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CONTRIBUTION DEFAULT REMEDIES IN A REAL ESTATE VENTURE

The failure of a partner to make a required capital contribution places strain on a real estate venture. It results in a capital shortfall and puts the partners at odds. For these and other reasons, the contribution default remedies play an important role in many, if not most, real estate venture agreements. Unfortunately, drafting these remedies can be complicated and the partners may not always have the time or patience to ensure that the remedies are harmonized and operate the way they would expect had they thought about it. It is therefore helpful to think through these provisions in advance, and be prepared with useful forms and guidance, to work within the time limitations of any particular transaction.

Contribution default remedies play an important role in many real estate venture agreements, and forms or sample provisions will not work for every deal and should be adapted to meet the needs of the parties.

Part 1: Scope and Terminology

This article discusses the following points to be considered, when drafting or choosing contribution default remedies:

- Potential consequences (and alternative formulations) of the right to withdraw a contribution when the other partner in a two-partner venture fails to contribute.
- Alternative ways to treat a capital call advanced by only one partner in a two-partner venture.
- How these provisions may become more complicated when there are more than two partners.
- Other remedies of the funding partner, and the enforceability of contribution default remedies generally.
- Third-party creditor issues.

Partnership terminology is used in this article, but the discussion generally applies equally to limited liability companies (LLCs). Sample contribution default remedy provisions (the Sample Provisions) are included in Exhibit 1 to provide a frame of reference.[1] For simplicity, it is assumed, unless otherwise stated, that there are only two partners—an investor and an operator. For the most part, discussion is presented from the vantage point of a non-defaulting investor (although many, if not most, of a non-defaulting investor's concerns may be shared by a non-defaulting operator).

Part 2: General Drafting Approach—Less Is More; All or Nothing

Attorneys and clients may be tempted, when creating a form, or even a specific partnership agreement, to cover every possibility in order to give the client maximum protection and flexibility. However, a balance must be struck between thorough drafting, on the one hand, and consummating a transaction in a timely and cost-effective manner, on the other hand. This balance is clearly a concern when providing for contribution default remedies because of the potential complexities and interrelationships of the alternative remedies involved. In this context, one is often well served by the principle that "less is more."

Partial Contributions. A good example is the issue of partial contributions. The Sample Provisions do not allow for partial contributions. If a partner advances less than all of what is required of it, the Sample Provisions provide for a refund of any partial advance made. Similarly, a non-defaulting partner is not permitted to advance less than all of the deficiency (Deficiency) which, as used herein, means the entire amount required to have been contributed by the defaulting partner. Although one might appreciate having the flexibility to make partial contributions, the approach taken here (i.e., all or nothing) was chosen because it involves less language and is less complicated (avoiding, among other matters, the need to provide for and address the consequences of contribution credit for a defaulting partner's partial contributions).[2] This may not be a perfect solution in all transactions, but in many transactions it can be a helpful simplification that will make the contribution default remedies more manageable. With these general notions in mind, the remedies for contribution defaults will be discussed below.

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Part 3: Funding Partner Initial Decision—To Fund or Not To Fund

When there is a capital call, and one partner timely contributes its share and the other does not, the Sample Provisions (like many partnership agreements) require the funding partner to make a decision either to withdraw its contribution or to advance the contribution of the defaulting partner.[3] This decision raises questions.

Withdrawal of Contribution. If the contribution is withdrawn:

- How will the partnership meet its capital needs without the capital that has been called? The Sample Provi-

EXHIBIT 1
Appendix: Sample Provisions

SAMPLE CONTRIBUTION DEFAULT PROVISIONS FOR TWO-MEMBER JV

Alternative Remedies: Revocation, Default Loan (to JV), Special Preferred Contribution, or Dilution

Section 3.3 Failure to Contribute.

3.3.1 Election. If a Member (the "**Non-Contributing Member**") fails to advance its Contribution Percentage[1] of any required capital contribution under Section 3.1 or 3.2 by depositing the same in the Operating Account within the time required, then such Non-Contributing Member's entire Contribution Percentage of such required capital contribution will be referred to herein as the "**Deficiency**," and any portion thereof that was advanced by such Member shall be refunded to it without any interest or return thereon. In the event of a Deficiency, the other Member (the "**Contributing Member**"), if it has timely advanced its Contribution Percentage of such capital contribution, may, in its sole and absolute discretion within the 15-day period (the "**Deficiency Election Period**") after the date the Deficiency was required to be contributed, elect to:

A. withdraw the advance of its Contribution Percentage of such contribution, in which event such advance shall be promptly refunded to it, but such refund will not waive the default of such Non-Contributing Member and will not release the Non-Contributing Member from any liability resulting from the failure to contribute; or

B. advance the Deficiency by depositing the same into the Operating Account and

(1) treat the entire amount advanced by the Contributing Member (both the Contributing Member's Contribution Percentage of the contribution and the Deficiency advanced on behalf of the Non-Contributing Member) as a preferred contribution (a "**Special Preferred Contribution**") to the Company as hereinafter provided;

(2) treat the advance of the Deficiency as a contribution (an "**Adjustment Contribution**") and effect the adjustments contemplated by the dilution formula hereinafter provided; or

(3) treat the entire amount advanced by the Contributing Member (both the Contributing Member's Contribution Percentage of the contribution and the Deficiency advanced on behalf of the Non-Contributing Member) as a loan (a "**Default Loan**") to the Company as hereinafter provided.

If the Contributing Member fails, within the Deficiency Election Period, to deposit the Deficiency into the Operating Account, then it shall be deemed to have elected to proceed under clause A above and the Company shall promptly return to the Contributing Member the advance of its Contribution Percentage of such contribution. Notwithstanding anything to the contrary in this Agreement, each Member's obligation to contribute its Contribution Percentage of a required contribution is conditioned upon the other Member timely advancing its Contribution Percentage of such required contribution; and if only one Member timely advances its Contribution Percentage of a required contribution, then the amount so advanced shall be advanced, in trust, and shall not be deemed to have been contributed (and therefore shall remain an asset of such Member and shall not be an asset of the Company) unless and until such Member timely elects to proceed under clause B above. If the Contributing Member timely deposits the Deficiency into the Operating Account, but fails to provide written notice of its election to proceed under clause B above, then it shall be deemed to have elected to proceed under clause B(1) above.

3.3.2 Special Preferred Contribution. The terms of each Special Preferred Contribution shall be as follows: (1) a preferred return shall accrue on the outstanding portion of each Special Preferred Contribution at the "**Applicable Rate**" (which, as used herein, means 25% per annum [i.e., 2-1/12% per month], compounded monthly, but not more than the maximum amount allowable under applicable law); (2) such Special Preferred Contribution shall be a contribution entitled to priority over other capital contributions (except as provided in the last sentence of this subsection 3.3.2), and not a loan; and (3) no Member shall be entitled to any distributions under Section 4.1 ("Distribution Waterfall") unless and until the "**Special Preferred Contribution Balance**" (i.e., the unrecouped portion of the Special Preferred Contribution and unpaid return thereon) has been distributed in full to the Contributing Member making the same, and all Distributable Cash[2] shall instead be distributed directly to Members making Special Preferred Contributions that remain outstanding until the Special Preferred Contribution Balances have been distributed in full. Such distributions shall first be applied to any unpaid return accruing thereon, and then to capital. If there is more than one Special Preferred Contribution outstanding at the time, the same shall be paid on a pro rata basis, based on the relative proportions of the Special Preferred Contribution Balances.

3.3.3 Adjustment Contribution. If there is an Adjustment Contribution, then the following terms will apply:

A. if a portion of a "Default Loan Balance" (as defined below) or Special Preferred Contribution Balance is converted into an Adjustment Contribution, then as of the date of such conversion, (1) the Contributing Member will be deemed to have contributed such Adjustment Contribution, (2) the portion of the Default Loan Balance or Special Preferred Contribution Balance not converted shall also be deemed to have been contributed by the Contributing Member (as a contribution that is not a Special Preferred Contribution), and (3) such contributions shall be deemed to have been used to satisfy such Default Loan Balance or Special Preferred Contribution Balance; and

B. at the time of an actual or deemed Adjustment Contribution:

(1) the Company Percentage of each Member shall be recalculated to equal the percentage equivalent of a fraction:

- the numerator of which is the amount, if any, by which (a) the sum of (i) all Applicable Contributions made or deemed made by such Member, and (ii) an amount equal to 50% (the "**Bonus Percentage**") of all Adjustment Contributions made or deemed made by such Member, exceeds (b) the Bonus Percentage of all Adjustment Contributions made or deemed made by the other Member; and
- the denominator of which is the total amount of all Applicable Contributions by all Members.

(Continued...)

EXHIBIT 1
Appendix: Sample Provisions *(Continued...)*

As used herein, **"Applicable Contributions"** means all contributions made or deemed made to the Company by all Members, (x) including all Adjustment Contributions (whether actually made or deemed made by reason of a conversion under subsection 3.3.5B below) and the portions of any Default Loan Balance or Special Preferred Contribution Balance deemed to have been contributed by the Contributing Member under subsection 3.3.3A above, but (y) excluding (i) any contribution made by Operator in accordance with Section 3.5 ("Reverse Waterfall") to the extent attributable to distributions under the Promote Clauses[3], and (ii) any Special Preferred Contributions;

(2) if Operator is the Non-Contributing Member, then, in addition to the adjustment under clause (1) above, the distributions to Operator under the Promote Clauses shall be reduced by the same proportion as the reduction in Operator's Company Percentage (and the distributions that are no longer made under the Promote Clauses by reason of this clause (2) shall instead be distributed in accordance with the Company Percentages, as modified under clause (1) above). For example, but without limitation on the foregoing, if Operator's Company Percentage were reduced from 10% to 6% (i.e., a 40% reduction) under subsection 3.3.3B(1) above, and if 20% of the distributions under a particular subsection of Section 4.1 ("Distribution Waterfall") were payable under a Promote Clause under that subsection, then such 20% amount would be reduced to 12% (i.e., a corresponding 40% reduction) and the remaining 8% would be distributed in accordance with Company Percentages, as modified above; and

(3) without limitation on the foregoing, if a Member's Company Percentage is reduced to 0%, then it shall be deemed to have automatically withdrawn from the Company and to have transferred all of such Members' right, title and interest in, and claims against, the Company and all of its rights under this Agreement (including its rights to profits, capital, distributions, loan repayments, voting and management) to the other Member (and shall execute such documentation as the other Member may reasonably request to confirm the foregoing).

3.3.4 Default Loan. Each Default Loan shall bear interest at the Applicable Rate and shall be due and payable upon written demand, but in no event later than the earlier to occur of dissolution and liquidation of the Company or ten (10) years after the date made. All amounts which would otherwise be distributed to the Members shall be paid instead to the Contributing Member that makes such Default Loan until the "**Default Loan Balance**" (i.e., the outstanding amount of principal and interest thereunder) has been paid in full. (For avoidance of doubt, Distributable Cash available for distribution to the Members shall not include amounts payable in respect of any Default Loan, but rather shall be net of all such amounts.) Such payments shall be applied first to interest and then to principal. If there is more than one Default Loan outstanding at the time, payments shall be allocated to such Default Loans pro rata in accordance with the relative Default Loan Balances.

3.3.5 Default Loans and Special Preferred Contributions; Priority and Conversion.

A. There shall be no distributions in respect of any Special Preferred Contribution, or any return thereon, while there is any outstanding principal or interest under any Default Loan.

B. For so long as any Default Loan Balance or Special Preferred Contribution Balance is outstanding, the Contributing Member shall have the right to convert a portion (equal to the ratio of the Deficiency to the aggregate of the capital call that gave rise to the Deficiency) of the then balance of the same to an Adjustment Contribution effective immediately upon written notice to the Non-Contributing Member.

3.3.6 Non-Exclusive Remedies. The rights of the Company and the Members pursuant to this Section 3.3 are not exclusive and shall not be deemed to waive any other right or remedy of the Company or any Member under this Agreement, at law or in equity, against any Non-Contributing Member for failure to make any required capital contribution. Once a Default Loan, Special Contribution or Adjustment Contribution has been made (or deemed made), no subsequent payment or tender by the Non-Contributing Member in respect of the Default Loan, Special Preferred Contribution or Adjustment Contribution may be made to reduce the same or affect the Company Percentages of the Members, as adjusted in accordance with this Section.

1 This Contribution Percentage is defined to be the Company Percentage unless the contribution in question is governed by a reverse waterfall (as discussed in Carey, "Real Estate JV Promote Calculations: Recycling Profits," Real Est. Fin. J. (Summer 2006), in which event it means the applicable percentage required by the reverse waterfall.

2 Distributable Cash might typically be defined as the amount of cash determined to be available for distribution after taking into account future capital requirements, reserves, and restrictions under loan documents.

3 If, for example, a particular level of the distribution waterfall provides for cash to be distributed (a) 80% to the members in proportion to their respective company percentages and (b) 20% to the operator as promote, then such clause (b) might typically be defined as a "Promote Clause"

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1 Partnership terminology is used in the body of this article because real estate professionals in a joint venture commonly refer to one another as partners. However, with occasional exception (e.g., due to state or foreign tax concerns or for fund documentation), LLCs are most frequently used in the authors' experience, and therefore the Sample Provisions are LLC provisions.

2 One might not worry about giving any contribution credit to a defaulting partner, but unless partial contributions are expressly addressed, equitable arguments that some credit is appropriate and intended may be raised. It may be expressly provided that there is no credit for a partial contribution, but that is likely, in practice, to yield the same result, namely no partial contributions.

3 It is also possible to allow for the funding of none, or less than all, of the Deficiency. But, as discussed earlier in connection with partial contributions, allowing for this additional flexibility may get complicated (particularly when the partnership agreement allows for loans to the defaulting partner). These additional alternatives are not covered by the Sample Provisions.

4 See, e.g., Cal. Corp. Code §§ 15905.02(c) and 17704.03(c) (2013); 6 Del. C. §§ 17-502(b)(1) and 18-502(b) (2013). *Cf.* Cal. Corp. Code § 17201. See also Part 7.1, *infra*. Note that this article presumes that the California Revised Uniform Limited Liability Company Act (i.e., Cal. Corp. Code 17701.01 et seq.) will take effect on 1/1/2014, without having been amended after this article was submitted to the publisher, and will thereupon apply to the circumstances discussed in this article in all relevant respects. See Cal. Corp. Code § 17713.04(a). *Cf.* Cal. Corp. Code § 17713.04(b). However, at least one commentator has questioned the constitutionality of the new Act, and several have raised concern that confusion may arise because new Section 17713.04(a) provides that (except as provided in the new

sions do not address this problem, but it should be considered, especially at the time the election is made.

- Might the withdrawn contribution be subject to a clawback by partnership creditors if a creditor had relied on the underlying contribution obligation[4] or if the refund was a fraudulent transfer[5] or a distribution in violation of the applicable partnership or limited liability company act?[6] The Sample Provisions attempt to mitigate this concern by providing that each partner's obligation to contribute its share of a required contribution is *conditioned* upon the timely advance of the other partner's share, and that, if the other partner fails to timely advance its share, the funding partner is not deemed to have made a contribution (and thus has not created a partnership asset) unless it affirmatively elects not to withdraw its advance during a 15-day election period.[7]
- Should the funding partner receive a return on its money for the period the money is held by the partnership? Unlike the Sample Provisions, some partnership agreements provide for such a return. But consider where the money to pay such a return will come from—will an additional capital call be necessary to pay it, and if so does a nominal amount of money warrant dealing with such logistical concerns? Moreover, is payment of a return (unless it is made solely and directly by the defaulting partner) inconsistent with the position suggested above, in the discussion of partnership creditors, that the refunded advance was never an asset of the partnership?
- Will the default be forgiven? The Sample Provisions provide that there will be no release of liability by reason of the withdrawal of the funding partner's contribution.[8] However, some partnership agreements provide otherwise.

Advance of Deficiency. If the contribution is not withdrawn, and instead the Deficiency is advanced by the funding partner, how should the Deficiency (and the funding partner's contribution of its share of the capital call) be treated? There are several alternatives, including the following:

- Preferred contribution: treating the total amount funded (i.e., both the regular contribution of the funding partner and the Deficiency it advances on behalf of the defaulting partner) as a preferred contribution.
- Dilution: treating the total amount funded as a contribution and adjusting the partnership interests in some way that increases the partnership interest of the funding partner (with a corresponding reduction in the partnership interest of the defaulting partner).
- Loan to partnership: treating the total amount funded as a loan to the partnership.
- Loan to defaulting partner: treating the advance of the Deficiency as a loan to the defaulting partner (which is deemed used by the defaulting partner to fund its contribution).

Not all of these alternatives will be appropriate in any given transaction and only the first three are included in the Sample Provisions. Each of the alternatives identified above will be discussed in more detail below.

3.1. Preferred Contribution to the Partnership

One alternative is to provide that the funding partner's advance of the Deficiency, and the funding partner's regular contribution, are collectively treated as a preferred contribution to the partnership, which is recouped together with a return (the "preferred return")—usually based on a relatively high compounded rate—before any other distributions are made.

3.1.1 Preferred Contributions: How Much Is Preferred?

In the authors' experience, the Deficiency and the funding partner's regular contribution are usually collectively treated as a preferred contribution, as indicated above. In some transactions, however, this collective treatment has been a source of confusion. Some partners think that *only* the Deficiency should be preferred. They do not think it is fair for the funding partner to get the high return that is typically associated with a preferred (default) contribution on the entire capital call.

Comparing a Loan to the Defaulting Partner. As a frame of reference, one can compare the preferred contribution with a loan to the defaulting partner, an alternative remedy discussed in Part 3.4 below. When the funding partner makes a loan to the defaulting partner, only the Deficiency is loaned and then repaid together with interest (which for purposes of comparison, is assumed to accrue at an interest rate equal to the rate of return on a preferred contribution). However, such a default loan would be repaid by the defaulting partner only (and typically the repayment would be paid from the distributions that would have gone only to the defaulting partner). By contrast, a preferred contribution is effectively paid by *both*

A balance must be struck between thorough drafting and consummating a cost-effective transaction.

Act) existing entities will become subject to the new Act, and new Section 17713.04(b) provides that (except as provided in the new Act) existing contracts entered into by the LLC or by the members of an existing entity (Are existing "contracts" limited to third-party contracts or could they include the operating agreement?) and will remain subject to the existing Act. See, e.g., Bishop, "California's New LLC Act—Call Me Laocoon, But I Foresee A Mess!," Cal. Corp. & Sec. L., 9/24/2012, http://calcorporatelaw.com/2012/09/californias-new-llc-act-call-me-laocoon-but-what-a-mess. Issues might include, for example, whether the existing Act or the new Act will govern a creditor's enforcement (in 2014 or later) of a contribution obligation on which the creditor relied in extending credit to the company (prior to 2014). These transition issues are beyond the scope of this article.

5 See, e.g., 11 U.S.C. section 548; Cal. Civ. Code § 3439.05.

6 See, e.g., Cal. Corp. Code §§ 15905.08, 17254, and 17704.05; 6 Del. C. §§ 17-607 and 18-607.

7 Creditor issues are discussed in more detail in Part 7, *infra*.

8 See Part 5, *infra*.

partners (being paid by distributions that would have gone to both partners).

What is often overlooked (or is not understood) is that if distributions are made in the same proportions as the applicable contributions were to be made, then regardless of the rate of return (and equivalent loan interest rate), the partnership will be required to distribute the same amount of total cash (all of which will end up in the funding partner's pocket) (1) to repay a preferred contribution (together with the preferred return) based on the entire capital call, or (2) to provide the defaulting partner with the amount necessary to repay the Deficiency, together with interest at the equivalent interest rate.[9] Under these circumstances, the funding partner's share of the capital call and the preferred return on that amount are effectively paid by the funding partner itself (from the portion of the preferred distributions that would have been distributed to the funding partner if they had not been preferred).

Disproportionate Regular Contributions. If only the Deficiency is treated as a preferred contribution, then the partners' regular contributions may be out of sync (e.g., no longer in the same proportion as partnership percentages).[10]

Example 3.1.1. Assume the following facts: (1) there is a partnership between two partners, each of which has a 50% interest, and (absent a default) all contributions and distributions are to be made equally; (2) the partners initially contribute $100X each, and the only other capital call is for an additional $100X; and (3) one partner fails to make its $50X additional contribution, while the other partner makes its $50X additional contribution and advances the defaulting partner's $50X Deficiency. If the entire $100X of additional capital is treated as a preferred contribution, then all distributions will be made to the funding partner until it receives $100X plus the agreed-upon return. Once that amount has been distributed, the unrecouped contributions would be 50/50, so that allocating the remaining distributions equally makes sense. However, if only the Deficiency were treated as a preferred contribution, then the funding partner would get all distributions until it recouped its $50X advance plus the requisite return; once the preferred contribution and its return were satisfied, the outstanding contributions would be $150X for the funding partner and $100X for the defaulting partner so that 50/50 distributions would be unfair to the funding partner (because of its extra $50X).

This problem could be solved by a hybrid remedy. For example, the partners could adjust the distributions so that after the $50X preferred contribution (and any associated return) is distributed to the funding partner, capital is refunded 60/40, which matches the ratio of remaining contributions ($150/$100), and then subsequent distributions remain 50/50 (without adjustment). However, that approach is not likely to be acceptable because it is worse for the funding partner than having the funding partner finance the defaulting partner's share of the extra $50X of unpreferred contributions at 0% (to make the unpreferred contributions $75/$75): the funding partner would be getting neither a return nor a priority on the extra $50X. Moreover, the funding partner would not be getting a proportionate increase in its share of profits.

Alternatively, the partners could adjust the partnership percentages to 60/40 or a more favorable ratio for the funding partner (using a bonus or penalty factor to give the funding partner credit for more than its 60% share of actual contributions) and provide that *all* distributions are made in this new ratio. But, for reasons discussed in Part 3.2 below, the funding partner may not want to be

9 The foregoing assumption (i.e., that distributions are made in the same proportion as the applicable contributions are to be made) may not always be true. Disproportionate distribution schemes are in fact common in partnerships with promote structures. See Part 3.1.3, *infra*.

10 The partners' regular contributions may not be proportionate to their partnership percentages if there has previously been a dilution based on a bonus or penalty formula; even then, the regular contributions may not be proportionate to the adjusted partnership percentages (as previously adjusted by the dilution formula) if only the Deficiency is treated as a preferred contribution.

11 See Section 511 *et seq.* regarding UBTI generally.

12 See Sections 514(c)(9)(B)(vi)(III), 514(c)(9)(E); McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners, 4th ed.* ¶ 9.03[3][c][i] (Thomson Reuters/WG&L, 2007) ("Generally, [the fractions] rule requires that allocations to any tax-exempt partner cannot result in that partner having a percentage share of overall partnership income for any taxable year greater than that partner's percentage share of overall partnership loss for the taxable year for which that partner's percentage loss share will be the smallest..."); Lokey and Loft, "Ventures with Tax-Exempt and Foreign Investors," Wm. & Mary Tax Conf., § IID5d(5)(c) at 18 (2008) ("Any time that a taxable partner's capital is subordinate to a qualified organization's capital, the allocations will not comply with the fractions rule because the tax-exempt partner will always have a share of net profits higher than its fractions rule percentage. (Because the tax-exempt partner's capital is senior, either the agreement must provide that profits build its capital account first, to the extent capital has been torn down, giving the tax-exempt member a 100% share of profits, or it must tear down the capital of the subordinated members first, giving the tax-exempt member a 0% share of overall losses.)"). See also Kahn, "Help With Fractions: A Fractions Rule Primer," 126 Tax Notes 953 (2/22/2010); Fass, Haft, Loffman, and Presant, *Tax Aspects of Real Estate Investments* (West Publishing, 2005), 1A § 13:20.

13 See Section 514(c)(9)(E)(ii)(II); Regs. 1.514(c)-2(c)(1)(ii) and 1.514(c)-2(d) (as amended in 2003).

14 Reg. 1.514(c)-2(d)(4)(ii).

15 Kahn, note 12, *supra*, at 963 n.52.

16 See note 12, *supra.*

17 Reg. 1.514(c)-2(g).

18 For concerns regarding the application of the fractions rule to preferred contributions resulting from a contribution default, see Letter from Chair

forced to elect a dilution remedy (even if there is a bonus or penalty factor). For these reasons (and to avoid the attendant complications), no such hybrid remedy is included in the Sample Provisions.

3.1.2 Preferred Contributions: Tax Issues

Preferred contributions may cause tax problems for certain tax-exempt partners (or direct or indirect tax-exempt investors in a partner) that are subject to tax on unrelated business taxable income (UBTI).[11] Specifically, preferred contributions may violate the "fractions rule" (which, in general terms, limits the shifting of losses from a tax-exempt partner to a taxable partner or income from a taxable partner to a tax-exempt partner).[12] There are exceptions for "reasonable preferred returns" and "reasonable guaranteed payments."[13] But the safe harbor "commercially reasonable" rate[14] is usually (in the authors' experience) much less than the desired rate of return for preferred contributions in the default context, and "[t]here is an absence of guidance on how a determination regarding reasonableness would be made."[15] Moreover, even if one ignores the preferred return *on* capital, the repayment of the capital itself is still preferred and the resulting subordination of the other capital may result in a fractions rule violation (because it could cause losses to be allocated away from the fractions rule sensitive partner).[16]

There is an exclusion for "unlikely losses,"[17] but the examples in the regulations do not include unanticipated defaults and many practitioners are not willing to rely on this exclusion.[18] To make matters worse, a fractions rule violation may occur even if the preferred contributions are never made (i.e., the right to make preferred contributions may in itself be violative).[19] However, compliance with the fractions rule is relevant only if there is at least one direct or indirect partner in the partnership that is a "qualified organization"[20] and (as is usually the case) there is at least one direct or indirect partner in the partnership that is not,[21] and may be avoided with appropriate structuring, typically by investing through a real estate investment trust (REIT) or a cor-

of Taxation Section of ABA to IRS Commissioner regarding "Comments Concerning Partnership Allocations Permitted Under Section 514(c)(9)(E)" (1/19/2010), available at http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/comments_concerning_partnership_allocations.authcheckdam.pdf [hereinafter ABA Taxation Section Letter].

19 The fractions rule applies on both an actual and prospective basis. Reg. 1.514(c)-2(b)(2)(i). "Thus, subject to [certain exceptions], if the partnership could allocate a percentage of overall partnership income in any year to a qualifying tax-exempt partner in excess of that partner's fractions rule percentage, the partnership violates the fractions rule." Kahn, note 12, *supra* at 961.

20 The term "qualified organization" is defined in Section 514(c)(9)(C) and includes trusts forming a part of a qualified employee benefit plan and exempt educational organizations (e.g., colleges and universities) and certain affiliated support organizations (endowments). The Section 514(c)(9) exception is available only to "qualified organizations" in connection with debt incurred in acquiring or improving real property (or debt incurred after acquisition or improvement if incurring such debt was "reasonably foreseeable"), and only when the several requirements of Section 514(c)(9), of which the fractions rule is one, are met. The fractions rule may seem irrelevant if (1) the Section 514(c)(9) exemption is not otherwise available (e.g., because the acquisition debt relates to personal rather than real property or one of the other requirements of Section 514(c)(9), aside from the fractions rule, is not met), or (2) subject to the next sentence, all income from the partnership's investment will be UBTI anyway (e.g., if the only income is from the development and sale of residential lots as inventory). However, if a tax-exempt investor investing through the partnership is a qualified organization and has or may have other partnership investments, fractions rule compliance may still be important. See ABA Taxation Section Letter, note 18, *supra*, at 4 ("in a tiered partnership setting, there is concern that violation of the fractions rule with respect to a lower-tier partnership may cause an upper-tier real estate fund to be treated as violating the fractions rule with respect to all of its investments"); *id.*, § VIII at 26-32.

21 Compliance with the fractions rule is not required if all of the partners are qualified organizations. Section 514(c)(9)(B)(vi)(I). For this purpose, an organization is not treated as qualified "if any income of such organization is unrelated business taxable income." Section 514(c)(9)(B) (see final sentence).

poration.[22] Consequently, the preferred contribution remedy is often, if not usually, omitted in deals involving qualified organizations that do not use a REIT or a corporate blocker.

3.1.3 Preferred Contributions: Impact on Promote

Preferred contributions may accelerate or defer the operator's promote relative to a loan to the operator as defaulting partner (depending on whether the preferred contribution rate is lower or higher than the promote hurdle rate). However, in the authors' experience, promote considerations generally have not been a deterrent to using preferred contributions. This subject is addressed in another article, which discusses a possible solution that may avoid any impact on the timing and amount of the promote (relative to the timing and amount when there is a loan to the defaulting partner).[23]

3.2 Dilution

Another alternative is to treat the entire amount funded by the funding partner (i.e., both its regular contribution and its advance of the Deficiency) as a capital contribution and adjust the partnership interests through what is often called a "dilution" or "squeeze-down" formula. There are many possible dilution formulas.[24] Most dilution formulas encountered by the authors are either (1) "non-punitive" or "pro rata" formulas that adjust the partnership percentages to be proportionate to capital contributions or (2) penalty or bonus formulas that inflate the capital credit for the capital contributed by the funding partner.

Pro Rata Capital Formulas: Adjustment Based on *Actual* Capital of Funding Partner. The simplest dilution formula adjusts partnership percentages so that they are proportionate to the actual capital contributed. In the authors' experience, this formula is typically based on *total* capital contributions (i.e., *gross* contributions determined without regard to distributions) as in Example 3.2.1A below. Alternatively, the formula may be based on *outstanding* capital contributions (i.e., *net* contributions determined by deducting distributions, but not a negative amount) as in Example 3.2.1B below. In either case, such a formula is sometimes called a "pro rata" or "non-punitive" dilution formula. But, as explained below, it can be punitive to either the defaulting or the funding partner depending on whether the equity *value* (i.e., the net fair market value of the partnership's assets at the time of comparison, after deducting debt and other liabilities) is more or less than the equity *capital* (i.e., actual capital contributions) taken into account.[25] To protect against unintended bad results for the funding partner, it is common to provide for one or more alternatives to dilution, such as the preferred contribution remedy described above and the loan remedies described below.

Penalty Capital Formulas: Adjustment Based on *Inflated* Capital of Funding Partner. More often than not, in the experience of the authors, a dilution formula gives the funding partner credit for *more* than 100% of the capital it advances on behalf of the defaulting partner (and sometimes even the capital it contributes on its own behalf).[26] This approach obviously increases the benefit to the funding partner when equity value is equal to or more than the equity capital taken into account, but may or may not avoid an additional loss to the funding partner when equity value is less than equity capital. For this reason, the precautions taken for pro rata dilution formulas are commonly taken for penalty formulas as well. A dilution formula rarely appears in isolation as the only remedy for the funding partner, and it is not likely to be used when the equity *value* is less than the equity *capital* taken into account in the dilution formula.

3.2.1 Dilution: Capital vs. Value-Based Formulas

The dilution formulas described above (and the formulas in the Sample Provisions) are based on *capital* invested without regard to the actual *value* of each partner's interest or the partnership's assets. The consequences may vary (dramatically and perhaps unexpectedly) depending on the discrepancy, at the time of the adjustment, between the partners' respective shares of total *capital* taken into account in the dilution formula and the partners' respective shares of equity *value*.

Not Sufficiently Protective. Sometimes the dilution formula may not protect the funding partner and could even benefit the defaulting partner. Consider the following example:

Example 3.2.1A. Assume the following facts: (1) there is a 50/50 partnership; (2) there is a $20 million aggregate capital commitment; (3) the partnership agreement provides that if a partner fails to put in its share of capital, the partnership interests will be adjusted to reflect the relative proportions of capital contributed (for simplicity, no bonus factor is included); (4) each of the partners contributes $5 million to acquire a $10 million office building, which is immediately sold for a huge profit before any further contributions are made; and (5) the remaining $10 million is later called to purchase a second building.

Under the facts of this example, each of the partners has a 50% interest at the time of the second capital call and each partner has received a return of all its prior capital contributions. If one of the partners elects not to fund its share, and the other partner funds the entire amount, of the second capital call, then the partnership interests would be adjusted to 75% and 25%, respectively. Despite failing to fund *any* portion of the $10 million investment, the defaulting partner would end up with the windfall of a 25% interest in the partnership!

Too Protective. One might quibble with the prior example because the partners had no outstanding capital at the time of the second capital call.

[22] See, e.g., Taylor, 'Blockers,' 'Stoppers,' and the Entity Classification Rules," 64 Tax Law. 6 (Fall 2010); Berg, Fisch, and Tattenbaum, "Using Private REITs to Minimize UBTI in Real Estate Investment Funds," 18 Real Est. Fin. J. 36 (Winter 2003); Morgan and Tomlinson, "Tax-Exempts Challenge Private Fund Sponsors," N.Y. L.J. (10/3/2006).

[23] See Carey, "Partner Loans to Fund Capital Call Shortfalls in Real Estate Partnerships: Loan to Non-Contributing Partner vs. Loan to Partnership," 5 Real Est. Industry L. Rep. 26, at 917 (12/25/2012) (hereinafter Carey, *Partner Loans*).

[24] See Carey, "Squeeze-down Formulas: Do They Work the Way You Think They Do?," Real Est. Fin. J. 43 (Fall 1997) (hereinafter Carey, *Squeeze-down Formulas*).

[25] *Id.*

[26] See Carey, *Squeeze-down Formulas* at 50 (discussion of "entire base" formulas).

[27] See Carey, *Squeeze-down Formulas* at 45-47.

a fair market value dilution formula might be more precise, such formulas are rare in the authors' experience because of the time and costs involved in determining value and the potential for disputes.[27]

Would basing the dilution formula on outstanding capital be a better solution? Unfortunately, this alternative approach also has problems and may sometimes be too punitive, as illustrated by the following example:

Example 3.2.1B. Assume the following facts: (1) there is a 50/50 partnership which acquires an office building at a below-market price in a rising market; (2) the partnership refinances the building and each of the partners recoups all of its capital and there are still millions of dollars of equity; (3) there is then a relatively small capital call (the first additional capital contribution) for $10,000 to cover an operating deficit; and (4) the partnership agreement provides that if a partner defaults in its obligation to contribute required capital, the partnership interests will be adjusted to reflect the relative proportions of the partners' outstanding capital contributions.

At the time of the small capital call, the partners have no outstanding capital. Consequently, if one of the partners fails to contribute its share, it would lose its entire interest in the partnership (and its share of millions of dollars of equity)!

Discrepancies with Value. The bottom line is that a capital-based dilution formula may yield strange results when the partnership's equity *value* is significantly different than the *capital* taken into account in the dilution formula. In the examples above, the disparities were exaggerated by distributions: the equity value was much less than the relevant capital in Example 3.2.1A ($10 million of equity value vs. $20 million of capital); and the equity value was much more than the relevant capital in Example 3.2.1B (millions of value vs. nominal capital). But the problem may exist even before any distribution has been made: if there has been appreciation or loss in the partnership's equity value, then the corresponding value associated with each new dollar of capital may be more or less than $1 respectively.

Why not use a fair market value adjustment to avoid this problem? While

3.2.2 Dilution: What Is Being Adjusted?

It is important that the partners understand what is being adjusted under the dilution remedy. Partnership percentages are usually modified under a dilution remedy, but what does this mean and is it the only modification?

Right to Receive Future Distributions. Partnership percentages are typically used to establish how certain (and sometimes all) *distributions* are made. Thus, the partners' shares of distributions that are made in accordance with partnership percentages will be adjusted accordingly. As illustrated in Part 3.2.3 below, the impact of the adjustment to distribution sharing may vary depending on the other provisions of the partnership agreement.

Obligation to Make Future Contributions. Partnership percentages may also be used to establish how the obligation to make certain (and sometimes all) *contributions* is shared. But not always. Sometimes a dilution formula does not adjust the partners' shares of future contributions. Although such an approach might be important to a partner with limited capital who may not be able to meet the burden of a larger capital commitment, it may become very draconian depending on how distributions are adjusted. To take an extreme example, imagine a partner, whose original partnership percentage was 50%, is entitled to only 5% of partnership distributions (by reason of the application of a dilution formula) but is still required to contribute 50% of all contributions.

Pro Rata vs. Penalty Capital Adjustment Formulas. In a pro rata capital adjustment formula, the adjustments are straightforward. The funding partner has contributed more capital than expected and the defaulting partner has contributed less capital than expected, but each is simply credited with what it has actually contributed. Such a formulation results in obvious adjustments to the total amount of capital each partner has contributed, its capital account, and its partnership percentage. The adjustments are more complicated and varied when a penalty capital adjustment formula is used due to the additional hypothetical capital credited to the funding partner.

There is a range of possibilities as to what may be adjusted under the partnership agreement by the additional hypothetical contribution. Some partnership agreements purport to adjust (1) all distributions, (2) only profit distributions after capital contributions have been recouped, or (3) only the final level of profit distributions. Some partnership agreements also adjust the capital accounts by, for example, reducing the defaulting partner's capital account, and increasing the funding partner's capital account, by the additional hypothetical capital.[28] Some partners may expect that such a capital shift will occur if the partnership agreement merely adjusts all of the distributions even if there is no express adjustment of capital accounts (assuming no capital has been recouped at the time of the adjustment). However, it may not. For example, if there is no capital account adjustment and the partnership agreement requires liquidation in accordance with (i.e., in proportion to) capital accounts, then the defaulting partner may get back the bonus penalty (resulting from the additional hypothetical contribution) upon liquidation. Even if there are adjustments to the capital accounts, they may be economically undone by tax allocations.[29]

Tax Adjustments. Of course, any adjustment to the economics may also cause or require adjustments to the tax allocations, but discussion of tax adjustments (and compliance with the fractions rule) in connection with dilution formulas is beyond the scope of this article.

Sample Provisions. The Sample Provisions explicitly address only the adjustment of partnership percentages and the promote percentages. As illustrated in Part 3.2.3 below, the effect of these adjustments may vary depending on the rest of the partnership agreement (e.g., tax and distribution provisions) and what actually happens in the partnership (e.g., the actual contributions and distributions).

28 The capital shift effected by such capital account provisions may have a significant tax impact (in addition to the apparent economic impact). Indeed, such tax consequences are sometimes the driving force for using these stronger forms of dilution formula, because they may cause capital account balances, future income and loss allocations and the determination of a partner's "fractions rule percentage" (i.e., a partner's smallest share of overall partnership loss) to be in line with the intended economic dilution.

29 See, e.g., Cuff, "Drafting Real Estate Partnership and Entity Agreements," L.A. Law., January 2006, at 12.

30 See, e.g., *id.* at 14; Cuff, "Tax Aspects of Partnership Dilution Procedures," 1 BET 16 (Mar./Apr. 1999); Schneider & O'Connor, "LLC Capital Shifts: Avoiding Problems When Applying Corporate Principles," 92 J. Tax'n 13 (Jan. 2000); BNA Tax Management Portfolio 591-2nd: Real Estate Transactions by Tax-Exempt Entities, II.G.5.a., n.243 ("(changes, resulting from closing or default adjustments during real estate venture, in partners' shares of partnership's income and losses did not cause partnership's tax allocations to contravene fractions rule)") (describing Ltr. Rul. 200351032)); Lokey and Loft, note 12, *supra,* § IID5d(5)(a) at 18 ("Many partnership agreements have a dilution provision in the event a partner fails to make its pro rata share of additional capital contributions. The regulations provide that changes in partnership allocations that result from transfers or shifts of partnership interests will be closely scrutinized, but that they generally will only be taken into account in determining whether the agreement satisfies the fractions rule in the taxable year of the change and subsequent taxable years. See Reg. 1.514(c)-2(k)(1). The change will be closely scrutinized to determine whether there was a prior agreement, understanding or plan to cause a shift in partnership allocations, or if the change was expected from the structure of the transaction. See *id.* Thus, although not free from doubt, a dilution caused by these types of provisions generally should constitute a shift in partnership interests within the meaning of this rule, and therefore should not be taken into account until the dilution provisions are actually triggered."); ABA Taxation Section Letter, note 18, *supra* ("there is little, if any, guidance for determining whether changes to the partners' shares of income and losses resulting from either a default or reduction in committed or contributed capital causes a partnership to violate, on a prospective basis (after the default or lowered capital contribution), the fractions rule.").

31 Cal. Rev. and Tax Code § 50 (change in ownership results in revised base year value); § 64(c)(1) ("When a person obtains control through direct or indirect ownership or control of more than 50 percent of any corporation, or obtains a majority ownership interest in any legal entity through the transfer of interests, the transfer shall be a change of ownership of the real property owned by the entity in which the controlling interest is obtained."). See also Cal. Rev. and Tax Code § 64(d) for a possible change in ownership resulting from transfers of more than 50% of the interests of "original co-owners" who previously took advantage of a change in form exemption.

3.2.3 Dilution: Interplay with Other Provisions and Facts

Dilution formulas should not be viewed in isolation. To properly assess the impact of a dilution adjustment, one needs to analyze the entire partnership agreement, especially the contribution, distribution, and tax allocation provisions, and also the actual contributions, distributions and allocations. The results may vary significantly depending on these factors, as illustrated by the following examples:

Example 3.2.3. Assume the following facts: (1) the partnership agreement provides that (a) an investor and operator are partners starting with partnership percentages of 75% and 25%, respectively, and (b) if a partner fails to make its share of a contribution, the partnership percentages are adjusted in accordance with the dilution remedy in the Sample Provisions; (2) except as provided in Example 3.2.3C below, the partnership agreement does not require that liquidating distributions be made in accordance with capital accounts; (3) the partners initially contribute $100X in accordance with their partnership percentages; (4) a second contribution of $25X is contributed by investor alone, and there are no further contributions; and (5) the only distribution is a liquidating distribution of $150X. Thus, the total contributions would be $125X ($100X and $25X), and following the second and final contribution, the adjusted partnership percentages would be 85% ([$75X + $25X + (50% of 25% of $25X)] / $125X) and 15% ([$25X + $0 - (50% of 25% of $25X)] / $125X). Now, consider three different distribution schemes and note the differing results:

Loss of *Profit and Capital* for Defaulting Partner. The defaulting partner could lose capital even though there is no debit to the defaulting partner's (or credit to the funding partner's) capital account for the additional hypothetical contribution. Such a loss is possible even if the partnership does not have a loss:

Example 3.2.3A. Assume the facts in Example 3.2.3 and that all distributions are made in accordance with the then partnership percentages. Under this formulation, (1) the $150X would be distributed $127.5X to the investor and $22.5X to the operator, and (2) the operator would have a whole-dollar loss of $2.5X ($25X - $22.5X) or 10% of its investment.

Loss of *Profit Only* for Defaulting Partner. It is also possible, of course, that the defaulting partner would not lose capital under such a formula:

Example 3.2.3B. Assume the facts in Example 3.2.3 and that distributions are made in accordance with (actual) outstanding capital until all capital contributions are recouped, and the balance is distributed in accordance with the then partnership percentages. Under this formulation, the adjusted partnership percentages are the same as in the prior example, but (1) $125X of the $150X would be distributed $100X to the investor and $25X to the operator, and the remaining $25X would be distributed $21.25X to the investor and $3.75X to the operator, and (2) the operator would have a whole-dollar profit of $3.75X.

It may be possible to combine a dilution remedy with other contribution default remedies.

The effect of the dilution formula under the two examples, which involve the same dilution formula and the same cash flows, is a loss of *both profits and capital* in Example 3.2.3A and a loss of *only profits* in Example 3.2.3B. This result is not surprising. In Example 3.2.3B partnership percentages are used only in the portion of the distribution waterfall that allocates profit distributions so that only profit distributions are adjusted. Similar examples are easily constructed by adjusting the amount of distributions and using any two different distribution waterfalls where one is less favorable to the defaulting partner for the assumed amount of distributable cash.

No Loss for Defaulting Partner. It is also possible that a requirement to liquidate in accordance with capital accounts could eliminate the impact of a dilution remedy.

Example 3.2.3C. Assume the facts in Example 3.2.3 except that (1) the partnership agreement provides that distributions (other than liquidating distributions) are made in accordance with partnership percentages, as in Example 3.2.3A, and liquidating distributions are required to be made in accordance with capital accounts, (2) the property is unencumbered raw land that produces no income or depreciation (and therefore there are no tax profits or losses to allocate), and (3) the liquidating distribution is in the amount of $125X (rather than $150X). After the second and final contribution, the capital accounts would be $100X and $25X, respectively. Thus, the total distributions to investor and operator would be $100X and $25X, and the operator would have no whole-dollar profit or loss.

In the preceding three examples, the same dilution provisions yield very different results: in Example 3.2.3A, the operator loses capital even though the property is sold for a profit; in Example 3.2.3B (where the only change to Example 3.2.3A is how distributions are made), the operator merely loses some of its profits; and in Example 3.2.3C, the bonus factor is effectively eliminated because of the amount of the liquidating distribution and the fact that it was made in accordance with capital accounts without the benefit of current tax items to allocate (or a "book-up" or "book-down" to adjust the capital accounts) to achieve the intended economic consequences of the dilution.

3.2.4 Dilution: Timing of Election

The Sample Provisions permit the funding partner to make an election to implement a dilution remedy concurrently with its advance of the Deficiency, or subsequently by way of converting the outstanding balance of a preferred contribution or loan to the partnership to common equity. However, sometimes a dilution remedy might be subject to a lockout period by providing that dilution is available only by way of conversion of a preferred contribution or default loan that has not been repaid (together with the applicable interest or return) within a certain period of time.

3.2.5 Dilution: Tax Issues

Partners are strongly advised to consult with a tax expert regarding the tax consequences of dilution remedies. Dilution raises a myriad of income tax issues (e.g., taxable capital shifts or deemed transfers of partnership interests, and fractions rule compliance), which are beyond the scope of this article.[30] In addition to income tax issues, consider whether transfer tax and real property tax reassessment issues may be implicated. For example, in California, if dilution causes certain changes of control in the partnership, such changes could give rise to a "change in ownership" triggering a reassessment and establishment of a new "base year value" for the real property owned by the partnership.[31] In addition, a documentary transfer tax may be imposed (as though all the real property owned by the partnership were transferred) in connection with a transfer of 50% or more of the partnership interests (and more generally, any "708 termination") and, in certain cities and counties in California, a documentary transfer tax may also be payable if dilution results in certain changes in control.[32]

3.3 Loan to Partnership

Another alternative remedy is to provide that the funding partner's advance of the Deficiency, collectively with the funding partner's regular contribution, may be treated as a loan to the partnership. This loan typically bears interest at a relatively high compounded rate and is repaid, together with interest, prior to any distributions. This remedy raises a number of issues.

3.3.1 What Is Amount of Loan? Should the loan to the partnership be limited to the amount of the Deficiency? For the same reasons discussed in Part 3.1.1 above in connection with preferred contributions, the entire amount advanced by the funding partner (both its regular share of the capital call and the amount advanced on behalf of the defaulting partner) is typically treated as a loan to the partnership (if that remedy is elected).

3.3.2 Loan to Partnership: Tax Issues. Tax considerations include the following:

- Loan interest may generate ordinary income for taxable partners.[33]
- Default loans may raise issues if a partner (or any investor in a partner) is a REIT. Although interest under a loan qualifies for the 95% (passive income) test,[34] it may not qualify for the 75% (real estate income) test[35] unless it is "secured by mortgages on real property or on interests in real property."[36] In the authors' experience, default loans to the partnership are rarely, if ever, secured. Often, however, the amount of default loan interest income may be sufficiently small (when compared to the REIT's other income) that it is not a significant concern. A REIT must also meet certain asset tests to ensure that its assets consist primarily of real estate. In particular, no more than 25% of the value of its total assets may be represented by certain securities,[37] which may include default loans. Moreover, with certain exceptions, REITs may not own more than 10% of the securities (by vote or value) of a single issuer.[38] Fortunately, debt of the partnership

32 According to the California Revenue and Taxation Code statutes regarding documentary transfer taxes, "If there is a termination of any partnership or other entity treated as a partnership for federal income tax purposes, within the meaning of Section 708 of the Internal Revenue Code, the partnership or other entity shall be treated as having conveyed all realty held by the partnership or other entity at the time of termination." Cal. Rev. and Tax Code § 11925(b). Section 708 provides, in part, that "a partnership shall be considered as terminated if (A) no part of any business continues to be carried on in a partnership, or (B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits." Section 708(b)(1). The documentary transfer tax rules (and tax rates) contained in the California Revenue and Taxation Code may be modified by local ordinance in "charter cities." See, for example, San Francisco Business and Tax Regulations Code, Article 12-C, in particular, Section 1114, which imposes a documentary transfer tax on "any acquisition or transfer of ownership interests in a legal entity that would be a change of ownership of the entity's real property under California Revenue and Taxation Code § 64."

33 Section 61(a)(4); *BNA Tax Management Portfolio 551-2nd: Section 482 Allocations: General Principles in the Code and Regulations*, § IV.C.3.d(5) ("In general, interest income is included in gross income as ordinary income.").

34 Section 856(c)(2)(B).

35 Section 856(c)(3).

36 Section 856(c)(3)(B).

37 Section 856(c)(4)(B)(i).

38 See Sections 856(c)(4)(B)(iii)(II) and (III). Although a "security" does not, for this purpose, include a REIT's interest as partner (Section 856(m)(3)(A)(i)) or its share, as a partner, of a debt instrument issued by the partnership (Section 856(m)(4)(A)), a default loan to the partnership may not be entirely excluded. Although there are further exceptions to the rule, they may not apply. Section 856(m). For a more detailed discussion of the 10% rule, see *BNA Tax Management Portfolio 742-3rd: Real Estate Investment Trusts*, III.B.3.

39 Section 856(m)(4)(B). Many REIT partners will take steps to ensure that the partnership is operated in such a manner to meet this test.

40 For loans, the lender must accrue interest. Regs. 1.446-1(c)(1)(ii) and 1.446-2(a)(1); *BNA Tax Management Portfolio 570-3rd: Accounting Methods—General Principles*, IV.C.1 ("Accrual method taxpayers recognize income when 'all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.' Ordinarily, a taxpayer's right to income is fixed under this 'all events test' when either the amount is unconditionally due or the taxpayer has performed. As a result, the general rule is frequently stated that accrual taxpayers recognize income when it is paid, due, or earned, whichever occurs first.") (citations omitted).

is not considered a security under the 10% rule if the partnership meets the 75% (real estate income) test.[39]

- The partner making the loan will be required to accrue interest income currently, regardless of whether interest is actually paid.[40] This is in contrast to a preferred return, where, in the authors' experience, many tax advisors take the position that income in respect of the return is allocated to the contributing partner only if and when the partnership has net income to be allocated, or when the accrual of the preferred return gives the funding partner a distribution right that effectively shifts capital from the capital account of the defaulting partner to pay the preferred return of the funding partner.

3.3.3 Loan to Partnership: Debt Restrictions. It is relatively common for mortgage loans to include debt restrictions (in the single purpose entity (SPE) covenants or elsewhere) that prohibit the borrower from incurring any other debt (except for certain trade payables and whatever additional exceptions the borrower is able to negotiate). It may therefore be important to negotiate an exception to the debt restrictions in a partnership mortgage loan to allow contribution default loans to the partnership (or to incur the mortgage debt through a partnership subsidiary if that allows the partnership to avoid such debt restrictions). Otherwise, this remedy may not be available without creating a default under the partnership's mortgage loan.

3.3.4 Loan to Partnership: Usury/Lender Licensing. Will the loan give rise to usury or lender licensing issues? Most partnership and LLC statutes provide that the law of the state of formation governs the internal affairs of a foreign partnership or LLC.[41] And in some jurisdictions, loans to a partnership (or to a partner that is an entity) may be exempt from the defense of usury under a commercial transaction exemption under the laws of the state of formation.[42] (In Delaware, there is also a usury exemption for obligations among partners which arise under the partnership agreement, although such exemption does not expressly apply to obligations of the partnership to its partners.[43]) Would it matter if the partnership is formed in

However, the interest payable by the partnership may (but not in all cases) be deductible by the partnership. Such deduction (if allowable) would be taken into account in determining the partnership's net income or loss for the tax year allocated to the partners. In such event, the overall tax impact to the lending partner would be the difference between the amount of interest income it is required to accrue and its allocable share of such interest deduction of the partnership.

41 See, e.g., Ribstein & Keatinge, *Ribstein and Keatinge on Limited Liability Companies* (West, 2012), § 13:3, at 48 ("Most LLC statutes provide that the law of a formation jurisdiction governs the organization, internal affairs, and member liability of a foreign LLC.") (endnote omitted); Rutledge, Jacobson & Ludwig, *State Limited Liability Company & Partnership Laws,* (2011-1 Supp.) 11 § 5.1, at 31 ("Generally the LLC acts provide that the laws of the jurisdiction under which a foreign LLC is organized govern its internal affairs and the liability of its members and managers.") (endnote omitted); Bromberg & Ribstein, *Bromberg and Ribstein on Partnership* (Aspen, 2011-1 Supp.) § 1.04(a), at 63 ("the internal affairs rule applies under the Revised Uniform Limited Partnership Act"); Cal. Corp. Code § 15909.01(a) ("The laws of the jurisdiction under which a foreign limited partnership is organized govern relations among the partners and between the partners and the partnership"); Cal. Corp. Code § 17450(a) ("The laws of the state under which a foreign limited liability company is organized shall govern its organization and internal affairs."); Cal. Corp. Code § 17708.01(a)(1) ("The law of the jurisdiction under which a foreign limited liability company is formed governs [its] organization [and] internal affairs."); 6 Del. C. §§ 15-106(a), 17-901(a)(1), and 18-901(a)(1). *Cf.* Cal. Corp. Code § 16106(a) (subject to certain exceptions for limited liability partnerships, "...the law of the jurisdiction in which a partnership has its chief executive office governs relations among the partners and between the partners and the partnership.").

42 See, e.g., Cal. Corp. Code § 25118 (providing a usury exemption for certain loans of at least $300,000 or to borrowers with total assets of at least $2 million but not if made or guaranteed by an individual); 6 Del. C. § 2301(c) ("Notwithstanding any other provision in this chapter to the contrary, there shall be no limitation on the rate of interest which may be legally charged for the loan or use of money, where the amount of money loaned or used exceeds $100,000, and where repayment thereof is not secured by a mortgage against the principal residence of any borrower."); 6 Del. C. § 2306 ("No corporation, limited partnership, statutory trust, business trust or limited liability company, and no association or joint stock company having any of the powers and privileges of corporations not possessed by individuals or partnerships, shall interpose the defense of usury in any action.").

43 See 6 Del. C. §§ 17-505, 18-505.

Delaware, but the partner not making the loan (i.e., the defaulting partner) and the partnership have their principal offices in California? What if the partner that is not making the loan is a California entity and the property is located in California?[44] Should lender licensing be treated any differently than usury?[45]

3.3.5 Loan to Partnership: Equitable Subordination and Recharacterization. If it is important that these loans are respected as debt (e.g., for tax reasons or priority), they should have a maturity date, expressly have priority over equity (including preferred contributions) and otherwise reflect the indicia of a true debt transaction. Ignoring tax concerns, the general priority of debt over equity may make loans a more attractive remedy than preferred contributions when both are available (recognizing that only one of these two remedies may be available in any particular deal due to the tax ramifications for REITs and tax-exempt investors and the possible prohibition against partnership debt in the partnership's mortgage loan documents). However, because of the relationship between the lender and debtor in such circumstances (i.e., because the funding partner is an "insider"), there may be a risk that such loans might be equitably subordinated to the partnership's obligations to third-party creditors, or recharacterized as equity.[46] But equitable subordination to the claims of other creditors generally requires inequitable conduct by the lender, and the recharacterization risk may be mitigated if the partnership agreement includes terms and provisions in respect of such loans that are reflective of a true debt transaction.[47] Moreover, in the authors' experience, the primary concern of the funding partner regarding priority is having priority over the defaulting partner (rather than over third-party creditors).

3.3.6 Loan to Partnership: Fiduciary Duties. Partners may owe fiduciary duties to each other and to their partnership. Query whether such duties may prohibit or impede enforcement of a partner's loan to the partnership?[48] The mere making of the loan and its enforcement would not appear, as a general rule, to result in a breach of fiduciary duty in light of the express statutory authorization allowing a partner to make loans to the partnership in many, if not most, limited partnership and LLC statutes.[49] Moreover, in some jurisdictions, such duties (but not the implied covenant of good faith and fair dealing) may be, and, in the authors' experience, typically are, limited or (at least under the Delaware statutes) waived altogether in the partnership agreement.[50]

Accordingly, absent inequitable conduct, if the partners have agreed to permit loans to the partnership in connection with contribution defaults by providing for such loans in the partnership agreement, and the partnership agreement includes typical limitations on or waivers of fiduciary duties in conformance with governing law, then it seems unlikely that making or enforcing a loan to the partnership in connection with a contribution default entails material risk of breach of fiduciary duty.

3.3.7 Loan to Partnership: Impact on Promote. Like preferred contributions, loans to the partnership may accelerate or defer the operator's promote relative to a loan to the operator

44 See Continuing Education of the Bar, *Counseling California Corporations* (3d ed., updated Apr. 2013) § 3A.22, at 474.24–.26 (discussing California's internal affairs doctrine for foreign corporations, which is codified in Cal. Corp. Code Section 2116, and possible exceptions to the doctrine, such as insider trading, which violates California's securities laws).

45 In California, Cal. Fin. Code § 22050(c) provides a licensing exemption for entities that make not more than one commercial loan per year. However, it is important to realize that a partner's failure to contribute may indicate an inability to make future contributions as well, and thus such exemption may be cold comfort if multiple default loans may be made.

46 See, e.g., 11 U.S.C. section 105(a) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."); 11 U.S.C. section 510(c) ("Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest"); In re Fitness Holdings Int'l, Inc., 714 F.3d 1141 (CA-9, 2013) (holding that a bankruptcy court has the authority to recharacterize a shareholder loan as equity, in connection with an allegation that the company's repayment of such loan was a fraudulent transfer).

47 See, e.g., In re Broadstripe, LLC, 444 Bkrptcy. Rptr. 51 (Bkrptcy. D. Del., 2010) (noting that "inequitable conduct" is a required element for equitable subordination under Fifth Circuit precedent, but that heightened scrutiny of insider con-

as defaulting partner (depending on whether the interest rate is lower or higher than the promote hurdle rate). See discussion of this issue for preferred contributions in Part 3.1.3 above.

3.4 Loan to Defaulting Partner

Many partnership agreements provide that the funding partner's advance of the Deficiency may be treated as a loan to the defaulting partner. Typically, the defaulting partner is then deemed to have used the loan to make its required contribution and all distributions to the defaulting partner are used to repay the loan (together with interest) before the defaulting partner is allowed to receive and retain any of its distributions.

3.4.1 Loan to Partner: Issues in Common with Loan to Partnership

Many of the issues with loans to the partnership also apply here. However, the loan itself will have a smaller principal balance and, consequently, the magnitude of the issues may diminish.[51] Additionally, the debt restrictions described in Part 3.3.3 above are generally not a concern in this context, and it seems unlikely that a loan to the defaulting partner might be equitably subordinated or recharacterized as equity. Moreover, the tax concerns of REIT partners (or investors) are different in this context because the REIT may not be able to rely on the fact that the partnership is being operated in a manner that satisfies the 75% (real estate income) test,[52] but may be able to mitigate its concerns by securing the loan with the defaulting partner's partnership interest.[53]

3.4.2 Loan to Partner: Bankruptcy

One of the primary reasons why loans to the defaulting partner are not addressed in the Sample Provisions is to avoid having a loan to a bankrupt partner. A partner may have some control over a bankruptcy filing by the partnership (to the extent the partnership agreement requires such partner to approve, or perhaps even initiate, any bankruptcy filing by the partnership), but it may not be possible to prevent the bankruptcy of the other partner

duct is appropriate because inequitable conduct seems more likely to occur when the lender is an insider); In re Lighthouse Lodge, LLC, 2010 Bankr. LEXIS 4574 (Bkrptcy. N.D. Cal., 12/14/2010) (declining to recharacterize a loan from an affiliate of a member to the related limited liability company, and citing In re Dornier Aviation (N. Am.), Inc., 453 F.3d 225 (CA-4, 2006) for a non-exhaustive list of considerations relevant to the determination of whether to recharacterize a debt as equity); Tucker, "Debt Recharacterization During an Economic Trough: Trashing Historical Tests to Avoid Discouraging Insider Lending," 71 Ohio St. L.J. 187 (2010); Robertson and Cicarella, "Developments in the World of Loan-to-Own," ABI Comm. News—Unsecured Trade Creditors Comm. (Aug. 2008); Kuhl and Wells, "Buddy, Can You Spare A Dime?," Inst. Real Est. Letter—N. Am. (October 2010).

48 See, e.g., Cal. Corp. Code §§ 15904.08, 17153, 17704.09(a); BT-I v. Equitable Life Assurance Soc'y of the United States, 75 Cal. App. 4th 1406 (1999); Kuhl and Wells, note 47, *supra*. But see, e.g., Cal. Corp. Code §§ 15903.05 and 17704.09(f).

49 See, e.g., 6 Del. C. §§ 17-107 and 18-107; Uniform Limited Partnership Act (2001) (ULPA) § 112; Uniform Limited Liability Company Act (2006) (ULLCA) § 409(f); see also Carey, *Partner Loans*, note 23, *supra* at 919–20; *cf.* BT-I, 75 Cal. App. 4th at 1410–15 (holding that the purchase and foreclosure of partnership debt was a breach of fiduciary duty, but distinguishable not only because the case involved now superseded California partnership statutes but because the loan in question was not contemplated by the partnership agreement). See also discussion of "enforceability" in Part 6 of this Article.

50 See, e.g., Cal. Corp. Code §§ 15903.05, 17005(d), and 17701.10(f); 6 Del. C. §§ 17-1101(d) and 18-1101(c).

51 For example, if interest is not currently deductible, then the lending partner may recognize more income with a loan to the partnership than a loan to the defaulting partner. See Carey, *Partner Loans*, note 23, *supra* at 921 n.16.

52 If the defaulting partner is an SPE treated as a partnership for federal income tax purposes, then it may satisfy the 75% test at the same time as the partnership, but the lending partner may not be able to ensure that the defaulting partner is and remains such an SPE.

53 Loans secured by interests in partnerships owning substantial real property may qualify as real estate assets. Rev. Proc. 2003-65, 2003-2 CB 336; Ltr. Rul. 200225034; Ltr. Rul. 200225033; Ltr. Rul. 200226013.

54 Several articles have discussed the limited effectiveness of bankruptcy remote provisions. See, e.g., Keith, "Bankruptcy Shelters," L.A. Law. (July/August 2013), at 25; Corbi, "How Remote Is 'Bankruptcy Remote' for Special Purpose Entities," Norton Bankr. Law Adviser (Nov. 2009), at 5, 8; Carey, *Partner Loans*, note 23, *supra*, at 918-19 n. 6.

55 See 11 U.S.C. sections 541(a)(1), (7) (property of the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case" as well as "[a]ny interest in property that the estate acquires after the commencement of the case").

(whether or not an SPE).[54] If the defaulting partner declares bankruptcy, then the proceeds of such loan might become part of the bankruptcy estate.[55] In addition, the defaulting partner (as debtor in possession) or the trustee, as applicable, may attempt to make a claim for recovery of (i.e., "avoid") either or both of (a) the deemed contribution to the partnership, if the requisite elements for a fraudulent transfer exist,[56] and (b) pre-petition payments to the funding partner in respect of the loan, if the requisite elements for a preferential transfer exist.[57] Moreover:

- If the funding partner is merely an unsecured creditor of the defaulting partner, then ultimately it may receive only cents on the dollar as repayment of its loan.[58]
- Even if (1) the partnership agreement purports to give the funding partner priority with respect to the defaulting partner's distribution rights (by providing, for example, that all amounts distributable to the defaulting partner shall instead be delivered by the partnership to the funding partner until its loan has been repaid[59]), or (2) the funding partner has a perfected security interest in such distribution rights for such purpose, the automatic stay may prohibit efforts to collect such payments to (or other enforcement of the loan by) the funding partner during the pendency of the bankruptcy proceeding,[60] and the bankruptcy trustee may claim such distributions as part of the bankruptcy estate.[61]
- Notwithstanding that the partners may have intended for the typical repayment provision to be the defaulting partner's absolute assignment of its distribution rights on its execution of the partnership agreement (albeit an assignment contingent on the funding partner making a loan, and limited to the amount necessary to repay the loan),[62] such arrangement may be interpreted as a mere agreement to pay over future distributions upon receipt,[63] or recharacterized as a disguised (and unperfected) security interest,[64] in which case the funding partner may ultimately end up in the same position as an unsecured creditor.

Thus, the defaulting partner's insolvency may result in a windfall to the bankruptcy estate at the expense of the funding partner with respect to pre-petition loans to the defaulting partner.[65] For some of the same reasons, if a loan to the defaulting partner is the only means of capitalizing the partnership in the event the defaulting partner is unwilling or unable to satisfy its contribution obligations, then such insolvency may force the funding partner to choose between walking away from its investment or advancing both its share of required capital and the Deficiency with substantial risk that it will not be able to recoup the Deficiency. However, these risks can be mitigated by providing for a loan to the partnership as an alternative remedy.

3.4.3 Loan to Partner: Competing Creditors

More generally, a loan to the defaulting partner creates a risk that the funding partner will be competing with the creditors of the defaulting partner when seeking repayment of its loan. What would happen, for example, if a creditor were able to attach (or obtain a charging order with respect to) the defaulting partner's distribution rights, or if the defaulting partner pledged its distribution rights to a creditor, in either case after entrance

56 See 11 U.S.C. section 548(a)(1)(B). In addition to the fraudulent transfer provisions of the Bankruptcy Code in section 548, the trustee or debtor in possession also succeeds to the state law actions that may be pursued by unsecured creditors for transfers that reach back longer than two years before the filing of bankruptcy. See 11 U.S.C. section 544(b). There may generally be little concern about a contribution being a fraudulent transfer (on the theory that the contribution is satisfaction of an antecedent debt in the form of a contribution obligation that arises on formation for which there is dollar-for-dollar equity credit). However, there might be a fraudulent transfer concern when contribution obligations arise at a time when the partnership's underlying investment is struggling and there is a question as to whether the deemed contribution is likely to be recouped from future distributions. For example, assume that a partner's obligation to contribute capital arises annually on unanimous approval of a new capital plan for the year. If the partnership is having financial difficulties, it is conceivable that the obligation to fund a particular capital plan arises at a time when the partnership is insolvent, so there may not be dollar-for-dollar credit (or otherwise reasonably equivalent value) for the contributions to be made under the capital plan. Similarly, in a preferred equity deal (where the return of the operator's contributions is subordinated to the return of the investor's contributions and a return on those contributions), there may not be dollar-for-dollar credit (or otherwise reasonably equivalent value) even when the partnership is solvent.

57 11 U.S.C. section 547(b).

58 In a Chapter 7 liquidation case, general unsecured creditors receive a pro rata distribution from available assets following the payment in full of priority and secured claims. See 11 U.S.C. section 726(a)(2). In a Chapter 11 reorganization case, general unsecured creditors are paid according to a plan approved by the bankruptcy court that is supposed to provide creditors with not less than such creditors would receive in a Chapter 7 liquidation. See 11 U.S.C. section 1129(a)(7).

59 In the authors' experience, the partnership agreement would typically provide that the partnership shall remit the defaulting partner's share of distributable cash directly to the funding partner as payment on the loan, but that such funds shall be deemed to have been distributed to the defaulting partner and then paid by it to the funding partner. The reason for this latter clause is to keep the capital accounts in sync: the defaulting partner is typically credited with the contribution it makes with the loan proceeds, and therefore it should be debited with the distribution used to repay the loan. Alternatively, a partnership agreement might be drafted to provide that the loan is to be repaid by way of a reallocation of distributable cash to the funding partner (with no loan or credit to the defaulting partner); however, query whether such alternative arrangement might be viewed the same as a nonrecourse loan to the defaulting partner payable out of distributions and maturing on liquidation (and might also have unintended and unfavorable tax consequences).

60 The automatic stay in bankruptcy prohibits efforts to commence or recover any claim against the debtor that arose prior to the commencement of the bankruptcy case. See 11 U.S.C. section 362(a)(1). The automatic stay also stays any act to obtain possession or exercise control over property of the estate. See 11 U.S.C. section 362(a)(3). However, Bankruptcy Rule 7001 specifically authorizes the filing of an adversary proceeding to "determine the validity, priority, or extent of a lien or other interest in property." See Fed. R. Bankr. P. 7001. In addition, a party in interest such as a partner of the debtor may petition the bankruptcy court to modify or terminate the automatic stay. See 11 U.S.C. section 362(d); see also, e.g., In re Catron, 158 Bkrptcy. Rptr. 629 (DC Va., 1993), *aff'd*, 43 F.3d 1465 (CA-4, 1994) (affirming ruling of bankruptcy court to modify stay in favor of non-debtor partners based on finding that debtor shifted his share of contribution onto his partners and improved his position at their expense).

61 See note 55, *supra*.

62 If the defaulting partner had made a present but contingent assignment upon execution of the partnership agreement, then presumably it would have ceased to hold (and thus its bankruptcy estate would not succeed to) a right to receive distributions from the partnership while the loan is outstanding.

63 The typical distributed-then-paid arrangement (see note 59, *supra*) requires that a distribution be deemed to have been made to the defaulting partner at the time of repayment of the loan, and thus seems incompatible with the notion that the defaulting partner has made a present but contingent assignment of all such distribution rights upon execution of the partnership agreement.

64 If the funding partner's priority access is recharacterized as a disguised security interest, it would be unperfected and may be voided by the bankruptcy trustee, resulting in unsecured creditor status for the funding partner. See 11 U.S.C. section 544(a)(1) ("The trustee may avoid any transfer of property by the debtor that is voidable by – (1) a creditor that extends credit to the debtor at the time of the

into a partnership agreement that provides for the above-described redirection of distributions to the funding partner, but prior to any loans having been made by the funding partner to the defaulting partner? Some partnership and limited liability company statutes suggest that such creditors' rights can be no greater than the defaulting partner's rights and are thus subject to the partnership agreement.[66] However, as discussed in Part 3.4.2 above, the analysis may depend on whether the funding partner's right of repayment (from the defaulting partner's distributions) is interpreted as a self-executing divestment of certain of the defaulting partner's distribution rights in the event of a contribution default, or instead as an executory agreement by the defaulting partner to assign such rights to the funding partner on the occurrence of a contribution default and advance of the Deficiency as a loan to the defaulting partner.[67] The prospect of a protracted proceeding (whether or not involving bankruptcy) with creditors of the defaulting partner may well be reason enough to make a loan to the partnership rather than a loan to the defaulting partner, if the former option is otherwise available.

commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien."); see also, e.g., Gross, Hahn, Wiles, and Chi To, *Collier Business Workout Guide* (Matthew Bender, 2012), ¶ 1.08[3][a], at 1-36 ("If a security interest is not properly perfected in accordance with Article 9 of the U.C.C. upon commencement of the case, the trustee may avoid the security interest.") (citations omitted); Rosenberg, Lurey, and Broude, *Collier Lending Institutions and the Bankruptcy Code* (Matthew Bender, 2012) ¶ 3.07[1][a], at 3-116 ("[T]he trustee automatically has the rights of a judicial lien creditor as of the date the petition is filed. The trustee, therefore, could avoid an unperfected or improperly perfected security interest in the debtor's property because, under the Uniform Commercial Code, an unperfected security interest is subordinate to the rights of a lien creditor.") (citations omitted).

65 Although not necessarily pertinent to a partner loan, the defaulting partner's bankruptcy may not be all gloom and doom for the funding partner. See, e.g., In re Catron, 158 Bankrptcy. Rptr. 639 (holding that the "ipso facto" protections of 11 U.S.C. section 365 were not applicable to the provisions in the partnership agreement, which permitted the non-debtor partners to buy out the debtor partner solely by reason of its bankruptcy); In re Lull, 2008 Bankr. LEXIS 4543 (Bkrptcy. DC Haw., 8/22/2008) (treating the disassociation of the debtor member on its bankruptcy (per the Hawaii Uniform Limited Liability Company Act) as a transfer of its membership interest to the other member, and thereby implicitly acknowledging that the "ipso facto" protections of 11 U.S.C. section 365 do not necessarily preclude transfer of the debtor's membership interest solely by reason of its bankruptcy); Harner, Black, and Goodman, "Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy," 13 Am. Bankr. Inst. L. Rev. L.J. 250 (2005). ("Some courts have concluded that an *ipso facto* provision in a partnership agreement is valid in bankruptcy (or is not invalidated by section 365(e)(1) of the Bankruptcy Code)."); id. at 188–89 ("Courts are now adopting a far more expansive approach to section 365(c)(1). Under this broader approach, a wide array of contracts have been excluded from a debtor's general assignment (and, as discussed below, assumption) authority, including partnership agreements and limited liability company agreements…. Indeed, numerous courts have determined that section 365(c)(1) prevents the assumption and performance of the contract by the debtor itself. Consequently, if a contract falls within the section 356(c)(1) exception, bankruptcy may end a debtor[esq]s rights under that contract….") (citations omitted). *Cf.* In re Smith, 185 Bkrptcy. Rptr. 285 (Bkrptcy. DC Ill., 1995) (determination of whether limited partnership agreement is executory requires analysis of whether limited partner is a passive investor or whether limited partner owes substantial future performance).

66 See, e.g., Cal. Corp. Code § 15907.03(a) ("[T]he court may charge the transferable interest of the judgment debtor. To the extent so charged, the judgment creditor has only the rights of a transferee."); Cal. Corp. Code § 17302(a) ("[A] court having jurisdiction may charge the assignable membership interest of the judgment debtor."); Cal. Corp. Code § 17705.03(a) ("A charging order requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor."); 6 Del. C. § 17-703(a) ("To the extent so charged, the judgment creditor has only the right to receive any distributions to which the judgment debtor would otherwise have been entitled in respect of such partnership interest."); 6 Del. C. § 18-703(a) (which tracks the Delaware partnership statute quoted above vis-à-vis limited liability companies). See also, e.g., Cal. Corp. Code § 15901.10(a) ("Except as otherwise provided in subdivision (b), the partnership agreement governs relations among the partners and between the partners and the partnership."); 6 Del. C. §§ 17005(a), 17701.10(a)(1).

67 Query whether an additional contribution default remedy worth considering is a loan of the Deficiency to the partnership, which in turn loans the Deficiency to the defaulting partner to make its contribution. With respect to California limited partnerships, such a structure might give the funding partner some comfort in light of the partnership's express statutory right to offset a partner's distributions by amounts that such partner owes to the partnership. Cal. Corp. Code § 15905.07 ("However, the limited partnership's obligation to make a distribution [to a partner or transferee] is subject to offset for any amount owed to the limited partnership by the partner or disassociated partner on whose account the distribution is made."). *Cf.* Cal. Corp. Code §§ 17250 and 17704.04(c) (which do not include the language quoted above from § 15905.07); 6 Del. C. §§ 17-606, 18-606 (which do not include the offset concept quoted above). This alternative remedy is not considered in this article because of the additional layer of complexity and because it merely shifts (rather than eliminates) many of the creditor/bankruptcy problems of the lender from the funding partner to the partnership.

3.4.4 Loan to Partner: Security Interest and Bankruptcy Remoteness

The bankruptcy and other creditor issues discussed above could be mitigated if there were a perfected security interest in the defaulting partner's right to receive distributions from the partnership.[68] However, it may be important that the security interest be granted at the outset to avoid future creditors having priority, and the other partner may want a reciprocal current security interest, which a partner may not want to give; moreover, the granting or enforcement of such a security interest might run afoul of transfer restrictions in mortgage loan, ground lease and other similar documents. The consequences of the defaulting partner's bankruptcy and potential battles with competing creditors could also be mitigated by a guarantee of the default loan by a creditworthy guarantor, or by adding SPE requirements and similar protections (perhaps even a springing guarantee), but these protections are not bulletproof and it may be difficult to get a partner to provide them without offering similar protections for one's own default loans.[69]

Part 4: Partnerships with More Than Two Partners

One might wonder whether the alternative remedy provisions discussed above for a two-partner partnership are easily adapted for a venture with more than two partners. Unfortunately, expanding the provisions to address more than two partners may be complicated unless all of the partners fit within two groups, each of which must act in concert. Generally, the complications revolve around harmonizing the elections of the funding (i.e., non-defaulting) partners. For example:

- *Only one of two funding partners wants a refund.* What happens if there are two funding partners, and one partner wants to withdraw its contribution and the other is willing to fund the entire Deficiency? Who should get its way? Should a partner be able to avoid its obligation to contribute cash needed by the partnership because another partner fails to fund its share? While the answer to this last question is commonly "yes" in a two-partner partnership, the interests of the partnership may dictate a negative response when there are one or more additional parties who are willing to fund the defaulting partner's share. Accordingly, many partnership agreements provide that the only time the contribution withdrawal remedy should be permitted is if no funding partner or partners are willing to fund the Deficiency.
- *Only one of two funding partners funds entire Deficiency.* What happens if there are two funding partners, neither wants to withdraw its contribution, and only one of them is willing to (and does) fund the entire Deficiency? If that partner elects to make a preferred contribution or loan to the venture, then regular contributions will be out of sync unless the other funding partner's regular contribution is also treated as a preferred contribution or loan to the venture. See Example 4.1 below.
- *Two funding partners jointly fund Deficiency.* What happens if there are two funding partners and they jointly fund the Deficiency, but one wants to make a preferred contribution or loan to the venture and the other funding partner wants to make a loan to the defaulting partner? See Example 4.2 below. What if the other funding partner wants to exercise a dilution remedy? See Example 4.3 below. What if one of the funding partners wants to make a loan to the defaulting partner and the other funding partner wants to exercise a dilution remedy? See Example 4.4 below.

Consider the following examples involving two funding partners who elect different remedies (where it is assumed, for simplicity, that D is a pro rata dilution remedy):

Remedies	Elected	Example
LP	RC	4.1
LP	LDP	4.2
LP	D	4.3
LDP	D	4.4

Legend:
"RC" = Regular Contribution
"LP" = Loan to Partnership
"LDP" = Loan to Defaulting Partner
"D" = Dilution

Observe that there is an additional remedy that the partners may consider when there are three or more partners (and one or more of the other funding partners are willing to fund the entire Deficiency): contributing one's regular contribution but not advancing any share of the Deficiency. Thus, RC is considered as an alternative in the chart above. However, to avoid further complexity, and to make the RC, LP, LDP and D elections independent, it is assumed that a partner electing the RC remedy is not entitled to make additional elections (e.g., to also trigger a dilution formula or treat its contribution as a loan to the partnership). Also, note that preferred contributions are not addressed because they are similar to loans to the partnership and if both a loan to the partnership and a preferred contribution were elected by two funding partners, one funding partner would simply have priority over the other. Thus, the chart above considers only four alternative remedies: RC, LP, LDP, and D.[70]

4.1 Two Funding Partners: Loan to Partnership; Regular Contribution

First, consider the case of two funding partners, neither of which withdraws its contribution, but only one of which funds the entire Deficiency and it elects to make a loan to the partnership.

68 See note 58, *supra*.

69 Admittedly, there may be circumstances in which a loan to the defaulting partner is preferable (e.g., when loans to the partnership are not permitted under the partnership's loan documents or preferred contributions create tax issues). However, if a loan to the defaulting partner is included as an alternative, then a number of *changes* to the sample provisions may be required. See also note 54, *supra'* for discussion of bankruptcy remote considerations.

70 Of the 16 possible pairings of these four alternatives, only four pairings are considered. Four of the 16 possible pairings involve two remedies that are the same, which is generally a good outcome that need not be discussed. Of the remaining 12, six are covered twice (once in each order), which leaves six pairings (ignoring the order within each pair): (LP, RC), (LP, LDP), (LP, D), (LDP, D), (LDP, RC), and (D, RC). The last two of these pairings are not considered for the following reasons: (LDP, RC) does not yield strange economic results (assuming all payments are made and, in particular, there are no creditor issues); and (D, RC) also does not yield strange economic results for many, if not most, dilution formulas (including a pro rata formula). However, if (contrary to the Sample Provisions) the dilution formula adds a hypothetical amount of capital to both (x) the capital contributions of the funding partner who funds the Deficiency and (y) the total capital contributions of the venture, then (D, RC) may yield inappropriate results: the funding partner who does not advance any portion of the Deficiency may be diluted. See discussion of "increased total" formulas in Carey, *Squeeze-down Formulas*, note 24, *supra* at 50.

Example 4.1. Assume the following facts:

1. There is a partnership between three equal partners (1/3 each).
2. The partnership agreement provides that (a) all contributions and distributions are made in accordance with partnership percentages, and (b) if a partner fails to advance its share of a required capital call and the other two partners timely advance their shares, and one or both of the contributing partners advance the Deficiency, then each funding partner who funds all or a portion of the Deficiency may elect (i) to treat the entire amount it advances as a loan to the partnership, (ii) to treat the portion of the Deficiency it advances as a loan to the defaulting partner, which is deemed to have been contributed by the defaulting partner (and the balance of its advance as a contribution), or (iii) to treat the entire advance as a contribution and adjust the partnership percentages to equal each partner's actual proportion of total contributions to date (i.e., a pro rata dilution remedy).
3. The initial contributions are $100X each for a total of $300X.
4. There is an additional $60X capital contribution, only two of the partners contribute their share, and then only one of the two contributes the $20X Deficiency.

If the contributing partner who funds the Deficiency makes a loan to the partnership, then that loan would be for $40X (the entire amount advanced by the partner in connection with the second capital call). But then the total contributions of the partners would be out of sync with the partnership percentages:

Defaulting Partner	Funding Partner (RC)	Funding Partner (LP)
$100X	$120X	$100X

In this example, it would no longer be fair to make distributions 1/3 each because the contributing partner who did not contribute any portion of the Deficiency but made its regular contribution would be shortchanged. This inequitable result could be addressed by adjusting the distribution percentages (using pro rata dilution), but that may not be desirable as discussed in Part 3.2 above. If both funding partners were instead deemed to have made a default loan to the partnership (in the respective amounts of $20X and $40X), then the contributions of the partners would be $100X, $100X, and $100X.

Difference Between Loan to Defaulting Partner and Loan to Partnership

As noted in the body of this article, there are two common types of potential contribution default *loan* remedies: one involves a loan *to the partnership* and the other involves a loan *to the defaulting partner.* What is the difference? (This question is explored in more detail in another article, Carey, *Partner Loans*, Note 23, *supra*). Some distinctions worth noting are:

- *Competing Creditors.* No lender wants a bankrupt borrower and it is easier to prevent the partnership (as opposed to a partner) from filing for bankruptcy protection. More generally, a default loan to the partnership rather than to the defaulting partner may be preferable to avoid competing with the defaulting partner's other creditors. In either case, the partner making the default loan may be subordinate to the creditors of the partnership to the extent it is looking to project funds to repay the default loan. But with a loan to the partnership, the non-defaulting partner can deal only with the partnership for repayment and stay ahead of the claims of the defaulting partner's creditors. While a partner could request a security interest to establish priority over other creditors as to the defaulting partner's distributions, the other partner may insist on a reciprocal security agreement, and this may interfere with plans to pledge partnership interests to a lender; moreover, a security interest will require some extra work to perfect (e.g., filing UCC financing statements), may require some monitoring (e.g., to file UCC continuation statements before the original financing statements lapse), and may require the consent of lenders, ground lessors, or others if the granting or enforcement of the security interest conflicts with internal transfer restrictions imposed on the partnership.
- *Mortgage Loan Restrictions.* A default loan to the partnership might run afoul of the debt limitations in the SPE requirements or other provisions of the partnership's mortgage loan documents, unless there is an appropriate carve-out for such loans. Similarly, if a default loan to the defaulting partner is secured by the defaulting partner's interest, then unless there is an applicable exception, there may be a violation of the transfer and encumbrance restrictions in the mortgage loan documents at the time the security interest is granted, when it is foreclosed, or both.
- *Economics.* A default loan to the defaulting partner should cover only the Deficiency (with each partner deemed to have made its regular contribution), while a default loan to the partnership should be in the aggregate amount of the Deficiency and the funding partner's regular contribution (with neither partner deemed to have made its regular contribution). Otherwise, the partners' regular contributions will be out of sync. In a straight-up deal, assuming the default loan is timely repaid from distributions (and there are no creditor issues), there is not much economic difference between the two approaches, except that in one case, the repayment distributions come directly from the partnership, and in the other case, the repayment distributions are first distributed to the defaulting partner and then paid over to the funding partner. However, if there is a promote, then a loan to the partnership could defer or accelerate the promote depending on whether the default loan rate is more or less than the relevant hurdle rate.
- *Prepayment.* It is easier to provide for a default loan to the defaulting partner to be prepayable by the defaulting partner (so it can stop the high interest charges). Such a prepayment right is also possible for a default loan to the partnership but it involves more language because the defaulting partner should pay only its share.

4.2 Two Funding Partners: Loan to Partnership; Loan to Partner

Next, consider the case of two funding partners who each fund their share of the Deficiency, but one of them elects to make a loan to the partnership (of the entire amount it funds) and the other elects to make a loan to the defaulting partner of its share of the Deficiency.

Example 4.2. Assume the same facts as in Example 4.1, except that the two funding partners each advance $10X of the Deficiency, one elects to make a loan to the partnership, and the other elects to make a loan to the defaulting partner. The funding partner that makes a loan to the partnership would have a loan of $30X (the entire amount advanced by the partner in connection with the second capital call) and total contributions of $100X; the funding partner that makes a loan to the defaulting partner would have a loan in the amount of $10X and total contributions of $120X; and the defaulting partner would have total contributions of $110X. Thus, the total contributions of the partners would be as follows:

Defaulting Partner	Funding Partner (LDP)	Funding Partner (LP)
$110X	$120X	$100X

In this example, it would no longer be fair to make distributions 1/3 each. This inequitable result could be addressed by adjusting the distribution percentages, but that may not *(Continued on page 43)*

Capital Contribution Default

(Continued from page 23) be desirable as discussed in Part 3.2 above. And even though the partner making a loan to the defaulting partner may get a larger percentage interest, there may not be sufficient distributions to catch up with the partner making a loan to the partnership (in light of the subordination of all distributions to the repayment of the loan to the partnership). Moreover, the partner making a loan to the partnership could conceivably end up with less than the defaulting partner if the partnership is sufficiently profitable (because the defaulting partner's partnership percentage would be greater)! If both funding partners make loans to the partnership, then the contributions would be $100X, $100X, and $100X; and if both funding partners make loans to the defaulting partner, then the contributions would be $120X, $120X, and $120X.

4.3 Two Funding Partners: Loan to Partnership; Dilution

Next, consider the case of two funding partners who each fund their share of the Deficiency, but one of them (the lending partner) elects to make a loan to the partnership (of the entire amount it funds) and the other elects to trigger a dilution remedy.

Example 4.3A. Assume the same facts as in Example 4.2, except that one funding partner elects to make a loan to the partnership and the other elects a pro rata dilution adjustment. The defaulting partner would have total contributions of $100X; the funding partner that elects dilution would have total contributions of $130X; and the funding partner that makes a loan to the partnership (the lending partner) would have a loan in the amount of $30X (the entire amount advanced by the partner in connection with the second capital call) and total contributions of $100X. After the pro rata dilution, the partnership percentages would be as follows:

Defaulting Partner	Funding Partner (D)	Funding Partner (LP)
100/330	130/330	100/330
30.0303%	39.3939%	30.0303%

Although the lending partner in the above example may get a high rate of return and priority for the default loan, it would also get diluted. Dilution of the lending partner could be avoided if $15X of its advance were instead treated as a contribution:

Example 4.3B. Assume the same facts as Example 4.3A, except that the partnership agreement allows the partner who does not elect to trigger a pro rata dilution remedy (i.e., the lending partner) to elect a hybrid remedy under which $15X of its $30X advance could be treated as a contribution, so that its loan to the partnership would be only $15X. This hybrid remedy allows the lending partner to retain its 1/3 interest under the pro rata dilution elected by the other funding partner (so that the dilution remedy dilutes only the defaulting partner):

Defaulting Partner	Funding Partner (D)	Funding Partner (Hybrid)
100/345	130/345	115/345
28.9855%	37.6812%	33.3333%

4.4 Two Funding Partners: Loan to Defaulting Partner; Dilution

Finally, consider the case of two funding partners who each fund their share of the Deficiency, but one of them elects to make a loan to the defaulting partner of its $10X share of the Deficiency and the other elects to trigger a pro rata dilution remedy.

Example 4.4. Assume the same facts as in Example 4.3A, except that the disparate remedies of the funding partners are a loan to the defaulting partner and dilution. Based on these assumptions, $20X of the lending partner's $30X advance would be treated as a contribution and the remaining $10X as a loan to the defaulting partner (which would be deemed used by the defaulting partner to make a contribution). In that event, the lending partner would retain its 1/3 interest under the pro rata dilution formula:

Defaulting Partner	Funding Partner (D)	Funding Partner (LDP)
110/360	130/360	120/360
30.5555%	36.1111%	33.3333%

Under these facts, the lending partner would have a priority loan to the defaulting partner but it would be repayable from a smaller share of distributions because a portion of the defaulting partner's interest would have been given to the other funding partner under the dilution formula.

4.5 Two Funding Partners: Comparing Disparate Remedies

As illustrated by Examples 4.3B and 4.4, it may be possible to (and some partnership agreements do) combine a dilution remedy with one or more other contribution default remedies and avoid diluting the non-defaulting partners. How do the results in these two Examples compare? The $10X loan to the defaulting partner in Example 4.4 would take longer to be repaid than the $15X loan to the venture in Example 4.3B (assuming the loans are payable out of only distributions or amounts that would otherwise have been distributed but for the loan):

- $32.73X of distributions would be necessary to repay the $10X loan to the defaulting partner under Example 4.4 (30.5555% x $32.73X = $10X).
- Whereas only $15X of what would otherwise be distributions (in the absence of any loans) would be necessary to repay the $15X loan to the venture under Example 4.3B (with $5X effectively paid by the lending partner to itself but the remaining $10X effectively paid by both the defaulting partner *and the other funding partner*).

In Example 4.3B, the other funding partner is subordinated to the loan to the partnership but it gets a larger percentage interest, and the defaulting partner ends up with a smaller percentage interest but also a smaller payment obligation (i.e., basically $5X of the principal amount of the loan to the venture as compared to the $10X loan it would repay alone under the second alternative). Thus, while there are trade-offs for the other funding partner and the defaulting partner under the two alternatives in Examples 4.3B and 4.4, the lending partner appears better off with Example 4.3B (with the same 1/3 percentage interest but quicker repayment of its loan).

4.6 Two Funding Partners: Conclusion

As the examples above illustrate, the partners should consider in advance the manner in which inconsistent elections are to be harmonized or modified. Sometimes it is possible to harmonize inconsistent remedies, such as a loan to the defaulting partner and dilution, but even then there may be problems (e.g., depending on the type of dilution, it is possible for a funding partner who does not advance any portion of the Deficiency to be diluted) and surprises (e.g., a partner who makes a loan to a defaulting partner will have a dwindling source of repayment if the defaulting partner is diluted). The more alternatives and partners there are, the more complicated this process can get. As a general rule, it is preferable for non-defaulting partners to exercise consistent contribution default remedies.

Part 5: Other Remedies of the Funding Partner

Although there is no uniform approach, many partnership agreements (and the Sample Provisions) provide that the alternative remedies discussed above are not the exclusive remedies for a contribution default. If the alternative remedies were exclusive, then the partnership and the funding partners might not be made whole. For example, if a partnership payment must be made by a certain time to avoid a fine or penalty and the funding of the Deficiency occurs after the fine or penalty is imposed, then the funding partner may not want to excuse the defaulting partner for any liability it may have for causing this additional cost. Similarly, an investor may not want an exclusive remedy provision to limit a right to remove the operator as general partner of the partnership if the operator is in default by reason of the operator's failure to fund its share of capital. Some partnership agreements may provide additional contractual remedies, including a right to:

- Buy the defaulting partner's interest at a discount.
- Obtain specific performance of the contribution obligation.
- Obtain damages (which may be liquidated) in respect of the default.
- Cause a dissolution of the partnership.
- Cause a change in management and voting rights.[71]

Some of these additional remedies may be conditioned on a partner's percentage interest dropping below a specified level.

Part 6: Enforceability

Some partnership and LLC statutes provide that contractual remedies for failure to contribute are generally enforceable, and specifically contemplate some of the remedies discussed in this article. For example, in the event a partner fails to make a required contribution, the Delaware limited partnership and LLC statutes, the California limited partnership statute and, until 1/1/2014, the California LLC statute each expressly permit the reduction of the defaulting partner's interest in the partnership, as well as loans by the other partners to cover the Deficiency.[72]

The California limited partnership statute (and, until 1/1/2014, the California LLC statute), however, may invite challenges to these aspects of partnership agreements, because it provides that each such remedy under a partnership agreement "shall be enforceable in accordance with its terms unless the partner seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the agreement was made."[73] There is no similar hedge with respect to enforceability under the Delaware limited partnership and LLC statutes, and interestingly, from and after 1/1/2014 (when the new California LLC statute comes into effect), the California LLC statute will be silent both as to permitted remedies for failure to contribute and the standard by which such remedies should be evaluated.[74]

Accordingly, there seems to be greater certainty under the Delaware statutes (relative to the California statutes) that each contribution default remedy in a partnership agreement will be respected and enforceable as written. But even if Delaware entities are used, query how a dilution remedy would be treated in bankruptcy?[75] One must always keep in mind the equitable defenses available to debtors in bankruptcy and thus the possibility that certain remedies may not be enforceable against an insolvent debtor.[76]

Part 7: Remedies of Third-Party Creditors

Although not covered by the Sample Provisions (which are intended to address only remedies of the partners), most partnership agreements include no-third-party-beneficiary provisions

[71] The Delaware limited partnership and LLC statutes (i.e., 6 Del. C. §§ 17-502(c), 18-502(c)) specifically contemplate other remedies, including "subordinating the member's limited liability company interest to that of non-defaulting members, a forced sale of that limited liability company interest, forfeiture of the defaulting member's limited liability company interest, and redemption." However, such remedies are not common in the authors' experience.

[72] See Cal. Corp. Code §§ 15905.02(d) and 17201(a)(3); 6 Del. C. §§ 17-502(c) and 18-502(c). *Cf.* Cal. Corp. Code § 17704.03.

[73] Cal. Corp. Code § 15905.02(d). See also Cal. Corp. Code § 17201(a)(3).

[74] See 6 Del. C. §§ 17-502(c) and 18-502(c); Cal. Corp. Code § 17704.03.

[75] See, e.g., *In re* Lull, note 65, *supra* (treating the disassociation of the debtor member as a transfer of its membership interest to another member, and concluding that such transfer was a preference to such other member relative to what it would have received as an unsecured creditor).

[76] See also Part 7.3 of this article, *infra*; Carey, *Squeeze-down Formulas*, note 24, *supra*, at 58–63 (discussing generally applicable enforceability concerns in connection with dilution remedies).

[77] Cal. Corp. Code § 15905.02(c).

[78] Cal. Corp. Code § 17201(b)(2). This statute is especially challenging to interpret, particularly the first sentence quoted here. In particular, it may not be clear whether the two conditions are alternative or conjunctive requirements. In other words, it may not be clear whether the conclusion, that a person whose claim against an LLC arises before the receipt of notice of the compromise may enforce the original obligation (call this conclusion C), can be reached if "the person had knowledge of the original obligation prior to the time the claim arose" (call this condition A) *or* "the compromise occurred after the time the claim arose" (call this condition B), or rather only if "the person had knowledge of the original obligation prior to the time the claim arose" *and* "the compromise occurred after the time the claim arose." While the inclusion of "and" in the statute between such conditions might seem to indicate that both must be satisfied, the repetition of "if" before the second condition suggests that the second condition is an independent clause and thus an alternative means of reaching the conclusion. In symbols, the first sentence of Section 17201(b)(2) reads as follows: C if A and if B. This does not appear to be equivalent to C if A and B. But it does appear to be equivalent to C if A and C if B, which is equivalent to C if A or B. Thus,

and thus implicitly or expressly provide that third parties do not have the right to enforce the contribution obligations of the partners. Are such provisions effective? Does it depend on whether the partnership or the partners have given certain assurances to the third parties involved and whether the third parties have reasonably relied on those assurances, or whether certain conditions have been satisfied?

7.1 Remedies of Third-Party Creditors: California

In California, this issue is confused by the use of different statutory standards for limited partnerships and limited liability companies:

- "A creditor of a limited partnership which extends credit or otherwise acts in reliance on [a contribution obligation], without notice of any compromise [by consent of all partners], may enforce the original obligation."[77]
- Whereas until 1/1/2014, "a person whose claim against a limited liability company arises before the receipt of notice of the compromise [of a contribution obligation with the unanimous vote of the members] may enforce the original obligation of a member to make a contribution to the limited liability company if the person had knowledge of the original obligation prior to the time the claim arose and if the compromise occurred after the time the claim arose,"[78] but "[a]ny other person with a claim against a limited liability company may enforce only the existing obligation of a member to make a contribution to the limited liability company,"[79] and "[a] person with a claim against a limited liability company may not enforce a conditional obligation of a member unless the conditions have been satisfied or waived."[80]
- And from and after 1/1/2014, "[a] creditor of a limited liability company that extends credit or otherwise acts in reliance on [a contribution obligation] may enforce the obligation,"[81] and "[a] conditional obligation of a member to make a contribution to a limited liability company shall not be enforced unless the conditions of the obligation have been satisfied or waived."[82]

Accordingly, it seems that reliance is a required element for a claim to enforce a partner's obligation to contribute to a California limited partnership, but until 1/1/2014, (1) if an original contribution obligation of a member of a California LLC has not been compromised as of the time the claim arises, then neither knowledge of nor reliance on the original contribution obligation appears to be required for enforcement,[83] and (2) if an original obligation of a member of a California LLC has been compromised as of the time the claim arises, then in order to enforce the original obligation, the statute appears to require that the "claim arises before receipt of notice of the compromise" and that the creditor "had knowledge of the original obligation prior to the time the claim arose"[84] (but if either of these two requirements is not met, then the creditor presumably may enforce the modified obligation, whether or not there is otherwise knowledge or reliance).[85]

Fortunately, from and after 1/1/2014, this discrepancy and confusion should be eliminated as reliance will be required for any such claim to enforce the obligation to contribute to a California limited partnership or LLC. However, and oddly, while both the pre- and post-January 1, 2014 California LLC statutes make clear that conditional (e.g., discretionary) contribution obligations may not be enforced by third parties, the California limited partnership statute is silent on this issue. Thus, query whether a creditor who relied on a conditional contribution obligation with respect to a California limited partnership might be able to enforce such obligation (even if the conditions have not been satisfied and the creditor's reliance was thus seemingly unreasonable)?

7.2 Remedies of Third-Party Creditors: Delaware

By contrast, in Delaware, the limited partnership and LLC statutes are con-

based on the logical construction of the sentence, it is the authors' belief that such conditions are intended to be alternatives. Substantive logic also supports this interpretation because the second condition (that the compromise occurred after the claim arose) seems to make the assumption (that the claim arose before notice of the compromise) superfluous.

79 Cal. Corp. Code § 17201(b)(2).

80 Cal. Corp. Code § 17201(c).

81 Cal. Corp. Code § 17704.03(c).

82 Cal. Corp. Code § 17704.03(b).

83 To see how this conclusion is reached, consider two cases: (1) if there is a compromise; and (2) if there is no compromise. *First*, assume there is a compromise. If (as indicated) the original obligation has not been compromised as of the time the claim arises, but is compromised later, then the "claim arises before the receipt of notice of the compromise" (assuming a creditor cannot receive notice of the compromise before it occurs) and "the compromise occurred after the time the claim arose" (as indicated). Thus, if there is a compromise, then this conclusion follows from the first sentence of Cal. Corp. Code § 17201(b)(2). *Second*, assume there is no compromise. If there is no compromise, then this conclusion follows from the second sentence of Cal. Corp. Code § 17201(b)(2) based on the assumption that "any other person" includes (x) any creditor whose claim does not arise before receipt of notice of the compromise, if there is a compromise, and (y) any creditor if there is no compromise. See, e.g., *Forming and Operating California Limited Liability Companies, 2d ed.* (CEB, updated 3/2013) § 6.31, at 218 ("Any person with a claim against an LLC may enforce an existing obligation of a member to make a contribution to the LLC.") [hereinafter CEB, Forming CA LLCs].

84 This conclusion follows from the first sentence of Cal. Corp. Code § 17201(b)(2). Knowledge of the original contribution obligation before the claim arises appears to be an express requirement of the statute in order to enforce an obligation that has been compromised as of the time the claim arises. However, such knowledge is not mentioned (but appears to be assumed) in a number of treatise summaries of this topic. See, e.g., Niesar, Berk, and Fleishhacker, *California Limited Liability Company Forms and Practice Manual, rev. ed.* (Data Trace, 2012) § 5.4.1, at 5-10 ("[I]f a claim arises against an LLC before the party making the claim receives notice of the compromise, the party can enforce the obligation of the Member to make the Contribution.") (citation omitted); 5 *Ballantine & Sterling California Corporation Laws, 4th ed.* (Matthew Bender, 2013) § 904.07[1], at 27-49 ("[A] person whose claim against an LLC arose before receipt of notice of such a compromise may enforce the original obligation to make the contribution but any other person with a claim may enforce only the existing obligation to make a contribution after giving effect to the compromise."); CEB, Forming CA LLCs, note 83, *supra*, § 16.37, at 732 ("An individual who has a claim against an LLC may enforce contribution obligations of LLC members that have not been fulfilled, provided the contribution obligation was not compromised before the date on which the claim arose.") (citation omitted).

85 This last conclusion arguably follows from the second sentence of Cal. Corp. Code § 17201(b)(2). However, if the creditor's claim arose before it had notice of the compromise but it failed to meet the knowledge requirement of the first sentence of Cal. Corp. Code § 17201(b)(2), then it is not entirely clear from the language of the statute that such creditor is included in the category of "any other person" in the second sentence of Cal. Corp. Code § 17201(b)(2). But exclusion of such a creditor would seem to be an odd result.

sistent and clear: "a creditor who extends credit may enforce the original [contribution] obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation," and "[a] conditional obligation to make a contribution may not be enforced unless the conditions of the obligation have been satisfied or waived."[86] In addition, at least one Delaware judge has noted (in dicta) that the above-described creditors' rights are not a backdoor to additional personal liability for the owners of limited liability entities and seem likely to be narrowly construed.[87]

7.3 Remedies of Third-Party Creditors: Equitable Considerations

Notwithstanding the detailed provisions of the above-referenced statutes, this puzzle cannot be completed without consideration of public policy. Indeed, the California statutes expressly state that the equitable remedies of third-party creditors (including claims of fraudulent transfer) are paramount,[88] and several statutes are generally subject to the laws of equity except as otherwise specifically stated.[89] Accordingly, it is important to keep in mind the governing statute, the terms of the partnership agreement, and the context in which its enforcement is sought.

Besides using Delaware rather than California limited liability entities, it seems that a partner can best protect itself against creditors' attempts to enforce contribution obligations by not informing third parties of its mandatory contribution obligations and attempting to avoid or minimize exposure to mandatory contribution obligations, so that there can be no reasonable reliance on the same. In addition, the Sample Provisions attempt to protect each partner from being required to make contributions when the other partners have refused (or are unable) to do so, by conditioning each partner's contribution obligation on each other partner timely contributing its share of the applicable capital call. However, due consideration should be given to the possibility of equitable intervention in favor of third-party creditors.

Conclusion

Contribution default provisions are routinely included in real estate venture agreements, but there is no one set of provisions that is likely to work for every deal. Before using any particular form or sample, a number of factors should be considered so that the document may be adapted to meet the needs of the parties. These factors include:

- *Number of Partners.* How many partners are there? The number of partners may have a significant impact on the form of the contribution default provisions. Considering all of the permutations may be challenging (multiple defaulting partners or multiple funding partners or both, and potentially different elections by multiple contributing partners or the same contributing partner with respect to different defaulting partners), especially if there are too many alternative remedies. The Sample Provisions assume there are only two partners.
- *Tax Considerations.* Do tax considerations make certain remedies undesirable (e.g., the 10% asset test for REITs or the fractions rule for tax-exempt qualified organizations)? The Sample Provisions include alternatives, but one or more of these alternatives may need to be eliminated if a partnership has direct or indirect partners with special tax requirements (or status).
- *Contractual Limitations.* Do restrictions in any partnership contracts prohibit or limit any contribution default remedies (e.g., mortgage loan restrictions that prohibit default loans to the partnership, or assignment restrictions that prohibit a dilution adjustment or the granting or enforcement of a security interest in a partnership interest to secure a default loan)?
- *Failure to Elect.* What happens if the contributing partner fails to elect an alternative remedy? Some partners may favor a refund under such circumstances but sometimes the partners may favor keeping the money in the partnership. (The Sample Provisions mandate a refund if the Deficiency is not advanced by the funding partner.) If there is no refund, then the provisions must determine how the contributing partner's advance should be treated (e.g., the Sample Provisions provide for treatment as a special preferred contribution unless the funding partner elects an alternative remedy).
- *Partial Advances.* Should partial contributions and partial advances of the Deficiency be allowed? The Sample Provisions do not do so because of the complications involved (including providing appropriate credit for partial contributions and allocating the actual funds advanced when there is a shortfall). On occasion, however, the partners may nonetheless want to spend the time and money to allow for this flexibility (e.g., if the partners have limited capital yet want to maximize the partnership's equity capital, in which event they may also favor keeping the money in the deal rather than permitting a refund).

In the press of time, one may not have the luxury to address all of the concerns of the partners, so some practicality is warranted. Armed with good samples and a good understanding of the issues, one has a better chance of reaching a mutually satisfactory result that is likely to work during the life of the partnership. ■

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86 6 Del. C. §§ 17-502(b) and 18-502(b).

87 See CML V, LLC v. Bax, 6 A.3d 238 (Del. Ch. 2010) ("Today, the trust fund doctrine has been largely discredited and abandoned, but its spirit lives on in the post-insolvency corporate creditor derivative action. Through Section 18-502, the LLC Act states any equitable desire to enable LLC creditors to enforce subscription agreements. By addressing the germ from which the analogous corporate creditor derivative action grew, the LLC Act removes the impetus for a similar experiment with LLCs.") (citations omitted).

88 See Cal. Corp. Code §§ 15905.02(d)(7), 17201(d), and 17704.03(d), each of which states: "Nothing in this section shall be construed to affect the rights of third-party creditors to seek equitable remedies nor any rights existing under the Uniform Fraudulent Transfer Act."

89 See, e.g., Cal. Corp. Code §§ 15901.07(a) and 17701.07(b) (and note that there is no equivalent provision in the pre-2014 California LLC act), each of which states: "Unless displaced by particular provisions of this [Act], the principles of law and equity supplement this [Act]."; 6 Del. C. §§ 17-1105 and 18-1104, each of which states: "In any case not provided for [in this Act], the rules of law and equity shall govern."