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

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

THURSDAY, MARCH 9, 2017

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

Today's faculty features:

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UCC ARTICLE 9:

- CHOICE OF LAW FOR SECURITY INTERESTS IN INTERMEDIATED SECURITIES UNDER THE HAGUE SECURITIES CONVENTION
 - ENFORCING SECURITY INTERESTS IN NON-STANDARD COLLATERAL – UNINCORPORATED ENTITIES
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1. Choice of law for security interests in intermediated securities under the Hague Securities Convention

1.1 *Effective date in United States*

1.2 *Scope of the Convention*

1.3 *Primary rule*

(a) Account agreement

(b) Qualifying Office

1.4 *Fall-back rules*

1.5 *Transition rules*

2. Legal and practical framework for the foreclosure of property

2.1 *Secured party's choices:*

(a) Collection – UCC § 9-607 (“If so agreed, and in any event after default, a secured party: (1) may notify an account debtor or other person obligated on collateral to make payment or otherwise render performance to or for the benefit of the secured party . . .”)

(1) If Part 6 applies, commercial reasonableness still applies

(2) If collect, subject to risk of debtor’s bankruptcy and application of automatic stay to collection efforts

(3) Unlikely to make sense for equity in an entity

(b) Disposition – UCC § 9-610(a) (“After default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral”)

(1) Methods

(i) Sale

(ii) Lease

(iii) License

(iv) “Otherwise dispose”

(2) Commercial reasonableness applies

- (c) Retention – UCC § 9-620 (“Except as otherwise provided in subsection (g), a secured party may accept collateral in full or partial satisfaction of the obligation . . .”)

3. Commercial reasonableness

3.1 When does it apply?

- (a) Collections
 - (1) Only if:
 - (i) Payment rights secure an obligation or
 - (ii) If buyer has recourse to the seller or secondary obligor (UCC § 9-607(c)(2)) (may still be “recourse” even if still a “true sale”)
 - (b) Dispositions
 - (1) “Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable.”
 - (2) UCC § 9-610(b)

3.2 Advertising

- (a) Consider underlying collateral (*i.e.*, what does the entity own)
- (b) Where?
- (c) How often?
- (d) Take into account likelihood of competitive bidding as against likely credit bid

3.3 Deciding whether to have a public or a private sale – UCC § 9-610

- (a) Decision whether to have a public or private sale itself must be commercially reasonable
- (b) Effects:
 - (1) Secured party cannot buy at a private sales in most circumstances – UCC § 9-610(c)
 - (2) Information in notice to debtor and others
- (c) What is a “public” and a “private” sale?

- (1) UCC § 9-610, Comment 7 (“Although the term is not defined, as used in this Article, a ‘public disposition’ is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. ‘Meaningful opportunity’ is meant to imply that some form of advertisement or public notice must precede the sale (or other disposition) and that the public must have access to the sale (disposition).”)

3.4 *Providing data about the entity (to the extent available)*

- (a) Non-disclosure agreement

3.5 *Sale of ownership interests in single-asset entity*

- (a) Disclosures about underlying asset (typically real estate)?

- (1) Disclosure risks?
- (2) Commercial reasonableness risks?

4. Rights of secured party prior to completion of foreclosure

4.1 *Debtor is owner of equity until foreclosure is completed*

- (a) Does not matter that equity may have been registered in name of secured party for perfection or protective purposes

4.2 *Obtain proxy to vote interests in entity?*

- (a) Look at entity law to see if proxy will be effective

4.3 *Lender liability issues?*

5. Notices

5.1 *Must give notice of proposed disposition*

- (a) UCC § 9-611(a) (“... a secured party that disposes of collateral under Section 9-610 shall send to the persons specified in subsection (c) a reasonable authenticated notification of disposition.”)

- (b) Not required in limited circumstances

- (1) UCC § 9-611(d) (“Subsection (b) does not apply if the collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market.”)

5.2 *To whom? – UCC § 9-611(c)*

- (a) Persons:

- (1) Debtor
- (2) Secondary obligor
- (3) Other secured parties who perfect by *filing* financing statement or under UCC § 9-311(a) in filing office then applicable for a new filing
- (4) Those who have requested notice

(b) Financing statement searches

(c) Safe harbor - UCC § 9-611(e)

5.3 *Timing - UCC § 9-612*

5.4 *Content - UCC § 9-613*

(a) Public sale or private sale - UCC § 9-613(1)(C) (“The contents of a notification of disposition are sufficient if the notification: . . . (C) states the method of intended disposition”)

(b) Timing - UCC § 9-613(1)(E) (“The contents of a notification of disposition are sufficient if the notification: . . . (E) states the time and place of a public disposition or the time after which any other disposition is to be made.”)

6. **When can the secured party buy the collateral?**

6.1 *Private sale*

(a) UCC § 9-610(c) (“A secured party may purchase collateral: . . . (2) at a private disposition only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.”)

(b) *See* discussion above of retention of the collateral and attempt to waive this restriction

6.2 *Public sale*

(a) UCC § 9-610(c) (“A secured party may purchase collateral: (1) at a public disposition;”)

7. **Compliance with the securities laws**

7.1 *Is the equity interest a “security” under federal or state securities law?*

- (a) Not affected by definition in UCC Article 8 or an opt-in to UCC Article 8

7.2 *Can the secured party make a “public” sale of unregistered securities*

- (a) '33 Act Rule 144
 - (1) Depending on several factors, Rule 144 may permit public resales by the secured party:
 - (2) Is the issuer a reporting company?
 - (3) Is the debtor an “affiliate” of the issuer?
 - (4) How long has the debtor held the stock?
 - (i) Secured party can “tack” holding period of debtor (Rule 144(d)(3)(iv))

7.3 *If Rule 144 not available, use SEC no-action letters, which permit a public UCC sale if:*

- (a) Not a subterfuge to make a public offering
- (b) Securities typically sold in a block
- (c) Securities typically sold to a single purchaser
- (d) Securities acquired with investment intent
- (e) Securities subject to transfer restrictions
- (f) Bidders and buyers are financially sophisticated
- (g) *See, e.g., General Electric Capital Corporation, 1998 WL 727229 (SEC No-Action Letter Oct. 19, 1998)*

7.4 *Decisions*

- (a) *Burns v. Anderson* (United States Court of Appeals for the Fourth Circuit, No. 03-2162, December 15, 2004, unpublished opinion) – available at <http://pacer.ca4.uscourts.gov/opinion.pdf/032162.U.pdf> (secured party used appraisal process to sell thinly-traded stock, as provided for in the security agreement; sale was commercially reasonable)

- (b) *Vornado PS, L.L.C. v. Primestone Investment Partners, L.P.*, 821 A.2d 296, 49 UCC Rep.Serv.2d 1348 (Del. Ch. 2002) (significant marketing process, including use of investment bank, by secured party to sell interests of partnership units was commercially reasonable)
- (c) *Solfanelli v. Meridian Bank*, 206 B.R. 699 (Bankr. M.D. Pa. 1996) aff'd in part and rev'd in part 230 B.R. 54 (M.D. Pa. 1999) aff'd 203 F.3d 197 (3d Cir. 2000) (use of a "market maker" with expertise in the relevant industry) to advise on the conduct of the sale of the collateral (stock traded on NASDAQ) was commercially reasonable)

8. Rights of transferee

8.1 Effects of restriction on transfer

- (a) UCC §§ 9-406 and 9-408 do not apply to "securities" (as defined in UCC Article 8)
 - (1) Has there been an opt-in to UCC Article 8 under UCC § 8-103?
- (b) Even if UCC §§ 9-406 and 9-408 do apply because interests in entity are not subject to Article 8, UCC §§ 9-406 and 9-408 may not have applicability if restrictions on transfer are in agreement among equity owners

8.2 Third-party transferee in a disposition under UCC § 9-610 – UCC § 9-617

- (a) Rights acquired
 - (1) UCC § 9-617(a) ("A secured party's disposition of collateral after default: (1) transfers to a transferee for value all of the debtor's rights in the collateral; (2) discharges the security interest under which the disposition is made; and (3) discharges any subordinate security interest or other subordinate lien [other than liens created under [cite acts or statutes providing for liens, if any, that are not to be discharged]].")
- (b) Effect of secured party's failure to follow rules

- (1) Good faith transferee acquires these rights, even if secured party does not comply with rules – UCC § 9-617(b) (“A transferee that acts in good faith takes free of the rights and interests described in subsection (a), even if the secured party fails to comply with this article or the requirements of any judicial proceeding.”)
- (c) Secured party as transferee
- (d) Secured party transfers debtor’s rights
 - (1) Not a voluntary transfer by debtor (UCC § 9-617, Comment 2 (“Such a person [transferee at foreclosure] is a ‘transferee’ inasmuch as a buyer at a foreclosure sale does not meet the definition of ‘purchaser’ in Section 1-201 (the transfer is not vis-à-vis the debtor, ‘voluntary’).”))

8.3 *Retention of collateral – UCC § 9-622*

- (a) Rights acquired – similar to those in disposition – UCC § 9-622(a)
- (b) Effect of failure to follow rules – UCC § 9-622(b) (“A subordinate interest is discharged or terminated under subsection (a), *even if* the secured party fails to comply with this article”)

9. Consider provisions in security agreement on standards – UCC § 9-603

- (a) Secured party and debtor may agree on standards for fulfillment of rights of debtor if standards are not “manifestly unreasonable”
- (b) Include provision where debtor acknowledges that:
 - (1) Secured party will need to comply with SEC rules
 - (2) Compliance with SEC rules may affect foreclosure sale price
 - (3) Debtor agrees that sale in compliance with SEC rules can still be commercially reasonable

SECURITY INTERESTS IN EQUITY INTERESTS

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March 9, 2017

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”)¹ 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.²

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¹ 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. Unless otherwise indicated, all “article” and “section” references in this outline are to articles and sections of the UCC.

² 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.³
- 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.⁴
 - (ii) It is a medium for investment and by its terms expressly provides that it is a security governed by Article 8.⁵

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.⁶ 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.⁷

- 2. ***Certificated security***. “Certificated security” means “a security that is represented by a certificate.”⁸
- 3. ***Uncertificated security***. “Uncertificated security” means “a security that is not represented by a certificate.”⁹
- 4. ***Security certificate***. “Security certificate” means a certificate representing a security, such as a traditional paper certificate.¹⁰
- 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.¹¹

³ See UCC § 8-102(a)(15)(ii).

⁴ See UCC § 8-102(a)(15)(iii)(A).

⁵ See UCC § 8-102(a)(15)(iii)(B).

⁶ See UCC § 8-103(a).

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

⁸ UCC § 8-102(a)(4).

⁹ UCC § 8-102(a)(18).

¹⁰ See UCC § 8-102(a)(16) & cmt. 16.

¹¹ 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.¹²
7. **Investment property.** Under Article 9, “investment property” includes (among other things) certificated and uncertificated securities.¹³
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.¹⁴
9. **Payment intangible.** A “payment intangible” is “a general intangible under which the account debtor’s principal obligation is a monetary obligation.”¹⁵

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.¹⁶
2. **Elements of attachment.** As a general rule, a security interest attaches to an equity interest when it becomes enforceable against the debtor with respect to the equity interest.¹⁷ Subject to certain exceptions,¹⁸ a security interest in an equity interest is enforceable only if the following requirements are met:

¹² See UCC § 8-102(a)(13).

¹³ See UCC § 9-102(a)(49).

¹⁴ 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” and “letter-of-credit rights” have the respective meanings assigned to such terms in Section 9-102, the term “letter of credit” has the meaning assigned to such term in Section 5-102, and the term “money” has the meaning assigned to such term in Section 1-201. 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.

¹⁵ See 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).

¹⁶ See UCC § 1-301(c); see also UCC § 9-301 cmt. 2.

¹⁷ See UCC § 9-203(a).

¹⁸ These exceptions are generally set forth in Section 9-203(c) through (i).

- a. Value. “Value” (as defined in Article 1) has been given.¹⁹
- 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.²⁰
- c. Evidence of agreement. One of the following conditions is met:
 - (i) The debtor has authenticated a security agreement that describes the collateral (*i.e.*, the equity interest).²¹
 - (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.²²
 - (iii) The collateral is investment property (*e.g.*, a certificated or uncertificated security) and the secured party has “control” under Section 9-106 pursuant to the debtor’s security agreement.²³

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 the local law of the jurisdiction in which the debtor is deemed to be located under Section 9-307.²⁴
 - (b) If a security interest in a certificated security is perfected other than by filing, the law governing

¹⁹ See UCC § 9-203(b)(1). For the definition of “value” in this context, see Section 1-204.

²⁰ See UCC § 9-203(b)(2).

²¹ See UCC § 9-203(b)(3)(A).

²² See UCC § 9-203(b)(3)(C).

²³ See UCC § 9-203(b)(3)(D).

²⁴ See UCC § 9-305(c)(1).

perfection is the local law of the jurisdiction in which the related security certificate is located.²⁵

(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 9-307.²⁶
- (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).²⁷ Generally, the issuer’s jurisdiction is the jurisdiction under which the issuer of the security is organized.²⁸

b. Methods of perfection.

(i) Certificated securities.

- (a) A security interest in a certificated security may be perfected by filing a financing statement.²⁹
- (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 8-106.³⁰

²⁵ 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.

²⁶ See UCC § 9-305(c)(1).

²⁷ See UCC § 9-305(a)(2).

²⁸ See UCC § 8-110(d).

²⁹ See UCC § 9-312(a).

³⁰ 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).

- (1) A secured party has control of a certificated security in bearer form if the certificated security is delivered to the secured party.³¹
 - (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.³²
- (c) A security interest in a certificated security may be perfected by taking “delivery” under Section 8-301.³³
 - (d) A security interest in a certificated security may be perfected on a temporary basis under the limited circumstances described in Section 9-312.³⁴ In each case, the period of temporary perfection is 20 days.³⁵ After the 20-day period expires, perfection depends upon compliance with other provisions of Article 9.³⁶

³¹ 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.

³² See UCC § 8-106(b). On the meaning of “delivery” for this purpose, see note 31 above.

³³ See UCC § 9-313(a). On the meaning of “delivery” for this purpose, see note 31 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).

³⁴ 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 an authenticated 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).

³⁵ See UCC §§ 9-312(e), 9-312(g).

³⁶ 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.

- (ii) Uncertificated securities.
 - (a) A security interest in an uncertificated security may be perfected by filing a financing statement.³⁷
 - (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 8-106.³⁸ Under Section 8-106, a secured party has control of an uncertificated security if either (A) the uncertificated security is delivered to the secured party³⁹ or (B) the issuer has agreed that it will comply with instructions originated by the secured party without further consent by the registered owner.⁴⁰

2. *General intangibles.*

- a. Governing law. The law governing perfection of a security interest in a general intangible is the local law of the jurisdiction in which the debtor is deemed to be located under Section 9-307.⁴¹
- 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.⁴²

³⁷ See UCC § 9-312(a).

³⁸ 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 39-40 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).

³⁹ 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.

⁴⁰ 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).

⁴¹ See UCC § 9-301(1).

⁴² See UCC § 9-310(a).

- (ii) A security interest in a payment intangible may be perfected by filing a financing statement.⁴³ In certain situations, a security interest in a payment intangible may also be perfected automatically upon attachment.⁴⁴
- (iii) 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.⁴⁵
 - (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).⁴⁶ Generally, the issuer’s jurisdiction is the jurisdiction under which the issuer of the security is organized.⁴⁷
- 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:
 - (i) Article 9 priority rules.
 - (a) Priority among conflicting security interests.
 - (1) Conflicting security interests held by secured parties, each of which has control

⁴³ See UCC § 9-310(a).

⁴⁴ See UCC § 9-309(2) (providing perfection upon attachment to certain assignments of payment intangibles), (3) (providing perfection upon attachment to 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 UCC § 9-109(d)(4), (5), (7).

⁴⁵ See UCC § 9-305(a)(1).

⁴⁶ See UCC § 9-305(a)(2).

⁴⁷ See UCC § 8-110(d).

under Section 8-106, rank according to priority in time of obtaining control.⁴⁸

- (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.⁴⁹
 - (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.⁵⁰
 - (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 9-323.⁵¹
- (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 certificated or uncertificated security) is filed.⁵²

⁴⁸ See UCC § 9-328(2)(A).

⁴⁹ See UCC § 9-328(1).

⁵⁰ See UCC § 9-328(5).

⁵¹ See UCC § 9-328(7).

⁵² 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 an authenticated 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).

- (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.⁵³
 - (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.⁵⁴
- (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.⁵⁵
 - (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 perfected.⁵⁶ As noted in part II.A.7 above, the term “investment property” includes uncertificated securities.⁵⁷

⁵³ See UCC § 9-323(b).

⁵⁴ See UCC § 9-323 cmt. 4.

⁵⁵ See UCC § 9-317(b).

⁵⁶ See UCC § 9-317(d).

⁵⁷ See UCC § 9-102(a)(49).

- (ii) Article 8 priority rules.
- (a) Section 8-303(b) provides that, in addition to acquiring the rights of a purchaser as set forth in Section 8-302, a protected purchaser acquires its interest in a certificated or uncertificated security free of any adverse claim.⁵⁸ 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.”⁵⁹
- (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.⁶⁰ Two exceptions apply: (1) a purchaser of a limited interest in a security acquires rights only to the extent of the interest purchased;⁶¹ 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.⁶² Subject to the above exceptions, this statutory provision implements the familiar “shelter” principle.⁶³
- (c) For purposes of the foregoing, a “purchaser” includes a secured party,⁶⁴ and an “adverse claim” 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.”⁶⁵

⁵⁸ See UCC § 8-303(b).

⁵⁹ 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).

⁶⁰ See UCC § 8-302(a).

⁶¹ See UCC § 8-302(b).

⁶² See UCC § 8-302(c) & cmt. 1.

⁶³ See UCC § 8-302 cmt. 1.

⁶⁴ See UCC § 1-201(b)(29), (30); see also UCC § 8-303 cmt. 1.

⁶⁵ UCC § 8-102(a)(1).

- (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).⁶⁶
 - (b) Section 9-331 provides specifically that Article 9 does not limit the rights of a protected purchaser of a security.⁶⁷ 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 8.⁶⁸

2. *General intangibles.*

- a. Governing law. The law governing priority in equity interests that constitute general intangibles is the same as the law governing perfection: the local law of the jurisdiction in which the debtor is deemed to be located under Section 9-307.⁶⁹
- 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 equity interests that are classified as general intangibles:
 - (i) Priority among conflicting security interests.
 - (a) 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 9-322.⁷⁰
 - (b) An exception to the foregoing arguably exists if the equity interests are classified as payment intangibles. To illustrate, imagine that one secured party (“SP-1”) is the first to file but not to perfect

⁶⁶ See UCC § 9-201(a) & cmt. 2.

⁶⁷ See UCC § 9-331(a).

⁶⁸ 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.

⁶⁹ See UCC § 9-301(1).

⁷⁰ See UCC § 9-322(a).

(such as might occur in a loan transaction in which the debtor authorizes a financing statement to be filed prior to loan closing) and that another secured party (“SP-2”) is the first to perfect. Imagine further that SP-2’s security interest arises out of the sale to it of the equity interests and that the sale is a transaction covered by Article 9.⁷¹ Under those circumstances, even if SP-1 subsequently attempts to take all actions necessary for attachment to occur under Section 9-203(b), SP-1 will be unable to do so: as a result of the sale to SP-2, the debtor no longer has any rights in the equity interests⁷² and, therefore, SP-1’s purported security interest in the equity interests cannot attach. Without attachment, SP-1’s purported security interest cannot be perfected.⁷³ Bottom line: even though SP-1 is the first to file or perfect, SP-2’s rights in the equity interests will take priority over SP-1’s rights.

- (ii) Priority between security interest and rights of lien creditor.
 - (a) 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.⁷⁴
 - (b) 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

⁷¹ In general, a sale of payment intangibles is within the scope of Article 9. *See* UCC § 9-109(a)(3).

⁷² *See* UCC § 9-318(a) (providing in part that a debtor that has sold a payment intangible does not retain a legal or equitable interest in the collateral sold).

⁷³ *See* UCC § 9-308(a) (providing that, as a general rule, a security interest is perfected if it has attached and all of the applicable requirements for perfection in Sections 9-310 through 9-316 have been satisfied).

⁷⁴ *See* UCC § 9-317(a)(2). Here, there is only one condition specified in Section 9-203(b)(3) that a secured party can meet: obtaining from the debtor an authenticated security agreement that describes the collateral (*i.e.*, the equity interests classified as general intangibles). *See* UCC § 9-203(b)(3)(A).

made pursuant to a commitment entered into without knowledge of the lien.⁷⁵

- (c) 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.⁷⁶ Also, Rule 2 does not apply to a security interest held by a secured party that is a buyer of payment intangibles.⁷⁷
- (iii) Priority between unperfected security interest and rights of buyer.
 - (a) In the case of equity interests classified as general intangibles other than payment intangibles, a buyer of the equity interests takes free of a security interest if the buyer gives value without knowledge of the security interest and before the security interest is perfected.⁷⁸
 - (b) In the case of equity interests classified as payment intangibles, a buyer of the equity interests will have rights superior to the rights of a holder of an unperfected security interest under the general priority rules set forth in Section 9-322.⁷⁹

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.⁸⁰ If a partnership or limited liability company whose interests do not otherwise constitute securities under

⁷⁵ See UCC § 9-323(b).

⁷⁶ See UCC § 9-323 cmt. 4.

⁷⁷ See UCC § 9-323(c).

⁷⁸ See UCC § 9-317(d).

⁷⁹ See UCC § 9-322(a)(2).

⁸⁰ 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).

Article 8 “opts in” to Article 8 with respect to the interests,⁸¹ the interests will no longer be classified as general intangibles but instead will be classified as investment property under Article 9.⁸² 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,⁸³ the interests will no longer be classified as investment property but instead will be classified as general intangibles under Article 9.⁸⁴ 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.⁸⁵

- 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)

⁸¹ 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).

⁸² For the definitions of the terms “investment property” and “general intangible,” see parts II.A.7 and II.A.8 above.

⁸³ 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).

⁸⁴ For the definitions of the terms “investment property” and “general intangible,” see parts IV.A.7 and IV.A.8 above.

⁸⁵ *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).

without the secured party's consent.⁸⁶ Some state laws, in fact, expressly validate this sort of approach.⁸⁷

- (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 8.⁸⁸
- (iii) For partnership or limited liability company interests that constitute securities, file a financing statement even if perfecting by delivery or control.⁸⁹ 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.⁹⁰
- (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.⁹¹

⁸⁶ 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.

⁸⁷ *See, e.g.*, DEL. CODE ANN. tit. 6, §§ 17-101(12) (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(7) (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").

⁸⁸ *See* Prendergast, cited in note 86 above, at 44. A model Article 8 matters proxy may be found in the appendix to that particular article. *See* Prendergast, cited in note 86 above, at 49-51.

⁸⁹ 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.

⁹⁰ 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.

⁹¹ 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).

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.⁹² 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.
- 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.⁹³

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

⁹² See UCC § 8-108(g), (h).

⁹³ 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).

provisions set forth in Sections 9-406 and 9-408.⁹⁴ 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 partnership or limited liability company interests that constitute certificated or uncertificated securities.⁹⁵
- (ii) In many cases, the security interest in the partnership or limited liability company interests cannot be enforced.⁹⁶
- (iii) Certain jurisdictions expressly exclude interests in partnerships and limited liability companies from the benefit of these statutory overrides.⁹⁷

⁹⁴ 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).

⁹⁵ 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).

⁹⁶ 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).

⁹⁷ 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).