will split the first $100 25-25-50
  - Thereafter *A*, *B*, *C* and *D* split 20-20-10-50

LINER LLP

II. Determining and Drafting Waterfalls

D. Drafting (Cont.)

Allocation of Proceeds Example

A. If $100 of proceeds is allocated by the waterfall, the results will be as follows:

Member	Sale Proceeds	Equity Value	Total
A	$50	$45	$95
B	$50	$45	$95
C	$0	$10	$10
D	($100)	$100	$0
Total	$0	$200	$200

LINER LLP

II. Determining and Drafting Waterfalls

D. Drafting (Cont.)

Allocation of Proceeds Example

A. If $100 of proceeds is allocated via liquidation values, the results will be as follows:

Member	Sale Proceeds	Equity Value	Total
A	$45	$45	$90
B	$45	$45	$90
C	$10	$10	$20
D	($100)	$100	$0
Total	$0	$200	$200

III. Specific Waterfall Considerations

A. Priority Returns

B. Carried Interests/Promotes

C. Different Waterfalls for Different Situations

D. Profits Interests

E. Tax Distributions

F. Liquidation Provisions

G. Effect of Capital Contributions

H. In-Kind Distributions

I. Capital Shifts

LINER LLP

III. Specific Waterfall Considerations

A. Priority Returns

1. Similar to preferred stock in corporations
2. Certain owners receive distributions before others
   a. Invested capital
   b. Return on investment
      i. Absolute returns
      ii. Time-value returns
         A. Preferred return
         B. Internal rate of return (IRR)
            - What if you cross an IRR once, but then fall below?

LINER LLP

III. Specific Waterfall Considerations

A. Priority Returns (Cont.)

3. Drafting Considerations
   a. Compounding convention for preferred return
   b. Describing IRR calculation
      i. Formulas
      ii. Excel Functions
      ➢ If you use both, <u>make sure they work the same</u>
   c. Try examples and compare to language in agreement and owners' expectations
   d. Schedule or Appendix of examples

LINER LLP

III. Specific Waterfall Considerations

B. Carried Interests/Promotes

1. Certain owners' (usually "sweat equity") shares of distributions increase as incentive
   a. Based on return to investors
   b. Based on performance targets
2. Multiple levels of increase
3. "Catch-ups" for priority returns of investors
4. Based on overall returns ("crossed") or investment-by-investment
   - Clawback obligations

LINER LLP

III. Specific Waterfall Considerations

B. Carried Interests/Promotes (Cont.)

5. Aggregate Basis
   a. All investors share in each distribution level pro rata
   b. Typical in real estate and operating companies
6. Investor-by-Investor Basis
   a. Proceeds divided among investors first (usually based on commitments or ownership percentages)
   b. Separate carried interest calculated for each investor
   c. Typical in private equity funds
   d. Can more easily charge investors different fees/costs

III. Specific Waterfall Considerations

B. Carried Interests/Promotes (Cont.)

Aggregate Basis Example

A and *B* each contributed $100 to the company. Investors get a 20% Preferred Return. *C* gets 20% carried interest. The Company makes a $400 distribution.

Waterfall Step	Member A	Member B	Member C
Return of Capital	$100	$100	$0
Preferred Return	$20	$20	$0
80-20 Carry	$64	$64	$32
Total	$184	$184	$32

LINER LLP

III. Specific Waterfall Considerations

B. Carried Interests/Promotes (Cont.)

Investor-By-Investor Example

A and *B* each contributed $100 to the company. *A* has 20% preferred return, *B* has 10%. *C* gets 20% carried interest.

Waterfall Step	Member A		Member B	
% of Contribution	50%		50%	
Distribution Share	$200		$200	
Member	A	C	B	C
Return of Capital	$100	$0	$100	$0
Preferred Return	$20	$0	$10	$0
80-20 Carry	$64	$16	$72	$18
Total	$184	$16	$182	$18

III. Specific Waterfall Considerations

C. Different Waterfalls for Different Situations

1. Common situations with separately-stated waterfalls
   a. Current cash flow
   b. Capital events
   c. Liquidation
2. Be careful that there is no overlap in the trigger events for different situations
3. If distributions in one waterfall are affected by distributions made under other waterfalls, make sure provisions are carefully coordinated
4. Remember a catch-all (no orphaned money)

III. Specific Waterfall Considerations

D. Profits Interests

1. Equity incentive compensation
   a. Not taxable when received
   b. Can generally qualify for favorable long-term capital gains treatment on sale
2. Waterfalls must generally provide that profits interests only share in gains and profits of the entity
3. Can be subordinated for all distributions
4. Can share in distributions of current profits and subordinated only on liquidation
5. Remember tax distributions

LINER LLP

<u>III. Specific Waterfall Considerations</u>

E. Tax Distributions

1. Typically pass-through entities for tax purposes, so owners (not the entity) pay taxes on entity's income
2. Tax is imposed on owners for entity's income, <u>even if there are no distributions</u> (phantom income/dry income)
3. Should entity cover taxes attributable to its activities (like C corporations), or should owners cover?
4. Tax distributions are intended to cover owners' tax liabilities if the entity does not otherwise make distributions
5. No tax distributions similar to mandatory capital contribution obligation

LINER LLP

III. Specific Waterfall Considerations

E. Tax Distributions (Cont.)

6. Special considerations
   a. Mandatory v. if cash available v. discretionary
   b. Assumed tax liability v. actual tax liability v. pro rata
   c. Applicable tax rate
   d. Annual or quarterly (estimated taxes)
   e. Timing (corporate v. individual payment deadlines)
   f. Offset against other distributions
   g. Measured by cumulative or annual distributions
   h. Priority where insufficient funds

III. Specific Waterfall Considerations

F. Liquidation Provisions

1. Specifically address how assets are distributed in liquidation
2. Can be the same as normal waterfall (or any other specific waterfall) or unique
3. Can be in accordance with capital accounts
    a. The old way
    b. Usually not how business people think about economics
    c. Makes tax allocations extraordinarily important

III. Specific Waterfall Considerations

G. Effect of Capital Contributions

1. When drafting, consider whether capital contributions by owners will affect future distributions (returns of capital, returns on investments) as intended
   a. Should they affect share of profits
   b. Should they affect priority returns
2. Will contributions result in a “capital shift” (discussed later)?

LINER LLP

III. Specific Waterfall Considerations

H. In-Kind Distributions

1. Entity distributes property instead of cash
2. Property is typically not as fungible as cash, so it matters what property you get
3. Are in-kind distributions prohibited?
4. Do certain owners have the right to choose what property is distributed to whom?
5. Do all owners share equally in each form of property?
   a. Distributions of undivided interests in property
   b. Often unwieldy to manage after distribution

III. Specific Waterfall Considerations

H. In-Kind Distributions (Cont.)

6. Special Situations
   a. Crown Jewels
   b. Contributed Assets
7. Does an owner want a first right to asset on liquidation?
   - Consider right to distribution of asset with obligation to contribute value in excess of liquidation rights
8. Valuations
   a. Fair market value
   b. Formulaic value

LINER LLP

III. Specific Waterfall Considerations

H. In-Kind Distributions (Cont.)

9. Tax issues
   a. Basis issues
   b. Built-in gain on contributed assets ("mixing bowls")
   c. Difference between real value and ascribed value

III. Specific Waterfall Considerations

I. Capital Shifts

1. What is a capital shift?
2. Example

   A and *B* are partners of *AB*. All distributions are 50-50. *A* contributes $100, *B* contributes $0. If *AB* is liquidated, *A* and *B* would each get $50. So, $50 of capital has been “shifted” from *A* to *B*.

3. Where the owner to whom the capital is shifted performs services for the entity or other owners, it is typically taxable as ordinary income on the amount of the shifted capital
4. Tax treatment not always clear where no services

LINER LLP

III. Specific Waterfall Considerations

I. Capital Shifts (Cont.)

5. Capital shifts can usually be avoided if invested capital has a priority in the liquidation waterfall
   - In Example, *A* would get $100 back, so no shift to *B*
6. Parties should be especially careful when drafting liquidation provisions when services are involved

LINER LLP

IV. Coordinating Tax with Waterfalls

A. Economic Importance of Allocations

B. Initial Capital Accounts

C. “Layer-Cake” Allocations

D. “Target” Allocations

E. Gross v. Net Allocations

IV. Coordinating Tax with Waterfalls

A. Economic Importance of Allocations

1. Allocations determine the tax liabilities of the owners
   a. Deductible losses
   b. Phantom income/dry income
   c. Character of income (long-term capital gain, short-term capital gain, dividend income, ordinary income)
2. If you liquidate in accordance with capital accounts, they affect economic rights of the owners to assets of the company

LINER LLP

IV. Coordinating Tax with Waterfalls

B. Initial Capital Accounts

1. Affect allocations and, potentially, distributions
   - ➢ Liquidations in accordance with capital accounts
2. Easy when all owners contribute cash – equals cash contributed
3. More difficult with property contributions – must value property
4. Waterfall provisions often imply values of properties.
5. Be careful of capital shifts
   - ➢ Value of contribution does not equal capital account

LINER LLP

IV. Coordinating Tax with Waterfalls

C. "Layer-Cake" Allocations

1. Sets forth a specific order for allocating profits and losses among owners
   - Similar to distribution waterfall
2. Generally used when liquidations are in accordance with capital accounts
   - This means the allocations determine the economics
3. Special allocations of items more likely to be respected
4. Be very careful when preferred returns accrue
   - Typical approach of reversing prior profit and loss allocations may not be what is intended

IV. Coordinating Tax with Waterfalls

C. “Layer-Cake” Allocations (Cont.)

5. If you get unusual allocations, the liquidation rights might not be what the owners intended

   - Consider a “target” allocation for year of liquidation and, if it is before the filing of the prior year return, the prior year

LINER LLP

IV. Coordinating Tax with Waterfalls

D. "Target" Allocations

1. Allocations made match capital accounts to a "target"
2. Normally used when liquidation is pursuant to a waterfall rather than in accordance with capital accounts
3. Typically made to target the liquidation waterfall
    a. Does not satisfy "substantial economic effect" safe harbor
    b. Relies on "partners' interests in the partnership"
4. Can target waterfalls or items other than liquidation
    a. Need to make sure liquidation in accordance with capital accounts

IV. Coordinating Tax with Waterfalls

D. "Target" Allocations (Cont.)

5. Can be coupled to some extent with special allocations
   - More risk of special allocations being disregarded than with layer-cake approach

IV. Coordinating Tax with Waterfalls

E. Gross v. Net Allocations

1. Gross allocations
   a. Allocate gross profits separately from gross losses
   b. Can result in some owners being allocated profits and other owners being allocated losses in the same year
   c. Can result in some owners being allocated profits even if the company has net losses and vice versa
   d. Easier to get capital accounts to intended levels
   e. Easier to make special allocations

LINER LLP

IV. Coordinating Tax with Waterfalls

E. Gross v. Net Allocations (Cont.)

2. Net allocations

   a. Allocate only net profits or net losses

   b. More likely to result in capital accounts that do not match intended levels

   c. More difficult to make special allocations

LINER LLP

V. Q & A

Q: Didn't we already cover everything?

V. Q & A

A: No way.

LINER LLP

Liner's Practice

LINER is a leading L.A. law firm serving multinational, national, middle market, emerging growth, and individual clients in four core areas: business litigation, entertainment and media litigation, corporate transactional, and real estate. We are recognized for our business-partner approach to client relations, our extensive legal practice and industry experience, and political acumen. In less than two decades, LINER has transformed itself from a visionary start-up to a thriving practice of over 75 attorneys providing sophisticated, integrated legal and advisory services. Our exponential growth is due in no small measure to a founding principle that underscores every transaction and trial in our care: that client partnerships predicate best legal practices.

Liner's Culture

In a nutshell, it's personal.

LINER lawyers share the belief that establishing and sustaining long-term business and personal relationships with clients is fundamental to successful practice. This philosophy engenders a unique sensitivity to the objectives and exigencies of our clients so that, by staying current with changes in the law and the markets that affect their business interests, we can provide counsel that identifies, addresses and anticipates their needs. Fee flexibility proves our commitment; LINER institutionally offers innovative pricing models to meet the requirements of specific engagements. This means we seek to structure billing to fit context, share risk, maximize partner involvement, and ensure meaningful legal solutions. LINER lawyers choose to join the firm for this innovative business focus that allows freedom from the constraints typically associated with conventional law firms.

We are an unconventionally entrepreneurial law practice.

direct: 310.500.3449
abeyzaee@linerlaw.com

Afshin Beyzaee is a partner and head of Liner's Tax practice. He is also a member of the firm's Corporate department. His clients include publicly traded and privately held corporations, partnerships, limited liability companies, business trusts, S corporations, private equity and real estate funds, financial institutions, and trade associations. A graduate of Harvard Law School, Afshin provides clients advice in a variety of tax and transactional planning matters, including structuring taxable and tax-free mergers and acquisitions, business reorganizations, forming limited liability companies, partnerships and other joint ventures, real estate transactions, restructuring troubled companies and investments, and issuances of debt, equity, hybrid, and derivative securities. Clients regularly look to him to find creative solutions when they run into structural roadblocks to implementing business deals they have negotiated.

direct: 310.500.3416
mkiely@linerlaw.com

Michael J. Kiely Michael J. Kiely is a partner in Liner's Real Estate department. His legal practice spans all areas of real estate, including finance, development, and land use. He has extensive experience representing developers, sellers and buyers, investors and promoters, lenders, and real estate joint ventures, in complex real estate development projects. He has negotiated dozens of limited liability company and other joint venture agreements for real estate assets, development projects, hotels, casinos, ski resorts, restaurants and other operating businesses. Michael's practice has a particular emphasis on projects involving the intersection of private real estate development and government, including land use, affordable housing, public-private partnership (P3) development, New Markets Tax Credits, and Mello Roos and other land secured public finance mechanisms. A graduate of UCLA Law, Michael has over 25 years of experience in the real estate field in which he has earned a reputation for being able to pull together the multiple parties, competing government policies, conflicting sets of regulations, and different risk profiles that are inherent in large, complex development projects.