REAL ESTATE

How Do You Say "Membership Interest" For An Equity Pledge?

Joshua Stein Contributor

I write about commercial real estate negotiations, deals and legal issues.

May 16, 2022, 10:51am EDT

Delaware doesn't define the term "membership interests" in its LLC law. (Photo by Education Images/Universal Images Group via Getty Images) [-] UNIVERSAL IMAGES GROUP VIA GETTY IMAGES

Commercial real estate lenders often make loans secured by pledges of equity interests in limited liability companies that own real estate, rather than just loans secured by mortgages of the real estate itself. Pledges of equity in an LLC give borrowers more loan proceeds than ordinary mortgages would by themselves, though sometimes those extra proceeds are expensive. This type of loan security is governed by the Uniform Commercial Code, not by mortgage law. And the UCC can be full of surprises.

For example, in one recent case, *National Health Investors, Inc. v. Welltower, Inc.* (Del. Ct. of Chancery 2021-1097-MTZ), the owner of a Delaware LLC agreed to pledge its equity in the LLC to secure a mezzanine loan. The owner signed a pledge agreement, describing the collateral as all its “membership interests” in the LLC. The lender then filed a publicly available Uniform Commercial Code financing statement notifying the world that the lender claimed a lien on those “membership interests.”

It seemed reasonable that, as the only member of the LLC, the borrower should hold all the membership interests in the LLC. It pledged those interests to secure the loan. Easy.

It wasn’t so easy when the loan went into litigation. There the borrower argued that the “membership interest” that the lender claimed as its collateral actually didn’t exist. The phrase “membership interest” was meaningless, the borrower said, because Delaware’s LLC law doesn’t mention the phrase “membership interest” anywhere at all.

The Delaware LLC law does mention “limited liability company interests,” but those consist solely of the rights to receive money from the LLC and enough information to pay taxes on that money. “Limited liability company interests” as defined by Delaware law don’t include any rights to manage the LLC, decide when it should distribute money, review its books and records, or become an actual “member” of the LLC.

The underlying LLC agreement didn’t solve the problem. It didn’t define “membership interest” either. So the borrower argued that the lender held a pledge of nothing at all.

The dispute settled confidentially, making it unclear how a court would have decided. But the possible disconnect in Delaware LLC law about membership interests and limited liability company interests has existed for over a decade. A future lender taking a pledge of membership interests (whatever that might mean) in a Delaware LLC should take care to define exactly what the lender intends to claim as its collateral.

To be on the safe side, the collateral shouldn’t just consist of “membership interests” in the LLC. Both the loan documents and the LLC agreement need to assure that if the loan goes into default, the lender will inherit the borrower’s entire interest in the LLC, and all rights of the borrower. And apparently the phrase “membership interest” might not capture all of that. Word choice matters. Here, brevity is not a good thing.

Remarkably, Delaware stands nearly alone in failing to define “membership interests” in its LLC law. Almost all other states do define the term. Doubly remarkably, Delaware is the one state that famously goes out of its way every year to fix glitches in its LLC law. It does this to prevent surprises, encourage use of Delaware LLC laws and companies, and thus facilitate commerce. This particular glitch – failure of the Delaware law to define “membership interests” — doesn’t seem to have caught the attention of the Delaware glitch fixers. Or maybe they don't think it's a glitch.

Even outside of Delaware, any lender taking a pledge of interests in an LLC (or any other collateral) should check that the collateral description uses words that clearly communicate the nature and scope of the lender's collateral, in a way that leaves no openings or arguments. If the lender can validly describe the collateral as "all assets" of the borrower, that can help.

This litigation also teaches deal attorneys and their clients that sometimes it pays to revisit the actual law that governs a transaction. One can't assume it says what one expects it says. And every state's LLC law is not necessarily the same.

Joshua Stein

I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

Published on Forbes.com May 16, 2022.