How To Perfect Equity Collateral Under Article 8

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With a little legal magic, a general intangible can be transmuted into investment property.

THIS ARTICLE DISCUSSES the different methods of perfecting a security interest in equity collateral in entities such as limited liability companies and partnerships pledged to secure the obligations of the pledgor/borrower to the pledgee/lender. The use of equity as collateral is a feature of mezzanine lending. Mezzanine lending is necessary when the mortgage lender to the entity holding the real property will not allow a second mortgage on the real property. The real estate owners are thus unable to borrow against the residual value in the real property resulting from the loan-to-value ratio of the mortgage debt.

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For example, assume that an entity is financing its acquisition of a commercial building valued at $100 million. The mortgagee lender is willing to advance funds based on a 75 percent loan-to-value ratio or $75 million. This advance rate requires the acquirer to come up with the additional $25 million. However, the mortgagee lender has precluded a second mortgage against the real property. To make up the difference in whole or part, the owner of the acquiring entity borrows additional funds from a mezzanine lender. The entity secures this additional indebtedness by pledging the equity ownership interest in the real property owner to the mezzanine borrower.

In response to the inability to place a second mortgage against the real property, the owners will form a first-tier acquisition entity to acquire and hold the real property and borrow against the value of the real property. They then form a second-tier entity as a holding company to hold the equity ownership in the acquisition entity holding the real property and to pledge this equity ownership to borrow against the unfunded value of the real property. A lender makes a loan to the first-tier entity. The real property secures this loan. Another lender makes a mezzanine loan to the second-tier entity. This loan is secured by the equity interest of the holding company in the first-tier entity.

However, the use of equity as collateral certainly is not limited to real property mezzanine lending. The use of equity as collateral is also important in many transactions when the owners of an entity are guarantying the obligations of that entity. An example would be financing provided to an entity with valuable intellectual property rights, such as licenses of technology. The licenses involved may preclude the assignment of those rights but might not include a prohibition against a change of control. If the intellectual property rights comprise part of the reliance collateral for the transaction, the only viable exit strategy might be selling the borrower as a going concern. The ability to sell the borrower as a going concern would require access to the equity interests in the borrower, access provided through a guaranty by the owners of the borrower of the obligations of the borrower/primary obligor to the lender and a pledge of the equity ownership in the borrower by the owners to secure their guaranty.

ARTICLE 8 • The securing of obligations with equity collateral brings into play both Article 8 and Article 9 of the Uniform Commercial Code. (All section and article references will be to the Uniform Commercial Code.) However, for many lawyers, especially lawyers who do not practice commercial law on a regular basis, Article 9 remains a mystery. Article 8 is totally off the screen, and may seem little more than a space saver between Article 7 and Article 9. However, not understanding Article 8 and its implications for equity collateral transactions can have a detrimental effect on your malpractice coverage premiums.

Malpractice Danger

It is also important to point out the technical complexity of Revised Article 9 and of Article 8. Periodic practice in this area may not provide the level of expertise necessary to satisfy the lawyer’s required standard of competence. The Special Report of the TriBar Opinion Committee: U.C.C. Security Interest Opinions—Revised Article 9, 58 Bus. Law. 1449 (2003) (“TriBar Report”), is very clear, although perhaps too subtle, on this issue when it states that “opinion preparers who do not regularly work with Article 9 should consider whether to involve a lawyer familiar with Article 9 in the preparation of a U.C.C. security interest opinion.” Id. at 1454. Article 9 is sufficiently complex on its own to preclude dabbling by general practitioners. The advice by the TriBar Report to call an expert is more urgent when Article 8 is rolled into Article 9.
Many attorneys involved in mezzanine loan transactions are quite pleased with themselves in having prepared a certificate evidencing the collateral equity interests in a limited liability company, in having that certificate endorsed over to the lender at a closing, and then having the lender take possession of the certificate to perfect its security interest. Many of the right steps are there. The problem, however, is that without more, a membership interest in a limited liability company is a general intangible and Article 9 provides only one method of perfecting a security interest in general intangibles—filing a financing statement at the appropriate filing office in the jurisdiction where the debtor is located. A general intangible cannot be possessed—hence the name intangible. The beautiful certificate evidencing a general intangible is of no legal effect.

Opting In To Article 8

Generally, an equity interest in a limited liability company, general partnership, or limited partnership is a general intangible and not a security for purposes of Article 8 or investment property for purposes of Article 9. Section 8-103 provides that, except for certain rarified situations that need not concern us here, equity interests in a limited liability company (“LLC”), a general partnership (“GP”), or a limited partnership (“LP”) are general intangibles unless the issuer explicitly “opts in” to Article 8 by specifying that the equity interests are securities governed by Article 8.

Opting-in is not very difficult. The LLC operating agreement, GP, or LP partnership agreement needs to contain certain minimal “magic” language to the effect that the equity interests in the issuer are governed by Article 8 of the applicable Uniform Commercial Code. Additionally, if the equity is certificated, the certificate should carry a legend that, at a minimum, says effectively the same thing (see Appendix A).

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One act does the magic and the other act puts potential purchasers on notice. That’s it, although a lender might want covenants in a security or pledge agreement that the issuer will not opt out of Article 8 and other protective provisions. Not very difficult, but a whole lot happens when the magic is performed.

If you take the above actions, the equity interest is magically transmuted from a general intangible into an Article 8 security and Article 9 investment property. As mentioned above, you can perfect a security interest in a general intangible only by filing; priority among security interests is determined under the “first to file” rules of Article 9. In contrast to a general intangible, you can perfect a security interest in investment property by:

- Filing;
- Possession; or
- Control (possession of the certificate evidencing certificated equity and an endorsement usually in blank of the certificate, or by a control agreement with the issuer in the case of uncertificated equity).

As investment property, a security interest perfected by control or possession would, in most cases, have priority over a competing se-
curity interest that had previously been perfected only by filing, even if the subsequent secured party had knowledge (as defined under Article 9—actual knowledge) of the competing security interest. As is obvious, if a secured party obtains control or possession of a certificated security, no other party can usually obtain control of the security because that control also requires possession of the certificate.

MANNER OF PERFECTION AND THE PRIOR-ITY RULES • Some examples of these priority rules might be helpful:

In the example contained in Appendix B, the membership interest is a general intangible because the issuer has NOT opted in to Article 8. There is only one mezzanine lender.

Now what happens if there are two mezzanine lenders financing the same borrower in the non-opt-in context? In Appendix C, the priority of the competing security interests is resolved by the “first-to-file” rule of Article 9.

The example in Appendix D involves a single mezzanine lender perfecting against the equity of an issuer that has opted in to Article 8.

Again, if there are two mezzanine lenders to the same borrower in the opt-in context, and both perfect by filing, the priority conflict is resolved by the first-to-file rule. See Appendix E.

If the two mezzanine lenders perfect their security interests in the equity collateral in the same manner by either possession or by control (e.g., two control agreements with the issuer in the context of uncertificated equity), again the first to perfect prevails. See Appendix F.

Now, what happens in the opt-in context if our two mezzanine lenders perfect by different methods? Again, we are dealing with investment property and not general intangibles. Therefore, there are three available methods of perfection: filing, possession, and control; and the perfection methods trump each other in reverse order. See Appendix G.

As a variation, let’s assume that one mezzanine lender perfects by possession (e.g., through a bailee arrangement) and the other mezzanine lender perfects by control (e.g., obtaining possession of the certificate with the necessary endorsement). See Appendix H.

Now, let’s take a more complex example, an example that shows in stark relief why a lender wants the debtor/pledgor to cause the issuer of the equity collateral to opt-in to Article 8. Let us assume that the first mezzanine lender lends against the equity collateral at a point in time when the issuer had not opted in to Article 8 and the membership interests in the LLC issuer were general intangibles. The mezzanine lender, understanding that the equity interests are general intangibles, files a financing statement in the appropriate jurisdiction to perfect its security interest.

Subsequently, and probably in violation of numerous covenants in the loan documents, the issuer decides to opt-in to Article 8. The bad debtor and issuer collude to certificate the morphed membership interests and borrow from a second mezzanine lender. The second mezzanine lender, not knowing of the adverse claim of the first mezzanine lender, perfects its security interest by taking possession of the certificates evidencing the membership interests with appropriate endorsements. Now what happens?

Appendix I graphically illustrates this fact pattern.

In this example, through fraud or whatever, the first mezzanine lender loses its priority perfected security interest in the equity collateral. The collateral is no longer a general intangible but has been morphed into a security for purposes of Article 8 and investment property for purposes of Article 9. The second lender perfects its security interest in the equity collateral by possession or control thereby trumping the