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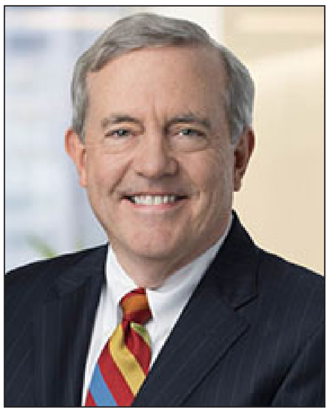
Capital call defaults - by Thomas Kearns



Thomas Kearns

A regular issue when negotiating a limited liability company agreement for a real estate project is what should happen if the company needs additional capital for the deal. This is particularly crucial for development deals where the members know that the initial capital will likely not be sufficient for completion of the work contemplated. Traditionally, many LLC agreements contain dilution provisions, sometimes with penalties, that provide for an adjustment to the members' profit-sharing ratios in the event of a failure by a member to contribute the member's share of the capital needed. There are a few issues with this remedy. First, should there be a penalty or should the ratios be adjusted by a simple dollar for dollar dilution? If a penalty is desired, how significant should it be? Second, the calculation of the dilution can be fraught depending on the multitude of potential circumstances. What if a member was admitted in the interim? What if interim distributions were made? Lastly, business people and lawyers are not necessarily experts at translating mathematical concepts into legal language, leading to the use of examples and a lot of time negotiating the exact language of the dilution clause.

A recent New York appeals court decision (DTI-DSIC, LLC v. 930-DSIC, LLC) interpreting Delaware law gives transactional lawyers representing the LLC's managing member an aggressive remedy for capital contribution defaults. The LLC agreement in DTI-DSIC contained a clause permitting the managing member to elect to require the defaulting member to sell its interest to the managing member or its designee for "such price as the managing member determines in good faith is fair and reasonable under the circumstances." Several years into the default, the managing member exercised that option. That exercise of rights may not have been particularly remarkable, but what the managing member did in these circumstances went further. The price was paid by means of a promissory note payable only out of future non-tax distributions by the company. That payment method was not provided for in the company's LLC agreement. (Notably, the defaulting member did not challenge the price itself in the public records reviewed by the author.)

As with most court decisions, there are a lot of specifics in the history of dealings between the members that may have influenced the court. But in the published opinions by both the trial and appeals courts, the courts appear not to be concerned that the managing member exercised the forced sale and paid the price by the contingent note. One factor may have been the defaulting member's conviction for fraud on an unrelated matter. Another factor may have been that the agreement provided for an express waiver of fiduciary duty as permitted under Delaware law (but which is not permitted under New York law).

What are the lessons that managing members and transactional lawyers should take away from this decision about capital call default provisions when negotiating LLC agreements governed by Delaware law?

First, if the agreement gives an express remedy to the managing member that includes a "fair and reasonable" standard, the concept will likely be upheld. Second, managing members may want an express provision that payment of any forced buyout can be paid by a promissory note payable only from non-tax distributions. Managing members may want the comfort of an express provision with respect to the contingent note since the note structure was among the more aggressive moves by the managing member in this case and could have led to a challenge to the required "fair and reasonable" price. If litigated the managing member will be able to point to the DTI-DSIC decision to support its position on the note.

Since the public record does not show a challenge to the reasonableness of the amount of the price, it may be possible that the managing member obtained an appraisal to support the price it chose.

From the non-managing member's view, having the price solely in the hands of the managing member may be problematic. An alternative such as an appraisal or a determination by the company's accountant might give more protection. In addition, a member should consider asking that the LLC agreement require that the "fair and reasonable" price be an all-cash price.

(Readers interested in case law on LLC issues should read the New York Business Divorce blog written by Peter Mahler and his fellow litigators at Farrel Fritz, P.C. The author first became aware of the DTI-DSIC decisions through their blog posts.)

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