How To Perfect Equity Collateral Under Article 8

James D. Prendergast And Keith Pearson

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

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

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

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

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

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

Malpractice Danger

It is also important to point out the technical complexity of Revised Article 9 and of Article 8. Periodic practice is this area may not provide the level of expertise necessary to satisfy the lawyer's required standard of competence. *The Special Report of the TriBar Opinion Committee: U.C.C. Security Interest Opinions—Revised Article 9,* 58 Bus. Law. 1449 (2003) ("TriBar Report"), is very clear, although perhaps too subtle, on this issue when it states that "opinion preparers who do not regularly work with Article 9 should consider whether to involve a lawyer familiar with Article 9 in the preparation of a U.C.C. security interest opinion." *Id.* at 1454. Article 9 is sufficiently complex on its own to preclude dabbling by general practitioners. The advice by the TriBar Report to call an expert is more urgent when Article 8 is rolled into Article 9.

Many attorneys involved in mezzanine loan transactions are quite pleased with themselves in having prepared a certificate evidencing the collateral equity interests in a limited liability company, in having that certificate endorsed over to the lender at a closing, and then having the lender take possession of the certificate to perfect its security interest. Many of the right steps are there. The problem, however, is that without more, a membership interest in a limited liability company is a general intangible and Article 9 provides only one method of perfecting a security interest in general intangibles—filing a financing statement at the appropriate filing office in the jurisdiction where the debtor is located. A general intangible cannot be possessed—hence the name intangible. The beautiful certificate evidencing a general intangible is of no legal effect.

Opting In To Article 8

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

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

Generally, an equity interest in a limited liability company, general partnership, or limited partnership is a general intangible and not a security for purposes of Article 8 or investment property for purposes of Article 9.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix I graphically illustrates this fact pattern.

In this example, through fraud or whatever, the first mezzanine lender loses its priority perfected security interest in the equity collateral. The collateral is no longer a general intangible but has been morphed into a security for purposes of Article 8 and investment property for purposes of Article 9. The second lender perfects its security interest in the equity collateral by possession or control thereby trumping the security interest of the first lender even though the first lender's security interest was previously perfected by filing. This is the case even though the first lender's security interest may remain perfected by the filing on the theory that the investment property is proceeds of the general intangible. *See* UCC §9-315(d)(1).

Protected Purchaser

In addition to the availability of possession and control along with filing as means of perfection resulting from the opting in to Article 8 and morphing the equity from a general intangible to a security, perfecting a security interest in investment property by control (but not possession) allows the secured party to qualify as a "Protected Purchaser." Section 8-303 provides that a purchaser (including a secured party) acquiring a security interest in a security, whether certificated or uncertificated, acquires its security interest "free" of adverse claims if the purchaser qualifies as a "Protected Purchaser." A "Protected Purchaser" is a purchaser of a certificated or uncertificated security, or an interest in the security, who:

- Gives value;
- Does not have notice of ANY adverse claim to the security; and
- Obtains control of the security, either by possession with endorsement for a certificated security or registration of the security in the name of the purchaser, or through a tri-party control agreement among the debtor, issuer and secured party for an uncertificated security.

"Purchase" and "Purchaser" are defined in sections 1-201(32) and (33). Purchaser includes a secured party. (The corresponding sections under Revised Article 1 are 1-201(b)(29) and (30).)

"Value" is defined in section 1-201(44) and is broadly defined and easily met, and would include the commitment to make a loan and certainly any advance. (The corresponding section under Revised Article 1 is 1-204.)

As described in section 8-105, "notice of an adverse claim" exists if there is actual knowledge of a claim. However, failure to seek further information when the facts indicate that there is a significant probability of an adverse claim can constitute notice, as well as failure to fulfill a duty of investigation imposed by law.

"Adverse Claim" is defined in section 8-102(a)(1) and has two elements:

- The claimant has a property interest (including a security interest) in the security, and
- It is a violation of the rights of the claimant for another person, whether our purchaser or secured party or any other third party, to hold, transfer, or deal with the security.

As described in section 8-105, "notice of an adverse claim" exists if there is actual knowledge of a claim. However, failure to seek further information when the facts indicate that there is a significant probability of an adverse claim can constitute notice, as well as failure to fulfill a duty of investigation imposed by law.

Keep in mind that the requirement of no notice of an adverse claim is an additional requirement not required for perfection by control of investment property. As stated in Official

Comment 8 to section 9-328: "The control priority rule does not turn on an inquiry into the state of a secured party's awareness of potential conflicting claims because a rule under which a person's rights depended on that sort of after-the-fact inquiry could introduce an unacceptable measure of uncertainty." Further, section 9-331(c) makes it quite clear that the filing of a financing statement under Article 9 does not constitute notice of a claim. However, compliance with the control priority rules do not constitute compliance with the rules for Protected Purchaser status. A secured party could obtain control priority without qualifying as a Protected Purchaser.

Section 8-105 provides the criteria for determining whether a person has "notice of an adverse claim." In addition to actual knowledge, section 8-105(a) provides two additional circumstances when such notice may be found. The first is if the person (in our case the secured party trying to attain Protected Purchaser status) is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim. As stated in Official Comment 4, this section is intended to codify the "willful blindness" test.

The debate in our context of secured transactions is over whether merely not searching the central filing office for filed financing statements against the intended equity collateral, absent any prior indication of another secured creditor in the picture, is a deliberate avoidance of information. Although the status requires that the secured party seeking Protected Purchaser status must at least be aware of facts indicating that another secured party may have extended credit against the equity interest, you could see an argument that it is commercially unreasonable not to search the central filing office in a mezzanine loan transaction. If the search would have disclosed a filed financing statement against the equity, perhaps the "willful blindness" test would be satisfied.

The moral of the story is that the rules of Article 9 on control perfection are not dispositive of Protected Purchaser status. More is required and the existence of a filed financing statement against the equity collateral is arguably sufficient to require the mezzanine lender to contact the secured party and determine whether the secured party claims an adverse interest in the collateral.

It is also important to remember that notice of any adverse claim defeats Protected Purchaser status for all adverse claims including those of which the secured party does not have notice.

NO HYPOTHETICAL SITUATION• To convince the reader that control perfection trumping prior filing perfection is not just a hypothetical situation dreamed up for purposes of this article, we offer the following actual case study that is a claim at First American under our *EAGLE 9®* UCC lien priority insurance with our mezzanine endorsement that insures the ownership of equity collateral. *See* Appendix J.

In Step 1, the First Mezzanine Lender makes a $100 million loan to the First Equity Owner, a California limited liability company that is the equity owner of the membership interests in the Delaware limited liability company that owns the subject real property. The mezzanine loan was needed to capture a portion of the equity value in the underlying real property so as to complete the acquisition of the real property. There was also a significant mortgage loan. The Property Owner Delaware LLC had not opted in to Article 8, the membership interest collateral therefore being a general intangible under Article 9, and the First Mezzanine Lender filed a financing statement in the office of the California Secretary of State to perfect its security interest in the general intangible equity interest asset of the First Equity Owner LLC.

The mezzanine loan was an agented credit and contained a provision providing for a success fee to the bank group of $2 million if the real property owned by the Property Owner subsidiary was sold for an amount in excess of $300 million.

Now, along comes Second Mezzanine Lender to refinance the First Mezzanine Lender. *See* Appendix K. The second mezzanine loan was for $100 million, advanced to Second Equity Owner, a newly formed Delaware LLC and a wholly owned subsidiary of the ultimate parent of the First Equity Owner. The funds were used by the Second Equity Owner to purchase all of the issued and outstanding membership interests in the Property Owner. The sale proceeds were then concurrently used by the selling First Equity Owner to repay the First Mezzanine Lender.

The Second Mezzanine Lender required as part of the loan transaction that the Second Equity Owner pledge its membership interest in the Property Owner Delaware LLC and that the Property Owner opt-in to Article 8 and certificate its membership interests. The Second Mezzanine Lender then took possession of the certificate with an appropriate endorsement, thereby perfecting its security interest by control. The Second Mezzanine Lender gave value and did not have notice of any adverse claim against the membership interests in the Property Owner and attained the status of a Protected Purchaser.

Because the refinance was only for $100 million, the agent for the First Mezzanine Lender syndicate did not demand payment of the $2 million success fee in the payoff letter.

After the close of the refinance a member of the First Mezzanine Lender loan syndicate challenged the transaction on the grounds that the refinance effectively was the sale of the underlying real property through the transfer of the equity ownership in the Property Owner. The syndicate member contended that the real property was in fact worth in excess of $400 million and the $2 million success fee was in fact payable on the refinance. *See* Appendix L.

The position of the syndicate member was that the effective transfer of the underlying real property through the transfer of the equity ownership was a fraudulent conveyance in that the consideration received for the real property worth in excess of $400 million was only $100 million. The syndicate member therefore demanded that the equity interests in the Property Owner be disgorged by the Second Equity Owner back to the First Equity Owner, and the security interest of the First Mezzanine Lender would therefore reattach to the membership interests and be senior in priority.

Our counter argument is that, regardless of the substance of the fraudulent conveyance argument, and even in the event that the membership interests in the Property Owner are disgorged by the Second Equity Owner back to the First Equity Owner, the priority of the security interest of the Second Mezzanine Lender would be senior to the security interest of the First Mezzanine Lender. The Protected Purchaser status of the Second Mezzanine Lender results in the security interest of the Second Mezzanine Lender being senior to the security interest of the First Mezzanine Lender. *See* Official Comment 1 to section 9-331. The legal result seems fairly obvious but we at First American are obligated to defend the attack on the priority of our Insured's security interest under our *EAGLE 9*® UCC priority insurance policy coupled with the Mezzanine Endorsement regardless of the merit of the claim or whether our Insured has yet to suffer an actual loss compensable under the policy. In the unlikely event that we do not prevail, First American will compensate the Second Mezzanine Lender for any suffered loss or damage.

CONSEQUENCES OF OPTING-IN • Opting in to Article 8 is not without its consequences, some of which might be objectionable to the issuer. Article 8 contains numerous provisions that will affect the rights and obligations of the issuer, whether an LLC, GP, or LP. Article 8 will also affect the rights and obligations of the holder of the security, secured parties, and other transferees of an interest in the security. Further, Article 8 imposes specific requirements if a certificate is certificated. *See* Appendix M.

As an example, section 8-204 provides that a restriction on transfer of a security imposed by the issuer, even if otherwise lawful, is ineffective unless the restriction is noted conspicuously on the security if certificated or, if uncertificated, the registered owner has been notified of the restriction. Further, section 8-209 provides that a lien in favor of the issuer upon a certificated security, e.g., for an unpaid capital contribution requirement, is valid against a purchaser of the security only if the lien again is noted conspicuously on the security. Transfers of securities are made with specific warranties set forth in section 8-108(b) unless waived in the manner specified. Additional sections of Article 8 prescribe further rules on the transfer of securities, on the rights and duties of the issuer with respect to registered owners, and the liability of the issuer for wrongful transfer.

It is also useful to point out that opting-in to Article 8 and transmuting the equity interest in the real property-owning entity from a general intangible to a security under Article 8 and investment property under Article 9 has NO relationship to whether the equity interest is a security for purposes of federal or state securities laws. No matter whether the equity interest is a passive investment, meeting the criteria for either a federal or state security is independent of the classification of the equity interest for purposes of the UCC. However, in all likelihood, a membership interest in an LLC (except perhaps the managing member interest) or a limited partnership interest in an LP meets the requirements for a federal and state security. The independent status of the equity interest as either a federal or state security may, however, determine certain other matters such as restrictions on the manner of foreclosure.

The restrictions and other matters affecting securities imposed by Article 8 may have import in a widely held partnership or limited liability company. However, in most of the mezzanine transactions in which we at First American have insured the ownership of the equity collateral for the mezzanine loan, the membership or partnership interests are held in closely held entities in which the number of holders is limited. In the context of a closely held entity, most if not all of the customary objections to the provisions of Article 8 are often unimportant if not irrelevant. Finally, given the significant benefit provided to a secured party lender in having the issuer of the equity collateral opt-in to Article 8, the Golden Rule should be dispositive. The person with the gold makes the rules.

The corporate lawyer should also appreciate the provisions of Article 8 with respect to the issuance and transfer of securities as adding certainty to the rights and obligations of the parties with respect to interests in partnerships and limited liability companies. These matters are often left vague and uncertain by state partnership and limited liability company statutes.

CONCLUSION• The applicability of Article 8 to real estate mezzanine lending is clear. The principal if not the sole collateral for the mezzanine loan is the equity interests of the mezzanine borrowers in the real property-owning entity. Relying on filing priority to perfect the lender's interest in a general intangible, given the import of the discussion above, is, at best, imprudent lending practice. For counsel to the lender to suggest any approach to collateral protection other than requiring the real property-owning entity to opt-in to Article 8 is arguably malpractice given what we have discussed in this article. The lawyer may require other protections, such as covenants against opting-out of Article 8 and requiring that the equity be certificated, but, at a minimum, the lawyer needs to understand the complexities of Article 8 in conjunction with Article 9 and advise his or her client effectively on the importance of control priority perfection and meeting the requirements of a Protected Purchaser.

The moral of the story is that it is hard to fathom a mezzanine lending transaction in which the lender would not require that the mezzanine borrowers cause the real property owner to opt-in to Article 8 and, given the relative ease of control perfection and foreclosure issues, to certificate the equity interests. Remember, if the secured party obtains control over a security, no one else can obtain control of that security.

APPENDIX A

The Membership Interest represented by this Certificate is a security governed by Article 8 of the [Delaware] Uniform Commercial Code.

[______________________ LLC]
a[Delaware] Limited Liability Company

Certificate Number	*Membership Interest*
Cert. No. [1]	[100%]

LIMITED LIABILITY COMPANY MEMBERSHIP INTEREST

This Certifies That [______]*** is the registered holder of [100%] of the Membership Interests of

[____________________, LLC]

In Witness Whereof, the said Limited Liability Company has caused this Certificate to be signed by its[manager] this ____ day of ________, 200__.

By: *[__________, INC., MANAGER]*

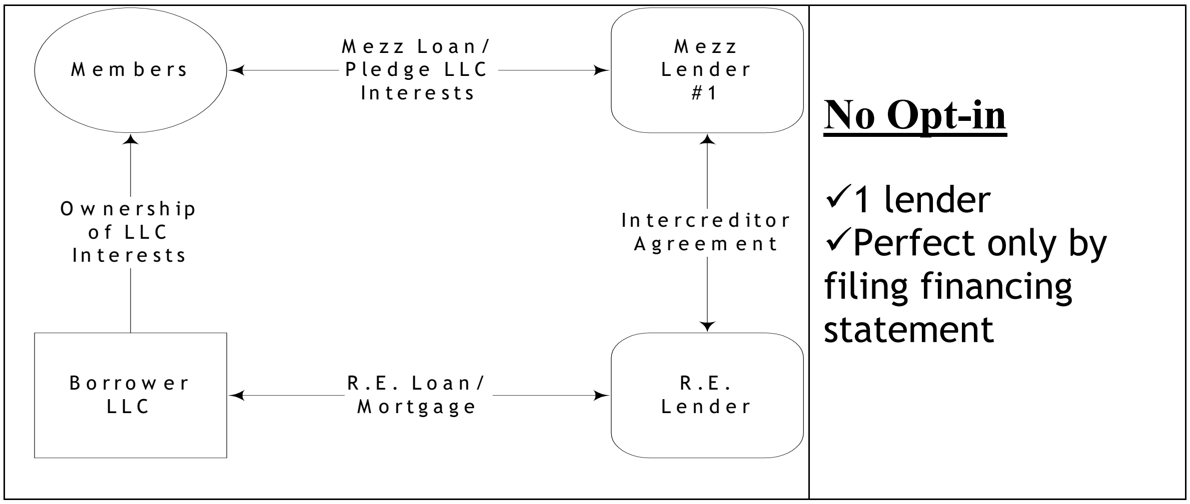
By: ______________________

Name: ______________________

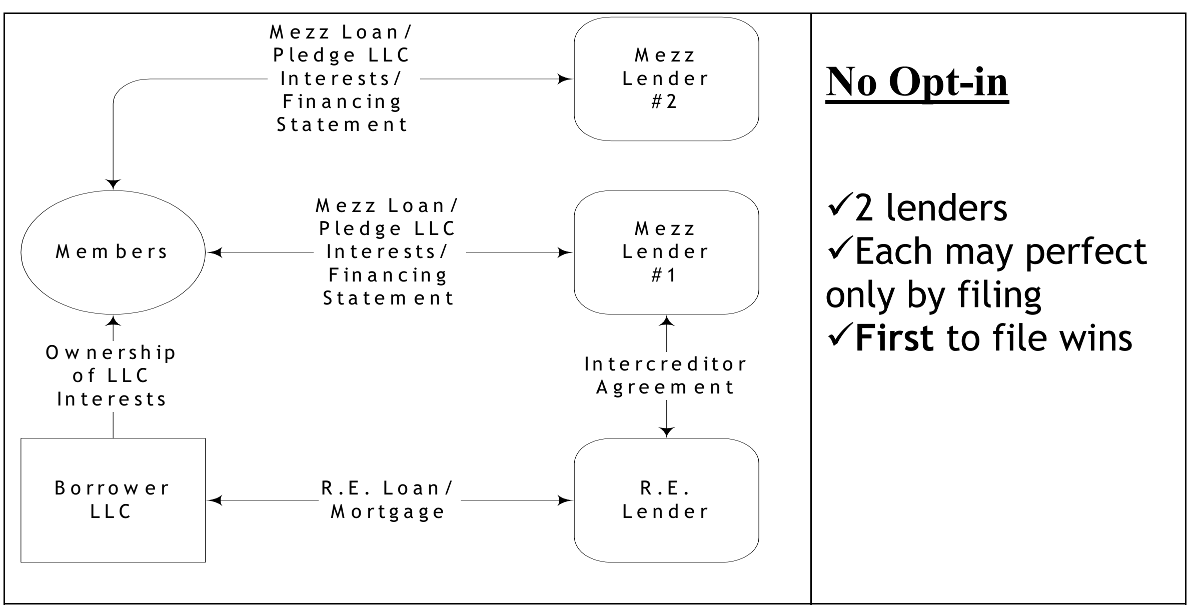
Its: ______________________

See Reverse Side
For Restriction On Transfer

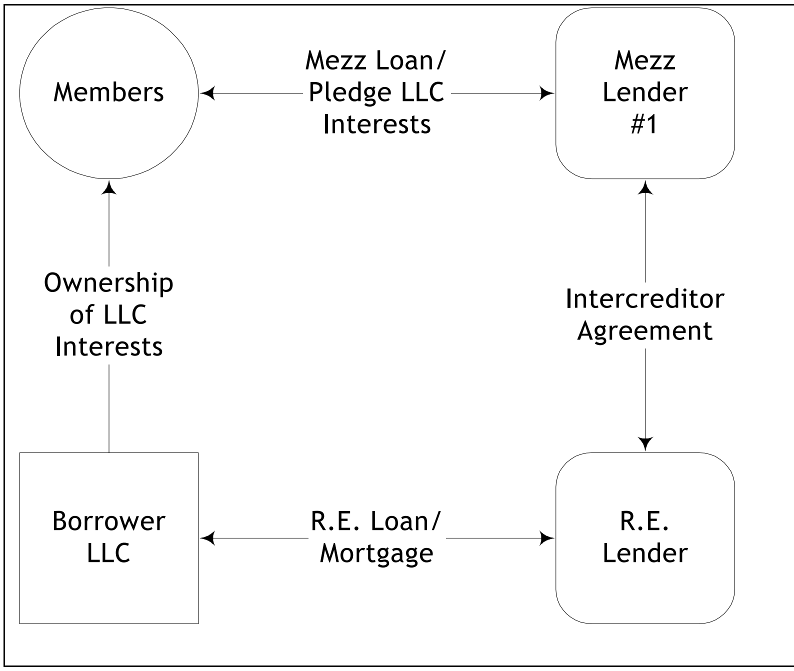
APPENDIX B



APPENDIX C



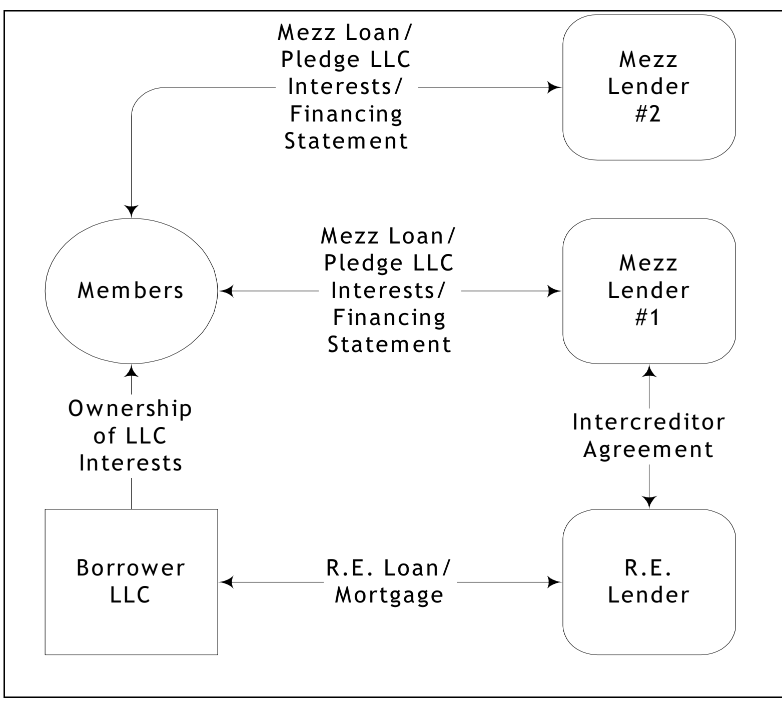
Appendix D



<u>Opt-in</u>

✓1 lender
✓Can perfect by filing, possession, or control

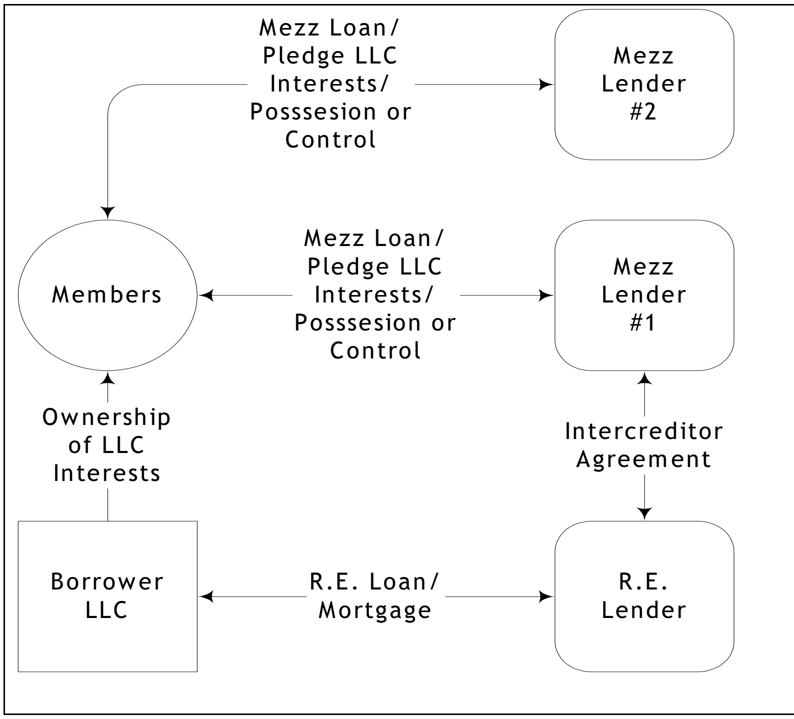
Appendix E



<u>Opt-in</u>

✓2 lenders
✓Each can perfect by filing, possession, or control
✓If both file, first to file wins.

APPENDIX F



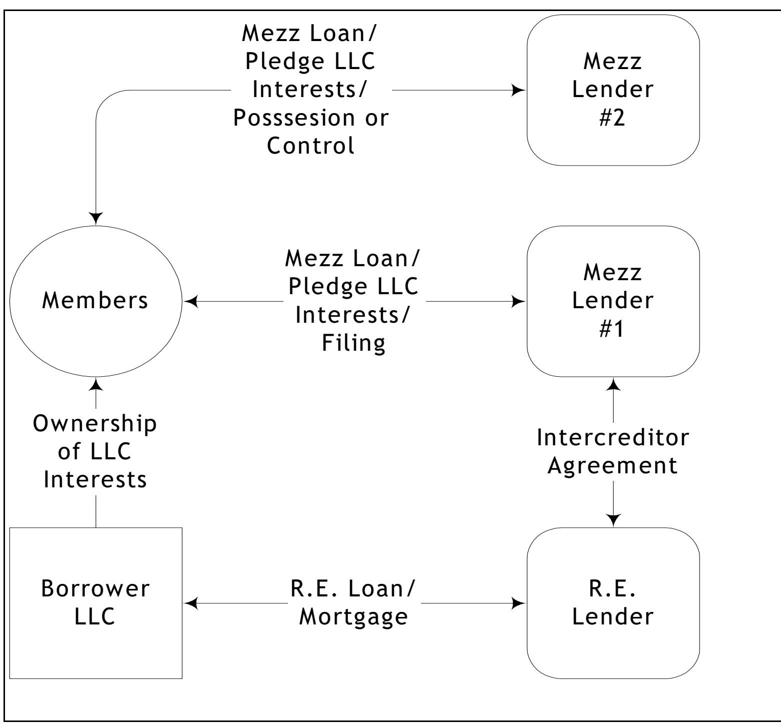
<u>Opt-in</u>

✓2 lenders
✓Each takes possession
✓**First** to take possession wins;

OR

✓2 lenders
✓Each obtains control
✓**First** to obtain control wins

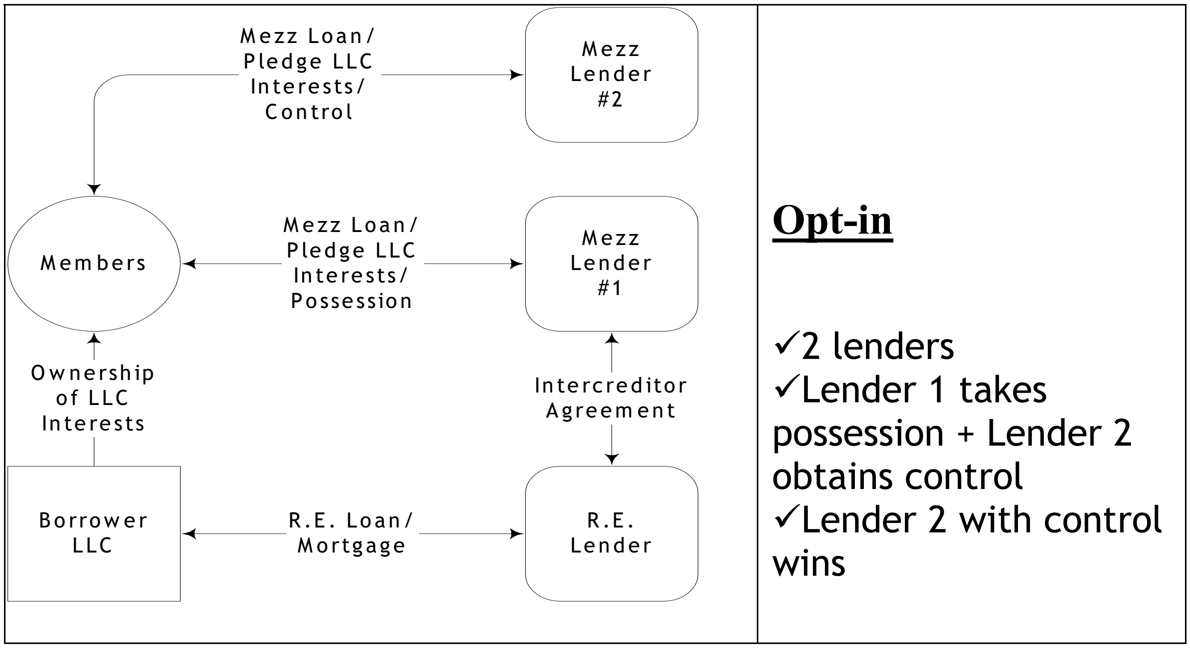
APPENDIX G



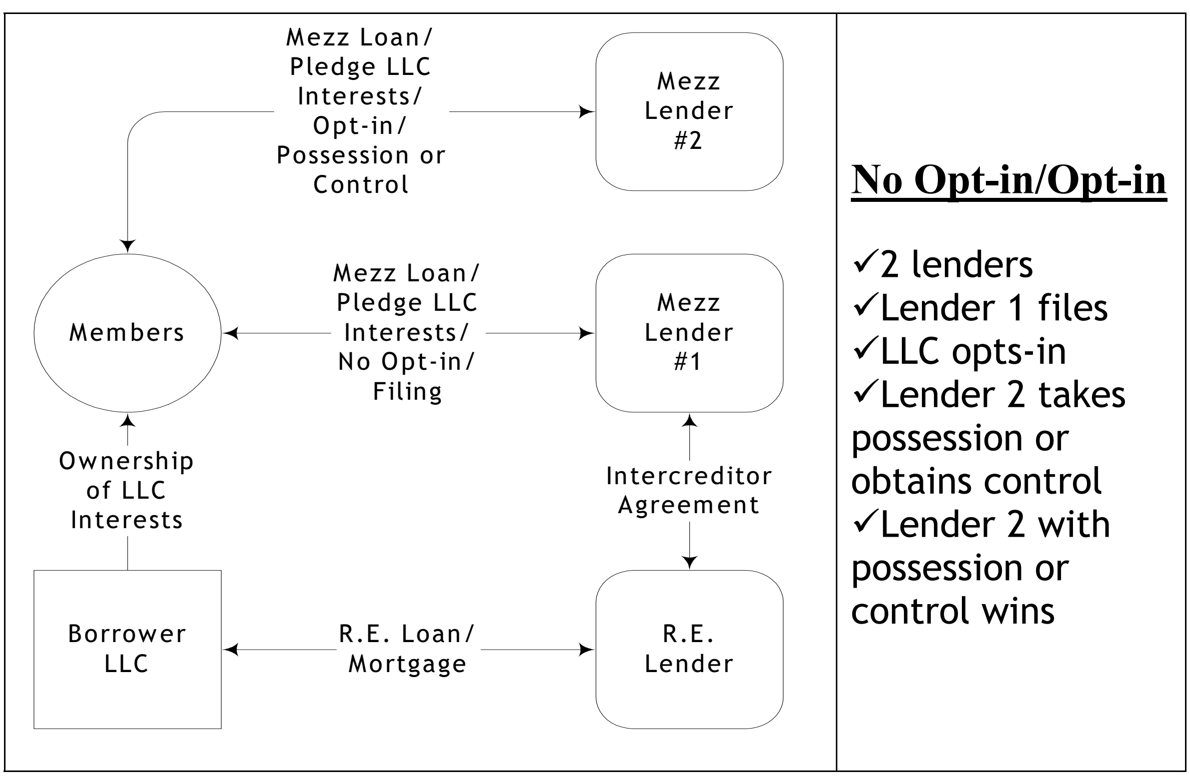
<u>Opt-in</u>

✓2 lenders
✓I files and other takes possession or obtains control
✓Lender with control or possession wins

Appendix H

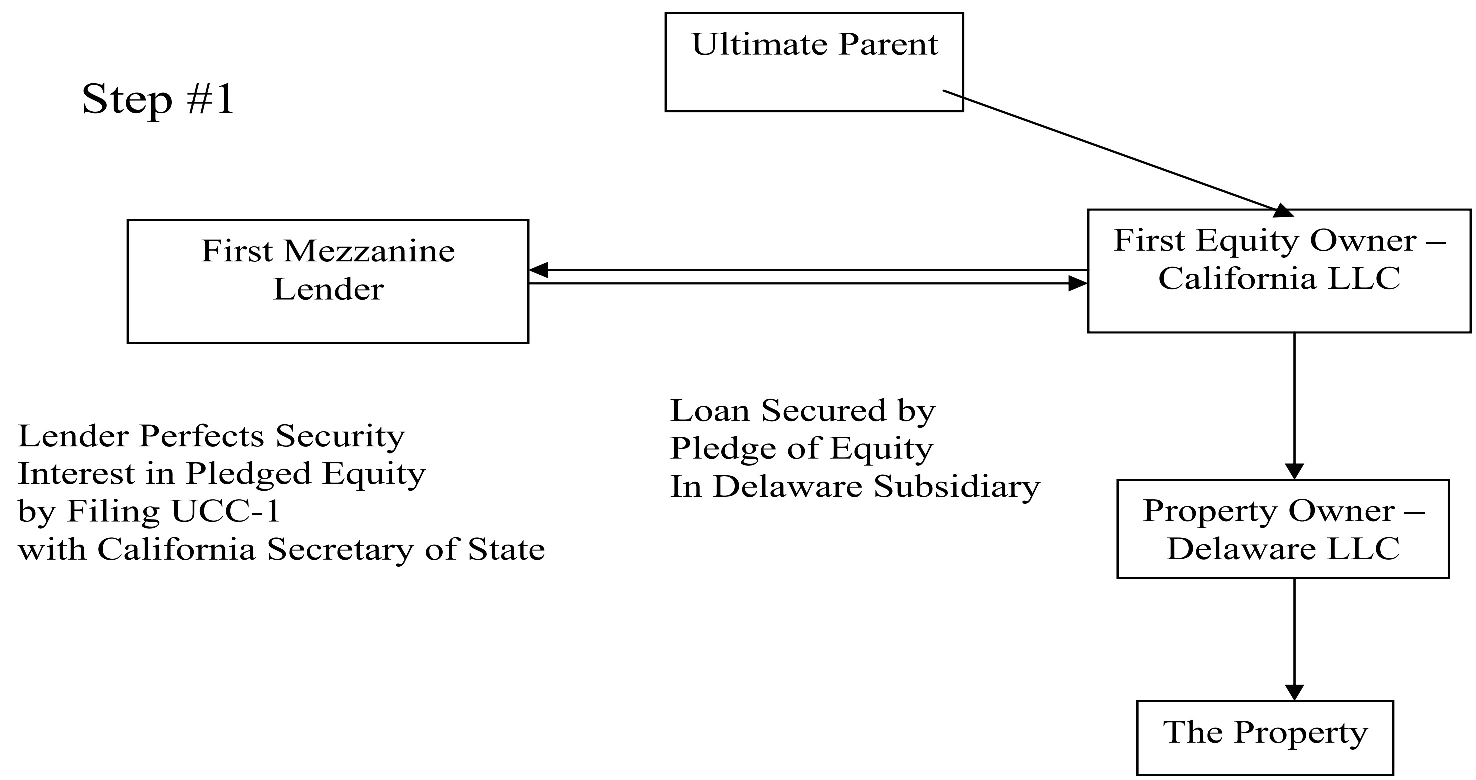


Appendix I



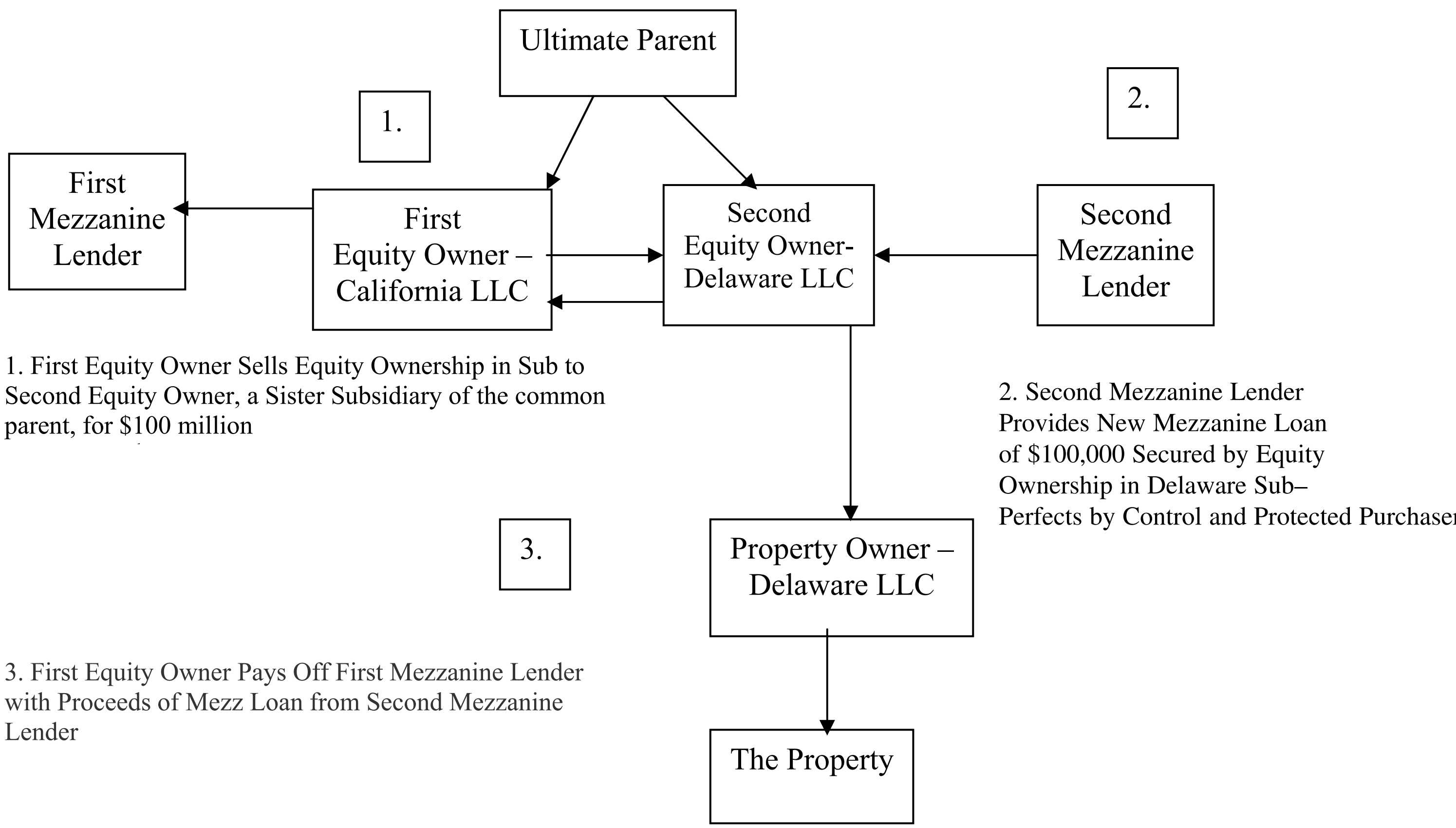
APPENDIX J

Step #1

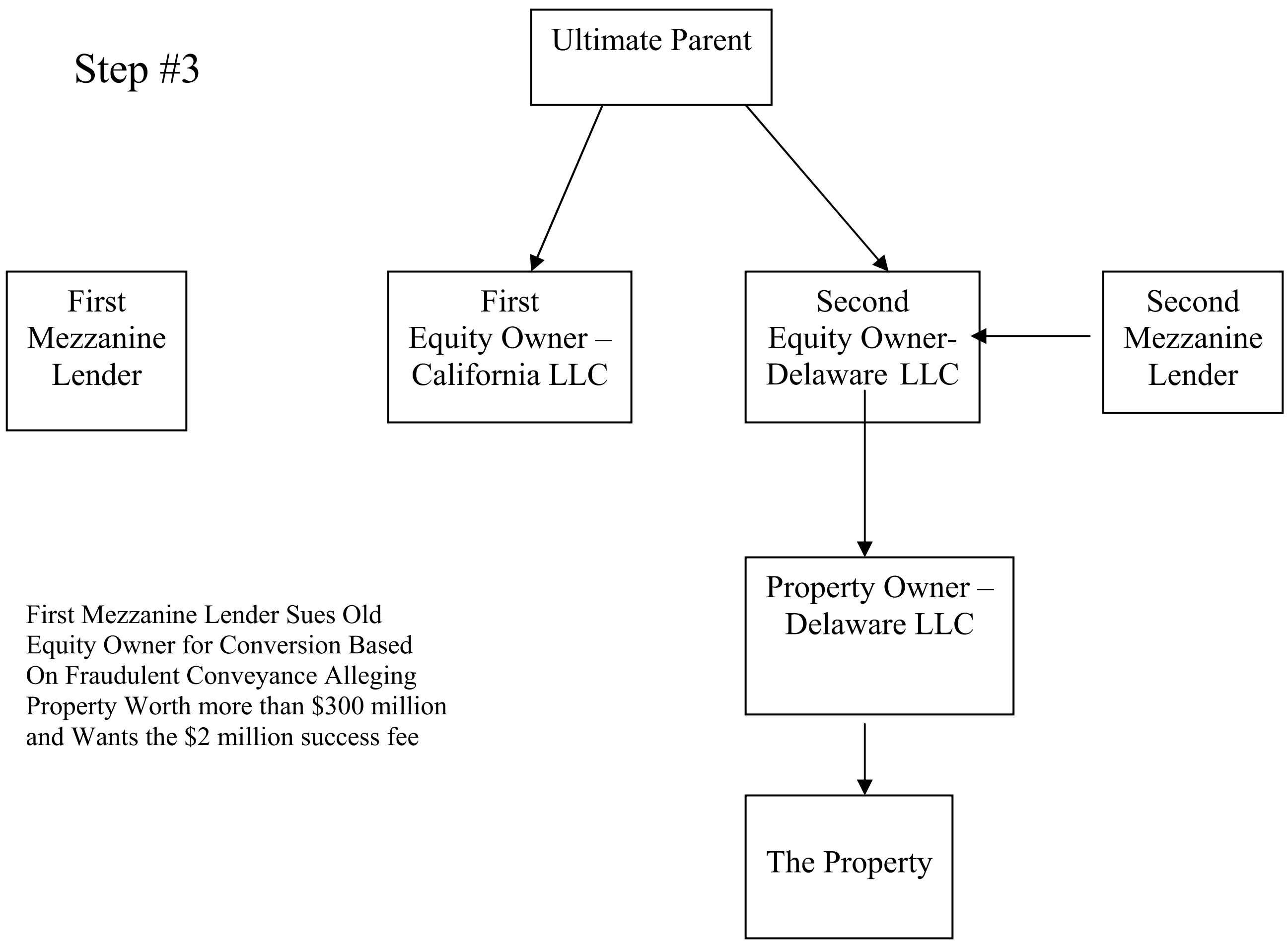


APPENDIX K

Step #2



APPENDIX L


Step #3
Ultimate Parent
First Mezzanine Lender
First Equity Owner – California LLC
Second Equity Owner- Delaware LLC
Second Mezzanine Lender
Property Owner – Delaware LLC
The Property
First Mezzanine Lender Sues Old Equity Owner for Conversion Based On Fraudulent Conveyance Alleging Property Worth more than $300 million and Wants the $2 million success fee

APPENDIX M

Possible borrower objections to opt-in

- ✓ UCC §8-202--terms of the security on the certificate or by reference
- ✓ UCC §8-204--conspicuously note restrictions on transfer on the certificate
- ✓ UCC §8-205--effectiveness of unauthorized signatures
- ✓ UCC §8-102(d)--effect on status under Federal securities laws (irrelevant as indicated below)
- ✓ Hassle factor
- ✓ Keeping track of certificate
- ✓ UCC § 8-102(d)--effect on status under Federal securities laws and effect on foreclosure (irrelevant as indicated below)

PRACTICE CHECKLIST FOR

How To Perfect Equity Collateral Under Article 8

Generally, an equity interest in a limited liability company, general partnership, or limited partnership is a general intangible and not a "security" for purposes of Article 8 or "investment property" for purposes of Article 9. Article 8 provides that, generally, equity interests in a limited liability company, general partnership, or a limited partnership are general intangibles unless the issuer explicitly opts into Article 8 by specifying that the equity interests are securities governed by Article 8. A security interest in a general intangible can only be perfected by filing. Priority among security interests will be determined by the "first to file" rules of Article 9.

- When representing the lender, do the following:

__ Insist that the issuer of the equity opt-in to Article 8;

__ Certificate the equity;

__ Take possession of the certificate;

__ Try to obtain an endorsement to perfect by control;

__ Obtain a covenant that the borrower will not opt-out;

__ Require independent member consent for opt-out; and

__ File back-up financing statement in case opt-in is defective or, if effective, in case borrower manages to opt-out later.