

# SECURITY INTERESTS IN DELAWARE LIMITED LIABILITY COMPANIES

by

Norman M. 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’ 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 a LLC).

## **Statutory Default Rules and 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 and conditions to the assignment of Economic Rights are generally enforceable. Although § 9-406

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\* Norman M. Powell is a partner in the law firm of Young Conaway Stargatt & Taylor, LLP. This article originally appeared in the *The Transactional Lawyer*, a publication of the Commercial Law Center, Gonzaga University School of Law (Vol. 1, Apr. 2011), and appears here through rights retained by the author.

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 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 limited liability company agreement or otherwise approved by the limited liability company'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, 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 LCC agreement or on a membership certificate.

*Enforcement.* Article 9 contemplates that the purchaser at 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 limited liability company agreement and security agreement to facilitate that outcome.