

THE PROBLEM:

Problem assumes that at time of needed investment each original point (bought for \$1000) is worth \$0 but with an additional investment of \$500 (per point) would be worth \$1000. The difficulty is that unless all investors participate all of the new money will be lost.

The problem suggests that the original partnership agreement may provide in different ways that non-contributing partners risk having their ownership interest in the firm diluted if they do not contribute when additional capital is needed.

The partnership agreement needs to provide for this because the default rules in the statutes would not help here. Under UPA and RUPA the partners agree on their respective capital contributions, and in default of agreement partners share equally in profits and assets. The partners could agree to amend the partnership agreement, but that won't help here. Why?

PRO RATA DILUTION:

Issue 500 points at original price of \$1000
Total raised: \$500,000
Total outstanding points: 1500
Value of all outstanding points after new investment: \$1,000,000
Value of each point: $\$1\text{m} \div 1500 = \667

PENALTY DILUTION 1:

Issue 2000 points at \$250 each
Total raised: \$500,000
Total outstanding points: 3000
Value of all outstanding points after new investment: \$1,000,000
Value of each point: $\$1\text{m} \div 3000 = \333

PENALTY DILUTION 2:

Issue 1000 points at \$500 each
Total raised: \$500,000
Total outstanding points: 2000
Value of all outstanding points after new investment: \$1,000,000
Value of each point: $\$1\text{m} \div 2000 = \500

THINGS TO THINK ABOUT:

What are the risks associated with dilution provisions in the partnership agreement?
What might mitigate these risks?

SAMPLE CLAUSES

●Except as set forth in this section, no Member shall be required to make any Capital Contributions. To the extent unanimously approved by the Members, from time to time, the Members may be permitted to make additional Capital Contributions if and to the extent they so desire, and only if the Managers determine that such additional Capital Contributions are necessary or appropriate for the conduct of the Company's business, including without limitation, expansion or diversification. In that event, the Members shall have the opportunity, but not the obligation, to participate in such additional Capital Contributions on a pro rata basis in accordance with their Interests. In the event a Member chooses not to contribute additional capital, his Membership Interest will be diluted proportionately, with the contributing Members' Membership Interests increasing proportionately according to their Capital Contributions and equally by the reduction of a non-contributing Member's Membership Interest.

●If the General Partner determines that the Partnership or any of the Operating Partnerships require funds in addition to the Capital Contributions, the General Partner is authorized to admit additional Partners to the Partnership and the Operating Partnerships, from time to time, upon such terms and conditions as it determines to be appropriate, which shall result in a pro rata dilution of the Interests of the Partners, provided, such additional Partners shall not be Affiliates of the General Partner or Limited Partners, or persons related to the General Partner or Limited Partners unless the General Partner obtains the prior written consent of..., which consent shall not be unreasonably withheld, conditioned or delayed.

●Additional Capital Contributions. In any year in which the Partnership incurs operating deficits, and funds for the payment thereof are not available and cannot be borrowed on terms acceptable to the General Partner, then each partner, general or limited, shall be required to contribute his proportionate share of such deficit as an additional capital contribution (determined in accordance with the percentages for the division of profits and losses provided in Paragraph 8 hereof, as subsequently modified by any other provisions in this Agreement) in an amount not to exceed his proportionate share of the excess of operating expenses and mortgage payments over gross revenues from the property. In the event any partner fails to make any such required contribution within thirty (30) days following the receipt of written notice of the requirement to make such a contribution, such partner shall be deemed in default and the remaining Limited Partners shall have the right to make such additional capital contribution pro rata and thereby increase their percentage interests in the capital of the partnership. In the event all Limited Partners have declined to provide all or any portion of such additional capital, then notwithstanding anything to the contrary herein contained, the General Partner is authorized to admit additional Limited Partners as necessary to raise the additional capital. The percentage interests in the capital and profits and losses of the Partnership shall be adjusted to reflect such additional cash capital contributions of the existing Partners and the admission and cash capital contributions of any Limited Partners to be added.