

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*. © 2016 Bradley T. Borden.

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.....	4
II.	Allocation-Dependent Equity Structures	10
III.	Distribution-Dependent Equity Structures (i.e., Distribution Waterfalls)	15
A.	Preferred Return Followed by Return of Capital.....	20
1.	Simple-Interest Preferred Return.....	20
2.	Compound-Interest Preferred Return	23
B.	Return of Capital Followed by Preferred Return.....	26
1.	Simple-Interest Preferred Return.....	26
2.	Compound-Interest Preferred Return	30
C.	IRR Return.....	33
1.	Undivided IRR Return.....	34
2.	<i>Pari Passu</i> IRR Return.....	37
2.	<i>Pari Passu</i> IRR Return.....	41
D.	Summary of Payouts Using Different Distribution Waterfalls.....	44
E.	Problematic Structures	45

1.	IRR Return Followed by Return of Capital	45
2.	IRR Based on Something other than Contributed Capital and Distributions	46
IV.	Financial Concepts in Distribution Waterfalls	48
A.	Overview of Financial Concepts	49
1.	Basic Time-Value-of-Money Concepts	49
2.	Simple Interest	50
3.	Compound Interest	52
4.	Nominal Rate versus Effective Rate	53
5.	Present Value and Net Present Value	55
6.	Internal Rate of Return	57
7.	Intraperiod Payments	58
8.	Counting Days	61
B.	Use of IRR in Entity Agreements	64
1.	Reorientation of Net Present Value	64
a.	Treating IRR as an Unknown Value and Cash Flows as Known Values	65
b.	Contextually Awkward Language	66
c.	Treating Contributions and Distributions as Prospective Payments	67
2.	Direct Method of Computing IRR Distributions	70
3.	Indirect Method for Computing IRR Distributions using Microsoft Excel	75
a.	Compounding Frequency and Intraperiod Payments	79
b.	Combining XIRR and Nominal Functions	80
c.	Imprecision from Reengineering XIRR Function	92
C.	Theoretical Shortcomings of IRR	97
D.	Choosing Between the Direct and Indirect Methods	98
E.	A More Complete Direct Method	100
V.	Tax Implications	103
A.	Tax-Item Allocations	103
1.	Safe-Harbor Compliant versus PIP Arrangements	104
2.	Capital-Account Treatment of Undistributed Preferred Return	105
3.	Allocations According to Partners' Interests in the Partnership	111
B.	Effect on Disguised-Sale Rules	112
IV.	Conclusion	114

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 stock,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.

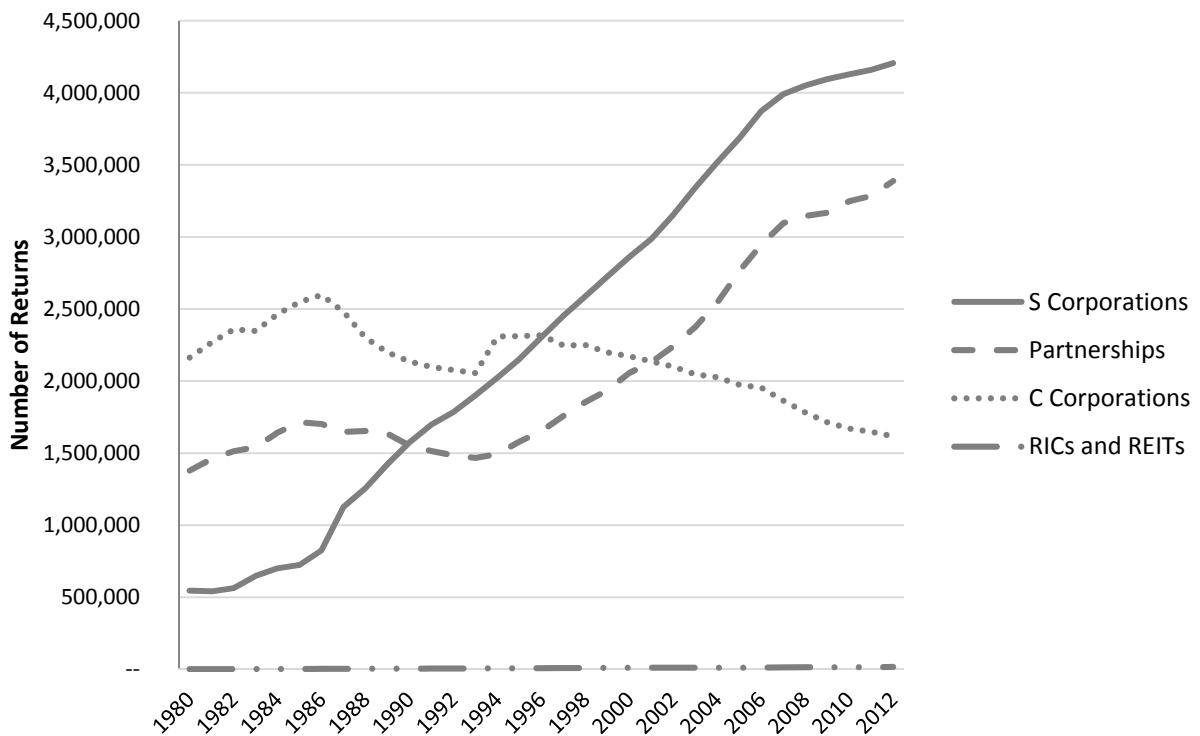
¹ See, e.g., Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. CIN. L. REV. 1078–82; Robert J. Rhee, *Bonding Limited Liability*, 51 WM. & MARY L. REV. 1417, 1445–46 (2010).

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.

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the [UT Law CLE eLibrary \(utcle.org/elibrary\)](http://utcle.org/elibrary)

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"