

Strafford

November 11, 2010

**Equity Interests
as Collateral in
Commercial Lending**

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Introduction

- Article “8.5” (interplay of Article 8 and Article 9)
- Characterization of equity interests
 - UCC type
 - Categories of investment property
 - Effects of characterization
- “Opting in” to Article 8
- Opinions
- Secured party remedies and duties
- Non-UCC considerations (state entity statutes, federal and state securities laws)

What's in a Name (Type or Category)?

- Description/indication of collateral
 - Functional vs. UCC type
- Choice of law
- Perfection methods
- Control/possession priority
- Protected purchaser/free of adverse claims
- Restrictions on assignment
- Remedies and duties
 - Article 9 and non-UCC law

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
 - **Tests are different!**
 - Characterization under Article 8 doesn't determine for non-UCC purposes [8-102(d)]

What is a Security? 8-103 Rules

- Security – share or similar equity interest issued by:
 - Corporation
 - Business trust/statutory trust
 - “Similar entity”
- Not a security:
 - Partnership interest
 - LLC interest
- Exceptions to exclusion of LLC and partnership interests:
 - Override exclusion of LLC and partnership interests by “opting in” [8-103(c)]
 - Held 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
 - A collection of “security entitlements”
 - Held at a “securities intermediary”
 - Different from an uncertificated security

Does Secured Party Prefer Investment Property?

- Article 8 applicable – so?
- “Protected purchaser” / free of adverse claims (overrides general rule of *nemo dat*) [8-303, 8-502, 8-510]
 - Title?
- Perfection by possession or control [9-313, 9-314]
 - Possession “super priority” [9-328(5)]
 - Control “super priority” [9-328(1), (3)]
- UCC insurance requirement

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]” - *see also*
 - OC 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?

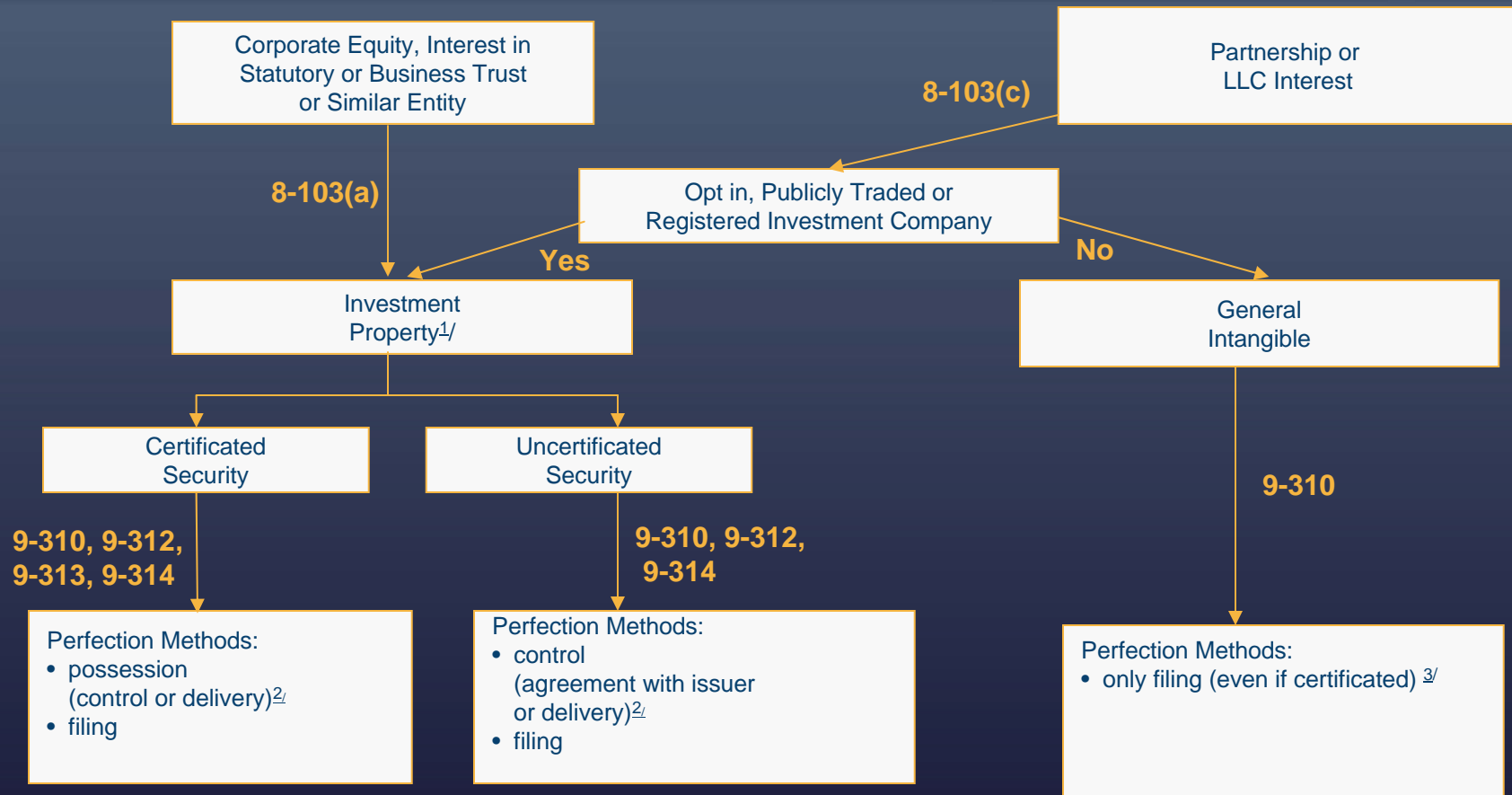
Do More than Opt In?

- Prevent opt out
 - Proxy to vote on Article 8 matters
 - LLC/partnership agreement provisions
 - Secured party voting/consent rights
 - Issuer agreement not to modify opt in and certification of interests provisions (“Article 8 matters”)

Methods of Perfection

- LLC or partnership interest (without opt in, publicly traded or registered investment company or held in securities account) = general intangible
 - Only filing (even if interest is certificated)
- Corporate stock, business/statutory trust, opt in, etc. = investment property
 - Filing
 - Possession (“delivery”) if certificated
 - Control

Methods of Perfection



^{1/} An equity interest held in a securities account would be a “security entitlement” as to which perfection methods are control and filing. See 9-310, 9-312, 9-314.

^{2/} The concepts of “control” in 8-106 and “delivery” in 8-301 are used in Article 9. See 9-106, 9-313(a).

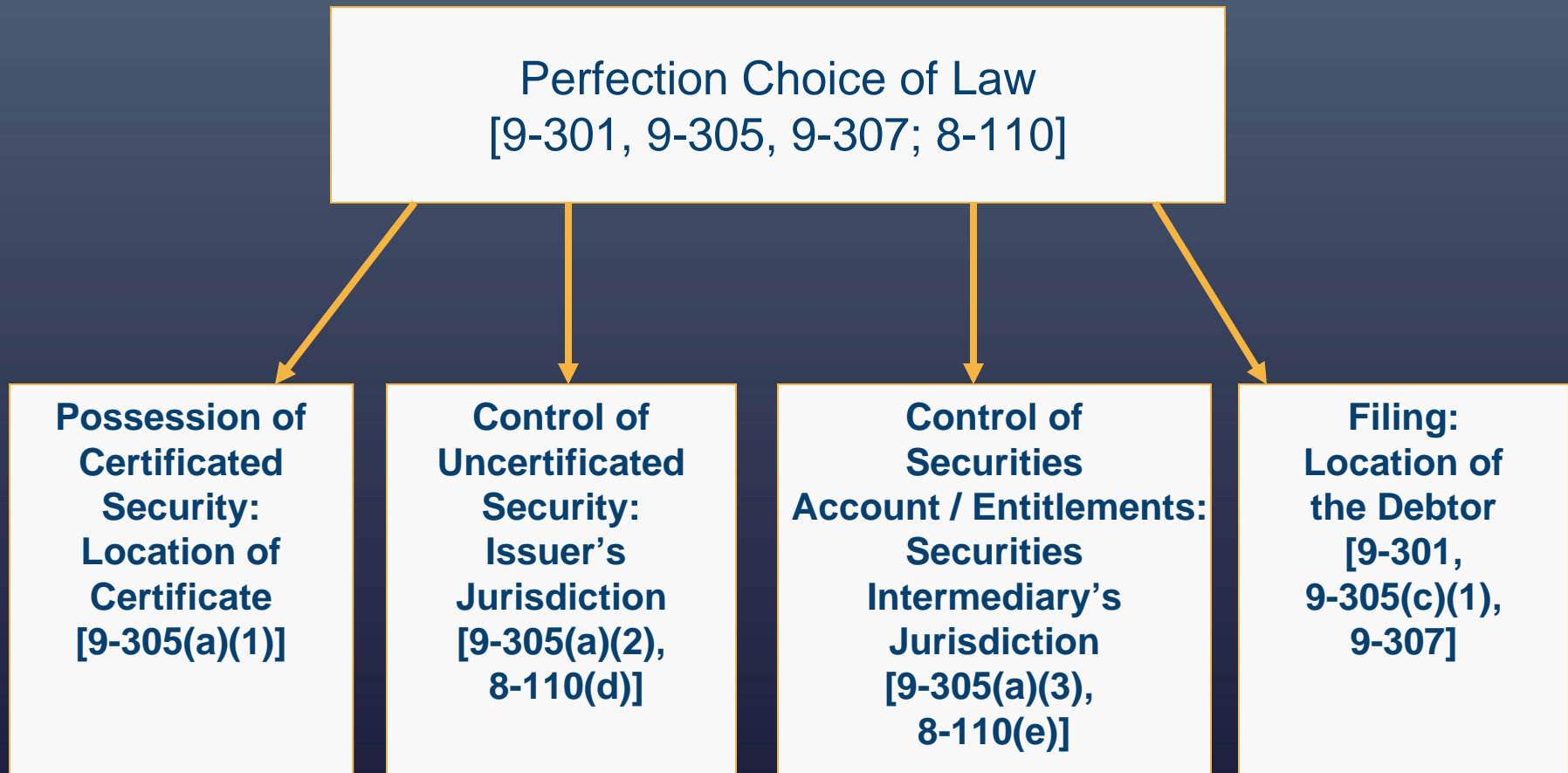
^{3/} If the interest can be categorized as a payment intangible, then a sale of the interest would be automatically perfected. See 9-309(3).

Automatic perfection is also applicable to security interests in investment property created by a broker or securities intermediary. See 9-309(10). Other automatic and temporary perfection rules can be found in 9-309(9), 9-312(e) and (g).

Differences among Methods of Perfection

- Priority
 - Filing vs. possession (if applicable) vs. control (if applicable) and rules for intermediaries [9-328]
- Protected purchaser/free of adverse 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), OC 6 to 9-607, 9-406 and 9-408, 8-204, 8-401]

Perfection Choice of Law



Note: See 9-305 re automatic and temporary perfection choice of law.

Priority Choice of Law



Note: Perfection method not relevant to priority choice of law.

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?
 - ***In re Weiss*** (transfer restrictions upheld, no security interest created)
- Intercreditor agreement (e.g. mezzanine financing)

Protected Purchaser Status

- “Protected purchaser” [8-303(a)]
 - Gives value [1-201(44), R 1-204]
 - Does not have notice of **any** adverse claim to the security [8-102(a)(1), 8-105]
 - Obtains control of the security [8-106]
- Applies to buyers and secured parties [1-201(32) & (33), R1-201(a)(29) & (30), 8-116]
- Substantially equivalent for securities accounts/security entitlements [8-502, 8-510]
- Takes free vs. priority [OC 2 to 9-331]
- Does this affect Article 9 Part 6 re security interests not extinguished by a foreclosure?

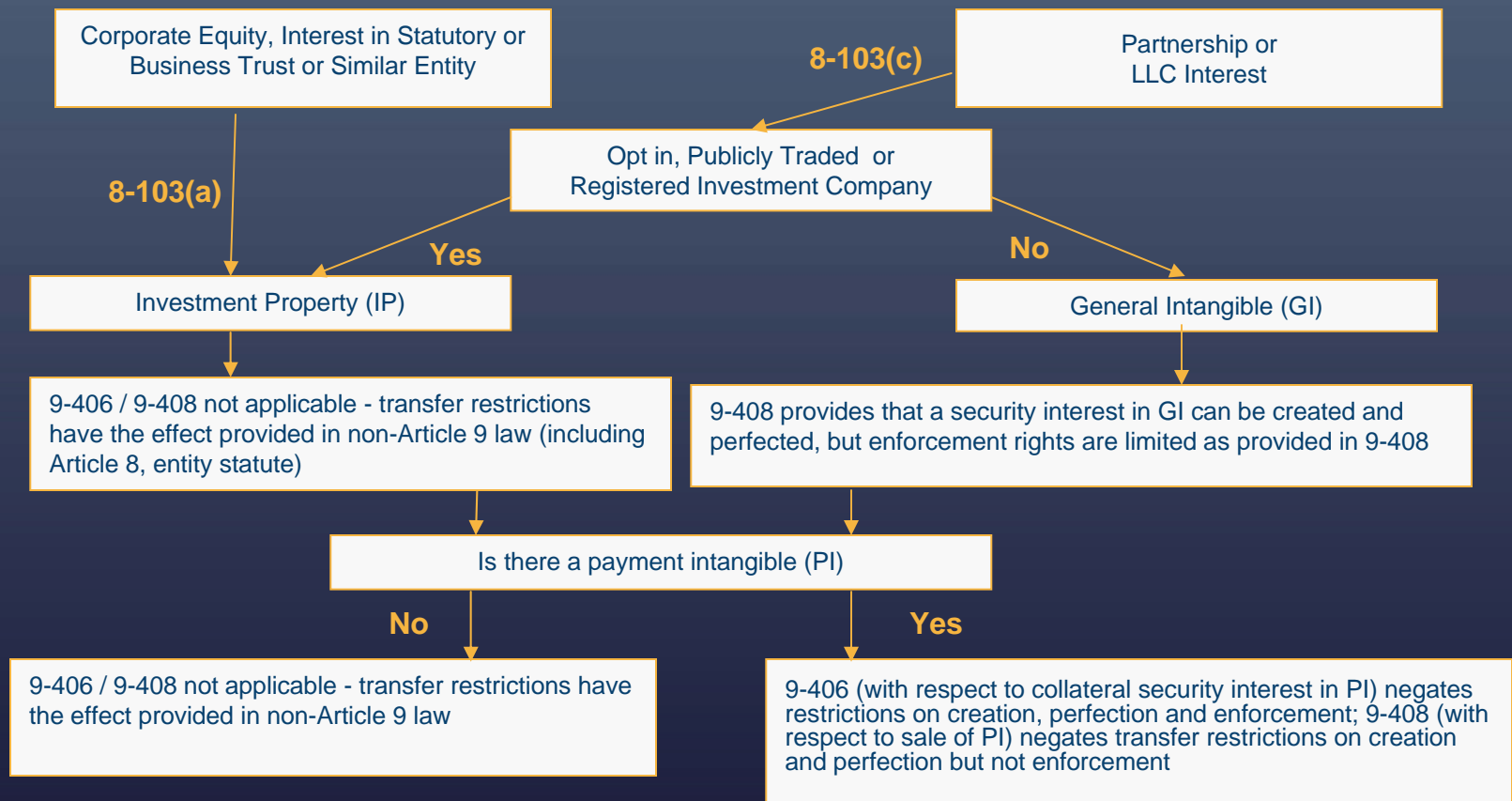
The Dark Side of the Opt in?

- 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, 9-408]?
- Effect on tax treatment? **No!**

Restrictions on Assignment

- 9-406 and 9-408 negate certain restrictions on assignment
 - Do not apply to investment property
 - May not negate all restrictions (e.g. private placement, '40 Act, tax, qualified transferee in mezz financing)
- Do 9-406/9-408 apply to membership interests?
 - Apply to agreement between “account debtor” and the assignor – does LLC or partnership agreement qualify?
 - Non-uniform: Delaware, Virginia, Kentucky, Texas, NY
- Choice of law [OC 3 to 9-401; 1-105(1) and R 1-301(a); OC 2 to 1-102, OC 3 to R 1-302]

Negation of Restrictions on Assignment



See notes on next slide.

Negation Analysis - Notes

- 1) Certification of interest not relevant to determination of whether interest is a general intangible or investment property. An LLC or partnership interest or other investment property held in a securities account would be a “security entitlement” (with same analysis as other investment property).
- 2) Delaware, Virginia, Kentucky and Texas have non-uniform UCC provisions and/or provisions in LLC and partnership statutes that make 9-406 and 9-408 inapplicable to partnership and LLC interests. Delaware also deals with statutory trusts. NY 9-406/9-408 do not negate statutory restrictions on assignment. See 9-401 OC3 regarding choice of law applicable to 9-406/9-408 negation of transfer restrictions – likely to be jurisdiction of organization of the issuer of the pledged interest.
- 3) Only transfer restrictions in an agreement between the debtor and the “account debtor” or in statute are negated; examine LLC or partnership agreement and state law as to who are the parties to the agreement with the debtor (*i.e.* pledging member or partner) and consider who the “account debtor” is for this purpose (issuer or other equity holders).
- 4) Consider whether (and when) a right to a distribution could become a PI separate from the IP or GI. Also consider Bankruptcy Code § 552 and similar issues if only distributions are collateral.
- 5) Consider whether the LLC or LP interest itself may be categorized (in whole or in part) as a PI.

Solutions?

- Hold membership interest in a securities account?
- Security interest in distributions and other proceeds (and not the underlying interest)?
 - When does security interest attach? [OC 3, 7 and 8 to 9-408, OC 6 to 9-322, OC 2 and 6 to 9-203]
 - Bankruptcy Code Section 552 cut off?
 - Do 9-406/9-408 apply?
 - Non-uniform provisions?
- Waiver/amendment of restriction

Entity Statutes – The Technical ...

- 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 its 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”
 - So 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

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)
- So need to check the relevant state’s entity statute

.... the Bad ...

- Control rights may not be held by debtor (e.g. manager managed LLC, springing member, special member)
- What rights are represented by the pledged interest?
 - Not all interests have the same rights
- What restrictions are placed on assignment of economic, control and other rights or on rights of assignee to become a member?

... and the (Potentially) Ugly

- Separation of economic from control and information rights upon foreclosure
- Unintended dissolution and winding up of entity upon transfer of economic rights in foreclosure
- **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

Closing Opinions – What’s Different?

- Creation/attachment
- Perfection
 - By filing
 - By possession (delivery)
 - By control
- Priority
 - Control priority
 - Protected purchaser or “free of adverse claims” – new **TriBar Report** soon
- Choice of law

Secured Party Remedies

- Is Article 9 applicable?
- Is this a security interest?
 - Repurchase transactions
 - Recharacterized sales
 - Forfeiture of interest for non-payment of capital contributions
- Remedies
 - Disposition
 - Acceptance of collateral (strict foreclosure)
 - Collection/enforcement of collateral
 - Repossession

Disposition

- 9-610 - SP may sell, lease, license or otherwise dispose of any or all of its collateral
- Every aspect of disposition must be commercially reasonable, including:
 - Method
 - Manner
 - Time
 - Place
 - Other terms
- “Commercially reasonable” requirement is non-waivable [9-602(7)]
 - Standards can be set by agreement [9-603(a)]

Every Aspect of Disposition ...

- 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

... Must be Commercially Reasonable

- 9-627(b) - Disposition is made in a commercially reasonable manner if made:
 - In the usual manner on any recognized market
 - At the price current in any recognized market at the time of disposition
 - Otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition
- 9-627(c) - Disposition is commercially reasonable if approved by a court, creditors' committee, etc.
 - Bankruptcy auctions as templates?
- 9-627(a) - Effect of low price

Recognized Market

- Items sold are fungible and prices are not subject to individual negotiation [OC 9 to 9-610, OC 4 to 9-627]
 - Example given: NYSE [OC 9 to 9-610]
- Market in which prices are individually negotiated or the items are not fungible is not a recognized market, even if the items are the subject to widely disseminated price guides or are disposed of through dealer auctions
- **Burns** – purchase at appraised price of NASDAQ traded stock (discount from trading price)

Scylla and Charybdis (and then some)

- Article 9 does not specify time period for disposition of collateral - OC 3 to 9-610 provides some guidance
 - May be prudent not to dispose of collateral when market has collapsed
 - May be more appropriate to dispose of a large inventory in parcels over a period of time instead of in bulk
 - If SP holds collateral for long period without disposing of it and there is no reason for not making a prompt disposition, may not meet commercially reasonable and good faith requirements
 - The fact that a greater amount could have been obtained by a collection, enforcement, disposition or acceptance at a different time or by a different method from that selected by SP is not of itself sufficient to preclude SP from establishing that the collection, enforcement, disposition or acceptance was made in a commercially reasonable manner

Establishing Standards by Agreement

- Parties may determine by agreement standards measuring fulfillment of:
 - 9-603(a) – 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)
 - 1-102(3), R 1-302(b) – performance of SP’s obligations of good faith, diligence, reasonableness and care
- Standard cannot be “manifestly unreasonable” (not defined in UCC)
- Agreement may not bind all with the right to seek remedies for SP failure to comply with Article 9 requirements [see 9-625]

Public or Private Disposition?

- OC 2 to 9-610 states private dispositions are encouraged
 - Assumption is that they frequently will result in higher realization on the collateral for all concerned
- **Vornado** - debtor raised objection to public sale (at which secured party was the purchaser) based on this comment
 - Court rejected - excluding SP as a bidder would not likely improve the price obtained and SP could not bid at private sale

Secured Party Purchase

- 9-610(c) - SP may purchase collateral:
 - 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
- Not listed in 9-602 as non-waivable
- **BUT** see OC 2 to 9-624 (it is nonwaivable)
- “Recognized market” – narrow definition

Public Disposition

- OC 7 to 9-610
 - 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
- What advertising and other efforts are required to satisfy this standard (and commercial reasonableness)?
- What if this isn't property "the public" would (or is permitted) to buy? ***Ford & Vlahos***

Securities Law Considerations

- Is the collateral a security?
 - Securities law (not UCC) test
- UCC public sale may not be exempt from securities laws
 - Series of SEC no-action letters sets out procedures and limits
 - Often reflected in security agreement provisions
- State securities laws
- Other considerations ('40 Act, '34 Act, Reg S, resale by purchaser at foreclosure)

Secured Party Duties

- SP duty of care in preservation and custody of collateral in possession of SP [9-207(a)]
 - Duty of care non-waivable / can set standards by agreement [1-102(3), R 1-302(b)]
- OC 5 to 9-207, OC 4 to 9-208
 - SP common law duty to return collateral
- 9-208, 9-209, 9-513 – SP duty to release specified types of collateral, notify account debtors, terminate financing statements
- Some duties only arise on payment of the secured obligations

Collection and Enforcement

- After default (or earlier if agreed by the debtor) the secured party may collect and enforce the collateral [9-607(a)]
 - Nonwaivable duty to collect in a commercially reasonable manner
 - SP delay in collecting may be unreasonable
- 9-607 does not require account debtor or other third party to cooperate - secured party may need a court order to enforce its rights
- Still the debtor's property - insolvency and other implications
 - When collateral is sold or accepted by secured party, then debtor's ownership is terminated

Acceptance of Collateral

- Not limited to tangible collateral in secured party's possession
- Full or partial satisfaction
- No “deemed acceptance”
- Process set out in 9-620, 9-621 and 9-622
- Nonwaivable [9-602(10)]
- Secured party obligated to act in good faith [1-203, R 1-304]
 - Non-waivable [1-102(3), R 1-302]

Consequences of Violation

- Reduction or loss of deficiency claim (rebuttable presumption rule) [9-626]
- Injunctive relief [9-625(a)]
- Damages claims [9-625(b)]
 - Any loss caused by failure to comply (may include loss resulting from debtor's inability to obtain, or increased cost of, alternative financing)
 - By debtor, obligor, other secured party or lienholder
- 9-625 and 9-626 non-waivable [9-602(13)]

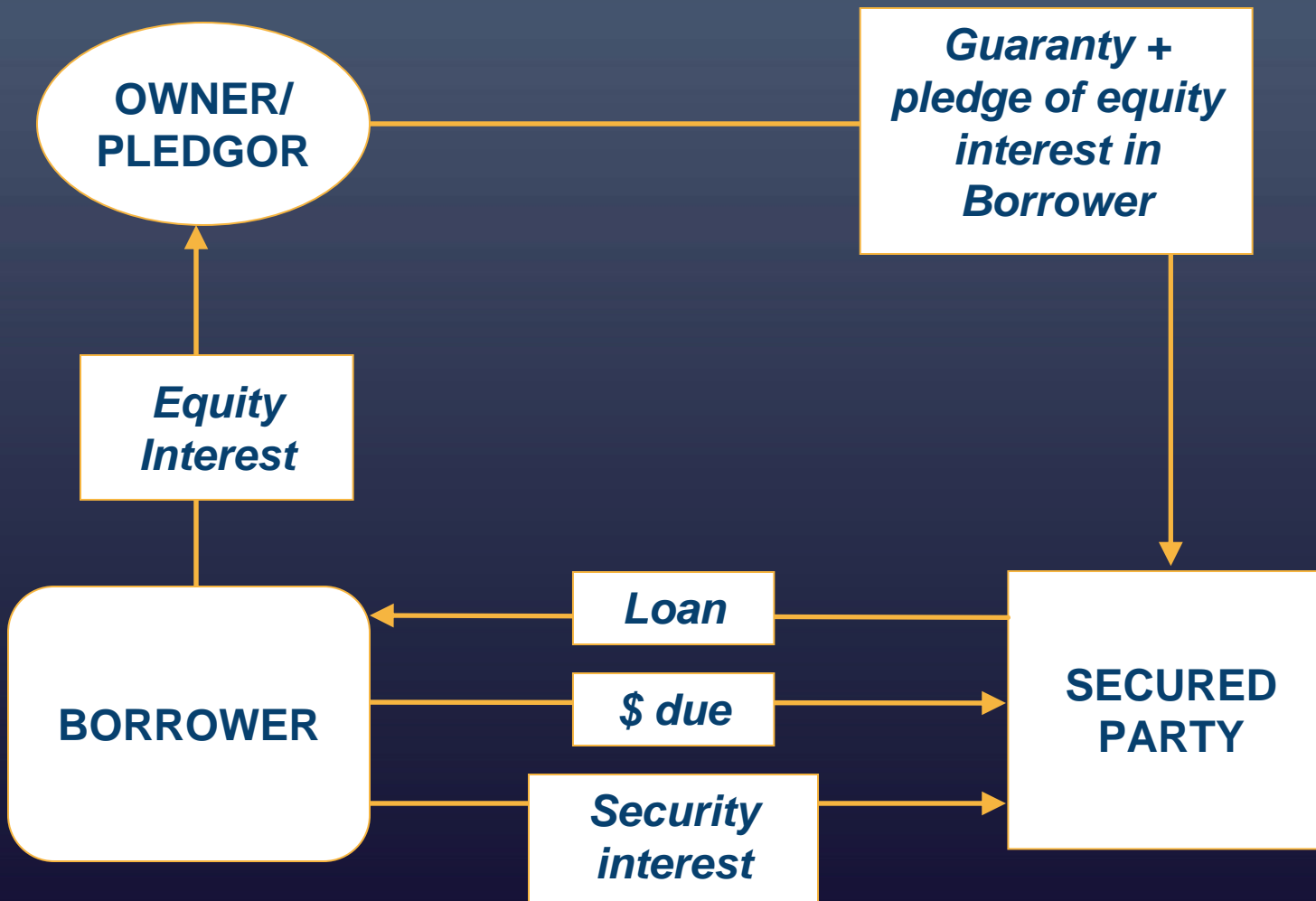
Consequences of Violation (cont'd)

- Loss of good faith transferee status [9-617]
- Not limited to violation of Article 9 Part 6 duties (*e.g.* 9-207 duty of care in custody of collateral)
- Non-UCC claims (*e.g.* conversion claim for failure to return collateral upon repayment of secured obligations)

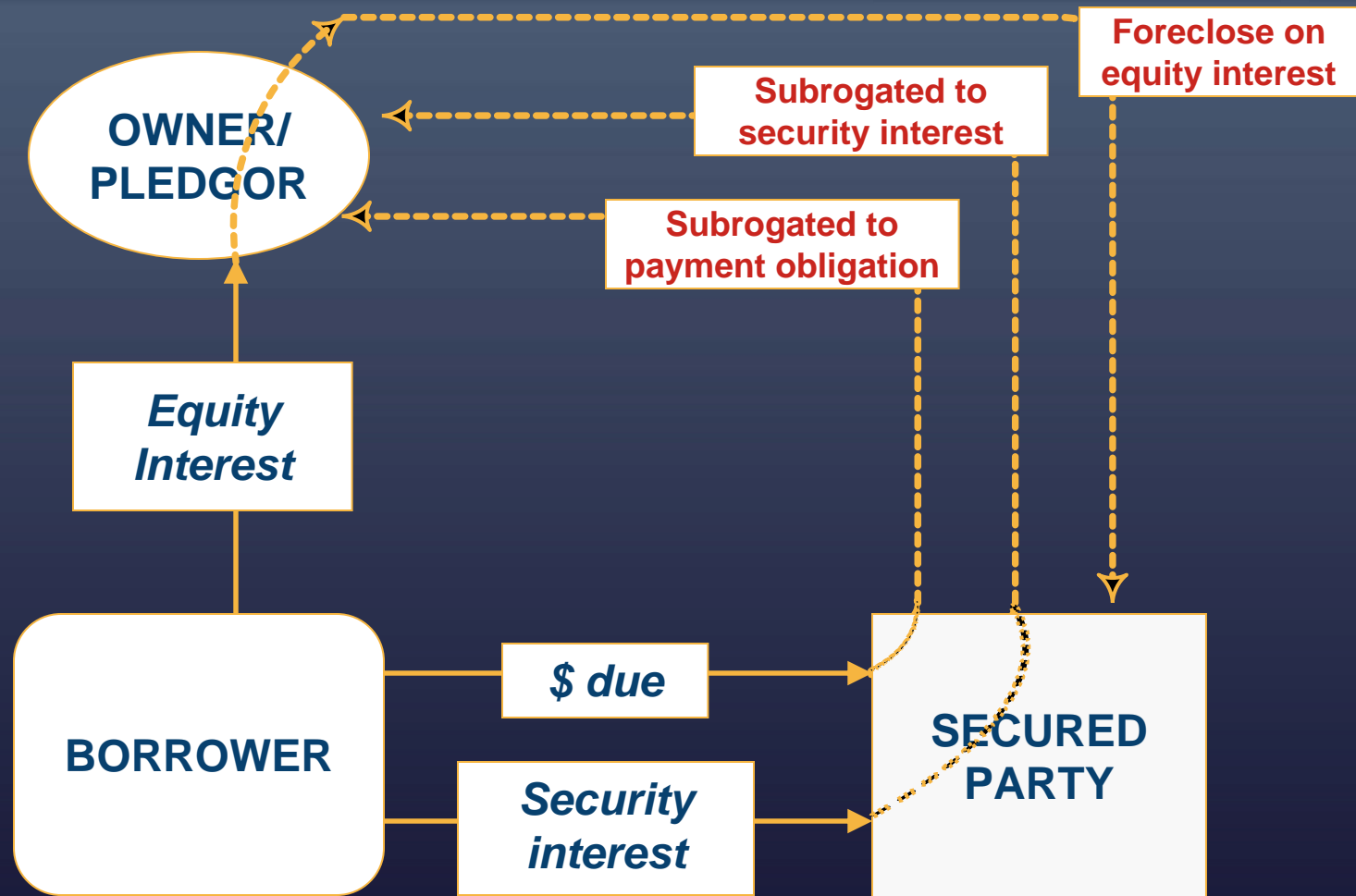
Exercise of Remedies – One Last Trap?

- Secondary obligor acquires the rights of the secured party after the secondary obligor is subrogated to the rights of a secured party with respect to collateral [9-618(a)(3)]
- Secondary obligor's rights to reimbursement from principal obligor and right of subrogation:
 - Restatement of Suretyship and Guaranty §§ 22, 27(1) and 28(1)(a) and (c)
 - California Civil Code § 2849
 - Similar for LC issuer [5-117(a)]

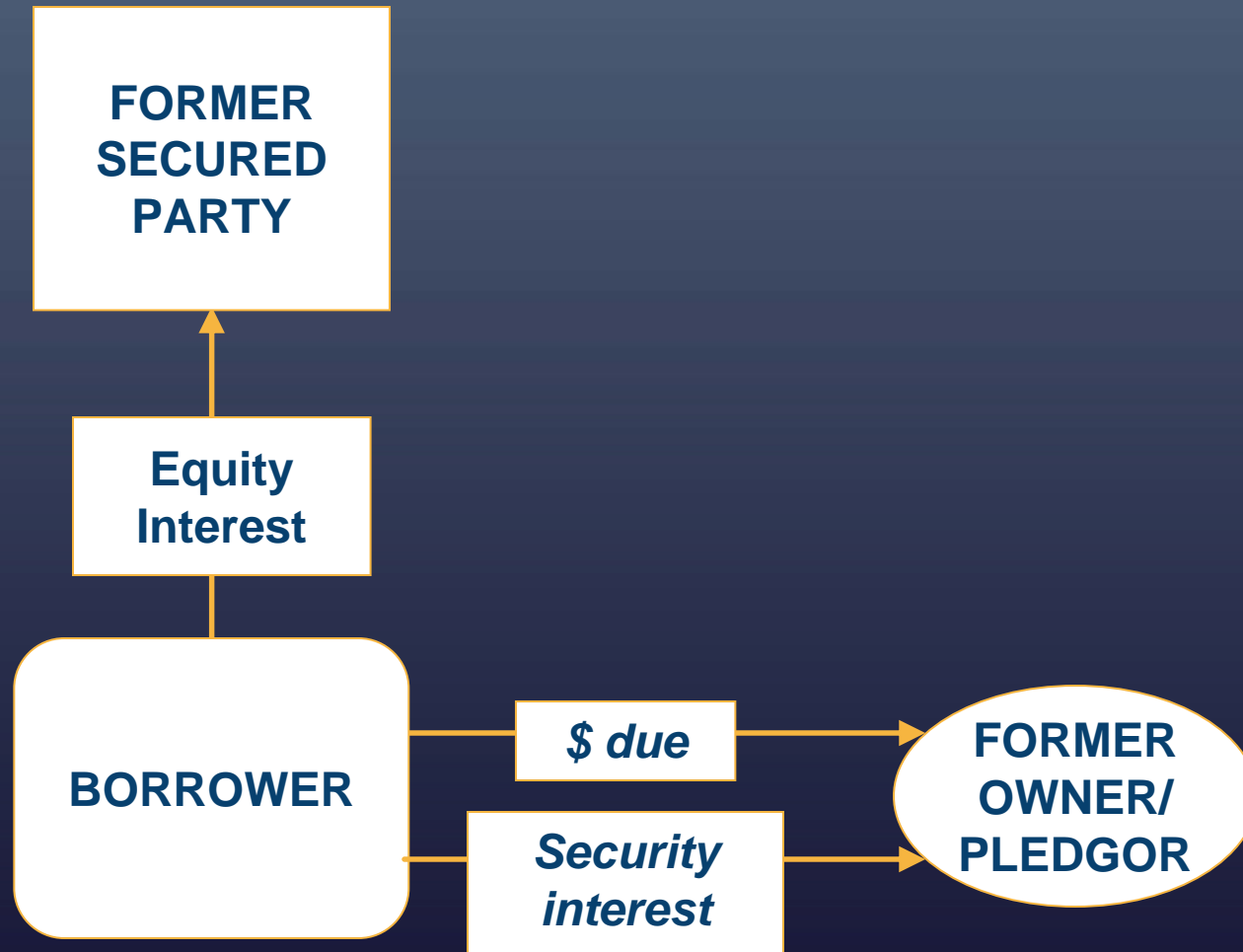
Loan Structure – Pledged Equity Interest



Enforcement of Security Interest in Equity



SP Acquires Equity – OOPS!



Case Cites

Burns v. Anderson (U.S. Court of Appeals for the Fourth Circuit, No. 03-2162, 12/15/2004 unpublished opinion)

<http://pacer.ca4.uscourts.gov/opinion.pdf/032162.U.pdf>

Ford & Vlahos v. ITT Commercial Finance Corp., 8 Cal. 4th 1220, 885 P.2d 877 (1994)

Vornado PS, L.L.C. v. Primestone Investment Partners, L.P., 821 A.2d 296, 49 UCC Rep.Serv.2d 1348 (Del. Ch. 2002)

In re Weiss, 376 B.R. 867 (Bankr. N.D. Ill. 2007)

Resources

Securities Law and the UCC: When Godzilla Meets Bambi,
38 UCC LJ 3 (2005)

It's a Matter of Collateral: LLCs, Partnerships and the UCC, 14 Business Law Today 53 (Jan./Feb. 2005)

Mezzanine Loans – The Vagaries of Membership Interests as Collateral (N. Powell and J. Prendergast) (2010) - available at American College of Commercial Finance Lawyers Inc. (www.accfl.com) website:

http://accfl.com/system/datas/25/original/LLC_Mezz_Foreclosure_Article_Master_with_footnotes_2010_.pdf

ABA Commercial Finance Committee

<http://www.abanet.org/dch/committee.cfm?com=CL190000>

ABA UCC Committee

<http://www.abanet.org/dch/committee.cfm?com=CL710000>

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