UT LAW CLE THE UNIVERSITY OF TEXAS SCHOOL OF LAW

PRESENTED AT

25th Annual LLCs, LPs and Partnerships

July 14-15, 2016
Austin, Texas

Equity Structure of Noncorporate Entities

Bradley T. Borden

EQUITY STRUCTURE OF NONCORPORATE ENTITIES

Bradley T. Borden[*]

ABSTRACT

The equity structure of any entity determines the economic rights of the entity's members to the residual assets of the entity. Corporations typically issue different types and classes of stock to create equity structure, such as preferred stock to provide both preferred returns and preferred liquidation rights over the rights afforded to common stock. Noncorporate entities typically use entity agreements to establish equity structure. Traditionally, noncorporate entities used profit sharing through allocations to establish the members' rights to residual assets of the entity (i.e., allocation-dependent capital structures). Today, however, the equity structures of many noncorporate entities use complex distribution formulas to create distribution-dependent equity structures. Although some of the most complex equity structures of noncorporate entities are found in private equity and real estate fund agreements, complex structures now appear in the agreements of smaller entities. Thus, the complexity and diversity of equity structures is becoming widespread. Despite the ubiquity of such structures, they receive little scholarly attention. The paucity of attention means that equity structures of noncorporate entities lack a uniform classification system. Consequently, practitioners, judges, scholars, and students are

---

[*] Professor of Law, Brooklyn Law School. The author thanks Bryan Garner, David Reiss, the participants at the 2015 LLC Institute, including Steve Frost, Tom Rutledge, and Steve Schneider, and participants at the 2016 J. Reuben Clark Law Society Faculty Group Conference, including Kif Augustine-Adams, Christine Hurt, Christian Johnson, Val Ricks, Paul Stancil, and Jeff Thomas. A version of this article will be published in a forthcoming issue of *The Real Estate Finance Journal*.

unfamiliar with this area of the law, and errors in drafting the equity structures of noncorporate entity appear to be common. Students of this area of the law have to piece information together to obtain something resembling a working knowledge of these structures, judges grapple understand and create the law, and scholars have no basis for applying their analytical skills to the equity structure of noncorporate entities. This Article brings order to this area of the law by identifying and classifying the various general types of equity structures of noncorporate entities. It also provides the financial tools needed to properly understand the more complex structures that incorporate internal rate of return (IRR) and recommends a better way to incorporate IRR in situations where business owners insist upon using it. Finally, the Article briefly discusses some of the basic tax issues that distribution-dependent structures raise.

Table of Contents

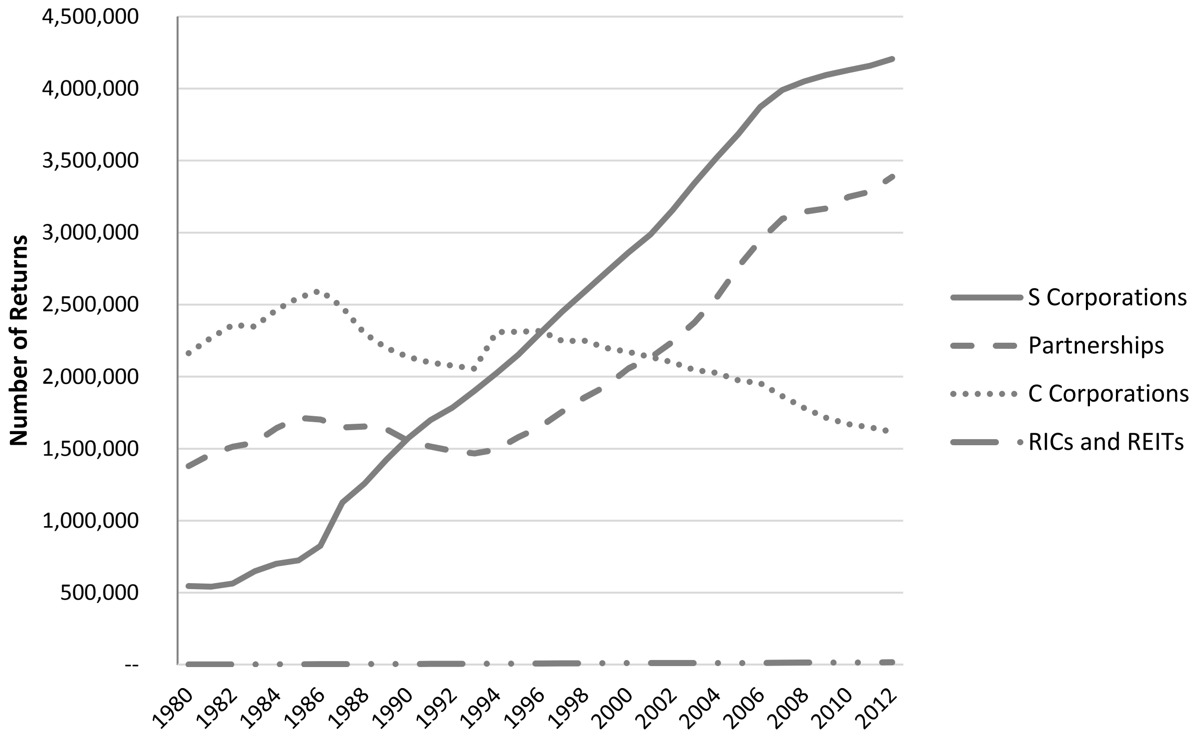
I. INTRODUCTION

The growth of partnerships and limited liability companies (LLCs) over the last several decades has been well documented.[1] While the number of taxable corporations have decreased,[2] the number of flow-corporations and tax partnerships (i.e., entities such as partnerships and LLCs) has increased significantly (see Figure 1).[3] S corporations can have no more than one class of sock,[4] so their capital structures remain simple. As the number of partnerships and LLCs has increased, the complexity of such entities also appears to be increasing. In particular, the equity structures of such entities can be quite complex, and complexity that was previously the province of large partnerships and LLCs now routinely appear in smaller entities. Consequently, a careful examination of the general types of equity structures is in order.

---

[1] *See, e.g.*, Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. CIN. L. REV. 1078–82; Robert J. Rhee, *Bonding Limited Liability*, 51 WM. & MARY L. REV. 1417, 1445–46 (2010).
[2] Corporations subject to subchapter C of the Internal Revenue Code (i.e., C corporations) are subject to tax.
[3] *See Statistics on Income Tax Stats—Integrated Business Data, Table I: Selected Financial Data on Businesses 1998–2012*, *available at* https://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data. Corporations subject to subchapter S of the Internal Revenue Code (i.e., S corporations) are not subject to the corporate-level tax.
[4] *See* I.R.C. § 136

Figure 1: Number of Entities by Type Based on Tax Returns Filed Per Year



A classification of the equity structures of noncorporate entities provides a framework for a more thorough examination of the various structures. Equity structures of noncorporate entities come in two general varieties—allocation-dependent structures and distribution-dependent structures. Traditional partnerships adopted allocation-dependent structures with their profit-sharing allocations. At their most basic level, partnerships with allocation-dependent equity structures allocate profits and losses to members pro rata based upon capital contributions. Such entities distribute available cash in accordance with those distributions and pro rata allocations. Allocation-dependent structures can, of course, become quite complicated with specific allocations of particular types of profits and losses.

Title search: Equity Structure of Noncorporate Entities

Also available as part of the eCourse
2016 LLCs, LPs and Partnerships eConference

First appeared as part of the conference materials for the
25th Annual LLCs, LPs and Partnerships session
"Ensuring an Internal Rate of Return (IRR) Distribution Waterfall Flows Correctly"