Pledge Agreements for Equity Interests in Partnerships and LLCs
Drafting Security and Operating Agreements to Maximize Protection for Lenders

TUESDAY, JANUARY 6, 2015
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Today’s faculty features:

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Pledge Agreements for Equity Interests as Collateral

January 6, 2015
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Equity Collateral

1. Secured Creditor status in equity collateral

2. Protected Purchaser status in equity collateral

3. Membership Interest issues
“Mezzanine lending. . .means lending to a borrowing entity or group of entities that directly or indirectly owns a real property-owning entity, which debt is secured by a perfected first security interest in the mezzanine borrower’s pledged ownership interests in the property owner”

THEREFORE A PERSONAL PROPERTY SECURED TRANSACTION!
Mezzanine Lending

- Real Property Lender
- Owner of Real Property
- Mezzanine Lender

Mortgage Loan

Equity Owners

Equity Secured Loans
Mezzanine Lending

- Property Lender
- Owner of Property
- Mortgage Loan
- Co-Borrowers
- Mezzanine Lenders #1, #2, #3, #4
- Equity Owners
- Mezzanine Loans
Law is the Same

PLEDGED EQUITY LENDING

Lender

Borrower

Asset Based Loan

Equity Owners

A

B

Equity Secured Guarantees
A GUIDE TO THINKING ABOUT PERFECTION

- Step 1: Does Article 9 Apply?
- Step 2: Attachment
- Step 3: Categorize the Collateral
- Step 4: Perfection Step
  - Filing (§9-310)
  - Perfection under non-Article 9 law (§9-311(a))
  - Possession (§9-313)
  - Control (§§9-314, 9-104, 9-106, 8-106)
- Step 5: Priority Consequences
Lien Perfection

Perfection of liens (security interests) in equity interest collateral.
US CMBS and CRE CDO: Moody’s Approach to Rating Commercial Real Estate Mezzanine Loans

- Pledge of 100% of the equity
- Opt In to Article 8
- Certificate the Equity
- File a Financing Statement
- Control the ability to Opt Out – hardwire or proxy
- UCC Insurance
Issues in Negotiating Mezzanine Loan Documentation

- Pledge Agreement
- UCC Insurance/Title Insurance
- Borrower Organizational Documents
- Usury
- Senior Encumbrances
  - Intercreditor Agreements
- Lender’s Remedies
NEED TO CONSIDER NOT ONLY

- **SECURED CREDITOR** STATUS UNDER ARTICLE 9 OF THE UCC;

- **PROTECTED PURCHASER** STATUS UNDER ARTICLE 8 OF THE UCC
Protected Purchaser Status and Equity Ownership Coverage

LENDER’S POLICY

- Mezzanine Endorsement – Primary Obligor
- Pledged Equity Endorsement – Secondary Obligor

BUYER’S POLICY

- Equity Ownership Endorsement
NEMO DAT QUOD NON HABET*

*“No man can give what he does not have”
EXCEPTIONS TO NEMO DAT:

- Negotiable Promissory Notes
- Negotiable Bills of Lading
- Securities under Article 8 – if a Protected Purchaser
“In addition to acquiring the rights of a purchaser, a protected purchaser also acquires its interest in the security free of any adverse claim.”

§8-303(b)
FIRST STEP IS TO BE A SECURED CREDITOR BY CONTROL OF A SECURITY UNDER ARTICLE 8 and INVESTMENT PROPERTY UNDER ARTICLE 9
NOTE: If entity subsequently opts-in to be a security under Article 8 (no way to prevent), then Protected Purchaser has priority in security over first lien-holder who perfected by filing!

Is it a security under Art. 8?

Entity Ownership Interests

Perfection by Filing Financing Statement

Perfection by Possession + Endorsement Control

Perfection by Control Agreement

Is it certificated or uncertificated?

Certificated

Uncertificated

WINS over filing!
THEN BE A PROTECTED PURCHASER UNDER ARTICLE 8
Section 8-303 of the U.C.C. defines a “protected purchaser” as a purchaser of a security or an interest who:

i. Gives value.

ii. Does not have notice of any adverse claim to the security.

iii. Obtains control of the security.
## ARTICLE 8 and ARTICLE 9 - INTERRELATIONSHIP

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**I WIN!!!!!!**
A Case Study

Step #1

Equity Owner – California LLC

Ultimate Parent

First Mezzanine Lender

Lender Perfects Security Interest in Pledged Equity by Filing UCC-1 with CA SOS

Loan Secured by Pledge of Equity In Delaware Sub

Property Owner – Delaware LLC

The Property
Step #2

1. Sells Equity Ownership in Sub to Sister Sub for $100,000,000

3. Pays Off First Mezzanine Lender with Proceeds of Mezz Loan from Second Mezzanine Lender

2. Provides New Mezzanine Loan Secured by Equity Ownership in Del. Sub – Perfects by Control and Protected Purchaser
A Case Study

Step #3

First Mezzanine Lender Sues Old Equity Owner for Conversion Based On Fraudulent Conveyance Alleging Property Worth $400,000,000 and Wants $2,000,000 kicker
Mezzanine Loans: The Vagaries of Membership Interest Collateral
A Typical Scenario

$30,000,000 mezz loan to DE LLC
Lender & lender’s counsel – California
Documentation – standard California loan docs
Collateral description – simple & clear:

“100% of my membership interest
in XYZ, LLC, a Delaware limited
liability company.”

Any problems?
“Membership Interest” Collateral

- “Membership Interest” in the LLC
  - Colloquialism describing intended collateral
  - Assumed by many to consist of both economic rights and control rights
  - Can appear in
    - Granting clauses of security agreements
    - Collateral descriptions in related UCC1 financing statements
    - Control agreements
“Membership Interest” Collateral

- But in Delaware?
  - “Membership Interest” is fraught with ambiguity
  - Term does not appear in the Delaware LLC Act
  - Instead the Delaware LLC Act discusses
    - Economic Rights
    - Control Rights
    - Member Status
  - So why use the term “Membership Interest?”
States’ Laws Differ (!)

- California’s LLC Act uses the term
  - “a member’s right in the LLC, 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”
  
(California Limited Liability Company Act § 17001(z))
States’ Laws Differ (!)

- New York’s LLC Act uses the term “a member’s aggregate rights in an LLC, including, without limitation, (i) the member’s right to a share of the profits and losses of the LLC, (ii) the right to receive distributions from the LLC, and (iii) the member’s right to vote and participate in the management of the LLC”

(New York Limited Liability Company Law § 102(r))
States’ Laws Differ (!)

- Florida’s LLC Act uses the term “a member’s share of the profits and losses of the LLC, the right to receive distributions of the LLC’s assets, voting rights, management rights, or any other rights under this chapter or the articles or organization or operating agreement” (Florida LLC Act § 608.402(23))
States’ Laws Differ (!)

- “Membership Interest” is defined fairly consistently in various states
- But a great many mezzanine loans are intended to be secured by interests in a Delaware LLC
Delaware Distinguishes Economic Rights, Control Rights, and Member Status

- A “limited liability company interest” is “a member’s share of the profits and losses of an LLC and a member’s right to receive distributions of the LLC’s assets”
  (Delaware LLC Act § 18-101(8))

- LLC interest is merely economic –
  - Herein, for clarity, “Economic Rights”
Delaware Distinguishes Economic Rights, Control Rights, and Member Status

- In Delaware an LLC interest is merely an Economic Right, and does NOT include
  - Right to manage or control
  - Right to information and review of LLC books and records
  - Right to compel dissolution
Delaware Distinguishes Economic Rights, Control Rights, and Member Status

- In Delaware management of a single-member LLC is ordinarily the exclusive province of the sole member
  - Herein, for clarity, “Control Rights”
  - Unless otherwise provided, members hold Control Rights in proportion to their Economic Rights
Delaware Distinguishes Economic Rights, Control Rights, and Member Status

- In Delaware, Control Rights can be vested in “managers” who need not be members
  - Managers can be further designated as officers, directors, or otherwise
  - The Delaware LLC Act provides few operational requirements and procedures for exercising Control Rights
  - Such matters should be addressed in the LLC Agreement
Delaware Distinguishes Economic Rights, Control Rights, and Member Status

- In Delaware, a “Member” is simply a person who is admitted to an LLC as a member (Delaware LLC Act § 18-101)
  - Herein, for clarity, “Member Status”
  - Member Status bears little fixed correlation to Economic Rights or Control Rights
  - A Member need not have any Economic Rights or Control Rights at all
A Better Scenario

Revised collateral description:

“100% of my membership interest in XYZ, LLC, a Delaware limited liability company, including without limitation all of the economic interest and the right to vote or otherwise control the LLC.”

Any problems?
Economic Rights and the Anti-Assignment Override

- Delaware’s LLC Act explicitly incorporates the public policy to give “maximum effect to the principle of freedom of contract and to the enforceability” of LLC agreements
  - Delaware LLC Act § 18-1101(b))

- Delaware permits and enforces restrictions on the alienability of rights and statuses relating to LLCs - Economic Rights, Control Rights, and Member Status
Economic Rights and the Anti-Assignment Override

- Economic Rights are assignable unless the LLC agreement provides otherwise.
  Delaware LLC Act § 18-702(a)

- UCC Article 9 generally overrides restrictions on assignment of certain rights to receive payments (§406 and 408)

- Are anti-assignment provisions effective with respect to Economic Rights?
Economic Rights and the Anti-Assignment Override

- The Delaware LLC Act provides that UCC 9-406 and 408 do not apply to “any interest in an LLC”
  - “including all rights, powers and interests arising under an LLC agreement or this chapter.”
  - “This provision prevails over §§ 9-406 and 9-408 of [UCC Article 9].
- For Delaware LLCs, there’s no override for Economic Rights, Control Rights, or Member Status.
Economic Rights and the Anti-Assignment Override

- "whether a debtor's rights in collateral may be voluntarily or involuntarily transferred is governed by law other than this article."
  - UCC Article 9 Section 401(a)

- “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 . . . .”
  - Official Comment 4 to Section 401
Economic Rights and the Anti-Assignment Override

This result is harmonious with the internal affairs doctrine

“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).
A Still Better Scenario

Further revised collateral description:

“100% of my membership interest in XYZ, LLC, a Delaware limited liability company, including without limitation all of the economic interest and the right to vote or otherwise control the LLC and all my rights as a member.”

Any problems?
The Further Challenge of Control Rights & Member Status

- 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."

  Section 18-702(b)(1)

- 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”. Delaware LLC Act § 18-702(a).
The Further Challenge of Control Rights & Member Status

- Summary observations on Economic Rights
  - Delaware law is clear and controlling
  - Default rule - a secured party can freely enjoy Economic Rights
  - Exception - subject to compliance with any restrictions in the LLC Agreement
  - Assignment doesn’t affect Control Rights
  - Assignment for security doesn’t affect Member Status
The Further Challenge of Control Rights & Member Status

- Summary observations on Control Rights
  - Delaware law is clear and controlling
  - Default rule - a secured party has no Control Rights
  - Exception – a secured party has whatever rights it’s given in the LLC Agreement
  - Note: Control Rights are positively correlated with Member Status unless otherwise provided
    - e.g. vesting of Control Rights in a Manager
The Further Challenge of Control Rights & Member Status

☐ Summary observations on Member Status
  ■ Delaware law is clear and controlling
  ■ Default rule - a secured party has no right to Member Status
  ■ Exception – as provided in the LLC agreement and upon
    ☐ Approval of all members, or
    ☐ Compliance with procedure in LLC Agreement
Foreclosure Gets You What, Exactly?

- Under the Delaware default rules
  - Secured party succeeds to all Economic Rights, but to neither Control Rights nor Member Status
  - Debtor Member (or Manager) retains Control Rights
  - Debtor Member retains Member Status
  - The party with incentive to “run” the LLC has no power to do so
  - The party with power to “run” the LLC has no incentive to do so
Foreclosure Gets You What, Exactly?

- What if there’s a foreclosure?
  - Under Article 9 the purchaser will succeed to all of the rights the debtor has pledged as collateral.
  - Under the Delaware LLC Act a different result follows (unless the parties contract otherwise)
    - no one can possess Control Rights or achieve Member Status absent approval of any remaining members or as provided in the LLC agreement.
    - Even the outright assignee of Economic Rights does not automatically or necessarily succeed to the Member Status lost by his assignor.
Foreclosure Gets You What, Exactly?

- Granting of a security interest is a type of assignment
- An assignee does not achieve Member Status or possess Control Rights absent facilitative language in the LLC agreement or consent by the other members
Foreclosure Gets You What, Exactly?

- If the debtor member loses Member Status and the secured party does not achieve Member Status, the LLC has no members
  - It must commence dissolution and winding up
Conclusions

- Always describe the collateral by use of words and phrases with antecedents in the Delaware LLC Act or the relevant LLC Agreement
  - The term “membership interest” appears nowhere in the Delaware LLC Act
Conclusions

☐ The Delaware LLC Act is controlling with respect to prohibitions on and preconditions to the granting of a security interest, even those merely in Economic Rights

- Economic Rights can be pledged unless restricted
- Control Rights and Member Status cannot be pledged absent facilitative language or action
Conclusions

- The Delaware LLC Act affords the contractual flexibility necessary to facilitate a secured party’s succeeding to Economic Rights, Control Rights, and Member Status.
- LLC Agreements and Security Agreements need to be drafted with great care to facilitate that outcome.
- Audit or review of existing security interests, and corrective measures, may be warranted.
Suggested concepts to be addressed in special section of LLC agreement

- Supercedes all other provisions of LLC agreement
- LLC agreement provides rights to and can be enforced by secured party (18-201(7))
- Member may transfer or assign his LLC interest to secured party
Suggested concepts to be addressed in special section of LLC agreement (cont’d)

- all of the Member’s right, title, and interest in the LLC, whether derived under the Certificate of Formation, the LLC Agreement, the LLC Act, or otherwise, including without limitation
  - its “limited liability company interest” (as such term is defined in Section 18-101(8) of the Statute),
  - the Member’s status as a “member” (as such term is defined in Section 18-101(11) of the Statute), and
  - the Member’s right to participate in the management of the business and affairs of the LLC
Suggested concepts to be addressed in special section of LLC agreement (cont’d)

- the Lender or other successful bidder at a foreclosure sale or other disposition automatically succeeds to the debtor’s
  - “limited liability company interest” (as such term is defined in Section 18-101(8) of the Statute),
  - status as a “member” (as such term is defined in Section 18-101(11) of the Statute), and
  - right to participate in the management of the business and affairs of the LLC
Suggested concepts to be addressed in special section of LLC agreement (cont’d)

- the Lender or other successful bidder at a foreclosure sale or other disposition
  - is deemed admitted as a member of the Company immediately before the Member ceases to be a member,
  - has power and authority to remove managers, and
  - has power and authority to amend & restate LLC Agreement.
Suggested concepts to be addressed in special section of LLC agreement (cont’d)

- if at any time the LLC would otherwise dissolve, such dissolution shall not occur if
  - the Lender designates a successor member for admission to the LLC (Section 18-801(a)(4)(b)),
  - Such admission shall be consummated and memorialized in any manner designated by the Lender in its discretion.