

Article Title: ARCHIVE | Legal Criteria: Revised Legal Criteria for Multi- And Single-Member LLCs Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by the article titled "Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities," published Oct. 1, 2006.) The limited liability company (LLC), a legal entity of fairly recent vintage, provides its owner-members with the limited liability advantages of a corporation and the tax-transparency of a partnership or S-corporation. In rated transactions, the LLC is often used as a "bankruptcy remote," special-purpose entity (SPE) in structured or semistructured transactions, usually as the issuer of the rated debt. In general, Standard & Poor's SPE criteria attempt to render a corporation, partnership, LLC, business trust, or other entity "bankruptcy remote," in part by contractually restricting its objects and powers, issuance of additional debt, and ability to merge and consolidate, and by providing a mechanism requiring the assent of an independent third party as a condition to filing a voluntary bankruptcy petition (the so-called "independent director" or "golden share" provision). The SPE criteria have three goals: reducing the possibility that the entity will become insolvent as a result of some activity not contemplated when the debt was rated; minimizing the effect of the insolvency of the "equity" (shareholder, partner, or member) on the SPE; and creating a disincentive for any owner of the SPE to file, or cause to be filed, the SPE into bankruptcy. In the four years since Standard & Poor's first published its criteria on the subject, the LLC has become an increasingly common participant in rated transactions. Moreover, certain tax law changes have permitted the development of the so-called single-member LLC, which has served in a variety of structured, corporate, project finance, and regulatory-based transactions. While Standard & Poor's has rated transactions with single-member LLCs, its previously published criteria had not specifically addressed this structure. Standard & Poor's has formalized its criteria for single-member LLCs, which it now publishes, along with a restatement of its criteria for multi-member LLCs. Characteristics of the LLC The District of Columbia and each of the 50 states have enacted statutes authorizing and recognizing the LLC. In Delaware (seemingly the preferred organizational jurisdiction), an LLC is formed by filing a certificate of formation and, usually, entering into an LLC agreement. The LLC agreement has its corporate counterpart in the articles of incorporation, by-laws, and shareholders agreement, and its limited partnership counterpart in the limited partnership agreement. Among other things, the LLC agreement defines the objects and powers of the LLC and establishes fundamental organizational matters. An owner of an LLC is termed a "member." In general, members may be corporations, partnerships, other LLCs, trusts, trustees, individuals, or other entities in their personal, or in a representative, capacity. In other jurisdictions, an LLC may be formed by filing "articles of organization," which cover much of the same detail as the LLC agreement. The defining characteristic of the LLC is its flexibility: The LLC combines many advantageous features of the corporation and the limited partnership. For example, contrary to the practice for limited partnerships, where participation in the management of the partnership by a limited partner brings with it the possibility of unlimited liability, or corporations, where the shareholders' role is restricted to voting for the board of directors and to other limited matters, a member of an LLC is, in principle, free to participate in the management of the LLC. Certain state LLC statutes allow the members considerable latitude in arranging for the LLC's management. Under the Delaware Limited Liability Company Act (Delaware Act), for example, the LLC can be managed through agreement of the members, by a board of managers (similar to a corporation's board of directors), or by one or more members individually (similar to the duties of a general partner of a partnership). The Delaware Act also allows a member or manager of the LLC to delegate its rights and powers to agents, officers, and employees of the member or manager, as the case may be. Analogous to a partnership, but unlike a corporation, the LLC could have a limited life and could be dissolved upon the bankruptcy, death, or dissolution of a member. However, many state LLC statutes (such as the Delaware Act) provide that an LLC shall have perpetual existence unless otherwise specified by its governing documents. Thus, an insolvency of one or more members of the LLC need not, in and of itself, cause the dissolution or termination of the LLC. However, because an LLC may not exist without any members at all, the liquidation, withdrawal, dissolution, or termination of all of the members may affect the existence of the LLC. Consistent with its other SPE criteria, Standard & Poor's believes that if the transaction rating depends on the SPE status of the LLC, it is important to minimize any events that may cause the LLC to dissolve. Accordingly, Standard & Poor's views favorably those state LLC statutes that permit the

greatest degree of flexibility in minimizing dissolution events and that do not require the unanimous consent of remaining members to continue the existence of the LLC upon the withdrawal or termination of a member. But all of this flexibility may come at a price. While the LLC may well have satisfied the "single purpose" and other criteria necessary for SPE status, the hybrid nature of the LLC structure (limited liability with tax transparency) may pose certain "characterization" issues in the event that one or more of the LLC's members were to become insolvent. The relatively undeveloped state of the bankruptcy law applicable to LLCs, along with the fact that the LLC possesses characteristics shared by both corporations and partnerships, raises questions about how an LLC will be treated if one or more of its members becomes insolvent. Standard & Poor's criteria deal with these issues by reducing the likelihood that an LLC would be exposed to the effects of a member insolvency. The following criteria address concerns arising out of the particular characteristics of LLCs and are designed to be consistent with the criteria for limited partnership and corporate SPEs. Criteria for Multi-Member LLC 1. The LLC must be established only to engage in the particular activity set forth in its organizational documents. The "particular activity" is that activity (and reasonably incidental other activities) which provides the cash flow necessary to pay timely interest and principal on the rated obligations. 2. To counter arguments that the LLC and an individual member should be substantively consolidated or that "piercing the veil" should be available to a creditor or an insolvent member, the LLC and the members and managers on behalf of the LLC must agree to abide by certain "separateness covenants" whereby the LLC will: Maintain books and records separate from any other person or entity; Avoid commingling assets with those of any other entity; Conduct its own business in its own name; Maintain separate financial statements; Pay its own liabilities out of its own funds; Observe all organizational formalities; Maintain an arm's-length relationship with its affiliates; Avoid guaranteeing or becoming obligated for the debts of any other entity or holding out its credit as being available to satisfy the obligations of others; Allocate fairly and reasonably any overhead for shared office space; Use separate stationary, invoices, and checks; Avoid pledging its assets for the benefit of any other entity; and Hold itself out as a separate entity. These separateness covenants are required, notwithstanding the fact that many state statutes provide that the LLC will be treated as a separate legal entity from its members. 3. The LLC must have an "independent manager" that is (i) a member that is an SPE as determined by Standard & Poor's published criteria, (ii) an SPE that is not a member, or (iii) a natural person. The "independent manager" of an LLC is an entity correlative to the "independent director" of an SPE corporation whose primary function is to vote for, consent to, or vote against or dissent from, as appropriate, the filing of (or acquiescence in) a voluntary bankruptcy petition against the LLC. (See graphic 1 for a definition of "independent manager.") Graphic 1 4. The LLC's organizational documents must prohibit it from filing a voluntary bankruptcy petition or from consenting to or acquiescing in an involuntary petition without the affirmative vote of all of the members (including the independent director of the SPE member, if applicable) and the "independent manager" (if the "independent manager" is not a member) of the LLC. The LLC's organizational documents must provide that, when acting on matters subject to the vote of the members, notwithstanding that the LLC is not then insolvent, the members and the "independent manager" shall take into account the interest of the LLC's creditors, as well as those of its members. The Delaware Act permits the duties (including fiduciary duties) and liabilities of a member or manager of an LLC that exist at law or in equity to the LLC or to another member or manager to be expanded or restricted by provisions in the LLC agreement and further provides that no member or manager acting under the LLC agreement shall be liable to the LLC or to any such other member or manager for the member's or manager's good faith reliance on the provisions of such LLC agreement. 5. The assets of any member must not at any time be commingled with the assets of the LLC; any dealings between the LLC and its members must be "arms-length" transactions. 6. The LLC's organizational documents must prohibit it from engaging in a merger, conversion, consolidation, or, except as contemplated by the transaction documents, asset transfer. 7. The LLC's organizational documents must prohibit additional debt or the incurrence of any other actual or contingent liability unless either (a) the additional debt or liability is rated by Standard & Poor's the same as the rating on the obligation in question (at the time of issuance and at all times going forward), or (b) the additional debt or liability is fully subordinated to the rated obligation, and, in either case, is nonrecourse to the LLC or any assets of the LLC other than cash flow in excess of amounts necessary to pay holders of the rated obligation, and does not constitute a

claim against the LLC to the extent that funds are insufficient to pay such additional debt or liability. 8. Upon dissolution of the LLC, or upon other events of default, holders of the LLC's rated obligations must have the independent ability to retain the collateral and continue to pay scheduled debt service, or to liquidate the collateral in the event the proceeds would be insufficient to repay all amounts due. 9. To the extent permitted by tax law, the LLC agreement or articles of organization should provide that the LLC should not be dissolved and its affairs should not be wound up solely upon the withdrawal or termination of a member (other than the last remaining member). If the LLC is dissolved, to the extent permitted by law, the articles of organization must provide that the LLC assets not be liquidated (except as permitted under the transaction documents) without the consent of 100% of the holders of rated obligations. Such holders may continue to exercise all of their rights under the existing security agreements or mortgages, and must be able to retain the collateral until the debt has been paid in full or otherwise completely discharged. 10. The LLC must be qualified under applicable law in the state in which the LLC's assets are located if the LLC is not organized under the laws of that state. 11. The LLC must provide Standard & Poor's with an opinion of counsel that, upon the insolvency of a non-SPE member, neither the LLC nor its assets would be consolidated with such member and, with respect to an SPE member, that upon the insolvency of the parent of such SPE member, neither the SPE member nor its assets would be consolidated with the parent. 12. If the LLC has no SPE members, Standard & Poor's concern is that the insolvency of a non-SPE member may precipitate the insolvency of the LLC itself, despite the fact that the LLC may be solvent and otherwise able to pay its debts as they become due. In addition to the LLC appointing an "independent manager," for a multi-member LLC having no SPE members, Standard & Poor's must receive legal comfort that the members would not be viewed as "general partners" of the LLC for purposes of Section 303(b)(3)(A) of the U.S. Bankruptcy Code and, therefore, in the event of insolvency of a member, the bankruptcy trustee of such a member could not unilaterally file the LLC into bankruptcy as a voluntary proceeding. Recognizing the absence of any direct authority on the issue, Standard & Poor's will accept an opinion premised on (i) the absence of general liability of LLC members under the relevant LLC statute (in contrast to general partners), (ii) the presence of specific provisions in the relevant LLC statute contemplating a single-member structure (in contrast to a partnership), and (iii) the quasicorporate nature of LLC governance. 13. If the LLC has no SPE members, Standard & Poor's must receive an opinion of counsel that (a) the required affirmative vote of the "independent manager" in order for the LLC to file a voluntary bankruptcy petition (see paragraph 3 above) is enforceable under applicable state law, and (b) in a bankruptcy proceeding of the LLC, a federal bankruptcy court would apply such state law in determining who has the authority to file a voluntary bankruptcy petition on behalf of the LLC.

Single-Member LLCs When Standard & Poor's first published its legal criteria for LLCs, federal tax considerations required LLCs to have at least two members to avoid "entity level" taxation. However, the "check-the-box" amendments to the Internal Revenue Code of 1986 permit a single-member LLC to avoid entity level taxation absent an election to the contrary. These amendments have had other effects: It is not now necessary to restrict transferability, limit the life of the LLC, or provide for minimum levels of capital contributions or capitalization of members in order to ensure pass-through tax treatment. There appear to be three variations of the single-member LLC: In the first, an SPE single member holds a 100% membership interest in the LLC; in the second, a non-SPE single member holds a 100% membership interest in the LLC but delegates certain rights and duties to an independent third party; in the third, a non-SPE member holds a 100% "economic" membership interest in the LLC with an SPE member or independent natural person holding a 0% "non-economic" membership interest. If not an SPE, the single "economic" member should be a legal entity, not a natural person. If the LLC has no SPE members, Standard & Poor's views the inclusion of the "springing member" provision described below as an advantage in structuring the LLC. With some adaptation, the criteria for multi-member LLCs may be made to apply to single-member LLCs as well.

LLC With SPE Single Member Structurally speaking, this variation is perhaps the least troublesome, as Standard & Poor's will assume that if the single member meets Standard & Poor's SPE criteria, the LLC is unlikely to become insolvent due to the single member's insolvency. The LLC must comply with the applicable criteria set forth under the above section **Criteria for Multi-Member LLCs**, including provision of the appropriate nonconsolidation opinions.

LLC With Non-SPE Single Member Like a multi-member LLC that has no SPE members,

Standard & Poor's concern with respect to a single-member LLC whose member is not an SPE is that the insolvency of the member may precipitate the insolvency or dissolution of the LLC itself. This concern is mitigated by compliance with the applicable criteria set forth under the section Criteria for Multi-Member LLCs, including provision of the opinions regarding nonconsolidation and enforceability of the "independent manager" provisions. In addition, for a non-SPE single-member LLC, an opinion should be provided to the effect that the bankruptcy of the non-SPE single member of the LLC will not, by itself, cause the LLC to be dissolved or its affairs to be wound up. See the section The "Springing Member," below.

LLC With "Economic" Non-SPE Member and "Non-Economic" SPE Member This type of LLC may more closely resemble the limited partnership model except that the "economic member" is generally an unrated (or lowly-rated) operating entity with the "non-economic" member serving as the "independent manager." A "non-economic" member may be either a legal entity or a natural person. As with a multi-member LLC having no SPE members, the concern with the "economic/non-economic" structure is that the insolvency of the non-SPE "economic" member may precipitate the insolvency of the LLC on the theory that the LLC will be treated, for bankruptcy purposes, as a partnership. This type of LLC must comply with the criteria for multi-member LLCs set forth above, except that Standard & Poor's will also require comfort that, like a single-member LLC whose member is not an SPE: The "non-economic" member must be functionally established as an SPE, the affirmative vote of which must be secured before the LLC could file a voluntary bankruptcy petition or consent to or acquiesce in an involuntary petition of the LLC; The death, bankruptcy, insolvency, or incapacity of the "economic" member will not, by itself, cause the LLC to be dissolved or its affairs to be wound up. See the section The "Springing Member," below; and Upon any insolvency of the "economic" member, neither the LLC nor its assets would be consolidated into the bankruptcy estate of such "economic" member. The "Springing Member" Standard & Poor's has taken assurance from the inclusion of the so-called "springing member" provision in the LLC agreement of a single-member LLC. This mechanism ensures that, in the event that the non-SPE member ceases to be a member of the LLC, the "independent manager" of the LLC automatically becomes a member of the LLC without any further act, vote, or approval of any person, so that the business of the LLC shall be continued without dissolution. Standard & Poor's must receive an opinion of counsel that such provision is enforceable. As appropriate, the criteria for single- and multi-member LLCs should be incorporated in the relevant LLC agreement or articles of organization and in the other transaction documents. State law and bankruptcy opinions should be delivered by outside counsel to Standard & Poor's for review well prior to closing. Standard & Poor's may require that the issuer provide a copy of the statute under which the LLC is constituted.