

COUNSELOR'S CORNER

LLC Membership Interest as Collateral: What Is the Transferable Interest?

Part 1 of 2

Allan Williams, Husch Blackwell LLP



12

LIMITED LIABILITY COMPANIES (LLCs) have consistently gained in popularity in Nebraska since the state first adopted the Limited Liability Company Act in 1993. As the popularity of LLCs has increased, it has become common practice for creditors to take a security interest in a debtor's LLC membership interest. Although an LLC membership interest may seem like adequate security for a loan, creditors should be aware that unlike foreclosing upon a corporation's stock, foreclosure on an LLC membership interest will not provide the creditor with the same governance rights the debtor enjoys.

This is the first article in a two-part series intended to provide you with a basic understanding of what "transferable interest" a creditor obtains and

what a creditor can do to protect its security interest in the debtor's LLC membership interest. This article discusses what rights a creditor obtains upon the foreclosure on an LLC membership interest. The second part of the series will address ways in which creditors can protect their security interests in a debtor's LLC membership interest and better protect the value of its interest in the event the creditor forecloses on the LLC membership interest.

One of the most fundamental principles of LLC law is that members are free to pick their own partners. For this reason, the Nebraska Uniform Limited Liability Act (the Act) is designed to divide a member's rights in an LLC into two categories: (1) the economic rights (i.e., the "transferable interest"), which constitute the rights to the distribu-

tions of the LLC¹; and (2) the governance rights (i.e., management rights, consent rights, rights to information, and the right to seek judicial intervention). The Act provides that a member may transfer or pledge its "transferable interest" in an LLC provided that the transferee does not have any right to participate in the management of the LLC or have access to the records or information concerning the LLC's activities.²

Creditors often assume that having a perfected interest in a debtor's LLC membership interest entitles the creditor to all of the same rights as the debtor upon foreclosing the LLC membership interest. This assumption is incorrect. While the economic interest in the LLC transfers, the debtor retains all governance rights along with all duties and obligations of membership in the LLC.

If the creditor holds a valid Membership Interest Pledge Agreement, the creditor can enforce its rights to the economic interest of the member once the debtor defaults on the loan. The agreement will provide all the remedies the creditor is entitled to, which presumably includes the ability to transfer its interest in the economic benefits of the LLC. In addition, a creditor is entitled to obtain a charging order against the economic interest of the debtor. A charging order is a lien on the economic interest of the debtor and imposes an obligation on the LLC to pay the creditor any distributions to which the debtor is entitled.³ The court issuing the charging order may appoint a receiver to make all inquiries the debtor may make to the extent necessary to effectuate the collection of distributions pursuant to a charging order.⁴ If the creditor is unable to recoup its debt within a reasonable amount of time, the creditor has the power to ask the court to foreclose on the lien and order the sale of the LLC membership interest.⁵

¹Neb. Rev. Stat. § 21-102.
²Neb. Rev. Stat. § 21-141.

³Neb. Rev. Stat. § 21-142.
⁴Revised Uniform Limited Liability Act § 503 cmt. (b)(1).

⁵Neb. Rev. Stat. § 21-142.

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The Act allows the LLC or any of its members to purchase the economic interest subject to a charging order at any time prior to the foreclosure sale of the LLC membership interest.⁶

A creditor must be mindful of which interests in a debtor's LLC membership interest are transferable in the event the creditor accepts the LLC membership interest as security for a debt. The interest that may be pledged as security is substantially different than the interest in pledged corporate stock. As discussed, a creditor does not gain the right to participate in the governance or management of the LLC, nor is the creditor able to gain access to the books of the LLC. This substantially impairs a creditor's ability to protect its interest in the LLC membership interest. Further, the lack of governance rights substantially affects the utility of taking a security interest in a debtor's LLC membership interest.

The next article in this series will discuss what a creditor can do to protect its security interest in a debtor's LLC membership interest. ▶

⁶Neb. Rev. Stat. § 21-142.



Allan Williams concentrates his practice on corporate and real estate transactions and provides support to Husch Blackwell's Real Estate, Development, and Construction Practice Specialty Center. You may contact Williams at (402) 964-5221 or allan.williams@huschblackwell.com.