

**CAPITAL CONTRIBUTIONS, FUNDING, NEW
EQUITY AND CAPITAL CALLS:
TRANSACTIONAL AND TAX CONSIDERATIONS
UNIVERSITY OF TEXAS PROGRAM ON
PARTNERSHIPS AND LLCs**

July 11, 2012
2:00 pm – 2:40 pm

Robert R. Keatinge
Holland & Hart LLP
555 17th Street, Suite 3200
Denver, Colorado 80202
303/295-8595
rkeatinge@hollandhart.com

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I. Introduction

In virtually every partnership or LLC – as a concession to the brevity of life, I will discuss partnerships below and only note differences in LLCs where relevant – the contribution of capital for operations is a crucially important, if often under-considered issue. This outline considers considerations with respect to all capital contributions and then notes specific considerations that may arise depending upon whether the capital being contributed by partners at the outset, by new investors after organization, or by existing partners, either voluntarily or in response to a capital call or traunched investment.

II. Capital Contributions in General

A. Non-Tax Issues

1. Ethical Issues and Conflicts. Because a contribution is a transaction between two persons (the contributing member or partner (“contributor”)) and the partnership or LLC receiving the contribution (“organization”), attorneys representing both the contributor and the organization should consider the appropriate ethical obligations and the potential for conflicts of interest under Texas Disciplinary Rules of Professional Conduct (“TDRPC”) Rules 1.06 and 1.12. The attorney should consider not only the question of who is the client, but the knowing consent to representation of the organization should be given by a partner or member other than contributor.¹

2. Securities Laws. Contributions may be considered the sale of securities, an important consideration which will be covered by in the next program.²

3. The Interest to be Received by the Contributor. Contributions are generally made either in exchange for, or in connection with, the contributor’s rights in the organization. As such, the nature of the partnership or LLC interest to be received by the contributor should be clearly identified. The governance and other non-economic rights,³ and rights to distributions⁴ associated with that interest should be clearly understood and identified.

4. Contributions of Property. A contribution of property to an organization is a transfer of property to the organization in exchange for consideration (the interest in the organization) and should be treated with the same respect and thoroughness as a purchase of property. Among these considerations are:

a. Representations and Warranties. Depending on the type of property being contributed, the contribution should be accompanied by the same sorts of representations and warranties as might

¹ TDRPC Rule 1.12 cmt. 5.

² Adrienne Randle Bond and Daryl B. Robertson, Raising Money: Securities Law Issues for General Business Lawyers.

³ George W. Coleman and Allen Sparkman, Governance, Indemnification, Fiduciary Duties and Voting: Strategic Considerations, Drafting Pitfalls and Best Practices

⁴ Cliff Ernst, Matthew S. Beard, and Michael A. DePompei, Distributions, Profit and Loss Allocations and Tax Reimbursement Provisions.

accompany a purchase of similar property. For example, there should be warranties of title, environmental condition, transferability, etc. The representations and warranties may be included in the organic agreement, a separate subscription agreement or a separate document. In any case, the agreement should cover consequences of the breach of any representation or warranty: e.g., damages, breach of the organic agreement, forfeiture of partnership interest, damages.

b. Encumbrances. If the property is subject to an encumbrance it is important to ensure that the transfer will not trigger “due on sale” clauses or otherwise injure the value of the contributed property and it is clearly understood between the contributor and the organization who will have responsibility for the liability.

c. Real estate. If the contribution consists of real estate, the organization should consider the need to obtain new title insurance on the property and should ensure that the transfer is properly recorded.

5. Is the Transfer the Property to the Organization really a Capital Contribution at all? Some transfers of money or property to a partnership that are characterized as contributions may, when properly characterized, actually be transactions of another sort. This situation will often arise when the purposes of the parties or the documentation is ambiguous or totally absent.⁵ Such a contribution may be:

a. A loan. If the transfer of cash or property to the organization is simply for the use by the organization and a subsequent return to the contributor, that fact should be appropriately documented. Members' loans to the LLC must be distinguished from contributions, which are equity investments subordinated to, and therefore available for the satisfaction of, the firm's debts.⁶ In making this distinction, courts may rely on general partnership law distinguishing advances and contributions. The LLC statutes do not restrict member loans to the firm and do not subordinate member loans to those of outside creditors, although the loans may be subordinated under bankruptcy law.

b. A purchase of the property by the organization.

c. A gift to other partners or the partnership itself.

⁵ The Texas Business Organization Code (“TBOC”) § 1.001(9) generally defines a “contribution” as: a tangible or intangible benefit that a person transfers to an entity in consideration for an ownership interest in the entity or otherwise in the person's capacity as an owner or a member. The benefit includes cash, services rendered, a contract for services to be performed, a promissory note or other obligation of a person to pay cash or transfer property to the entity, or securities or other interests in or obligations of an entity, but does not include cash or property received by the entity:

- (A) with respect to a promissory note or other obligation to the extent that the agreed value of the note or obligation has previously been included as a contribution; or
- (B) that the person intends to be a loan to the entity.

⁶ See *In re DeLuca*, 194 B.R. 65 (Bankr. E.D. Va. 1996) (where operating agreement did not give either LLC member a unilateral right to contribute additional capital, advance of expenses should be characterized as loan rather than additional capital that might affect the members' voting rights in the absence of contrary agreement); *Country Club of the Ozarks, LLC v. CCO Investments, LLC*, 338 S.W.3d 325 (Mo. Ct. App. S.D. 2011) (contribution not evidenced by a promissory note was a capital contribution rather than a loan under the operating agreement); *Lynes v. Helm*, 2007 MT 226, 339 Mont. 120, 168 P.3d 651 (2007) (manager contributed funds as loans, repayment of which was proper and not an unlawful distribution of capital); *Blair v. McDonagh*, 177 Ohio App. 3d 262, 2008-Ohio-3698, 894 N.E.2d 377 (1st Dist. Hamilton County 2008) (issue of fact as to whether advances were loans rather than capital contributions where operating agreement did not require advances or contributions, agreement provided that if general manager determines that LLC needs funds a member may “advance” such funds, and there was evidence that contributing member intended the advances to be loans); *Thompson v. Davis*, 308 S.W.3d 872 (Tenn. Ct. App. 2009), appeal denied, (Feb. 22, 2010) (plaintiffs' contributions constituted loans for which distributions to plaintiffs were repayment). Members' loans to the LLC also should be distinguished from their guarantees of the LLC's debts to third parties. See *Alimenta (USA), Inc. v. Oil Seed South, LLC*, 276 Ga. App. 62, 622 S.E.2d 363 (2005) (operating agreement provided for indemnification only of member's guarantee of third party loans and not of member's loan to LLC).

Also available as part of the eCourse

[LLC and Partnership Capital and Economics: Capital Raising Issues; Capital Contributions, Funding, New Equity and Capital Calls; and LLC and Partnership Interests as Collateral](#)

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