

LIMITED LIABILITY COMPANIES: A PRIMER FOR THE CANADIAN FINANCE LAWYER

Smarter Way to Cross Blog Archives
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The use of limited liability companies in the United States has expanded dramatically over recent years. A limited liability company (LLC) offers its owners protection from liability like a corporation, but with the advantage of pass through tax treatment under US tax laws. However in Canada, LLCs don't enjoy the same pass through tax treatment and the ownership of an LLC by a Canadian taxpayer can result in material adverse tax consequences. LLCs have nevertheless become more frequent participants in cross-border transactions, typically in the role of a subsidiary of another US entity.

As US finance lawyers working on cross-border financing transactions, we have noticed that Canadian lawyers do not always understand US LLCs, sometimes shoe-horning LLCs into vocabulary, documents and legal principles intended for corporations. This blog explains some of the basics of LLCs for the Canadian finance lawyer.

Q: What are the key “constating” or organizational documents of LLCs? A: An LLC is formed by filing a certificate of formation (Delaware nomenclature), articles of organization (New York nomenclature) or equivalent formation document in the state of organization. The members (equivalent to shareholders) of the LLC enter into a limited liability company agreement (Delaware nomenclature) or operating agreement (New York nomenclature) setting their agreement with respect to the operation of the LLC (we'll use the term “operating agreement”). Copies of these organizational documents should be obtained and certified by an appropriate representative of the LLC as part of a finance transaction

Q: What is the management structure of an LLC? A: An LLC can be “member-managed” or “manager-managed”. The operating agreement (and sometimes the articles of organization or equivalent formation document) will indicate the selected option, and also set forth how any managers are appointed, and the authority of the members and any managers. Sometimes the operating agreement will allow for the appointment of officers. We often see officers where the organizers want to mimic the management structure of related corporations. The key thing to remember: there is no standard model. You can't understand the management of an LLC unless you review the operating agreement.

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Q: What authorizing resolutions should I obtain? A: What resolutions are needed depends on the management provisions set forth in the operating agreement and the ownership structure of the particular LLC. Some examples:

- For a multi-member, member-managed LLC, a resolution of the members may be required to authorize a given member or other agent (or officer) to enter into the transaction.
- For a single member, member-managed LLC, no resolutions of the LLC itself may be required unless the sole member is authorizing an officer or other agent to sign and deliver the documents (but see last bullet point under this answer).
- For a manager-managed LLC, a resolution of the manager or managers (and sometimes the members) may be necessary to authorize a given manager or other agent (or officer) to enter into the transaction.
- For any manager or member that is an entity rather than a natural person, resolutions may be required of that entity to authorize its officers or other representatives to act

Q: What is the proper terminology for describing a member's ownership interest in an LLC and how is that ownership interest quantified? A: A member of an LLC has a "membership interest" or "limited liability company interest" (we'll use "membership interest"). Sometimes that membership interest may be expressed as a certain number of "units" or as a percentage interest. Sometimes there are classes of membership interests. "Distributions" (rather than dividends) are paid to holders of membership interests in accordance with the terms of the operating agreement. Once again, the operating agreement has to be scrutinized to determine the management and economic rights associated with a particular membership interest, no matter what labels are used to describe that membership interest.

Q: Are there certificates evidencing a membership interest? A: Whether or not there are share certificates evidencing a membership interest depends on the terms of the operating agreement. More often than not, there are no certificates. Sometimes a lender will require an opt-in provision (discussed below) and that the membership interest is evidenced by a certificate.

Q: How does a lender perfect a security interest in or pledge of a membership interest? A: Assuming for the purpose of this response that perfection is governed by the Uniform Commercial Code (UCC) of one of the US States, and not the law of Canada or another jurisdiction, perfection depends on whether the membership interest is characterized as a "security" or "general intangible" under the UCC.

Generally, a membership interest is a "security" if (a) it is traded on a securities exchange or in securities market, (b) it represents an interest in a registered investment company or (c) the LLC operating agreement contains a provision opting to treat the membership interests as securities subject to Article 8 of the UCC (a so called "opt-in" provision). Whether or not a membership interest is a security does NOT depend on whether the membership interest is certificated.

Perfection with respect to a membership interest that is a security can be accomplished by "control" or by filing a financing statement, with "control" giving the secured party priority over a secured party that has perfected its security interest by filing. If there is a certificate evidencing such a membership interest, then the secured party generally achieves control by obtaining physical possession of the certificate endorsed to the secured party or in blank (on the certificate itself or in a separate transfer instrument). If such a membership interest is uncertificated, perfection by control is generally accomplished by means of a tri-party "control" agreement among the LLC, the member and the secured party or by the

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membership interest being transferred by the LLC into the name of the secured party in the records of the LLC.

If the membership interest is not a security, it is a general intangible. Perfection with respect to a general intangible can only be achieved by filing a financing statement. Perfection cannot be accomplished by control, even if there is a certificate evidencing the membership interest. It may nevertheless be advisable for a lender, in addition to filing a financing statement, to obtain possession of such a certificate, with an instrument of transfer signed in blank. Taking such steps should prevent transfer of the certificate to another party (which is desirable even if the transferee would take title subject to the security interest granted to the lender) and will facilitate the lender's transfer of the certificate to a purchaser in an enforcement scenario.

Many operating agreements restrict the transfer or pledge of a membership interest. The effect of such restrictions varies based on the State law that applies. In any event, when a secured party is relying on a pledge of a membership interest, and there are restrictions on transfer or pledge under the operating agreement, a modification of the operating agreement or a consent is advisable.

The bottom line: For the owners of an LLC, the beauty of an LLC is its flexibility. But with this flexibility comes potential complexity. For a lender and its counsel, an LLC may require careful due diligence, more specific tailoring of documents and particular care if the lender is taking a pledge of a membership interest in the LLC.