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LLC interest forfeiture is disfavored - by Thomas Kearns

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Under New York law an LLC member's interest may not be forfeited for a zero or near zero price if the member fails to make a required capital call. New York courts have repeatedly upheld this concept. Cases denying forfeiture include Atlantis v. Nabe ($1 buyout is a "draconian,…unenforceable penalty") and Quinn v. Stuart Lakes (stock becoming void on death is against New York's public policy). There are occasional exceptions depending on the circumstances including if the interest was granted to an employee subject to a vesting schedule and the employee resigns before the vesting date occurs. But despite this inability to forfeit the interest, LLC managers have other tools at their disposal.

First, there are several typical LLC agreement clauses affecting future distributions of profits that LLC managers can use to address a capital contribution default by a member. One is a rescue loan provision where the manager is authorized to arrange for loans from others to cover the defaulted amount at a high interest rate. Often the LLC agreement authorizes the manager itself or other members to make the rescue loan and the rescue loans almost always have a priority when it comes to distributions of the LLC's future profits.

The rescue loan provision is often tied to a dilution provision of the defaulting member's equity percentage in the LLC if the loan is not repaid by the defaulting member quickly. Those dilution provisions permit the lending manager/other members to convert the loan into equity by reducing the defaulting member's percentage of future profits and increasing the percentages of the manager or members who made the default loan (although the future distribution priority often remains). These dilution provisions usually include a significant penalty so that when the dilution is calculated, the defaulted amount is multiplied by 115% or higher percentage to give the funding members consideration for the new investment.

Other tools available to the LLC manager include the loss of voting or approval rights by the defaulting member, assuming they had any to start with, and the triggering of a buy/sell provision. There are many variations of buy/sell provisions with hundreds of articles and books being written about all of the alternatives. But I want to mention a few highlights. First, book value buy/sell clauses are clearly enforceable under New York law even if the book value is significantly less than fair market value. (Stern v. Birnbaum (50% book value clause upheld) and Rosiny v. Schmidt (book value buy/sell is not unconscionable.) More common is a fair market value buyout but there are several key ways the LLC agreement can address the fair market value calculation. One way is to be sure that the clause addresses the fair market value of the defaulting member's interest itself and not such member's interest in the proceeds from the sale of the asset. Sometimes that is expressed as an affirmative statement that the fair market value calculation shall specifically include recognized discounts for the lack of control available to a potential purchaser of the interest and the lack of free marketability of the interest.

Another method of addressing the fair market value buy/sell amount is to grant the LLC manager the right to pick an independent appraiser of its choice to determine fair market value and to have that appraisal be binding. This streamlines the process but care should be taken to make sure the

appraisal is done professionally and is backed up by industry standard procedures so that a court is able to summarily dismiss a complaining defaulting member's claims.

The appraiser selection clause often has standards such as a minimum number of years of experience in a jurisdiction or in a certain type of property or both. Note that strict adherence by the LLC manager to the requirements of the LLC agreement is usually insisted on by a court if the transaction is challenged by the defaulting member.

In sum, in most circumstances LLC agreements can't forfeit a defaulting member's membership interest for the failure to make future capital calls but there are methods that LLC agreements should include to equitably address such default and to compensate the LLC manager or other members who rescue the business.

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