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Using Limited Liability Company Interests and Limited Partnership Interests as Collateral

By [Tarik J. Haskins](#)

In recent years, there has been an explosion in the use of alternative entities such as limited liability companies, limited partnerships, and general partnerships (collectively referred to herein as “alternative entities”). In addition, limited liability companies have become the preferred vehicle for creating bankruptcy remote entities in many financing transactions, which may also feature mezzanine financing arrangements in which the equity interests in the limited liability company is the mezzanine secured party’s primary collateral. Therefore, it is imperative that commercial finance attorneys understand the consequences of using equity interests in alternative entities as collateral. Although practitioners may be inclined to treat equity interests in alternative entities the same as corporate stock, the provisions of the Uniform Commercial Code (UCC) relating to the use of equity interests in alternative entities as collateral are different from those relating to the use of corporate stock as collateral. Therefore, practitioners cannot approach the issue of perfecting a security interest in equity interests in alternative entities the same as he or she would approach perfection in corporate stock. This article will describe (1) the methods of perfecting a security interest in equity interests in alternative entities, (2) mistakes practitioners often make when using equity interests in alternative entities as collateral, and (3) a

few helpful tips for practitioners to keep in mind when using equity interests in alternative entities as collateral. This article will primarily focus on the relevant UCC provisions related to using equity interests in alternative entities as collateral, but to the extent references are made to statutes governing alternative entities, it will refer to the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act. However, the concepts discussed will also have applicability in other jurisdictions, which might have similar statutes.

Basic Perfection Methods

In connection with any secured financing, the secured party’s counsel should first determine what type of collateral he or she is dealing with in order to determine how to perfect its security interest in such collateral. Unlike corporate stock, equity interests in an alternative entity may not always be the same type of collateral for purposes of the UCC. Equity interests in limited liability companies and partnerships can be a “general intangible” or “investment property.” UCC §§ 9-102(a)(49) and 9-102(a)(42). Unless the alternative entity has taken affirmative steps to have its equity interests treated as “securities” for purposes of Article 8 of the UCC, such equity interests will probably be general intangibles. UCC § 8-103(c). Thus, a secured party must review the al-

ternative entity’s governing document and certificate of interest, if any, to determine whether the subject alternative entity has opted in to Article 8 to have its equity interests treated as securities, in which case, such interests will be investment property, not general intangibles.

Once the secured party’s counsel has determined what type of collateral the equity interests are for UCC purposes, then he or she can determine how to perfect the secured party’s security interest in the collateral. If the equity interests are general intangibles, the sole method of perfection is by filing. UCC § 9-310(a). Therefore, if the equity interests are general intangibles, for priority purposes, the familiar rules of first to file will govern multiple interests in the equity interests. UCC § 9-322(a). To the extent the equity interests are “securities,” and therefore “investment property,” then the secured party’s counsel must determine whether such interests are “certificated securities” or “uncertificated securities.” If the equity interests are “certificated securities,” the secured party can perfect its interest by filing, control or possession. UCC §§ 9-312(a), 9-313(a), and 9-314(a). If the equity interests are uncertificated securities, a secured party can perfect by control or filing. UCC §§ 9-312(a) and 9-314(a). For purposes of priority, a security interest perfected by control has priority over a security interest held by a secured party that does not have

control of the investment property. UCC § 9-328(l).

Common Mistakes

To recap briefly, equity interests in alternative entities can be “investment property” or “general intangibles” and the nature of the collateral will determine the permissible methods of perfection. This all seems relatively simple, but now let’s briefly describe some of the mistakes that practitioners make in dealing with this type of collateral. As an overarching premise, it is imperative that the practitioner appreciate that he or she is not dealing with corporate stock and therefore what might apply to corporate stock will not apply in the world of alternative entities. Thus, it will not be sufficient to simply follow the same procedures that such practitioner has followed to perfect an interest in corporate stock. For example, under Delaware law, in contrast to corporate stock, an equity interest in a limited partnership or a limited liability company is made up of distinct economic rights and governance rights, and the two sets of rights are not bound together by statute. Ultimately, a secured party will want to have the right, upon default, to take control of the equity interests, and have the ability to receive, or transfer, the economic benefits of the equity interest as well as the governance rights. Thus, it is critical for the secured party to adequately describe the collateral to ensure that the collateral description is broad enough to create a security interest in the economic and governance rights.

A practitioner should be careful about simply using terms like “membership interests,” “limited liability company interests,” or “partnership interests,” which may not be sufficient to encompass economic and governance rights. For example, under the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act, the terms “limited liability company interest” and “partnership interest” under the relevant act simply refers to a person’s right to share in the entity’s profits and losses and the right to receive distributions not gov-

ernance rights. Delaware Limited Liability Company Act § 18-101(8) and Delaware Revised Uniform Limited Partnership Act § 17-101(13). Thus, a collateral description using the terms “limited liability company interest,” “partnership interest,” or “membership interest” to describe an equity interest in a Delaware entity would not be sufficient to include the governance rights in the secured party’s collateral. Therefore, a secured party that used such a collateral description might find itself with a security interest in the economic rights of such entity only and no ability to cause a distribution of the entity’s assets or to exercise any governance rights.

The second mistake we often see is a failure to perfect the security interest in a manner that provides the secured party with priority over other secured parties with a competing security interest in the collateral. The method of perfection depends on the type of collateral being perfected. Are the equity interests in the alternative entity “general intangibles” or “investment property”? If the equity interests are investment property, the secured party may perfect by filing, control, or possession, but a security interest perfected by control will have priority over a security interest held by a secured party that does not have control of the investment property. UCC § 9-328(l). Again, the mistake we often see here is a failure to realize that the collateral is “investment property” and the secured party’s failure to perfect its security interest by control or possession.

Some of the great benefits of Revised Article 9 are the self-help remedies that enable a secured party to take a number of actions without judicial assistance to realize the value of its collateral in order to satisfy the obligations secured by the security interest. Those self-help remedies include, but are not limited to, strict foreclosure, and selling or otherwise disposing of the collateral to a third party. UCC §§ 9-620 and 9-610. Thus, one of the other mistakes we see is a failure by secured parties to take advantage of the contractual flexibility inherent in most alternative entity statutes to protect its security inter-

est and facilitate such self-help remedies. Furthermore, such a mistake is often compounded by practitioners using corporate stock pledge agreements as precedent and substituting member for shareholder and membership interests for shares, which without more will probably be insufficient to protect fully the interests of the secured party. Also, if practitioners simply follow corporate precedent, he or she may fail to use the entity’s governing document to enhance the secured party’s protection and facilitate many of the self-help remedies available under the UCC.

Thus, as will be described below, the secured party will want to make sure that the security agreement and the entity’s governing documents contain the necessary protections to allow the secured party to effectively, and efficiently, exercise the self-help remedies available to a secured party under the UCC.

Practical Tips

As a general matter, due to the contractual flexibility inherent in most alternative entity statutes, a secured party should take advantage of its ability to build additional protections into the subject entity’s governing documents, and not simply rely upon the representations, warranties, and covenants set forth in the security documents. For example, the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act each contain features that enable creditors to obtain additional rights and protections. Each act specifically permits the governing document to provide rights to a person that is not a party to the governing document. Delaware Limited Liability Company Act § 18-101(7) and Delaware Revised Uniform Limited Partnership Act § 17-101(12). Thus, counsel for the secured party should take steps to marry the contractual flexibility afforded by the alternative entity statutes to the favorable self-help remedies available under the UCC to ensure that the secured party will be able to realize the value of its equity interest collateral upon a default.

First, provide an adequate description

of the collateral in connection with the creation of the security interest. Many alternative entity statutes, including Delaware, disaggregate economic rights from the governance rights provided to a holder of equity interests in the alternative entity. Therefore, the description of the collateral set forth in the security agreement that creates the interest must be broad enough to give the secured party a security interest not only in the economic rights but also the governance rights; otherwise if the description is not broad enough a secured party may find itself holding an interest solely in the economic rights that a debtor has in the alternative entities, similar to a charging order. Thus, the collateral description should make clear that it refers to the debtor's governance rights under the governing document as well as the debtor's economic rights.

Second, it cannot be emphasized enough: know your collateral. As mentioned above, a secured party should have a good understanding of what type of collateral the equity interests in the alternative entity are for purposes of the UCC. Thus, is the collateral a general intangible or investment property, and if investment property, is it certificated or uncertificated. Each of the foregoing conclusions will influence how a secured party perfects its security interest. In the event that the collateral is a general intangible, a secured party may want to request that the subject alternative entity actually opt-in to Article 8 of the UCC and perfect its security interest therein by control. Not only does opting in have the benefit of providing the secured party with a superior method of perfecting its interest, by control, but because the equity interests will be governed by Article 8, the secured party may in certain cases receive the benefits of being a "protected purchaser" and therefore actually receive an interest in the subject collateral that is superior to the interest of the debtor in such collateral because the secured party may take free of any adverse claims. UCC § 8-303(b). Opting in to Article 8 can be accomplished by executing a short amendment to the subject

governing document, which expressly provides that the alternative entity's equity interests will be governed by Article 8.

Related to knowing your collateral, it is also important that the secured party make sure that the subject collateral stays the same type of collateral after the security interest is perfected. Thus, in order to protect itself, the secured party should certainly build covenants into the security document, but also to the extent permitted by the applicable alternative entity statute, the secured party should hardwire protections into the alternative entity's governing documents. Hence, a provision should be added to the governing document to prohibit the entity from amending the governing document to opt-in or opt-out of Article 8, as the case may be. Furthermore, for an entity governed by Delaware law, such entity can expressly provide in its governing document that the secured party must consent to any amendment that would change an equity interest's status as a security or non-security.

Third, provide a mechanism in the documentation to permit the transfer of the equity interests and the admission by a transferee to the alternative entity. In order to fully take advantage of the self-help remedies available to a secured party under the UCC, a secured party should build a mechanism into the security agreement and the subject alternative entity's governing document to permit the secured party or a third-party transferee of such equity interest to acquire the equity interests and to be admitted to the entity upon an event of default. This is a common pitfall for secured parties seeking to exercise self-help remedies. Unless the secured party takes steps to facilitate a transfer and automatic admission following a default by the debtor, a secured party may find that it is only able to acquire the economic rights under the equity interest. For example, under Delaware law, unless otherwise provided in the governing documents, the secured party's admission to the alternative entity will require the cooperation of the debtor, and possibly the other equity holders, (Delaware Limited Liability

Company Act § 18-301(b) and Delaware Revised Uniform Limited Partnership Act § 17-301(b)), and following a default, the debtor and the other equity holders may not be thrilled to assist the secured party with transferring the interest and admitting the transferee to the entity. Thus, in dealing with an alternative entity where admission is required to exercise governance rights, the parties may want to add a mechanism directly into the governing document whereby upon an event of default, the secured party will be automatically admitted to the entity, or alternatively, in some cases, a power of attorney can be granted to the secured party in order to facilitate such admission.

In addition, the secured party may require that the governing document contain language that structures the entity's interests more like corporate stock, whereby a transferee succeeds to the transferor's rights automatically upon transfer without further action on the part of the issuer or its equity holders. Under the Delaware statutes governing alternative entities, it is crucial to make sure that the admission issue is addressed if the entity only has one member or one limited partner because the transfer of the equity interest by the debtor to the secured party will cause the entity to dissolve because it has no members or limited partners. Delaware Limited Liability Company Act § 18-801(4) and Delaware Revised Uniform Limited Partnership Act § 17-801(4). That is the case because under the Delaware laws governing alternative entities, the debtor will cease to be a member or partner, as applicable, following the transfer of the interests and unless the governing document provides for an admission mechanism, the secured party or third-party transferee will not be admitted to the entity, which will cause the entity to lack the requisite partner or member needed to avoid dissolution.

Finally, due to the contractual nature of alternative entities, and particularly in Delaware, which expressly states that the policy of its alternative entity statutes is to give maximum effect to the principle

of freedom of contract, the secured party should not merely rely upon the covenants and representations in the loan documents. Thus, instead of relying upon covenant defaults, protections may be added to the governing document that remove from the power and authority of the entity the ability to take certain actions that reduce, or might reduce, the secured party's protection. As previously mentioned, the governing document should limit the entity's ability to change the status of the collateral from a security to a non-security or vice versa, and it should prohibit amendments to the governing document that remove other secured party protections. In addition, the secured party may consider adding limitations on the power to issue additional equity interests or limit the authority to make distributions while obligations are outstanding. Thus, the secured parties should take advantage of the ability to enhance their protections in the alternative entity's governing documents.

Conclusion

As the use of alternative entities increases, it is incumbent upon commercial finance attorneys to understand the characteristics of such interests and to ensure that they understand how to perfect such collateral, and otherwise deal with such collateral. Due to the flexibility of many of the alternative entity statutes and the contractual freedom available to the parties thereunder, care should be taken to ensure that a secured party sufficiently protects its security interest by taking some of, or at least considering, the actions described above. As stated at the beginning, the most important step in this process is to recognize that equity interests in alternative entities are not exactly like corporate stock and the approach by a secured party to protect its security interest in such collateral should be markedly different.

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