

“OPTING IN” TO ARTICLE 8 – LLC AND PARTNERSHIP INTERESTS AS COLLATERAL

Lynn Soukup

Alston & Bird LLP, Washington D.C.

lsoukup@alston.com

Introduction

Generally, a purchaser of property cannot acquire better title than its transferor had – the principle of *nemo dat quod non habet*. Article 8 of the Uniform Commercial Code (UCC) creates one of the few exceptions to this general principle – Article 8 contains provisions to protect the “finality” of transactions involving securities that in some cases override the general rule of *nemo dat*. Article 8 only applies to securities. Generally an interest in a limited liability company (LLC), general partnership (GP) or limited partnership (LP) will not be a security. However, Article 8 provides a mechanism to bring these interests within the scope of Article 8 (which also provides benefits to a secured party under Article 9 with respect to the perfection and priority of a security interest in such interests).

As a result, a prospective secured lender may require that the issuer of an LLC, GP or LP interest being used as collateral elect to have the interest treated as a security for purposes of Articles 8 and 9 of the UCC (an action referred to as “**opting in**” to Article 8) and (because of additional benefits under Article 9) require that the interest be certificated. While the secured party expects specific benefits from requiring the opt in and certificate, the opt in and certificated interest may also have other effects, which should be evaluated.

In addition a secured party should think about preserving the *status quo* – a secured party that required an opt in should take steps to prevent the issuer from opting out of Article 8 at a later time, a secured party that did not require an opt in should take steps to prevent a subsequent opt in and a secured party should also take steps to maintain the certificated or uncertificated nature of the interest it has taken as collateral.

Insurers may require an opt in, a certificated interest and other actions before providing security interest insurance coverage for an LLC, GP or LP interest as collateral – for example in a real estate “mezzanine” loan secured by LLC or partnership interests. An insurer providing security interest insurance for an LLC or partnership interest as collateral will have the same concerns and goals as a secured party – acquiring the best possible rights in the collateral.

Treatment of LLC, GP and LP Interests in the Absence of an Opt In

Generally, an LLC, GP or LP interest will be a general intangible (and not a security) for purposes of Articles 8 and 9 of the UCC. Section 8-103 provides rules for determining whether certain obligations and interests are “**securities**” as defined in Section 8-102(a)(15). Section 8-103(c) states that “[a]n 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 Article [*i.e.* Article 8], or it is an investment company security [as defined in Section 8-103(b) and limited to registered investment companies and similar entities].” Official Comment 4 to Section 8-103 states that (i) Section 8-103(c) establishes the general rule that LLC, GP and LP interests are not securities unless they are in

fact dealt in or traded on securities exchanges or in securities markets, and (ii) the issuer, however, may explicitly “opt in” by specifying that the interests or shares are securities governed by Article 8. *See also* Section III(C)(8) of the Prefatory Note to Article 8.

How to Opt In

Section 8-103(c) states that an LLC, GP or LP interest is a security if “its terms expressly provide that it is a security governed by this Article.” Accordingly, the LLC operating agreement or partnership agreement should contain the language specifying that the interest is a security governed by Article 8. It should be possible to opt in for some but not all of the same class (or similar classes) of interests, since Section 8-103(c) 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. While generally not required by Section 8-103(c), a certificate representing the interest may also refer to the opt in, and noting certain information on the certificate may provide some additional protection to the secured party (as discussed below).

While having the LLC or partnership interest maintained as a financial asset in a securities account would provide some of the same benefits as an opt in, that is not likely to be an available means of holding LLC, GP and LP interests and does not create a certificated security (which a secured party may require for the reasons discussed below).

An opt 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. *See* Section 8-102(d).

Benefits to a Secured Party of an Opt In

Availability of Article 8 “protected purchaser” status for secured party. Section 8-303 provides that a purchaser (including a secured party) of a certificated or uncertificated security that meets the requirements to be a “**protected purchaser**” acquires its interest in the security free of any adverse claim. A “protected purchaser” is a purchaser of a certificated or uncertificated security, or of an interest therein, who (1) gives value, (2) does not have notice of any adverse claim to the security, and (3) obtains control of the certificated or uncertificated security. Section 8-303(a). “**Purchaser**” is defined in Section 1-201(32) and (33) to include a secured party. “**Value**” is defined in Section 1-201(44) and would include making a loan or a binding commitment to make a loan. Section 8-105 describes when a person has “**notice of an adverse claim,**” and includes a “willful blindness” test.¹ The means of obtaining “**control**” of a security are described in Section 8-106.

While delivery (*i.e.*, possession) of a certificated security is sufficient to perfect a security interest in that security, it is not control and therefore will not qualify the secured party for protected purchaser status. 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 (ii) registration of the security in the name of the secured party. Section 8-106(b). A forged indorsement is not “effective.” Section 8-

¹ The “good faith” requirement found in the definition of “bona fide purchaser” in former Article 8 is not part of the definition of “protected purchaser.”

107(b). However, a secured party that obtains a certificate with a forged indorsement and has the security registered in its name will have control of the security and can qualify as a protected purchaser. *See* James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 UCLA L. REV. 1431, 1464 (1996). (The issuer will be liable under Section 8-404 for a transfer pursuant to a forged indorsement). Registration of an LLC or partnership interest in the name of the secured party is not likely occur, in which case protection from a forged indorsement will not be available to a secured party with a certificated interest as collateral.

The Article 8 protected purchaser provisions enable a secured party that meets the requirements of Section 8-303(a) to acquire better rights in the collateral than the debtor had – a “finality” rule that trumps the general rule of *nemo dat*.

Where the protected purchaser is a secured lender, a previously perfected security interest in a security will only be subordinated (by operation of Section 9-328) rather than extinguished by the “takes free” language in Section 8-303. *See* Official Comment 1 to Section 9-331, which states that “whether a holder or purchaser referred to in Section 9-331 [including a protected purchaser] takes free or is senior to a security interest depends on whether the purchaser is a buyer of the collateral or takes a security interest in it.”

There is no comparable protection available to the holder of a security interest in a general intangible.

Ability to obtain priority by perfection by control or delivery. A security interest in a general intangible can only be perfected by the filing of a financing statement, Section 9-310 (Former Section 9-302), and the priority of competing security interests in a general intangible would be determined by the “first to file” rules in Section 9-322 (Former Section 9-312).

A security interest in a security can be perfected either by filing or by control (or, in the case of a certificated security, by delivery (*i.e.* possession of the certificate by the secured party or certain third parties)). Sections 9-310, 9-312, 9-313 and 9-314 (Former Section 9-115(4) and (6)); Section 8-106 (means of obtaining control); Section 8-301 (means of effecting delivery).² Only perfection by control will qualify the secured party for protected purchaser status, as described above.

The priority of competing security interests in a security perfected by filing would be determined by the “first to file” rules. Section 9-322 (Former Section 9-312). A security interest in a security perfected by control (or by delivery of a certificated security) would have the benefit of the priority rules in Section 9-328 (Former Section 9-115(5) and (6)), and in most cases would take priority over a competing security interest that had previously been perfected by filing (even if the subsequent secured party had knowledge of the competing security interest). *See* Official Comments to Section 9-328.

² Temporary perfection is also available with respect to certificated securities. Section 9-312(g) (Former Section 9-304). Automatic perfection is available for certain security interests in securities, *see* Sections 9-206, 9-309(9) and (10) (Former Sections 9-115(4)(c) and (d), 9-116), although these provisions are not likely to apply to transactions involving LLC, GP or LP interests.

Superpriority status is available for certain security interests in securities, *see* Section 9-328 (Former Section 9-115(5)), although these are not likely to apply to transactions involving LLC, GP or LP interests.

There is no comparable non-filing priority available to the holder of a security interest in a general intangible.

Flexibility in method of perfecting a security interest. 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, if a partner does not contribute the other partners can make the contribution as a deemed loan to the noncontributing partner, and the other partners are granted a security interest in the noncontributor's partnership interest to secure those loans. If there are 10 partners (so that each is 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 collateral agent arrangement) may be the most efficient way to handle perfection. If states that impose significant recordation or stamp taxes on UCC filings, the ability to perfect by control could be used to reduce transaction costs.

There are no provisions for non-filing perfection of a security interest in a general intangible (except for automatic perfection of a sale of a payment intangible, which would not be applicable to the LLC or partnership interest).

Distributions as Proceeds Under Former Article 9. One historical reason for requiring an opt in has been rendered unnecessary by Article 9's expanded definition of "**proceeds.**"

Under Former Article 9 the limited definition of "proceeds" raised perfection and bankruptcy issues that an opt in might solve. In *FDIC v. Hastie (In re Hastie)*, 2 F.3d 1042 (10th Cir. 1993), after filing bankruptcy the debtor received cash dividends on pledged stock, in which the secured party claimed a perfected security interest. The court held that ordinary dividends on corporate stock were not "proceeds" of the stock (at the time of the *Hastie* case, Former Section 9-306(1) provided that proceeds were "whatever is received upon a sale, exchange, collection or other disposition of the collateral or proceeds"), that the security interest in the dividends was not perfected by possession of the stock certificates and that because the secured party did not have a perfected security interest in the post-petition dividends the debtor (as a hypothetical lien creditor under Bankruptcy Code Section 544) could avoid the security interest. In *In re Mintz*, 192 B.R. 313 (Bankr. D. Mass. 1996) the secured party had a security interest in rights to distributions from a partnership. The court held that payments of the distributions were not proceeds of the right to receive the distributions and that under Bankruptcy Code Section 552(a) a security interest in the distributions would be cut off with respect to distributions payable following the filing of the debtor's bankruptcy. Bankruptcy Code Section 552(a) provides that property acquired by the debtor after the commencement of the debtor's bankruptcy proceeding is not subject to a security interest resulting from a security agreement entered into by the debtor before the commencement of the case. Bankruptcy Code Section 552(b) creates an exception to this general rule, and provides that if a security agreement was entered into prior to the commencement of the case and if the security interest created by such agreement extends to property of the debtor acquired before commencement of the case and to proceeds of such

property, then such security interest extends to such proceeds acquired by the debtor after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, based on the equities of the case, orders otherwise.

The 1994 revisions to Article 8 modified the definition of proceeds in Former 9-306(1) to remove the issues raised by the *Hastie* case (by adding that any payments or distributions made with respect to investment property collateral (including securities) were proceeds). The 1994 revisions did not, however, remove the issues raised by the *Mintz* case (or similar issues that could arise even if the LLC, GP or LP interest itself had been pledged) since the addition to the definition of proceeds was limited to payments or distributions in respect of investment property (which, in the absence of an opt in, generally would not include an LLC, GP or LP interest). Therefore, secured parties required an opt in for LLC, GP or LP interests as collateral to bring the distributions in respect of those interests within the Former Article 9 definition of proceeds (as modified by the 1994 revisions to Article 8). Although it was not certain that the opt in would solve the issue under Bankruptcy Code Section 552, it at least provided an argument that the distributions in respect of LLC, GP and LP interests were proceeds of the interests within the meaning of Section 552(b) and therefore not subject to the cut off of security interests rule in Section 552(a). The Article 9 treatment of the distributions is not dispositive of whether the distributions are proceeds for purposes of Bankruptcy Code Section 552, but has often been a factor considered by courts in the Section 552 analysis.

With Article 9's broader definition of proceeds an opt in is no longer needed to deal with the limits in the Former Article 9 definitions of proceeds or the related issue under Bankruptcy Code Section 552. Section 9-102(a)(64) defines proceeds to include "whatever is collected on, or distributed on account of, collateral" (*i.e.* the distributions will be proceeds for Article 9 purposes, whether or not there has been an opt in). *See also* Official Comment 13(a) to Section 9-102.

Benefits to a Secured Party of a Certificated Interest

Ability to obtain exclusive control. If the secured party takes control or delivery 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.

If a third party has taken delivery of the certificate under Section 8-301(a)(2), however, then multiple secured parties could have control of the same certificated security. Article 9 provides a "first to obtain control has priority" rule, Section 9-328, but the secured party is relying on representations and warranties (of the debtor and the third party that has taken delivery) for its assurance that it was the first to obtain control and therefore has priority under Article 9. The Article 9 priority rule is a change from Former Article 9, which provided that parties with control had equal priority in the certificated security. Former Section 9-115.

Control of an uncertificated security (unless re-registration in the name of the secured party is used, which is not likely to be an available means of holding LLC, GP or LP interests) depends on a control agreement among the secured party, the debtor and the issuer, and multiple parties can acquire control. Article 9 provides a "first to obtain control has priority" rule, Section

9-328, but the secured party is relying on representations and warranties (of the debtor and the issuer of the uncertificated security) for its assurance that it was the first to obtain control and therefore has priority under Article 9. The Article 9 priority rule is a change from Former Article 9, which provided that parties with control had equal priority in the uncertificated security. Former Section 9-115.

Regardless of the category of the collateral (as a general intangible or a security), the secured party will be depending on the accuracy of representations and warranties as to the interests in the issuer that are outstanding and any covenants restricting the issuance of additional interests or modifications of the terms of the collateral. In the case of a certificated security, the secured party can also be adversely affected if the debtor falsely claims that its certificate (in fact in the possession of the secured party or a third party) was lost, destroyed or stolen and obtains a replacement (which could result in dilution of the value of the secured party's collateral if a protected purchaser acquires rights in the new certificate). *See* Section 8-405(b).

Means of obtaining control may be easier to put into effect. Article 8 provides means to obtain control of an uncertificated security (so requiring the interest to be certificated is not necessary for the secured party to be able to obtain control and the related benefits as to protected purchaser status and a priority security interest). However, it may be easier to obtain control of a certificated security (by taking possession of a certificate with an effective indorsement) than to obtain control of an uncertificated security (which would require 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, GP or LP interest, or (ii) a control agreement among the issuer, the debtor and the secured party). While the issuer of the LLC, GP or LP interest may cooperate in an opt in to Article 8 and in providing for the interest to be certificated, it may not be willing to undertake the responsibilities (and potential liability) provided by a control agreement.

Characterization of a certificated interest. Under Article 9, if the LLC, GP or LP interest is certificated, an opt in provides certainty that the certificate will not be classified as an instrument as defined in Section 9-102(a)(47) (Former Section 9-105(1)(i)).

Under Former Article 9 having the certificated interest classified as an instrument would have been fatal to the perfection of a security interest if the secured party relied solely on filing to perfect its security interest. Former Article 9 provided that a security interest in an instrument could only be perfected by possession (with some limited exceptions for temporary perfection without possession). Former Section 9-304. However, Article 9 provides for perfection of a security interest in an instrument by the filing of a financing statement (in addition to perfection by possession and temporary perfection rules), so the risk of having an unperfected interest if the certificate is an instrument can be eliminated by filing a financing statement (although there will be potential priority and loss of perfection issues without possession).

Under Article 9, the secured party may prefer to have the non-filing priority rules that are applicable to a security, Section 9-328, rather than the non-filing priority rules that are applicable to an instrument, Section 9-330, apply to the transaction. For example, Section 9-330(d), which determines the priority of a security interest in an instrument perfected by possession over an earlier security interest in the instrument perfected by another means, provides that the priority of

the subsequent possessory security interest depends on whether the subsequent secured party took without knowledge that its security interest "violates the rights" of the earlier secured party. Section 9-328, which determines the priority of a security interest in an security perfected by control (or delivery of a certificated security) over an earlier security interest in the security perfected by a means other than control, does not expressly impose such a limitation on the priority of a subsequent secured party that takes control (or delivery of a certificated security). *But see* Official Comment 8 to Section 9-328 (secured party's actual knowledge that rights of another party are being violated may be a factor in determining whether non-Article 9 principles of law may result in liability or subordination of the security interest).

Protection against subsequent purchasers and other persons. Having information (such as the fact of the opt in, restrictions on modifying the opt in, other terms of the LLC operating agreement or partnership agreement and restrictions on assignment of the security (including restrictions on other security interests)) noted on a certificated security may provide the secured party with protections not available if the security is uncertificated. For example, Section 8-105(a) specifies when a person has notice of an adverse claim for purposes of determining whether that person is a protected purchaser. Information that appears on a security certificate would generally provide sufficient notice; with respect to an uncertificated security it could be more difficult to prove notice. Similarly, Section 8-202(a) provides that (i) even against a purchaser for value and without notice, the terms of a certificated security include terms stated on the certificate and terms made part of the security by reference on the certificate to another instrument, indenture or document and (ii) the terms of an uncertificated security include those stated in any instrument, indenture or document pursuant to which the security is issued.

Other Effects of an Opt In under Article 8

While the secured party wants the opt in because of protections the opt in provides, the opt in will have other consequences under Article 8. If the issuer of the LLC, GP or LP interest has opted in (and the interest is an Article 8 security), all of Article 8 applies to the issuer, the security and holders of the security. Article 8 contains numerous provisions that will affect the rights and obligations of the issuer, the holder of the security, secured parties and other transferees of the interest, including the provisions described in this paragraph. Similarly, Article 8 imposes specific requirements if a security is certificated, including the provisions described in this paragraph. Section 8-204 provides that a restriction on transfer of a security imposed by the issuer, even if otherwise lawful, is ineffective against a person without knowledge of the restriction unless (1) the security is certificated and the restriction is noted conspicuously on the security certificate or (2) the security is uncertificated and the registered owner has been notified of the restriction. Similarly, Section 8-209 provides that a lien in favor of the issuer upon a certificated security is valid against a purchaser only if the right of the issuer to the lien is noted conspicuously on the security certificate. A person who transfers a certificated security or an uncertificated security, or takes other similar actions with respect to such securities, makes the warranties specified in Section 8-108 unless otherwise agreed (although as a practical matter these warranties are likely to be the same as those included in a contract for the sale of a security or in a security agreement). Transfers of the security must comply with Sections 8-104 and 8-301. Section 8-202 establishes responsibilities and defenses of the issuer of the security. Section 8-207 establishes rights and duties of the issuer with respect to registered owners of the security. Section 8-401 establishes the duty of the issuer to register

transfers. Section 8-402 permits the issuer to seek certain assurances in accordance with requests for transfer. Section 8-403 permits certain parties to demand that the issuer not register the transfer. Section 8-404 establishes the issuer's liability for wrongful transfer. Sections 8-405 and 8-406 establish procedures with respect to lost, destroyed or wrongfully taken securities certificates, including the effect of failure to notify the issuer if the certificate has been lost, apparently destroyed or wrongfully taken.

A secured party may appreciate the certainty that the applicability of Article 8 would bring to many aspects of the interest that it is taking as collateral. Some issuers may view certainty as a benefit, while others may not want to change from the requirements with which they believe they are familiar or may not want to have potentially different obligations and liabilities than would apply to related entities (or to other interests issued by the same entity).

Other Effects of an Opt In under Article 9

Anti-assignment provisions may be valid if there is an opt in. The negation of anti-assignment provisions in Sections 9-406 and 9-408 apply to general intangibles (including payment intangibles) but not to a security. If an opt in is to be effected, the secured party should also determine whether there are anti-assignment provisions that were ineffective (because the interest was a general intangible) that would become effective as a result of the opt in (and the collateral being categorized as a security). Not all restrictions on assignment would be negated by Sections 9-406 and 9-408 (whether the collateral is a security or a general intangible), so diligence on such restrictions would be prudent whether or not there has been an opt in.

If counsel concludes that it is not clear whether an anti-assignment provision is of the type that will be negated by Sections 9-406 and 9-408, there are ways to provide certainty. If counsel wants certainty that an anti-assignment provision will be given effect (to the extent provided by other law), either (i) require an opt in (so that the interest is a security and not subject to Section 9-406 or 9-408 (except to the extent that a right to distributions in respect of the interest or other proceeds (such as sale proceeds) of the interest may be payment intangibles or an account), (ii) create or require a Delaware entity and rely on the Delaware law provisions described in the next paragraph that uphold restrictions on assignment of LLC and partnership interests, or (iii) have the restriction created in an agreement between the holder and a party other than the LLC or partnership (9-406 and 9-408 only apply to a contractual restriction on assignment in an agreement between the assignor and the account debtor (*i.e.* the LLC, GP or LP) or contained in a promissory note). If counsel wants certainty that an anti-assignment provision will not impede the creation, perfection or enforcement of a security interest, obtain consent of the appropriate parties; even if the LLC, GP or LP interest has not been the subject of an opt in (and is a general intangible) Section 9-408(a) would only permit the creation, attachment and perfection of a security interest (and would not negate a restriction on enforcement of the security interest and related disposition of the collateral). Also Sections 9-406 and 9-408 would only negate a contractual restriction on assignment in an agreement between the account debtor (*i.e.* the LLC, GP or LP) and the assignor, and restrictions on assignment may arise under other agreements (including the LLC or partnership agreement) to which the account debtor may not be a party).

Effective February 1, 2002, Delaware enacted amendments to the Delaware Revised Uniform Partnership Act (adding Section 15-104(c)), the Delaware Revised Uniform Limited

Partnership Act (adding Section 17-1101(e)) and the Delaware Limited Liability Company Act (adding Section 18-1101(e)). The amendments provide that Sections 9-406 and 9-408 of Article 9 do not apply to any interest in a Delaware partnership (including all rights, powers and interests arising under a partnership agreement or the Delaware Revised Uniform Partnership Act), a Delaware limited partnership (including all rights, powers and interests arising under a partnership agreement or the Delaware Revised Uniform Limited Partnership Act) or a Delaware limited liability company (including all rights, powers and interests arising under a limited liability company agreement or the Delaware Limited Liability Company Act), and that these new provisions in the entity statutes prevail over Sections 9-406 and 9-408 of Article 9. 2001 DE H.B. 372, 373 and 374. An assignment of interests in such entities will be in part governed by Section 15-503 (with respect to a general partnership), Section 17-702 (with respect to limited partnerships) and Section 18-702 (with respect to a limited liability company), which recognize that an LLC or partnership agreement may restrict transfers of LLC, GP or LP interests. Delaware made conforming amendments to Sections 9-406 and 9-408, and also amended those provisions to exclude interests in specified types of trusts. Section 9-406(i)(4) provides that Section 9-406 does not apply to “an interest in a trust, including any right or power of a beneficiary (including a settlor) or owner of a trust, arising under a governing instrument (as defined in Section 3301(d) of Title 12), Title 12, or other applicable law, to the extent that Delaware law governs such interest” and Section 9-406(i)(5) provides that Section 9-406 does not apply to “an interest in a partnership or limited liability company.” Similarly, Section 9-408(e)(3) and (4) exclude these types of interests in trusts, partnerships and LLCs from Section 9-408.

With respect to a Delaware LLC, partnership or trust, Delaware law is likely to be the law governing the effectiveness of an anti-assignment provision included in an LLC or partnership agreement.

Virginia has adopted provisions similar to those in Delaware applicable to LLC, GP and LP interests.

Risks to the secured party of requiring a certificated interest. If the secured party takes possession of a certificate and the certificate is then lost, destroyed or stolen, it may lose perfection of its security interest if it did not also perfect by filing a financing statement. It would also be possible for a protected purchaser to acquire the certificate and take free of (or have priority over) the secured party’s security interest. In addition the secured party may be liable to the debtor under Section 9-207 for failure to exercise reasonable care in the custody of collateral in its possession.

Controlling Distributions

Requiring an opt in and a certificated interest will not provide the secured party with the right to receive distributions in respect of the LLC, GP or LP interest. If receiving the distributions is important to the secured party, other actions (such as an agreement with the issuer of the interest) are needed.

Preventing the Issuer from Opting Out

In addition to an agreement with the issuer that it will not opt out, the secured party should consider requiring that the LLC operating agreement or partnership agreement provide

that the language opting in to Article 8 cannot be amended without the secured party's consent. An opt out could result in loss of perfection if the only method of perfection used was control (since only filing is effective to perfect a security interest in a general intangible) or loss of priority. An opt out could also result in a collateral description in a security agreement or collateral indication in a financing statement no longer correctly identifying the collateral (*e.g.* if collateral is referred to as a security and becomes a general intangible as a result of an opt out).

Preventing the Issuer from Opting In

A secured party that does not require an LLC, GP or LP to opt in should consider taking steps to prevent an opt in (*e.g.* an agreement with the issuer that it will not opt in or an amendment of the LLC operating agreement or partnership agreement to prohibit an opt in without the secured party's consent). If the issuer opts in when the secured party did not plan to have securities as collateral, a transferee of the interest from the debtor could have priority over the secured party's security interest or qualify as a protected purchaser and take free of adverse claims (including the secured party's interest). An opt in could also result in a collateral description in a security agreement or collateral indication in a financing statement no longer correctly identifying the collateral (*e.g.* if collateral is referred to as a general intangible and becomes a security as a result of an opt in).

Maintaining Interest as Certificated or Uncertificated

If the secured party has required a certificated interest, then it should consider (and prohibit) what actions the issuer might take (such as converting to another form of entity) that might result in the certificate no longer representing the interest in the entity. Similarly, a secured party that has not required that the interest be certificated should consider requiring that the interest cannot subsequently be certificated.

Other Considerations in Opting In

Having the issuer opt in may avoid a trap for the unwary. Hedge funds are generally organized as partnerships or LLCs, but with rare exceptions are not registered investment companies. Nonetheless, people on securities industry margin desks, as well as their investing customers, think of hedge fund interests as being securities, just as they do mutual fund shares. In these cases, opting in avoids disappointment of those expectations. The caveat is that expectations for other kinds of LLC, GP and LP interests, as envisioned by Section 8-103(c), are just the opposite (*i.e.* that these interests are not securities subject to Article 8).

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