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# Structuring Pledge Agreements for Equity Interests in Partnerships and LLCs to Maximize Protection for Lenders

Key Provisions for the Security Agreement and the Borrower's Operating Agreement, UCC Requirements

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# Structuring Pledge Agreements for Equity Interests in Partnerships and LLCs to Maximize Protection for Lenders

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February 2019



# Topics

- UCC characterization of equity interests
- Describe the collateral
- Restrictions on assignment
- Perfection
- Priority
- Series entities
- Secured party remedies



## UCC Articles 8 and 9 – characterization of equity interests

- UCC type
  - Investment property
  - General intangible
- Categories of investment property
  - Certificated security
  - Uncertificated security
  - Security entitlement / securities account



## Effect of categorization on structuring

- Description / indication of collateral
  - Functional v. UCC type
- Choice of law
- Restrictions on assignment
- Perfection methods
- Priority
  - Control / possession
  - Protected purchaser





## Equity interests under Article 9

- Article 8 determines what is a security / investment property for purposes of Article 9 [§§ 8-102, 8-103]
- Treatment under securities laws or other non-UCC law does not determine whether an equity interest is a security / investment property for UCC purposes [§ 8-102(d)]



# Certificated and uncertificated securities – (§ 8-103)

- Security = share or similar equity interest issued by:
  - Corporation / business trust / statutory trust
  - “Similar entity”
- Not a security:
  - Partnership interest
  - LLC interest
  - Unless ...
- Exceptions to exclusion of LLC and partnership interests:
  - Override exclusion by “opting in” [§ 8-103(c)]
  - Held as a security entitlement (in a securities account)
  - Registered investment company / publicly traded



# Categories of investment property

- Certificated securities
  - Evidenced by a certificate under non-UCC law
- Uncertificated securities
  - Book-entry on issuer records
- Securities account/security entitlement
  - A collection of “security entitlements”
  - Held at a “securities intermediary”
  - Different from an uncertificated security
  - Different from a deposit account

## Does secured party prefer investment property?

- “Protected purchaser” / free of claims [§§ 8-303, 8-502, 8-503, 8-510]
  - Title?
- Perfection by delivery (possession) / control [§§ 9-313, 9-314] (discussed below)
- Priority (discussed below)
  - Possession “super priority” [§ 9-328(5)]
  - Control “super priority” [§ 9-328(1), (3)]



## How to opt in

- § 8-103(c) – LLC or partnership interest is a security if “its terms expressly provide that it is a security governed by this Article [8]”
  - Comment 4 to § 8-103
  - Prefatory Note to Article 8 [Section III(C)(8)]
- Certificate doesn’t make interest an Article 8 security
- Legend a certificate?



## Prevent opt out?

- Proxy to vote on changes to opt in, certification of interest provisions, etc.
  - See notes below on proxies
- LLC/partnership agreement provisions
  - Secured party voting/consent rights
  - Prevent modification of entity agreement (including through merger)
- Issuer agreement not to modify opt in and certification of interests provisions




# Collateral description – entity statutes

- Collateral description – what terms does the applicable state entity statute use?
  - Delaware LLC Act does not use the term “membership interest” – discusses:
    - Economic rights
    - Control rights
    - Member status
- Delaware LLC Act limits definition of “limited liability company interest” to economic rights: “a member’s share of the profits and losses of an LLC and a member’s right to receive distributions of the LLC’s assets”
  - Doesn’t cover (i) right to manage or control, (ii) right to information and review of books and records, or (iii) right to compel dissolution

# Description of collateral

- Description is sufficient, whether or not it is specific, if it reasonably identifies what is described [ § 9-108(a)]
  - Examples of reasonable description (including by UCC type) [ § 9-108(b)]
  - Description of a security entitlement, securities account or commodity account is sufficient if it describes: (i) by those terms or as investment property, or (ii) the underlying financial asset or commodity contract [ § 9-108(d)]
  - Consumer transaction rule [9-108(e)]
- *Monticello* (*aff'd* 2011 unreported 6th Cir. opinion)
  - § 9-108(d) not a safe harbor, but a limitation on the more general rules in § 9-108(a) and (b)





## Entity statutes – description of interest

- Compare NY LLC Act
  - Membership interest = “a member’s aggregate rights in an LLC including, without limitation, (i) the member’s right to a share of the profits and losses of the LLC, (ii) the right to receive distributions from the LLC, and (iii) the member’s right to vote and participate in the management of the LLC”
- Other states similar to NY (but not identical)
- Check the relevant state’s entity statute




## Delaware LLC Act

- § 18-702(a) – economic rights are assignable in whole or in part except as provided in the LLC agreement
- § 18-702(b)(1) - unless the LLC agreement provides otherwise an assignment of an LLC interest does not entitle the assignee to become or exercise any rights or powers of a member
- § 18-704(a) – assignee may become a member (1) as provided in the LLC agreement or (2) unless otherwise provided in the LLC agreement upon the affirmative vote or written consent of all of the members of the LLC



## Side effects

- Unintended dissolution and winding up of entity upon transfer of economic rights in foreclosure – e.g. under Delaware LLC Act
  - § 18-702(b)(3) – upon foreclosure debtor member is dissociated from member status
  - § 18-801(a)(4) – if no member, LLC is dissolved and shall be wound up
- Practice pointer - the UCC result doesn't always follow from the entity statute and governing agreements
  - Need to review entity statute and agreements, think about need for amendments to agreements and / or consents, and document the security interest appropriately



## Ability to transfer of transferable interest – § 502(a)(3).

“... a transfer, in whole or in part, of a transferable interest ... does not entitle the transferee to:

“(A) participate in the management or conduct of the company’s activities and affairs; or

“(B) ... have access to records or other information concerning the company’s activities and affairs.”

## Other effects of opt in

- All of Article 8 applicable
  - Effect of transfer restrictions [§ 8-204]
  - Issuer rights and duties [§ e.g. 8-401]
- Lost certificates / replacement certificates [§ 8-405]
  - Subsequent protected purchaser [§ 8-405(b)]
- Effect on Article 9 negation of anti-assignment provisions [§§ 9-406 and 9-408]?
  - 2018 Amendments to §§ 9-406 and 9-408



## Clash of principles

- Pick your partner
- Ability to finance



# Separation of interests

- Economic rights
  - Distributions
- Governance
  - Voting
  - Information



## Terms for components of interests

- Interests
- Membership interests
- Financial rights
- Economic rights
- Governance rights
- Management rights
- Units





## Assignability under Uniform Limited Liability Company Act § 503

“... a transfer, in whole or in part, of a transferable interest ... does not entitle the transferee to:

“(A) participate in the management or conduct of the company’s activities and affairs; or

“(B) ... have access to records or other information concerning the company’s activities and affairs”



## Assignability – court decisions

- *In re Weiss*, 376 B.R. 867 (Bankr. N.D. Ill. 2007) (pledgor had no power to pledge his interests because the *prior* approval of the other members had not been obtained)
- *In re McKenzie*, 2011 Bankr. Lexis 2088 (Bankr. E.D. Tenn. 2011) (same)



## Anti-assignment overrides

- UCC § 9-406(d)
  - “Strong” override
- UCC § 9-408(a)
  - “Weak” override



## UCC § 9-406 – Scope

- Applies to terms in an agreement “between an account debtor and an assignor or in a promissory note”
- Covers obligations (as collateral) on accounts, chattel paper, payment intangibles (but not general intangibles), and promissory notes
  - Is membership interest in an LLC a “general intangible” (that is not a “payment intangible”) or a “payment intangible”?
  - Answer affects whether § 9-406 or § 9-408 applies
- See limits on types of transactions below



## UCC § 9-406 – scope

- “Assignor” refers not only to assignments for security but also to sales (see § 9-102, cmt. 26)
- But § 9-406(d) does not apply to sales of promissory notes and payment intangibles (see § 9-406(e))



## UCC § 9-408 – scope

- Applies to security interests securing obligations in:
  - General intangibles (other than payment intangibles)
  - Health-care-insurance receivables
- Applies to sales of:
  - Payment intangibles
  - Promissory notes



## Scope for legal restrictions

- § 9-406:
  - Applies only to accounts and chattel paper
  - Does not apply to general intangibles (including payment intangibles)
  - As a result, § 9-406 does not apply to legal restrictions affecting an LLC membership interest
- § 9-408:
  - Applies to promissory notes and general intangibles (including payment intangibles)



## Payment rights outside the scope of both sections

- Investment property
  - Effect on LLC that “opts in” to Article 8, § 8-103



## Effect of § 9-406(d)

- Notwithstanding anti-assignment provision, “security interest” in covered payment right can be:
  - Created
  - Perfected
  - Enforced
- Account debtor or obligor on promissory note cannot declare a default

## Effect of § 9-408(a)

- Notwithstanding anti-assignment provision, “security interest” in covered property in a covered transaction can be:
  - Created
  - Perfected
- Account debtor cannot declare a default
- But account debtor does not have to recognize secured party. See § 9-408(d)



## Who is the “account debtor” in an LLC anti-assignment agreement?

- Anti-assignment overrides apply only to agreement with “account debtor” (§ 9-102(a)(3))
  - Who is the “account debtor” with respect to distributions from the LLC?
  - Who is the “account debtor” with respect to the agreement not to assign an interest in the membership interest?



## Non-uniformities in enactment

- Many states exclude application to special needs trusts and structured settlements
- Several states (including Delaware) exclude application of UCC anti-assignment overrides to obligations owed by LLCs and partnerships



## Recent developments

- 2010 amendments to Article 9
  - Add language to § 9-406(e) clarifying effect on disposition after default
- Draft PEB Commentary re unincorporated business entities

# Different effects among perfection methods

- Priority
  - Filing v. possession (if applicable) v. control (if applicable) and rules for intermediaries [9-328]
- Protected purchaser / free of claims
  - Requires investment property and control
- Effect on restrictions on assignment and exercise of remedies
  - Issuer may not be obligated to deal with secured party absent control [§§ 9-607(e), Comment 6 to 9-607, 9-406 and 9-408, 8-204, 8-401]



## Perfection – choice of law

- Possession of certificated security:
  - Location of Certificate [§ 9-305(a)(1)]
- Control of uncertificated security:
  - Issuer's jurisdiction [§§ 9-305(a)(2), 8-110(d)]
- Control of securities account / entitlements:
  - Securities intermediary's jurisdiction [§§ 9-305(a)(3), 8-110(e)]
- Filing:
  - Location of the debtor [§§ 9-301, 9-305(c)(1), 9-307]
- Possible effect of Hague Securities Convention

## Perfection not enough?

- Distributions [§ 8-207, state entity statutes, entity organizational documents]
- Sale of interest [§ 8-401, state entity statutes, entity organizational documents]
  - Restrictions on assignment, admission of new owner?
- Intercreditor agreement (e.g. mezzanine financing)





## Priority – choice of law

- Certificated Security:
  - Location of Certificate [§ 9-305(a)(1)]
- Uncertificated Security:
  - Issuer's Jurisdiction [§ 9-305(a)(2), 8-110(d)]
- Securities Account:
  - Securities Intermediary's Jurisdiction [§§ 9-305(a)(3), 8-110(e)]
  - Possible effect of Hague Securities Convention

# Protected purchaser and “takes free”

- Applies to buyers and secured parties - definition of purchase / purchaser [§§ 1-201(32) & (33), R1-201(b)(29) & (30), 8-116]
- “Protected purchaser” [§ 8-303(a)]
  - Gives value [§ 1-204]
  - Does not have notice of any adverse claim to the security [§§ 8-102(a)(1), 8-105]
  - Obtains control of the certificated or uncertificated security [§ 8-106]
- “Takes free” rules substantially equivalent for securities accounts / security entitlements [§§ 8-502, 8-503, 8-510]
- Takes free vs. priority [Comment 2 to § 9-331]
- Does this affect Article 9 Part 6 re security interests not extinguished by a foreclosure?



## Series LLCs and division of LLC – possible effect on analysis

- What is a “series” entity?
  - LLC, 6 Del. C. § 18-215
  - Limited Partnerships, 6 Del. C. § 17-218
- Is the “series” an entity/issuer?
  - Description of collateral
  - Series economic and governance rights?
- Can an interest in a series be a “security”?
- What is the “issuer’s jurisdiction”
- Delaware amendments for “registered” series, 6 Del. C. §§ 18-218 and 219
- Effect of “division” of LLC, 6 Del. C. § 18-217

## Which state's law applies when the law is different?

- Generally, the law that governs the payment obligation or general intangible applies, not the law that governs the security agreement
  - See §§ 9-401, Comment 3; *see also* 1-301(a)
- Internal affairs doctrine applies?
  - *Alphonse v. Arch Bay Holdings, L.L.C.*, 548 F. App'x 979 (5th Cir. 2013)


## Pre-foreclosure remedies – proxies

- Do proxies work before the secured party or foreclosure buyer becomes a member?
- *In re RiverAir, LLC*, No. 04-17586(SMB) (Bankr. S.D.N.Y. Feb. 3, 2005), Tr. of Hr'g (oral decision) (as provided in security agreement, upon default “[t]he membership interest should have been registered in the [secured parties'] name and this Court as a court of equity will deem this to have been done.”)
- *In re Lake County Grapevine Nursery Operations*, 441 B.R. 653 (Bankr. N.D. Cal. 2010) (Provisions of the California Corporations Code (governing LLCs) to provide that the pledgors retain voting rights until the secured party has enforced the security agreement and become a member)
- *In re Crossover Financial, LLC*, 477 B.R. 196 (D.Colo. 2012) (same)
- *But see, e.g., Delaware 6 § 18-302(d)*



## Remedies – general

- SP may sell, lease, license or otherwise dispose of any or all of its collateral [UCC § 9-610]
- Every aspect of disposition must be commercially reasonable
- ‘Commercially reasonable’ requirement is non-waivable [§ 9-602(7)]
- Use collection as a remedy? [§ 9-607]
  - Possible state remedy limitations (*Olmstead*, 44 So.3d 76 (Supreme Ct Fla. 2010))



## Remedies – commercial reasonableness

- Case-by-case analysis
- Efforts to find a buyer
  - General and specialized advertising / solicitations
  - Content of advertising
  - Use of brokers, dealers, websites, auctioneer
- Location of sale, other access for bidders
- Restrictions on bidders
- Provision of information about the collateral
  - Subject to confidentiality issues, provide available information

## Remedies – variation by agreement

- Parties may determine by agreement standards measuring fulfillment of:
  - Rights of debtor or obligor and duties of SP under Part 6 (even if § 9-602 provides provision cannot be waived or varied by agreement) [§ 9-603(a)]
  - Performance of secured party's obligations of good faith, diligence, reasonableness and care [§§ 1-102(3), R 1-302(b)]
  - Standard cannot be 'manifestly unreasonable'
- Agreement may not bind all with the right to seek remedies for SP failure to comply with Article 9 requirements [§ 9-625]





# Private dispositions

- Private dispositions are encouraged [§ 9-610, Comment 2]
  - Assumption is that they frequently will result in higher realization on the collateral for all concerned
- *Vornado PS, L.L.C. v. Primestone Investment Partners, L.P.*, 821 A.2d 296, 49 UCC Rep.Serv.2d 1348 (Del. Ch. 2002) debtor raised objection to public sale (at which secured party was the purchaser) based on this comment
  - Court held that excluding SP as a bidder would not likely improve the price obtained and SP could not bid at private sale

# Can the secured party buy?

- Secured party may purchase collateral [§ 9-610(c)]:
  - At a public disposition
  - 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 quotes
- Prohibition on secured party buying at private sale not listed in § 9-602 as non-waivable
  - § 9-624, Comment 2 (nonwaivable as substantive purchase by secured party at private sale)
  - New Comment coming
- ‘Recognized market’ – narrow definition



## Public sales

- Meaning [§ 9-610, Comment 7]
  - Price is determined after the public has had a meaningful opportunity for competitive bidding
  - Some form of advertisement or public notice must precede the sale
  - Public must have access to the sale



## SEC issues

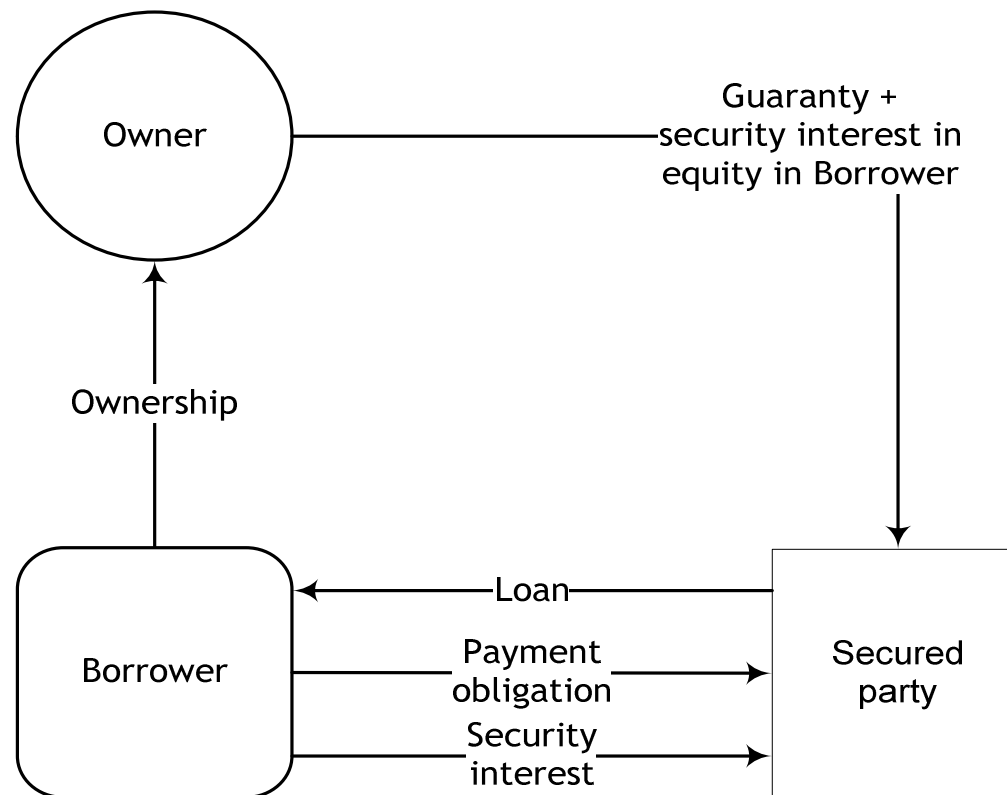
- Is the collateral a ‘security’ under Federal and state securities laws?
  - Securities law (not UCC) test
- UCC public sale has to comply with securities laws (§ 9-601, Comment 8):
  - “8. Investment Property. Dispositions of investment property may be regulated by the federal securities laws. Although a “public” disposition of securities under this Article may implicate the registration requirements of the Securities Act of 1933, it need not do so. A disposition that qualifies for a “private placement” exemption under the Securities Act of 1933 nevertheless may constitute a “public” disposition within the meaning of this section. Moreover, the “commercially reasonable” requirements of subsection (b) need not prevent a secured party from conducting a foreclosure sale without the issuer’s compliance with federal registration requirements.”



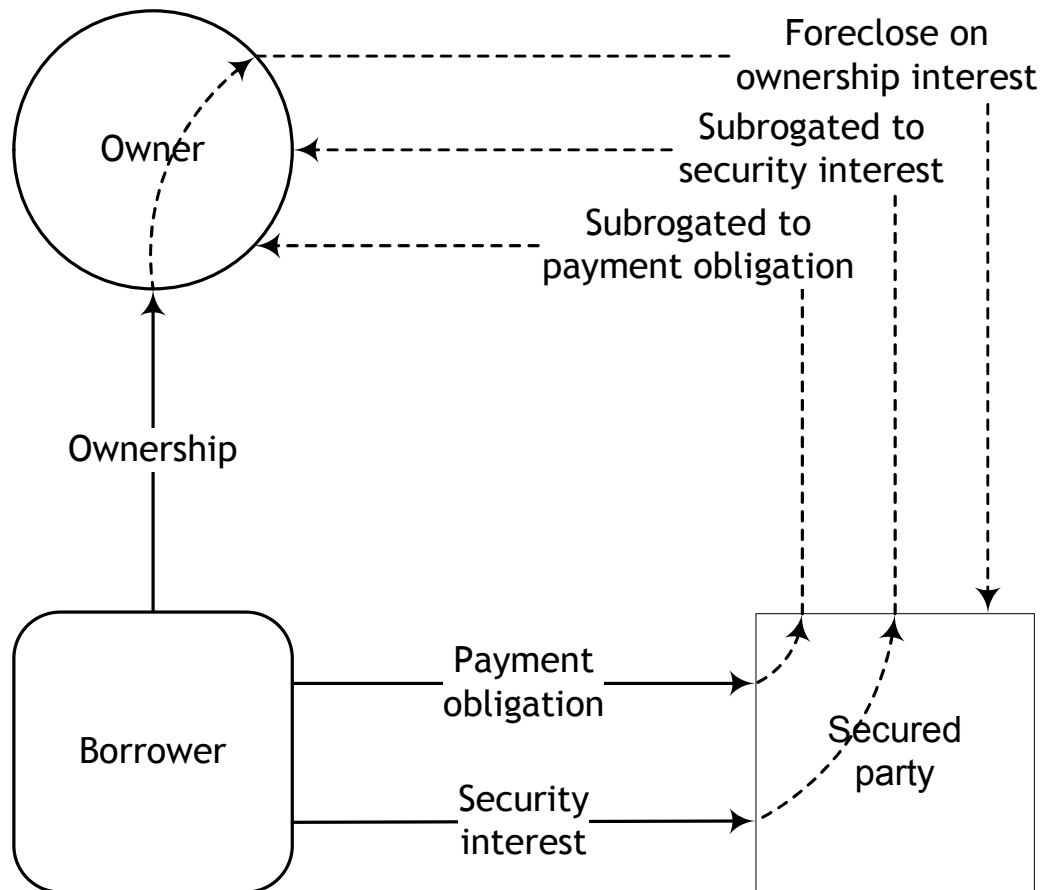
## SEC issues (additional)

- Series of SEC no-action letters sets out procedures and limits:
- Factors include:
  - Investment intent
  - Information available
  - Transfer restrictions
  - Limited number of purchasers
- Often reflected in security agreement provisions
- State securities laws
- Other considerations ('40 Act, '34 Act, Reg S, resale by foreclosure purchaser)

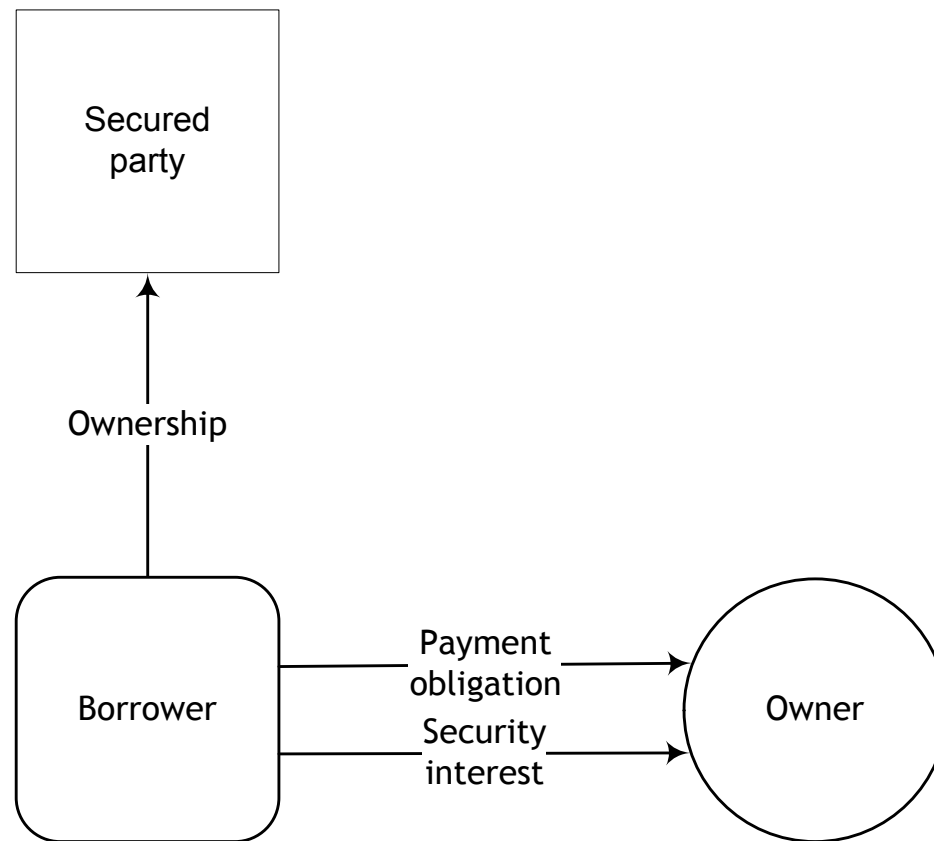
# Foreclosure strategy and trap



# Foreclosure strategy and trap



## Foreclosure strategy and trap







# Thank You

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