Mezzanine Loans: The Vagaries Of Membership Interest Collateral

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Norman M. Powell and James D. Prendergast

Does a mezzanine lender succeed to Economic Rights, Control Rights, and Member Status of the borrower after a default? The answer might surprise you.

IT'S EARLY in the summer of 2007. Pat is a promising young associate, licensed and practicing with a major firm in California (although the attorney could be licensed and practicing anywhere), and probably a real estate attorney (although the attorney need not be that either). Pat's firm represents a lender (you remember those — an entity authorized and empowered, and at certain points in the economic cycle inclined and able, to extend credit). The pending transaction is a so-called mezzanine loan, and will be secured by a security interest in the membership interests in a Delaware limited liability company (LLC). (A "membership interest" may (or may not) consist of some combination of what is referred to in this article as Economic Rights, Control Rights, and Member Status.) Scanning the firm's forms file for an equity pledge agreement, Pat finds the form used in a large number of similar transactions. It includes a choice of California law as governing. After filling in the name of the lender client as secured party and the name of the pledging member as debtor, Pat enters the text "100% of the membership interest in 1000 Park Avenue LLC, a Delaware limited

liability company" for the definition of "Collateral" and formats appropriate signature blocks. After review by the partner in charge of the transaction, the document is forwarded to borrower's counsel, who is expected to opine as to, among other things, its enforceability.

The lender has made the loan on the basis that, should there occur a default, it can exercise its remedies and, in effect, take over 1000 Park Avenue LLC or facilitate a third party's doing so following a foreclosure under Part 6 of U.C.C. 9 (Article 9). The lender, and any such third party, will want more than a mere right to receive any distributions — a recovery similar to that afforded by a charging order. (A charging order is the exclusive remedy by which a judgment creditor of a member of a Delaware LLC or of a member's assignee may satisfy a judgment out of the judgment debtor's LLC interest. A judgment creditor has only the right to receive any distribution or distributions to which the judgment debtor would otherwise have been entitled. *See* 6 Del. C. §18-703.) The lender will want full operational and managerial authority over 1000 Park Avenue LLC and the ability to develop or otherwise deal with the fledgling project. Lender's counsel's security agreement, referring as it does to "100% of the membership interest," seems to facilitate this outcome, and borrower's counsel's enforceability opinion, though limited to California law, seems to provide additional comfort to such effect.

Alas, 2007 was long ago. It is now 2010, the project has stalled, and the lender is considering declaring a default. The lender, recognizing that real estate values have fallen, knows that exercising its remedies may or may not make it whole, but is glad it can at least take over the project (or initiate a sale to a third party willing to do so), and reap the best outcome available in the current market. But the lender may have gotten something quite different than it thought, and perhaps quite different than its counsel thought. Borrower's counsel's enforceability opinion, while perhaps accurate and prepared with appropriate care, may have unwittingly reinforced the misunderstandings. 2010's soft market is about to deal a harsh blow to one lender and, perhaps, to two law firms. It is possible, though, that the current relations between the lender and the borrower are such that these issues can be revisited and documents revised as appropriate to better assure the intended outcome should default and exercise of remedies occur.

In recent years, a great many real estate projects have been financed by a combination of traditional mortgage loans and so-called mezzanine loans. The former are loans extended to the entities that own the projects, and are generally secured by first-priority mortgages thereon. The latter are loans extended to the parent entities of the entities that own the projects (or the parents of such parents through multiple tiers), and are secured by Article 9 security interests in the parent entity's interest in its direct subsidiary, which for a variety of reasons is often a single-member Delaware LLC. This article discusses certain issues relating to the creation and enforcement of security interests in "membership interests" in limited liability companies, including issues of dissociation, dissolution, and cancellation. (For a general discussion of the formation and use of Delaware alternative entities, see Norman M. Powell, *Delaware Alternative Entities — The Benefits and Burdens of Contractual Flexibility,* Probate and Property, January/February 2009, at 11.) While its focus is on the single-member LLCs that predominate in mezzanine loans, the concepts discussed are generally applicable to multi-member limited liability companies as well, though some will have fewer and less significant consequences to other limited liability companies so long as they continue to have more than one member.

"MEMBERSHIP INTEREST" COLLATERAL • Often the lender and borrower describe the intended security for the mezzanine loan as 100

percent of the "membership interest" in the LLC, which, they assume, is very much like 100 percent of the stock in a corporation, which is to say, ultimately, total economic participation in profits, losses, and distributions (Economic Rights) and total voting and managerial control (Control Rights). The term "membership interest" often appears in the granting clauses of security agreements, in the collateral descriptions in related U.C.C.-1 financing statements, and in control agreements by which security interests in uncertificated securities may be perfected. (An interest in a LLC is typically a general intangible, but it is a security governed by U.C.C. Article 8 if its terms expressly so provide. *See* U.C.C. §8-103. 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* U.C.C. §§9-328(1) and 9-312(a).) But the term "membership interest," as applied to a Delaware LLC, is fraught with ambiguity — the term does not appear anywhere in the Delaware Limited Liability Company Act, 6 Del. C. §18-101 – 18-1109 (Delaware LLC Act). Rather, the Delaware LLC Act carefully distinguishes among what are here termed Economic Rights, Control Rights, and the status of being a member (Member Status). Why, then, do many secured parties describe their collateral as "membership interest"? Perhaps because the term is widely used and well-defined in the LLC acts of many jurisdictions other than Delaware.

States' Laws Differ (!)

Under section 17001(z) of the California LLC Act, the term "membership interest" means "a member's right in the limited liability company, collectively, including the member's economic interest, any right to vote or participate in management, and any right to information concerning the business and affairs of the LLC provided by this title." Cal. Corp. Code §17001(z). Under Section 102(r) of the New York Limited Liability Company Law the term "membership interest" means "a member's aggregate rights in a limited liability company, including, without limitation, (i) the member's right to a share of the profits and losses of the limited liability company, (ii) the right to receive distributions from the limited liability company, and (iii) the member's right to vote and participate in the management of the limited liability company." N.Y. Ltd. Liab. Co. Law §102(r). Florida's LLC Act defines "membership interest" as "a member's share of the profits and the losses of the limited liability company, the right to receive distributions of the limited liability company's assets, voting tights, management rights, or any other rights under this chapter or the articles of organization or operating agreement." Fla. Stat. §608.402(23). Thus, the term "membership interest" is defined fairly consistently in the various states, and in accord with the seeming presumption of similarity to its corporate analog. But a great many mezzanine loans are intended to be secured by interests in Delaware LLCs.

Delaware Law

Delaware law distinguishes Economic Rights, Control Rights, and Member Status:

- **Economic Rights.** Section 18-101(8) of the Delaware LLC Act provides that an LLC interest is "a member's share of the profits and losses of a limited liability company and a member's right to receive distributions of the limited liability company's assets" — that is, Economic Rights. It does not include Control Rights, nor does it include rights to information and review of LLC books and records, or the right to compel dissolution. Unless otherwise provided in its LLC agreement, a Delaware LLC is managed by its members in proportion to their interests in its profits, with a simple majority of such interests controlling. Delaware LLC Act §18-402. Thus, management of a single-member LLC

is ordinarily the exclusive province of its sole member;

- **Control Rights.** Alternative allocations of managerial authority can be achieved if and to the extent provided in the LLC agreement. For example, a Delaware LLC may be managed, in whole or in part, by a manager who need not be a member. Delaware LLC Act §18-401. Managers can be further designated as officers, directors, or otherwise. Unlike corporate law statutes, the Delaware LLC Act provides little in the way of operational requirements or procedures for managers, officers, and directors — any such matters, to the extent relevant, should be addressed comprehensively in the LLC agreement. For example, an LLC agreement could create the role of manager, and designate as the manager the same person or entity that happens to be the sole member, but go on to vest in a mezzanine lender the absolute right (but perhaps not any obligation) to remove such manager and designate a replacement upon the occurrence of a default under the mezzanine loan, the better to facilitate, and maintain value during the pendency of, foreclosure or other exercise of remedies;

- **Member Status.** Under the Delaware LLC Act, Member Status bears little fixed correlation to either Economic Rights or Control Rights. Indeed, by definition a member is simply "a person who is admitted to a limited liability company as a member," and need not have any Economic Rights or Control Rights at all. Delaware LLC Act §18-101(11). Consider the "springing member," a character commonly found in many bankruptcy-remote single-member LLCs. As a general matter, an LLC dissolves at such time as it has no members. Delaware LLC Act §18-801(a)(4). Recall that dissolution is a process or stage during which the LLC is limited to winding up its affairs and distributing its assets (*see, generally,* Delaware LLC Act §§18-803 and 18-804), and that the LLC continues to exist until dissolution is complete and a certificate of cancellation has been filed with the Delaware Secretary of State (Delaware LLC Act §18-203). To reduce the likelihood of dissolution, many single-member LLCs are formed under LLC agreements that create and define the role of a "springing member." Essentially, the springing member is a person who has agreed to become a "special member" automatically and concurrently with the termination of the membership, or dissociation, of the sole member. Before becoming a special member, the springing member is not a member of the LLC at all, and has neither Economic Rights nor Control Rights. But even after progressing from springing member to special member, and thus achieving Member Status, the special member has neither Economic Rights nor Control Rights (excepting only limited rights to facilitate the admission of a replacement member, and such other rights (if any) as may be provided by the LLC agreement).

Economic Rights And The Anti-Assignment Override

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

Under Section 18-702(a) of the Delaware LLC Act, Economic Rights are "assignable in whole or in part except as provided in a LLC agreement." Thus, prohibitions and conditions to the assignment of Economic Rights are generally enforceable. Many would point to the provisions of Sections 406 and 408 of Article 9, which generally

override restrictions on assignment of certain rights to receive payments. Contemporaneously with its enactment of non-uniform text to sections 406 and 408 rendering them inapplicable to any interests in limited liability companies, the Delaware General Assembly amended the Delaware LLC Act to like effect. Delaware LLC Act §18-1101(g). Thus, the very law under which the Delaware LLC is formed and exists explicitly provides that anti-assignment provisions will be enforced. (Section 18-1101(g) of the Delaware LLC Act explicitly provides that Article 9 Sections 406 and 408 "do not apply to any interest in a limited liability company." Note that the scope of this exclusion is considerably broader than merely "LLC interest" — the statutorily defined term for what this article refers to as Economic Rights.)

In this connection, note that Article 9 section 401(a) provides that "whether a debtor's rights in collateral may be voluntarily or involuntarily transferred is governed by law other than this article." Official Comment 4 thereto is instructive: "Subsection (a) addresses the question whether property necessarily is transferable by virtue of its inclusion…within the scope of Article 9. It gives a negative answer…." This result is harmonious with the internal affairs doctrine, which provides that "a state should not regulate the internal operations of a foreign corporation but leave such governance to the state of incorporation." 18 Am. Jur. 2d Corporations §15 (2d ed. 2008).

The Further Challenge Of Control Rights And Member Status

Recall that Control Rights are vested in a Delaware LLC's members in proportion to their Economic Rights (if any), unless a different arrangement is specified in the LLC agreement. The Delaware LLC Act 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 point is further made by section 18-702(b)(1), which provides that unless the LLC agreement provides otherwise, "[a]n assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member." Last, Section 18-704(a) provides as follows: "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." 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.

FORECLOSURE GETS YOU WHAT, EXACTLY? • As noted above, the outcome seemingly mandated by the Delaware LLC Act, at least when the parties have not taken advantage of their contractual freedom to facilitate a different outcome, is that the secured party succeeds to all Economic Rights while all Control Rights and Member Status remain in the debtor. As a result, the debtor, who has no further Economic Rights, has sole and exclusive power to decide when, if ever, to make distributions, sell assets, wind up the company, etc. The foreclosing secured party, who has neither Control Rights nor Member Status but does possess all Economic Rights, is relegated to hopeful impotence. This outcome is a vestige of the LLC's roots in partnership law and its "pick-your-partner" doctrine, and considerations relevant to the treatment of LLCs for federal income tax purposes

before 1997's "check-the-box" regulations, which together placed great importance on defeating free transferability of interests for reasons not relevant to a contemporary single-member LLC. But this sundering of Economic Rights, on the one hand, and Control Rights and Member Status, on the other, brings about a result most would think undesirable and some would describe as absurd. It is well to remember that this outcome is not mandated by the Delaware LLC Act, but merely follows from application of its default rules where the parties have not facilitated a different outcome by inclusion of appropriate contractual provisions in the LLC agreement. The proximate cause of the problem, if we can call it that, is not the statute, but the LLC agreement. While the law sanctions the disregard of statutory language that yields an absurd result so as to achieve the outcome intended by the legislature, it is an altogether different matter to argue for disregard of statutory language so as to achieve what the parties could, but did not, achieve under the plain meaning of the statutory language. Nevertheless, we consider arguments to two alternative outcomes:

- Upon foreclosure, the debtor member is dissociated from Member Status under 18-702(b)(3), thus leaving the LLC with no member and in dissolution under Section 18-801(a)(4); or
- The foreclosing creditor/winning bidder succeeds to the Economic Rights, Control Rights, and Member Status, and the debtor member ceases to possess any of them.

The second of these adds the notion of succession to that of dissociation, and in that sense is the harder for which to argue, requiring as it does disregard of additional statutory provisions that could have been overridden or altered by contract. But the first of these leads to the exquisitely nonsensical result of dissolution for want of any members.

Curiously, whereas the Delaware LLC Act permits the admission of a member who has no LLC interest, the Delaware LLC Act also provides that a member loses its Member Status upon assignment of all of its Economic Rights. Both the granting of a security interest in and the outright assignment of Economic Rights constitute assignments, but in a limited exception to this rule, the granting of a security interest does not of necessity result in loss of Member Status. The Delaware LLC Act provides that, unless otherwise provided in the LLC agreement, "the pledge of, or granting of a security interest" in, a member's Economic Rights "shall not cause the member to cease to be a member or to have the power to exercise any rights or powers of a member." Delaware LLC Act §18-702(b)(3). That is, while the granting of a security interest is an assignment, it is an exception to the general rule that (unless otherwise provided in the LLC agreement) assignment of all Economic Rights results in loss of Member Status. One assumes these statutory default rules reflect the legislature's presumptions about the likely intentions of relevant parties. It may be said that in a great many transactions in which a member makes an outright assignment of all of its Economic Rights there is no desire or intention that it nevertheless retain its Member Status. An exception seems warranted for the mere granting of a security interest, at least in the context of a performing loan, performance of the secured obligation and, in time, release of the security interest. Yes, the granting of a security interest is an assignment, but it is different than an outright assignment. An assignment merely for security is generally anticipated to be released after performance of the secured obligation, whereupon the debtor will again be possessed of the full quantum of rights it possessed before granting the security interest. But what if the secured loan matures into foreclosure? Article 9 seems to contemplate that the purchaser at foreclosure sale will succeed to all of the rights the debtor has pledged as collateral. A different result follows from the default rules of the Delaware LLC Act, which is clear on the point that no one can possess Control Rights or achieve

Member Status absent approval of any remaining members or as provided in the LLC agreement. As discussed above, even the outright assignee of Economic Rights does not automatically or necessarily succeed to the Member Status lost by his assignor.

Because the granting of a security interest is a type of assignment, any assignee is subject to the limitations of sections 18-702(b)(1) and 18-704(a)(1) mentioned above, and does not achieve Member Status or possess Control Rights absent facilitative language in the LLC agreement. As noted above, where Control Rights are vested in a non-member manager, assignment of Economic Rights, even if accompanied by loss of Member Status, does not in and of itself cause a change in the locus of Control Rights. But if the debtor member loses Member Status, and the secured party does not achieve Member Status, the LLC will have no members and, consequently, must commence dissolution and the winding up of its affairs pursuant to section 18-801(a). This seems a result to be disfavored by all, and suggests our second alternative outcome. Perhaps the foreclosing secured party (or any third party who purchases at the foreclosure sale) is to be admitted to Member Status without regard to the presence or absence of facilitative language in the LLC agreement and thereby save the LLC from dissolution for want of any members.

Given the ubiquity of single-member LLCs in mezzanine loan transactions, and the irrelevance of both the "pick-your-partner" doctrine (there are no other members to protect), and the pre-1997 considerations defeating free transferability of interests (just "check the box" for desired tax treatment), there is a compelling argument that the Delaware LLC Act should be amended to provide by its default rules for the admission as successor member of the foreclosing secured party or other successful purchaser at a foreclosure sale, but only in the context of a single-member LLC. While the "check-the-box" rationale for constraining achievement of Member Status is anachronistic in all LLCs, the "pick-your-partner" rationale remains as relevant in multi-member LLCs as it ever was. But in the context of the single-member LLC, the vehicle that has come to predominate in mezzanine loans, the constraint exposes lenders to serious frustration unless documentation is particularly well drawn, without commensurate benefit to any legitimate constituency. While it can be said that the statute is in no way flawed, permitting as it does exactly the outcome presumably intended in most mezzanine loan transactions, it can perhaps be argued that, at least with respect to single-member LLCs, its default rule should be more harmonious with the outcome presumably intended in most, if not all, mezzanine loans.

CONCLUSION • 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 many states, appears nowhere in the Delaware LLC Act. Regardless of what state's law is designated as governing the purported granting of the security interest, the Delaware LLC Act is controlling with respect to prohibitions on and preconditions to the granting of a security interest, even in Economic Rights. 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. Many mezzanine lenders probably assume that, following a default, they'll be able to succeed to Economic Rights, Control Rights, and Member Status. Current law seems at odds with this expectation, at least in the absence of specific contractual provisions in the relevant LLC agreement. Current law would have Control Rights and Member Status remain in the

debtor despite the vesting of all Economic Rights in the secured party. The reasons for this retention of Control Rights and Member Status — the "pick-your-partner" doctrine rooted in partnership law and the defeating of free transferability of interests so as to achieve desired treatment for federal income tax purposes prior to 1997's "check-the box" regulations — are, however, utterly absent in the context of the single member LLC. 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. A statutory amendment to change this default setting would likely facilitate the outcomes intended and envisioned by parties to mezzanine loan transactions. Existing transactions should be reviewed and appropriate steps taken to assure that LLC agreements and security agreements use the appropriate terminology, and include the necessary contractual provisions, to facilitate the intended outcome following default and a secured party's exercise of remedies. A routine audit, or pre-workout documentation review, would be a good time for such review and rehabilitation.

So let's pick the story up where we left off: The autumn of 2010 is fast approaching. 1000 Park Avenue had languished, its future no more clear than that of the luxury apartments once envisioned for nearby Stuyvesant Town. 1000 Park Avenue LLC is the subject of several lawsuits intended to determine whether it's in dissolution, what in fact the successful bidder at the foreclosure sale received, whether that bidder has a claim against the foreclosing lender, and whether the lender has claims against its counsel or, based on the third-party legal opinion it delivered, its borrower's counsel. Pat is exploring opportunities.

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