Drafting Capital Call Remedies For Real Estate Partnerships

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The best approach is to plan for the worst.

WHEN CAPITALIZING a real estate partnership,[1] the threshold economic issues revolve around the respective roles of partners, the initial amounts of capital being contributed, and the timing of initial contributions. As time goes on, however, it is quite possible that a real estate project might stall and require additional capital contributions from its partners. This possibility has become an all-too-familiar reality over the past five years, as many developers and operators find themselves tight on cash flows and the "Great Recession" has taken its toll on even the most attractive and best-planned real estate projects.

A capital call (i.e., a partnership's request for additional equity contributions from its partners) should

[1] It is increasingly common for U.S.-based real estate developers, investors, and operators to acquire, develop, improve upon and operate real property through limited liability companies (LLCs). However, the author uses the term "partnership" in this article more generally to describe property-owning entities because the default classification of multi-member LLCs under Federal income tax law is that of a "partnership." Moreover, the author has elected to use the term "partner" or "partners" in lieu of "member" or "members" to describe owners of LLCs because these are the terms which appear in the Federal tax code — more specifically, Subchapter K of the Internal Revenue Code of 1986, as amended. Similarly, the term "partnership agreement" is used notwithstanding the fact that the laws governing LLCs typically refer to an agreement among the members as an "operating agreement," a "company agreement," or an "LLC agreement."

not be controversial if everyone has the financial resources and the resolve to continue to fund the project. Rather, it is the alternative (and more likely) scenario that can cause problems — what happens if one partner is able and willing to make a capital call, but the other partner cannot (or will not) meet its funding obligation?

Hopefully, the partnership agreement adequately addresses the rights and remedies of the respective partners. If not, then the "willing and able" partner will be faced with a dilemma: contribute 100 percentof the additional equity needed to keep the project afloat and hope that the project turns around so that the contributing partner is able to recoup its investment, or, alternatively, stop contributing money to the partnership and run the risk of letting the project fail. This predicament becomes all the more dire if the project is financed and the contributing partner has recourse liability (i.e., a personal repayment guaranty) resulting from defaulting loan payments.

Generally, state unincorporated entity statutes (i.e., laws which relate to partnerships and LLCs) do not obligate partners to contribute additional capital when a capital call is made. Rather, partners are free to contract with one another concerning the obligations flowing from capital calls, and, to the extent that the partnership agreement obligates a partner to contribute additional equity to a partnership, states generally take the approach that the express terms of the partnership agreement must be honored.

So, what happens when a capital call is made and the partnership agreement is silent concerning rights and remedies of the partners? The answer will depend on the "default rules" enacted by the state in which the partnership is formed. In most instances, though, state law would permit the contributing partner to contribute capital voluntarily on behalf the non-contributing partner and receive credit toward its capital account for the amount of such voluntary contributions. By doing so, the contributing partner would change the proportions in which capital will be returned to the partners.

For example, assume that a capital call of $1 million is made and each partner is required to contribute additional capital in proportion to his current capital account balance. If each partner has a capital account balance of $1 million, then each partner will be responsible for 50 percent(or $500,000) of the additional equity being requested. If the partnership agreement is silent with respect to the rights and remedies of a contributing partner, then the non-contributing partner may refuse to contribute its $500,000 without further recourse. However, if the contributing partner voluntarily elects to contribute the non-contributing partner's share of the additional equity, then the contributing partner will receive capital account credit for both his share of the additional equity ($500,000), plus the amount of the additional equity which was requested from the non-contributing partner ($500,000) — i.e., the contributing partner will receive $1 million of capital account credit. As a consequence, the capital accounts no longer reflect a 50/50 split between the partners. Instead, the capital account of the contributing partner has increased to $2 million and the non-contributing partner's capital account remains at $1 million. If the partnership were to sell the property shortly thereafter and liquidate, then, assuming that distributions are made in proportion to each partner's current capital account balance, the proceeds on liquidation would be split 2/3 in favor of the contributing partner and 1/3 in favor of the non-contributing partner.

Beware, though: the distribution provisions of a partnership agreement could undermine the impact of voluntary contributions made by the contributing partner. For example, if the non-contributing partner is entitled to receive a "promote interest" in the partnership (i.e., a percentage of equity in the partnership based upon the rendering of services), then the contributing partner's increased

capital interest in the partnership is less beneficial to him (and, in turn, less consequential to the non-contributing partner) because the non-contributing partner is still entitled to receive distributions attributable to its promote interest. Therefore, the more complicated the "waterfall of distributions" may be in a partnership agreement, the more critical it will be for partners to consider in advance the consequences which might flow from the non-contributing partner's failure to satisfy its capital call obligations.

Rather than relying on default rules of a particular state's unincorporated entity statutes, partners should expressly address in the partnership agreement the rights and remedies available to partners when one partner fails to contribute his proportionate share of additional requested capital. At a minimum, the partnership agreement should provide that the contributing partner is not obligated to make voluntary contributions on behalf of the non-contributing partner. In addition, the partners should consider including the following rights and remedies in the partnership agreement.

1. Loans

The non-contributing partner's share of the additional equity contributed could be treated either as a loan made to the partnership by the contributing partner (which partner-to-partnership loan would be repayable out of operating cash flow similar to other debt obligations of the partnership), or as a loan from the contributing partner to the non-contributing partner (which partner-to-partner loan would be repayable out of the non-contributing partner's proportionate share of distributions from net cash flow and the non-contributing partner would receive capital account credit for the amount of the contribution made on its behalf, which would effectively result in the contributing partner funding one-half of his own return). Either way, the parties must consider the interest rate of the loan. Presumably, the parties will want the interest rate on a partner-to-partner loan to be higher than the partners' projected return on investment capital, so as to discourage either partner from relying on the other partner to loan it money to fund a capital call. On the other hand, the parties might not want a partner-to-partnership loan to accrue interest at a high rate since the contributing partner would be repaying itself out of the partnership's operating cash flow, effectively taking money out of its own pocket. Other issues relating to loan treatment of additional equity contributions include: (i) should the loan repayment obligation be recourse or non-recourse to the non-contributing partner; (ii) in the partner-to-partner context, does the loan result in an automatic lien on the non-contributing partner's interest in the partnership; and (iii) under what state laws will the loan be governed.

2. Punitive Dilution

As noted above, a voluntary capital contribution may not be as beneficial to the contributing partner as the parties intend. Therefore, the parties might want to consider adopting a punitive dilution clause which provides the contributing partner with capital account credit based on a penalty rate (e.g., for each $1 of capital contributed to the partnership, the contributing partner will receive $1.50 of capital account credit).

3. Loss of Fees And Promote

The parties could agree that a partner's failure to contribute its proportionate share of a capital call will result in a loss of any fees otherwise payable to the non-contributing partner (or its affiliates). In addition, if, as referenced above, the non-contributing partner is entitled to receive a promote interest from the partnership, then the non-contributing partner's failure to fund its share of a capital call should result in a divesting of the non-contributing partner's promote interest. Also, a failure to fund a capital call should result in the termination of any service agreements between the partnership and the non-contributing partner (or its affiliates). The theory behind each of these remedies is that the

non-contributing partner is receiving fees, a promote interest or compensation from other service agreements because of his expertise and his commitment to making the project profitable. Therefore, if a capital call occurs, it is, at least in part, because of poor execution on the part of the non-contributing partner, and that partner should not be entitled to benefit from his poor performance.

4. Loss of Control; Voting Rights

A non-contributing partner could lose its status as the "general partner" or "manager" of the partnership (i.e., the non-contributing partner would no longer be responsible for day-to-day decision making authority of the partnership). Moreover, the non-contributing partner could lose its right to vote on certain (or all) matters. For example, if the non-contributing partner has a veto right over certain "major decisions" (e.g., the refinancing or sale of the project, dissolution of the partnership, or the partnership's election of a voluntary bankruptcy), the non-contributing partner could lose those rights if it fails to contribute its proportionate share of additional equity.

5. Buy-Out Option

The failure to satisfy a capital call by the non-contributing partner could trigger a buy-out in favor of the contributing partner. Buy-out provisions should address details like deadlines for exercising the buy-out option and closing on the acquisition of the non-contributing partner's interest in the partnership, as well as the consequences which might result if the contributing partner is unable (or unwilling) to consummate settlement under the buy-out.

6. Cost-Overruns

If the partnership contemplates the development and construction of a new project, then the partners might consider requiring the "development partner" to be responsible for contributing any additional capital necessary to cover "cost overruns" of the partnership's agreed-upon development budget. These payments would not be treated as contributions of additional equity to the partnership (and thus, the development partner would not receive capital account credit for cost overrun payments). The theory behind this is that the development partner is running the project and is in the best position to undertake cost-saving measures in order to ensure that the project does not bust the budget. The development partner (who is oftentimes entitled to receive other fees and a promote interest related to its services, as described above) might attempt to chip away at these types of mandatory payments by carving out 'permissible' cost-overruns (e.g., costs caused by force majeure, lender-related costs and fees, costs directly caused by the general contractor, etc.), establishing line item contingencies within the budget, and negotiating its authority to reallocate cost-savings within the agreed-upon budget. As a backstop to this mandatory funding obligation, the principal(s) of the development partner may be required to guaranty repayment with a personal guaranty (or provide a guaranty from a creditworthy affiliate).

Capital calls can put stress on a partnership and the business relationship between its partners. By remaining silent in a partnership agreement (thereby relying on state law default rules), the business parties may be putting themselves in a difficult position where a capital call results in a less-than-desirable consequence to a contributing partner. Therefore, business parties should take care to consider in advance the rights and remedies of each partner in the event that a capital call is made and one partner fails to contribute its share to make certain that the appropriate remedies are contemplated in the partnership agreement. This article has proposed some alternative rights and remedies, however, the relationship and creativity of the partners ultimately will dictate how capital call provisions should be (and are) addressed in the partnership agreement.