

Presented:

Partnerships, Limited Partnerships and LLCs

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**Planning, Drafting and Implementing
Capital Call Provisions****Cliff Ernst**

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I. Introduction.

At the heart of almost every transaction involving the formation of a new entity are these questions:

- Who will invest in the entity?
- How much will they invest?
- When will they invest?

If the entity being formed is an unincorporated entity (a partnership or a limited liability company), then the lawyer or lawyers representing the organizers of the entity will be required to negotiate and draft provisions in the company agreement for a limited liability company or the partnership agreement for a partnership that clearly spell out the rights and obligations of the parties regarding these questions. These provisions are usually referred to as “capital contribution” or “capital call” provisions. This outline will begin by focusing on issues related to planning, negotiating and drafting capital contribution provisions.

If the parties anticipate that the transaction will involve future investments in the entity by some or all of the parties--in other words not all of the funding is paid upon the formation--then there is at least one more question that needs to be addressed by the parties and their counsel:

- What happens if a party doesn't make an investment that it agreed to make?

The statutes don't answer this question. They authorize the parties and their lawyers to agree to a wide range of provisions offering a wide range of answers to this question. In fact the answer to this question may be limited only by the creativity of the lawyers and the willingness of the parties to agree to the proposed remedies. Texas cases on this topic will be examined and analyzed and several drafting examples will be provided.

Unless noted otherwise, the sample contract language presented in this outline has been adapted for use in both limited liability company and partnership agreements. 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 corporation¹ (which is relatively rare).² For purposes of all discussions and sample contract language contained in this outline, it has been assumed that limited liability companies will be classified as partnerships.

The author wishes to acknowledge and thank his partners and fellow practitioners (including opposing counsel in some instances) who provided him with the examples of capital contribution provisions that provided a basis for the sample provisions included in 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. Capital Formation for Unincorporated Entities Compared to Corporations.

One of the fundamental principals often quoted by legal scholars in detailing the differences between corporations and partnerships (and by analogy limited liability companies) is that corporations are creatures of statute and partnerships are creatures of contract. While this fundamental difference has many implications and affects the business law practitioner in many ways, perhaps one of the areas of greatest impact is capital formation – planning for, drafting for and implementing the financial investment the owners make in a business entity.

A. Corporations.

The Texas Business Organizations Code³ (the “TBOC”) provides the framework, or the “play book,” for capital formation by corporations. Corporations raise capital by issuing shares.⁴ Shares are sold by the corporation to investors for consideration determined according to the rules stated in the TBOC,⁵ most typically for a purchase price set by the board of directors of the corporation.⁶ Corporate shares may have a “par value” or may be “without par value”.⁷ So that

¹ Treas. Reg. § 301.7701-3.

² 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.

³ TEX. BUS. ORGS. CODE ANN. § 1.001 et seq. (Vernon 2008).

⁴ § 21.151.

⁵ § 21.160.

⁶ § 21.160(a)(1).

⁷ § 21.152(b).

there can be no doubt, the organizer of a corporation is required to describe in the certificate of formation of a corporation filed with the Secretary of State,⁸ not only how many shares the corporation is authorized to issue,⁹ but also the par value of each class of shares or that the shares are without par value.¹⁰ If the shares have a par value, the consideration set by the board of directors for the shares may not be less than the par value of the shares.¹¹

Through its definitions, the TBOC also in effect establishes the accounting methodology for capital contributions to a corporation. The “stated capital” of a corporation is defined as (i) the aggregate par value of all shares with par value that have been issued by the corporation¹² plus (ii) (x) the aggregate consideration expressed in terms of U.S. dollars the corporation received for all issued shares that do not have a par value less (y) any amount allocated by the board to surplus within sixty days of issuance.¹³ “Surplus” is defined as the amount by which the net assets of a corporation exceed the stated capital.¹⁴ Stated capital is also changed by dividends, board action and in other circumstances.¹⁵

Since the statute contains these explicit rules and definitions, the only drafting required of the practitioner in connection with the capital formation for a corporation is a description of the shares in the certificate of formation and a board resolution setting a price for the shares. The other details are, by and large, covered by the statute.¹⁶

B. Partnerships and Limited Liability Companies.

While the TBOC does contain provisions relating to capital formation for partnerships and limited liability companies, which we will examine in further detail later in this outline, these provisions can be generally summarized as addressing the enforceability of contractual provisions rather than addressing the fundamental mechanics of capital formation in the way that

⁸ § 3.001(a).

⁹ § 3.007(a)(1).

¹⁰ § 3.007(a)(2).

¹¹ § 21.161(a).

¹² § 21.002(11)(A).

¹³ § 21.002(11)(B).

¹⁴ § 21.002(12).

¹⁵ § 21.002(11)(C).

¹⁶ Of course, the practitioner will also want to give careful consideration to state and federal securities laws that apply in connection with capital formation by corporations or other entities (including drafting subscription documents, etc.), transfer restriction provisions and other related provisions, all of which are beyond the scope of this outline.

the corporation statutes do. The result is that it is left up to the drafter of the organization documents (the partnership agreement for a partnership¹⁷ and the company agreement for a limited liability company¹⁸) to describe the details and mechanics. A substantial part of the remainder of this outline will be a presentation and examination of various contractual provisions regarding capital contributions for unincorporated entities.

III. Applicable Provisions of the Texas Business Organizations Code.

Let us begin by examining what the TBOC does provide with regard to capital contributions to partnerships and limited liability companies.

A. Regarding Partnerships Generally.

Chapter 152 of Title 4 of the TBOC contains the specific Texas statutory provisions for partnerships including limited partnerships to the extent not inconsistent with TBOC Chapter 153 of Title 4 covering certain aspects of limited partnerships.¹⁹ The fundamental concept underlying capital account maintenance for all partnerships²⁰ is stated in TBOC § 152.202.^{21 22}

§ 152.202. Credits of & Charges to Partner.

- (a) Each partner is credited with an amount equal to:
 - (1) the cash and the value of property the partner contributes to a partnership; and
 - (2) the partner's share of the partnership's profits.
- (b) Each partner is charged with an amount equal to:
 - (1) the cash and the value of other property distributed by the partnership to the partner; and
 - (2) the partner's share of the partnership's losses.

¹⁷ TEX. BUS. ORGS. CODE ANN. § 152.002(a) (Vernon 2008).

¹⁸ § 101.052.

¹⁹ § 153.003.

²⁰ These capital account maintenance provisions also govern limited liability companies that are classified as partnerships for federal income tax purposes. See Part I of this outline above.

²¹ TEX. BUS. ORGS. CODE ANN. § 152.202 (Vernon 2008).

²² See also § 151.001 for a corresponding definition of a partnership "capital account".

While thousands of gallons of ink have been spilled drafting capital account provisions in partnership agreements and company agreements and explaining and analyzing capital formation and distribution concepts in legal and accounting treatises and text books, the concept is a very simple one: give each partner (or member) credit for what he or she contributes to the partnership plus his or her share of partnership profits and charge each partner for what he or she takes out of the partnership plus his or her share of partnership losses.

There are only a few other references to contributions by partners in TBOC Chapter 152. An agreement to contribute or contributing money or property is a factor indicating the creation of a partnership.²³ Unless agreed otherwise, a partner is required to contribute that partner's negative balance in its capital account upon winding up of the partnership.²⁴ Upon the winding up of the partnership, each partner is also required to contribute the amount necessary to satisfy partnership obligations in the same proportion as he or she shares in losses.²⁵ These obligations survive the wrongful withdrawal from the partnership.²⁶ Winding up is beyond the scope of this outline.

B. Regarding Limited Partnerships.

Chapter 153 of Title 4 of the TBOC contains the specific Texas statutory provisions for limited partnerships. A contribution to a limited partnership by a partner may consist of “a tangible or intangible benefit” to the partnership or other property of any kind including: cash, a promissory note, services performed, a contract for services to be performed and another interest in or security of the limited partnership or another entity.²⁷ A promise by a limited partner to make a capital contribution must be in a written document signed by the limited partner.²⁸ Unless the partnership agreement provides otherwise, a partner or a partner's legal representative is obligated to perform an enforceable promise to make a contribution even if the limited partner dies, becomes disabled or has another change in circumstances.²⁹ Unless provided otherwise in the partnership agreement, the obligation of a partner to make a capital contribution to the partnership may be compromised or released only by consent of all of the partners.³⁰ A creditor of a limited partnership who extends credit or otherwise acts in reasonable reliance on an

²³ § 152.052(a)(5).

²⁴ § 152.707(d).

²⁵ § 152.708(a)(1).

²⁶ § 152.603.

²⁷ § 153.201.

²⁸ § 153.202(a).

²⁹ § 152.202(b).

³⁰ § 153.203.

obligation of a partner to contribute to a limited partnership may enforce the obligation if the obligation is reflected in a document signed by the partner and the obligation has not been compromised or released in an amendment to or cancellation of the written obligation.³¹ A compromise or release will not be effective to relieve the general partner of obligations to creditors.³² TBOC Chapter 153 also contains a nonexclusive list of consequences that are permitted in a partnership agreement when a partner breaches an enforceable promise to make a capital contribution.³³ We will examine this list in detail in the portions of the outline dealing with drafting such provisions.

C. Regarding Limited Liability Companies.

Title 3 of the TBOC contains the specific Texas statutory provisions for limited liability companies. An assignee of a membership interest in a limited liability company is liable for the assignor's obligation to make contributions to the company unless the assignee did not know about the obligation and it could not be ascertained from the company agreement.³⁴ To be enforceable, a promise to make a contribution to a limited liability company must be in a written document signed by the person making the promise.³⁵ A member or member's legal representative is obligated to perform an enforceable promise to make a contribution even if the member dies, becomes disabled or has another change in circumstances.³⁶ A member or member's legal representative who does not perform an enforceable promise to make a contribution is obligated to pay to the company in cash the value of the contribution as stated in the company agreement or the company's records less an amount already paid for the contribution.³⁷ An obligation to make a capital contribution may be released or settled only by consent of each member of the company.³⁸ A creditor of a limited liability company who extends credit or otherwise acts in reasonable reliance on an obligation of a member to contribute the company may enforce the obligation if the obligation is stated in a document signed by the member and not amended or cancelled to evidence the release or settlement of the obligation.³⁹ TBOC § 101.153(d)⁴⁰ contains a list of consequences that are permitted in a company agreement

³¹ § 152.204(a).

³² § 152.204(b).

³³ § 153.202(d).

³⁴ § 101.110.

³⁵ § 101.151.

³⁶ § 101.152.

³⁷ § 101.153(a).

³⁸ § 101.154.

³⁹ § 101.155.

⁴⁰ § 101.153(d).

when a member breaches an enforceable promise to make a capital contribution. We will examine this list in detail in the portions of the outline dealing with drafting such provisions.

The TBOC requires a limited liability company to keep at its principal office or make available at its principal office, among other information, a written statement of the amount of a cash contribution, and a description and statement of the agreed value of any other contribution, made or agreed to be made by each member of the company,⁴¹ the dates any additional contributions are to be made by a member⁴² and any event that would require a member to make additional capital contributions.⁴³ A limited liability company is not required to keep or make this information available if the information is stated in a written company agreement. A drafting tip for the practitioner is to be certain to state this required information, if possible, in the company agreement.

IV. Loan Versus Capital Contribution.

If your client is an investor, one thing to consider in representing your client is whether the investment should be structured as a loan and not a capital contribution. Loans to an entity can be fairly easy to document. Repayment of a loan is not income to the investor (except to the extent the repayment represents interest income). And as a lender, the investor will not be allocated profits or losses of the entity, which greatly simplifies the accounting for the investment. In many cases the entity will prefer not to show the investment as debt on its balance sheet and will not want to be obligated to repay the investment unless the entity is profitable. However, from the investor's perspective there may be advantages to a loan that should be considered.

V. Capital Contribution Provisions and Related Issues.

The TBOC provides that a member may contribute to a limited liability company and a partner may contribute to a limited partnership tangible or intangible property of any kind including cash, a promissory note, services performed, a contract for services to be performed and an interest in or security of the limited partnership or another entity.⁴⁴ The TBOC also provides that a person is not required to make a contribution to the company, to pay cash or transfer property to the company or to assume an obligation to make a contribution or otherwise pay cash or transfer property to the company in order to become a member of a limited liability company or acquire a membership interest in a limited liability company.⁴⁵

⁴¹ § 101.501(7)(A).

⁴² § 101.501(7)(B).

⁴³ § 101.501(7)(C).

⁴⁴ § 1.002(9) and § 153.201.

⁴⁵ § 101.102(b).

This Part V. of the outline will focus on negotiating and drafting provisions of a company or partnership agreement that obligate the members/partners to make contributions to the entity.

A. Initial Contributions in Cash.

Excerpted below are simple capital contribution provisions for a company agreement or partnership agreement when the initial contributions will be made in cash at the time of the formation of the entity. The amount of the initial capital contribution of each member/partner is specified on an exhibit to the agreement.

Initial Capital Contributions. Each [Member/Partner] has made as its initial capital contribution to the capital of the [Company/Partnership] (“Initial Capital Contribution”) the amount in cash set forth opposite the [Member’s/Partner’s] name on the attached Exhibit A under the heading “Initial Capital Contribution.”

B. Limiting Additional Contributions.

When reviewing a company or partnership agreement for an investor client it is important to have a clear understanding with the client about its obligations with respect to additional capital calls by the company or partnership. As discussed above (see Part II.A.), the investment required with regard to stock is typically fixed at the time the stock is issued. This is such an established practice that lawyers are routinely asked to opine, and are comfortable opining, that stock in a corporation is “fully paid and nonassessable”, meaning that a shareholder cannot be required to make any additional contributions to the capital of the corporation by virtue of owning the shares.⁴⁶ Clients who are accustomed to investing in stock in a corporation may be unfamiliar with the concept of additional capital calls. Therefore, it is important for the practitioner to review carefully the capital contribution provisions to avoid the unhappy result of a client surprised when he or she receives a request from the company or partnership to provide additional funds for operations. (See Part V.I. below for a discussion of how a review of additional capital obligations by a company’s lawyer affected the outcome of recent litigation.)

Set forth below is an example of a typical additional capital contribution provision. While this language is framed as “permitting” the manager/general partner to call for additional capital contributions, note that in fact no member/partner is obligated to make an additional capital contribution unless they agree to do so. These provisions also “permit” loans by members/partners, but only with the approval by a specified percentage of the members/partners.

Additional Capital Contributions. To whatever extent, if any, the cash generated by the [Company/Partnership] or obtained from lenders is insufficient to cover the expenses of the [Company/Partnership], the [Manager/General Partner] may request the [Members/Limited Partners] to make additional

⁴⁶ Scott FitzGibbons and Donald W. Glazer, *Legal Opinions in Corporate Transactions: The Opinion That Stock is Duly Authorized, Validly Issued, Fully Paid and Nonassessable.*, 43 Wash. & Lee L. Rev. 863 (1986).

contributions to the capital of the [Company/Partnership] (“Additional Capital Contributions”), but only with the approval of all of the [Members/Limited Partners]. If the [Company/Partnership] needs additional capital, but the [Manager/General Partner] and the [Members/Limited Partners] do not approve additional contributions, any [Member/Partner] may loan to the [Company/Partnership] the required funds upon terms and conditions agreed upon by the [Manager/General Partner] and the Requisite Percentage of the [Members/Limited Partners].

While the provisions excerpted above protect the investors from being required to make any additional investment beyond their initial contributions without their approval, the following provisions contain a stronger affirmative statement of this concept (in the last sentence).

Capital Contributions. Each initial [Member/Partner] shall contribute to the capital of the [Company/Partnership] the Capital Contribution set forth opposite such [Member’s/Partner’s] name on the attached Exhibit A for and in consideration of the number of Units set forth opposite such [Member’s/Partner’s] name on the attached Exhibit A. The capital contributions described above shall constitute the full obligation of the [Members/Partners] to furnish funds to the [Company/Partnership] and no additional capital contributions of cash or other property shall be required of any [Member/Partner] other than that which it hereafter agrees and obligates itself to make.

The following provisions specifically address the risk that a member’s or partner’s interest may be diluted if voluntary contributions are allowed.

Additional Contributions. The [Manager/General Partner] may assess additional contributions to the capital of the [Company/Partnership] only with the Approval of the [Members/Partners]. As used herein the term “Approval of the [Members/Partners]” shall mean the affirmative vote of at least fifty-one percent in interest of all of the [Members/Partners] at a meeting duly convened pursuant to Meetings section of this Agreement or the written approval of [Members/Partners] who own in the aggregate at least fifty-one percent in interest of the [Company/Partnership]. Additional contributions, if any, will be assessed pro rata among the [Members/Partners] based upon the respective percentage ownership of the [Members/Partners] on the date of the assessment. Each [Member/Partner] shall be required to contribute the amount of the aggregate assessment multiplied by such [Member’s/Partner’s] then current percentage of interest in the [Company/Partnership]. The [Members/Partners] shall not be permitted to make additional voluntary contributions to the [Company/Partnership] other than those indicated in this Section. Thus, [Members/Partners] may not alter their percentage interests in the [Company/Partnership] by making additional voluntary contributions without the Approval of the [Members/Partners].

C. No Limitations on Additional Capital Contributions.

It would seem a rare situation that investors would be willing to give a manager or general partner unrestrained authority to make additional capital calls in the future. However, the following provisions purport to do just that. The only limitation on the manager/general partner imposed by these provisions is its good faith believe that the company/partnership will face a cash shortfall.

Additional Contributions. If at any time, and from time to time, the [Manager/General Partner] in good faith believes that the [Company/Partnership] is, or at any time within the following ninety (90) days will be, in the position of having payment obligations in excess of cash or equivalent resources with which to fund such obligations, attempt to cause the [Company/Partnership], to borrow such funds, the [Manager/General Partner] shall make such situation, and in particular the amount (the “cash need amount”) of the excess of obligations over resources so determined, known to the [Members/Limited Partners] who shall each then be obligated to contribute to the [Company/Partnership], within fifteen (15) days following receipt of notice from the [Manager / General Partner], funds in an amount equal to such [Member’s/Limited Partner’s] Residual Percentage multiplied by the cash need amount.

D. Contributions of Personal Property (Other Than Cash).

Excerpted below are capital contribution provisions for a company agreement or partnership agreement when an initial contribution at the time of the formation of the entity will be made in personal property other than cash. In effect the party making the contribution is selling assets to the company/partnership⁴⁷ and all of the issues applicable to any sale of personal property apply, including whether the contributor/seller should make representations and warranties to the company/partnership and other members/partners in connection with the contribution/sale.

Initial Capital Contribution of Personal Property. As its initial capital contribution to the capital of the [Company/Partnership], [Member/Partner] will contribute, sell, transfer, assign, convey and deliver to the [Company/Partnership] all of its right, title and interest in and to the assets set forth opposite [Member’s/Partner’s] name on the attached Exhibit A under the heading “Initial Capital Contribution.” Simultaneously with its execution and delivery of this Agreement, [Member/Partner] is executing and delivering to the [Company/Partnership] an Assignment and Bill of Sale of even date with this Agreement substantially the form attached hereto as Exhibit B selling,

⁴⁷ However, the transaction may not be taxable as a sale for federal income tax purposes. See the discussion in Part V.G. below.

transferring, assigning and conveying such assets to the [Company/Partnership]. The parties agree that such assets have a fair market value for purposes of this Agreement of \$_____.

Attached as Schedule A to this outline is a form of Assignment and Bill of Sale that could be used in connection with a contribution of personal property to a company/partnership by a founder. Consideration should be given to whether any representations or warranties would be appropriate to add to the Assignment and Bill of Sale based upon the type of property being contributed. For example, if the contributed assets are equipment, should the contributor make a representation about the condition of the equipment, or if the assets are accounts receivable, should the contributor make a representation about the aging and collectability of the receivables?

E. Contributions of Real Estate.

Frequently a real estate venture will involve a contribution of improved or unimproved real estate by one or more parties to the venture. And family limited partnerships are often formed specifically for the purpose of receiving and holding family real estate assets. Just as with a contribution of personal assets, in this situation the contributor is effecting a sale of its real estate to the company/partnership.⁴⁸ The lawyer handling the formation should take into account all of the issues involved in a sale of real estate and should consider whether the company/partnership agreement should include provisions typically included in a real estate purchase agreement such as provisions for title insurance, a survey, a property inspection, an environmental study, environmental representations and indemnities, and so forth. In the alternative, maybe the contributor/seller and venture entity should enter into a separate real estate purchase agreement that recites that the consideration for the real estate being conveyed is the interest in the venture. Excerpted below are capital contribution provisions for a company agreement or partnership agreement when real estate is being contributed at the time of the formation of the entity. Note that these provisions contemplate that the company/partnership will assume certain liabilities related to the assets.

Contribution of Property. For and in consideration of the Percentage Interest set opposite its name on Exhibit A, [Member/Partner] agrees to grant, contribute and convey to the [Company/Partnership]:

(a) That certain tract of real property situated in _____ County, Texas, and described on Exhibit B (the “Land”), together with all improvements, structures, fixtures, equipment and landscaping (“Improvements”) constructed thereon, consisting of an apartment complex with a total of _____ (_____) rental units known as “_____.”

⁴⁸ However, the transaction may not be taxable as a sale for federal income tax purposes. See the discussion in Part V.G. below.

(b) All leases and rental agreements in existence with respect to the Land and the Improvements (the “Leases”);

(c) All personal property (the “Personal Property”) owned by [Member/Partner] that is located on or in the Land and the Improvements or used in connection with the operation thereof, an inventory of such Personal Property to be prepared by [Member/Partner] and delivered to the [Company/Partnership] within ten (10) days from the date hereof; and

(d) All appurtenances (the “Appurtenances”), including all the rights, ways, waters, licenses, contract rights, benefits, easements, claims, awards, privileges and alleys to the same belonging or in any wise appertaining; and all right, title and interest of [Member/Partner] in any land lying in the bed of any street, alley, road or avenue, open or proposed, in front of or adjoining the Land.

The Land, Improvements, Leases, Personal Property and Appurtenances are hereinafter collectively called the “Contributed Property.” As additional consideration for the Property, the [“Company/Partnership] agrees to assume and pay, according to the terms thereof, all principal and interest now remaining unpaid on that one certain promissory note (the “Note”) in the original principal sum of \$_____ dated _____, 20__ executed by [Member/Partner] payable to the order of _____ Bank. Simultaneously with its execution and delivery of this Agreement, [Member/Partner] is furnishing to the [Company/Partnership]: (1) a Blanket Conveyance, Bill of Sale and Assignment conveying the Personal Property free and clear of all liens and encumbrances; (2) an Assignment of Leases conveying the Leases and the security deposits; (3) the originals of the Leases; (4) assignments of all warranties, contracts and other agreements from and with contractors, surveyors, servicers, and suppliers of the Contributed Property; and (5) a Warranty Deed to the Contributed Property in form reasonably satisfactory to the [Company/Partnership]. The Warranty Deed shall except only to matters affecting the Property which are approved by the [Company/Partnership] in accordance with the Title Matters section of this Agreement. Simultaneously with [Member’s/Partner’s] execution and delivery of this Agreement, the [Company/Partnership] is furnishing to [Member/Partner] and it’s lender documents in form reasonably satisfactory to [Member/Partner] and it’s lender evidencing its assumption of the Note. The parties agree that the fair market value of the Property for purposes of this Agreement is \$_____.

Attached as Schedule B to this outline is a form of Warranty Deed that could be used in connection with a contribution of real estate to a company/partnership.

F. Valuing a Non-Cash Contribution.

Typically a company or partnership agreement will contain a provision similar to the following provision:

A Capital Account shall be maintained for each [Member/Partner]. It is the intention of the [Members/Partners] that the Capital Accounts be maintained in accordance with Treasury Regulation Section 1.704-1(b). In that regard, each [Member's/Partner's] Capital Account shall be ... increased by ... the fair market value of property contributed by such [Member/Partner] to the [Company/Partnership] (net of liabilities securing such contributed property that the [Company/Partnership] is considered to assume or take subject to under Section 752 of the IRC).

While language like this will provide a baseline for valuing non-cash assets that are contributed to a company/partnership, it is good practice to state in the company/partnership agreement the value that the parties agree to place on the asset for purposes of establishing the contributor's capital account. Not only will this avert misunderstandings, confusion and disputes at a later date and be helpful to the accountants charged with the responsibility of establishing and maintaining the capital accounts, but it will satisfy the requirement of the TBOC that a limited liability company keep a record of the value of contributions.⁴⁹ Notice that the provisions cited in Parts V.D. and V.E. above contain an acknowledgment of the value. The parties and their advisors should also consider whether independent third party validation of the agreed valuation is helpful or necessary. If the entity is a family limited partnership being established for estate planning purposes, the lawyer handling estate matters will most likely encourage an independent appraisal of the value of the contributed property to support a subsequent appraisal of any partnership interests that may be the subject of gifting and to avoid intra-family disputes over valuation.

G. Certain Tax Consequences.

Federal income taxation related to establishing and maintaining partnership capital accounts is a highly complex area of the law, well beyond the scope of this outline. However, an overview of the tax issues related to capital contributions seems warranted, especially to make the reader aware of a few "traps for the unwary".

The general rule stated in Section 721(a)⁵⁰ of the IRC is that no gain or loss is recognized by the partnership or the partner when a partner makes a contribution of property to a partnership in exchange for an interest in the partnership.⁵¹

⁴⁹ A limited liability company must keep at its principal office a statement of the agreed value of any non-cash contributions made or agreed to be made by each member unless the information is stated in a written company agreement. TEX. BUS. ORGS. CODE ANN. § 101.501(b) (Vernon 2008).

⁵⁰ I.R.C. § 721(a).

The practitioner should be aware of four exceptions to the general “no gain or loss” rule:

1. Services. Partnership interests issued in exchange for services are not eligible for nonrecognition treatment under IRC Section 721(a).^{52 53} If the company/partnership agreement provides that a member/partner is receiving an interest in the company/partnership in exchange for services rendered or to be rendered,⁵⁴ then the member/partner may be receiving taxable compensation subject to taxation as ordinary income. In addition, payroll taxes and withholding obligations may apply.

2. Partnership Investment Company. If the company or partnership is a “partnership investment company” then the nonrecognition allowed by IRC Section 721(a) does not apply.^{55 56} The rationale behind this exception is that a partnership should not be used to allow an investor to diversify its investments on a tax free basis. If (1) more than 80% of the assets of a partnership are securities, (2) partners contribute assets with a value in excess of their tax basis, and (3) contributions by partners result in diversification of assets for the partners, then the contribution will be treated as a sale triggering tax on the gain. Techniques apply to avoid recognizing gain, such as all partners contributing an identical mix of securities.

3. Disguised Sale. A contribution of real estate or personal property (other than cash) may be taxable as a “disguised sale” under IRC Section 707(a).⁵⁷ If a partner contributes assets to a partnership that have a value in excess of the partner’s tax basis in the assets and the partner receives consideration other than a partnership interest from the partnership, then the partner is treated as having sold part of the property for the additional consideration in a taxable transaction. The disguised sale rules look not only to what is received by the contributing partner at the time of the transfer, but also to what is received within a period

⁵¹ In this outline it is assumed that limited liability companies will be classified as partnerships for federal income tax purposes. See Part I. above.

⁵² I.R.C. § 721(a).

⁵³ See McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, Chapter 5 for a thorough discussion of the federal income tax consequences of issuing partnership interests in exchange for services, which is beyond the scope of this outline.

⁵⁴ TEX. BUS. ORGS. CODE ANN. § 153.201(3).

⁵⁵ I.R.C. § 721(b).

⁵⁶ See McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 4.07 for a detailed discussion of “partnership investment companies.”

⁵⁷ I.R.C. § 707(a).

of time after the transfer (generally two years). Cash received by borrowing against the contributed property, either before or after the transfer can trigger the disguised sale rules.⁵⁸

4. Assumption of Indebtedness. If a partner contributes property to a partnership that is subject to indebtedness and the partnership takes the property subject to the liability or assumes the liability of the contributing partner, then the transaction may result in gain (but not loss) recognition to the partner.⁵⁹

H. Multiple Capital Calls.

Private equity funds and similar investment vehicles are traditionally organized as unincorporated entities, typically limited partnerships. Unlike an entity that requires large initial outlay of funds at the commencement of its business, such as an entity formed to raise the equity portion of a real estate development to be funded by a loan, these investment funds typically involve commitments by the limited partners to make capital contributions over time as the fund finds investments that meet the investment criteria of the fund. The partnership agreements for these funds often involve a complex capital call provisions.

Set forth below is an example of the capital call provisions from a private equity fund contemplating multiple capital calls.⁶⁰ Note that while these provisions may seem open-ended because they allow capital calls not only for a stated finite amount, but also for “Partnership Expenses” (see Part V.B. above), in fact the definition of “Partnership Expenses” is quite narrow.

Capital Commitments.

(a) Limited Partner Capital Commitments. Subject to the provisions of the Permitted Excuse section of this Agreement⁶¹ and the Alternative

⁵⁸ See *Disguised Sales: Exploring the Outer Boundaries*, Journal of Taxation, October 2006, at 252 for an in-depth discussion of this topic.

⁵⁹ See McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 4.03 for an in-depth discussion of this topic.

⁶⁰ To avoid additionally complicating these already complex call provisions, and because private equity funds are so frequently organized as limited partnerships, these provisions are presented only as partnership provisions without the alternative limited liability company terminology used elsewhere in this outline.

⁶¹ The referenced Permitted Excuse section reads as follows:

Permitted Excuse. If a Limited Partner reasonably determines that its making of, or participation in, an investment contemplated to be made from a Capital Contribution to the Partnership would be more likely than not to result in a material violation of any applicable federal, state or foreign law or any rule or regulation of any Governmental Authority then in effect and applicable to such Limited Partner or its partners, shareholders or members, or (b) the making of such Capital Contribution is, with respect to a Portfolio Company substantially likely to cause a Limited Partner classified as a tax-exempt organization pursuant to Section 501(c)(3) of the IRC to lose its status as such (each such event being a “Permitted Excuse”), then, in such case, such Limited Partner shall notify the General Partner in writing and with reasonable particularity of the (Footnote continued on the next page)

Investment Vehicle section of this Agreement,⁶² each Partner agrees to and shall make cash contributions to the capital of the Partnership up to the amount set

specific legal basis for its alleged Permitted Excuse at least five (5) Business Days prior to the Due Date of the Capital Contribution with respect to which the alleged Permitted Excuse is asserted. Materiality of a potential violation shall be based on the anticipated loss or harm to a Limited Partner or any of its partners, as applicable, relative to the amount of a Limited Partner's (or such partner's) Capital Contribution to the Partnership in respect of the investment in question. If the Limited Partner providing such notice delivers to the General Partner an opinion of counsel reasonably satisfactory to the General Partner to the effect that such Limited Partner's Permitted Excuse is valid or if such Limited Partner fails to deliver such an opinion but the General Partner in good faith determines that such Permitted Excuse is valid, then such Limited Partner shall be deemed to have a Permitted Excuse and such Partner shall be exempt from making the applicable Capital Contribution. The Capital Commitment of a Limited Partner that has a Permitted Excuse as determined by the General Partner pursuant to this Section shall not be reduced as a result of such Permitted Excuse. If a Limited Partner fails to deliver notice of an alleged Permitted Excuse as provided above at least five (5) Business Days prior to the Due Date (unless such notice is waived by the General Partner) or the General Partner does not determine that such Limited Partner has a Permitted Excuse, the Limited Partner shall thereupon automatically and without further notice be a Defaulting Partner subject to the provisions of the Default in Capital Commitment section of this Agreement. Any shortfall due to a Permitted Excuse shall be treated in accordance with the provisions of the Shortfall in Capital Contributions section of this Agreement.

⁶² The referenced Alternative Investment Vehicle section reads as follows:

Alternative Investment Vehicle. The General Partner may determine, in the exercise of its reasonable judgment that it is in the best interests of the Partnership to make a potential investment in Portfolio Securities through one or more alternative entities organized by or on behalf of the General Partner or its Affiliates and having economic terms, conditions and management substantially identical, to the extent practicable, to those of the Partnership ("Alternative Investment Vehicles"); provided that (i) the General Partner or an Affiliate thereof shall serve as the general partner (or in an equivalent position) with respect to any such Alternative Investment Vehicle (without limiting the responsibilities and obligations of the General Partner hereunder), (ii) any contributions made by the Partners to any such Alternative Investment Vehicle shall reduce the unused Capital Commitments of the Partners making such contributions and that all distributions and allocations made by such Alternative Investment Vehicle shall solely, for calculation purposes, be aggregated with the distributions and allocations made pursuant to this Agreement, (iii) upon the dissolution of the Partnership, such Alternative Investment Vehicle shall similarly be dissolved or terminated, and (iv) any such Alternative Investment Vehicle shall be organized as a limited partnership, a limited liability company, a business trust or other entity for which a U.S. "check-the-box" election, to be treated as a partnership, could be made under the IRC. The General Partner shall use its Best Efforts to ensure that such Alternative Investment Vehicle is structured in a manner that would not unfairly discriminate among the Partners and that the respective rights and obligations of the General Partner and the Limited Partners contained in this Agreement apply in all material respects to the participants in such Alternative Investment Vehicle, provided that (i) the General Partner shall not receive any fee from an Alternative Investment Vehicle, (ii) the indemnification and exculpation under an Alternative Investment Vehicle will be identical to those in this Agreement, and (iii) the investment limitations in the Investment Limitations section of this Agreement herein shall apply to an Alternative Investment Vehicle. Each Limited Partner agrees to execute and deliver such documents and to take such actions as may be reasonably requested by the General Partner to give effect to this Section.

forth opposite his or her name on Exhibit A attached hereto plus any amounts necessary to fund the Partnership Expenses set forth in clause (x) of the Partnership Expenses section of this Agreement.⁶³ The amount of a Partner's commitment to make such capital contributions hereunder, less any portion of the commitment that is released or reduced pursuant to the Permitted Excuse section, is referred to herein as a "Capital Commitment." Each Partner's Capital Commitment shall be reduced by the amount of Capital Contributions made by such Partner; provided, that, (x) any Capital Contributions returned to Partners pursuant to the Distributions section of this Agreement with respect to (i) investments in Portfolio Companies in respect of which the distributions are made on or prior to the first anniversary of the date Capital Contributions were made to fund any such investment, and (ii) any Management Fees, shall, in either case, be subject to call and (y) any amounts returned to a Partner pursuant to the Payments by Additional Limited Partners section of this Agreement⁶⁴ shall be added to each

⁶³ The referenced clause (x) of the Partnership Expenses section reads as follows:

(x) all costs, fees and expenses of any judicial, administrative or arbitration actions, suits, proceedings (public or private) or governmental proceedings or investigations, and the amount of any judgments or settlements paid in connection therewith, including indemnification payments permitted pursuant to this Agreement and (y) the costs of winding-up and liquidating the Partnership.

⁶⁴ The referenced Payments by Additional Limited Partners section reads as follows:

(a) Payments by Additional Limited Partners. As a condition to being admitted as an additional Limited Partner hereunder, each such additional Limited Partner shall pay on the date of its admission:

(i) to the Partnership, for disbursement in turn to the other Partners, an amount equal to (A) such Partner's percentage of the total Capital Commitments (after giving effect to his admission) multiplied by the total amount contributed by the other Limited Partners at or prior to the admission of the additional Limited Partner (less the amount distributed to the other Partners at or prior to the admission of the additional Limited Partner with respect to any Portfolio Security that has been sold or disposed of prior to such additional Limited Partner being admitted), including amounts contributed to pay Partnership Expenses (other than the Management Fee), together with (B) interest on such amounts payable in accordance with the foregoing clause (A) at the annual rate of seven percent (7%), compounded annually, from the date any such amount would have been payable if such additional Limited Partner had been admitted on the Initial Closing Date to the date of actual payment; and

(ii) to the Manager, (A) that amount with respect to the Management Fee that such additional Limited Partner would have been liable hereunder had such additional Limited Partner become a Limited Partner on the Initial Closing Date, together with (B) an amount equal to interest on such amount at the annual rate of seven percent (7%), compounded annually, from the date such amount would have been payable if such additional Limited Partner had been admitted on the Initial Closing Date to the date of actual payment.

(Footnote continued on the next page)

Partner's unused Capital Commitment. Capital Commitments of a Partner shall not be assets of the Partnership until and only to the extent such Partner actually contributes capital to the Partnership. The Capital Commitments of the Limited Partners shall not exceed in the aggregate the amounts set forth opposite each Limited Partner's name on Exhibit A attached hereto plus the pro rata portion (based on the amounts in Exhibit A) of any amounts necessary to fund the Partnership Expenses set forth in clause (x) of the Partnership Expenses section of this Agreement.

(b) General Partner Capital Commitment. The Capital Commitment of the General Partner shall be an amount equal to one percent (1.00%) of the sum of the Capital Commitments of all Partners. Except as otherwise required by law the General Partner shall not be obligated to restore or contribute to the capital of the Partnership all or any portion of a negative balance in its Capital Account.

Capital Contributions.

(a) Procedures. The amount of capital contributed by a Partner pursuant to its Capital Commitment is referred to herein as a "Capital Contribution." Capital shall be called for contribution to the Partnership from time to time by the General Partner (each, a "Capital Call"). All Capital Calls shall be made in writing and except as otherwise provided in this Agreement shall be made to all Partners pro rata in proportion to their respective Capital Commitments remaining to be called and shall be made by separate notice ("Call Notices") containing the information set forth in paragraph (c) below. The General Partner shall deliver Call Notices to the Limited Partners in accordance with the Notices section of this Agreement at least ten (10) Business Days before the installment payable in response to the Call Notice is due (the "Due Date"). All Capital Contributions shall be paid on their Due Date. The obligation to fund Capital Commitments shall terminate without notice upon expiration or earlier termination of the Commitment Period,⁶⁵ except for the following obligations that shall extend beyond the expiration or earlier termination of the Commitment

Notwithstanding the foregoing, to the extent the Capital Accounts of any existing Limited Partners exceed the amount of Capital Contributions of such Limited Partners at the time of the proposed admission of an additional Limited Partner, then the General Partner reserves the right to modify the terms and conditions of admitting additional Limited Partners and to make such allocations to the Capital Accounts as it deems necessary to cause Capital Accounts to be maintained in accordance with applicable Treasury Regulations and to reflect the economics as set forth in this Agreement.

⁶⁵ "Commitment Period" is defined as follows:

"Commitment Period": the period of five years from the date on which Limited Partners are admitted to the Partnership by the General Partner (the "Final Closing Date"), which date shall occur on or before _____, 20__; provided that, the General Partner may, in its sole discretion, extend the Final Closing Date to any date up until _____, 20__.

Period: (i) the obligation to fund the Follow-on Commitment Amount to fund Follow-on Investments, which obligation shall terminate upon expiration of the Follow-on Commitment Period; (ii) the obligation to fund Capital Calls that are the subject of outstanding Call Notices; (iii) the obligation to fund any Partnership Expenses and (iv) the obligation to fund the applicable Management Fee. Any Due Date in respect of which a Call Notice has been delivered may be postponed by the General Partner one or more times for an aggregate of up to thirty (30) Business Days following the originally scheduled Due Date. The General Partner shall give prompt notice to each Limited Partner, in accordance with the Notices section of this Agreement, of any such postponement, whereupon such rescheduled Due Date shall be the Due Date for purposes hereof. To the extent that the information contained in the original Call Notice has materially changed, the notice of postponement shall set forth such changes.

(b) Payment and Investment of Capital Contributions. All payments of the Partners hereunder shall be made to the Partnership by wire transfer of federal funds or other immediately available funds (or by such other reasonable means as the General Partner may designate) by such time as the General Partner shall designate in the applicable Call Notice on the relevant Due Date to an account of the Partnership designated by the General Partner for such purpose. So far as practicable, Capital Contributions shall be invested by the General Partner in Temporary Investments pending the purchase of Portfolio Securities. Any amounts, together with any interest earned on Temporary Investments, paid by a Partner pursuant to a Call Notice for an investment in Portfolio Securities shall either be invested in Portfolio Securities or refunded to such Partner within thirty (30) Business Days of the originally scheduled Due Date. If any amount is refunded, such Partner's Capital Commitment remaining to be called shall be increased by the amount so refunded, excluding such interest.

(c) Information in Call Notices. Each Call Notice for Capital Calls shall specify:

- (A) the scheduled Due Date;
- (B) the aggregate amount of payments to be made on the Due Date by all Partners;
- (C) the amount of the Management Fee for such period;
- (D) the required payment to be made by the Limited Partner to which the Call Notice is delivered and the percentage such payment represents of the entire Capital Contributions to be made by all Partners to which the Call Notice is delivered;
- (E) the account to which such payment shall be paid; and
- (F) whether such payment is to be applied in whole or in part to the payment of Partnership Expenses.

(d) Shortfall in Capital Contributions. If a Limited Partner's failure to make a Capital Contribution either due to a Permitted Excuse results in a shortfall ("Shortfall") in the Partnership's ability to purchase a given amount of securities of a Portfolio Company on the Due Date, the General Partner shall forthwith deliver a new Call Notice to the remaining Limited Partners assessing them their pro rata portion of the amount of the Shortfall, payable on the later of (i) the Due Date of such Capital Contribution (or such later date as may be specified by the General Partner) and (ii) ten (10) Business Days after the date of such new Call Notice, provided, that, no Limited Partner's Capital Commitment shall be increased thereby.

I. Case Law.

Courts have generally recognized and upheld the enforceability of capital call provisions in company and partnership agreements.⁶⁶ At least two relatively recent Texas cases have considered and upheld capital call provisions.

In *Brewer v. Tehaucana Venture, Ltd.*,⁶⁷ a 1987 opinion from the Fourteenth Court of Appeals in Houston, Mr. Brewer, a limited partner, brought an action against the limited partnership and its general partner to recover a distribution he believed he was entitled to upon the winding up of the partnership. The partnership was formed to acquire a tract of land and ranching operations for investment purposes. The partnership made a capital call for partnership expenses, and Brewer refused to pay his share of the capital call because the partnership did not demonstrate to him that reasonable efforts were being made to sell the property. The partnership agreement did not excuse Brewer from paying the cash call for his stated reason. It also provided that if a partner failed to meet a cash call, the general partner had the right to purchase the defaulting partner's interest upon payment of the call within ten days after the default. At the trial, the jury found that the general partner did not strictly comply with the terms of the forfeiture provisions because it did not purchase the interest within ten days. One of the owners of the general partner testified that the general partner did assume Brewer's liability by paying the call, but that it delayed doing so because it was trying to get Brewer to make his payment. He testified that: "We were trying to keep him in, not get him out". The court found that strict compliance with the ten day term was immaterial in view of the testimony that the general partner did eventually buy Brewer's interest and delayed doing so only to try to convince him not to default. Shortly after the general partner bought Brewer's interest, a buyer was found for the ranch, it was sold, the partnership was wound up and the payment for Brewer's interest in the winding up was greater than ten times the amount of the defaulted call. Brewer argued that the general partner knew about the pending sale when it purchased his interest, but the jury found that it did not and that there was no breach of fiduciary duty by the general partner. The

⁶⁶ See Bromberg & Ribstein, *Bromberg and Ribstein on Partnership*, §12.08 (Aspen Publishers, 1st ed. 1988, 2007 Supp.) for a thorough, multi-jurisdictional discussion of relevant case law related to enforcement of capital call provisions.

⁶⁷ *Brewer v. Tehaucana Venture, Ltd.*, 737 S.W.2d 349 (Tex. App.—Houston, 1987, no writ).

appellate court upheld this finding and also awarded attorney's fees to the general partner and the partnership. Brewer didn't raise an issue about the enforceability of the partnership provisions and the court cited no precedent (statutory or case law) to support its holdings regarding the partnership provisions.

In *Potter v. GMP, L.L.C.*,⁶⁸ a 2004 case from the Texas Court of Appeals, San Antonio, the appellate court upheld the trial court's enforcement of additional capital call provisions in the regulations of a Texas limited liability company agreement. The limited liability company, GMP, L.L.C., sued Mr. Potter, a minority member of the company, for breach of contract based upon his failure to make a capital call pursuant to the company's regulations. The trial court found that the regulations were ambiguous, creating an issue of fact for the jury as to the intended meaning of the regulations. The jury found that the parties intended for capital calls to be mandatory and awarded damages to the company based upon Mr. Potter's refusal to meet an additional capital call.

The opinion of the appellate court contains a detailed discussion of the provisions of the regulations related to the capital call and the circumstances surrounding the negotiation and drafting of the same. It is interesting reading for anyone charged with the task of negotiating and drafting capital call provisions. The capital call provisions in question read as follows:

Without creating any right in favor of any third party, each Member shall contribute to the Company, in cash, on or before the date specified as hereinafter described, that Member's Sharing ratio of all monies that in the judgment of a Majority in Interest of the Members are necessary to enable the Company to cause the assets of the Company to be properly operated and maintained and to discharge its costs, expenses, obligations, and liabilities.

Most lawyers would interpret these provisions as clearly making a capital call mandatory for all of the members if the capital call was duly approved by a majority in interest of the members as required by these provisions. The court agreed. However the defendant Potter argued that two subsequent sections of the regulations overrode the provision quoted above.

The first of these additional provisions were notice provisions, which read as follows;

The Managers shall notify each Member of the need for Capital Contributions . . . when appropriate, which notice must include a statement in reasonable detail of the proposed uses of the Capital Contributions Members shall express their assent or objection to such additional Capital Contributions in writing or at a meeting of the Members within ten (10) days of receipt of the referenced Notice.

The second provision argued by defendant Potter provided:

⁶⁸ *Potter v. GMP, L.L.C.*, 141 S.W.3d 698 (Tex. App.—San Antonio, 2004, pet. dism'd).

No Member shall be liable for the debts, liabilities, or obligations of the Company beyond his respective Initial Capital Contribution, unless separately agreed in writing by said Member.

The court found as a matter of law that these three provisions, read together, created an ambiguous contract and thus it was a proper fact question for the jury to consider what the parties intended. There was testimony by Mr. Potter and his lawyer and his wife that the issue of additional capital contributions was never raised at meetings that the parties attended to discuss the regulations prior to their execution. There was testimony by the majority members that additional capital calls were discussed in the presence of Mr. Potter and that at the closing everyone, including Mr. Potter and his wife, were advised that there would be a need for additional capital contributions in the future. Additionally, handwritten notes taken by the company's attorney at a meeting at which Mr. Potter was present were admitted into evidence in the trial and the notes referenced capital contributions and capital calls. Based upon the evidence, the jury found that Mr. Potter agreed to make additional capital contributions. The court awarded damages for the company and also ordered defendant Potter to pay the company's attorney's fees. The appellate court upheld the damages and found that a suit by a company against a member to pay an additional capital contribution is the type of action for which attorney's fee can be awarded.⁶⁹

These cases provide three important practice points related to negotiating, drafting and implementing capital call provisions:

1. Avoid Ambiguities. Be sure that other provisions in the agreement do not conflict with the capital call provisions or give rise to an argument that the agreement is ambiguous. Potter's argument that the notice provisions he cited relieved him of liability for a capital call approved by the majority seems a weak argument. However, the other provision Potter cited does seem to create ambiguity. Most likely, the draftsman of this agreement included this provision to protect the members from a claim by a third party creditor seeking to enforce the capital call provisions. In hindsight, the draftsman should have harmonized this provisions with the capital call provision or included language like the following: “.. provided, however, that this section will not be interpreted to relieve a Member from making an additional capital contribution approved by a Majority in Interest of the Members.”

2. Document Negotiations. Be sure that additional capital call provisions are discussed with and explained to all of the members, preferably in writing. The testimony of the majority members and the drafting lawyers notes were persuasive to the jury in the *Potter* case.

3. Attorney's Fees. Note that if a company or partnership is required to sue a member or a partner for an additional capital contribution the *Brewer* case and the *Potter* case provide solid precedent for recovery of attorney's fees by the company or partnership against the defaulting party.

⁶⁹ *Potter*, 141 S.W.3d at 705. See TEX. CIV. PRAC. & REM. CODE ANN. § 38.001(8) (Vernon 2004).

VI. Consequences of Failure to Contribute.

TBOC § 101.153(b)⁷⁰ contains a list of provisions that may be included in a company agreement affecting the membership interest of a member who fails to perform an enforceable promise to make a payment of cash or transfer of other property to the company, whether as a contribution or in connection with a contribution already made. TBOC § 153.202⁷¹ contains a nonexclusive list of provisions that may be set out in a limited partnership agreement as a consequence for failing to make a payment of cash or transfer of other property to a partnership as a contribution.

Some drafters of company or partnership agreements will simply recite in the agreement the list of remedies authorized by the statutes. However, a recitation of these remedies with no specifics or mechanics doesn't give the manager or general partner much guidance for enforcing capital calls or provide much predictability for the investors. Therefore, the more common practice is to include more detailed provisions spelling out the rights of the parties and describing specific procedures. We will now turn to an examination of these sorts of detailed provisions that may be included in the governing documents consistent with the statutory authority for consequences of defaulting on capital calls.

A. Loan from the Other Owners.

TBOC § 101.153(b)(4)(B)⁷² states that the company agreement of a limited liability company may provide that upon the failure of a member to make a required capital contribution, the membership interest of the defaulting member may be made the subject of a loan from other members of the company in the amount necessary to satisfy the promise to contribute. Contrast this provision with TBOC § 153.202(d)(5)⁷³ which states that a partnership agreement of a limited partnership may permit the lending of money to the defaulting partner by the other partners of the amount necessary to meet the defaulting partner's commitment. Neither of these provisions state that the defaulting member/partner will be required to pay the funds loaned by the other members/partners to the company/partnership for purposes of satisfying the contribution obligation. Therefore, in drafting provisions to create a remedy for a contribution default that involves loan(s) to the defaulting member/partner by the other members/partners, it would be important to state the defaulting member/partner will use the to proceeds of the loan(s) to fund his or her capital contribution obligation.

Set forth below is an example of such a provision. In reviewing the example below, note the following:

⁷⁰ TEX. BUS. ORGS. CODE ANN. § 101.153(b) (Vernon 2008).

⁷¹ § 153.202.

⁷² § 101.153(b)(4)(B).

⁷³ § 153.202(d)(5).

1. Loaned funds are to be paid directly to the company/partnership. This assures that the funds will be used to satisfy the defaulting member's/partner's capital contribution obligation.

2. The loan will be repaid directly from the first distributions payable to the defaulting member/partner.

3. The provisions include the granting of a security interest by the defaulting member/partner in its ownership interest to secure the loans.

The following provision shall apply if any [Member/Partner] fails or refuses to make any Additional Capital Contribution pursuant to a Cash Call by the [Manager/General Partner] in accordance with this Agreement (the "Defaulting Contributor") within fifteen (15) days after the request therefor (a "Defaulted Additional Contribution"):

(a) The [Members/Partners] (excluding any [Member/Partner] who is an Affiliate of the Defaulting Contributor) who have made in full their share of such requested Additional Capital Contribution (the "Non-Defaulting Contributors") may, but shall not be obligated to, make a deemed loan (a "Defaulted Contribution Loan") to the Defaulting Contributor by advancing such sums to the [Company/Partnership] with notice that such sums shall be deemed a Defaulted Contribution Loan hereunder, which Defaulted Contribution Loan shall be automatically deemed secured by the portion of the Ownership Interest of the Defaulting Contributor that would otherwise constitute the Dilution Percentage⁷⁴ pursuant to the UCC Security Interest created herein by each Partner in favor of the other for this purpose.

(b) Defaulted Contribution Loans under this Section shall bear interest at the lesser of (A) the rate that will yield the same amount of interest as the Preferred Return on Additional Capital, or (B) the maximum rate allowed by applicable law, and such loan will be repaid directly by the [Company/Partnership] (in addition to being payable by the Defaulting Contributor on demand) out of the first distributions of Additional Capital Contributions or Preferred Return on Additional Capital otherwise distributable to the [Member/Partner] for whom such loan was made. If the Defaulted Contribution Loan is not repaid by the Defaulting Contributor in full within ten (10) days of demand, such Defaulted Contribution Loan amount shall be automatically be converted to capital/equity Additional Capital Contribution of the demanding [Member/Partner] and cause automatic dilution of the Defaulting Contributor's Ownership Interest as provided in Dilution section of this Agreement, or if such automatic dilution is not permitted by any applicable law the Defaulted Contribution Loan shall not be deemed converted to equity and the

⁷⁴ "Dilution Percentage" is defined in the form of provisions set forth in Part VI.C. below of this outline.

[Member/Partner] to whom such loan is due may immediately proceed to foreclose its UCC Security Interest on the Dilution Percentage of the Defaulting Contributor's Ownership Interest as provided in paragraph (d) below. Any Defaulted Additional Contributions or Defaulted Contribution Loans made under this Section shall be made in such proportions as the Non-Defaulting Contributors agree or, in the absence of agreement, in the ratio of their respective Ownership Interests.

(c) If any contribution by a [Member/Partner] of a Defaulted Additional Contribution is prevented by any applicable law from causing an automatic shifting of the Ownership Interests of the [Members/Partners] as contemplated herein, such contributions shall be conclusively deemed to have been Defaulted Contribution Loan secured by the UCC Security Interest created herein against the appropriate Dilution Percentage of the Ownership Interest of the [Member/Partner] to whom such Defaulted Contribution Loan shall have been deemed made and permission is granted for any bookkeeping or accounting entries to the contrary to be unilaterally made by the [Manager/General Partner].

(d) Any Defaulted Contribution Loan or deemed Defaulted Contribution Loan and all renewals, modifications, and extensions thereof shall be automatically secured by a lien and security interest hereby created and granted pursuant to the Texas Uniform Commercial Code by each [Member/Partner], as debtor, in favor of each other [Member/Partner], as secured party, on a current basis, against the relevant Dilution Percentage of the Ownership Interest of the debtor [Member/Partner] on whose behalf such Defaulted Contribution Loan has been made (the "UCC Security Interest"). Each [Member/Partner], as debtor, hereby authorizes each other [Member/Partner], as secured party, to file a financing statement describing the such [Member's/Partner's] Ownership Interest in the [Company/Partnership] reflecting the UCC Security Interest created herein. Such UCC Security Interest may be foreclosed from time to time by the [Member/Partner] for repayment of a Defaulted Contribution Loan made or deemed made by it to such [Member/Partner], which Defaulted Contribution Loans shall be due and payable upon demand.

B. Reduction in Percentage Interest.

TBOC § 101.153(b)(1)⁷⁵ states that the company agreement of a limited liability company may provide that upon the failure of a member to make a required capital contribution, the membership interest of the defaulting member may be reduced. TBOC § 153.202(d)(1)⁷⁶ provides that partnership agreement of a limited partnership may provide for reduction in the percentage or other interest in the partnership of any partner who fails to make a promised

⁷⁵ TEX. BUS. ORGS. CODE ANN. § 101.153(b)(1) (Vernon 2008).

⁷⁶ § 153.202(d)(1).

payment of cash or transfer of other property as a contribution or with respect to a contribution previously made.

Reduction of the ownership interest of a member/partner who defaults on a capital contribution obligation, sometimes called “dilution,” has a great deal of appeal on the surface. It often strikes the promoter and investors as a fair way to penalize the defaulting member/partner and reward the members/partners who keep up with future capital calls. However, a practitioner who has been involved in the negotiation and drafting of dilution provisions will most likely report that the surface appeal of dilution can be very illusory. First, dilution, or a reordering of the relative interests of the owners, does nothing to address the need of the entity to replace the shortfall in funds needed by the entity that is created by the default. Because of this, dilution provisions are often coupled with provisions giving the non-defaulting members/partners an opportunity to make-up up the shortfall in contributions. When this approach is followed, only those partners/members who make-up the shortfall are entitled to an increase in their ownership interests. Second, attempting to design, draft and explain to clients a fair and predictable methodology for determining the appropriate amount of dilution can quickly become a difficult exercise.

One option for drafting dilution provisions is to establish a fixed dollar value of interests in the entity at the time of the execution of the company/partnership agreement. This value could be based upon the initial capital contributions by the members/owners. This is the approach taken by the draftsman of the following dilution provision. Notice that this provision only increases the ownership interests of non-defaulting members/partners who make the defaulted shortfall.

Upon any contributions of Defaulted Initial Capital Contributions by a Non-defaulting Initial Contributor under this Section, the Ownership Interest of the Defaulting Initial Capital Contributor shall be reduced, and the Ownership Interest of the [Member/Limited Partner] making such Defaulted Initial Capital Contribution shall be increased, without further notice or other action of any kind by any party, by an amount equal to one percent (1%) (of the aggregate Ownership Interests in the [Company/Partnership]; that is, not 1% “of” the Defaulting Initial Capital Contributor’s Ownership Interest) for each \$100,000 of such Defaulted Initial Capital Contribution made by such [Member/Limited Partner], or the relevant fraction of a 1% Ownership Interest in the event of contribution of an odd amount not totaling exactly a multiple of \$100,000 (the “Dilution Percentage”). For example, if the Defaulted Initial Capital Contribution obligation was \$250,000, and the Ownership Interest of the Defaulting Initial Capital Contributor was 25% at the time of such contribution obligation, the Ownership Interest of the Defaulting Initial Capital Contributor would be deemed reduced to 22.5% and the Ownership Interest of the [Member/Limited Partner] making the excess \$250,000 Defaulted Initial Capital Contribution would be deemed increased by that same 2.5% Ownership Interest (for example, from a 25% Ownership Interest in the Partnership to a 27.5% Ownership Interest).

Another option for drafting dilution provisions is to change the percentage interests of the members/partners based upon total capital contributions. The following provision is an example.

Note that in this example the party who fails to contribute is not called a “defaulting” member/partner, but is rather called a “non-contributing” member/partner. Note also that the company/partnership and the other members/partners agree that dilution of the non-contributing party’s percentage interest is to be the sole remedy for failure to contribute.

Additional Capital Contributions; Dilution.

(a) To whatever extent, if any, the cash generated by the [Company/Partnership] or obtained from lenders is insufficient to cover the expenses of the [Company/Partnership], the [Manager/General Partner] may, with the approval of the Requisite Percentage of the [Members/ Limited Partners], request the [Member/Partners] to make additional contributions to the capital of the [Company/Partnership]. Such contributions (“Additional Capital Contributions”) shall be made pro rata in accordance with each [Member/s/Partner's] respective Invested Capital⁷⁷ at the time of the request therefor by the [Manager/General Partner], unless a [Member/Limited Partner] decides not to contribute as provided below.

(b) The following provision shall apply if a [Member/Limited Partner] (“Non-contributing [Member/Partner]”) does not make any Additional Capital Contribution within fifteen (15) days after the request therefor:

(i) The [Members/Partners] other than the Non-contributing [Member/Partner] may, but shall not be obligated to, contribute to the [Company/Partnership] as Additional Capital Contributions up to the amount not so contributed by the Non-contributing [Member/Partner] (the “Make-up Additional Contribution”).

(ii) Any Make-up Additional Contribution made under this Section shall be made in such proportions as the contributing [Members/Partners] agree or, in the absence of agreement, in the ratio of their respective Invested Capital. If any [Member/Partner] fails to contribute its proportionate share of the Make-up Additional Contribution within fifteen (15) days of written notice of the Non-contributing [Member’s/Partner’s] decision not to contribute and the amount of the Make-up Additional Contribution required (a “Non-Electing [Member/Partner]”), then the remaining [Members/Partners] shall have the sole right thereafter to contribute the Non-Electing Partner’s share thereof hereunder.

⁷⁷ “Invested Capital” is defined as follows:

The amount (not less than zero) of a [Member’s/Partner’s] Capital Contribution less any distributions to such [Member/Partner] in such [Member’s/Partner’s] capacity as a [Member/Partner] pursuant to the Distributions section of this Agreement and the Winding Up section of this Agreement.

(iii) Following any Additional Capital Contribution hereunder with respect to which any [Member/Partner] does not contribute its pro rata share of the Additional Capital Contribution calculated as provided in paragraph (b)(ii) above, then the Percentage Interests of all [Members/Partners] shall be adjusted, without further notice or other action of any kind by any party, as follows: the adjusted Percentage Interest of each [Member/Partner] shall be an amount (expressed as a percentage rounded to the nearest one hundredth of one percent) that equals the quotient of (1) all Capital Contributions of such [Member/Partner] made as of the adjustment date divided by (2) the aggregate amount of all Capital Contributions by all [Members/Partners] as of such date.

(iv) Dilution of the Percentage Interest of a Non-contributing [Member/Partner] shall be the sole remedy of the [Company/Partnership] or the other [Members/Partners] against the Non-contributing [Member/Partner] and the Non-contributing [Member/Partner] shall have no other liability for electing not to contribute.

C. Sale or Redemption at Appraised Value.

TBOC § 101.153(b)(3)⁷⁸ states that the company agreement of a limited liability company may provide that upon the failure of a member to make a required capital contribution, the membership interest of the defaulting member may be redeemed or sold at a value determined by appraisal or other formula. TBOC § 153.202(d)(6)⁷⁹ states that a limited partnership agreement may provide the following consequence for failing to contribute: a determination of the value of the defaulting partner's partnership interest by appraisal or by formula and redemption or sale of the partnership interest at that value.

Below is an example of a provision utilizing redemption. The redemption price is determined by an appraisal of the fair market value of the defaulting owner's interest or the positive capital account balance of the defaulting owner's capital account, whichever is less. Note that in this provision, the purchase price is subject to a "haircut" of one-third less than its value, presumably to create a strong disincentive for any member/partner to default and to stop a member/partner who has a change of heart about being an owner from using the default provisions as a relatively easy way to exit the company/partnership for the full value of its investment.

Upon any written notice to the Delinquent [Member/Partner] of the failure to make such Capital Contribution and if such Capital Contribution has not been made to the [Company/Partnership] within five Business Days of the Delinquent [Member's/Partner's] receipt of such notice, the [Company/Partnership] shall have the right, but not the obligation, to purchase

⁷⁸ TEX. BUS. ORGS. CODE ANN. § 101.153(b)(3) (Vernon 2008).

⁷⁹ § 153.202(d)(6).

the interest of the Delinquent [Member/Partner] in the [Company/Partnership] for a price equal to the lesser of (i) 66-2/3% of the fair market value of such Delinquent [Member's/Partner's] interest in the [Company/Partnership], or (ii) 66-2/3% of the positive capital account balance of such Delinquent [Member/Partner] existing as of the date of the [Manager's/General Partner's] Notice to such Delinquent [Member/Partner] of its delinquent Capital Contribution, or zero, if such capital account balance is negative (the "Purchase Price"). For the purposes of this Section only, the fair market value of the Delinquent [Member's/Partner's] Ownership Interest shall be determined by the agreement of the [Manager/General Partner] and the Delinquent [Member/Partner] or if such parties are unable to agree on the fair market value of the Delinquent [Member's/Partner's] interest in [Company/Partnership] within fifteen days of the receipt of notice by the Delinquent [Member/Partner] from the [Manager/General Partner] of the [Company's/Partnership's] exercise of its rights hereunder (the "Exercise Notice"), then such fair market value shall be determined by "baseball" arbitration in accordance with following provisions. The [Manager/General Partner] and the Delinquent [Member/Partner] shall attempt to agree on an arbitrator. If the parties are unable to agree on an arbitrator within twenty days of the receipt by the Delinquent [Member/Partner] of the Exercise Notice from the [Manager/General Partner], the [Manager/General Partner] shall promptly designate an independent investment banker, investment advisor or investment banking firm with reasonable experience in the _____ industry to serve as an independent arbitrator. Within twenty days after the selection of the independent arbitrator, each of the [Manager/General Partner] and the Delinquent [Member/Partner] shall submit in writing to the independent arbitrator their determination of an amount in United States dollars representing the fair market value of the Delinquent [Member's/Partner's] interest in the [Company/Partnership]. The [Company/Partnership] shall provide to the arbitrator such information concerning the [Company/Partnership] and its assets as the arbitrator may reasonably request for the purpose of performing his or her duties hereunder, provided that the [Company/Partnership] shall not be obligated to furnish any information the furnishing of which may violate any existing confidentiality obligation of the [Company/Partnership] and the [Company/Partnership] may, if reasonably necessary to protect confidential information, require the arbitrator to enter reasonable confidentiality agreements before furnishing such information. The arbitrator shall choose from the two amounts so submitted the one such arbitrator believes most closely reflects the amount a willing buyer would pay and a willing seller would accept for the Delinquent [Member's/Partner's] interest in the [Company/Partnership] taking into account the limitations on transferability of such interest reflected in this Agreement. If only one Person submits a determination of fair market value to the arbitrator within such time period, the arbitrator shall select the amount so submitted. The fees and expenses of the arbitrator shall be borne by the Delinquent [Member/Partner], provided that the [Company/Partnership] shall have the right to pay such arbitrator's fees and deduct the amount from amounts

payable to the Delinquent [Member/Partner] hereunder. At any time within sixty days following the determination of the fair market value of the Delinquent [Member's/Partner's] interest in the [Company/Partnership], the [Company/Partnership] shall have the right, but not the obligation, to purchase such interest in the [Company/Partnership] by tendering to such Delinquent [Member/Partner] cash in the amount of the Purchase Price or at the election of the [Manager/General Partner] a non-interest bearing promissory note of the [Company/Partnership] (containing an express provision that the holder of the promissory note would have recourse only against the [Company/Partnership] and not against [the General Partner or any other Partner/any Member] for repayment of such promissory note) in the original principal amount of 100% of the Purchase Price, due and payable on a date which is ninety days after the liquidation of the [Company/Partnership]. Upon tender of the consideration as set forth above to the Delinquent [Member/Partner], the [Company/Partnership] shall be deemed to have repurchased the Delinquent [Member's/Partner's] interest in the [Company/Partnership] and Exhibit A shall be deemed amended to reflect such Delinquent [Member's/Partner's] Sharing Points as zero. The [Manager/General Partner] may call for Capital Contributions pursuant to the Capital Contributions section of this Agreement to purchase such Delinquent [Member's/Partner's] interest in the [Company/Partnership] (which shall be treated for all purposes as an Investment Contribution) and the [Members'/Partners'] proportionate shares of such Capital Contribution shall be determined as if the Delinquent [Member's/Partner's] Sharing Points were zero. The payment to be made to the Delinquent [Member/Partner] pursuant to this Section is, and shall be conclusively deemed to be, in complete liquidation and satisfaction of all the rights and interest of the Delinquent [Member/Partner] (and all Persons claiming by, through or under the Delinquent [Member/Partner]) in and with respect to the [Company/Partnership] including without limitation any interest in the [Company/Partnership], any rights to specific [Company/Partnership] property and (insofar as the affairs of the [Company/Partnership] are concerned) against the [Members/Partners] and shall constitute a compromise to which all [Members/Partners] have agreed.⁸⁰

D. Forfeiture.

TBOC § 101.153(b)(4)(B)⁸¹ states that the company agreement of a limited liability company may provide that upon the failure of a member to make a required capital contribution, the membership interest of the defaulting member may be made the subject of forfeiture. TBOC

⁸⁰ This language was adopted from a limited partnership agreement governed by Delaware law and that agreement contained the following additional language: “. . . shall constitute a compromise to which all Partners have agreed pursuant to Section 17-502(b) of the Delaware Revised Uniform Limited Partnership Act.”

⁸¹ TEX. BUS. ORGS. CODE ANN. § 101.153(b)(4)(B) (Vernon 2008).

§ 153.202(d)(4)⁸² provides that a limited partnership agreement may provide the following consequence for failing to contribute: forfeiture of the partner's partnership interest.

An example of forfeiture provisions is set forth below. The provisions below are adopted from provisions from the agreement for a private equity fund. To address the need of the fund to replace the capital commitment of the defaulting owner, these provisions include a mechanism for reallocating the forfeited interest (including the commitment to make capital contributions) to the other owners pro rata. If any of the other owners decline to accept their pro rata share of the reallocated interest (in effect increasing their capital commitments), the manager/general partner is authorized to sell the forfeited interest to the other owners or to a third party.

(a) Subject to paragraph (c) below, the [Manager/General Partner] in its sole discretion may cause the Defaulting [Member/Partner] to forfeit up to 50% of its interest in the [Company/Partnership] without payment or other consideration therefore, and the [Manager/General Partner] shall offer such forfeited portion of the Defaulting [Member's/Partner's] interest in the [Company/Partnership] to the other [Members/Partners] (other than any Defaulting [Members/Partners] and Persons not able to purchase such interests pursuant to the Disqualified Persons section of this Agreement) pro rata according to their respective Commitments. The [Manager/General Partner] shall provide a notice to each [Member/Partner] setting forth the amount of the forfeited portion of the Defaulting [Member's/Partner's] interest offered to such [Member/Partner]. In the event that any [Member/Limited Partner] elects not to accept its pro rata share of the forfeited portion of a Defaulting [Member's/Partner's] interest in the [Company/Partnership], such [Member/Limited Partner] shall notify the [Manager/General Partner] within ten days, or such longer time period as the [Manager/General Partner] may determine in its sole discretion, after receiving notice of such offer from the [Manager/General Partner], and any forfeited portion of a Defaulting [Member's/Partner's] interest in the [Company/Partnership] not accepted may be offered again by the [Manager/General Partner] in its sole discretion according to the provisions of this paragraph (a) as if such forfeited portion had not previously been offered.

(b) Subject to paragraph (c) below, to the extent a Defaulting [Member's/Partner's] interest is not forfeited and reallocated pursuant to paragraph (a) above (including the remaining portion of such Defaulting [Member's/Partner's] interest not subject to forfeiture), the [Manager/General Partner] in its sole discretion may offer to the [Members/Partners] (other than any Defaulting [Members/Partners] and Persons not able to purchase such interests pursuant to the Disqualified Persons section of this Agreement) the portion of the Defaulting [Member's/Partner's] interest in the

⁸² § 153.202(d)(4).

[Company/Partnership] which is not forfeited and reallocated pro rata according to their respective Commitments at an aggregate price equal to the lower of the net book value or fair market value (as reasonably determined by the [Manager/General Partner]) of such portion of the Defaulting [Member's/Partner's] interest in the [Company/Partnership] which is not forfeited and reallocated. If the remaining portion of the Defaulting [Member's/Partner's] interest is not purchased in the manner set forth herein, the [Manager/General Partner] in its sole discretion may offer the remaining interest to a third party or parties on not more favorable terms than as originally offered to the [Members/Partners], in which case such third party or parties shall, as a condition of purchasing such interest, become a party to this Agreement.

(c) Any [Member/Partner] or third party acquiring a portion of the Defaulting [Member's/Partner's] interest shall assume the portion of the Defaulting [Member's/Partner's] obligation to make both defaulted and future Capital Contributions pursuant to its Commitment which is commensurate with the portion of the Defaulting [Member's/Partner's] interest being acquired by such Person; provided, however, that the [Manager/General Partner] shall have the right, in its sole discretion, to reduce the Commitment pertaining to the portion of the Defaulting [Member's/Partner's] interest acquired by a Person to the amount of Capital Contributions made by the Defaulting [Member/Partner] with respect to such portion of the Defaulting [Member's/Partner's] interest (which amount of Capital Contributions shall be equal to the pro rata portion of the aggregate Capital Contributions made by the Defaulting [Member/Partner] with respect to its entire interest) on or prior to the date of the default, and the aggregate Commitments of the [Company/Partnership] shall be commensurately reduced. Except as otherwise set forth in this section, the [Manager/General Partner] shall handle the mechanics of making offers and shall in its sole discretion set time limits for acceptance.

E. Subordination.

TBOC § 101.153(b)(2)⁸³ states that the company agreement of a limited liability company may provide that upon the failure of a member to make a required capital contribution, the membership interest of the defaulting member may be subordinated to the membership interests of nondefaulting members. TBOC § 153.202(d)(2)⁸⁴ provides that partnership agreement may provide the following consequence for failing to contribute: subordination of the partner's partnership interest to the interests of nondefaulting partners.

While this consequence by itself does not address the need of the entity to replace the shortfall in funds needed by the entity created by the default, if the partnership has another

⁸³ § 101.153(b)(2).

⁸⁴ § 153.202(d)(2).

source of funds, this consequence is appealing because it is easy for investors to comprehend and the results of the consequence are fairly predictable and easy to implement.

Below are provisions where the right of the defaulting owner to receive any distributions is subordinated until the amount that the owner would have received is equal to the defaulted amount. The subordination is described in these provisions as a “set-off.” While it might be preferable to track the language of the statute (i.e., describe the consequence as subordination of distributions of the defaulting owner behind distributions to the other owners), a set-off achieves the same economic effect.

Failure to Make Capital Commitment.

(a) If a Contribution Default has occurred with respect to any [Member/Limited Partner], the [Company/Partnership] shall provide such [Member/Limited Partner] (a “Defaulting [Member/Partner]”) with written notice of the Contribution Default and the Defaulting [Member/Partner] shall have twenty days from the delivery of such notice to cure such Contribution Default and, in the sole discretion of the [Manager/General Partner], the [Company/Partnership] shall have the right to declare that interest shall accrue at the lesser of (i) the Prime Rate or (ii) the maximum interest that may be charged by the [Company/Partnership] on such amounts under applicable usury or other law on such outstanding unpaid Capital Commitment, from and including the date such payment was due until the date of payment to the [Company/Partnership]. In the event that the Defaulting [Member/Partner] has not cured the Contribution Default before the expiration of the cure period, then, following the expiration of the cure period, the [Company/Partnership] at the sole discretion of the [Manager/General Partner] shall, in addition to any other rights the [Company/Partnership] may have at law or at equity, have the right to take one or more of the following actions:

(i) Foreclose on the pledge of the Defaulting [Member’s/Partner’s] Units and exercise all rights of a secured party with respect to the Pledged Collateral under the UCC;

(ii) Cause any distributions otherwise payable to the Defaulting [Member/Partner] under this Agreement to be set off or withheld from such Defaulting Partner in accordance with the Set-off and Withholding of Certain Amounts section of this Agreement; and/or

(iii) Suspend all voting rights, rights to distributions and, to the fullest extent permitted by law, other rights provided to the Defaulting [Member/Partner] under the TBOC and this Agreement, in which case the Defaulting [Member’s/Partner’s] Units shall not be counted for purposes of determining the Units entitled to vote hereunder.

(b) Notwithstanding anything to the contrary contained in this Agreement, in addition to exercising the foregoing remedies against a Defaulting

[Member/Partner], or any other rights hereunder or under applicable law, the [Manager/General Partner] shall have the right to make an additional request to all [Members/Limited Partners] other than the Defaulting [Member/Partner] calling for an additional Capital Contribution in the aggregate amount of the Capital Contribution the Defaulting [Member/Partner] failed to make to be made by such [Members/Limited Partners] on a pro rata basis based on the Proportionate Share of each such [Member/Limited Partner]. Any request for an additional Capital Contribution pursuant to the immediately preceding sentence shall not increase any non-defaulting [Member's/Limited Partner's] Capital Commitment and any amount contributed by any non-defaulting [Members/Limited Partners] pursuant to such request shall reduce the amount of such Defaulting [Member's/Partner's] unpaid Capital Commitment.

Set-off and Withholding of Certain Amounts.

Notwithstanding anything to the contrary contained in this Agreement or the Subscription Agreement, the [Company/Partnership] may, in the [Manager's/General Partner's] sole discretion, set-off against or withhold from any distribution to any [Member/Partner] pursuant to this Agreement any amounts due from such [Member/Partner] to the Partnership pursuant to this Agreement and the Subscription Agreement, to the extent not otherwise paid. Any amount so set-off or withheld pursuant to this Section shall be applied by the [Company/Partnership] to discharge the obligation in respect of which such amounts were withheld. All amounts set-off or withheld from distributions to a [Member/Partner] pursuant to this Section shall be treated as amounts distributed to such [Member/Partner] by the [Company/Partnership] and paid to the [Company/Partnership] by such [Member/Partner] for all purposes under this Agreement. The [Company/Partnership] shall deliver written notice of any such set-off or withholding to each [Member/Partner] subject thereto within ten Business Days after such set-off or withholding.

The provisions below combine the concept of forfeiture with subordination. The defaulting owner's capital account is reduced by 20% and reallocated to the non-defaulting owners, and the defaulting owner is entitled to no distributions until the winding up of the entity.

Defaulting Capital Commitment.

(a) If any [Member/Limited Partner] shall fail to contribute all or a portion of any Capital Call as set forth in a Call Notice on or before the Due Date therefor, and shall not within ten (10) days of the receipt of notice of such failure delivered by the [Manager/General Partner], have cured such failure (such [Member/Limited Partner] being herein referred to as a "Defaulting [Member/Partner]" and such failure to cure as a "Default"), in the discretion of the [Manager/General Partner], a Defaulting [Member's/Partner's] Capital Account may immediately be reduced by twenty percent (20%) of the amount thereof upon each Default by such Defaulting [Member/Partner] and allocated to all non-Defaulting [Members/Limited Partners and to the General Partner]

pro rata in proportion to each such [Member's/Partner's] Percentage of Contributed Capital.

(b) For so long as the Defaulting [Member/Partner] remains a [Member/Limited Partner], it shall not be allocated any portion of Net Income or Net Realized Gains, or otherwise be taken account of in any determination of Capital Accounts or interests in the [Company/Partnership], but shall be allocated its portion of Net Loss or Net Realized Losses. Any such Net Income or Net Realized Gains shall instead be allocated to the Non-Defaulting [Members/Partners] or additional [Members/Limited Partners] in accordance with the provisions of the Allocations section of this Agreement. Defaulting [Members/Partners] (including Defaulting [Member/Partners] removed as [Members/Limited Partners]) shall not be entitled to any distributions under the Distributions section of this Agreement until the winding up of the [Company/Partnership].

(c) During the winding up period of the [Company/Partnership], after the payment in full of all amounts required to be paid pursuant to paragraphs (a)(i) and (ii) of the Final Distribution and Allocation section of the Agreement,⁸⁵

⁸⁵ The referenced Final Distribution and Allocation section reads as follows:

(a) In the final Fiscal Year of the [Company/Partnership] each item of Net Income and Net Loss and Net Realized Gain and Net Realized Loss shall be allocated to the [Members/Partners] in such manner as would, to the extent possible, result in the [Members/Partners] having zero balances in their Capital Accounts if all distributions by the [Company/Partnership], including liquidating distributions, were made in accordance with the Distributions section of this Agreement. If the Fair Market Value of [Company/Partnership] assets to be distributed in kind exceeds ("book gain") or is less than ("book loss") the book value of such assets, to the extent not otherwise recognized to the [Company/Partnership], such book gain or book loss shall be taken into account in computing Net Income or Net Loss, Net Realized Gain and Net Realized Loss for such Fiscal Year for all purposes of crediting or charging the Capital Accounts of the [Members/Partners] pursuant to the Allocation section of this Agreement as if such assets had been sold and the proceeds distributed pursuant to the Distributions section. Thereupon, all of the assets of the [Company/Partnership], or the proceeds therefrom, shall be distributed or used as follows and in the following order of priority:

(i) for the payment, or the reasonable provision for the payment, of the debts and liabilities of the [Company/Partnership], including, to the extent permitted by law, amounts owed to the [Manager/General Partner] and any [Members/other Partners] in their respective capacities as creditors of the [Company/Partnership], and the expenses of liquidation including conditional, contingent or unmatured debts and obligations of the [Company/Partnership];

(ii) to the [Members/Partners], other than a Defaulting [Member/Partner], in accordance with the positive balances of their respective Capital Accounts and as otherwise necessary to give effect to the terms of and permit distributions in accordance with the Distributions section of this Agreement;

(Footnote continued on the next page)

the [Company/Partnership] shall pay each Defaulting [Member/Partner] (in each case, without interest) an amount equal to the lesser of (i) its Capital Contributions actually paid to the [Company/Partnership]; (ii) its Capital Account as of the date of its Default, as reduced as provided in paragraph (a) above; and (iii) _____ percent of the total distributions to [Members/Partners] under the Final Distribution and Allocation section multiplied by the Defaulting [Member's/Partner's] Percentage of Contributed Capital. To the extent that the Defaulting [Member/Partner] is entitled to receive less than its Capital Account balance pursuant to this paragraph (c), such deficiency shall be allocated to the Capital Account balances of the non-Defaulting [Members/Partners] as follows: _____ percent to the non-Defaulting Limited Partners and _____ percent to the [Manager/General Partner] and shall be distributed to them in accordance with paragraphs (a)(i) and (ii) of the Final Distribution and Allocation section.

(d) To the extent permitted by law, each Defaulting [Member/Partner] waives any rights to receive any payments or to demand an accounting of the [Company/Partnership], in each case, prior to the termination of the [Company/Partnership]. Each Defaulting [Member/Partner] (including Defaulting [Member/Partners] removed as [Members/Limited Partners]) shall remain fully liable with respect to its [Company/Partnership] obligations, to the extent provided by law, as if such Default had not occurred. The full amount of such Defaulting [Member's/Partner's] Capital Commitments or Capital Contributions, as of the date of its Default, shall be included in calculating the amount of the Management Fees that shall be payable by such Defaulting [Member/Partner]. Each Defaulting [Member/Partner] shall also pay to the [Company/Partnership] its pro rata portion (based on the Capital Commitments of the [Members/Partners] immediately prior to the Default by such Defaulting [Member/Partner] or as otherwise provided in this Agreement) of other [Company/Partnership] Expenses. The [Manager/General Partner] shall have the right, in its discretion, to offset amounts payable by any Defaulting [Member/Partner] to the [Company/Partnership] (including [Company/Partnership] Expenses) against amounts payable by the [Company/Partnership] to such Defaulting [Member/Partner].

(iii) to the Defaulting Partners in accordance with the Default in Capital Commitment section of this Agreement; and

(iv) thereafter, ___% to the [Members/Limited Partners], other than a Defaulting [Member/Partner], in proportion to their Contributed Capital, and ___% to the [Manager/General Partner].

F. Other Consequences.

TBOC Section 101.153(b)(4)(D)⁸⁶ states that the company agreement of a limited liability company may provide that upon the failure of a member to make a required capital contribution, the membership interest of the defaulting member may be made the subject of “...another penalty or consequence”. TBOC Section 153.202(d)(1)⁸⁷ provides that a limited partnership agreement may provide for “...another penalty or consequence.” Other penalties of consequences that might be considered include: elimination of voting rights,⁸⁸ elimination of all rights as a member/partner,⁸⁹ charging interest on the amount of the defaulted capital call,⁹⁰ and foreclosure on the ownership interest of the defaulting member/partner.⁹¹

VII. Conclusion.

The practitioner who undertakes to assist a client in connection with the formation of and/or investment in a limited liability company or partnership will need to include among her or his tasks consideration of capital contribution provisions. When forming a corporation, establishing the capitalization of the entity is a fairly simple task, largely governed by statute. When forming an unincorporated entity, the lawyer preparing the entity documents must draft capital contribution provisions that spell out the rights and obligations of the entity and the investors with respect to the capitalization of the entity. These provisions can range from simple provisions consisting of a few sentences to lengthy, complex provisions, depending upon the nature and purpose of the entity and the arrangements and agreements reached among the parties. If the capitalization provisions contemplate that there will be obligations to contribute additional capital beyond the assets contributed upon the formation of the entity, the capitalization provisions should include provisions for consequences of a default of these obligations. The statutes permit a wide range of consequences and the effectiveness of any capital call provisions will be a reflection of the creativity and sophistication of the organizers and the creativity, sophistication and skill of their lawyers.

⁸⁶ TEX. BUS. ORGS. CODE ANN. § 101.153(b)(4)(D) (Vernon 2008).

⁸⁷ § 153.202(d)(1).

⁸⁸ See the sample provisions quoted under Part VI.E. above for an example of elimination of voting rights.

⁸⁹ See the sample provisions quoted under Part VI.E. above for an example of elimination of all rights.

⁹⁰ See the sample provisions quoted under Part VI.D. of this outline for an example of interest charges.

⁹¹ See the sample provisions quoted under Part VI.A. and Part VI.E. above for examples of foreclosure rights.

SCHEDULE A

TO

***PLANNING, DRAFTING AND IMPLEMENTING
CAPITAL CALL PROVISIONS***

**ASSIGNMENT
AND
AND BILL OF SALE
FROM**

TO

Effective _____, 20__

KNOW ALL PERSONS BY THESE PRESENTS THAT:

I.

_____, (“Seller”), for and in consideration of the sum of Ten and No/100 Dollars (\$10.00) and other good and valuable consideration, the sufficiency and adequacy of which is hereby acknowledged, has sold, transferred, assigned, conveyed and delivered, and by these presents does sell, transfer, assign, convey and deliver unto _____, a Texas [limited liability company/ limited partnership] (“Purchaser”), effective as of _____, 20__ (the “Effective Date”), all right, title and interest of Seller in and to [all properties, assets and rights, tangible and intangible, owned by Seller on the Effective Date, including without limitation all assets of Seller reflected on the balance sheet of Seller as of the Effective Date, a copy of which is attached hereto as Exhibit “___”, not including the Excluded Assets (as defined below) but including without limitation,] all of the following assets and property:

[INSERT A DESCRIPTION OF ASSETS; BELOW ARE EXAMPLES.]

1. The computers, desks, chairs and other furniture and equipment described on Exhibit “___” attached hereto;

2. All right, title and interest of Seller in and to software, including associated computer programming code (including both object code and source code versions thereof), documentation (including, unless otherwise specified, user manuals and other written materials that relate to particular code or databases), materials useful for design (for example, logic manuals, flow charts, and principles of operation), and other written materials or tangible items installed on the computers described on Exhibit “___” hereto;

3. The inventory described on Exhibit “___” hereto;

4. The accounts receivable of Seller listed on Exhibit “___” including all rights of Seller to collect, deposit, compromise or otherwise deal with such accounts on or after the Effective Date; and

5. The trade name “_____” and all rights of Seller; if any, associated with such name.

The assets and property described in this Article I are referred to herein as the “Transferred Assets.”

[II.

There are expressly excluded from the Transferred Assets the assets listed on Exhibit “___” attached hereto.]

III.

TO HAVE AND TO HOLD all of the Transferred Assets, together with all and singular the rights, privileges, hereditaments and appurtenances belonging to or in anywise pertaining to any or all of the Transferred Assets, unto the said Purchaser, its successors and assigns forever.

IV.

From time to time after the date hereof, without further consideration, Seller will execute and deliver or cause to be executed and delivered, at Seller's expense, such other instruments of conveyance and transfer and take such other action as Purchaser reasonably may require more effectively to vest in Purchaser beneficial and record title to, and to put Purchaser in possession of, any properties sold, transferred, assigned, conveyed and delivered hereunder to Purchaser.

V.

Seller hereby binds itself to warrant and forever defend the title to the Transferred Assets against every person who lawfully claims or may claim the same or any part thereof.

VI.

Seller agrees that Purchaser is not assuming any of Seller's liabilities, contingent or otherwise, whether now threatened or pending, including any liability for taxes hereafter assessed against the Transferred Assets relating to the period ending prior to the Effective Date. [Seller further agrees to indemnify and hold Purchaser and the property of Purchaser free and harmless from any and all claims, losses, damages, injuries, and liabilities arising from or in connection with the ownership and operation of the Transferred Assets prior to the Effective Date.]

VII.

This Assignment and Bill of Sale may be executed in several counterparts, all of which are identical. Each of such counterparts shall for all purposes be deemed to be an original, and all such counterparts shall together constitute but one and the same instrument.

IN WITNESS WHEREOF, Seller has caused this Assignment and Bill of Sale to be executed effective the Effective Date.

SELLER:

_____,
a Texas _____

By: _____
Name: _____
Title: _____

Date of Execution

ACCEPTED AND AGREED TO:

PURCHASER:

_____,
a Texas [limited liability company/partnership]

By: _____
Name: _____
Title: _____

Date of Execution

SCHEDULE B

TO

***PLANNING, DRAFTING AND IMPLEMENTING
CAPITAL CALL PROVISIONS***

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVER'S LICENSE NUMBER.

WARRANTY DEED

THE STATE OF TEXAS §
 § KNOW ALL PERSONS BY THESE PRESENTS:
COUNTY OF _____ §

That _____ ("Grantor"), solely as a contribution to the capital of Grantee hereinafter named, and to secure the payment of which no lien, express or implied, is retained, [*OPTIONAL NOTE ASSUMPTION CLAUSE*: and for the further consideration of the assumption and agreement to pay by Grantee, according to the terms thereof, all principal and interest now remaining unpaid on that one certain promissory note (the "Note") in the original principal sum of \$_____ dated _____, 20____ executed by _____ payable to the order of _____ and secured by a vendor's lien retained in deed of even date therewith upon the herein-described Property and additionally secured by a deed of trust recorded as Document No. _____ of the Official Public Records of _____ County, Texas (the "Deed of Trust"), and, by acceptance of this deed, Grantee assumes and promises to keep and perform all of the covenants and obligations of the grantor named in said Deed of Trust]; has GRANTED, CONTRIBUTED and CONVEYED, and by these presents does hereby GRANT, CONTRIBUTE and CONVEY unto _____, a Texas limited [liability company / partnership] ("Grantee"), all of that certain real property in

_____ County, Texas, described on **Exhibit A** attached hereto and incorporated herein (together with any improvements located thereon, the “Property”).

For the same consideration, Grantor hereby GRANTS, SELLS and CONVEYS, without warranty, whether express, implied, statutory or otherwise, all interest, if any, of Grantor in and to (a) strips or gores, if any, between the Property and abutting properties, and (b) any land lying in or under the bed of any street, alley, road or right-of-way, opened or proposed, or stream or river, abutting or adjacent to the Property;

TO HAVE AND TO HOLD the Property, together with all and singular the rights and appurtenances in any wise belonging thereto, unto Grantee and Grantee’s successors and assigns, forever.

Grantor does hereby bind Grantor and Grantor’s heirs, executors, legal representatives, administrators, successors and assigns to WARRANT AND FOREVER DEFEND all and singular the Property unto Grantee and Grantee’s successors and assigns, against every person whomsoever lawfully claiming or to claim the same or any part thereof [*OPTIONAL SPECIAL WARRANTY CLAUSE*: , by, through or under Grantor, but not otherwise].

[*ALTERNATIVE HYBRID WARRANTY CLAUSE*: Grantor does hereby bind Grantor and Grantor’s heirs, executors, legal representatives, administrators, successors and assigns to WARRANT AND FOREVER DEFEND all and singular the Property unto Grantee, against every person whomsoever lawfully claiming or to claim the same or any part thereof; and further to WARRANT AND FOREVER DEFEND all and singular the Property unto Grantee’s successors and assigns against every person whomsoever lawfully claiming or to claim the same

or any part thereof, by, through and under Grantor, but not otherwise. Grantor intends by reason of the foregoing warranty to provide a general warranty to Grantee and a special warranty to Grantee's successors and assigns.]

This conveyance is made by Grantor and accepted by Grantee subject to the matters referenced on **Exhibit B** attached hereto and incorporated herein for all purposes, to the extent, and only to the extent, that such matters may be in full force and effect and applicable to the Property.

By its acceptance of this deed, Grantee assumes the payment of all ad valorem taxes and assessments on the Property.

EFFECTIVE as of _____, 20_____.

[NAME OF GRANTOR],
a Texas [liability company / partnership]

By: _____

Name: _____

Title: _____

Address for Grantee:

Exhibits:

Exhibit A: Property Description

Exhibit B: Permitted Exceptions

STATE OF TEXAS §
 §
COUNTY OF _____ §

 This instrument was acknowledged before me on this ____day of _____,
20__ by _____, _____ of
_____, on behalf of said Texas [limited liability company/partnership].

Notary Public, State of Texas

After recording return to:

