

## **Assignment of an LLC Member's Rights to Profits, Losses, and Distributions: A Violation of the Due-on-Sale Clause?**

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Assume that a limited liability company ("LLC") has obtained a loan from a mortgage lender, which loan is separately guaranteed by each of the LLC's individual members. The Loan Agreement prohibits "any change in ownership of the [LLC]", and each guarantor has agreed that it "will not transfer any ownership interest in [the LLC]." Would the quoted language prohibit any member's transfer of all of its rights to receive its share of profits, losses and distributions of the LLC, as opposed to the member's outright assignment of its entire membership interest in the LLC and substitution of the transferee as a new member?

The lender may have some problems enforcing its due-on-sale clause if the clause only prohibits an LLC member from "transfer[ing] its ownership interest" in the LLC and says nothing about the "assignment" of "lesser" rights, such as its share of LLC profits and distributions.

With the advent of securitized and conduit financing and the use of bankruptcy-remote borrowing entities to comply with rating-agency requirements, it has become more common for mortgage due-on-sale clauses to contain a "change of control" provision, i.e., a prohibition against certain "direct or indirect" changes in the equity ownership, control or management structure of the mortgagor (usually a limited partnership or limited liability company). This provision usually provides that if certain principal individuals or entities at any time own less than a specified percentage of the management, ownership, membership, general partnership, or voting interests of the borrowing entity, or if the borrowing entity sells, conveys, or assigns more than a specified percentage of such interests, a default will have occurred under the loan documents and the mortgagee may accelerate the loan. The parties of course heavily negotiate permitted transfers. Assuming that a senior mortgage note is securitized, rating agency affirmation may be required, even for permitted conveyances and transfers. Also, the lender on a junior note in a securitized transaction may want a separate approval right.

If the mortgage lender does not draft the due-on-sale clause specifically to include these specific types of equity and control transfers, a court likely will determine that such transfers do not constitute a violation of the clause. For example, in *Fidelity Trust Co. v. BVD Associates*, 196 Conn. 270, 491 A.2d 180 (1985), the court held that a change of membership occasioned by the withdrawal of general partners of a limited partnership, which was a distinct legal entity and remained so after the change in the general partnership interests, was not sufficient to constitute a "sale or conveyance" under the applicable due-on-sale clause. In *Hodges v. DMS Co.*, 652 S.W.2d 762 (Tenn.App. 1982), the court held that in the absence of express language covering such a transfer, the withdrawal of two of the partners of the partnership mortgagor, while the business was

continued in lieu of liquidation, did not amount to a sale or transfer of the secured property even though the entity had changed by operation of law, and did not activate the due-on-sale clause.

It still may be possible to legally avoid the enforcement of a due-on-sale clause in certain limited instances, albeit almost always in those situations where the clause contains ambiguous limitations or has not been carefully and comprehensively drafted by the lender. Many courts would still prefer to construe due-on-sale clauses as illegal restraints on alienation notwithstanding federal law to the contrary. Mortgage lenders and their counsel may inadvertently give them the opportunity to do so by virtue of sloppy or inadequately drafted contractual language.

What is the nature of an LLC interest, and what constitutes an "assignment" of such an interest?

See the following relevant provisions of the Delaware LLC Act, Del. Code Ann. tit. 6, § 18-101, *et seq.* (Note that, "[a]n assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member"):

§ 18-701. Nature of limited liability company interest

A limited liability company interest is personal property. A member has no interest in specific limited liability company property.

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§ 18-702. Assignment of limited liability company interest

(a) A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement and upon:

(1) The approval of all of the members of the limited liability company other than the member assigning the limited liability company interest; or

(2) Compliance with any procedure provided for in the limited liability company agreement.

(b) Unless otherwise provided in a limited liability company agreement:

(1) An assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member;

(2) An assignment of a limited liability company interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned; and

(3) A member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of the member's limited liability company interest. Unless otherwise provided in a limited liability company agreement, the pledge of, or granting of a security interest, lien or other encumbrance in or against, any or all of the limited liability company interest of a member shall not cause the member to cease to be a member or to have the power to exercise any rights or powers of a member.

(c) Unless otherwise provided in a limited liability company agreement, a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company. A limited liability company agreement may provide for the assignment or transfer of any limited liability company interest represented by such a certificate and make other provisions with respect to such certificates.

(d) Unless otherwise provided in a limited liability company agreement and except to the extent assumed by agreement, until an assignee of a limited liability company interest becomes a member, the assignee shall have no liability as a member solely as a result of the assignment.

(e) Unless otherwise provided in the limited liability company agreement, a limited liability company may acquire, by purchase, redemption or otherwise, any limited liability company interest or other interest of a member or manager in the limited liability company. Unless otherwise provided in the limited liability company agreement, any such interest so acquired by the limited liability company shall be deemed canceled.

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#### § 18-703. Member's limited liability company interest subject to charging order

(a) On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the limited liability company interest of the judgment debtor to satisfy the judgment. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the limited liability company, which receiver shall have only the rights of an assignee, and the court may make all other orders, directions, accounts and inquiries the judgment debtor might have made or which the circumstances of the case may require.

(b) A charging order constitutes a lien on the judgment debtor's limited liability company interest. The court may order a foreclosure of the limited liability company interest subject to the charging order at any time. The purchaser at the foreclosure sale has only the rights of an assignee.

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§ 18-704. Right of assignee to become member

(a) An assignee of a limited liability company interest may become a member as provided in a limited liability company agreement and upon:

(1) The approval of all of the members of the limited liability company other than the member assigning limited liability company interest; or

(2) Compliance with any procedure provided for in the limited liability company agreement.

(b) An assignee who has become a member has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member under a limited liability company agreement and this chapter. Notwithstanding the foregoing, unless otherwise provided in a limited liability company agreement, an assignee who becomes a member is liable for the obligations of the assignor to make contributions as provided in § 18-502 of this title, but shall not be liable for the obligations of the assignor under subchapter VI of this chapter. However, the assignee is not obligated for liabilities, including the obligations of the assignor to make contributions as provided in § 18-502 of this title, unknown to the assignee at the time the assignee became a member and which could not be ascertained from a limited liability company agreement.

(c) Whether or not an assignee of a limited liability company interest becomes a member, the assignor is not released from liability to a limited liability company under subchapters V and VI of this chapter.

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It is also instructive to see how bankruptcy courts treat attempted assignments of LLC interests. (Under recently enacted amendments to the Illinois LLC act, a member who becomes a debtor in bankruptcy and executes an assignment for the benefit of creditors, etc., becomes a “dissociating member” and such a member’s right to participate in the management of the LLC thereupon terminates.) In *In re Ashley Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003), the debtor, who filed a Chapter 13 bankruptcy petition that was later converted to a Chapter 7 liquidation, was the sole member and manager of a Colorado LLC at the time of the filing. The LLC was not a debtor in bankruptcy. The Chapter 7 trustee contended that because the debtor was the sole member and manager at

the time the debtor filed bankruptcy, he now controlled the LLC and could therefore sell the real property owned by the LLC and distribute the net sales proceeds to the bankruptcy estate. The debtor argued that the trustee acted only for the debtor's creditors and at most was entitled to a statutory charging order (against distributions made on account of the debtor's LLC membership interest) and could not assume management of the LLC or sell its property. The court referred to the Colorado LLC statute, under which the debtor's membership interest constituted the personal property of the member. According to the court, "[b]ecause there are no other members in the LLC, the entire membership interest passed to the bankruptcy estate, and the trustee became a 'substituted member.'" *Id.* at 540. The court also stated that, "upon the Debtor's bankruptcy filing, the Trustee now controls, directly or indirectly, all governance of that entity, including decisions regarding liquidation of the entity's assets." *Id.* at 541. The court reasoned that because there were no other members in the LLC, no written unanimous approval of the transfer was necessary, as would be the case under Colorado law if there were other members – no matter how small such other membership interests may be. See also *In re Garrison-Ashburn, L.C.*, 253 B.R. 700 (Bankr. E.D. Va. 2000), the court held that both before and after the enactment of amendments to the applicable LLC statute providing for the continued existence of an LLC, the bankruptcy of a member effected an assignment of that member's interest, whereby the disassociated member would retain his or her right to share in the LLC profits, losses and distributions but would forfeit any right to participate in management of the LLC.

(Colorado's LLC statute, similar to those in other states -- including Delaware -- provides that if such unanimous consent is not obtained, the bankruptcy estate is only entitled to receive the bankrupt member's share of the profits or other compensation that the bankrupt member was otherwise entitled to and would not be entitled to any role in the voting or governance of the LLC. However, in a footnote the court stated that this statutory limitation "does not create an asset shelter for clever debtors. To the extent a debtor intends to hinder, delay or defraud creditors through a multi-member LLC with 'peppercorn' co-members, bankruptcy avoidance provisions and fraudulent transfer law would provide creditors or a bankruptcy trustee with recourse." *Id.* at 541 n.9). The court rejected the debtor's assertion that the trustee should be entitled only to a charging order, holding that a charging order existed only to protect other members of an LLC, and in a single-member LLC there were no non-debtor members to protect. The court ruled that the trustee, as the sole member of the LLC, controlled the LLC and could cause the LLC to sell its property and distribute the net proceeds to the bankruptcy estate, or alternatively the trustee could elect to distribute the LLC's property to the bankruptcy estate, and then liquidate the property himself. However, the court did permit the debtor to make a claim for her post-petition mortgage payments to preserve the real property of the LLC, which was now an asset of the bankruptcy estate.