

Membership Interests in a Limited Liability Company as Collateral

A limited liability company (“LLC”) is one of the most commonly chosen entity structures used by new businesses today. LLCs are owned by its members, who hold either membership units or membership interests. Membership units/interests consist of both financial and governance rights, although a particular member may have financial rights but no governance rights or vice-versa. Membership units/interests may be evidenced by a membership certificate but, most frequently, are uncertificated. Whether membership units/interests are certificated or uncertificated will usually be set forth in the LLC’s organizational documents. As LLCs are commonly the entity structure of choice, it is important for banks to understand how to accept and perfect a security interest in the membership units/interests as collateral for loans.

Regardless of whether the membership units/interests are certificated or uncertificated, a security interest in membership units/interests needs to be granted to the secured party. This will typically be accomplished through a pledge agreement, which should specify whether the security interest granted to the secured party is a security interest in the pledgor’s financial rights, governance rights or both. Without such specification, a pledging party may be able to argue that the pledge is simply a pledge of the financial rights.

In many cases, the organizational documents for the LLC either (i) expressly prohibit a member from transferring or pledging their membership units/interests; or, (ii) grant a right of first refusal to the LLC or other members. In these instances, the secured party must obtain the consent and waiver from the LLC and/or the other members before accepting the pledged units/interests. However, in cases where there is no direct prohibition against a pledge, or if a right of first refusal does not exist, it is still wise to obtain the consent of the LLC and other members to prevent an objection at a later time. The form of the consent and waiver from the LLC and other members can be as simple or complex as the parties agree. For example, the consent and waiver should, at a minimum, contain a consent to the pledge and a waiver of any transfer or pledge prohibitions and any first refusal rights. Also, the consent and waiver should have an acknowledgment that the LLC and other members will recognize the secured party as the holder of the pledged membership units/interests should the secured party give notice of an event of default in its lending relationship. In more complex transactions, the consent and waiver may also be reflected in a modification to the LLC’s organizational documents. In addition, the secured party may want to include provisions granting the LLC or the remaining members the option to acquire the pledged membership units/interests should the secured party acquire it or vice-versa (i.e. a “push provision”, or a “push-put provision”).

It should also be noted that in accepting a pledge of membership units/interests, it is often the intent of the parties that the secured party will receive the distributions made on the membership

units/interests while the debt is outstanding. If this is the case, the secured party should obtain an assignment of the distributions from the pledging member. Again, the assignment of distributions should be consented to by the LLC and other members to ensure that the assignment will be honored.

As for perfection, the manner of perfection depends upon whether the membership units/interests are certificated or uncertificated. When membership units/interests are uncertificated, they are “general intangibles” under the Uniform Commercial Code (“UCC”). If such is the case, perfection and priority issues are determined solely by the order of UCC financing statements filed against the membership units/interests. Thus, prior to accepting the pledged uncertificated membership units/interests, the secured party should perform a current UCC search on the pledging member to ensure the secured party obtains the proper first priority security interest.

In the cases where the membership units/interests are certificated, they are generally considered to be a security, which can be perfected by filing a UCC financing statement or taking control of the certificate(s) (i.e. actual possession of the certificate(s) or entering into a control agreement with a third party in possession). Although certificated membership units/interests may be perfected by filing a UCC financing statement, perfection by control will have priority over any parties perfected by filing alone. As a result, it is generally recommended that a secured party perfect by both methods to ensure a first priority security interest on certificated membership units/interests. Thus, prior to accepting the pledged certificated membership units/interests, the secured party should (i) perform a current UCC search on the pledging member; and, (ii) either have the original certificate delivered to the secured party at closing or, if the certificate is in the possession of a third party, have a negotiated control agreement signed at closing.

Now that you are perfected, what happens if your borrower defaults? In our second part in this series, we will detail the steps to take control of the membership units/interests and to liquidate the same.