

Expert Q&A on Current Issues with LLC/LP Interests as Collateral

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An expert Q&A with Tarik J. Haskins, Morris, Nichols, Arsht & Tunnell LLP on current issues with limited liability company interests and limited partnership interests as collateral.

Limited Liability Company (LLC) and Limited Partnership (LP) Interests are Often Used as Collateral by Borrowers. What Trends Have You Seen Recently Relating to LLC/LP Interests as Collateral? What are the Reasons for These Trends?

LLC interests is a term commonly used to describe a member's ownership interest in an LLC. State laws may use different terminology for LLC interests, including membership interests or units. State laws may also differentiate between the status of a member and the different rights a member has relating to their LLC interest, for example governance rights and economic rights. These same issues also apply to LP interests. If parties are not familiar with these state law issues, they should consult local counsel.

Interests in LLCs and LPs are often important collateral for a secured party and this collateral raises additional issues for counsel compared to a pledge of corporate shares. For more information, see [Practice Note, Security Interests: LLC and LP Interests](#). For the purposes of this Article, where appropriate, LLC/LP interests means LLC interests or LP interests.

One of the trends that we have noticed in recent years is a focus on the ability to exercise control rights over the LLC/LP interests. Secured parties are frequently focused on ensuring that the security agreement will permit them, following an event of default under the security agreement, to exercise control rights in the LLC or LP so that they can cause the LLC or LP to take

actions that preserve the value of the secured parties' collateral.

During the COVID-19 pandemic and as a result of the economic strain on many businesses, we saw many secured parties attempt to enforce the rights and remedies provided to them under their security agreement. The preferred mode of enforcement by secured parties was often the exercise of a proxy or power of attorney granted to the secured party in the security agreement. For more information on proxies and powers of attorney, see the discussion below.

Secured parties sought to direct the operations of the subject LLC or LP without actually becoming the owner of the LLC/LP interests. We saw secured parties use the proxy/power of attorney to:

- Put new management in place.
- Run a sale process to sell the entity.
- Effect other changes at the LLC or LP.

This trend, we believe, was a result of secured parties seeking to exercise their rights with reduced risk and in a manner that would not involve obtaining full ownership of the pledged LLC/LP interests.

What are the Current Drafting Issues in Operating Agreements and Security Agreements for LLC/LP Interests as Collateral Relating to UCC Collateral Classification?

As noted above, many secured parties are focused on enforcement rights and therefore have focused more intently on at least two issues.



The first issue is the proxy/power of attorney and ensuring that the proxy/power of attorney is drafted:

- Broadly enough to allow the secured party to take the actions as it determines to be necessary or desirable to preserve the value of its collateral.
- To allow the secured party to exercise the proxy/power of attorney without consent or further action by the pledgor or prior notice to the pledgor.

For purposes of the Delaware Limited Liability Company Act (the Delaware LLC Act) and the Delaware Revised Uniform Limited Partnership Act (the Delaware LP Act), a proxy and a power of attorney are devices used to authorize another person to act on behalf of the person granting the proxy or power of attorney. Traditionally, a proxy is limited to granting authority with respect to acting for another under corporate law to vote the grantor's shares. A power of attorney, however, is not limited to corporate law and permits a grant of authority to act as an agent or attorney-in-fact for a grantor more generally.

While the distinction between a proxy and a power of attorney may be relevant with respect to corporations because statutes like the Delaware General Corporation Law set out rules governing the use of proxies, the distinction is less relevant under Delaware's alternative entity laws because neither the Delaware LLC Act nor the Delaware LP Act set out rules for the use of proxies and generally treats proxies and powers of attorney the same.

Under each of the Delaware LLC Act and the Delaware LP Act, unless an entity's governing document provides otherwise, the use of proxies and powers of attorney are permitted. Consequently, this article will not distinguish between proxies and powers of attorney and any reference to a proxy/power of attorney, will refer to an authorization by the grantor act on its behalf.

The second issue relates to ensuring that the security agreement and the entity's governing documents act in harmony with one another, so that the governing documents of the entity do not function to prevent the secured party from exercising rights granted to it in the security agreement. For example, we have encountered a security agreement that granted the secured party a proxy to vote the pledged LLC interests but required registration of the proxy on the books of the LLC prior to exercising this proxy. The secured party therefore needed the subject LLC to register the proxy on its books and

records as a condition precedent to exercise and the subject LLC refused to do so.

In addition, we have seen governing documents that require consent of the LLC/LP or pledgor before a person can be "admitted" to the entity and exercise governance rights in the event of a foreclosure.

The foregoing circumstances illustrate the importance of ensuring that the security agreement and governing documents sync up, including as it relates to foreclosing on LLC/LP interests and ensuring that a transferee can be admitted to the LLC or LP as a partner or member and exercise governance rights following a foreclosure.

What are the Current Drafting Issues in Operating Agreements and Security Agreements for LLC/LP Interests as Collateral Relating to Governing Law?

As it relates to governing law issues, there are no recent drafting issues related to governing law clauses. Most secured parties continue to prefer New York law as the governing law for security agreements. In spite of the security agreement's choice of law, however, it will be important for a secured party to understand the underlying law for the subject LLC/LP because this law will have an effect on how rights are exercised with respect to the subject LLC or LP, including any requirements related to the exercise of a proxy/power of attorney or admission to the subject LLC or LP as a partner or member.

What are the Current Drafting Issues in Operating Agreements and Security Agreements for LLC/LP Interests as Collateral Relating to Transfer Restrictions?

As noted above, secured parties are keenly focused on transfer restrictions and primarily focused on making sure that the governing documents act in harmony with the security agreement. A secured party will want to make sure that it can exercise all of the rights granted to it in the security agreement, without impediment from the governing document. In particular, secured parties will be focused on ensuring that the proxy/power of attorney

granted to it in the security agreement can be exercised without any action by the pledgor or the subject LLC or LP.

Further, secured parties have sought to draft the operating agreement in such a way that the LLC/LP interests issued by the subject LLC or LP function like shares of stock of a corporation and allow a transferee to succeed to a transferor's governance rights automatically without any action or approval by any other person. If a secured party's diligence reveals possible issues that might arise regarding exercising its rights following a foreclosure of the LLC or LP interests, then a secured party may seek to amend the relevant governing document to ensure that it is able to exercise these rights.

Finally, it is worth noting that in 2018, the American Law Institute (ALI) approved amendments to Article 9 of the Uniform Commercial Code (UCC) that would render Sections 9-406 and 9-408 inapplicable to a security interest in an ownership interest in an LLC or LP. Therefore, while Sections 9-406 and 9-408 of the UCC offered a limited override of transfer restrictions set out in a governing document, the proposed amendments will render this limited override inapplicable to pledges of LLC/LP interests. For more information on UCC Sections 9-406 and 9-408 and this override, see the discussion below.

While the Delaware UCC already provided that Sections 9-406 and 9-408 were inapplicable to LLC/LP interests, in coming years other jurisdictions are likely to adopt the proposed amendments to the UCC making Sections 9-406 and 9-408 inapplicable to a pledge of LLC/LP interests. Therefore, secured parties will need to be even more vigilant in making sure that any transfer restrictions in an entity's governing documents do not limit their ability to transfer the LLC/LP interests as part of its enforcement remedies.

What are the Current Drafting Issues in Operating Agreements and Security Agreements for LLC/LP Interests as Collateral relating to Distributions and Proceeds?

As it relates to drafting issues around distributions and proceeds, we are not aware of any recent developments. Secured parties continue to draft the security agreement to:

- Permit distributions by the subject LLC or LP before an event of default.
- Following an event of default, prohibit any distributions.

What are the Current Drafting Issues in Operating Agreements and Security Agreements for LLC/LP Interests as Collateral relating to Remedies?

As it relates to remedies and current drafting issues, I think the primary issue that we see is ensuring that:

- There is no requirement for action by the pledgor or subject LLC or LP before exercising remedies.
- Any notice requirement provides for a short notice period to allow for a secured party to exercise remedies as quickly as possible.

As we might expect, when a secured party seeks to exercise remedies, the debtor may not be as compliant as a secured party might desire. It is therefore imperative that the provisions in the security agreement are not drafted to require any action by the pledgor or subject LLC or LP prior to exercising enforcement remedies. For example, we have found that proxies/powers of attorney that require registration by the LLC or LP before exercise may be difficult to enforce because the LLC or LP will be resistant to register it.

What Other Issues Are You Seeing Relating to LLC/LP Interests as Collateral?

The only other issue that we have seen more recently is a focus on covenants related to an "opt-in" to Article 8 of the UCC.

As we might expect, secured parties will focus on making sure that a secured party's collateral will remain the same type of collateral for UCC purposes for the term of the security agreement. Under the UCC, LLC/LP interests constitute "general intangibles" by default, however, if the subject LLC or LP "opts in" to Article 8 of the UCC, then these interests are transformed into "securities" for UCC purposes.

The method of perfection and priority rules vary depending on how the LLC/LP interests are categorized for UCC purposes. Therefore, a secured party should seek assurances through the covenants in the security agreement to make sure that these LLC/LP interests remain the same type of collateral for UCC purposes during the term of the security agreement.

How has the Legal Landscape for LLC/LP Interests as Collateral Changed Recently, Including in Delaware?

The legal landscape in Delaware for LLC/LP interests has not really changed.

The legal landscape outside of Delaware has changed some as it relates to the limited transfer restriction override provided by Sections 9-406 and 9-408 of the UCC.

One of the fundamental principles underlying each of the Delaware LP Act and the Delaware LLC Act is the “pick your partner” principle. The “pick your partner” principle holds that it is important to the owners of an LLC and LP who their co-owners are and a co-owner should not have the ability to transfer its equity interests and force a new co-owner on the non-transferring persons. Therefore, by default, LLC/LP interests in an LLC and LP are non-transferable without the consent of the other owners. The “pick your partner” principle is in tension with the principle underlying the UCC which seeks to facilitate voluntary transfers of personal property. The UCC principle of facilitating voluntary transfers is reflected in the anti-assignment provisions set out in Sections 9-406 and 9-408 of the UCC, which seek to override certain transfer restrictions.

Many years ago, Delaware included in its UCC statute, a provision that makes clear that Sections 9-406 and 9-408 of the UCC do not apply to security interests in LLC/LP interests. In 2018, the ALI approved amendments to the UCC that would follow the Delaware UCC by rendering the transfer restriction overrides provided by Sections 9-406 and 9-408 inapplicable to security interests in LLC/LP interests. Although not many states have amended their UCC statutes to incorporate this change, we believe states will do so in the near future. Once a state passes this amendment, it will put more pressure on secured parties to draft security agreements and governing documents in such a way that the transfer restrictions set out in the

governing documents do not adversely affect a secured party’s ability to enforce its remedies in the security agreement.

It is worth noting that even in states that do not adopt the proposed amendments, secured parties should still recognize the limited benefits provided by the Sections 9-406 and 9-408 of the UCC, in that these provisions do not apply to collateral that constitutes “securities” for purposes of the UCC. LLC/LP interests do not constitute securities for UCC purposes unless the issuer of these LLC/LP interests “opts in” to Article 8 of the UCC pursuant to its constituent documents. Therefore, to the extent that a secured party is taking LLC or LP interests as collateral that are subject to an “opt-in”, the secured party should be aware that it will not be able to rely on Sections 9-406 and Section 9-408 anti-assignment override at all. In this case, a secured party will either:

- Need to understand that its enforcement rights may be limited by an issuer’s transfer restrictions.
- Enter into documentation with the issuer and co-owners to allow the secured party to exercise its rights under the security agreement without limitation.

What Do You Think Will be the Most Important Issues in the Future for LLC/LP Interests as Collateral?

I believe that the use of proxies/powers of attorney will be one of the most important issues that affect the use of LLC/LP interests as collateral. These enforcement mechanisms can be a powerful and quick way for a secured party to “step into the shoes of the pledgor” and preserve its collateral without the obligation of becoming the owner of the subject LLC or LP. During the COVID-19 pandemic, we saw secured parties use this tool to quickly step in and preserve their collateral when other more cumbersome enforcement remedies could not have been exercised in a timely manner.

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