Click to view the latest
Business Law **TODAY**

BUSINESS LAW TODAY

Delaware Insider:

Failure to Make Capital Contribution Does Not Necessarily Result in Reduction of Interest in LLC or LP

By Jason C. Jowers

Hypothetical 1: Two people (Member A and Member B) agree to form a Delaware LLC, and they agree to contribute $50,000 each in start-up capital. Each member is to receive a 50% interest in the company. Member A contributes $50,000, but Member B contributes only $10,000. Does Member B own 50% of the company?

Hypothetical 2: Two people agree to form a Delaware LLC, and they both agree to contribute $50,000 in start-up capital. Each member receives a 50% interest in the LLC. The company is managed by Member A. After a period of operations, Member A decides the company is in need of additional capital. He makes a capital call for an additional $50,000 from each member. Member A contributes the additional $50,000. Member B contributes nothing. Does Member B still own 50% of the company?

* * *

The Delaware Court of Chancery was recently faced with a variation of Hypothetical 1 in *Grove v. Brown*, 2013 WL 4041495 (Del. Ch. Aug. 8, 2013), and its answer to the question posed above likely has implications to the answer to Hypothetical 2. Although failure to make an initial capital contribution may be somewhat unusual, LLC members and LP partners often must decide how to answer a capital call like that in Hypothetical 2. In the *Grove* decision, the Court of Chancery explained that a member's failure to make the full amount of his initial capital contribution did not cause *any* reduction in his membership interest. If the members of an LLC or partners of an LP wish to have membership interest or partnership interest reduced for a deficiency of a capital contribution, the Court of Chancery held those parties must contract for it in the operating agreement. As explained below, in the context of capital calls, courts have enforced such provisions permitting dilution for failing to respond to a capital call. However, if the LLC agreement is silent on the subject, based on the *Grove* decision, a non-contributing member who fails to answer the call may find that the non-contributing member still owns the same amount of interest, and the contributing member who pays in additional capital may find that you do not always get what you pay for.

Act Permits LLC Agreement to Provide for Reduction of Membership Interest

The Delaware Limited Liability Company Act (the "Delaware LLC Act") permits an LLC agreement to provide for the reduction of a member's interest if that member fails to provide capital when so required. Specifically, 6 *Del. C.* § 18-502(c) provides:

> A limited liability company agreement *may provide* that the interest of any member who fails to make any contribution that the member is obligated to make shall be subject to specified penalties for, or specified consequences of, such failure. Such penalty or consequence may take the form of reducing or eliminating the defaulting member's proportionate interest in a limited liability company . . . .

(Emphasis added). This language, however, is clearly permissive. It is not one of the few mandatory provisions in the Delaware LLC Act. To the contrary, it states that an LLC agreement "may provide" for a reduction in a member's interest if a required capital contribution is not made. The Delaware Revised Uniform Limited Partnership Act (the "Delaware LP Act") contains a provision that similarly permits a partnership agreement to reduce a partner's proportionate interest in the limited partnership in the event that partner fails to make a required capital contribution. *See* 6 *Del. C.* § 17-502(c). Significantly, neither Section 17-502(c) nor Section 18-502(c) distinguish between a failure to make a required initial capital contribution and a failure to make a subsequent required contribution in response to a valid call for capital.

If Operating Agreement Permits Dilution for Failure to Answer Capital Call, Delaware Will Enforce the Provision

Courts have found provisions adopted pursuant to Sections 17-502(c) and 18-502(c) enforceable. However, the Court of Chancery has held the parties to the strict language of the agreement. In *Telstra Corp. v. Dynegy, Inc.*, 2003 WL 1016984 (Del. Ch. 2003), Telstra exercised a put option it had under the partnership agreement. If Telstra exercised the put in the first two years of the partnership's existence, which it did, then Telstra was entitled to a purchase price that equaled the value of its capital account. A dispute arose as to whether it was appropriate to "book down" the value of Telstra's capital account based on a decline in the company's fair market value. Under the terms of the partnership agreement, a "book down" was only triggered upon certain events, one of which was a disparate capital contribution.

The partnership agreement permitted capital calls. However, for a call for capital, the partnership agreement required: (1) approval of the board of managers, (2) notice sent to the partners, and (3) a 90 day window for the partners to answer the call. An officer of the partnership issued the relevant call without approval of the board of managers, rendering it invalid. Dynegy provided additional funds in response to the invalid capital call. Holding the parties to the terms of the agreement and refusing to allow Dynegy to benefit from the invalid capital call, the court found that "the Partnership was not permitted to accept the defendants' purported 'capital contribution,'" and that "the defendants were not free under the terms of the Agreement to unilaterally make a disproportionate contribution of capital to the Partnership." Moreover, even if the call had been issued by the board, 90 days had not passed at the time Telstra exercised its put. The court found that "[i]t is only when a partner fails to contribute its pro rata share of the capital contributions by the due date that the non-contributing partner's Partnership interest will be diluted." Although the *Telstra* court never specifically referenced Section 17-502(c), it recognized that the provision permitting a reduction in partnership interest based on a capital call to be enforceable.

Although not decided by a Delaware court, in *Abuy Development, L.L.C. v. Yuba Motorsports, Inc.*, 2008 WL 1777412 (E.D. Mo. 2008), the U.S. District Court for the Eastern District of Missouri found that Section 18-502(c) of the Delaware LLC Act permitted a provision that reduced a partner's 50 percent holding in YCM, a Delaware LLC, based on failure to make a capital contribution. Initially, YCM was capitalized by a contribution of funds from Abuy, and Yuba received equal capital credit for preliminary work done on the project. Subsequently, each member was required to make an additional capital contribution in response to a call issued pursuant to the agreement. Abuy not only contributed capital to satisfy its obligation, but also contributed capital on behalf of Yuba pursuant to a promissory note between Abuy and Yuba. However, Yuba then failed to pay back the loan. After default on the loan, Abuy reduced Yuba's interest in YCM. The YCM operating agreement specifically permitted one member to loan the other funds to answer a capital call. However, if the member who had been loaned money failed to pay back the loan plus interest, then under the terms of the YCM operating agreement "the Non-Defaulting Member may elect . . . to adjust the Capital Accounts of the Defaulting Member and the Non-Defaulting Member to reflect that the Non-Defaulting Member has made such Capital Contribution on its own behalf and not on behalf of the Defaulting Member thereby increasing the Percentage Interest of the Non-Defaulting Member and reducing the Percentage Interest of the Defaulting Member. . . ." In upholding the reduction of Yuba's membership interest, the court specifically cited to Section 18-502(c) of the Delaware LLC Act as authorizing the provision.

Although the *Telstra* and *Abuy* decisions demonstrated that courts will enforce provisions adopted pursuant to Sections 17-502(c) and 18-502(c), they failed to address what would happen to a partner's or member's interest if that partner or member failed to contribute capital and the operating agreement was silent as to the remedy.

Court of Chancery Refuses to Dilute Membership Interest in Absence of Provision in LLC Agreement

In *Grove v. Brown*, 2013 WL 4041495 (Del. Ch. Aug. 8, 2013), the Court of Chancery addressed the appropriate remedy for a failure of a member to make the full amount of his initial capital contribution where the agreement was silent on the subject. Mary Marlene Grove and Larry Grove on the one hand, and Melba Brown and Hubert Brown on the other, formed Heartfelt Home Health, LLC (Heartfelt), which was a home healthcare staffing agency. Under the terms of the Heartfelt operating agreement, each member was to contribute $10,000 as an initial capital contribution, and each member was to receive a 25 percent stake in Heartfelt. In its first year of operations, Heartfelt was very successful. This success, however, led to a disagreement over the future of the business. The Groves advocated expansion into Maryland, and the Browns favored focusing on the existing business in Delaware. As will be further discussed below, the Groves and the Browns also disagreed over whether each member owned 25 percent of the company.

Unable to resolve their disagreements, the Groves proposed to sell their equity to the Browns. The Groves also threatened to seek dissolution. In response, the Browns purported to merge Heartfelt with another entity they had formed, Heartfelt Home Health II, LLC (Heartfelt II). The Browns contended that they could cause a cash out merger because they claimed to hold more than 50 percent of Heartfelt due to the failure of the Browns to make a full capital contribution. In response, the Groves filed an action for breach of fiduciary duty.

As a threshold matter, the court had to determine whether the Browns only owned 50 percent of Heartfelt, which would have denied them the legal authority to merge out the Groves. The Heartfelt operating agreement provided:

> The Members initially shall contribute a total of $40,000 to the Company capital. The description and each individual portion of this initial contribution are as follows:

Hubert E. Brown Jr.	$10,000	25%
Melba E. Brown	$10,000	25%
Larry E. Grove	$10,000	25%
Mary Marlene Grove	$10,000	25%

"The Operating Agreement further provides that profits and losses should be divided among the members 'in proportion to each Member [sic] relative capital interest in the company.'" Although the operating agreement provided that each member would contribute $10,000 in capital, the Groves collectively contributed only $13,000. Specifically, Larry Grove had not contributed the full amount of the required $10,000. Based on this shortfall, the Browns claimed the Grove's collective interest in the company had been reduced below 50 percent. Rejecting this argument and referring to the language cited above, the court stated:

> I find that these terms are unambiguous and that the Operating Agreement therefore provides that each of the four members was – and is today – an equal 25% owner of Heartfelt. Nothing in the Operating Agreement indicates that the allocation of relative ownership interests was contingent on the Members' actions post-signing. Though the Operating Agreement imposes an obligation on the members to provide capital to Heartfelt, the Operating Agreement does not provide that one member's failure to do so divests that member of his or her share of the company.

The court noted Section 18-502(c) permits an LLC agreement to provide for the reduction of a member's interest based on the failure to make a required capital contribution. The Heartfelt operating agreement, however, failed to provide for reduction or dilution of a member's interest in the entity for failure to make such a capital contribution. Accordingly, the court found that Larry Grove held a 25 percent stake in the company despite his deficient capital contribution.

Because the procedural context of the case involved a challenge to the merger of Heartfelt with Heartfelt II, as a partial remedy, the court held there should be an accounting to determine the amount of unpaid capital owed Heartfelt. By extension, in other situations outside of the merger context, if a member has failed to pay all or some of a required capital contribution, an action for breach of contract could be brought against that member to satisfy the unpaid portion of the required contribution.

Conclusion

The policy of both the Delaware LLC Act and the Delaware LP Act is to give the maximum effect to the freedom of contract. To that end, Sections 17-502(c) and 18-502(c) provide partners in Delaware LPs and members in Delaware LLCs the right, but not the obligation, to contract for the appropriate penalties in the event a partner or member fails to make a required capital contribution. However, the case law, and particularly the recent *Grove* case, teaches a number of lessons regarding this freedom to determine the remedy for failure to contribute the required capital. First, both Section 17-502(c) and 18-502(c) are permissive in nature. Based on *Grove*, a court will not attempt to rewrite the parties' agreement to reallocate the membership interest even if the actual contributions are disproportionate. Second, based on the *Telstra* and *Abuy* decisions, courts will strictly apply the language of LP and LLC agreements adopted pursuant to either 17-502(c) or 18-502(c) when considering whether to permit a reduction in interest. Since traditionally equity has abhorred a forfeiture, it is not surprising that courts require careful compliance with provisions that will lead to a forfeiture of some or all of a member's or partner's interest.

Finally, although *Grove* dealt with initial capital contributions, nothing about the decision limits *Grove*'s holding to a failure to make an initial contribution rather than a failure to answer a subsequent capital call. Therefore, if the parties to an operating agreement wish to permit a member's interest to be reduced if that member fails to answer a capital call, the parties should make clear in the operating agreement the penalty of reduction in interest for failing to answer the capital call. Otherwise, there may be an action against the non-contributing member for an unpaid amount of the required capital contribution, but no reduction in membership interest.

Jason C. Jowers is a partner at Morris James LLP in Wilmington, Delaware, where he practices in the areas of corporate, alternative entity, and complex commercial litigation.