

Security Interest in Delaware Limited Liability Companies

Norman N. Powell

Introduction

A variety of transactions are structured to involve the creation and perfection of security interests in Delaware limited liability companies (“LLCs”). Some of these transactions are highly specialized, such as so-called mezzanine loans in the commercial real estate context. Others are more ordinary, such as working capital lines or other financings to small businesses. As has been the case historically, such loans are often guaranteed by the business’s owners, who secure their guaranties by granting the lender a security interest in some or all of their interests in the business entity. Based on entity formation trends, businesses are more likely than ever before to be organized as LLCs as contrasted with corporations. This article discusses certain issues relating to the creation and perfection of security interests in LLCs.

What is the Intended Collateral?

Lawyers and their clients often describe the intended collateral as all of the debtor’s “membership interest” in the relevant LLC, which they assume is, ultimately, the debtor’s total economic participation in profits, losses, and distributions (“Economic Rights”) and total voting and managerial control (“Control Rights”). The term “membership interest” is a handy,

but dangerously imprecise, colloquialism when applied to a Delaware LLC. The term does not appear anywhere in the Delaware Limited Liability Company Act, **Del. Code Ann. tit. 6, §§ 18-101 to 18-1109** (the “Delaware LLC Act”). Instead, the Delaware LLC Act carefully distinguishes among Economic Rights, Control Rights, and the status of being a member (“Member Status”). *But cf.* **Cal. Corp. Code § 17001(z); N.Y. Ltd. Liab. Co. Law § 102(r); Fla. Stat. § 608.402(23)** (each referring to a “membership interest” in an LLC).

Statutory Default Rules & Contractual Overrides

Consistent with Delaware’s policy to give “maximum effect to the principle of freedom of contract and to the enforceability” of LLC agreements, Delaware permits and enforces restrictions on the alienability of rights and statuses relating to LLCs. *See Delaware LLC Act § 18-1101(b)*. These restrictions apply to Economic Rights, Control Rights, and Member Status.

Under **§ 18-702(a)** of the Delaware LLC Act, Economic Rights are “assignable in whole or in part except as provided in a limited liability company agreement.” Thus, prohibitions of and conditions to the assignment of Economic Rights are generally enforceable. Although § 9-406 and § 9-408 of the UCC would generally override such restrictions on assignment, Delaware enacted non-uniform text to those provisions, rendering them inapplicable to interests in LLCs, and contemporaneously amended the Delaware LLC Act to like effect. *See Delaware LLC Act § 18-1101(g)*. Thus, Delaware law explicitly provides that anti-assignment provisions will be enforced.

More significantly, the Delaware LLC Act creates a sort of presumption against the assignability of Control Rights and Membership Status. Specifically, it provides that the assignee of a member’s Economic Rights “shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement” and upon satisfaction of certain other conditions. **Delaware LLC Act § 18-702(a)**. The Act also provides that unless the LLC agreement provides otherwise, “[a]n assignment of a limited liability company interest does not entitle

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the assignee to become or to exercise any rights or powers of a member.” **Delaware LLC Act § 18-702(b)(1)**. With respect to Membership Status, it provides that:

An assignee of a limited liability company interest may become a member as provided in a limited liability company agreement and upon (1) the approval of all of the members of the limited liability company other than the member assigning limited liability company interest; or (2) compliance with any procedure provided for in the limited liability company agreement.

Delaware LLC Act § 18-704(a).

Thus, while a secured party can freely enjoy Economic Rights, subject to compliance with restrictions and waiver of prohibitions, if any, contained in the LLC agreement, a secured party can enjoy Control Rights and achieve Member Status only to the extent provided in the LLC agreement or otherwise approved by the LLC’s members.

Attachment, Perfection, and Enforcement of a Security Interest

Attachment. Commercial lawyers representing secured parties need to understand the foregoing and its impact. Because Economic Rights are assignable unless specified otherwise in the LLC agreement, a security interest can readily be created in them. By contrast, Control Rights and Member Status, generally speaking, are assignable only if and as provided in the LLC agreement. Whatever the intended scope of collateral, commercial lawyers should consult the LLC agreement to determine to what aspects of a Delaware LLC interest, if any, a security interest can attach. That caveat aside, such a security interest would be created in the ordinary manner. Likewise, perfection is fairly straightforward, though not without some threshold issues.

Perfection. Although an interest in an LLC is typically a general intangible, it is a security governed by UCC Article 8 if it is traded on a securities exchange or its terms expressly so provide. *See* UCC § 8-103(c). Control is the preferred method to perfect security interests in securities, though such security interests may also be perfected by the filing of financing statements. *See* UCC §§ 9-328(1), 9-312(a). Thus, secured parties should file in any event, as a simple and effective means in all cases of perfecting a security interest in an LLC interest. Secured parties

should also achieve “control” if the interest constitutes a security, either by virtue of where it is traded or due to a statement to that effect in the LLC agreement or on a membership certificate.

Enforcement. Article 9 contemplates that the purchaser at a foreclosure sale succeeds to all of the debtor’s rights to the collateral. U.C.C. § 9-617(a)(1). A different result follows from the default rules of the Delaware LLC Act, which are clear on the point that no one can acquire or exercise Control Rights or Member Status absent approval of the remaining members or as provided in the LLC agreement. In other words, if a security interest attaches only to Economic Rights, then a foreclosure sale buyer will acquire only those Economic Rights. Thus, absent facilitative language in the LLC agreement or in a separate document, the foreclosed-upon debtor, who has no further Economic Rights, continues to enjoy whatever power it previously had to decide, for example, when, if ever, to make distributions, sell assets, or wind-up the company. The secured party who has neither Control Rights nor Member Status, is relegated to hopeful impotence. The secured party may seek the entry of a charging order, which is “the exclusive remedy by which a judgment creditor of a member or of a member’s assignee may satisfy a judgment out of the judgment debtor’s limited liability company interest.” **Delaware LLC Act § 18-703(d)**. But even this remedy does not compel the managers to declare a distribution.

Even if the LLC agreement expressly authorizes a member to pledge or assign Control Rights or Membership Status, commercial lawyers should be cognizant of the fact that the LLC agreement could later be amended to delete that authorization. While it is unlikely that such an amendment could invalidate the prior grant of a security interest, it might impair the secured party’s later ability to consummate a sale of the Control Rights or Membership Status. Accordingly, caution demands that the members contract not to make such an amendment and that the LLC agreement itself prohibit such amendment absent consent by the secured party.

Conclusions

When addressing a security interest in a Delaware LLC, care should be taken to describe the collateral by use of words and phrases with sufficient antecedents in the Delaware LLC Act or the relevant LLC agreement. The term “membership interest,” while featured in the LLC Acts of some states, appears nowhere in the

Delaware LLC Act. Economic Rights can be pledged as security unless the LLC agreement provides otherwise. Control Rights and Member Status are a different matter. A secured party, or third-party purchaser at a foreclosure sale, cannot succeed to Control Rights or Member Status absent facilitative affirmative language or action. The Delaware LLC Act affords the contractual flexibility necessary to facilitate a secured party's succeeding to Economic Rights, Control Rights, and Member Status, but requires that care be taken in drafting the LLC agreement and security agreement to facilitate that outcome.

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Exercising Voting Rights After Default

Stephen L. Sepinuck

Imagine that, in connection with a loan to either a limited liability company ("LLC") or its members, the lender obtains a security interest in the economic rights and control rights of one or more of the members. Perhaps these rights are the primary collateral. Alternatively, the assets of the LLC may be the primary collateral and the security interest in these rights is merely intended to help ensure that the LLC will not interfere with enforcement actions against its assets by, for example, filing for bankruptcy protection. In either case, the borrower defaults and now the secured party wishes, pending a sale of the membership interests, to exercise the control rights. May it do so? A recent decision puts a hurdle in the lender's path, but one that the lender can avoid with careful drafting and due diligence.

The Court Decision

In *In re Lake County Grapevine Nursery Operations*, **441 B.R. 653** (Bankr. N.D. Cal. 2010), the members of two California LLCs pledged their membership interests to secure an \$800,000 debt. The pledge agreement purported to automatically cut off the members' voting and distribution rights upon default and to vest those rights in the secured party. When,

after default, the LLCs filed Chapter 11 bankruptcy petitions, the secured party moved to have the proceedings dismissed on the ground that the members lacked the authority to file the petitions for the LLCs.

The court acknowledged that, in the absence of specific state law to the contrary, the occurrence of default is sufficient to trigger a transfer of voting rights to a secured party. However, the court concluded that the California Corporations Code did indeed provide to the contrary. Specifically, **§ 17150** provides that an LLC must be managed by its members unless the articles of organization provide otherwise. **Section 17301(c)** then provides that the "granting" of a security interest in a membership interest "shall not cause the member to cease to be a member or to grant anyone else the power to exercise any rights or powers of a member."

Reading these two provisions together, the court concluded that a secured party could not exercise pledged voting rights until the secured party had enforced the security agreement and become a member. Neither pledging a membership interest nor declaring a default was sufficient.

A Brief Critique

The court's analysis is unpersuasive and its conclusion questionable. After all, **§ 17301(c)** states merely that the *creation* of a security interest does not affect a member's voting rights; it says nothing about a default under the terms of the security agreement. In contrast, UCC § 9-601(a) expressly states that a secured party has the rights "provided by agreement of the parties" except to the extent § 9-602 provides otherwise. Nothing in § 9-602 in any way restricts or invalidates an automatic transfer of voting rights upon default or a declaration of default. The court should have been reticent to read the California Corporations Code so broadly as to conflict with Article 9.

Moreover, the court's analysis suggests that, unless the articles of organization provide otherwise, no one other than a member can ever exercise the member's voting rights. But it is highly unlikely the Corporations Code was intended to abrogate the law of agency. After all, when a corporation is a member of an LLC, it must act through a human agent, suggesting that someone other than the member itself must be able to exercise a member's voting rights. A secured party exercising post-default remedies is essentially an agent appointed by the debtor, albeit one acting for its own benefit rather than for the debtor's.

Drafting Advice

It may be possible to draft around the court's conclusion, at least if the applicable business organizations law is similar to California's. The court's analysis was based in part on [California Corporations Code § 17150](#), which permits an LLC to be managed by someone other than a member if the LLC's articles of organization so provide. Accordingly, a prospective lender should insist that the articles of organization be amended to permit the lender, after declaring a default, to either: (i) manage the LLC; or (ii) exercise the voting rights of the members whose interests have been pledged. The lender should also insist on an agreement from all concerned not to thereafter repeal that amendment.

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When Does an Enforceable Contract Exist: Avoiding Unnecessary Litigation

John Drake

Classic contract doctrine teaches that an agreement to agree is not binding on the parties, and that determining whether the parties have made an enforceable agreement depends in part on their objective manifestation of assent to a bargain. Generally, the question of whether the parties have reached agreement is a factual question. These simple propositions lead to difficult questions in their application when the parties have memorialized part or all of their agreement in written documents. As parties negotiate terms, they often document agreement to those terms in written proposals and counterproposals.

The Ninth Circuit's decision in *First National Mortgage Co. v. Federal Investment Realty Trust*, [631 F.3d 1058](#) (9th Cir. 2011) serves as an important reminder of these basic principles. A mortgage company and a real estate developer entered into protracted negotiations over a proposed lease of commercial real estate. As the negotiations progressed,

the parties exchanged a series of documents which outlined the parties' respective proposals and counterproposals. The last of these documents was styled as a "Final Proposal" and was signed by representatives of both parties. The final paragraph of the document provided that "[t]he above terms are hereby accepted by the parties subject only to approval of the terms and conditions of a formal agreement."

Predictably, this arrangement ultimately proved that "the devil is in the details." When the parties were unable to agree to further "terms and conditions," the developer walked. The mortgage company sued for breach of contract and was awarded summary judgment. On appeal, the developer argued that the Final Proposal was not binding because the parties had contemplated further negotiations as well as the execution of a formal lease agreement. In rejecting this argument, the court applied a familiar rule of contract law: "Whether a writing constitutes a final agreement or merely an agreement to make an agreement depends primarily upon the intention of the parties . . . [which] must be determined by a construction of the instrument taken as a whole." Given that the document was a "Final Proposal" and that the developer had failed to include standard non-binding language – which it had included in prior drafts – the court affirmed the jury verdict that the agreement was indeed binding.

In order to avoid costly litigation over whether parties intended to be bound by terms in a document generated during negotiations, attorneys should incorporate – or perhaps more fittingly, counsel their clients to incorporate – language into every non-final written document clearly stating whether the document is binding or non-binding.

By signing this document, the parties hereby acknowledge that this agreement is a binding and enforceable contract, notwithstanding the possibility of further negotiations or the execution of a formal agreement in the future.

or

This document is intended to memorialize certain terms and conditions to which the parties have tentatively agreed in the course of negotiation. By signing this document, the parties acknowledge that the terms in this document are not intended to constitute a binding

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Document the Representative Capacity of the Secured Party of Record

Brittney McCarthy

Article 9 expressly provides that a filed financing can be sufficient even if it identifies as the secured party a collateral agent or other representative, and even if that person's agency status or representative capacity is not indicated on the financing statement. *See* §§ 9-502(a)(2), 9-503(d) & cmt. 3.

Nevertheless, without some authenticated record attesting to the filer's agency status or representative capacity, the real secured party or parties may be left with an unperfected interest. This is the lesson gleaned from a recent bankruptcy decision, in which the court had to determine whether the transactional documents in question granted some secured parties the authority to file on behalf of several others. *In re QuVIS, Inc.*, **2010 WL 2228246** (Bankr. D. Kan. 2010).

In that case, after the lapse of the initial financing statement, which separately identified each of several dozen noteholders involved in a transaction as secured parties, a few of the noteholders filed new financing statements. Each of the new financing statements identified only the filer as the secured party. Subsequently, in the debtor's bankruptcy proceeding, some creditors challenged whether the remaining noteholders were perfected.

Although the loan agreement authorized "each Lender to perform every act which such Lender considers necessary to protect and preserve the Collateral and Lenders' interest therein," the court concluded that an alleged agent or representative must be able to demonstrate some source of its authority. Because the loan agreement did not contain language expressly authorizing any of the listed noteholders to act as an agent or representative of the others, the court ruled that the security interests of the other noteholders were unperfected.

Other courts have reached similar conclusions. For example, the court in *In re Adirondack Timber Enterprise, Inc.*, **2010 WL 1741378** (Bankr. N.D.N.Y. 2010), ruled that even if the debtor had granted a security interest to a manufacturer's subsidiary, that security interest was not perfected by the manufacturer's filing. In *In re Amron Technologies, Inc.*, **2007 WL 917236** (Bankr. M.D. Ga. 2007), the

court held that only one of four joint creditors – the one who had filed a financing statement – was perfected because there was no express or implied agency agreement among the creditors that made the filer's financing statement effective for the other creditors.

These cases convey an important lesson for secured parties: include in the loan agreement, the security agreement, or in some separate document, language by which: (i) the secured party appoints the filer as its representative or agent; and (ii) the representative or agent accepts that appointment. The following language should suffice:

Secured Party hereby appoints [name, its successors and assigns] to act as Secured Party's representative, and [name] agrees to act as a representative of Secured Party, in perfecting Secured Party's security interest in the Collateral by filing one or more financing statements or amendments thereto, taking possession of Collateral, or obtaining control over Collateral.

or

Each Secured Party authorizes the other Secured Parties, their successors, and assigns, individually and collectively, to act as Secured Party's representative, and each Secured Party agrees to act both for itself and as a representative of the others, in perfecting the security interest in the Collateral by filing one or more financing statements or amendments thereto, taking possession of Collateral, or obtaining control over Collateral.

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Recent Cases

SECURED TRANSACTIONS

Attachment Issues

Zaremba Group, LLC v. FDIC,

2011 WL 721308 (E.D. Mich. 2011)

Husband of managing member of LLC had no apparent authority to grant bank a security interest in an LLC's certificates of deposit because apparent authority must arise from acts of the principal, not the agent, and the LLC did nothing other than make the initial deposit

shortly after the husband said it would occur. The LLC did not ratify the purported grant by signing a bank resolution ratifying all transactions purportedly done on the LLC's behalf because the LLC had no knowledge of the husband's actions at the time and the loan purportedly secured by the CDs was not for the LLC's benefit.

Perfection Issues

In re Camtech Precision Mfg., Inc.,

2011 B.R. 190 (Bankr. S.D. Fla. 2011)

Filed financing statement that listed additional debtors on separate exhibits but which lacked a check mark in the additional debtors box on the first page was inadequate to perfect security interests granted by additional debtors because the filing was not indexed by or discoverable under the names of the additional debtors.

Priority Issues

In re Arctic Express, Inc.,

2011 WL 722211 (6th Cir. 2011)

Bank with a security interest in accounts of regulated motor carrier was liable to independent drivers who obtained class action settlement against carrier for breach of escrow obligations. The regulations under the Motor Carrier Act created a trust by operation of law that was funded as soon as the carrier's customers paid – not when the funds were later transferred from the cash collateral account to the operating account or when the carrier paid the drivers after subtracting the amount to be held in escrow – and the bank was not a good faith purchaser of the funds because it was a secured lender, not a buyer of the accounts.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Textron Financial Corp. v. Ship and Sail, Inc.,

2011 WL 344134 (D.R.I. 2011)

Jury waiver clause in loan agreement was not binding on guarantors, whose guaranty agreements contained no such clause.

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Center of Hope Christian Fellowship v. Wells Fargo Bank,

2011 WL 939235 (D. Nev. 2011)

Clause in agreement providing that the agreement's arbitration clause "does not limit the right of any party to . . . foreclose against real or personal property collateral" did not constitute a waiver of the right or obligation of any party to submit any dispute to arbitration, in part because the debtor disputed whether a default had occurred. Separate clause providing that no dispute concerning the debt will be submitted to arbitration unless the mortgagee so elects was substantively unconscionable because it was one-sided.

Schron v. Grunstein,

2011 WL 539154 (N.Y. Sup. Ct. 2011)

Option agreement and credit agreement executed the same day by substantially the same parties and later amended on the same day were to be regarded as separate agreements, in part because of the lack of cross-references and the existence of a merger clause in the option agreement. As a result, funding the loan pursuant to the credit agreement was not a condition precedent to the enforceability of the option agreement.

West Ridge Group, LLC v. First Trust Co. of Onaga,

2011 WL 635567 (10th Cir. 2011)

Loan agreement that provided that "Borrower may pay . . . a pro-rata share of any outstanding indebtedness to obtain a corresponding pro-rata partial release" of the mortgaged property required borrower to pay based on the relative value – not the relative acreage – of the parcel to be released.

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