

NEW LLC RULES AFFECT BOTH LENDERS AND BORROWERS

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Starting January 1, 2022, there will be new opportunities and pitfalls for lenders to Ohio limited liability companies as well as for borrowers that are Ohio LLCs. Some of the changes are especially relevant for lenders to special purpose entities (“SPEs”), such as in commercial real estate lending, but many will be relevant in other situations as well. Some of the changes will affect taking interests in an Ohio LLC as collateral, regardless of whether the borrower is an LLC or another form of entity. Our emphasis here is on changes in Ohio law, but many of the points discussed below are also relevant to LLCs formed in other states.

Negative covenants. The new law expressly provides that an LLC operating agreement can provide rights to persons who are not members of the LLC and are not even parties to the operating agreement. Why might that matter?

All commercial loan transactions involve negative covenants, which require that the borrower not take certain actions. When those negative covenant provisions are contained in a loan agreement, a breach by the borrower gives the lender remedies as a contract party. Depending on the drafting and the circumstances, the lender would be able to exercise the typical rights of a creditor, such as accelerating the maturity of the debt, suing to force compliance, or, in the case of a secured creditor, moving against the collateral. In the case of a loan with a confession of judgment clause, the lender can even take an immediate court judgment against the borrower.

But with a contract right, the lender may not be able to persuade a court to enforce actual performance as opposed to merely awarding money damages. It is not necessarily a satisfying situation for a lender to have to fight out those issues while the situation potentially degrades because of the borrower’s breach. For example, if a borrower sets out to transfer certain assets in breach of the loan agreement, the eventual award of damages may not be nearly as good a remedy as a court order stopping the transfer in the first place. A lender might be able to obtain a temporary restraining order or a preliminary injunction quickly, but that depends on a number of legal standards that are far from layups.

In contrast, if a properly drafted negative covenant is contained in the operating agreement of an LLC, the breach of that covenant is not merely a breach of contract – it renders the act unauthorized and arguably invalid. Enjoining the act should be a readily available remedy and, depending on the rights of third parties, a completed transaction could be unwound. The new Ohio LLC Act expressly provides that an operating agreement may provide rights to persons who are not parties to the agreement, which will allow a lender to embody negative covenants in the operating agreement and thereby avail itself of the argument that an action is unauthorized. (Perhaps needless to say, the amendment and termination provisions of the operating agreement need to address the special consent requirements as well.)

In practice, it may not be necessary for a lender to take legal action to stop something such as a sale of assets in violation of the operating agreement. A potential buyer is likely to investigate the authority of the borrower to transfer the assets and, upon seeing a provision requiring certain approvals, insist on evidence that those approvals were received. Unfortunately, we must note that even thorough documentation cannot prevent an unscrupulous borrower from taking improper actions that may cause serious difficulty for a lender.

This concept of reflecting negative covenants in the operating agreement itself is particularly applicable in the context of an SPE, where a lender expects to be able to totally prevent certain actions taken without its consent. One such action that possibly may not be blocked by a negative covenant, even in an operating agreement, is the filing of a bankruptcy petition. At least one court has held that federal policy allowing a business to file for bankruptcy outweighs

This Client Advisory is part of a series highlighting different features of the Ohio LLC Act that goes into effect on January 1, 2022. For other content regarding the Act, click [here](#).

the policy of allowing parties to agree on such matters, at least where the agreement was one imposed by the lender as a condition of the loan. Even under existing law, it is not uncommon for a lender to require that certain SPE covenants and limitations be included in a borrower's operating agreement – but if those provisions confer a right in favor of a lender to enforce terms in the operating agreement as permitted under the new LLC Act, they become much more useful and protective of the lender's position.

The “independent director.” A measure commonly taken in the context of the SPE in a commercial mortgage transaction – particularly mortgages destined for the secondary market – is to provide that certain actions cannot be taken by the borrower unless a designated person not affiliated with the borrower, often referred to as an “independent director,” consents to the action. This even more clearly establishes that an action taken contrary to the provision is not just a breach of contract but is unauthorized and, therefore, invalid. In the case of an LLC, the strongest measure may be to provide that the consent of a particular member is required. But the independent person that the lender wants to have those rights is not an owner in the LLC and, therefore, has not contributed value to the LLC and has no stake in its profits. The new Ohio Act accommodates this situation by providing, “A person may be admitted as a member without acquiring a membership interest and without making or being obligated to make a contribution to the limited liability company.” Historically, lenders have sometimes used one of their affiliates to serve as independent director, but there has been concern that the affiliation might create problems with the effect of the arrangement. Today, service providers who are unaffiliated with lenders will serve for a fee.

Restrictions on using LLC interests as collateral. The new Act affects the process of taking and – more importantly – enforcing a security interest in LLC membership interests. One principle in the law is that the owner of property should be allowed to use it as collateral, but a countervailing principle is that owners of a closely held business should be able to restrict who can be an owner in the business. The drafters of the Uniform Commercial Code came down, at least in part, on the side of allowing security interests in certain kinds of property even if that property exists under an agreement that prohibits a security interest (the so-called “UCC Overrides”). Under the truly uniform version of the UCC Overrides, a secured party relying on those sections does not get all of the rights of a secured party, but it does get a valid security interest. In some jurisdictions, a secured party may be given more complete rights, including a right to foreclose the security interest.

The new Ohio LLC Act reverses that effect by stating that those UCC Override provisions of the Ohio version of the UCC do not apply to membership interests in an Ohio LLC. As a result, a provision in an operating agreement that provides that any attempted grant of a security interest will be void should be given effect. A lender can, of course, overcome that problem by requiring that the operating agreement be amended or waived by the appropriate parties to allow the security interest.

There is, however, a further wrinkle that members of an LLC need to be aware of. Even if they have a prohibition on the grant of security interests in membership interests, the new Ohio LLC Act only overrides the Ohio UCC provisions. If a security agreement is governed by the law of a different jurisdiction, the law of that jurisdiction might include the UCC Overrides to one extent or another, and that override might be given effect even in the case of interests in an Ohio LLC.

Different ways to treat membership interests as collateral. Although the new LLC Act does not change some issues related to LLC interests as collateral, they are worth discussing in this context. Membership interests in an LLC can be treated as either “securities” or “general intangibles” under the UCC. A membership interest is a security under the UCC only if the governing documents expressly provide that it is a security governed by Article 8 of the UCC. (Note that the question of whether the interests are “securities” under applicable securities laws is an entirely separate question.) The importance of the distinction is that a security interest in a general intangible can be perfected only by filing a financing statement in the proper public office; however, a security interest in a security can be perfected either by such filing or by the secured party taking “control” of the security. Although there are various ways to take control, the most common is for a secured party to take physical possession of a certificate for the security. The crucial point in all of this is that perfection by control has higher priority than perfection by filing, regardless of the order in time. As a result, the most reliable method of perfection is to require that the operating agreement provide that the

membership interests are securities and that they are to be evidenced by certificates, which the lender then possesses for the duration of the lien.

Series LLCs. For specific issues related to possibly lending to a separate series of an LLC, which will be possible under the new Act, please see our Client Advisory on series LLCs here.

Takeaways. If you have an LLC as a borrower, consider whether any of the negative covenants should be built into its operating agreement as well as the loan agreement. Especially in the context of an SPE, consider designating an “independent member.” If you are taking LLC interests as collateral, review the LLC’s documentation carefully to make sure that it permits the security interest. If you want to take the most solid form of security interest in LLC membership interests, take a physical pledge of certificates for membership interests that have been properly designated as certificated securities.

Additional Information

For more information, please contact:

- **Glenn E. Morrical** | 216.696.3431 | glenn.morrical@tuckerellis.com
- **Ludgy A. LaRochelle** | 216.696.4732 | ludgy.larochelle@tuckerellis.com
- **Daniel L. Schiau II** | 216.696.3892 | daniel.schiau@tuckerellis.com
- **Thomas W. Ostrowski** (*commercial finance*) | 216.696.5572 | thomas.ostrowski@tuckerellis.com
- **William J. Stavole** (*commercial litigation and creditor rights*) | 216.696.5798 | william.stavole@tuckerellis.com
- **John C. (Chaz) Weber** (*commercial real estate finance*) | 216.696.4887 | chaz.weber@tuckerellis.com

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