

*Presenting a live 90-minute webinar with interactive Q&A*

# Equity Interests as Collateral: Creating and Enforcing Security Interests in Stocks, Partnerships, and LLCs

Planning and Documentation Issues, Avoiding Potential Pitfalls in Perfecting Security Interests

---

THURSDAY, DECEMBER 1, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

---

Today's faculty features:

James S. Cochran, Partner, **O'Connor Cochran LLP**, Los Angeles

Steven O. Weise, Partner, **Proskauer Rose LLP**, Los Angeles

---

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

# SECURITY INTERESTS IN EQUITY INTERESTS

James S. Cochran\*  
O'Connor Cochran LLP  
December 1, 2022

## I. PRELIMINARY MATTERS

- A. **Focus of Outline.** The focus of this outline is on the rules of law in the Uniform Commercial Code (the “UCC”)<sup>1</sup> that apply to *commercial* transactions in which security interests in partnership, limited liability company and other equity interests are involved. Unless otherwise noted, this outline does not address non-UCC rules of law (such as those relating to tax and other statutory liens) nor does it discuss the provisions of the UCC that affect *consumer* transactions.
- B. **Arcane Matters.** The UCC contains a number of provisions that are of limited interest to general practitioners. For the most part, these provisions will not be discussed in this outline.

## II. SECURITY INTERESTS IN EQUITY INTERESTS

### A. Key Definitions.

1. **Security.** A “security” is, except as otherwise provided in Section 8-103, an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer that satisfies all of the following requirements:
- a. **Transferability test.** It is represented by a security certificate in bearer or registered form, or the transfer of it may be registered upon books maintained for that purpose by or on behalf of the issuer.<sup>2</sup>

---

\* James S. Cochran is a partner at O'Connor Cochran LLP, a real estate and finance law firm based in Los Angeles, California. Formerly a co-chair of the Uniform Commercial Code Committee of the California State Bar's Business Law Section and a member of the Section's Executive Committee, Mr. Cochran is currently a member of the Opinions Committee of the California Lawyers Association's Business Law Section. He may be reached at [jcochran@oconnorcochran.com](mailto:jcochran@oconnorcochran.com). Mr. Cochran wishes to thank James D. Prendergast, former General Counsel of the UCC Division of First American Title Insurance Company, and Steven O. Weise, a partner in the Los Angeles office of Proskauer Rose LLP, for their editorial assistance in the preparation of this outline.

<sup>1</sup> In this outline, all references to the UCC are to the current official text of the UCC promulgated by the UCC's sponsoring organizations, The American Law Institute and the Uniform Law Commission, as modified by the recently approved 2022 amendments. Unless otherwise indicated, all “article” and “section” references in this outline are to articles and sections of the UCC.

<sup>2</sup> See UCC § 8-102(a)(15)(i).

- b. Divisibility test. It is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.<sup>3</sup>
- c. Functional test. It is *either* of the following:
  - (i) It is, or is of a type, dealt in or traded on securities exchanges or securities markets.<sup>4</sup>
  - (ii) It is a medium for investment and by its terms expressly provides that it is a security governed by Article 8.<sup>5</sup>

Section 8-103 provides that a share or similar equity interest issued by a corporation, business trust, joint stock company or similar entity is a security.<sup>6</sup> However, Section 8-103 also provides that an interest in a partnership or limited liability company is not a security unless (1) it is dealt in or traded on securities exchanges or in securities markets, (2) its terms expressly provide that it is a security governed by Article 8, or (3) it is an investment company security.<sup>7</sup>

- 2. ***Certificated security***. “Certificated security” means “a security that is represented by a certificate.”<sup>8</sup>
- 3. ***Uncertificated security***. “Uncertificated security” means “a security that is not represented by a certificate.”<sup>9</sup>
- 4. ***Security certificate***. “Security certificate” means a certificate representing a security, such as a traditional paper certificate.<sup>10</sup>
- 5. ***Bearer form***. “Bearer form,” as applied to a certificated security, refers to a form in which the security is payable to the bearer of the security certificate according to its terms but not by reason of an indorsement.<sup>11</sup>

---

<sup>3</sup> See UCC § 8-102(a)(15)(ii).

<sup>4</sup> See UCC § 8-102(a)(15)(iii)(A).

<sup>5</sup> See UCC § 8-102(a)(15)(iii)(B).

<sup>6</sup> See UCC § 8-103(a).

<sup>7</sup> See UCC § 8-103(c). The term “investment company security” is defined in Section 8-103(b).

<sup>8</sup> UCC § 8-102(a)(4).

<sup>9</sup> UCC § 8-102(a)(18).

<sup>10</sup> See UCC § 8-102(a)(16) & cmt. 16.

<sup>11</sup> See UCC § 8-102(a)(2).

6. **Registered form.** “Registered form,” as applied to a certificated security, refers to a form in which both of the following apply: (a) the security certificate specifies a person entitled to the security; and (b) a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the issuer or the security certificate so states.<sup>12</sup>
7. **Investment property.** Under Article 9, “investment property” includes (among other things) certificated and uncertificated securities.<sup>13</sup>
8. **General intangible.** A “general intangible” is any personal property (including things in action) other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction.<sup>14</sup>
9. **Payment intangible.** A “payment intangible” is “a general intangible under which the account debtor’s principal obligation is a monetary obligation.”<sup>15</sup>
10. **Controllable payment intangible.** A “controllable payment intangible” is “a payment intangible evidenced by a controllable electronic record that provides that the account debtor undertakes to pay the person that under Section 12-105 has control of the controllable electronic record.”<sup>16</sup>

**B. Attachment.**

1. **Governing law.** The law governing attachment of a security interest in an equity interest is generally determined by agreement of the debtor and the secured party.<sup>17</sup>
2. **Elements of attachment.** As a general rule, a security interest attaches to an equity interest when it becomes enforceable against the debtor with

---

<sup>12</sup> See UCC § 8-102(a)(13).

<sup>13</sup> See UCC § 9-102(a)(49).

<sup>14</sup> See UCC § 9-102(a)(42). For purposes of this definition, the terms “account,” “chattel paper,” “commercial tort claim,” “deposit account,” “document,” “goods,” “instrument,” “investment property,” “letter-of-credit rights” and “money” have the respective meanings assigned to such terms in Section 9-102 and the term “letter of credit” has the meaning assigned to such term in Section 5-102. In addition, the term “oil, gas, or other minerals before extraction” has the meaning set forth in official comment 4.c to Section 9-102.

<sup>15</sup> UCC § 9-102(a)(61). In this context, the term “account debtor” means a person obligated on the general intangible. See UCC § 9-102(a)(3).

<sup>16</sup> UCC § 9-102(a)(27B). For purposes of this definition, the term “controllable electronic record” has the meaning assigned to such term in Section 12-102(a)(1), and the term “control” has the meaning assigned to such term in Section 12-105(a).

<sup>17</sup> See UCC § 1-301(a); see also UCC § 9-301 cmt. 2.

respect to the equity interest.<sup>18</sup> Subject to certain exceptions,<sup>19</sup> a security interest in an equity interest is enforceable only if the following requirements are met:

- a. Value. “Value” (as defined in Article 1) has been given.<sup>20</sup>
- b. Rights. The debtor has rights in the collateral (*i.e.*, the equity interest) or the power to transfer rights in the collateral to a secured party.<sup>21</sup>
- c. Evidence of agreement. One of the following conditions is met:
  - (i) The debtor has signed a security agreement that describes the collateral (*i.e.*, the equity interest).<sup>22</sup>
  - (ii) The collateral is a certificated security in registered form and the related security certificate has been delivered to the secured party under Section 8-301 pursuant to the debtor’s security agreement.<sup>23</sup>
  - (iii) The collateral is investment property (*e.g.*, a certificated or uncertificated security) or a controllable payment intangible and the secured party has “control” under Section 9-106 (in the case of investment property) or Section 9-107A (in the case of a controllable payment intangible) pursuant to the debtor’s security agreement.<sup>24</sup>

## C. **Perfection.**

### 1. ***Certificated and uncertificated securities.***

- a. Governing law.
  - (i) Certificated securities.
    - (a) If a security interest in a certificated security is perfected by filing, the law governing perfection is

---

<sup>18</sup> See UCC § 9-203(a).

<sup>19</sup> These exceptions are generally set forth in Section 9-203(c) through (i).

<sup>20</sup> See UCC § 9-203(b)(1). For the definition of “value” in this context, see Section 1-204.

<sup>21</sup> See UCC § 9-203(b)(2).

<sup>22</sup> See UCC § 9-203(b)(3)(A).

<sup>23</sup> See UCC § 9-203(b)(3)(C).

<sup>24</sup> See UCC § 9-203(b)(3)(D).

the local law of the jurisdiction in which the debtor is deemed to be located under Section 9-307.<sup>25</sup>

- (b) If a security interest in a certificated security is perfected other than by filing, the law governing perfection is the local law of the jurisdiction in which the related security certificate is located.<sup>26</sup>

(ii) Uncertificated securities.

- (a) If a security interest in an uncertificated security is perfected by filing, the law governing perfection is the local law of the jurisdiction in which the debtor is deemed to be located under Section 9-307.<sup>27</sup>

- (b) If a security interest in an uncertificated security is perfected other than by filing, the law governing perfection is the local law of the “issuer’s jurisdiction” as specified in Section 8-110(d).<sup>28</sup> Generally, the issuer’s jurisdiction is the jurisdiction under which the issuer of the security is organized.<sup>29</sup>

b. Methods of perfection.

(i) Certificated securities.

- (a) A security interest in a certificated security may be perfected by filing a financing statement.<sup>30</sup>

---

<sup>25</sup> See UCC § 9-305(c)(1).

<sup>26</sup> See UCC § 9-305(a)(1). Under this rule, if the security certificate is located in a foreign jurisdiction (*i.e.*, a jurisdiction that has not adopted the UCC), the law governing both perfection and priority will be the local law of the foreign jurisdiction, which may not produce the result desired by the secured party. A partial solution to this problem is first to rely on perfection by filing and then, if and when the security certificate is physically transferred to a jurisdiction that has adopted the UCC, to rely on perfection by another method (*e.g.*, delivery or control). Of course, this approach will work only if, under the various rules contained in Section 9-307, the debtor is deemed located in a jurisdiction that has adopted the UCC. Also, because perfection by filing only affects the law governing perfection, this approach will not change the law governing priority until the security certificate is physically transferred to the UCC jurisdiction.

<sup>27</sup> See UCC § 9-305(c)(1).

<sup>28</sup> See UCC § 9-305(a)(2).

<sup>29</sup> See UCC § 8-110(d).

<sup>30</sup> See UCC § 9-312(a).

- (b) A security interest in a certificated security may also be perfected by “control” under Section 9-106, which for this purpose has the meaning set forth in Section 8-106.<sup>31</sup>
  - (1) A secured party has control of a certificated security in bearer form if the certificated security is delivered to the secured party.<sup>32</sup>
  - (2) A secured party has control of a certificated security in registered form if (A) the certificated security is delivered to the secured party and (B) either the certificate is indorsed to the secured party or in blank by an effective indorsement or the certificate is registered in the name of the secured party, upon original issue or registration of transfer by the issuer.<sup>33</sup>
- (c) A security interest in a certificated security may be perfected by taking “delivery” under Section 8-301.<sup>34</sup>
- (d) A security interest in a certificated security may be perfected on a temporary basis under the limited circumstances described in Section 9-312.<sup>35</sup> In each case, the period of temporary perfection is 20

---

<sup>31</sup> See UCC §§ 9-314(a) (a security interest in investment property may be perfected by control under Section 9-106), 9-102(a)(49) (investment property includes a security, whether certificated or uncertificated), 9-106(a) (a person has control of a certificated or uncertificated security as provided in Section 8-106).

<sup>32</sup> See UCC § 8-106(a). For this purpose, “delivery” has the meaning set forth in Section 8-301(a). See UCC § 8-106 cmt. 2. Under Section 8-301(a), delivery of a certificated security to a “purchaser” (such as a secured party) generally occurs when the purchaser or another person (other than a securities intermediary) acting on the purchaser’s behalf acquires physical possession of the related security certificate. See UCC § 8-301(a)(1)-(2) & cmt. 2.

<sup>33</sup> See UCC § 8-106(b). On the meaning of “delivery” for this purpose, see note 32 above.

<sup>34</sup> See UCC § 9-313(a). On the meaning of “delivery” for this purpose, see note 32 above. Note that for a certificated security in registered form, indorsement of the security certificate is generally not a requirement. See UCC § 8-301(a).

<sup>35</sup> See UCC §§ 9-312(e) (a security interest in a certificated security is perfected without filing or the taking of possession or control for a period of 20 days from the time the security interest attaches to the extent that it arises for new value given under a signed security agreement), 9-312(g) (a perfected security interest in a certificated security remains perfected for 20 days without filing if the secured party delivers the security certificate to the debtor for the purpose of either (i) ultimate sale or exchange or (ii) presentation, collection, enforcement, renewal or registration of transfer).

days.<sup>36</sup> After the 20-day period expires, perfection depends upon compliance with other provisions of Article 9.<sup>37</sup>

- (ii) Uncertificated securities.
  - (a) A security interest in an uncertificated security may be perfected by filing a financing statement.<sup>38</sup>
  - (b) A security interest in an uncertificated security may also be perfected by “control” under Section 9-106, which for this purpose has the meaning set forth in Section 8-106.<sup>39</sup> Under Section 8-106, a secured party has control of an uncertificated security if either (A) the uncertificated security is delivered to the secured party<sup>40</sup> or (B) the issuer has agreed that it will comply with instructions originated by the secured party without further consent by the registered owner.<sup>41</sup>

## 2. *General intangibles.*

### a. Governing law.

- (i) The law governing perfection of a security interest in a general intangible that is not a payment intangible is the

---

<sup>36</sup> See UCC §§ 9-312(e), 9-312(g).

<sup>37</sup> See UCC § 9-312(h). Note that “if the security interest is not perfected by another method until after the 20-day period expires, there will be a gap during which the security interest is unperfected.” UCC § 9-312 cmt. 9.

<sup>38</sup> See UCC § 9-312(a).

<sup>39</sup> See UCC §§ 9-314(a) (a security interest in investment property may be perfected by control under Section 9-106), 9-102(a)(49) (investment property includes a security, whether certificated or uncertificated), 9-106(a) (a person has control of a certificated or uncertificated security as provided in Section 8-106). Currently, the UCC provides two methods for obtaining control of an uncertificated security. See text accompanying notes 40-41 below. However, certain jurisdictions may have non-uniform provisions providing additional methods for obtaining control. For example, Delaware’s version of the Uniform Commercial Code provides a third method for obtaining control of an uncertificated security. See DEL. CODE ANN. tit. 6, § 8-106(c)(3).

<sup>40</sup> See UCC § 8-106(c)(1). “Delivery,” for this purpose, is defined in Section 8-301(b). See UCC § 8-106 cmt. 3. Under Section 8-301(b), delivery of an uncertificated security to a purchaser (such as a secured party) generally occurs when the purchaser or another person (other than a securities intermediary) acting on the purchaser’s behalf becomes the registered owner of the uncertificated security. See UCC § 8-301(b) & cmt. 3.

<sup>41</sup> See UCC § 8-106(c)(2). Note that a secured party who satisfies the requirements of this provision has control of the uncertificated security even if the registered owner retains the right to make substitutions for the uncertificated security, to originate instructions to the issuer or otherwise to deal with the uncertificated security. See UCC § 8-106(f).

local law of the jurisdiction in which the debtor is deemed to be located under Section 9-307.<sup>42</sup>

- (ii) The law governing perfection of a security interest in a payment intangible that is not a controllable payment intangible (hereinafter referred to as an “ordinary payment intangible”) is the local law of the jurisdiction in which the debtor is deemed to be located under Section 9-307.<sup>43</sup>
- (iii) The law governing perfection of a security interest in a controllable payment intangible is the local law of the related controllable electronic record’s jurisdiction as set forth in Section 12-107(c) and (d).<sup>44</sup> An exception applies, however, in the case of perfection by filing and in the case of automatic perfection created by a sale of the controllable payment intangible. In those cases, the law governing perfection of a security interest in a controllable payment intangible is the local law of the jurisdiction in which the debtor is deemed to be located under Section 9-307.<sup>45</sup>

b. Methods of perfection.

- (i) A security interest in a general intangible that is not a payment intangible may only be perfected by filing a financing statement.<sup>46</sup>
- (ii) A security interest in an ordinary payment intangible may be perfected by filing a financing statement.<sup>47</sup> In certain situations, a security interest in an ordinary payment intangible may also be perfected automatically upon attachment.<sup>48</sup>

---

<sup>42</sup> See UCC § 9-301(1).

<sup>43</sup> See UCC § 9-301(1).

<sup>44</sup> See UCC § 9-306B(a).

<sup>45</sup> See UCC § 9-306B(b).

<sup>46</sup> See UCC § 9-310(a).

<sup>47</sup> See UCC § 9-310(a).

<sup>48</sup> See UCC §§ 9-309(2) (providing for perfection upon attachment in the case of certain assignments of payment intangibles) and 9-309(3) (providing for perfection upon attachment in the case of sales of payment intangibles). In general, sales of payment intangibles are covered by Article 9. See UCC § 9-109(a)(3). In limited circumstances, however, an exception may apply that takes the transaction outside the scope of Article 9. See, e.g., UCC § 9-109(d)(4), (5), (7).

- (iii) A security interest in a controllable payment intangible may be perfected by filing and, in certain circumstances, may be perfected automatically.<sup>49</sup> A security interest in a controllable payment intangible may also be perfected by control under Section 9-107A.<sup>50</sup>
- (iv) Caveat: if an equity interest that constitutes a general intangible (including a payment intangible) is evidenced by a certificate, the equity interest continues to be a general intangible.

#### D. **Priority.**

##### 1. ***Certificated and uncertificated securities.***

- a. Governing law. The law governing priority in certificated and uncertificated securities is as follows:
  - (i) In the case of a certificated security, the law governing priority is the local law of the jurisdiction in which the related security certificate is located.<sup>51</sup>
  - (ii) In the case of an uncertificated security, the law governing priority is the local law of the “issuer’s jurisdiction” as specified in Section 8-110(d).<sup>52</sup> Generally, the issuer’s jurisdiction is the jurisdiction under which the issuer of the security is organized.<sup>53</sup>
- b. Order of priority. Following are the relative priorities of the rights of secured parties and other persons asserting competing claims to or interests in certificated and uncertificated securities:

---

<sup>49</sup> See UCC §§ 9-312(a) (providing for perfection by filing), 9-309(2) (providing for perfection upon attachment in the case of certain assignments of payment intangibles), and 9-309(3) (providing for perfection upon attachment in the case of sales of payment intangibles).

<sup>50</sup> See UCC §§ 9-314(a) (providing for perfection by control), 9-107A(a) (providing that a secured party has control of a controllable electronic record as provided in Section 12-105), and 9-107A(b) (providing that a secured party has control of a controllable payment intangible if the secured party has control of the controllable electronic record evidencing the controllable payment intangible).

<sup>51</sup> See UCC § 9-305(a)(1).

<sup>52</sup> See UCC § 9-305(a)(2).

<sup>53</sup> See UCC § 8-110(d).

- (i) Article 9 priority rules.
  - (a) Priority among conflicting security interests.
    - (1) Conflicting security interests held by secured parties, each of which has control under Section 8-106, rank according to priority in time of obtaining control.<sup>54</sup>
    - (2) A security interest held by a secured party having control of a certificated or uncertificated security has priority over a security interest held by a secured party that does not have control.<sup>55</sup>
    - (3) A security interest in a certificated security in registered form which is perfected by taking delivery under Section 8-301 and not by control has priority over a conflicting security interest perfected by a method other than control.<sup>56</sup>
    - (4) In all other cases, priority among conflicting security interests in a certificated or uncertificated security is governed by the general rules set forth in Sections 9-322 and 9-323.<sup>57</sup>
  - (b) Priority between security interest and rights of lien creditor.
    - (1) Rule 1: A security interest is subordinate to the rights of a person that becomes a lien creditor before the earlier of the following times: (1) the time when the security interest is perfected; and (2) the time when one of the conditions specified in Section 9-203(b)(3) is met and a financing statement

---

<sup>54</sup> See UCC § 9-328(2)(A).

<sup>55</sup> See UCC § 9-328(1).

<sup>56</sup> See UCC § 9-328(5).

<sup>57</sup> See UCC § 9-328(7).

covering the collateral (*i.e.*, the certificated or uncertificated security) is filed.<sup>58</sup>

- (2) Rule 2: A security interest is subordinate to the rights of a person who becomes a lien creditor *to the extent that* the security interest secures an advance made more than 45 days after the person becomes a lien creditor unless either (1) the advance is made without knowledge of the lien or (2) the advance is made pursuant to a commitment entered into without knowledge of the lien.<sup>59</sup>
  - (3) Caveat: Rule 2 does not elevate the priority of a security interest that is subordinate to the rights of a lien creditor under Rule 1; it only subordinates.<sup>60</sup>
- (c) Priority between unperfected security interest and rights of buyer.
- (1) In the case of a certificated security, the rule is that a buyer of a security certificate takes free of a security interest if the buyer gives value and receives delivery of the security certificate without knowledge of the security interest and before the security interest is perfected.<sup>61</sup>
  - (2) In the case of an uncertificated security, the rule is that a buyer of investment property other than a certificated security takes free of a security interest if the buyer gives value without knowledge of the security interest and before the security interest is

---

<sup>58</sup> See UCC § 9-317(a)(2). Here, there are three conditions specified in Section 9-203(b)(3) that a secured party can meet: (i) obtaining from the debtor a signed security agreement that describes the collateral (*i.e.*, the certificated or uncertificated security); (ii) if the collateral is a certificated security in registered form, taking delivery of the security certificate under Section 8-301 pursuant to the debtor's security agreement; and (iii) acquiring control of the certificated or uncertificated security under Section 9-106 pursuant to the debtor's security agreement. See UCC § 9-203(b)(3)(A), (C), (D).

<sup>59</sup> See UCC § 9-323(b).

<sup>60</sup> See UCC § 9-323 cmt. 4.

<sup>61</sup> See UCC § 9-317(b).

perfected.<sup>62</sup> As noted in part II.A.7 above, the term “investment property” includes uncertificated securities.<sup>63</sup>

- (ii) Article 8 priority rules.
  - (a) Section 8-303(b) provides that a so-called protected purchaser acquires its interest in a certificated or uncertificated security free of any adverse claim.<sup>64</sup> For purposes of this provision, a “protected purchaser” means “a purchaser of a certificated or uncertificated security, or of an interest therein, who (1) gives value; (2) does not have notice of any adverse claim to the security; and (3) obtains control of the certificated or uncertificated security.”<sup>65</sup>
  - (b) Section 8-302 generally provides that a purchaser of a certificated or uncertificated security acquires all rights in the security that the transferor had or had power to transfer.<sup>66</sup> Two exceptions apply: (1) a purchaser of a limited interest in a security acquires rights only to the extent of the interest purchased;<sup>67</sup> and (2) a purchaser of a certificated security who as a previous holder had notice of an adverse claim does not improve its position by taking the security from a subsequent protected purchaser.<sup>68</sup> Subject to the above exceptions, this statutory provision implements the familiar “shelter” principle.<sup>69</sup>
  - (c) For purposes of the foregoing, a “purchaser” includes a secured party,<sup>70</sup> and an “adverse claim”

---

<sup>62</sup> See UCC § 9-317(d).

<sup>63</sup> See UCC § 9-102(a)(49).

<sup>64</sup> See UCC § 8-303(b).

<sup>65</sup> UCC § 8-303(a). For purposes of this provision, the term “value” has the meaning assigned to such term in Section 1-204, the term “notice of an adverse claim” has the meaning assigned to such term in Section 8-105, and the term “control” has the meaning assigned to such term in Section 8-106(a)-(c).

<sup>66</sup> See UCC § 8-302(a).

<sup>67</sup> See UCC § 8-302(b).

<sup>68</sup> See UCC § 8-302(c) & cmt. 1.

<sup>69</sup> See UCC § 8-302 cmt. 1.

<sup>70</sup> See UCC § 1-201(b)(29), (30); see also UCC § 8-303 cmt. 1.

means “a claim that a claimant has a property interest in a financial asset and that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset.”<sup>71</sup>

- (iii) Interplay between Article 8 and Article 9 priority rules.
  - (a) Section 9-201 provides generally that a security agreement is effective according to its terms against purchasers of the subject collateral, except as otherwise provided in Article 9 or any other Article of the UCC (*e.g.*, Article 8).<sup>72</sup>
  - (b) Section 9-331 provides specifically that Article 9 does not limit the rights of a protected purchaser of a security.<sup>73</sup> Section 9-331 further provides that a protected purchaser takes priority over an earlier security interest, even if perfected, to the extent provided in Article 8.<sup>74</sup>

## 2. ***General intangibles.***

- a. Governing law. The law governing priority in equity interests that constitute general intangibles is as follows:
  - (i) In the case of general intangibles that are not controllable payment intangibles, the law governing priority is the local law of the jurisdiction in which the debtor is deemed to be located under Section 9-307.<sup>75</sup>
  - (ii) In the case of controllable payment intangibles, the law governing priority is the local law of the related controllable electronic record’s jurisdiction as set forth in Section 12-107(c) and (d).<sup>76</sup>
- b. Order of priority. Following are the relative priorities of the rights of secured parties and other persons asserting competing claims to

---

<sup>71</sup> UCC § 8-102(a)(1).

<sup>72</sup> See UCC § 9-201(a) & cmt. 2.

<sup>73</sup> See UCC § 9-331(a).

<sup>74</sup> See UCC § 9-331(a). Note that this rule protects a qualifying secured party whose later-in-time security interest would otherwise be subordinate to the earlier-in-time security interest of another secured party.

<sup>75</sup> See UCC § 9-301(1).

<sup>76</sup> See UCC § 9-306B(a).

or interests in equity interests that are classified as general intangibles:

- (i) Article 9 priority rules.
  - (a) Priority among conflicting security interests.
    - (1) Generally speaking, priority among conflicting security interests in equity interests that constitute general intangibles is determined by the general priority rules set forth in Section 9-322.<sup>77</sup>
    - (2) An exception to the foregoing exists if the equity interests are controllable payment intangibles and only one of the two competing secured parties has control of the controllable payment intangibles. In that event, the security interest held by the secured party having control has priority over the conflicting security interest held by the secured party not having control.<sup>78</sup>
  - (b) Priority between security interest and rights of lien creditor.
    - (1) Rule 1: A security interest is subordinate to the rights of a person that becomes a lien creditor before the earlier of the following times: (1) the time when the security interest is perfected; and (2) the time when one of the conditions specified in Section 9-203(b)(3) is met and a financing statement covering the collateral (*i.e.*, the equity interests classified as general intangibles) is filed.<sup>79</sup>
    - (2) Rule 2: A security interest is subordinate to the rights of a person who becomes a lien creditor *to the extent that* the security interest secures an advance made more than 45 days after the person becomes a lien

---

<sup>77</sup> See UCC § 9-322(a).

<sup>78</sup> See UCC § 9-326A.

<sup>79</sup> See UCC § 9-317(a)(2).

creditor unless either (1) the advance is made without knowledge of the lien or (2) the advance is made pursuant to a commitment entered into without knowledge of the lien.<sup>80</sup>

(3) Caveats: Rule 2 does not elevate the priority of a security interest that is subordinate to the rights of a lien creditor under Rule 1; it only subordinates.<sup>81</sup> Also, Rule 2 does not apply to a security interest held by a secured party that is a buyer of payment intangibles.<sup>82</sup>

(c) Priority between unperfected security interest and rights of buyer.

(1) In the case of equity interests classified as general intangibles that are not controllable payment intangibles, a buyer of the equity interests (other than a secured party) takes free of a security interest if the buyer gives value without knowledge of the security interest and before the security interest is perfected.<sup>83</sup>

(2) In the case of equity interests classified as controllable payment intangibles, a buyer of the equity interests (other than a secured party) takes free of a security interest if, without knowledge of the security interest and before it is perfected, the buyer gives value and obtains control of the controllable payment intangibles.<sup>84</sup>

(ii) Article 12 priority rules.

(a) Section 12-104(e) provides that a so-called qualifying purchaser acquires its interest in a

---

<sup>80</sup> See UCC § 9-323(b).

<sup>81</sup> See UCC § 9-323 cmt. 4.

<sup>82</sup> See UCC § 9-323(c).

<sup>83</sup> See UCC § 9-317(d).

<sup>84</sup> See UCC § 9-317(i).

controllable electronic record (including one evidencing a controllable payment intangible) free of a claim of a property right in the controllable electronic record.<sup>85</sup> For this purpose, a “qualifying purchaser” means “a purchaser of a controllable electronic record or an interest in the controllable electronic record that obtains control of the controllable electronic record for value, in good faith, and without notice of a claim of a property right in the controllable electronic record.”<sup>86</sup> In addition, for purposes of determining whether a purchaser of a controllable payment intangible is a qualifying purchaser, the purchaser obtains control of the controllable payment intangible if the purchaser obtains control of the related controllable electronic record.<sup>87</sup>

- (b) Section 12-104(d) generally provides that a purchaser of a controllable electronic record acquires all rights in the controllable electronic record that the transferor had or had power to transfer.<sup>88</sup> Two exceptions apply: (1) a purchaser of a limited interest in a controllable electronic record acquires rights only to the extent of the interest purchased;<sup>89</sup> and (2) a purchaser of a controllable electronic record who previously engaged in fraud or illegal activity in connection with the controllable electronic record does not improve its position by acquiring the controllable electronic record from a subsequent qualifying purchaser.<sup>90</sup> Subject to the above exceptions, this provision implements the familiar “shelter” principle.<sup>91</sup>

---

<sup>85</sup> See UCC § 12-104(e).

<sup>86</sup> UCC § 12-102(a)(2). Here, “value” has the meaning assigned to such term in Section 12-102(a)(4), and “control” has the meaning assigned to such term in Section 12-105(a).

<sup>87</sup> See UCC § 12-104(b).

<sup>88</sup> See UCC § 12-104(d).

<sup>89</sup> See UCC § 12-104(d).

<sup>90</sup> See UCC § 12-104 cmt. 4.

<sup>91</sup> See UCC § 12-104 cmt. 4.

- (iii) Interplay between Article 12 and Article 9 priority rules.
  - (a) Section 9-201 provides generally that a security agreement is effective according to its terms against purchasers of the subject collateral, except as otherwise provided in Article 9 or any other Article of the UCC (*e.g.*, Article 12).<sup>92</sup>
  - (b) Section 9-331 provides specifically that Article 9 does not limit the rights of a qualifying purchaser of a controllable electronic record or a controllable payment intangible.<sup>93</sup> Section 9-331 further provides that a qualifying purchaser takes priority over an earlier security interest, even if perfected, to the extent provided in Article 12.<sup>94</sup>

## E. Special Issues.

### 1. *Shifting collateral.*

- a. **Problem.** Unlike shares or similar equity interests issued by a corporation, interests in a partnership or limited liability company are uniquely susceptible to changes in collateral classification for Article 9 purposes.<sup>95</sup> If a partnership or limited liability company whose interests do not otherwise constitute securities under Article 8 “opts in” to Article 8 with respect to the interests,<sup>96</sup> the interests will no longer be classified as general intangibles but instead will be classified as investment property under Article 9. Similarly, if a partnership or limited liability company whose interests do not otherwise constitute securities under Article 8 “opts out” of Article 8 with respect to its interests,<sup>97</sup> the interests will no longer be classified as investment property but instead will

---

<sup>92</sup> See UCC § 9-201(a) & cmt. 2.

<sup>93</sup> See UCC § 9-331(a).

<sup>94</sup> See UCC § 9-331(a).

<sup>95</sup> Under Article 8, a share or similar equity interest issued by a corporation is always classified as a security, but an interest in a partnership or limited liability company may or may not be so classified. See UCC § 8-103(a), (c).

<sup>96</sup> A partnership or limited liability company “opts in” to Article 8 with respect to its interests if the terms of the interests expressly provide that they are securities governed by Article 8. See UCC § 8-103(c) & cmt. 4. Interests in a partnership or limited liability company may otherwise constitute securities under Article 8 if the interests are dealt in or traded on securities exchanges or in securities markets or if the interests constitute investment company securities. See UCC § 8-103(c).

<sup>97</sup> A partnership or limited liability company “opts out” of Article 8 if, after having previously elected to opt in to Article 8, the partnership or limited liability company modifies the terms of its interests so that they no longer expressly provide that the interests are securities governed by Article 8. See UCC § 8-103(c).

be classified as general intangibles under Article 9. Because the rules governing perfection and priority of security interests in investment property and general intangibles differ in many respects, a secured party who takes a security interest in partnership or limited liability company interests without considering the impact on its security interest of a “shift” in collateral classification runs the risk that its security interest will become unperfected or, worse, will be subordinated to or even “cut off” by the interest of another person.<sup>98</sup>

b. Solutions. Following are certain approaches that a secured party taking a security interest in partnership or limited liability company interests might consider in order to mitigate the risk of shifting collateral:

- (i) “Hardwire” into the organizational documents of the partnership or limited liability company whose interests are being pledged a prohibition against opting in to or out of Article 8 (depending on the desired collateral classification) without the secured party’s consent.<sup>99</sup> Some state laws, in fact, expressly validate this sort of approach.<sup>100</sup>
- (ii) Obtain from the pledgor of the partnership or limited liability company interests an Article 8 matters proxy, *i.e.*, an irrevocable proxy agreement granting the secured party the exclusive right to vote the interests on all matters related to Article 8.<sup>101</sup>
- (iii) For partnership or limited liability company interests that constitute securities, file a financing statement even if

---

<sup>98</sup> *Cf., e.g.*, UCC § 9-312 cmt. 4 (noting generally that, in the case of securities and other kinds of investment property, a security interest perfected by filing will be subordinate to a conflicting security interest perfected by control and, accordingly, a secured party who perfects its security interest by filing runs the risk that its rights will become subordinated to the rights of another secured party who perfects its security interest by control).

<sup>99</sup> On the advantages of this approach, see James D. Prendergast, *Secured Real Estate Mezzanine Lending (with Form)*, THE PRACTICAL REAL ESTATE LAWYER, Mar. 2007, at 35, 43, 48.

<sup>100</sup> *See, e.g.*, DEL. CODE ANN. tit. 6, §§ 17-101(14) (providing that, in the case of a limited partnership, “[a] partnership agreement may provide rights to any person, including a person who is not a party to the partnership agreement, to the extent set forth therein”), 18-101(9) (providing that “[a] limited liability company agreement may provide rights to any person, including a person who is not a party to the limited liability company agreement, to the extent set forth therein”).

<sup>101</sup> *See* Prendergast, cited in note 99 above, at 44. A model Article 8 matters proxy may be found in the appendix to that particular article. *See* Prendergast, cited in note 99 above, at 49-51.

perfecting by delivery or control.<sup>102</sup> Supplement this by obtaining appropriate insurance covering (among other things) loss sustained or damage incurred by reason of a subsequent purchaser of the interests taking the interests free of the secured party's security interest.<sup>103</sup>

- (iv) For partnership or limited liability company interests that constitute general intangibles, use the financing statement as a "bulletin board": insert in the financing statement a prominent notice to the effect that (A) the secured party has a property interest in the interests and (B) it is a violation of the secured party's rights for another person to hold, transfer or deal with the interests.<sup>104</sup>

## 2. *Warranties upon redelivery of certificated securities.*

- a. Implied warranty. Under Article 8, a secured party who redelivers a security certificate to the debtor, or after payment and on order of the debtor delivers a security certificate to another person, is deemed to warrant (among other things) that the secured party does not know of any adverse claim to the certificated security.<sup>105</sup> This implied warranty is not limited to adverse claims created by the secured party or a person claiming through the secured party. As a result, if at the time of redelivery the secured party knows of an adverse claim to the certificated security asserted by any person whatsoever, the secured party will be exposed to potential liability on a breach-of-warranty claim.

---

<sup>102</sup> Because the secured party's collateral package will often include property that does not constitute a security under Article 8 and is not classified as investment property under Article 9, filing a financing statement will normally be advisable in any event.

<sup>103</sup> An example of an appropriate insurance policy is First American Title Insurance Company's EAGLE 9 UCC Insurance Policy for Lenders and related Mezzanine Endorsement.

<sup>104</sup> These are the two elements of an adverse claim under Article 8. *See* UCC § 8-102(a)(1). To be sure, the mere filing of a financing statement under Article 9 does not constitute notice of an adverse claim under Article 8. *See* UCC § 8-105(e). Arguably, however, if a subsequent purchaser of the interests reviews the financing statement in the course of its due diligence activities, the purchaser will have notice of an adverse claim to the interests. *See* UCC § 8-105(a). In that event, the purchaser will not be able to qualify as a protected purchaser under Section 8-303 and, accordingly, will acquire the interests subject to (rather than free of) the secured party's security interest. *See* UCC §§ 8-303(a)(2), 8-302(a).

<sup>105</sup> *See* UCC § 8-108(g), (h).

- b. Disclaimer of warranty. To avoid being deemed to make this particular warranty, the secured party should insert an express disclaimer of the warranty in the underlying security agreement.<sup>106</sup>

3. *Anti-assignment provisions.*

- a. Problem. Partnership and limited liability company agreements often contain provisions that purport to restrict or prevent the assignment of interests in the related partnerships and limited liability companies. Even agreements that are more liberally drafted may provide that, unless the other partners or members expressly agree otherwise, an assignment of interests does not entitle the assignee to be admitted as a partner or a member.
- b. Preferred approach. The preferred approach to this problem is to obtain the written consent of all the other partners or members. The consent should cover not only the pledge of the interests to the secured party but also any transfer of the interests pursuant to a public or private disposition under Section 9-610 or an acceptance under Section 9-620. If necessary, the consent should also cover the admission as a partner or a member of (i) any transferee of the interests following a public or private disposition and (ii) the secured party following an acceptance.
- c. Less desirable approach. Another approach to this problem is to rely on the statutory overrides of contractual anti-assignment provisions set forth in Sections 9-406 and 9-408.<sup>107</sup> This approach has a number of serious limitations, however. The principal limitations are as follows:
  - (i) Sections 9-406 and 9-408 are applicable only to partnership or limited liability company interests that constitute payment intangibles or other general intangibles and not to

---

<sup>106</sup> See UCC §§ 8-108 cmt. 5 (noting that the warranty provisions in Section 8-108 apply “unless otherwise agreed” and that the parties to a transaction may enter into express agreements to allocate the risks of possible defects differently), 1-302(a) (generally permitting variation by agreement of the effect of the UCC’s provisions).

<sup>107</sup> See UCC §§ 9-406(d) (providing that, subject to certain exceptions, a term in an agreement between an account debtor and an assignor or in a promissory note that purports to restrict assignment of an account, chattel paper, payment intangible or promissory note is generally ineffective), 9-408(a) (providing that, subject to certain exceptions, a term in a promissory note or in an agreement between an account debtor and a debtor which relates to a health-care-insurance receivable or a general intangible that purports to restrict assignment of the promissory note, health-care-insurance receivable or general intangible is generally ineffective).

partnership or limited liability company interests that constitute certificated or uncertificated securities.<sup>108</sup>

- (ii) In many cases, the security interest in the partnership or limited liability company interests cannot be enforced.<sup>109</sup>
- (iii) Certain jurisdictions expressly exclude interests in partnerships and limited liability companies from the benefit of these statutory overrides.<sup>110</sup> Any jurisdiction that adopts the 2018 amendments to Article 9 of the UCC will constitute such a jurisdiction.

---

<sup>108</sup> See UCC §§ 9-406(d) & (e) (covering assignments for security, but not sales, of payment intangibles), 9-408(a) & (b) (covering assignments for security of ordinary general intangibles and sales of payment intangibles).

<sup>109</sup> See UCC § 9-408(d) (providing in pertinent part that, to the extent that a term in an agreement described in Section 9-408(a) would be effective under law other than Article 9 but is ineffective under Section 9-408(a), the creation, attachment, or perfection of a security interest in the general intangible is unenforceable).

<sup>110</sup> See, e.g., DEL. CODE ANN. tit. 6, §§ 9-406(i)(5), 9-408(e)(4), VA. CODE ANN. §§ 8.9A-406(k), 8.9A-408(g).