Maximizing Protection for Lenders of an Equity Interest Pledge

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Lenders often agree to take a pledge of equity in a limited liability company ("LLC") or a partnership as collateral security for a loan. Article 8 of the Uniform Commercial Code (the "UCC") determines what qualifies as a security[1]. A security is a share or similar equity interest issued by a corporation. Shares or similar equity interests can be certificated (i.e., evidenced by a numbered certificate) or uncertificated (i.e., evidenced by a book entry). Too often, lenders may assume that because an equity interest in a LLC or partnership is certificated, that it is a security under Article 8. However, an LLC or partnership interest does qualify as a security unless such entity has opted in to Article 8 of the UCC[2]. Without opting in, an LLC or partnership interest will be considered a general intangible for purposes of Article 8 and 9 of the UCC. In order to qualify as a security, the issuer of such security must expressly provide in its operating agreement or partnership agreement that it is a security governed by Article 8.

When a lender is taking a pledge of equity as collateral security for a loan, it is important for lenders and their counsel to do their due diligence by reviewing the governing documents of the issuer. Lenders should require that the issuer opt in to Article 8 prior to the closing of the loan by amending its operating agreement or partnership agreement. In addition to opting in, lenders should also require that any equity interest be certificated thereby affording the lender additional protections under Article 9 of the UCC. By requiring the opt in, lenders are afforded the protections of a "protected purchaser" under the UCC[3]. Also, by requiring that the equity interests be certificated, lenders can perfect their security interest by taking possession and control[4] which grants them far greater protections under the UCC than simply filing a UCC-1finanicng statement to cover a security interest in a general intangible.

Additionally, lenders should take steps to ensure that an issuer cannot opt out of Article 8 in the future by providing that the operating agreement or partnership agreement cannot be amended without the lenders prior consent. Lastly, if a lender elects not to require an issuer to opt in or to certificate its equity interest, it should consider prohibiting such issuer from opting in and/or certificating its equity interest in the future. A lender can accomplish this by prohibiting the operating agreement or partnership agreement from being amended without the lenders prior consent. Failure to do so could result in (a) the lenders security interest in its general intangible to be trumped by possession and control by a subsequent secured party or (b) such security interest could become invalid for failure to correctly identify the collateral[5].

[1] UCC Sections 8-102 and 8-103
[2] UCC Section 8-103(c)

[3] UCC Section 8-303(a)
[4] UCC Section 9-314
[5] UCC Sections 9-502(a)(3) and 9-108

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