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Capital Call Provisions in LLC and Partnership Agreements

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I. Introduction.

When faced with the task of drafting formation documents for a new entity, there are several issues a lawyer and her or his client must consider, including what type of entity best suits the needs of the client and the situation, who will control the entity, what steps should be taken to comply with federal and state securities laws, and many others. But perhaps the issues that are near the top of the list for most clients and in most situations are the financial considerations: how will the entity be funded and how will profits from the entity be divided?[1] This outline will focus on the first issue, the funding of the entity, in the context of unincorporated entities.

Unincorporated entities (limited liability companies, general partnerships or limited partnerships) are often selected by practitioners and clients to own and operate ventures because of the flexibility offered by these structures in establishing the relationship among the entity owners. And while this flexibility makes the unincorporated entity a valuable choice, this same flexibility can impose an additional responsibility or burden on the lawyer to understand the needs and concerns of her or his client and draft documents that address those needs and concerns. This outline will attempt to address those needs and concerns as they relate to the funding of the entity. To attempt to provide some clarity to these issues, they will be considered in a "decision tree" format, identifying forks in the road that the lawyer and the client will face as they navigate the decision process and examining the issues surrounding those decision forks and consequences of the choices. From time to time sample contract language will be provided and referenced in the appendices to this outline.

One last introductory matter relates to the decision to form a limited liability company versus a partnership. The issues surrounding that decision are outside the scope of this paper, and that choice will have little consequence for the issues related to the funding of the venture. Of course, the nomenclature will vary slightly depending upon the entity chosen. The governing document for a limited liability company is called a company agreement,[2] while the governing document for a general partnership or limited partnership is called a partnership agreement or

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1 A related issue that lawyers should always consider is how will losses be divided, although most clients rarely start new ventures or form new entities anticipating losses. A detailed discussion of the allocation of profits and losses is beyond the scope of this outline. See Whitmire, Nelson, McKee, Kuller, Hallmark & Garcia, *Structuring and Drafting Partnership Agreements* ¶ 5.01 through ¶ 5.05 for a detailed discussion of this topic.

2 TEX. BUS. ORGS. CODE ANN. § 101.001 (Vernon 2010).

limited partnership agreement.[3] The owners of a limited liability company are called "members"[4] and the owners of a partnership are called "partners".[5] The governing person or entity of a limited liability company is the "manager" or the "managing member"[6] and the governing person or entity of a limited partnership is the "general partner"[7]. Generally speaking, limited liability companies are treated as partnerships for federal income tax purposes.[8] Business and drafting decisions related to the initial funding of the entity (as well as other financial decisions related to the operations and termination of the entity) are not significantly impacted by the choice to form a limited liability company or a partnership. For purposes of this the paper, no distinction will be made and the appended drafting examples provide alternative nomenclature for both types of entities.

The author wishes to acknowledge and thank his partners and fellow practitioners (including opposing counsel in some instances) who provided him with some of the examples of contract provisions that provided a basis for the sample provisions included as appendices to this outline. The sample provisions included should not be considered forms 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 absence of a particular term in these sample provisions should not be taken as an indication that the provision is or is not "market standard".

II. Debt Versus Equity.

The first fork in the decisions road related to the funding of an unincorporated entity is whether to treat the investor's investment as debt or equity. Many people assume that an investor in an unincorporated entity will naturally want to be an "owner" of the entity, that is that the investment will be structured as equity. However, it is always valuable to at least consider that in certain circumstances structuring the relationship between the venture and the investor as a borrower/lender relationship may better suit the needs of the client.

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[3] § 151.001(A)(5) and § 152.002.

[4] § 101.101(a).

[5] § 152.053.

[6] § 101.251.

[7] § 153.152.

[8] According to the so-called "check-the-box" rules under the Internal Revenue Code of 1986, as amended (the "IRC"), limited liability companies with more than one member are automatically classified as partnerships unless the company elects to be classified as a corporation (which is relatively rare). Treas. Reg. § 301.7701-3. See McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners,* ¶ 3.06 for an in-depth discussion of classification of partnerships and limited liability companies under the IRC, a topic that is beyond the scope of this outline.

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