

# Commercial Aspects of Deficit Restoration Obligations in LLC and Partnership Transactions

By David Burton and Vladimir Fet

This article provides an overview of the commercial aspects associated with the inclusion of a deficit restoration obligation (DRO) in a limited liability company or partnership agreement.<sup>1</sup> A DRO is a tax structuring technique that permits a partner to be allocated more tax losses (e.g., depreciation) or distributed more cash (or other property) than the tax rules view to be the partner's appropriate share.<sup>2</sup>

## Negative Capital Accounts and the PIP Rule

If a partner is allocated more tax losses or distributed more money than the tax rules deem its appropriate share, it results in an "impermissibly negative" capital account. If at the outset of the partnership it is reasonably anticipated that such a situation may occur, the tax rules empower the Internal Revenue Service (IRS) to disregard the allocations provisions of the partnership agreement and to deem the allocations of tax items to be in accordance with the "partners' interests in the partnership" (PIP). Note that the IRS cannot change the cash (or other property) distribution provisions; it is only empowered to change the allocations of tax items.

Applying the PIP rule is straightforward in simple partnerships. For instance, partner A contributes \$60 and partner B contributes \$40 to the partnership. They also agree to share profits and losses 60/40 at all times. Under such facts, application of the PIP rule would result in the allocation of 60% of profit and losses for A and 40% of profit and losses for B. Thus, tax advisors have little to fear from the IRS's application

of PIP. As a result, in partnerships that are less tax intensive, DROs are rarely used.



## DROs in Tax Equity Partnerships

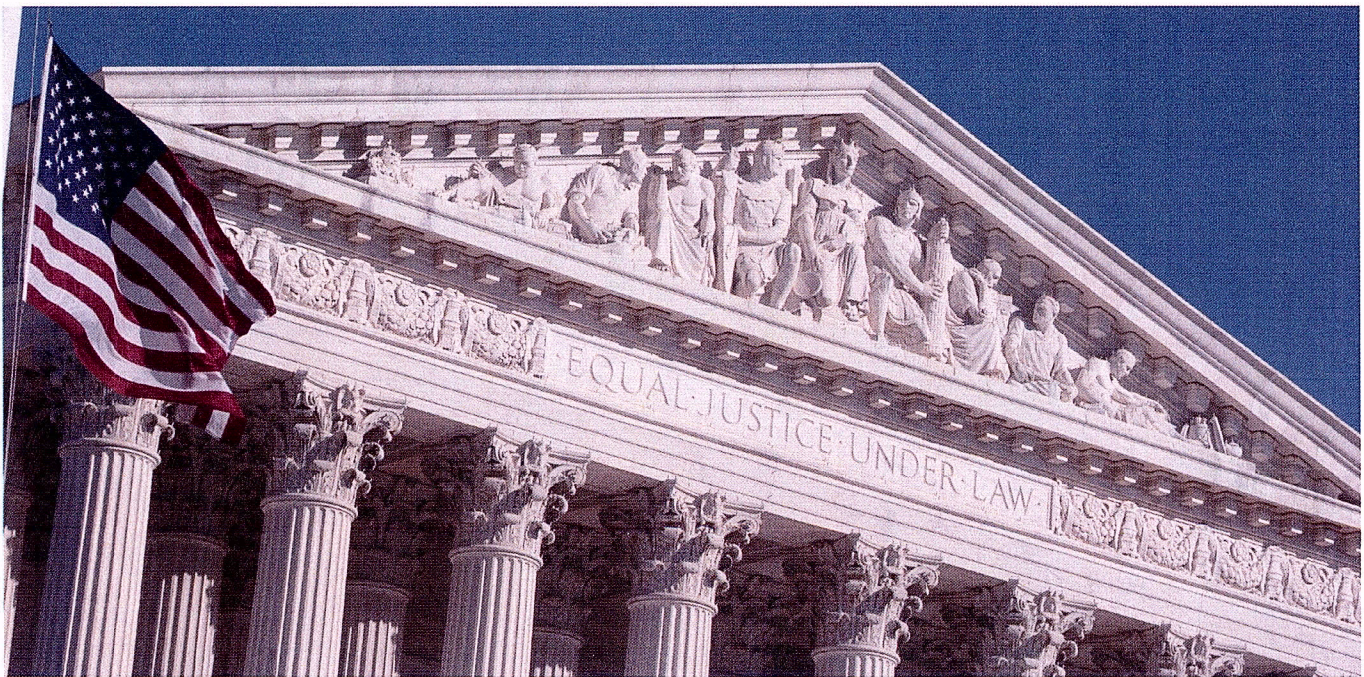
It is less clear how to apply the PIP rule in tax equity flip partnerships, which are commonly used as a source of funding for renewable energy projects. In flip partnership agreements, the allocation percentages do not necessarily track the capital contributions and change as financial hurdles are achieved. Here, the IRS application of PIP could result in the developer being allocated tax credits or depreciation that the partners intended to be provided to the tax equity investor. Thus, DROs are a common feature in renewable energy partnerships because the partners do not want to gamble on what the IRS would deem PIP to be.

A typical DRO provision states that after giving effect to all allocations, distributions and contributions for all periods, if the partner providing the DRO has a deficit capital account balance, such partner will be obligated to contribute cash to the partnership in a specified amount by the end of the partnership's taxable year during which its liquidation occurs

<sup>1</sup> In the remainder of this article, we only refer to a partnership agreement; however, the substantive points we make are equally applicable to a limited liability company agreement.

<sup>2</sup> If a partner is an individual and concerned about the "at risk" tax rules that limit tax benefits associated with nonrecourse debt for which an individual does not have personal liability, it is important to note that the Tax Court has determined that providing a DRO does not make a partner at risk for such debt. *Hubert Enterprises, Inc. v. Commissioner*, 125 T.C. 72 (2005). In other words, from the Tax Court's standpoint, a DRO is not a solution to the potential at risk tax problem that individuals may face.





(or within a specified number of days after the date of such liquidation). The amount of the DRO obligation would be limited to a cap that cannot exceed the amount of the deficit balance in the partner's capital account.

### Triggering a DRO

A DRO provision can only be triggered if the partnership in question has to liquidate, which under typical partnership agreement provisions would be subject to each partner's consent unless required by a court order. The likelihood of a court order requiring the partnership's dissolution is usually remote. There is a higher risk of liquidation for partnerships that own assets that are security for a loan (i.e., a "lowered" deal). In the current market, leveled deals are rare. In renewable energy projects, a court order to liquidate may result from the lawsuit by a plaintiff injured by the partnership's or its contractor's negligent acts or omissions (e.g., during construction or maintenance of a solar project). Usually, such types of losses are covered by the contractor's and/or partnership's liability insurance as well as through the contractor's indemnification obligations in the applicable project document. If, however, the above contractual measures fail to ensure that the full amount of judgment is satisfied by or through the contractor, the court may order that the judgment be enforced against the partnership's assets, which may then be attached and sold. In such an event, a court order for liquidation of the partnership may follow, which will in turn trigger the applicable partner's obligations under the DRO.

Thus, generally speaking, it appears unlikely that a partner would ever be required to satisfy the DRO, absent an unsatisfied plaintiff's judgment or foreclosure by a secured lender.

### DRO Elimination

Although not required by tax rules, partners generally find it to be commercially advantageous for the DRO to be eliminated prior to the end of the transaction. To achieve this, the financial model for the transaction is structured in such a way that if the deal progresses as expected then, prior to the end of the transaction, the capital account of the partner providing the DRO will be at least zero. Thus, the DRO obligation will be effectively eliminated. Such an arrangement enables the partners to liquidate the partnership without having the DRO triggered.

In addition, it is generally market practice that if the partner providing the DRO is a special purpose entity with limited assets, then its DRO obligation needs to be guaranteed by a parent company or another affiliate that is reasonably expected to have assets sufficient to satisfy the DRO. Otherwise, there is a concern that the IRS could attack the substance of the DRO.

*David Burton is a partner in Akin Gump's New York office and Vladimir Fet is counsel in Akin Gump's Los Angeles office. Mr. Burton can be reached at 212.872.1068 and Mr. Fet can be reached at 310.552.6616.*