

**Perfecting a Security Interest in an LLC Membership Interest in Virginia**

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With limited liability companies being the entity of choice for many businesses in Virginia and the lending opportunities that they create, it is important to understand how to perfect a security interest in an LLC membership interest.

Under Virginia's UCC, a membership interest may be classified as either a "security" (Va. Code § 8.8A-103(c)) or a "general intangible" (Va. Code § 8.9A-102(42)). Establishing and determining the correct classification is important because different rules are invoked for the perfection and priority of a security interest in a security versus a general intangible.

Va. Code § 8.8A-103(c) provides that a membership interest 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 [Article 8.8A of the Virginia Code], 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." Accordingly, a membership interest is not a "security" unless: the LLC's articles of organization or operating agreement "opt-in" to Article 8.8A by specifying that the membership interests are securities governed by Article 8.8A; (ii) the membership interests are actually dealt in or traded on securities exchanges or securities markets; (iii) the LLC is an investment company; or, (iv) the membership interest is a financial asset held in a securities account.

If a membership interest is not a "security," which most often is the case, then it is a "general intangible."

**Membership Interest as "General Intangible"**

A security interest in a membership interest that is a general intangible can be perfected only by filing a financing statement. Va. Code § 8.9A-310. The priority of competing security interests in a general intangible is determined by the "first in time" rules in Va. Code § 8.9A-322. Accordingly, it is important that the secured party perform a UCC search on the pledging member to ensure that the secured party will obtain a first priority security interest in the pledged membership interest. Note that even if the membership interest is represented by a certificate, if the membership interest is a general intangible, filing a financing statement is the only effective method of perfection. This is the case even if the certificate is signed over to the secured party or the certificate contains a legend advising third parties that the membership interest is subject to a pledge or other restrictions, which would otherwise perfect a security interest in a stock interest.

## **Membership Interest as “Security”**

A security interest in a membership interest that is a security can be perfected by filing a UCC financing statement, but such a security interest also can be perfected by obtaining control of the security (Va. Code §§ 8.9A-306, 8.8A-306), which includes taking delivery of a certificated security (Va. Code §§ 8.9A-301, 8.9A-313). Thus, the typical ways in which to perfect a security interest in a stock interest would apply.

The method used to perfect a security interest in a membership interest that is a security can affect the priority of the secured party’s security interest. For a membership interest that is a security, perfection by control will have priority over any other security interest perfected by filing alone (Va. Code § 8.9A-328). In addition to the priority of perfection by control of a security, such perfection also has the advantage of not lapsing unexpectedly, which could occur because of failure to continue or amend a financing statement. However, even if perfection is obtained by control, it still is advisable to file a financing statement as a precaution.

### **Best Practices**

Before engaging in any transaction that provides for the establishment of a security interest in a membership interest, the secured party always should review the LLC’s articles of organization and operating agreement to determine the nature of the membership interest as a general intangible or security. A membership interest classified as a security provides the secured party with greater protection. Accordingly, if after review of the LLC’s articles of organization and operating agreement it is determined that the membership interest is a general intangible, then if possible, the secured creditor should require that the articles of organization and operating agreement be amended to “opt-in” to Article 8.8A so that the membership interest will be classified as a security. This will allow the security interest to be perfected through both the certificate pledge process and the filing process, with all of the protections these processes would entail.

Additionally, the operating agreement will often expressly prohibit a member from pledging membership interests in the LLC, or may provide the LLC or other members a right of first refusal in the event of such a pledge. In such event, the secured party must obtain the consent and waiver from the LLC and other members before accepting the pledged membership interests. Otherwise, a secured party may find itself in a position where its security interest technically is perfected, but the secured party’s interest may not be valid under the LLC’s governing documents.