

MEMORANDUM

To: Peter Mahler
Date: June 6, 2016
From: John Cunningham
Subject: Deadlocks—questions and answers

- 1) Question No. 1—How important is the “deadlock issue” in LLC formation practice?
You recently wrote an article for a group of estate planners who also handle LLC formations on how to draft LLC operating agreements to handle deadlocks among LLC members, and you address this issue in some detail in *Drafting Limited Liability Company Operating Agreements*, your Wolters Kluwer LLC book. What do you see as the importance of this issue among the dozens of issues that should be addressed in the operating agreements of multi-member LLCs?
- 2) Answer to Question No. 1.
 - a) The short answer is: Very important. Many LLCs you form for multi-member LLCs are probably going to be multi-member LLCs with two members; many of these two-member LLCs will have two *equal* members; and for many—perhaps most—of these LLCs with two equal members, the key issue in the operating agreement you write for them will be deadlock. But first some background:
 - b) My focus in answering this question—multi-member LLCs with two equal members. In answering your question, I’ll focus only on deadlocks among the members of multi-member LLCs with two equal members, since, although there can of course be deadlocks among the members of LLCs with three or more members—e.g., in any multi-member LLC with an even number of members or in which members have vetoes—these deadlocks often involve very different considerations than two-member deadlocks..
 - c) There are very large numbers of multi-member LLCs with two equal members. There are presently at least 10 million active U.S. LLCs. IRS filing statistics suggest that about 75% of all LLCs have only a single member and that about 20% consist of two-member LLCs. Only about 5% have three or more members. Finally, my experience and, I think, common sense suggest that a very substantial portion of two-member LLCs have two *equal* members—i.e., each member is entitled to an equal share of LLC profits and one vote on every LLC matter. In these LLCs, the risk of deadlock is, by definition, pervasive.
 - d) Even in multi-member LLCs with two equal members who start out as friends, serious LLC disputes are common. Furthermore, on the basis of my 20 years’ experience as an LLC lawyer, it is clear to me that even among the most reasonable and fair-minded members of an LLC with two equal members, and even if, when they form their LLC, these members are good friends, serious disputes between them about important LLC matters are almost inevitable; and

- the longer the members do business together in their LLC, the greater the risk of these disputes. As the saying goes, “business is hard on friendship.”
- e) Deadlocks between the members of multi-member LLCs with two equal members have destroyed many of these LLCs. Finally, I know from much professional experience that these disputes have destroyed many two-members LLCs that would otherwise have had great success. And of course they’ve ruined forever the friendships of the disputants.
 - f) Deadlock is the most important issue in multi-member LLCs with two equal members. Thus, assuming (as is often the case) that in forming LLCs that will have two equal members, you are representing both members jointly, the issue of possible deadlock between the members is, as I’ve stated above, the single most important issue you need to address in the LLC’s operating agreement.
- 3) Question No. 2—How, in general, should you address deadlocks with clients forming multi-member LLCs with two equal members?.
- a) Teach your clients about deadlocks and their destructiveness. To address it effectively, you obviously must first of all to point it out in vivid terms to the members, and perhaps mention a lurid story or two, based, ideally, on your own practice experience, of two-equal-member LLCs in which member disputes have destroyed LLCs.
 - b) Identify all reasonably foreseeable disputes.
 - i) In addition, however, you have to grill the members to ascertain, to the extent possible, all of the actual disputes that might eventually arise between them in the specific circumstances they envision for their LLC. These disputes may vary greatly from one two-member LLC to another. But your question, and the effort of the members to answer it, will by itself help the members to appreciate the reality and the importance of the issue.
 - ii) One of the most common such disputes may involve situations in which a third party offers to buy the LLC or to make an investment in it on terms that the first member wants to accept and the second wants to reject.
- 4) Question No. 3. What types of specific provisions do you suggest in the operating agreements of LLCs with two equal members?
- a) Dispute resolution provisions.
 - i) Every operating agreement for a multi-member LLC, regardless of the number of its members, should contain what are perhaps best described as “general” dispute resolution provisions. These should often consist of a mediation provision and a provision for arbitration if mediation fails. The arbitration provisions should generally provide for arbitration by a single arbitrator under generally accepted arbitration provisions such as the Commercial Arbitration Rules of the American Arbitration Association.
 - ii) They should also contain, among many other additional provisions, those governing the choice of the arbitrator, the site of the arbitration, the definition of arbitrable matters, and, in my view, a “loser pays” provision.

- b) Texas shoot-out provisions.
 - i) However, unless the members prefer otherwise, the operating agreements of multi-member LLCs with two equal members should often contain, in addition, a “Texas shoot-out” provision. Under this provision, if the members disagree about an important LLC matter and can’t resolve the disagreement voluntarily, then either may make an offer to buy out the other; and the other must either accept this offer or buy out the first member on the same terms.
 - ii) Since the first member will know that he may be the seller rather than the buyer in this arrangement, he will presumably have drafted these terms to be fair and reasonable.
 - iii) This kind of provision is called a “Texas shoot-out” because, once it is implemented, only one of the two members will continue as a member.
 - iv) The main situation in which a Texas shoot-out may *not* be appropriate is when one of the members has substantially more financial resources than the other. If you are representing the two members jointly, you must point out this issue to the members, and you will probably have to address the issue whether the offer by the first member really does involve a material LLC dispute rather than a minor dispute used as a basis for a forced buy-out.
 - c) Sale of the LLC by both members. A third dispute resolution provision that is often useful in the operating agreements for multi-member LLCs for two equal members is a provision under which, if they are deadlocked, they must work together to sell the LLC to one or more buyers (whom the operating agreement should sometimes provide may include one of the members).
 - d) “Incompatibility provisions.”
 - i) Finally, there are a few LLC acts—the LLC acts of my home state of New Hampshire and of Florida and New Jersey are three examples—that contain “incompatibility” provisions.
 - ii) These provisions provide that if a member of a multi-member LLC comes to believe that he or she cannot work compatibly with the other member—i.e., that it is “impracticable” for the two to continue as co-members—the member may apply to an arbitrator to a court to require one or more other member to sell their memberships to the first member on terms that the arbitrator or court views as reasonable. This provision, too, will protect the members from the bad consequences that may befall all of them if the LLC is dissolved.
 - e) The need to *coordinate* anti-deadlock provisions. However, making sure that the above mediation and arbitration provisions and the above Texas shoot-out provision are properly coordinated among themselves and with this “compatibility” provision will require careful discussion with the members and careful drafting.
- 5) Question No. 3. What if the members of an LLC with two equal members cannot resolve their dispute under the operating agreement, but rather, they inform you that

they feel they have to resolve it in court? What advice do you normally provide in this situation?

- 6) Answer to Question No. 3. Assuming that it is consistent with the rules of legal ethics for me to provide both of them with advice on this question, I generally advise them as follows:
- a) The anguish of litigation. The litigation of LLC member disputes is likely to be time-consuming, expensive, and emotionally devastating--sometimes even for the winner. And in much litigation, there will be much uncertainty as to the outcome. Thus, before they go to court, they should do everything possible to resolve their dispute on their own.
 - b) The resolution may be a "fire sale" dissolution. In addition, they should realize that unless (as in New Hampshire) the court can resolve their dispute by some other means, the resolution will have to take the form of a dissolution of their LLC, its winding-up and its liquidation—that is, the sale of its assets to third parties. This dissolution process is likely to generate cash to the members that will be far less than the LLC's going-concern value. In other words, "dissolution" will really mean *fire sale*.
 - c) *Thus, my advice is that they should do all they can to avoid resolving their dispute in court.*