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Interest Dilution as Contribution-Default Remedy in LLCs and Partnerships

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Introduction

Contributions (i.e., transfers of capital or other items of value to an entity in a member capacity) are the foundation of the equity structure of LLCs and partnerships and often determine members' financial interests and management rights in such entities. Entity documents, such as an LLC operating agreement, typically establish members' liability for both initial and additional contributions. Because some members may fail to satisfy contribution commitments, entity documents should also detail the remedies that will apply if a member fails to satisfy a contribution commitment. The stakes for such provisions are high. First, contribution provisions determine the extent to which members are obligated to contribute capital to an entity, which in turn can affect the porosity of the entity's liability shield. Second, contributions typically affect members' interests in entities. Those interests in turn often affect members' voting power and determine compliance with tax-rule thresholds, such as those defining related-party classification and domestic-foreign-entity status. Third, contributions can affect members' financial interests by altering the timing and amounts of distributions to which members are entitled.

Contribution-default remedies fall into two general categories: (1) those intended to prevent disruption of membership interests, and (2) those intended to disincentivize default. Remedies that prevent disruption of membership interests typically take the form of member-to-member loans, under which the member who covers a defaulting member's contribution is deemed to lend proceeds to the defaulting member, following which the defaulting member is deemed to contribute the proceeds to the entity.

If preserving initial ownership interests is not a concern, contribution-default remedies may allow disproportionate additional contributions, which dilute the non-contributing member's interests and increase the contributing member's interests in the entity. Dilutive remedies may provide for natural dilution, accounting only for

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the effect that monetary amounts of the disproportionate contributions have on the members' interests, or punitive dilution, reducing the non-contributing member's interest by more than the monetary effect of the disproportionate contribution. Disincentivizing-contribution-default remedies can also include crossover member-to-member loans, which treat the amount of a contribution that covers the non-contributing member's obligation as a loan to the non-contributing member that can convert to a contribution by the contributing member. They can also include member-to-entity loans.

Freedom to contract allows members to choose any contribution-default remedy, so the range of remedies can be significant, and the quality of adopted remedy provisions can vary significantly. This paper presents examples of various general types of contribution-default remedies, uses financial analysis to illustrate the effects of remedies, and shows how ambiguities result from using terms and concepts imprecisely. Financial analyses also illustrate how remedies can alter both the defaulting and contributing members' returns, change a share of residual equity into a fixed return, and affect the order of payouts.

Limited liability companies (LLCs) and partnerships generally require contributions of capital or services to be viable and functional. Members of LLCs and partnerships often commit to contribute capital or services at the time of formation (initial contributions) and possibly at some later date (additional contributions). Members of partnerships and multiple-member LLCs run the risk that they may fulfill their contribution commitments while other members may default on such commitments. Such contribution defaults can have significant financial, economic, and tax effects on the entity. Members also recognize that contribution defaults can affect the members' ownership, voting, and financial interests in the entity.

In some situations, members' interests are carefully calibrated to achieve specific regulatory objectives, and a disruption of those carefully-calibrated interests can trigger unwanted regulatory penalties. For instance, non-U.S. investors who own more than 50 percent of some types of entities are subject to U.S. reporting requirements and may be subject to higher tax rates.[1] Non-U.S. investors seek assurance that those interests will not be disrupted if one or more of the members of an entity in which they invest fails to meet a capital commitment. LLCs and partnerships with non-U.S. investors therefore adopt mechanisms that ensure that a

[1] For instance, non-U.S. investors may prefer not to hold interests in United States real property because ownership of such interests may impose tax reporting requirements on such investors. *See* I.R.C. § 897(a). Interests in a qualified investment entity, such as a partnership, that is domestically controlled does not come within the definition of United States real property. *See* I.R.C. § 897(h)(2). The rules use a 50-percent ownership threshold to determine whether an entity is domestically controlled. *See* I.R.C. § 897(h)(4)(B). Thus, if U.S. persons satisfy the 50-percent ownership threshold, interests in a partnership held by non-U.S. persons can avoid being classified as United States real property. Non-U.S. persons who want to avoid holding United States real property interests typically insist that entity agreements they enter into include provisions that prevent investment by non-U.S. persons to violate the 50-percent ownership threshold.

default will not disrupt the ownership percentages, or, at a minimum, will not allow the non-U.S. investor's interests to exceed the regulatory limit.

In other situations, members who satisfy their contribution commitments want to ensure they are not penalized by other members' failure to satisfy a contribution commitment. Contributing members want to ensure that their interests increase in relation to the interests of defaulting members. Thus, they ensure that LLC and partnership agreements include contribution-default remedies. The concepts of contribution commitments and contribution defaults are fundamental, but specific aspects of commitments and defaults can become complex. Examples illustrate the fundamentals.

Example 1: Proportionate Contributions. Arrie, Nova, and Rey form Arovey LLC. Each agrees to contribute $100,000 upon formation and commits to contribute an additional $100,000, if the Arovey LLC calls for additional capital, as presented in Table 1.

Table 1: Member Contributions and Contribution Commitments

Member	Contribution	Commitment
Arrie	$100,000	$100,000
Nova	$100,000	$100,000
Rey	$100,000	$100,000

The members each have a one-third interest in Arovey LLC. If they make proportionate additional contributions, their interests in Arovey LLC will remain one-third. For various reasons,[2] one or more of the members may not satisfy a capital call and be in default with respect to the capital commit. At formation, the members should anticipate the possibility that a member could default and include in the entity agreement remedies that will be available to members who satisfy their commitments. Those remedies can range from dilution of the defaulting members' interests in the entity to interest forfeiture to diminished rights to distributions. Members who would be subject to regulatory penalties if members' interests change may use mechanisms such as constructive member-to-member loans to preserve the members' original interests in the entity.

This Article examines the different types of default remedies that members include in LLC and partnership agreements. It also considers the mechanisms that members use to ensure that membership interests are not disrupted. After identifying the various types of remedies and mechanisms, the Article examines some of the difficulties that members face in drafting default and other interest-maintenance provisions. Many such provisions appear to create unintended or unworkable

[2] For instance, members may fall upon financial difficulties and lack the funds needed to satisfy the capital commitment. Members may decide that the venture will not be successful and refuse to contribute additional capital to it. Members may have a falling out and some may wish to part ways and refuse to contribute additional capital, hoping to cause the entity to dissolve.

financial arrangements and may have unintended tax consequences. While entity agreements generally must address commitments to contribute both services and capital, this Article focuses on capital commitments.

Examples of Contribution Commitments and Contribution Default Remedies

Partnership and LLC agreements typically include provisions requiring capital contributions and include provisions that address members' failure to satisfy their capital commitments. Provisions addressing failure to satisfy capital commitments fall into two general categories: (2) general contribution-default remedies and (2) interest-maintaining mechanisms.

Contribution Commitments

Unless provided otherwise, the discussion assumes that the members agree to make initial contributions, and they satisfy those initial-contribution obligations. They also agree to make proportionate additional contributions. This is not always the case in practice. In some arrangements, some members may agree to make additional contributions, while others only agree to make initial contributions. In such arrangements, the additional contributions by some members should adjust the members' interests in the entity. Example 2 illustrates the different types of contributions commitments.

Example 2: Types of Contribution Commitments. Arrie, Nova, and Rey form Arovey LLC. Each agrees to contribute $100,000 upon formation and commits to contribute an additional $100,000, if the Arovey LLC calls for additional capital. The members each have a one-third interest in Arovey LLC.[3] If they make proportionate additional contributions, their interests in Arovey LLC will remain one-third. For instance, if Arovey LLC make a capital call of $150,000, and each of Arrie, Nova, and Rey contribute $50,000, they will each remain one-third members. Alternatively, Arrie, Nova, and Rey could each agree to contribute $100,000 initially, but agree to different levels of additional contributions.

The parties may anticipate that Arovey LLC could need additional capital, but Arrie and Nova may not be in a position to commit to make additional contributions. Thus, Arrie may agree to be liable for up to an additional $150,000. If Arovey LLC calls for the additional capital contribution, Arrie's total contribution would be $250,000 ($100,000 initial contribution + $150,000 additional contribution) of the LLC's $450,000 total contributions ($300,000 initial contributions + $150,000 additional contributions), or about 56 percent. Nova's and Rey's $100,000 contributions would be each about 22 percent of the total contributions, following the additional contribution. Table 2 presents the members' contributions in whole dollar terms and their respective contributions as a percentage of total contributions.

[3] This Article rounds percentage interest and gain calculations to round numbers as needed for ease of illustration.

Table 2: Effect of Disproportionate Additional Contribution on Total Contributions

Member	Initial Contribution	Initial Percentage	Additional Contribution	Total Contribution	Percent of Total
Arrie	$100,000	33.33%	$150,000	$250,000	55.56%
Nova	$100,000	33.33%	$0	$100,000	22.22%
Rey	$100,000	33.33%	$0	$100,000	22.22%
Total	$300,000		$150,000	$450,000	

Thus, the members maintain their proportionate interests if they make proportionate additional contributions, but their interests will most likely change if members do not make additional contributions in the same proportion as they made initial contributions. This simple example illustrates how disproportionate additional contributions alter the members' contributions as a percentage of total contributions. The effect that additional contributions have on members' interests in an entity often will depend on factors other than contributions,[4] but a discussion of the factors that affect members' interests and the methods for computing the post-contribution interests is beyond the scope of this Article. Regardless of the contribution structure that an entity adopts, the entity will most likely want to protect against default by including contribution-default remedies. Default remedies should help encourage members to fulfill their agreed-to contribution commitments and protect members who do fulfill contribution obligations against members who default on such obligations.

Typical Contribution-Default Remedies

Typical contribution-default remedies serve two primary purposes, they discourage members from defaulting on contribution commitments and they protect the interests of members who make contributions when other members default. Consider two types of contribution-default remedies: (1) interest dilution and (2) distribution set-offs.

Interest Dilution

Interest-dilution remedies come in two types—(1) natural dilution and (2) punitive dilution. As the terms indicate, both types of remedies dilute the interests of a non-contributing member, but punitive dilution penalizes the non-contributing member for failing to make the contribution.

[4] For instance, the entity's gains and losses and value at the time of the additional contribution can also affect the members' interests.

Natural Dilution

Natural dilution occurs when at least one member fulfills a contribution commitment while at least one member defaults on a contribution commitment, and the entity adjusts the members' interests to reflect the resulting disproportionate contribution. Example 3 demonstrates natural dilution that results from a disproportionate additional contribution.

Example 3: Natural Dilution. Drawing from the Arovey LLC facts in Examples 1 and 2, assume Arrie, Nova, and Rey each agreed to contribute up to $100,000, but Rey defaulted when Arovey LLC made a capital call. If Arrie and Nova each contributed $100,000 in answer to the capital call, their total contributions would be $200,000 ($100,000 initial contribution + $100,000 additional contribution), while Rey's total contribution would be $100,000 (the amount of the initial contribution). Each of the members began with a one-third interest because they each contributed $100,000 initially. Because Rey defaulted on her additional contribution commitment, her interest should be diluted when Arrie and Nova satisfied their contribution commitment. If they relied upon contributions to determine interests, Arrie's and Nova's interests should be 40 percent ($200,000 individual contribution ÷ $500,000 total contributions), and Rey's interest would be 20 percent ($100,000 individual contribution ÷ $500,000 total contributions). Thus, Rey's interest is diluted from about 33 percent to 20 percent, while Arrie's and Nova's interests each increase from about 33 percent to 40 percent. Table 3 illustrates the effect that the additional disproportionate contributions have on member interests, based upon total contributions.

Table 3: Natural Dilution of Disproportionate Additional Contribution

Member	Initial Contribution	Initial Percentage	Additional Contribution	Total Contribution	Percent of Total
Arrie	$100,000	33.33%	$100,000	$200,000	40%
Nova	$100,000	33.33%	$100,000	$200,000	40%
Rey	$100,000	33.33%	$0	$100,000	20%
Total	$300,000		$200,000	$500,000	

Entity agreements often give non-defaulting members the opportunity to cover shortfalls of defaulting members. For instance, the Arovey LLC operating agreement may allow Arrie and Nova to contribute amounts in excess of the $100,000 they agreed to contribute to cover Rey's default. Assume that they each agree to pay an additional $50,000 to cover Rey's $100,000 shortfall. Under this scenario, Arrie's and Nova's percent of total contributions would increase as reflected in Table 4.

Table 4: Natural Dilution of Disproportionate Additional Contribution—Members Cover Default Shortfall

Member	Initial Contribution	Initial Percentage	Additional Contribution	Total Contribution	Percent of Total
Arrie	$100,000	33.33%	$150,000	$250,000	41.67%
Nova	$100,000	33.33%	$150,000	$250,000	41.67%
Rey	$100,000	33.33%	$0	$100,000	16.67%
Total	$300,000		$300,000	$600,000	

The metric used to determine a member's interests following a disproportionate contribution generally will affect the interests the members have following the contribution. Entities base computations of percentage interests on either total contributions or the value of the entity. Entities that use value must establish whether they will compute value using historical costs or fair value. The metric they use will alter the effect the contribution has on the members' interests in the entity.

Punitive Dilution

Punitive dilutions reduce defaulting members' interests by more than the amount resulting from the change attributable to disproportionate contributions. Arrie, Nova, and Rey could adopt punitive instead of natural dilution provisions. For instance, they could provide that in the event a member fails to satisfy a contribution commitment, the defaulting member's interest will be reduced by some amount in addition to the reduction resulting from the natural dilution. They will have to create a formula to apply the punitive dilution. As Example 4 demonstrates, one punitive dilution technique is to apply a multiplier to the amount contributed by a non-defaulting member to cover another member's default.

Example 4: Punitive Dilution with Multiplier. For instance, assume the members of Arovey LLC each contribute $100,000 at the time of formation and agree to contribute up to an additional $100,000 each, if Arovey LLC issues a call for additional capital. When Arovey LLC makes the call for additional capital, Rey defaults on her $100,000 contribution obligation and Arrie and Nova each contribute $50,000 in addition to the $100,000 they are each obligated to contribute. The Arovey LLC operating agreement also provides that for purposes of determining the members' contribution percentages, any amounts contributed to cover a defaulting member's contribution obligation will be deemed to be 200% of the actual amount contributed. Thus, Arrie and Nova will each be deemed to have contributed their initial $100,000 contribution, their additional $100,000 contribution, and $100,000 deemed contribution to cover Rey's default ($50,000 actually contributed × 200%). Table 5 presents the results of this punitive dilution.

Table 5: Punitive Dilution of Disproportionate Additional Contribution—Members Cover Default Shortfall						
Member	**Initial Contribution Percentage**	**Initial Percentage**	**Actual Additional Contribution**	**Deemed Additional Contribution**	**Total Contribution**	**Percent of Total**
Arrie	$100,000	33.33%	$150,000	$50,000	$300,000	42.86%
Nova	$100,000	33.33%	$150,000	$50,000	$300,000	42.86%
Rey	$100,000	33.33%	$0	$0	$100,000	14.28%
Total	$300,000		$300,000	$100,000	$700,000	

The effect of the punitive multiplier is evident by comparing the information in Table 4 to the information in Table 5. In Table 4, Arrie's and Nova's interests are 41.67% if the multiplier does not apply, but they are 42.86% in Table 5 if the multiplier does apply. Rey's interest, if the multiplier does not apply would be 16.67%, but it would be 14.28%, if it does apply. Thus, the multiplier increases Arrie's and Nova's interests by 1.19 percentage points and decreases Rey's interests by 2.39 percentage points. The effect of the multiplier will diminish as the amount of total contributions increases. Its effect will also depend upon the use of the percentage interests. For instance, percentage interests may determine voting rights or distribution rights.

Example 4 illustrates a punitive dilution technique wherein the members apply a multiplier to the amount contributed by a non-defaulting member to cover another member's default. A second potential punitive dilution technique is for the LLC agreement to provide that a member forfeits a portion of her interest when she fails to make a mandatory capital contribution. Unlike a shift in her percentage interests, which may occur on a prospective basis only, a forfeiture provision often shifts a member's existing rights in partnership capital to other members. Example 5 illustrates the shift that occurs as a result of an interest forfeiture.

Example 5: Punitive Dilution with Forfeiture of Interest. For instance, assume the members of Arovey LLC each contribute $100,000 at the time of formation and agree to contribute up to an additional $100,000 each, if Arovey LLC issues a call for additional capital. When Arovey LLC makes the call for additional capital, Rey defaults on her $100,000 contribution obligation. Arrie and Nova each contribute $50,000 in addition to the $100,000 they are each obligated to contribute to cover the default. The Arovey LLC operating agreement provides that if a member defaults on a capital call obligation, the defaulting member forfeits a portion of her interest in LLC capital and profits equal to 50% of the capital call amount.[5] At the time of the capital call, each member's capital account is $100,000 and the fair market value of Arovey's assets is $390,000. Table 6 presents the results of this punitive dilution.

Table 6: Punitive Dilution of Disproportionate Additional Contribution—Forfeiture of Interest

Member	Initial Contribution	Initial Percentage	Additional Contribution	Punitive Forfeiture of Interest	Capital Account	Percent of Total[6]
Arrie	$100,000	33.33%	$150,000	$25,000	$275,000	45.83%
Nova	$100,000	33.33%	$150,000	$25,000	$275,000	45.83%
Rey	$100,000	33.33%	$0	($50,000)	$50,000	8.33%
Total	$300,000		$300,000	$0	$600,000	

The effect of the punitive forfeiture is evident by comparing the information in Table 4 to the information in Table 6. In Table 4, Arrie's and Nova's interests are 41.67% with no punitive dilution, but they are 45.83% in Table 6 with the forfeiture provision. Rey's interest is 16.67% if the forfeiture provision does not apply, but it would be 8.33% if it does apply. Moreover, Rey's capital account has decreased from $100,000 to $50,000 as a result of the forfeiture provision. This decrease of $50,000 effectively shifts capital in that amount to Arrie and Nova. In fair market value terms, Rey's interest in Arovey's assets had a value of $130,000 prior to the capital call (33.33% x $390,000). But, following the application of the forfeiture provision, Rey's interest in Arovey's assets has a value of $57,500 (8.33% x $690,000). Thus, Rey not only has a reduced share of Arovey's future profits as a result of the reduced percentage interest, the value of her proportionate share of Arovey's assets has decreased by $72,500.

[5] Courts appear willing to uphold dilution agreements, but the manner in which an agreement is drafted could expose the defaulting member to damages for failure to fulfill a capital-call commitment. *See, e.g.*, Vinton v. Grayson, ____ A.3d ____ (Super. Ct. Del. 2018) (holding that the agreement's preservation-of-remedies clause subjected the defaulting member to damages); Canyon Creek Development, LLC v. Fox, 46 Kan.App.2d 370 (2011) (holding that the contract limited the remedy to interest-dilution).

[6] Percentage interests in Example 5 are determined based on relative capital contributions, as adjusted for the forfeiture of interest provision.

Determining Interests

To this point, the analysis has assumed that the members' interests are based upon contributions. Using contributions to determine interests does not capture the effect changes in the entity's value could have on the members' interests. The members would most likely insist that any additional contributions be measured against the value of their interests at the time of the additional contributions. If the entity measures the effect of additional contributions against the value of the members' interests, then an increase in the entity's value will diminish the effect of the additional contribution, and a decrease in the entity's value will enhance the effect. The example of Arovey LLC helps illustrate how basing interest determinations on the value of the entity may affect the interests the parties have in the entity following a disproportionate additional contribution. Assume, for instance, that, at the time of the additional contribution, the value of the entity is alternatively $210,000 (Example 6) and $390,000 (Example 7). The examples to this point have used the $300,000 initial contribution amount as the basis for determine members' interest before and after the additional contribution.

Example 6: Effect of Diminished Value on Membership Interests. Assuming Arovey LLC is worth $210,000 at the time of the additional contribution and each member has a one-third interest in the entity (based upon their initial contributions of $100,000 each), each member's interest will have a $70,000 value. The contributing member will prefer to use that valuation to determine their interests in the entity following the additional contributions because they will end up with larger interests in the entity. For instance, assume Arovey LLC makes a call for $300,000 additional capital contributions, Rey defaults on her obligation, and Arrie and Nova each contribute $150,000 to cover their respective contribution obligations and to cover Rey's default amount. Following the contribution, Arovey LLC's value will be $510,000, which includes Arovey LLC's $210,000 value at the time of the additional contribution plus the $300,000 additional contribution. Following the contributions, the values of Arrie's and Nova's interests will include their pre-contribution $70,000 value and their $150,000 contributions, so the total value will be $220,000, so they will have 43.14% interests in Arovey LLC. The value of Rey's interest will remain $70,000, so she will have a 13.72% interest in the entity. Table 7 presents the effects of the contributions under these circumstances.

Table 7: Natural Dilution of Disproportionate Additional Contribution—Entity is Losing Value

Member	Pre-Call Value	Pre-Call Percentage	Additional Contribution	Post-Contribution Value	Percent of Total
Arrie	$70,000	33.33%	$150,000	$220,000	43.14%
Nova	$70,000	33.33%	$150,000	$220,000	43.14%
Rey	$70,000	33.33%	$0	$70,000	13.72%
Total	$210,000		$300,000	$510,000	

Example 7: Effect of Increased Value on Membership Interests. Now consider the results if Arovey LLC is worth $390,000 at the time of the additional contribution. The value of the members' one-third interests (based upon initial contributions) will be $130,000. After Arrie and Nova each contribute $150,000, Arovey LLC's value will be $690,000. The value of Arrie's and Nova's interests at that time will be $280,000, and Rey's will be $130,000, so Arrie's and Nova's interests will be 40.58%, and Rey's will be 18.84%. Table 8 summarizes these results.

Table 8: Natural Dilution of Disproportionate Additional Contribution—Entity is Increasing in Value

Member	Pre-Call Value	Pre-Call Percentage	Additional Contribution	Post-Contribution Value	Percent of Total
Arrie	$130,000	33.33%	$150,000	$280,000	40.58%
Nova	$130,000	33.33%	$150,000	$280,000	40.58%
Rey	$130,000	33.33%	$0	$130,000	18.84%
Total	$390,000		$300,000	$690,000	

Notice the effect that the additional contributions have on the members' interests depends upon the value used to determine the members' interests. If the value of the entity has decreased since the most recent prior measurement of interests, then the amount of increase each member will realize as a result of the additional disproportionate contribution will be greater than it would be had the entity computed member interests using contribution ratios. Alternatively, the increase in the contributing members' interests will be less, if the entity has increased in value since the most recent prior measurement of interests.

Distribution Set-Offs

A distribution set-off remedy may provide that the entity shall have the right to continue to charge interest on the outstanding unpaid balance of unpaid requested committed capital contribution, until the date of payment to the entity and cause any distributions otherwise payable to the Defaulting Partner to be set off or withheld from such Defaulting Partner. The manager may set-off against any distribution to any Partner pursuant to this Agreement any unpaid requested committed capital, to the extent not otherwise paid. Any amounts so set-off pursuant to this Section shall be applied by the Partnership to discharge the obligation in respect of which such amounts were withheld. All amounts set-off pursuant to this Section with respect to

any Partner shall be treated as amounts distributed to such Partner by the Partnership and paid to the Partnership by such Partner for all purposes under this Agreement. This set-off language includes the empowering provision, which allows the entity to withhold distributions, and a provision that imagines the defaulting partner making a contribution and receiving a distribution.

Notice that the diminished rights to distributions require an imaginary contribution and distribution. Without such imaginary transactions, the entity would not be able to fulfill distribution obligations. Example 8 illustrates the need of the imaginary contribution and distribution.

Example 8: Distribution Off-Sets. Drawing from the Arovey LLC example, each member made an initial $100,000 contribution and took Class A interests in Arovey LLC. Arrie, Nova, and Rey each agreed to contribute up to an additional $100,000. One year after formation, Arovey LLC makes a capital call for each member to contribute an additional $100,000, but Rey defaulted when Arovey LLC made a capital call. Arrie and Nova each contributed $100,000 in answer to the capital call. Following the additional capital contributions, Arrie and Nova have each contributed $200,000 and Rey has contributed $100,000. Table 9 represents the members' contributions.

Table 9: Member Contributions

Member	Initial	Additional
Arrie	$100,000	$100,000
Nova	$100,000	$100,000
Rey	$100,000	$0

Assume that the Arovey LLC operating agreement includes a waterfall distribution with three tiers. Tier 1 provides that it will distribute available cash first to Class A interest holders to provide an 8-percent simple return. Tier 2 provides that it will any remaining available cash to Class A interest holders to return their capital contributions. Tier 3 provides it will distribute any remaining available cash 80 percent to Class A interest holders in proportion to their contributions and 20 percent to Class B interest holders. Choi, the Arovey LLC manager, holds all of the Class B interests. Two years after formation, Arovey LLC has $700,000 of available cash and will make its first distribution. Consider how Arovey LLC would distribute the proceeds under three different scenarios. First, assume that it distributes the proceeds pursuant to the distribution provisions, without regard to the contribution-default remedy.

Disregard Default. Under Tier 1, the distribution requirement includes an 8-percent simple return on the Year 1 contribution for two years for each member, which would be $16,000 ($100,000 × 8% × 2). For Arrie and Nova, who made Year 2 contributions, the Tier 1 distribution requirement also includes an 8-percent simple return on the Year 2 contributions, which would be $8,000 ($100,000 × 8%) for each. Thus, under Tier 1, Rey will receive $16,000 and Arrie and Nova will each receive

$24,000. Tier 2 requires Arovey LLC to distribute $100,000 to Rey and $200,000 to each of Arrie and Nova to return their capital contributions. Following those distributions, Arovey LLC will have $136,000 left to distribute under Tier 3, so it will distribute $108,800 (80%) to Arrie, Nova, and Rey in proportion to their contributions and $27,200 (20%) to Choi. Rey's contributions are 20 percent of the total ($100,000 ÷ $500,000), so her Tier 3 distribution will be $21,760 ($108,800 × 20%). Arrie's and Nova's contributions are each 40 percent of the total ($200,000 ÷ $500,000), so their Tier 3 distributions will be $43,520 ($108,800 × 40%). Table 10 summarizes the amounts distributed to each member under this scenario.

Table 10: Distributions Based Upon Actual Contributions

Member	Tier 1	Tier 2	Tier 3	Total
Arrie	$24,000	$200,000	$43,520	$267,520
Nova	$24,000	$200,000	$43,520	$267,520
Rey	$16,000	$100,000	$21,760	$137,760
Choi			$27,200	$27,200
Total	$64,000	$500,000	$136,000	$700,000

Second, consider the dilemma that Arovey LLC would be in if the operating agreement included nothing more than an empowering provision of the default remedy. The empowering provision allows Avorey LLC to withhold contributions from a defaulting member.

Withhold Defaulted Amount. Rey failed to contribute $100,000, so Avorey LLC could withhold amounts that would otherwise be distributable to the defaulting member. Without the contribution-default remedy, Avorey LLC would otherwise distribute $137,760 to Rey. If Avorey LLC were to withhold the $100,000 default amount from the $137,760 that it would otherwise distribute to Rey, then it would only distribute $37,760 ($137,76 - $100,000). By withholding that amount, it would then have $100,000 remaining to distribute. Avorey LLC has satisfied the Tier 1 and Tier 2 distribution obligations, so supposedly the remaining $100,000 would be distributed under Tier 3. Avorey LLC must determine how it will make that distribution. Tier 3 requires distributing 80 percent of the Tier 3 amount to Arrie, Nova, and Rey, in proportion to their contributions, and distributing 20 percent to Choi. If Avorey LLC distributes any portion of that amount to Rey, it will not withhold the $100,000. To ensure compliance with the withholding provision, Avorey LLC could either distribute the 80-percent amount ($80,000 = $100,000 × 80%) between Arrie and Nova based upon their equal contributions. Alternatively, it could divide the portion of the 80 percent that would otherwise be distributed to Rey under Tier 3 between the Class A holders and the Class B holder. The operating agreement does not determine how Avorey LLC should treat the second layer of the amount that it would otherwise distribute to Rey, if Rey had not defaulted on the contribution obligation. To illustrate, if $80,000 is apportioned to Class A members under Tier 3, Rey would be entitled to a distribution of 20 percent of that amount ($100,000 contribution by Rey ÷ $500,000 total contribution), which would be $16,000. If Avorey LLC were to distribute that amount to Rey, the distribution would effectively erode the amount that Avorey LLC was to withhold from Rey. Instead of

distributing $37,760 to Arrie (the amount otherwise distributed to her minus the withheld amount), Avorey LLC would distribute $53,760 to her, which would appear to give her more than she is otherwise entitled to receive.

Because Rey should not receive the $16,000 of the withheld amount, Avorey LLC could run that amount through the Tier 3 distribution structure. That would result in a distribution of $2,560 ($16,000 × 80% × 20%) to Rey, which Avorey LLC would then have to run through the Tier 3 distribution structure. Avorey LLC would have to continue that iterative process until the amount that would be distributed to Rey does not exceed $37,760. Using this method, Avorey LLC would distribute 38 percent of the withheld amount to each of Nova and Arrie and 24 percent to Choi. To determine those percentages, Avorey LLC would first determine the percentage of Tier 3 distributions that each member would receive absent the withholding. Avorey LLC would divide 80 percent of those distributions among themselves 20 percent to Rey and 40 percent to each of Nova and Arrie. Thus, Rey would receive 16 percent of the total distributions (80% × 20%), and Nova and Arrie would receive 32 percent of the total distributions (80% × 40%). Choi would receive 20 percent. If, as a result of applying the withholding remedy, Avorey LLC did not make any distributions to Rey, it could distribute the amount it would otherwise distribute to her to Nova, Arrie, and Choi in proportion to the Tier 3 distributions they would otherwise receive. If Rey received a Tier 3 distribution, the other three members would otherwise receive 84 percent of the Tier 3 distribution (100% - 16% otherwise distributed to Rey). Nova and Arrie would each receive about 38 percent of that amount (32% ÷ 84%) and Choi would receive about 24 percent (20% ÷ 84%). Thus, Avorey LLC may consider distributing the amount withheld from Rey to those members in those percentages. If it does distribute according to those percentages, Nova and Arrie would each receive $38,000 ($100,000 × 38%), and Choi would receive $24,000 ($100,000 × 24%). Under this approach, the members' shares of contributions would change considerably, as presented in Table 11.

Table 11: Distributions Based Upon Actual Contributions

Member	Amount Otherwise Received	Amount Withheld	Reapportionment of Amount Withheld	Total
Arrie	$267,520		$38,000	$305,520
Nova	$267,520		$38,000	$305,520
Rey	$137,760	($100,000)		$37,760
Choi	$27,200		$24,000	$51,200
Total	$700,000	($100,000)	$100,000	$700,000

Third, consider how Avorey LLC would distribute the available cash, taking into account the imaginary contributions and distributions.

Imaginary Contributions. Under this alternative, Avorey LLC would treat Rey as satisfying her contribution obligation and making the $100,000 additional contribution. Because Rey did not actually make the contribution, it would be an imaginary contribution, as shown in Table 12.

Table 12: Member Contributions		
Member	**Initial**	**Additional**
Arrie	$100,000	$100,000
Nova	$100,000	$100,000
Rey: Actual	$100,000	$0
Imaginary		$100,000

When Avorey LLC made the distribution, it would make actual distributions to all of the members related to their actual contributions. It would also record imaginary distributions to Arrie related to the imaginary contribution. Avorey would only have $700,000 of available cash to distribute, but it would imagine that it has enough cash to cover the imaginary distributions to Rey. The imaginary distributions would include the 8-percent return on Rey's $100,000 imaginary additional contribution, an imaginary return of the imaginary contribution, and an imaginary Tier 3 distribution. Rey's Tier 3 distribution, including her imaginary Tier 3 amount, should equal the Tier 3 amount that Arrie and Nova actually receive. Table 13 presents the actual and imaginary amounts that Avorey LLC would distribute.

Table 13: Distributions Based Upon Actual Contributions				
Member	**Tier 1**	**Tier 2**	**Tier 3**	**Total**
Arrie	$24,000	$200,000	$43,520	$267,520
Nova	$24,000	$200,000	$43,520	$267,520
Rey: Actual	$16,000	$100,000	$21,760	$137,760
Imaginary	$8,000	$100,000	$21,760	$129,760
Choi			$27,200	$27,200
Total: Actual	$64,000	$500,000	$136,000	$700,000
w/ Imaginary	$72,000	$600,000	$157,760	$829,760

The imaginary contributions and distributions do not appear to affect the amount of distributions that Rey would receive, if Avorey LLC simply distributed the available cash according to Avorey LLC's distribution provisions. This comparison shows that if Avorey LLC considers imaginary contributions and distributions, the concept that Avorey LLC will withhold distributions is illusory. It doesn't actually withhold distributions under this alternative or under the alternative in which it distributes available cash according to the distribution provisions. Instead, it merely distributes according to the distribution provisions, which are determined by contributions.

The second alternative illustrates a potential result of actual withholding. Under that alternative, Arrie actually receives less than she contributed. The withholding carries punitive results. Even if Avorey LLC does not actually withhold distributions to a punitive extent, if it charges interest on unfulfilled contribution commitments, it will have to adopt the accounting techniques (or techniques similar to them) applied in the second alternative. The amount of interest that Avorey LLC charges will have to come out of the distributions that it would otherwise make to Rey. Unless the amount charged exceeds Rey's Tier 3 distribution, Avorey LLC could charge the interest against that distribution and then reapportion the withheld amount according as illustrated in the second alternative.

Constructive Loans

Constructive loans come in two general forms—member-to-member loans and member-to-entity loans. The loans are constructive loans because they occur as function of the entity agreement. For instance, pursuant to the entity agreement a person who transfers money to an entity to cover the contribution of a defaulting member is treated as lending money to the defaulting member or to the entity. Constructive loans differ from formal loans, which result from an arrangement outside the entity agreement between the performing member and the defaulting member or between the performing member and the entity. Entities may adopt constructive loans to help ensure that contribution-defaults do not affect the members' interests in the entity. The reasons for preserving interests may be many. For instance, the application of tax and other regulatory rules may depend upon membership interests of various classes of members. The United States, for example, applies one set of rules to non-U.S. investors, if they hold less than 50 percent of the interests in the entity, and another set of rules, if they hold more than 50 percent of the interests in the entity.[7]

A member-to-member constructive loan comes in to existence when a member makes a contribution to cover a defaulting member's failure to satisfy a capital call. The loan is constructive because funds do not actually pass from the lending member to the defaulting member. Instead, the lending member transfers funds to the entity, but the parties have agreed that such transfers will be treated as a transfer to the defaulting member in the form of a loan, and the member will be treated as contributing the funds to the entity. The entity agreement should provide that the lending member will take a security interest in the defaulting member's membership interest. The entity agreement should also provide that distributions to which the defaulting member would be entitled will be paid to the lending member until the constructive loan is satisfied, which requires repayment of the principal and payment of interest.

A constructive member-to-entity loan comes into existence when an entity agreement provides that payments to cover a defaulting member's contribution obligation will be treated as a loan from the paying member to the entity. A distinguishing aspect of member-to-entity loans is that they provide the paying member a distribution priority. Because entities pay debt obligations before making distributions, the paying member will receive principal and interest payments on the constructive loan before the entity makes any distributions. Otherwise, the terms of a member-to-entity loan may be similar to the terms of a member-to-member loan.

Constructive loans run the risk of being classified as contributions. The paying member will expect the constructive loan to not dilute the return on the member's investment. If an investor expects to receive a 15-percent return on contributed capital, then it will expect to receive a similar return form constructive loans. Such

[7] See (n 1).

a return, if not typical in lending transactions, could suggest that the payment is a contribution, not a loan.[8] Such a reclassification would undermine the purpose of the constructive loans that are designed to preserve the members' interests in the entity.

Example 9: Member-to-Member Constructive Loan. The facts are the same as example 8, except the Arovey LLC agreement provides for a constructive member-to-member loan in the event of a default pursuant to a capital call. The members of Arovey LLC each contribute $100,000 at the time of formation and agree to contribute up to an additional $100,000 each, if Arovey LLC issues a call for additional capital. When Arovey LLC makes the call for additional capital, Rey defaults on her $100,000 contribution obligation and Arrie and Nova each contribute $50,000 in addition to the $100,000 they are each obligated to contribute. The Arovey LLC operating agreement provides that the contributions of the deficiency amount of $50,000 by each of Arrie and Nova are treated as loans to Rey. In turn, Rey is deemed to have contributed the loan proceeds to Arovey LLC.

The terms of the loan provide for repayment of the principal plus interest of 8 percent, matching Arrie's simple return under tier 1 of Arovey LLC's distribution structure. The Arovey LLC agreement further provides that all distributions to the defaulting member (Rey) will be used to repay the loans before the defaulting member is permitted to receive and retain any distributable amounts. Because Rey is deemed to borrow and contribute $50,000 from each of Arrie and Nova, Rey retains her one-third interest in Arovey LLC. Table 14 presents the results of this constructive loan remedy.

[8] *See* Thomas D. Greenaway & Michelle Marion, *A Simpler Debt-Equity Test*, 66 TAX LAW. 73 (2012); William T. Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

Table 14: Member-to-Member Constructive Loan—Contribution Remedy						
Member	**Initial Contribution Percentage**	**Initial Percentage**	**Actual Additional Contribution**	**Deemed Contribution**	**Total Contribution**	**Percent of Total**
Arrie	$100,000	33.33%	$100,000	$0	$200,000	33.33%
Nova	$100,000	33.33%	$100,000	$0	$200,000	33.33%
Rey	$100,000	33.33%	$0	$100,000	$200,000	33.33%
Total	$300,000		$300,000	$100,000	$600,000	

Crossover Constructive Loans

A member-to-member loan crosses over from being a loan to a member to becoming a contribution to the entity, if the defaulting member does not cure the default within a specified period. An entity agreement should provide how a constructive member-to-member loan may cross over to a contribution to the entity and detail the effect of the crossover contribution. The timing of the crossover will vary from entity to entity. Consider possible crossover structures. First, the lending member could be deemed to contribute the loan to the entity for additional interests in the entity, following which the entity would be deemed to distribute the loan to the defaulting member in redemption of some of the defaulting members' interests in the entity. Second, the defaulting member could be deemed to transfer interests to the lending member in satisfaction of the loan. Third, the entity could be deemed to make a distribution to the defaulting member in an amount equal to the outstanding loan principal and interest. The members should consider how they will treat the crossover, but there is no guarantee that the tax authorities will respect such treatment.

Each of the crossover techniques requires a determination of the effect that the crossover will have on the members' interests in the entities. The method for determining the effect the crossover will have on the members' interests should provide whether the effect will include an interest-dilution component. The entity agreement could hard-wire the crossover value at the time of default. Such hard-wiring would establish the interests that the lending member would receive if the loan crosses over to a contribution. Alternatively, the entity agreement could provide for an open-ended crossover, which would delay determination of the interests to be received on crossover until the time of crossover. With open-ended crossovers, the amount of interests the lending member receives and the defaulting member forfeits would depend upon the value of the interests at the time of the crossover. With hard-wired crossovers, the loan would crossover to a contribution if the value of the interests increased from the time of the loan until the time of the crossover. With such an arrangement, the lender would acquire interests in the entity at a discount, if the value of the interests increased.

If a crossover is open-ended, then the lender would have to compare the value of the loan to the value of the interests that it would receive upon crossing over to a contribution. Open-ended provisions can relate to both time and amount of interests. The value of the interests to be received in an open-ended arrangement can be fixed and determine the amount of interests that the lender will receive, or the arrangement can provide that the lender and entity manager will negotiate the amount of interests to be transferred. Example 10 illustrates how a crossover loan may work.

Example 10: Member-to-Member Crossover Loan. As with prior examples, Arrie, Nova, and Rey each contribute $100,000 to form Arovey LLC and each being with a one-third interest in Arovey LLC. Arovey LLC makes a capital for each member to contribute $100,000. Arrie and Nova each fulfill their capital-call obligations, but Rey defaults. The Arovey LLC operating agreement provides that if members pay to cover a defaulting member's contribution obligation, the payment will be treated as a loan to the defaulting member. If the member fails to cure the default within six months, the loan will become a contribution to the Arovey LLC. Arrie and Nova each transfer $50,000 to Arovey LLC to cover Rey's default. The $50,000 payments are loans to Rey.

Rey does not cure her default within six months after the capital call, so the loans to Rey become capital contributions by Arrie and Nova. The Arovey LLC operating agreement provides that when a member-to-member loan crosses over, the lending member is deemed to contribute 200% of the amount of the loan at the time of the crossover. The interest dilution is based upon the value of the members' interests at that time.

This open-ended structure gives the defaulting member extra time to decide whether to cure or remain in default. If the member defaulted out of concern for the entity's financial situation, the member-to-member loan, in this example, gives the defaulting member another six months to further assess the entity's situation. If the

defaulting member believes the entity's financial situation has improved over that period of time, the member could cure the default. Otherwise, the member would remain in default and forfeit interests in the entity.

Convertible Constructive Loans

Member-to-entity loans that can become contributions are convertible constructive loans because they may convert to equity interests at some point. If an entity agreement provides for constructive loans, it should also establish the terms of converting the loan to membership interests. As with crossover loans, the terms can be hardwired or open-ended.

When a lender converts a constructive loan to a contribution, the effect should be similar to a member making a disproportionate additional contribution. Entity agreements that adopt convertible constructive loans should establish whether the conversion will result in natural or punitive dilution of the defaulting member's interests in the entity.

Contribution of Promise

Failure to satisfy a capital call is different from a failure to perform on a contributed promise to make a payment to an entity. The contribution of a promise to make a payment to an entity is a contribution, and the member who contributes the promise should receive an interest in the entity in exchange for the contribution. The entity agreement should provide what the consequences will be for a promisor who fails to make the promised payments. Such failure could result in a loss of interests in the entity, perhaps be treated as a rescission of the contribution, or be treated as a distribution from the entity of the contributed promise in redemption of the entity interests the promisor. If the failure to fulfill the promise occurs in proximity to the contribution of the promise and no distributions or allocations have occurred, then rescission may be an option. If the entity had made allocations and distributions based upon the interest determined with the contributed promise, the entity agreement should provide how it will account for such items, if the member defaults on the promise. At that point, rescission may not be possible because the entity has accounted for the interests the person acquired with the promise.

Conclusion

Contributions are essential to most entities. Members who agree to make contributions may fail to fulfill such contribution obligations. Members should recognize that possibility exists when they form or join an entity with others and establish how they will address contribution defaults. The nuances of the general types of contribution-default remedies discussed in this article illustrate that members should carefully consider the type of contribution-default remedies they will adopt. One size does not fit all, and the preference for one remedy over another may depend upon the members' respective situations at the time of a capital call. At

the time they enter into the agreement, the members will not know what their preferences will be at the time of a future capital call. Consequently, they should consider adopting contribution-default remedies that are fair and easy to administer.