The New Normal: Lender Revisions to Pass-Through Entity Governing Documents

CLIENT ALERT | June 23, 2016

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RISK AND UNCERTAINTY ARE DRIVING LENDERS TO TAKE A DEEP LOOK INTO THE MECHANICS OF GOVERNING DOCUMENTS FOR PASS-THROUGH ENTITIES, BUT ARE ALSO CREATING A MARKET DYNAMIC WHERE LENDERS ARE MORE UNIFORMLY REQUESTING CHANGES IN PROVISIONS RELATING TO THE RELATIONSHIP AMONG EQUITY HOLDERS/SECURED PARTIES.

This article was published in the June 23, 2016 issue of Middle Market Growth, a weekly newsletter published by Association of Corporate Growth (ACG).

As limited liability companies (LLCs) and limited partnerships (LPs and, together with LLCs, the Pass-Through Entities) continue to grow in popularity as acquisition vehicles in private equity transactions, an interesting trend has arisen in their organizational documents. Financing sources (Lenders) have found it difficult to perfect and enforce

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security interests in equity interests of these Pass-Through Entities — which has led to Lenders commenting on and revising the governing documents of Pass-Through Entities in a way that would have been unusual just a few years ago.

One might wonder why a Lender would want to become involved in amending the private agreement governing the relationship among the investors beyond ensuring that the agreement permits a day-one pledge of equity interests to the Lender. The reason is that case law and state law on the subject have created some unfavorable outcomes and risks for Lenders.

Consider, for example, a situation where a secured Lender believes that it is receiving a pledge of the entire interest in an acquisition "topco" formed as an LLC in Delaware (Topco). Although Topco's operating agreement allows for a grant of a security interest in equity interests in Topco, it does not specify if the interests are "securities" within the meaning of the Uniform Commercial Code (UCC) or what rights are included within the scope of the security interest grant. The operating agreement does expressly prohibit the admission of new members to Topco without the consent of all members and states that there will be a waiting period before any new members can be admitted and that any transfer that does not comply with this structure will be deemed null and void.

While these provisions among members sound fairly typical for such operating agreements, they can present a minefield of issues for secured Lenders. A Lender looking to enforce a security interest in a distressed asset that is rapidly losing value does not want to find out that they have to wait a few months and seek consent from a disparate group of investors with whom relations might have already soured. That same Lender does not want to be in bankruptcy court with another secured creditor, challenging a competing claim to the equity interests that results in the subsequent secured creditor receiving certificated interests in Topco and having a superior interest to the equity interests in Topco, even though the first Lender properly filed its UCC-1 financing statements first. Nor does that Lender want an investor who becomes a member in Topco post-closing to challenge the types of rights the Lender is able to receive upon enforcement. And the Lender does not want to find out that, at best, it has a right to a profit interest in Topco (without any associated governance rights) or, even worse, that the restrictions in the operating agreement act as a bar to enforcement and override the Lender's ability to receive any interest in the entity at all.

This type of risk and uncertainty is driving Lenders to take a deep look into the mechanics of governing documents for Pass-Through Entities, but it is also creating a market dynamic where Lenders are more uniformly requesting changes in provisions relating to the relationship among equity holders/secured parties. One might wonder why a Lender does not just file a UCC-1 financing statement and/or take delivery of a certificate and blank stock power evidencing the equity interests, just as a Lender would do when structuring a comparable security interest in the shares of capital stock of a corporation. The issue is that, while this might provide a day-one security interest to a Lender, applicable case law and state law suggest that this may not be enough to ensure that the Lender receives on enforcement the bundle of rights agreed on in the term sheet and described in the credit approval.

The amendments to the Pass-Through Entities' governing documents that Lenders typically require seek, in essence, to more fully describe the collateral (and associated rights) in which the Lender wants to obtain an enforceable security interest. The amendments also aim to avoid a situation where, on enforcement, a court would need to conduct a complex conflicts of laws analysis to determine (1) which law should govern (i.e., the state law that governs the grant of the security interest or the law of the state where the Pass-Through Entity is formed) and (2) whether the anti-assignment overrides[1] provided for under the UCC would be sufficient to overcome restrictions contractually provided for in the Pass-Through Entities' governing documents or imposed by the law of the state where the Pass-Through Entity is formed.

Pass-Through Entities have become quite popular because they enhance the flexibility of an acquirer across a range of debt and equity financing strategies and provide the opportunity to structure tax-advantaged co-investments and management equity compensation that might not be available in the typical corporate form. We do not believe that the complexities in perfecting and enforcing security interests in the equity interests of Pass-Through Entities will drive a move away from Pass-Through Entity-based acquisition structures. We do envision, however, that the changes that Lenders are requesting to the Pass-Through Entities' governing documents will become more standardized in form and substance. Rather than Lenders pushing on a deal-by-deal basis for the removal of transfer provisions and waiting periods, the insertion of language designating such equity interest as "securities" within the meaning of Article 8 of the UCC, and the addition of pre-consents to the admission of Lenders as members/partners, we expect that, in the next few years, standardized versions of these provisions will become part of the boilerplate wording for operating agreements and other governing documents of Pass-Through Entities.

Endnote

1. With respect to certain classes of collateral, UCC anti-assignment overrides can dispense with limitations on the grant and/or enforcement of a security interest. The term "UCC anti-assignment overrides" in this context refers to sections 9-406 and 9-408 of the applicable UCC. The effect of UCC anti-assignment overrides on the grant of a security interest in an equity interest would need to be reviewed on a case-by-case basis and involves an analysis of both the laws governing the formation of the corporate entities and the UCC.