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Issues in Commercial Lending: LLC Interests as Collateral

The LLC has become the preferred organizational form for new entities in the United States. As a result, lenders desiring to secure their loans with an equity pledge (typically either in the borrower itself or its subsidiaries) are increasingly taking pledges of LLC membership interests as part of their collateral. Lenders may be comfortable with a pledge of shares of stock in a corporation, however, there are differences between a pledge of stock and a pledge of an LLC membership interest that can have a significant impact on the ultimate value of the pledge of an LLC membership interest.

One significant difference between a pledge of stock and a pledge of an LLC membership interest is the method that a secured party must use to perfect its security interest in the pledged equity interest. Whereas Article 9 of the UCC governs the creation, attachment and perfection of a security interest, Article 8 determines how pledged equity will be classified for purposes of Article 9 and, therefore, how the security interest must be perfected.

Under Article 8, shares of stock in a corporation, by definition, are a “security” for purposes of the UCC, while an LLC membership interest is not defined as a “security” for purposes of the UCC unless certain steps are taken by the issuer to “opt-in” to the definition of a “security”. If the issuer has elected to “opt-in”, thereby making the LLC membership interest a “security” under Article 8, the rules applicable to “investment property” under Article 9 will govern the perfection of a security interest in that interest.

If the issuer of an LLC membership interest has not elected to “opt-in” under Article 8, the interest will likely be treated as a “general intangible” under Article 9 for purposes of perfection. A potential pitfall for a secured lender is that the perfection of a security interest in a “general intangible” is accomplished differently than the perfection of a security interest in “investment property”, and the failure to properly perfect may jeopardize the secured lender’s rights in the collateral.

Additionally, secured lenders should be aware that the prior consent of the company and/or the other members of the company may be necessary for the pledge of an LLC membership interest to be effective, as the organizational documents of the issuer may prohibit a pledge absent such consent. Furthermore, even if the pledge is effective, a secured lender, or its transferee, may not necessarily acquire the same rights and benefits as a member of the LLC upon the foreclosure of the security interest. Without obtaining consent to be admitted as a member of the company upon foreclosure, the lender may be entitled to financial distributions and nothing more.

Please contact Trey DeLoach, Nikki Gibson, Nick Kuntz, George Coleman or Mary Irozuru with questions regarding this topic, or to arrange for a more detailed presentation.