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Sale of Partnership and LLC Interests: A Walk Through Purchase and Sale Agreements

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CONSIDERATIONS RELATING TO NEGOTIATING AND DRAFTING PURCHASE AND SALE AGREEMENTS

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CONSIDERATIONS RELATING TO NEGOTIATING AND DRAFTING PURCHASE AND SALE AGREEMENTS

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I. Introduction.

The Business and Public Filings Division of the Office of the Texas Secretary of State reports that unincorporated entities, and in particular limited liability companies, have become the entities of choice in the State of Texas. More than half of all new entities formed in Texas in 2005 and 2006 were limited liability companies or limited partnerships.[1] It remains to be seen what impact, if any, the recently adopted changes in the Texas franchise tax laws (sometimes called the "margin tax") will have on future choices of entity for business enterprises in the state of Texas, but if current trends continue, it is likely that more and more businesses in Texas and elsewhere will be conducted as unincorporated entities. As these businesses mature, it seems inevitable that lawyers, accountants, brokers and others who deal with the purchase and sale of business enterprises will be encountering transactions involving the sale of a limited liability company or limited partnership.

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[1] The Master File Statistics Report generated on July 1, 2007 by the Office of the Texas Secretary of State shows the following total number of active (i.e., "in existence") for-profit corporations, limited liability companies and limited partnerships :

Domestic For-Profit Corporations:	392,717
Domestic Limited Liability Companies:	251,714
Domestic Limited Partnerships:	142,900

The Filed Documents Report by the Office of the Texas Secretary of State shows the following number of certificates of formation were filed to create new for-profit corporations, limited liability companies and limited partnerships (consequently, these statistics do not include those entities created by conversion or merger):

Domestic For-Profit Corporations:	33,757
Domestic Limited Liability Companies:	58,288
Domestic Limited Partnerships:	16,355

The Filed Documents Report by the Office of the Texas Secretary of State for calendar year 2005 shows the following:

Domestic For-Profit Corporations:	34,856
Domestic Limited Liability Companies:	53,097
Domestic Limited Partnerships:	20,835

The primary purpose of this outline is to consider a form of purchase and sale agreement that might be appropriate for a transaction involving the purchase and sale of ownership interests in a limited liability company or limited partnership and certain issues related to such a transaction in the context of the form.

Before examining the form, a few preliminary observations are helpful.

II. Why Sell Ownership Interests?

One of the first questions always considered in connection with the purchase and sale of a business enterprise is the appropriate structure for the transaction. In particular, should the transaction be structured as a sale of assets by the target entity, or should it be structured as a sale of the ownership interests by the owners of the target entity (in a stock transaction, a sale of stock by the stockholders). Several factors affect this decision. We will begin by a brief examination of these factors in the context of the sale of an unincorporated entity.

A. Tax Considerations. Federal income tax considerations are an important, if not the most important, consideration in structuring any purchase and sale of a business. If the target entity is classified as a C Corporation for federal income tax purposes, then the sellers will likely have a strong incentive for structuring the transaction as a sale of stock or ownership interests to avoid the double taxation that would arise upon a sale of assets. If the entity is classified as a partnership or a disregarded entity, then the concern of double taxation will be eliminated, although other taxation considerations may apply. Refer to the outline prepared by William H. Hornberger, which follows the forms presented in this outline, for a discussion of selected federal income tax considerations relating to sales of partnership interests.

B. Liability Protection. Purchasers typically prefer to purchase the assets of a corporation rather than purchase the corporation through the purchase of its outstanding stock to avoid liabilities of the corporation, especially unknown or contingent liabilities. This is also a valid consideration in the context of the sale of the business enterprise conducted as a limited liability company or limited partnership. While a purchaser will attempt to protect itself from liability by conducting a thorough due diligence review of the business and by obtaining representations and warranties and indemnities from the sellers (all of which will be discussed further later in this outline), it would still seem to be the case that, all other factors being equal, a purchaser will have a strong preference for purchasing the assets of the business from the target entity, paying the purchase consideration to the target entity.

C. Post Purchase Distributions. If the sale of a business is structured as purchase and sale of assets by the target entity, then such transaction is typically followed by a distribution of the purchase proceeds to the owners of the entity, either in liquidation of the target entity, or otherwise. In the context of a sale by a limited liability company or limited partnership, the post-purchase distributions will be governed by the governing documents of the seller, either the Company Agreement or Regulations of the limited liability company[2] or the Agreement of

[2] The governing document of a limited liability company formed before the effectiveness of the Texas Business Organization Code on January 1, 2006 is called the Regulations; the governing document of a limited liability company formed under the Texas Business Organization Code is called the Company Agreement.

Limited Partnership of the limited partnership. These governing documents should be reviewed carefully in connection with the structuring of the purchase and sale transaction to be sure that the owners understand and are comfortable with way the sale proceeds will be distributed and will not surprised by the final distribution of the purchase consideration. For example, some governing documents provide for a different distribution scheme that applies to the distributions of the proceeds of a "capital transaction" versus the distribution of ordinary income. It seems unlikely the distribution provisions of the governing documents will be a strong determining factor in choosing a sale of ownership interests instead of a sale of assets, but they should be considered.

D. Avoidance of Assignments and Separate Conveyances. Besides tax considerations, the most frequent reason that the purchase and sale of a business is structured as a sale of the ownership interests (i.e. a stock sale) and not a sale of assets, is to avoid having to separately convey all of the assets of the business. If the target entity has entered into numerous contracts, then each of these contracts will need to be assigned by the target entity to the purchaser, typically with a separate assignment document for each contract. If the contracts require the consent of the other contracting party or parties, then additional labor and time will be required to obtain proper consents. In addition, the pending purchase and sale will have to be disclosed and described to customers, vendors, landlords and other contracting parties where consents are needed. It is general practice to document the sale of other tangible and intangible assets through the use of a General Conveyance that identifies in a schedule or otherwise the transferred assets. Depending upon the complexity of the business and the desires of the purchaser and seller for specificity, preparation of this schedule of assets can, in many cases, be a very cumbersome and expensive proposition. Additionally, if the assets being conveyed consist of real estate, motor vehicles or other "titled" assets, then a separate deed, title assignment, etc. will have to prepared, executed and recorded or filed in the land office, motor vehicle registration office or other appropriate filing office. Filing fees and transfer taxes, if applicable, will be incurred in connection with the filings and transfers. Sometimes the daunting task of identifying and scheduling and conveying all assets together with the desire to minimize the need obtain consents and the desire to keep the transaction confidential prevails over the risk that the purchaser perceives in taking on the liabilities of the target entity. These considerations would apply regardless of whether the target entity is a corporation or an unincorporated entity.

III. Due Diligence Considerations.

A detailed discussion of due diligence procedures is beyond the scope of this outline. Many of the elements of a due diligence examination are "gender neutral" and will not be affected by the organizational form of the target entity. However, as will be discussed further later in this outline in the context of specific representations and warranties, certain aspects of the ownership and operation of an unincorporated entity, particularly accounting and tax matters, will be remarkably different for an unincorporated entity as compared to a corporation. Special attention should be focused during the due diligence process on such matters as capital account maintenance, records of distributions, any indication of wrongful distributions,[3] transfers and

[3] Wrongful distributions, which may create an obligation of limited partners to return the distribution, are dealt with in Section 153.112 and Section 153.210 of the Texas Business Organizations Code.

redemptions of ownership interest, and employee compensation arrangements that involve granting to employees or consultants ownership interests in the target entity.

IV. Mergers.

Another common structure for the acquisition of a business enterprise is a merger of the acquiring entity (or a subsidiary of the acquiring entity) with the target entity. A detailed examination of the many tax and business law issues involved in the mergers of unincorporated entities with other unincorporated entities or with corporations is beyond the scope of this outline. These issues have been examined in detail in the following excellent outlines: *Mergers, Conversions and Transmogrification* by Robert Keatinge, presented at The University of Texas School of Law Continuing Legal Education Program on Current Issues Affecting Partnerships, Limited Partnerships and Limited Liability Companies, July 17 and 18, 2003, and *Mergers, Acquisitions and Conversions with Partnerships and LLCs* by Michael K. Pierce and Kevin Thomson, presented at The University of Texas School of Law Continuing Legal Education Program on Current Issues Affecting Partnerships, Limited Partnerships and Limited Liability Companies on July 15 and 16, 2004.

If one were presented with the task of preparing a form of Merger Agreement involving an unincorporated entity, the form presented in this outline might be of some utility. Although the portions of the form dealing with the mechanics of the transaction (Article 2) would change, certain portion of the form such, as the sellers' representations and warranties (Article 3 and Article 4), covenants and conditions (Article 7, Article 8, and Article 9) and indemnities (Article 11) might be instructive.

V. The Form.

This brings us to our examination of our form of purchase and sale agreement. The following form is an amalgamation of provisions from a number of purchase and sale agreements and is not the product of a real, negotiated transaction. In particular the author wishes to acknowledge and are indebted to the members of the Committee on Negotiated Acquisitions of the American Bar Association's Business Law Section for their *Model Stock Purchase Agreement with Commentary* and the *Manual on Acquisition Review*, both published in 1995, and their *Model Asset Purchase Agreement with Commentary* published in 2001.

The form agreement commences on the next page. Commentary on the form for the balance of this outline will be presented in the form of footnotes to the form.

FORM[4] OF
[MEMBERSHIP / PARTNERSHIP] INTEREST[5]
PURCHASE AGREEMENT

This [Membership / Partnership] Interest Purchase Agreement ("Agreement") is made as of _____, 20__, by _____, a _____ [limited liability company / limited partnership / corporation] (the "Purchaser"), and each of the Persons listed on Exhibit "A" (collectively, the "Sellers" and each a "Seller")[6].

W I T N E S S E T H

WHEREAS, the Sellers own, respectively, the [membership / partnership] interests (the "Interests") of _____, a Texas [limited liability company / limited partnership] (the "Company" / the "Partnership"), indicated in Exhibit "A", and

WHEREAS, _____, [a _____ corporation / limited liability company] and _____, [a _____ corporation / limited liability company] (the "Principal Seller[s]") [is / are] the [managing member[s] / manager[s] / general partner[s]] of the [Company / Partnership] and [is / are] actively involved in managing the business of the [Company / Partnership], and accordingly, [is / are] in a position to make certain representations, warranties and covenants in respect of the [Company / Partnership][7]; and

WHEREAS, each of the Sellers wishes to sell, and the Purchaser wishes to purchase, the Interests, subject to the conditions contained in this Agreement;

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[4] This form agreement is not a form to be completed by filling in the blanks. Drafters should be certain that any agreement used by them is appropriate for the particular transaction. The presence or the absence of a particular provision in this form should not be taken as an indication that the provision is or is not "market standard."

[5] Consistent with the *Model Limited Liability Company Membership Interest Redemption Agreement* prepared by the Subcommittee on Limited Liability Companies of the Committee on Partnerships and Unincorporated Business Organizations, Section of Business Law, American Bar Association (published at 61 Bus. Law 1197, 2005–2006), we have chosen to call our form a "Membership Interest Purchase Agreement" or "Partnership Interest Purchase Agreement." Some Company Agreements and Partnership Agreements designate membership or partnership interests as "Units". If drafting an agreement in a transaction where interests are designated as "Units," it may be appropriate to name the agreement "Unit Purchase Agreement."

[6] In stock purchase agreements, the sellers of stock are typically designated Stockholders or Shareholders. To simplify this form, the interest owners who are selling interests are called Sellers, rather than Unitholders, Interestholders, Limited and General Partners, Members or other similar designations.

[7] In stock sale transactions where one or more "principal" stockholders own a controlling interest in the target entity and participate actively in the management of the target entity and minority shareholders play a passive role, the Sellers may prevail in limiting the representations and warranties made by the minority shareholders to matters, such as share ownership, within their knowledge and control. Because limited partnerships are managed and controlled by a general partner and because limited liability companies are frequently managed and controlled by one or more managers or one or more managing members, this form contemplates that the limited partners or members not involved in management would persuade the Purchaser to accept similar limited representations from the passive owners.

NOW, THEREFORE, in consideration of the mutual covenants and agreements set forth in this Agreement, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties do hereby agree as follows:

ARTICLE 1

Definitions

Section 1.1 **Definitions**. Certain terms used in this instrument are capitalized. Such terms shall have the meaning set forth in the text or in Section 12.18.

ARTICLE 2

Sale and Transfer of Interests; Closing

Section 2.1 **Agreement to Purchase and Sell**. Subject to the terms and conditions of this Agreement, at the Closing, the Sellers will sell, transfer and assign the Interests to the Purchaser, and the Purchaser will purchase the Interests from the Sellers.

Section 2.2 **Purchase Price**. The purchase price for the Interests (the "Purchase Price") is the aggregate sum of _____ Dollars ($_____).[8] The Purchase Price shall be payable by the Purchaser to the Sellers as set forth on Exhibit "A".[9]

Section 2.3 **Closing**. The closing of the transactions contemplated by this Agreement (the "Closing") will take place at the offices of the Purchaser's counsel at _____, at 10:00 a.m. (local time) on the later of (i) _____ 20__ or (ii) the date that is two business

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[8] *The Model Stock Purchase Agreement* promulgated by the Committee on Negotiated Acquisitions of the Section of Business Law of the American Bar Association provides for an adjustment to the agreed purchase price based upon changes in the target corporation's consolidated stockholder's equity between the date of the balance sheet relied upon by the Purchaser to determine the purchase price and the closing date. Mechanics are included for a post-closing preparation of financial statements as of the closing date and a "true-up" of the purchase price after the closing date financial statements are finalized. It has been the author's experience that there are no "standard" provisions for post closing adjustments to purchase price. In fact purchasers differ widely in their approach to post closing adjustments and the language they use regarding post closing adjustments. For this reason, this form does not include provisions for a post closing adjustment to the purchase price. However, it should be anticipated that the Purchaser may insist on such provisions and that such provisions will likely be among the most heavily negotiated provisions in the purchase agreement.

[9] In a stock sale transaction, the purchase price is often expressed as $X per share. This is a function of the fact that shares are more or less fungible; each share of a particular class of stock represents essentially the same rights as every other share of that class. The rights and obligations respecting ownership interests in partnerships and limited liability companies often vary widely from partner to partner or from member to member. For example, a "money partner" may be entitled preference distributions calculated based upon a percentage return of her invested capital or based upon a specified internal rate of return as well as return of her capital contribution before the "sweat equity" partner receives any distributions. These differences in rights of partners or members will of course affect the value of the interests. This form attempts to take into account the fact that it is likely the purchase price paid to each Seller will not be just a function of the Percentage Interest or number of Units owned by the Seller. Instead of describing the price as $X per Unit, this form contemplates that an exhibit (Exhibit "A") would list the name of each Seller and the amount of the Purchase Price to be paid to each.

days following the termination of the applicable waiting period under the HSR Act[10], or at such other time and place as the parties may agree. Subject to the provisions of Article 10, failure to consummate the purchase and sale provided for in this Agreement on the date and time and at the place determined pursuant to this Section 2.3 will not result in the termination of this Agreement and will not relieve any party of any obligation under this Agreement.

Section 2.4 **Closing Obligations**. At the Closing:

(a) Each of the Sellers will deliver to the Purchaser:

(i) an assignment of interest in substantially the form of Exhibit "B"[11] or other form of assignment or transfer document reasonably satisfactory to the Purchaser, with all blanks properly completed to indicate the Interest being sold by the Seller hereunder and executed by the Seller;

(ii) a certificate executed by the Seller representing and warranting to the Purchaser that each of the Seller's representations and warranties contained in Article 3 was accurate in all respects as of the date of this Agreement and is accurate in all respects as of the Closing Date as if made on the Closing Date (giving full effect to any supplements to the Disclosure Letter that were delivered by the Sellers to the Purchaser prior to the Closing Date in accordance with Section 6.5); and

(b) The Principal Seller[s] will deliver or cause to be delivered to the Purchaser:

(i) an employment agreement in the form of Exhibit "C", executed by each of the Key Employees (collectively, "Employment Agreements");

(ii) a noncompetition agreement in the form of Exhibit "D", executed by each of the Principal Seller[s] and Key Employees (collectively, the "Noncompetition Agreements"); and

(iii) a certificate executed by the Principal Seller[s] representing and warranting to the Purchaser that each of the representations and warranties of the Principal Seller[s] in Article 4 was accurate in all respects as of the date of this Agreement and is accurate in all respects as of the Closing Date as if made on the Closing Date (giving full effect to any supplements to the Disclosure Letter that were delivered by the Sellers to the Purchaser prior to the Closing Date in accordance with Section 6.5); and

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[10] For purposes of The Hart-Scott-Rodino Antitrust Improvements Act of 1976, the term "entity" means "any natural person, corporation, company, partnership, joint venture, association, joint-stock company, trust, estate of a deceased natural person, foundation, fund, institution, society, union, or club, whether incorporated or not ..." C.F.R. § 801.1(a)(2). (Emphasis added.)

[11] Interests in partnerships and limited liability companies are typically not certificated interests. Such interests are usually transferred by means of an assignment instrument. A form of assignment is included as Exhibit "B" to this form.

(c) The Purchaser will:

(i) pay to the Sellers the respective amounts indicated as the "Closing Payments" on Exhibit "A" by direct wire transfers of immediately available funds to the accounts of Sellers as set forth in Exhibit "A" or to such other account of which a Seller may notify the Purchaser in writing prior to the Closing;

(ii) deliver promissory notes payable to each of the Sellers in the respective principal amounts indicated in Exhibit "A" (collectively, "Promissory Notes");

(iii) pay the sum of $_____ (the "Escrowed Funds") to the Escrow Agent by direct wire transfer of immediately available funds to the account specified by the Escrow Agent;

(iv) deliver a certificate executed by the Purchaser to the effect that, except as otherwise stated in such certificate, each of the Purchaser's representations and warranties in this Agreement was accurate in all respects as of the date of this Agreement and is accurate in all respects as of the Closing Date as if made on the Closing Date; and

(v) deliver the Employment Agreements, executed by the Purchaser; and

(d) the Purchaser and the Sellers will enter into an escrow agreement in the form of Exhibit "E" (the "Escrow Agreement") with _____ (the "Escrow Agent"); and[12]

(e) the Sellers will enter into a contribution agreement in the form of Exhibit "F"; and

(f) the Purchaser will be admitted as a [member / general partner / limited partner] of the [Company / Partnership] and will continue the business of the [Company / Partnership], and immediately following such admission, the Sellers will cease to be [members / partners] of the [Company / Partnership].[13]

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[12] The Purchaser may require that a portion of the purchase price be paid into an escrow account either to satisfy "true-up" obligations or to provide readily available funds for any liability of the Sellers under the indemnification provisions of the Agreement.

[13] Notice that the withdrawal of the Seller(s) occurs immediately following the admission of the Purchaser(s) so that there is no moment in time in which the target has no members or partners, resulting an inadvertent dissolution of the target.