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Pre-Emptive Rights In Partnerships and LLCs

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Agreements governing partnerships and limited liability companies that develop, own and operate real estate deal in a variety of ways with the need to raise additional capital. In many cases the general partner or managing member (the sponsor) is given the right to call for capital from the existing members beyond their initial capital contributions. The members may be obligated to contribute capital in response to such a call, in which case they will typically be subject to various penalties if they fail to make their required contribution (including personal liability, punitive dilution, subordination to the additional advances of those who did contribute, right on the part of contributing parties to fund shortfalls as loans bearing a default interest rate, and/or loss of governance rights).

Often additional capital contribution obligations will be subject to a cap or may be limited to the early years of the venture. Such obligations may also be limited to certain specified purposes (such as to cover property taxes, insurance costs or scheduled debt service). Alternatively, capital contributions may be optional, with the additional equity of those who elect to contribute diluting that of the other members (or being treated as a loan or priority capital) but on a non-punitive basis.

It is less common for the sponsor to have a broad right to raise equity capital from third parties or existing investors—or from the sponsor itself or its affiliates—on terms not specified in the partnership or operating agreement. This is in part because giving the sponsor the right to raise third-party capital entails the possibility of introducing a stranger into the collective arrangement—a change that is so fundamental that it would be expected to require the unanimous approval of all parties or at least majority approval. Even if the new equity is being provided by existing investors or the sponsor, it may involve the payment of a priority return, the subordination of the existing equity or other features that significantly alter the basic economics of the entity and may therefore be seen as meriting member approval.

> Granting pre-emptive rights to the other investors in connection with future capital raises can serve as a useful tool in counterbalancing the sponsor's requirement for flexibility with the interests of the other members.

In certain cases, however, particularly where there are multiple minority limited partners or non-managing members with few control rights, the sponsor will be able to negotiate the right to raise capital from third parties or from existing members in its discretion, so long as the existing investors are not disproportionately affected by such capital raise (i.e., as long as a class of interests is not disproportionately affected when compared to another class, or an individual investor is not disproportionately affected when compared to other investors in the same class). It is important to note that if the sponsor is entitled to a carried interest, the absence of a "disproportionate" effect does not necessarily mean that the impact of the additional capital on each existing member would be exactly the same.

Pre-Emptive Rights

There are various protections that can be provided to the investors in lieu of a veto right over the sources and terms of additional capital. The terms of such additional capital could be set forth in the governing agreement—i.e., so long as the sponsor can provide or source additional equity or debt on the terms set forth in the governing agreement, no approval is required from the other investors. A drawback of this approach is that, if additional funds are not available in the then-current market on the specified terms, the sponsor risks being held up by the other investors in its capital-raising efforts. A useful alternative is to grant the investors pre-emptive rights—i.e., a right to provide a pro rata share of the required capital on the same terms as the additional capital provided by the sponsor, other existing investors and/or third parties.

Pre-emptive rights protect the investor, assuming it has the cash to exercise the right, against involuntary dilution, including the potential loss of governance rights if governance rights are tied to the continued ownership of a specified percentage of the entity. Also, and particularly when the additional capital is being provided by the sponsor or its affiliates, pre-emptive rights provide a market check on the terms of the additional capital (although it should be noted that an investor with a strong bargaining position may insist, in addition to pre-emptive rights, on some form of additional market check on capital raises in which it elects not to participate).

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It is important to the investor that the pre-emptive process give the investor sufficient time to determine whether to exercise the right and to obtain the funds to contribute the necessary capital. From the sponsor's perspective, however, the pre-emptive rights process cannot be so cumbersome that the sponsor would risk losing a third party interested in providing additional capital or not having the additional capital available in time for its intended purposes. One solution to addressing both such concerns is to provide in the governing agreement that, if the circumstances require, the sponsor is allowed to consummate the additional capital raise without first giving the pre-emptive rights holders the opportunity to participate, provided that such holders can exercise their pre-emptive rights post-closing.

The terms of any pre-emptive rights, including whether all investors will be granted pre-emptive rights, will vary depending on the nature of the transaction, the parties' relative bargaining power and the nature of the existing investors' respective interests. For example, when a member of the entity is granted interests in the entity as part of an employee incentive plan, it would be typical not to grant pre-emptive rights to such member. The share of the additional investment opportunity subject to pre-emptive rights may also be subject to negotiation. The investors with pre-emptive rights are typically given an "over-allotment" right, which allows any investor that exercises its pre-emptive rights to also provide its proportionate share of any capital that other investors with pre-emptive rights elect not to provide.

Potential Exclusions

The following highlights several potential pre-emptive rights exclusions.

Debt Financing. The additional capital required by the entity may take the form of a loan from the sponsor or a third-party lender. It would be unusual (and highly impractical) if investors were granted pre-emptive rights with respect to third-party debt financing. However, granting pre-emptive rights with respect to sponsor loans would provide the investors protection against non-market terms in the absence of other protections in the governing agreement.

Sponsor Equity Financing. In some transactions the sponsor may have the right to contribute additional needed equity without giving the other investors pre-emptive rights. However, in such cases the governing agreement would likely set forth some parameters with respect to the terms of such sponsor equity or, at the very least, require that such equity be provided on arms' length terms (perhaps by reference to actual third-party terms available in the marketplace).

Known Additional Closing Capital Needs. If the parties know at the time of closing that the entity will require additional funds for its initial purposes (e.g., to close on the acquisition of the target real property or to undertake known capital improvement projects), the capital needed to fill such gaps in the entity's initial capitalization might be excluded from the existing investors' pre-emptive rights on the theory that the sponsor needs to be able to raise the additional capital quickly (without having to go through the pre-emptive rights process) and that, if the existing investors were willing to fill the initial capital shortage, they could have subscribed to a larger share of interests from the outset.

In such instances, the other investors might get protection against dilution on unfavorable terms, or having to accept the introduction of additional parties to the entity, by having the entity's governing documents provide some parameters for the terms of such additional capital and/or the identity of such potential new investors (whether in the form of a specified list of "pre-approved" additional investors or some more general constrains on what constitutes a permitted additional investor).

Other Excluded Equity Issuances. The parties should carefully consider the universe of other exclusions from the investors' pre-emptive rights, so as not to hinder the intended operations of the entity (although the excluded actions may be subject to other restrictions, including treatment as major decisions that require investor approval).

Typical exclusions from investors' pre-emptive rights include (i) the issuances of equity to (or conversion of options or other rights into equity by) employees as part of an employee incentive plan; (ii) the issuance of securities to acquire additional assets; (iii) interests issued in connection with mergers, consolidations and other business combinations involving the entity; (iv) an initial public offering by the entity; and (v) issuance of equity (or granting the right to acquire equity) to a lender in connection with a debt financing transaction (for example, in the form of an equity kicker or convertible debt). Such exclusions permit the entity (subject to any required investor approvals) to undertake activities the primary underlying purpose of which is not simply to raise additional capital to meet capital needs of the entity in connection with the entity's operations but to incentivize management, grow the holdings of the entity, facilitate a business combination, provide an exit for the investors or obtain more favorable loan (or loan workout) terms.

The exact parameters of such exclusions will be subject to negotiations. As an example, the initial public offering carve-out may require that the initial public offering raise a specified minimum amount and/or involve a specified percentage of interests in the entity to qualify for the exception. Similarly, the amount of equity acquired by a lender pursuant to the exception may be subject to a cap.

Conclusion

When representing the sponsor of a real estate partnership or limited liability company, in the absence of an affirmative obligation on the part of the existing investors to provide any additional needed capital, it is important that the documents governing the entity provide for sufficient flexibility for the sponsor to address the entity's future capital needs. Granting pre-emptive rights to the other investors in connection with future capital raises can serve as a useful tool in counterbalancing the sponsor's requirement for flexibility with the interests of the other members, including protecting the other members against the dilution of their equity position in circumstances in which the members would be willing to participate in the additional capital raise. However, the provisions regarding the pre-emptive rights process and the appropriate exclusions from the pre-emptive rights need to be carefully negotiated and drafted.