

# advisory

## IMPORTANT CONSIDERATIONS WHEN DRAFTING WATERFALL PROVISIONS IN OPERATING AGREEMENTS

There are many challenges to starting a business, and financing is the highest priority. Investors will be focused on how profits and losses are allocated and how their interest will be protected. It is crucial that a clear and valid contract that describes these allocations is created. The contractual documents and/or state law will govern how these issues are addressed and it is important to fully understand the consequences.

The distribution of assets and/or funding is generally addressed in the operating agreement if the entity is a limited liability company, or the shareholder agreement if the entity is a corporation. What is referred to as waterfall provisions relates to how and when the distribution will occur. It dictates each party's rights under the contract and who has a priority in the distribution.

As a general proposition, members or shareholders will allocate distributions in proportion to the original investment. This means that if Investor A invested 40% of the total capital in the company, Investor B invested 30% of the total capital, Investor C invested 15% of the total capital, and Investor D invested 15% of the total capital, the distributions would be as follows:

- Investor A would receive 40% of the distributions
- Investor B would receive 30% of the distributions
- Investor C would receive 15% of the distributions
- Investor D would receive 15% of the distributions

When dealing with waterfall provisions, the difference is that the tiers would outline the amounts to be distributed to each investor before the distributions are fully disbursed. The first distribution, or tier, would be a return of capital to first repay the investor's total investment in the company. Upon receipt of the total investment, the next tier in the waterfall would be a preferred return, which is generally a percentage of the investment paid back. The operating agreement would also state that the managing member or manager has the authority to retain a significant portion of the company's profits in order to provide operating capital and allow it to meet its share of the gains. The final tier is to the remaining members on a pro-rata basis.



When drafting waterfall provisions, it is important that all parties understand and agree upon the structure and what rights are assigned to each shareholder. In order to avoid disputes when distributions are being made, the investors should be separately represented to mitigate confusion and ensure that each investor is fully-protected. Questions that need to be addressed include:

- What type of distribution will be disbursed (i.e., cash flow, capital events, tax, liquidation, in-kind)?
- Do owners share in all distributions equally or on a pro-rata basis?
- Will there be priority rights?
- Will there be an accrued preferred return?
- What is the timing for distributions? Will distributions occur in specific time periods (i.e. quarterly or annually)?
- Will specific owners or managers control the amount of distributions?

These are all very important decisions that should be clearly defined in the waterfall provisions of an operating agreement. Not only should the waterfall provisions reflect the goals of the investors and the company, but they should also anticipate major events, such as change in control and, should this occur, if there will be tag-along rights, which are pre-negotiated rights that a minority shareholder includes in their initial issuance of a company's stock. As with all legal documents, the devil is in the details when it comes to important considerations an investor will need to make prior to agreeing to a waterfall. For further information on operating and shareholder agreements, please contact PLDO Managing Principal Gary R. Pannone at 401-824-5100 or email [gpannone@pldolaw.com](mailto:gpannone@pldolaw.com).



Gary R. Pannone  
Managing Principal

PANNONE LOPES  
DEVEREAUX & O'GARA LLC  
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