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Taking Security in NAV Lending: Delaware LLCs as Holding Vehicles

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When taking security in a NAV facility, borrowers often operate within a corporate structure where portfolio investments are held by holding vehicle subsidiaries. These holding vehicles serve various purposes, including tax efficiency, risk management, and creating specialized structures for co-investing and accessing new markets. In this scenario, the borrower pledges to the lenders the bank accounts into which these holding vehicles are required to deposit all distributions and sale proceeds from portfolio investments. Often, the borrower also pledges its equity interests in these holding vehicles, in addition to pledging the bank accounts. (See Brian Kurpis' overview of these collateral structures **here**) This article highlights issues practitioners should be mindful of when taking security of the equity interest in holding vehicles, with a focus on Delaware limited liability companies (and limited partnerships), and provides practical tips to ensure these issues are adequately addressed.

From a security/enforcement standpoint, a critical aspect of due diligence in any transaction is identifying the entity type and jurisdiction of formation for each holding vehicle. This diligence includes reviewing the operating agreements of these holding vehicles. We often see these holding vehicles set up as limited liability companies ("LLCs"), and it is not uncommon for the limited liability company agreement ("LLCA") to contain provisions establishing a manager-managed LLC. These LLCAs will designate a manager or managers (who can be LLC members or outside individuals or entities) to handle the daily operations and decision-making of the LLC.

In NAV facilities where the membership interests of a manager-managed LLC are being pledged, and the lenders intend to replace the manager when transferring the membership interest in a foreclosure sale, it is critical to ensure that the LLCA contains express provisions allowing the members to remove the manager in connection with such foreclosure without cooperation from the existing manager or the borrower. Where the equity interests in the manager have not been pledged as part of the collateral package, the absence of adequate manager replacement provisions in the LLCA will create difficulties for lenders who wish to remove the manager when transferring the membership interests of the LLC, even when the lenders control 100% of the membership interests in the LLC.

This issue is of particular concern for Delaware-formed LLCs (i.e., those that are manager-managed). Under Delaware's LLC Act, there is no 'default rule' allowing a majority interest of members to replace the manager when the LLCA is silent on the point (or even a rule allowing 100% of the members to replace the manager for that matter). This can create potential leverage issues for lenders taking steps to fully enforce their security when they intend to ultimately acquire the management rights over Delaware-formed LLCs.

Of particular concern is the scenario in which a manager refuses to resign as manager in circumstances where the LLCA does not have manager removal provisions. Section 18-402 of Delaware's LLC Act provides that "a manager shall cease to be a manager as provided in a limited liability company agreement." In contrast, Section 414 of New York's LLC Law states that, "[e]xcept as provided in the operating agreement, any or all managers of a limited liability company may be removed or replaced with or without cause by a vote of a majority in interest of the members entitled to vote thereon." As a result, if the LLCA for the Delaware-formed LLC lacks manager removal provisions, pursuant to Section 18-110 of Delaware's LLC Act, the only recourse for members seeking to remove a manager is to apply to the Delaware Court of Chancery for a determination of the validity of the removal by those members. However, this can be a high bar.**[1]** Delaware's LLC Act is based on a contractarian principle, meaning that even where such interpretation

leads to a counterintuitive outcome, the courts treat the LLCA as a contract between the parties and the primary source for determining rights and responsibilities, including manager removal.[2]

Delaware Limited Partnerships

It is worth highlighting that a similar issue for general partner removal and concurrent replacement can present itself for Delaware limited partnerships. In sum, where a Delaware limited partnership agreement ("LPA") is silent on the removal/replacement mechanics for a general partner, the limited partners will also need to seek judicial intervention from the Delaware Court of Chancery to remove the general partner and appoint a new one. Absent any wrongdoing on the part of the existing general partner, its dissolution, insolvency, bankruptcy, a breach of fiduciary duties, a breach of the LPA itself, or an express removal right in the LPA,[3] an application to the Delaware Court of Chancery for general partner removal would need to be predicated on the general partner's conduct relating to the partnership business or affairs making it not reasonably practicable to carry on the business or affairs in partnership with the general partner.[4] This is obviously a high bar to satisfy for equitable relief.

An event of withdrawal of a general partner can trigger the dissolution of the limited partnership, particularly if there is no other general partner. See Section 17-801 of the Delaware Revised Uniform Partnership Act.

Key Takeaways

It is important to ensure the following points are appropriately addressed during the diligence phase of the transaction when dealing with manager-managed Delaware-formed LLCs. Additionally, in light of the above-mentioned information regarding Delaware limited partnerships, an analogous diligence undertaking should be performed on LPAs to ensure a similar issue does not present itself when limited partnership interests are pledged and lenders also wish to have the ability to acquire the general partnership rights via replacing the general partner:

- Do the LLCA terms provide that members have the unilateral ability to amend the terms of the LLCA? This is to ensure the manager cannot veto necessary amendments following the transfer of membership interests in an enforcement scenario. For completeness, we note that the NAV facility transaction documentation would include terms that preclude amendments to the operating agreements of holding vehicles deemed adverse to the lenders' security interests.
- Do the LLCA terms include an express provision allowing for the replacement of the manager at any time and for any reason (i.e., without cause) with approval from the majority of interest (>50%) of the membership interests? LLCAs that contain language allowing for the removal of a manager only with the manager's consent should be avoided by lenders in these contexts.
- Do the LLCA terms contain any restrictions on who the replacement manager can be? We often see LLCAs contain provisions that require the replacement manager to be an affiliate of the existing manager. These provisions should be avoided by lenders in these contexts as they could serve to complicate a foreclosure.
- Do the LLCA terms contain provisions requiring prior notification to the manager before removal? Lenders should be aware of the procedural time periods for removal of a manager and, to the extent that the process is unnecessarily onerous from an enforcement standpoint, seek to have these terms amended in a manner reasonably satisfactory to the lenders.

It is worth noting that where a management agreement is in place between the existing manager and the LLC, these terms should also be reviewed carefully to determine whether the management agreement can be terminated at the discretion of the parties. If not, consideration should also be given to amending the agreement to ensure that the manager cannot sue the LLC for breach of contract should it be removed as the manager. As always, we are here to assist and answer any questions you have relating to the proper documentation requirements for your membership or limited partnership interest pledges in respect of manager-managed LLCs or limited partnerships, as applicable.

[1] In AM General Holdings LLC v. The Renco Group, Inc., C.A. No. 7639-VCS (Apr. 10, 2019), a member of an LLC requested the Court to remove the managing member. In a previous decision, the Court dismissed a request for removal based on breach of fiduciary duties. The LLC agreement did not provide a mechanism for removal. In this case, the member argued that it had the right to remove the managing partner because the agreement provided that the members were entitled to seek "specific performance" and "other appropriate relief or remedy". The Court declined to grant equitable relief on the basis that the remedy for breach of contract was limited to damages, specific performance and injunctions and not equitable relief. It is worth noting that, had the member successfully argued a breach of fiduciary duty and based the request for removal on breach of such fiduciary duty, the Court may have been inclined to grant such request.

[2] See *Bold St. Peters, L.P. v. Bold on Boulevard LLC, et al.* (C.A. No. 2024-0653-MTZ)

[3] See Section 15-601 and 17-402 of the Delaware Revised Uniform Partnership Act for further grounds for general partner removal.

[4] See Section 15-601(5) of the Delaware Revised Uniform Partnership Act.