

## **CAPITAL CALLS: AGREEMENTS TO CONTRIBUTE MORE CAPITAL OVER TIME**

First Run Broadcast: January 15, 2019

**Live Replay: June 28, 2019**

1:00 p.m. ET/12:00 p.m. CT/11:00 a.m. MT/10:00 a.m. PT **(60 minutes)**

Many companies need additional capital to fund current operations and fuel growth. When raising capital, these companies often look first to their existing investor base. These are often closely held companies where the existing ownership base wants to retain its control of the company. The company may build into its operative documents – shareholder agreements, operating agreements, even its articles of incorporation or organization – a plan whereby the company can “call” on existing investors to contribute additional capital, pro-rata or by some other formula. There are variety of complex mechanisms for achieving these types of “capital calls” and adjusting the ownership interests and other rights of incumbent investors who do not contribute additional capital. This program will provide you a practical guide to planning capital calls in closely held businesses, including how to adjust the financial and governance rights of the company’s owners.

- Advantages/disadvantages of requiring capital from existing investor base over time
- Forms of follow-on contributions – pro-rata and other structures
- Readjustment of stake in company when certain investors do not participate – dilution issues
- Voting, informational and related issues on the contribution of additional capital
- Obtaining additional capital from investors beyond the original
- Counseling clients about potential investor group disputes

### **Speaker:**

**C. Ben Huber** is a partner in the Denver office of Greenburg Traurig, LLP, where he has a broad transactional practice encompassing mergers and acquisitions, restructurings and reorganizations, corporate finance, capital markets, venture funds, commercial transactions and general corporate law. He also has substantial experience as counsel to high tech, biotech and software companies in the development, protection and licensing of intellectual property. His clients include start-up companies, family- and other closely-held businesses, middle market business, Fortune 500 companies, venture funds and institutional investors. Mr. Huber earned his B.A. from the University of Colorado and his J.D. at the University of Colorado Law School.

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**CAPITALIZING THE CLOSELY-HELD COMPANY  
CONTRIBUTIONS AND COMMITMENTS**

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## **OUTLINE**

- I. Framing the Topic**
- II. Planning for Capital Needs**
- III. Basic Concepts**
- IV. Funding Mechanics**
- V. Remedies for Failure to Fund**
- VI. Seeking Capital from New Investors**

### **EXHIBIT A – Sample Operating Agreement Provisions**

## **I. FRAMING THE TOPIC**

- Focus on LLCs and other pass-through entities, not corporations
- Focus on equity capital contributions from founders and early investors, not debt financing or private placements

## II. PLANNING FOR CAPITAL NEEDS

- New businesses need capital.
- Founders (and perhaps other early investors) cover immediate expenses. But, how are longer term capital needs going to be addressed?
  - Shoestring Approach
  - Leverage Approach
  - Private Placement Approach
  - Investor Group Approach
- Factors to be considered:
  - The type of business to be pursued and the business plan
    - Financing requirements and investors for various businesses differ – no one size fits all
    - Different customs in different industries
  - How much money the company is expected to need and when
    - The more money the company needs or expects to need, the more likely it will need to come from a larger base of investors
    - Depending on when the company anticipates needing money, consider taking in as little as possible early on
  - The identity of the investors
    - Friends and family, high net worth individuals, family offices, and institutional investors have different expectations
    - Certain investors may also raise company concerns
- Investor Group Approach - Other important questions
  - “What is the overall transaction context for the formation of the company?”
    - Operating Company
    - Holding Company
    - Joint Venture
  - “How will the company be owned?”
    - Equal ownership (50/50)
    - Proportionate ownership (e.g., 1/3, 1/3, 1/3)
    - Mix of minority and majority interest holders.

### III. BASIC CONCEPTS

- Capital Contributions – A capital contribution is the payment an investor or member makes to the company, in the form of cash or other assets, in exchange for its equity interest in the company. From a timing perspective, there are two types of capital contributions:
  - *Initial Capital Contributions* – An initial capital contribution is the first contribution an investor makes to a company as its initial investment in the company.
  - *Additional Capital Contributions* – An additional capital contribution is a contribution of capital that is made after the initial investment.
- Equity Interests – In exchange for their capital, investors receive equity interests in the company, which represent a percentage of ownership in the company. Although the percentage is typically a negotiated matter, there are two common approaches:
  - *Percentage Interest based on Investments.* Percentage based on capital contributions where the investor receives an interest on a pro rata basis with each other investor according to all of the investors' respective capital contributions. Each investor's percentage interest is equal to the aggregate amount of such investor's capital contributions divided by the aggregate amount of all of the investors' capital contributions.
    - *Note re timing issue.* Investors who come in after initial investors have already funded all or a portion of their capital commitments may be required to contribute their pro rata portion of all prior contributions plus some amount of interest. A pro rata portion of such new capital and interest is then distributed to each earlier investor as a partial return of their capital and to compensate them for risk of funding earlier.
    - *Note re failure to fund.* As discussed in more detail later, if an investor files to make a requisite contribution they may be “squeezed down” disproportionately.
  - *Percentage Interest based on Company Value.* Percentage based on the value of the company at the time of investment. An investor's percentage interest equals the amount of capital it contributes divided by the value of the company at the time of such investment (as agreed to by the investor and the company and after taking into account the investor's capital contribution). The existing investors are then diluted proportionally.
  - Given flexibility of LLCs, the parties could agree to some other arrangement to determine an investor's interest in the company. But, be wary of unintended adverse tax consequences.

- Capital Commitments – A capital commitment is an obligation to make an initial capital contribution and/or one or more additional capital contributions.
- Contributions versus Commitments. Which is better? “A bird in the hand is worth two in the bush” but may depend on terms of equity.

#### IV. FUNDING MECHANICS

- Investors are typically required to make an initial capital contribution when they become a member and, thereafter, pursuant to one or more capital calls if they have agreed to contribute additional capital.
- A capital call is a notice sent by company management to the members requiring that they fund all or a portion of their respective capital commitments. The notice sets forth the specific amount to be funded by each member and the due date by when it must be received.
- The extent to which the company's management can call for additional capital is often limited or conditioned in some fashion.
  - *No Discretion* – Management may not call for additional capital contributions.
  - *Member Approval* – Management may only call for additional capital if some threshold voting percentage of the members approves the capital call (e.g., members holding a majority of the membership interests or perhaps a supermajority of the membership interests, 66 1/3% 75%, 90%).
  - *Scheduled Capital Calls* – Management may only call for additional capital pursuant to a specific schedule agreed to by the members that sets forth the timing and amount of additional capital contributions.
  - *Emergency Situations* – Management may only call for additional capital in emergency situations to cover unanticipated and nondiscretionary expenses (e.g., expenses the company must pay by law or contract).
  - *Budgetary Discretion* – Management may only call for additional capital in accordance with an annual budget, i.e., for the amounts set forth in the budget at the times contemplated by it. Annual budget usually subject to review and approval by the members.
  - *Budgetary Discretion with Cost Overruns* – In addition to being permitted to call for additional capital in accordance with the annual budget, management may make capital calls to cover cost overruns. Such authority, however, is typically limited to a percentage (e.g., 10% to 20%) of the corresponding budget items that were exceeded.
  - *Milestone Payments* – Management may only call for additional capital upon the occurrence of certain events or milestones (e.g., development of a prototype device, completion of a beta version of a software application or approval of a plat by the local zoning authority).
  - *Total Discretion* – Management may call for additional capital contributions at any time for any reason.

- Caps on Additional Capital Contributions. The members' respective commitments or obligations to make additional capital contributions may be capped.
- Pro Rata Funding and Dilution – In our operating company model, members are typically required to make additional capital contributions on a pro rata basis and are diluted accordingly so that they maintain their same percentage interests in the company upon funding their capital calls.

## V. REMEDIES FOR FAILURE TO FUND

The company and non-defaulting members typically have a menu of various remedies that they can choose from if a member defaults on its obligation to make additional capital contributions.

- Right to Sue – Sue defaulting member for specific performance or damages.
- Dilute Defaulting Member
  - *Pro Rata Dilution* – The non-defaulting members can make their capital contributions and dilute the defaulting member on a pro rata basis.
  - *Disproportionate Dilution* – the non-defaulting members can make their capital contributions and dilute the defaulting member on a disproportionate basis. This is a punitive reduction in the defaulting member's interest in the company (e.g., 10% to 25%) for failure to fund, which then results in a corresponding increase in the non-defaulting members' interests.
- Make Defaulting Member's Contribution and Further Dilute Defaulting Member
  - *Pro Rata Contribution* – All or a portion of the non-defaulting members can elect to make the defaulting member's contribution (on a pro rata basis among those non-defaulting members electing the option) and further adjust their respective interests in the company on a pro rata basis accordingly.
  - *Cram Down Contribution* – All or a portion of the non-defaulting members can elect to make the defaulting member's contribution (on a pro rata basis among those non-defaulting members electing the option) and further adjust their respective interests in the company on a disproportionate basis.
- Make Defaulting Member's Contribution as One or More Loans – All or a portion of the non-defaulting members can elect to make the defaulting member's contribution by way of one or more interest-bearing loans to the defaulting member (on a pro rata basis among those non-defaulting members electing the option), with the proceeds of the loan being paid directly to the company in respect of the defaulting member's contribution.
  - The amount of interest is reflective of a default (e.g., 8% to 18%).
  - The loan(s) are either repaid directly by the defaulting member or paid back through the defaulting member's share of company distributions.
  - If not repaid within a certain period of time, the loan can be converted to additional membership interests in the company (via a pro rata contribution or cram down contribution as described above).
  - The loan(s) may be secured by the defaulting member's interest in the company.

- Forced Sale to Non-Defaulting Members – The non-defaulting members may have the right to purchase the defaulting member’s interest in the company.
- Forced Sale to Third Party – The company or the non-defaulting members may have the right to require the defaulting member to sell its interest in the company to a third party.
- Loss of Voting and Other Rights – A defaulting member may lose its voting or consent rights as well as any other rights it may have (at least until such member has made or repaid its capital contribution or default loans).
- Loss of Management Position. If the defaulting member is the manager or managing member, such member may be terminated and replaced as the manager or managing member.
- Note Regarding Mechanics – The more members the company has, the more complicated the mechanics of electing and participating in remedies can be.

## VI. RAISING CAPITAL FROM NEW INVESTORS

Raising money from new investors presents challenges:

- Difficult to Locate
- Disruptive
- Pricing Issues
- Deal Protections
  - Voting rights (appoint managers, require higher approval percentage, negative consent or veto rights, etc.)
  - Information rights (board observers, periodic financial statements, annual budgets, business plans, company documents such as resolutions)
  - Preemptive rights (offer existing investors first to purchase their pro rata share of any new securities offered before going to new investors – can chill new investment)
  - Economic anti-dilution rights (full ratchet, narrow based weighted average, broad based weighted average, etc.)
  - Structural anti-dilution rights
  - Other Rights – Right of First Refusal, Drag-Along, Tag-Along, Liquidity Option (e.g., Put Right or Forced Sale of the Company)
- Compliance with applicable federal and state securities laws and exemptions.
- Chart comparing pros and cons of seeking additional capital from existing investors versus new investors:

Investor	Pros	Cons
Existing Investor	<ul style="list-style-type: none"> <li>• Built in source of funding – no need to go elsewhere</li> <li>• Familiar with business – no need to educate</li> <li>• No new stakeholder that may wish to influence management or control business</li> <li>• No need to negotiate new deal terms (assuming existing investor has a capital commitment)</li> </ul>	<ul style="list-style-type: none"> <li>• “Going to the well” too many times can create disgruntled investors</li> <li>• The more money you take from existing investors, the more of a say they may feel they have and the more activist they may become</li> <li>• As ownership increases, investors may obtain greater control rights (e.g., seat on board or equivalent and may need their vote for any requisite member or shareholder approvals)</li> </ul>
New Investor	<ul style="list-style-type: none"> <li>• May bring new opportunities, connections and synergies depending on new investor</li> </ul>	<ul style="list-style-type: none"> <li>• May be hard to find</li> <li>• Time consuming and disruptive</li> <li>• New stakeholders may want more</li> </ul>

	<ul style="list-style-type: none"> <li>• May dilute investor base, making control more disparate and harder for one group to make demands or control the company</li> <li>• new money could be less expensive and require fewer protections for investor (depending on value of company, extent of need for new capital, state of business and proposed uses of new capital) – better terms</li> </ul>	<p>control and influence</p> <ul style="list-style-type: none"> <li>• New money could be more expensive and require more protections for investor (depending on value of company, extent of need for new capital, state of business and proposed uses of new capital) – more onerous terms</li> </ul>
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## EXHIBIT A

### SAMPLE OPERATING AGREEMENT PROVISIONS

#### Selected Definitions

“**Additional Capital Contribution**” has the meaning set forth in Section 3.02(a).

“**Budget**” has the meaning set forth in Section 7.06.

“**Business**” means [DESCRIPTION OF THE COMPANY'S BUSINESS] (the "**Business**")

“**Capital Contribution**” means, for any Member, the total amount of cash and cash equivalents and the Book Value of any property contributed to the Company by such Member.

“**Contributing Member**” has the meaning set forth in Section 3.02(b).

“**Cram-Down Contribution**” has the meaning set forth in Section 3.02(c).

“**Default Amount**” has the meaning set forth in Section 3.02(b).

“**Default Loan**” has the meaning set forth in Section 3.02(b).

“**Default Rate**” has the meaning set forth in Section 3.02(b).

“**Delaware Act**” means the Delaware Limited Liability Company Act, Title 6, Chapter 18, §§ 18-101, *et seq.*, and any successor statute, as it may be amended from time to time.

“**Fiscal Year**” means the calendar year, unless the Company is required to have a taxable year other than the calendar year, in which case Fiscal Year shall be the period that conforms to its taxable year.

“**Managing Member**” means, initially, the Minority Member, or such other Member as may be designated or become the Managing Member pursuant to the terms of this Agreement.

[“**Managers**” means (a) each Person identified as of the date hereof as a Manager in Section \_\_\_ and (b) each Person who is hereafter elected as a Manager in accordance with Section \_\_\_. Managers need not be Members of the Company or residents of the State of Delaware but must be natural individuals.]

“**Member**” means the Managing Member or the Non-managing Member [or (a) each Person identified on the Members Schedule as of the date hereof as a Member who has executed this Agreement or a counterpart thereof (each, an “**Initial Member**”); and (b) each Person who is hereafter admitted as a Member in accordance with the terms of this Agreement and the Delaware Act, in each case so long as such Person is shown on the Company's books and records as the owner of Membership Interests. The Members shall constitute “members” (as that term is defined in the Delaware Act) of the Company.]

**“Membership Interest”** means an interest in the Company owned by a Member, including such Member’s right (a) to its distributive share of Net Income, Net Losses and other items of income, gain, loss and deduction of the Company; (b) to its distributive share of the assets of the Company; (c) to vote on, consent to or otherwise participate in any decision of the Members as provided in this Agreement; and (d) to any and all other benefits to which such Member may be entitled as provided in this Agreement or the Delaware Act. The Membership Interest of each Member shall be expressed as a percentage interest and shall be [the same proportion that such Member’s total Capital Contribution bears to the total Capital Contributions of all Members/as set forth on Schedule A].

**“Non-Contributing Member”** has the meaning set forth in Section 3.02(b).

**“Non-Managing Member”** means at any time the Member that is not the Managing Member.

### Selected Provisions

**Section 3.01. Initial Capital Contributions.** Contemporaneously with the execution of this Agreement, each Member has made an initial Capital Contribution and is deemed to own Membership Interests in the amounts set forth opposite such Member’s name on Schedule A attached hereto. The Managing Member shall update Schedule A upon the issuance or Transfer of any Membership Interests to any new or existing Member in accordance with this Agreement.

### **Section 3.02. Additional Capital Contributions.**

- (a) In addition to the Initial Capital Contributions of the Members, the Members shall make additional Capital Contributions in cash, in proportion to their respective Membership Interests, as determined by the Managing Member from time to time to be reasonably necessary to pay any operating, capital or other expenses relating to the Business (such additional Capital Contributions, the **“Additional Capital Contributions”**), *provided*, that such Additional Capital Contributions shall not exceed corresponding amounts expressly provided for in the Budget, as it may be amended from time to time. Upon the Managing Member making such determination for Additional Capital Contributions, the Managing Member shall deliver to the Non-Managing Member a written notice of the Company’s need for Additional Capital Contributions, which notice shall specify in reasonable detail (i) the purpose for such Additional Capital Contributions, (ii) the aggregate amount of such Additional Capital Contributions, (iii) each Member’s share of such aggregate amount of Additional Capital Contributions based upon each such Member’s Membership Interest, and (iv) the date (which date shall not be less than [NUMBER] Business Days from the date that such notice is given) on which such Additional Capital Contributions shall be required to be made by the Members.
- (b) If any Member shall fail to timely make, or notifies the other Member that it shall not make, all or any portion of any Additional Capital Contribution which such Member is obligated to make under Section 3.02(a), then such Member shall be deemed to be a **“Non-Contributing Member”**. The non-defaulting Member (the

“**Contributing Member**”) shall be entitled, but not obligated, to loan to the Non-Contributing Member, by contributing to the Company on its behalf, all or any part of the amount (the “**Default Amount**”) that the Non-Contributing Member failed to contribute to the Company (each such loan, a “**Default Loan**”), *provided*, that such Contributing Member shall have contributed to the Company its pro rata share of the applicable Additional Capital Contribution. Such Default Loan shall be treated as an Additional Capital Contribution by the Non-Contributing Member. Each Default Loan shall bear interest (compounded monthly on the first day of each calendar month) on the unpaid principal amount thereof from time to time remaining from the date advanced until repaid, at the lesser of (i) [PERCENTAGE]% per annum or (ii) the maximum rate permitted at law (the “**Default Rate**”). Each Default Loan shall be recourse solely to the Non-Contributing Member’s Membership Interest. Default Loans shall be repaid out of the distributions that would otherwise be made to the Non-Contributing Member under Article VI or Article XII, as more fully provided for in Section 3.02(d). So long as a Default Loan is outstanding, the Non-Contributing Member shall have the right to repay the Default Loan (and interest then due and owing) in whole or in part. Upon the repayment in full of all Default Loans (but not upon their conversion as provided in Section 3.02(c)) made in respect of a Non-Contributing Member (and so long as the Non-Contributing Member is not otherwise a Non-Contributing Member), such Non-Contributing Member shall cease to be a Non-Contributing Member.

- (c) At any time after the date [NUMBER] months after a Default Loan is made, at the option of the Contributing Member, (i) such Default Loan shall be converted into an Additional Capital Contribution of the Contributing Member in an amount equal to the principal and unpaid interest on such Default Loan pursuant to this Section 3.02(c), (ii) the Non-Contributing Member shall be deemed to have received a distribution, pursuant to Article VI, of an amount equal to the principal and unpaid interest on such Default Loan, (iii) such distribution shall be deemed paid to the Contributing Member in repayment of the Default Loan, (iv) such amount shall be deemed contributed by the Contributing Member as an Additional Capital Contribution (a “**Cram-Down Contribution**”), and (v) the Contributing Member’s Capital Account shall be increased by, and the Non-Contributing Member’s Capital Account shall be decreased by, an amount equal to the principal and unpaid interest on such Default Loan. A Cram-Down Contribution shall be deemed an Additional Capital Contribution by the Contributing Member making (or deemed making) such Cram-Down Contribution as of the date such Cram-Down Contribution is made or the date on which such Default Loan is converted to a Cram-Down Contribution. At the time of a Cram-Down Contribution, the Membership Interest of the Contributing Member shall be increased proportionally by the amount of such contribution, thereby diluting the Membership Interest of the Non-Contributing Member. Once a Cram-Down Contribution has been made (or deemed made), no subsequent payment or tender in respect of the Cram-Down Contribution shall affect the Membership Interests of the Members, as adjusted in accordance with this Section

3.02(c).

- (d) Notwithstanding any other provisions of this Agreement, any amount that otherwise would be paid or distributed to a Non-Contributing Member pursuant to Article VI shall not be paid to the Non-Contributing Member but shall be deemed paid and applied on behalf of such Non-Contributing Member (i) first, to accrued and unpaid interest on all Default Loans (in the order of their original maturity date), (ii) second to the principal amount of such Default Loans (in the order of their original maturity date) and (iii) third, to any Additional Capital Contribution of such Non-Contributing Member that has not been paid and is not deemed to have been paid.
- (e) Notwithstanding the foregoing, if a Non-Contributing Member fails to make its Additional Capital Contribution in accordance with Section 3.02(a), the Contributing Member may:
  - (i) institute proceedings against the Non-Contributing Member to obtain payment of its portion of the Additional Capital Contributions, together with interest thereon at the Default Rate from the date that such Additional Capital Contribution was due until the date that such Additional Capital Contribution is made, at the cost and expense of the Non-Contributing Member; [or]
  - (ii) elect to dissolve and liquidate the Company pursuant to Article XII[./; or]
  - (iii) [purchase the Membership Interest of the Non-Contributing Member at a price equal to [PERCENTAGE]% of the lesser of (i) the price paid by the Non-Contributing Member for its Membership Interest and (ii) the Fair Market Value of its Membership Interest][./; or]
  - (iv) [force a sale of the Company to a third party other than an Affiliate of any of the Members on commercially reasonable market terms as reasonably determined by the Contributing Member; *provided*, that if the Non-Contributing Member pays the unfunded portion of its required Additional Capital Contribution prior to the Contributing Member's election of a forced sale, the Contributing Member shall no longer have the right to force a sale of the Company under this [Section 3.02(e)(iv)].]
- (f) [If a Member is characterized as a Non-Contributing Member, then, so long as the Member remains a Non-Contributing Member, it shall forfeit and no longer be entitled to any consent or voting rights granted in this Agreement.]
- (g) Except as set forth in this Section 3.02, neither Member shall be required to make additional Capital Contributions or make loans to the Company.

**Section 1.01 Additional Capital Contributions.** No Member shall be required to make any additional Capital Contributions to the Company. Any future Capital Contributions made by

any Member shall only be made with the consent of the Managers [and, in connection with an issuance of Membership Interests, made in compliance with **Error! Reference source not found.**]. To the extent that a Member makes an additional Capital Contribution to the Company, the Managers shall revise the Members Schedule to reflect an increase in the Membership Interest of the contributing Member that fairly and equitably reflects the value of its additional Capital Contribution in relation to the aggregate amount of all Capital Contributions made by the Members.

#### **Section 7.06. Budget**

- (a) The initial business plan and [monthly/quarterly] and annual budgets for the Company through the Fiscal Year ending [DATE] (the "**Budget**"), which have previously been approved by the Members, are attached hereto as Schedule B. The Budget shall include detailed capital and operating expense budgets, cash flow projections (which shall include amounts and due dates of all projected calls for Additional Capital Contributions) and profit and loss projections. The Managing Member shall operate the Company in accordance with the Budget.
- (b) At least [NUMBER] days before the beginning of each Fiscal Year (commencing with the Fiscal Year ending [DATE]), the Managing Member shall prepare and submit to the Non-Managing Member proposed revisions (including any extensions thereof) to the Budget for such upcoming Fiscal Year. Not later than [NUMBER] days following its receipt of the proposed revisions, the Non-Managing Member must, by written notice to the Managing Member, either approve or disapprove the revised Budget. If the Non-Managing Member shall not have responded in writing to the proposed revisions prior to the end of such [NUMBER] day period, the Non-Managing Member will be deemed to have approved the revised Budget. If the Non-Managing Member disapproves of the proposed revisions, then the Members shall use good faith efforts to agree on a revised Budget. The Managing Member shall continue to operate the Company in accordance with the existing Budget until a revised Budget is approved by both Members.