

# LLC & Partnership Interests as Security: Article 8 and "Opting-In"

*Presented by:*

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Salt Lake City | Ogden | St. George | Las Vegas



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## Introduction

1. Classification of Equity Interests (UCC Type)
2. Opting Into Article 8
3. Effects of Classification
  - Perfection
  - Priority
  - Choice of law
4. Examples
5. Transformation of UCC Type
6. Secured Party Considerations

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## Classification (UCC Type)

- **Securities**
  - Corporate stock
  - Business trust/statutory trust
  - Registered investment company or publicly traded
- **Not Securities**
  - Membership interest in an LLC
  - Partnership interest (general or limited partnership)
- However, Article 8 provides a mechanism – referred to herein as “opting-in” – for bringing LLC and partnership interests within the definition of “security” for purposes of Articles 8 and 9.

Utah Code Ann. §§ 70A-8-102 and 70A-9a-102(42)(a).

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## Classification (UCC Type)

Utah Code Ann. §70A-8-102(3):

"An interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this chapter, or it is an investment company security. However, an interest in a partnership or limited liability company is a financial asset if it is held in a securities account."

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## Opting Into Article 8

- **Generally:** To effect an opt-in, the operating agreement or limited partnership agreement will need to include language specifying that the LLC or partnership interest is a "security" governed by Article 8. (See Exhibit "A" for sample language).
- **Certificates:** In the case of an LLC or partnership interest represented by a certificate, the certificate may (and in practice often does) refer to the opt-in and may also refer to other matters relating to the security interest (such as the security interest in the security represented by the certificate and restrictions on further encumbrances).

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## Opting Into Article 8

- **Classes of Interests:** It appears that it is possible to opt-in for some but not all of the same class (or similar classes) of interests since UCA §70A-8-102(3) states that the terms of "an interest" in an LLC or partnership are to provide that the interest is a security governed by Article 8.
- **Securities Laws:** Opting-in to Article 8 with respect to an LLC or partnership interest will not affect whether the interest is a "security" for purposes of federal or state securities laws or other non-UCC laws. Utah Code Ann. §70A-8-101(4).

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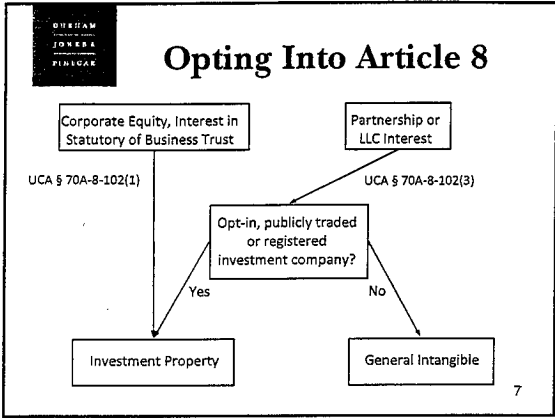
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- DURHAM**  
**JONES**  
**FINCH**
- ## Perfection
- General Intangible:
    - Filing of a financing statement
  - Certificated Security:
    - Filing of a financing statement
    - Possession (delivery or control)
  - Uncertificated Security:
    - Filing of a financing statement
    - Control
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- DURHAM**  
**JONES**  
**FINCH**
- ## Perfection
- Certificated Security: Possession (delivery or control)
    - Obtaining control of a certificated security requires delivery of the certificate to the secured party together with either (i) an effective indorsement of the security (either on the certificate or a separate stock power or similar form of assignment separate from certificate) or (ii) registration of the security in the name of the secured party. Utah Code Ann. §§70A-8-105(2)(b), 9a-106(1).
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## Perfection

- **Uncertificated Security: Control**
  - Obtaining control of an uncertificated security requires either (i) re-registration of the interest in the name of the secured party, which is not likely to be an available means of holding an LLC or partnership interest, or (ii) a control agreement among the issuer, the debtor and the secured party. Utah Code Ann. §§70A-8-105(3), 70A-9a-106(1).

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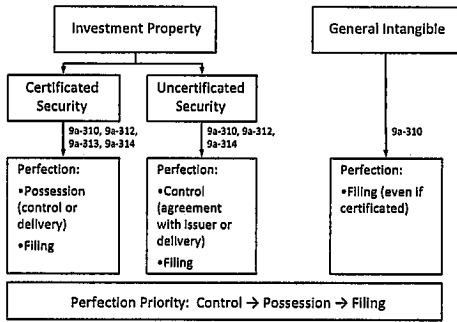
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## Perfection



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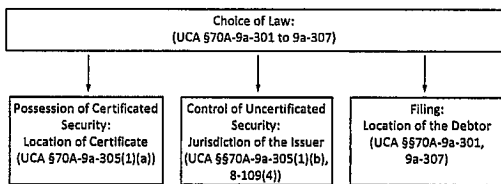
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## Perfection: Choice of Law



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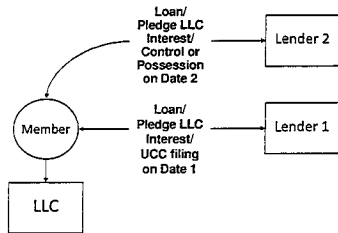
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### Example 1: No Opt-In



- No opt-in (general intangible)
  - Lender 1 files on date 1
  - Lender 2 takes control or possession on date 2
  - Lender 1 has priority
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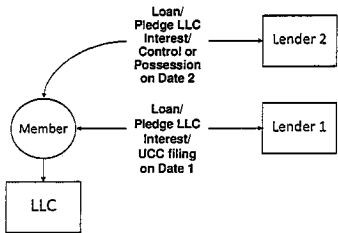
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### Example 2: Opt-In



- Opt-in (investment property)
  - Lender 1 files on date 1
  - Lender 2 takes control or possession on date 2
  - Lender 2 has priority
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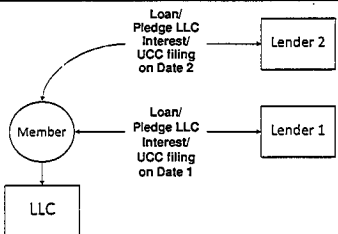
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### Example 3: Opt-In



- Opt-in (investment property)
  - Lender 1 files on date 1
  - Lender 2 files on date 2
  - Lender 1 has priority
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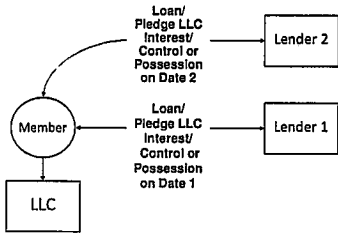
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### Example 4: Opt-In



- Opt-in (investment property)
- Lender 1 takes control or possession on date 1
- Lender 2 takes control or possession on date 2
- Lender 1 has priority

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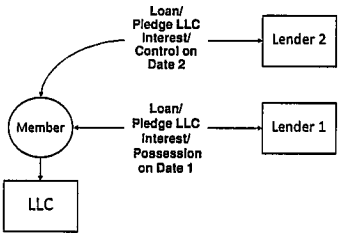
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### Example 5: Opt-In



- Opt-in (investment property)
- Lender 1 takes possession on date 1
- Lender 2 takes control on date 2
- Lender 2 has priority

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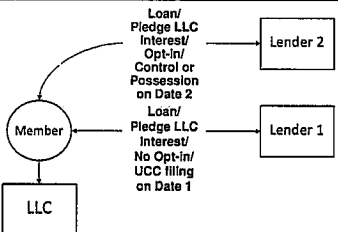
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### Example 6: Transformation



- No opt-in (general intangible)
- Lender 1 files on date 1
- LLC opts-in (investment property)
- Lender 2 takes control or possession on date 2

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## Transformation of UCC Type

1. "A security interest perfected only by filing is subordinate to a conflicting security interest perfected by control or delivery. See Section 9-328(a), (5). Thus, although filing is a permissible method of perfection, a secured party who perfects by filing takes the risk that the debtor has granted or will grant a security interest in the same collateral to another party who obtains control."

- Official Comment 4 to Section 9-312.

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## Transformation of UCC Type

2. "The control priority rule does not turn on either temporal sequence or awareness of conflicting security interests. Rather, it is a structural rule, based on the principle that a lender should be able to rely on the collateral without question if the lender has taken the necessary steps to assure itself that it is in a position where it can foreclose on the collateral without further action by the debtor. ... A secured party who is unwilling to run the risk that the debtor has granted or will grant a conflicting control security interest should not make a loan without obtaining control of the collateral."

- Official Comment 3 to Section 9-328.

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## Transformation of UCC Type

3. "[T]he control priority rule means that a secured party who obtains control has priority over a conflicting security interest perfected by filing without regard to inquiry into whether the control secured party was aware of the filed security interest. ... Although filing is now a permissible method of perfection, in order to avoid disruption of existing practices in this business it is necessary to give perfection by filing a different and more limited effect for securities than for some other forms of collateral.

- Official Comment 3 to Section 9-328.

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## Transformation of UCC Type

4. "The priority rules are not based on the assumption that parties who perfect by the usual method of obtaining control will search the files. Quite the contrary, the control priority rule is intended to ensure that, with respect to investment property, secured parties who do obtain control are entirely unaffected by filings. To state the point another way, perfection by filing is intended to affect only general creditors or other secured creditors who rely on filing. The rule that a security interest perfected by filing can be primed by a control security interest, without regard to awareness, is a consequence of the system of perfection and priority rules for investment property."

- Official Comment 3 to Section 9-328.

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## Secured Party Considerations

1. Amending the Operating Agreement: As additional protection, consider having the issuer amend its operating agreement to opt-in/opt-out and provide that it cannot be amended with respect to Article 8 matters without the consent of the secured party.

Note: Section 48-2c-506 of the Utah Revised Limited Liability Company Act provides: "An operating agreement may be altered, amended, or repealed as provided in the operating agreement. If an operating agreement does not provide for a procedure for altering, amending, or repealing the operating agreement, the operating agreement may be altered, amended, or repealed only by the written consent of all members."

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## Secured Party Considerations

### 2. Irrevocable Proxy

- Prevent Issuer From "Opting Out": An irrevocable proxy from the debtor to the secured party to vote the interest with respect to an amendment to the partnership or LLC agreement to alter the opt-in. (See Exhibit "A" for sample language).
- Prevent Issuer From "Opting-In": If the debtor has a minority interest that prevents modification of the LLC or partnership agreement to cause the LLC or partnership to opt-in, consider having debtor issuing an irrevocable proxy to the secured party to prevent the issuer from opting-in. Secured party can perfect and have priority via filing.

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### Secured Party Considerations

3. Prevent Issuer From Changing Certification: A secured party should also take similar steps to maintain the certificated or uncertificated nature of the interest it has taken as collateral. For example, if a secured party has perfected by control (through possession) of a certificated security, and the LLC or partnership agreement is amended so that the interest is no longer represented by the certificate, the perfection and priority of the security interest may be adversely affected.

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### Secured Party Considerations

4. Subordination of Creditor-Members under ULLCA:  
UCA §48-2c-1308(1) provides the following asset distribution priority in the winding up of an LLC's business:

- First, to pay or satisfy the liabilities of creditors other than members, in the order of priority established by law;
- Second, to pay or satisfy the liabilities to members in their capacity as creditors;
- Third, to pay or satisfy the expenses or costs of winding up the LLC;
- Thereafter, to the members.

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### Secured Party Considerations

5. Flexibility in method of perfection: There may be circumstances where filing is a burdensome means of perfecting a security interest and control or delivery is more efficient. For example, consider a transaction in which every partner in a partnership has an obligation to contribute capital, and if a partner does not contribute, the other partners can make the contribution as a deemed loan to the noncontributing partner and be granted a security interest in the noncontributor's partnership interest to secure those loans. If there are 10 partners (so that each is potentially a secured party with respect to 9 other partners), then a single control agreement with the partnership (rather than multiple financing statement filings or the cost of a third-party collateral agent arrangement) may be the most efficient way to handle perfection.

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## Secured Party Considerations

6. Certificated Securities Provide Ability to Obtain Exclusive Control: If the secured party has possession of a certificated security, no other party can obtain control; as a result there can be no protected purchaser that can take free of the security interest in the certificate and no competing secured party that can obtain priority by taking control or delivery of the certificate.

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**LLC and Partnership Interests as Security: Article 8 and "Opting-In"**  
**Mark Astling**  
**Durham, Jones & Pinegar**  
**January 12, 2011**

**Exhibit "A"**  
**Sample Language**

**1. Sample Language for Utah LLC or partnership agreement:**

**a. Opt-In Language:**

"Each interest in the [issuer] shall constitute and shall remain a "security" within the meaning of (i) Article 8 of the Utah Uniform Commercial Code, Utah Code Ann. §70A-8-101 *et seq.* (the "Utah UCC") and (ii) the Uniform Commercial Code of any other applicable jurisdiction that now or hereafter substantially includes the 1994 revisions to Article 8 thereof as adopted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association on February 14, 1995, and the [issuer] has, pursuant to the [list relevant organizational documents of the issuer] (collectively, the "Agreement"), "opted in" to such provisions for the purpose of the Uniform Commercial Code. Notwithstanding any provision of this Agreement to the contrary, to the extent that any provision of this Agreement is inconsistent with any non-waivable provision of Article 8 of the Utah UCC, such provision of Article 8 of the Utah UCC shall be controlling."

**b. Opt-Out Language:**

"Each interest in the [issuer] shall constitute and shall remain a "general intangible" within the meaning of (i) Article 8 of the Utah Uniform Commercial Code, Utah Code Ann. §70A-8-101 *et seq.* (the "Utah UCC") and (ii) the Uniform Commercial Code of any other applicable jurisdiction that now or hereafter substantially includes the 1994 revisions to Article 8 thereof as adopted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association on February 14, 1995, and neither the [issuers's] [list relevant organizational documents of the issuer], nor any other agreement or instrument with respect to the interest, provide by their terms that the interest is a "security" governed by Article 8 of the Utah UCC.

**2. Sample Language for Irrevocable Proxy:**

1. Irrevocable Proxy. Pledgor hereby irrevocably constitutes and appoints Secured Party, from the date of this Agreement until the termination of this Agreement in accordance with its terms, as Pledgor's true and lawful proxy, for and in Pledgor's name, place and stead to vote the Pledged Interests and any and all other equity interests in Company owned by Pledgor, whether directly or indirectly, beneficially or of record, now owned or hereafter acquired (the Pledged Interests together with all such other equity interests, the "Pledgor's Interests"), with respect to any Article 8 Matter (as hereinafter defined). The foregoing proxy shall include the right to sign Pledgor's name (as

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**January 12, 2011**

[member/partner] of the Company) to any consent, certificate or other document relating to the Company that applicable law may permit or require, to cause the Pledgor’s Interests to be voted in accordance with the preceding sentence. Pledgor hereby revokes all other proxies and powers of attorney with respect to the Pledgor’s Interests that Pledgor may have appointed or granted, to the extent such proxies or powers extend to any Article 8 Matter. Pledgor will not give a subsequent proxy or power of attorney (and if given, will not be effective) or enter into any other voting agreement with respect to the Pledgor’s Interests with respect to any Article 8 Matter.

As used herein, “Article 8 Matter” means any action, decision, determination or election by the Company or its [member(s)/partner(s)] that its [membership/partnership] interests or other equity interests, or any of them, be, or cease to be, a “security” as defined in and governed by Article 8 of the Uniform Commercial Code, and all other matters related to any such action, decision, determination or election.

**THE PROXIES AND POWERS GRANTED BY PLEDGOR PURSUANT TO THIS AGREEMENT ARE COUPLED WITH AN INTEREST AND ARE GIVEN TO SECURE THE PERFORMANCE OF THE PLEDGOR’S OBLIGATIONS UNDER THE PLEDGE AGREEMENT AND UNDER THIS AGREEMENT.**