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Addressing Shortfalls Created By Capital Contribution Defaults



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One of the fundamental issues addressed in real estate joint venture agreements is the co-venturers' respective obligation to contribute money to the venture. Given that capital contribution obligations of the co-venturers are not always recourse obligations (and that the co-venturers are often single-purpose entities with no assets apart from their interests in the joint venture), joint venture agreements must establish effective mechanisms for dealing with funding defaults that do not rely on a lawsuit by the venture or the non-defaulting venturer against the defaulting venturer—a remedy that in any event would not result in an expeditious satisfaction of the venture's cash needs. This article examines the remedies customarily available to non-breaching venturers in the event of a funding default, and briefly discusses certain issues to consider when determining which of these remedies are appropriate in any particular circumstance.

Legal Framework

Since many (likely most) joint ventures formed today to own real estate in New York are either New York or Delaware limited liability companies or limited partnerships, a quick word on permissible remedies under the laws governing those forms of entity is appropriate. Both Delaware's and New York's limited liability company and limited partnership statutes afford co-venturers significant flexibility in dealing with capital contribution defaults. In nearly identical language, each of these statutes expressly states that the applicable operating or partnership agreement may provide for specified penalties if a member or partner fails to make a required capital contribution, which may take the form of the remedies described below or other penalties or consequences.¹ The Delaware acts go even further in acknowledging, outside

of the limited context of capital commitments, that an operating or limited partnership agreement may contain such default remedies as the members or partners desire² and that the policy of such acts is to give "maximum flexibility to the principle of freedom of contract."³

Common Remedies

When a joint venturer fails to satisfy its capital commitment, the venture's cash needs must be satisfied from another source, and the non-defaulting venturer is generally the party that can provide the necessary funds most readily. Non-defaulting venturers often have the right to remedy the deficit created by a capital contribution default in one of three ways:⁴

- By making a capital contribution to the venture,
- By making a loan to the venture (or in a variation, an advance of preferred equity with distribution priority and a preferred return), or
- By making a loan to the defaulting venturer, which is usually funded directly to the venture and deemed contributed by the defaulting venturer to the joint venture in satisfaction of the capital call.

If a non-defaulting venturer cures a shortfall with a capital contribution to the venture, its ownership interest in the venture will increase while concurrently diluting, or "squeezing-down," the defaulting venturer's ownership stake in the joint venture. Often, this dilution will be done on a punitive basis, such that the defaulting venturer will lose more than its proportionate share of its interest in the venture.

For example, assume that two venturers enter into a 50/50 joint venture, each venturer has previously contributed \$50,000, the venture has a \$10,000 cash need and one of the venturers defaults in its obligation to contribute \$5,000 to the venture. If the non-defaulting venturer contributes its share as well as the share of the defaulting venturer (on a non-punitive basis), then the percentage interests of the venturers will be adjusted to be in a 60/50 ratio, or 54.5 percent and 45.5 percent.

If the joint venture agreement provides for a punitive squeeze-down (for example, 150 percent), then the \$10,000 contributed would be deemed to be a capital contribution of \$15,000, and the percentage interests would be recalculated to be in a 65/50 ratio, or 56.5 percent and 43.5 percent.⁵

If a non-defaulting venturer prefers to make a loan to the venture or to the defaulting venturer, interest on the loaned funds will accrue at a negotiated rate that is generally punitive in order to deter defaults. In addition, a loan to the defaulting venturer may be secured by a pledge of that venturer's equity interest in the joint venture.

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The extent of the availability of remedies will vary from agreement to agreement. The non-defaulting venturer may be permitted to exercise more than one of these remedies simultaneously (i.e., fund a portion as a loan and a portion as a capital contribution). In some cases the venturer may have the right to switch from one remedy to another—for example, some joint venture agreements provide that a loan which is not repaid within a specified period of time after notice can be converted, at the option of the lender member, into an equity contribution.

If there is more than one non-defaulting venturer, the joint venture agreement often provides that the non-defaulting venturers have the right to make any contributions or loans on a proportionate basis, based upon their relative interests in the joint venture.

Capital Contribution vs. Loan

In considering which remedy to exercise in response to a funding default, the non-defaulting venturer should consider the fundamental differences between debt and equity.⁶ Specifically, equity involves more risk but creates the potential for participation in the upside of the business. Debt involves less risk, since it is afforded a higher

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priority claim than equity (in that principal and interest on any loans to the venture will be distributed to any venturers who make such loans prior to any distributions to equity) but will pay only the stated interest without giving the lending venturer a share of any appreciation in the venture's assets.

Accordingly, a non-defaulting venturer who is optimistic about the venture's prospects may be more likely to fund a capital deficit with equity, whereas a venturer with a more conservative or pessimistic view may prefer the priority afforded by a loan. In this regard, it is important to highlight that loans to the defaulting venturer, unlike loans to the venture, are not liabilities of the joint venture but rather obligations of the defaulting venturer, do not have repayment priority over other capital contributions and are only repaid from equity distributions from the joint venture otherwise payable to the defaulting venturer. Note also that in a venture where one venturer receives a "promote," a loan to the venture will subordinate the promote in the waterfall, whereas a loan to the venturer will have no effect on the promote.

Assuming that a non-defaulting venturer has determined that it wants to fund the shortfall as debt, the number of investors in the joint venture may dictate the type of loan utilized. In the case of a joint venture with three or more investors, permitting a non-defaulting venturer to make a high-interest loan to the venture is prejudicial to the other non-defaulting venturers because it subordinates their rights to distributions to repayment of the loan.

Although all of the non-defaulting venturers may be given the opportunity to participate in the loan, not all of those venturers may have the wherewithal or the inclination to participate. Therefore, only loans to the defaulting venturer, which exclusively affect distributions to that venturer, should be permitted. Such a concern is not present when dealing with a two-party joint venture, and thus either variety of loan is appropriate in that context.

If the non-defaulting venturer elects to make a loan to the joint venture (as opposed to the other venturer), one question is whether the loan should fund only the defaulting venturer's share of the capital call or whether all amounts advanced by the non-defaulting venture in response to the capital call—including its own share (even if already advanced as a capital contribution)—should be included in the loan. If a non-defaulting venturer wishes to make a loan to the joint venture, then it stands to reason that funds advanced by the non-defaulting venturer in respect of its share of the subject capital call should also be deemed to be a loan to the venture; otherwise, when the loan is repaid the non-defaulting venturer will end up paying its share of the liability when the full amount should be borne by the defaulting venturer, clearly an unintended result.

Interestingly, not all joint venture agreements provide for this, and sometimes the agreement will treat the non-defaulting venturer's contribution for its own account as capital and the non-defaulting venturer's contribution for the default amount as debt. However, if the non-defaulting venturer advances the shortfall as a loan to the defaulting venturer, then the non-defaulting venturer's share of the subject capital can and should continue to be treated as a capital contribution.

A simple example using the same facts as the example given above is illustrative (i.e., assume that two venturers enter into a 50/50 joint venture, each venturer has previously contributed \$50,000, the venture has a \$10,000 cash need and one of the venturers defaults in its obligation to contribute \$5,000 to the venture). If only the defaulted amount (and not the entire \$10,000) is funded as a loan to the joint venture, then when the first \$5,000 is distributed to the non-defaulting venturer by the venture to repay the loan, the non-defaulting venturer is in essence paying the half of this obligation of the venture. The \$5,000 being distributed would otherwise have been distributed \$2,500 to each venturer. In fact, the defaulting venturer should be bearing the entire liability. This problem is not present if the entire \$10,000 is treated as a loan to the joint venture.

Squeeze-Down Provisions

It is important to ensure that the provisions implementing any squeeze-down do not result in a windfall to the defaulting venturer nor have a greater than anticipated punitive effect.

For starters, the joint venture agreement should be clear that any dilution adjustments apply to the venturers' percentage interests in the venture. However, if distributions by the venture are first applied to reduce unreturned capital or are made in accordance with capital accounts rather than simply allocated in accordance with percentage interests, then adjustments will need to be made following a squeeze-down to rebalance the venturers' unreturned capital or capital account balances in proportion to the new percentage interests; otherwise, the non-defaulting venturer will not get the benefit of the squeeze-down in the case of a capital event.⁷

If a non-defaulting venturer cures a shortfall with a capital contribution to the venture, its ownership interest in the venture will increase while concurrently diluting, or "squeezing-down," the defaulting venturer's ownership stake in the joint venture.

It is important to note that, as the following example demonstrates, even a non-punitive squeeze-down—i.e., one that dilutes the defaulting venturer on a dollar-for-dollar basis, based on actual capital contributions—may benefit the non-defaulting venturer beyond the parties' intentions if the value of the venture's equity has increased over time and exceeds the aggregate amount of capital invested in the venture. Conversely, if the value of the venture's equity has decreased over time and is worth less than the aggregate amount invested by the venturers in the venture, then dilution based on capital contributions could result in the non-defaulting venturer benefitting less than was intended.

Assume the same facts as in the example given above but that at the time of the \$10,000 cash need the venture's assets are worth \$500,000 rather than the original \$100,000. If dilution is effected exclusively in proportion to contributed capital, then by making a \$5,000 curative contribution, the non-defaulting

venturer is able to increase its 50 percent share in equity now worth \$500,000 into an approximately 54.5 percent share, thereby increasing its equity value from \$250,000 to \$272,000. Effectively, the non-defaulting venturer is benefitting by \$22,000 for a \$5,000 default contribution.

On the other hand, if at the time of the cash need the venture's equity is valued at \$25,000, then the non-defaulting venturer is paying an extra \$5,000 but is only increasing its equity value by \$1,125 (in the latter case it would, of course, be preferable to advance the required funds as a loan to the venture rather than as capital). In order to avoid these results, dilution could be based on the value of the venture's equity at the time of the default contribution rather than on contributed capital.

Occasionally, a joint venture agreement will base a squeeze-down calculation on unreturned capital, rather than aggregate capital contributions. The effect of this is necessarily to increase the punitive effect of a squeeze-down (since it would only lower the denominator in the calculation). This approach is problematic for several reasons, however. Conceptually, the joint venture agreement should create a greater incentive for a venturer to fund when the venture is less successful, but the effect of using unreturned capital is the opposite—the incentive increases as the capital is returned in a successful project. Moreover, once all of the contributed capital is returned (such as on account of a cash-out refinancing), a squeeze-down formula based on unreturned capital would not work at all.

As shown above, the options available to, and ultimately exercised by, a joint venturer to cure its co-venturer's failure to fulfill its capital commitment are not "one size fits all" but should be tailored to fit the particular facts and circumstances of each transaction.

1. See Del. RULPA §17-502(c), Del. LLC Act §18-502(c), NY RLP §121-502(c) and NY LLC Act §502(c).

2. See Del. RULPA §17-306 and Del. LLC Act §17-306.

3. See Del. RULPA §17-1101(b) and Del. LLC Act §18-1101(c).

4. Other remedies for a capital contribution default may include withdrawal of any corresponding capital contributions made by the non-defaulting venturers with respect to the capital call that is the subject of the default, potential forfeiture or discounted sale of the defaulting venturer's interest in the joint venture, subordination of the defaulting venturer's interest in the distribution waterfall and loss of voting rights. None of these remedies address the cash shortfall created by the default.

5. Note that some venture agreements would only apply the punitive multiple to the default contribution, and this example assumes it is applied to the entire capital call.

6. A non-defaulting venturer should also consider any income tax and transfer tax implications in electing whether to fund any shortfall as debt or equity.

7. The venturers should also consider whether any dilution adjustments should only apply with respect to shares of future distributions or whether they also should modify the venturers' respective obligations to fund future capital calls.