LLC and Partnership Transfer Restrictions Excluded From UCC Article 9 Overrides

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The organizational law of limited liability companies (LLCs) and partnerships has always fundamentally embraced an idea known as the "pick-your-partner principle," under which transfers of a member's or partner's ownership interest are restricted by statute, and those restrictions may be tightened or loosened by agreement. In recent years the pick-your-partner principle has interacted in complex and not always practical ways with Article 9 of the Uniform Commercial Code (UCC). Since 2001, UCC §§ 9-406 and 9-408 have overridden a broad range of statutory and agreement-based anti-assignment provisions, subject to complex exceptions that have tended to protect the pick-your-partner principle in many significant respects, while also proving analytically very difficult to handle. Recently, however, in an important step forward, Article 9's overrides of anti-assignment provisions have recently been amended to make them simply inapplicable to LLC and partnership interests.

One hopes that these amendments to Article 9's overrides (hereinafter the "2018 amendments" because they were approved last year) will soon be enacted by the states, but in the meantime, the current overrides will remain on the books in various jurisdictions with all of their existing complexities. Accordingly, this article focuses not only on the 2018 amendments, but also on an analysis of the overrides as they now stand, as applied to LLC and partnership interests. The amendments themselves are quite simple, but the article discusses them only after analyzing the overrides because the amendments are more easily understood against that background.

I. Background on Unincorporated Organization Law and UCC Article 9

Any co-owner of a privately held business organization may have a substantial stake in determining who the other co-owners are. If a second co-owner has the power to transfer its interest to a stranger, then the second co-owner can, in effect, force the first co-owner into a venture with the stranger/transferee without the first co-owner's consent. The policy and effect of the pick-your-partner principle under LLC and partnership law is to prevent such an outcome.

UCC Article 9, by contrast, has the very different policy orientation of facilitating voluntary transfers of personal property. Article 9's most familiar application is to transfers of property as security for the repayment of loans, but Article 9 also applies to outright sales of certain types of personal property. Some of these transfers and outright sales are precisely those that the pick-your-partner principle seeks to prevent, and as a result, for personal property consisting of LLC or partnership interests, the interaction of the pick-your-partner principle with Article 9 has been complex and thorny. Some have even called it recondite.

Ownership interests in a business organization, particularly one that is unincorporated, can be formally or informally bifurcated into governance rights and economic (or financial) rights. Governance rights consist of the owner's right to vote on, consent to, or otherwise make decisions about the organization's activities, and the right to receive information about the organization. Economic rights consist of the owner's entitlement to receive monetary distributions from the organization, whether from its profits or from an eventual dissolution and winding up. A complete ownership interest typically comprises both governance rights and economic rights. A good example of purely economic rights is a transferable interest in an LLC or limited partnership. See, e.g., Uniform Limited Liability Company Act (ULLCA) § 102(24) (2013).

Article 9 broadly covers ordinary security interests in both of the above aspects of ownership rights as well as in virtually all other personal property, plus the outright sales of some types of personal property, to be explained below. In light of this vast coverage, and in order to provide appropriately tailored rules for particular patterns of transaction, Article 9 subdivides personal property into an array of statutorily defined "types," or classifications. The most important classification for purposes of this article is general intangibles, which is Article 9's residual or catch-all classification, meaning that it includes any personal property that does not fall within the other Article 9 classifications. Hence, an asset is a general intangible only if it is not, for example, inventory or other goods, accounts, instruments, chattel paper, or securities or other investment property. See UCC § 9-102(a)(42). Examples of general intangibles range from trademarks to taxicab medallions, and centrally for purposes of this article, the category includes most LLC and partnership interests. (LLC or partnership interests may alternatively be classified as securities, using an opt-in process discussed in Part II.C.)

The other key type of property for purposes of this article is payment intangibles, which is a subset of general intangibles. The distinction between a general intangible that is also a payment intangible on one hand, and a general intangible that is not a payment intangible on the other, is that the former includes only general intangibles under which the "principal obligation" of the "account debtor" is "a monetary obligation." § 9-102(a)(62). In this article, the important term "account debtor" may be understood simply as the entity that is obligated on a payment intangible or other general intangible, i.e., the LLC or partnership itself as opposed to its members or partners. To determine whether the "principal obligation" is "monetary," one must weigh the relative importance of a member's or partner's governance and economic rights: if the LLC's or partnership's principal obligation in respect of the ownership interest is economic and thus "monetary," then the ownership interest is a general intangible that is also a payment intangible (or simply "payment intangible" for short). Otherwise, the ownership interest is a general intangible that is not a payment intangible. In general, if a member or partner has governance rights that the LLC or partnership is obligated to respect, the ownership interest is likely a general intangible that is not a payment intangible.

This distinction between payment intangibles and other general intangibles affects Article 9's scope, which is crucial to understanding the overrides because of course the overrides apply only within that scope. Article 9's scope includes two principal types of transactions relevant to this article: interests in either payment intangibles or other general intangibles that secure a loan or another obligation (referred to in this article as ordinary security interests), and outright sales of

payment intangibles. In fact, outright sales of payment intangibles are statutorily defined in Article 9 as "security interests," purely as a matter of terminological convenience, because many (though not all) of Article 9's rules for ordinary security interests also apply directly to sales of payment intangibles. By contrast, Article 9's scope does not include outright sales of general intangibles that are not payment intangibles, because most of such sales have little enough in common with ordinary security interests that inclusion would not be sensible. (The boundary between an outright sale of property and an ordinary security interest in the property is not always self-evident, but that topic is beyond the scope of this article. See, e.g., § 9-109 cmt. 4.) One final note on Article 9's scope is that transfers by gift or, generally, transfers by operation of law are not covered.

Bringing these strands together, Article 9 typically does not apply at all to the most common kind of transfer in this area—namely, outright sales of a member's or partner's complete ownership interest—because such a transaction is typically the sale of a general intangible that is not a payment intangible. By the same token, Article 9 does not apply to outright sales of a member's or partner's governance rights alone. But Article 9 does apply, and hence its overrides discussed below might apply, to ordinary security interests in complete ownership interests; to ordinary security interests in economic rights alone; and to outright sales of economic rights alone.

The fact that Article 9 applies to a particular transaction, though, does not necessarily mean that there is a practical conflict between an Article 9 override and the pick-your-partner principle. Whether a practical conflict exists depends on three elements. First, do the applicable statutes governing the organization directly restrict transfers? Such restrictions are universal or nearly so in the case of governance rights and complete ownership interests (e.g., ULLCA § 407(b)(2) (2013)), but they are nonexistent or nearly so in the case of economic rights (e.g., *id.* § 502(a)). Second, do the LLC's or partnership's own organic documents alter (or perhaps track) the statutory law just mentioned, for example by restricting transfers of economic rights? Organizations may indeed adopt restrictions on the transfer of economic rights, in order to ensure that all owners retain their economic stake in the organization and, as a result, have reasonably well-aligned governance incentives. And finally, if a restriction on transfer is imposed by either of the foregoing sources, does one of the Article 9 overrides invalidate or limit the restriction?

II. Navigating Unamended §§ 9-406 and 9-408

Part of what makes Article 9's overrides of anti-assignment provisions difficult is that they appear in two separate sections that are phrased quite similarly, but have subtle distinctions, and do not overlap. The first override, in § 9-406, is relatively strong and simple in its effects, but it applies to only a narrow set of transactions. The second override, in § 9-408, applies more broadly and is more complex in its provisions that apply to LLC and partnership interests, but it has only relatively weak effects on the transactions to which it applies. Taking into account the narrowness of the first and the weakness of the second, plus the availability of the opt-in process discussed in Part II.C, the overrides have generally not posed substantial problems for those who seek the protection of the pick-your-partner principle. On the other hand, general conclusions only take one so far in particular transactions.

A. Section 9-406

Article 9's first override, beginning at § 9-406(d), invalidates any "term in an agreement between an account debtor and an assignor" to the extent that that term "prohibits, restricts, or requires the consent of . . . the account debtor" to "the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in . . . the payment intangible." The simplicity of this provision is evident from its shortness, and the strength of this provision is that it overrides restrictions on all aspects of security interests, including "enforcement," as further discussed below.

The § 9-406 override is narrow, however, in three important ways. First, it applies only to payment intangibles (leaving aside its application to other types of property not relevant to this article), and only to ordinary security interests in them. See § 9-406(e). In other words, the override does not apply to transfers of governance rights, in either an outright sale or an ordinary security interest; and it does not apply to transfers of a complete ownership interest in either an outright sale or an ordinary security interest, assuming that the complete ownership interest is a general intangible that is not a payment intangible. Nor does the override apply to an outright sale of a payment intangible (other than a foreclosure sale or a secured party's acceptance of the payment intangible in satisfaction of the obligation it secures). See the discussion of § 9-408 in Part II.B. The narrowness of the § 9-406 override is important as a practical matter because when an LLC's or partnership's organic documents impose restrictions on transfer, the restrictions sometimes apply by their own terms only to governance rights or complete ownership interests, not to purely economic rights (classified as payment intangibles) in the first place.

Second, the § 9-406 override has no effect on an anti-assignment clause in an agreement among the organization's members or partners *inter se*, as opposed to terms in an agreement with the organization itself. This is because the override applies only to terms in an agreement with "an account debtor" and the assignor/transferor, and as noted in Part I, the LLC or partnership itself, rather than the other members or partners, is the account debtor in this context. Moreover, there may be substantial grounds to question whether the override applies even to an anti-assignment clause that is set forth directly in the organization's operating agreement, partnership agreement or other organic documents, because as a formal matter, an LLC or partnership is usually not a party to these agreements. On the other hand, substance-over-form arguments should be borne in mind on this point.

Third and relatedly, if the term of the agreement imposes a consent requirement, the override applies only if the consent required is that of the LLC or partnership itself, as opposed to one or more members or partners. For example, if an LLC is member-managed, the agreement will almost certainly require the consent of the members, and accordingly, the override will not apply to that requirement.

B. Section 9-408

Article 9's other override, beginning at § 9-408(a), invalidates any term in "an agreement between an account debtor and a debtor which relates to . . . a general intangible" that "prohibits, restricts, or requires the consent of . . . the account debtor" to "the assignment or transfer of, or

creation, attachment, or perfection of a security interest in . . . the . . . general intangible." It also invalidates any provision of a statute or other rule of law that similarly "prohibits, restricts, or requires the consent of . . . [an] account debtor" to "the assignment or transfer of, or creation of a security interest in, a . . . general intangible." Thus § 9-408 is more complex than § 9-406 as applied to LLC and partnership interests, because it overrides not only terms of agreements, but also statutes or other rules of law. (Although § 9-406 also overrides some statutes or other rules of law, it does so only for classifications of collateral that are not relevant to this article.)

Section 9-408 is also broader than § 9-406 in two additional ways. First, it applies to a broader range of transactions, namely outright sales of payment intangibles (statutorily included in Article 9's term "security interest," as noted in Part I) and ordinary security interests in general intangibles that are not payment intangibles. Outright sales of economic rights, covered here, perhaps are more common than ordinary security interests in them, covered in §9-406; and certainly general intangibles that are not payment intangibles is the most common classification of an LLC or partnership interest.

Second, the statutes that § 9-408 overrides are of broad applicability because they are restrictions on the transfer of general intangibles that are not payment intangibles, i.e., virtually all complete ownership interests, plus all governance rights taken alone. As a practical matter, such statutory restrictions are nearly universal in this area, though a particular organization's organic documents may sometimes alter the statutory default rules.

On the other hand, just as for § 9-406 above, § 9-408 does not apply to an anti-assignment clause in an agreement among the organization's members or partners *inter se*, as opposed to an agreement with the organization itself. Similarly, and again just as for § 9-406, if the term of the agreement imposes a consent requirement, § 9-408 applies only if the consent required is that of the organization itself, as opposed to one or more members or partners. This override of consent requirements, in § 9-408 unlike § 9-406, extends to statutes as well as terms in an agreement, but nonetheless only if the consent required is that of the organization itself as opposed to one or more members or partners—but this is not how the LLC and partnership statutes work. Instead, the statutes place the power to give or withhold consent in the hands of the members or partners themselves.

The feature of this override that makes its effects relatively weak, and thereby substantially accommodates parties seeking the protection of the pick-your-partner principle, is that § 9-408 invalidates restrictions only on the "creation, attachment, or perfection" of security interests. It does not, unlike § 9-406, invalidate restrictions on "enforcement" of security interests. Subsection 9-408(d) amplifies on this point by specifying among other things that, even giving effect to the § 9-408 override, a security interest that is subject to an otherwise enforceable restriction is "not enforceable" against the "account debtor" (i.e., the LLC or partnership itself), and "does not entitle the secured party to enforce the security interest." In other words, under § 9-408, a security interest (including an outright sale of a payment intangible) may go forward as between the transferor and transferee, but not as between the transferee and the LLC or partnership. The secured party acquires property rights (an ordinary security interest or an ownership interest) to the transferring member's or partner's ownership interest, and the value of these rights would be respected, for example in a bankruptcy of the transferor, or as applied to

proceeds from a transfer not affected by a restriction. See UCC § 9-408 cmt. 7. But the secured party is nonetheless without power of its own to step into the transferor's shoes and exercise the transferor's governance or economic rights.

Summarizing the substance of the two overrides, it is useful to think in terms of four permutations, based on the two classifications of collateral and the two forms of transaction. First, an outright sale of a general intangible that is not a payment intangible is not within the scope of Article 9, so neither override applies. Second, with an ordinary security interest in a general intangible that is not a payment intangible, the relatively weak override in § 9-408 applies, so that the secured party cannot enforce the transferred governance or economic rights against the organization. Third, with an outright sale of a payment intangible, again the relatively weak override in § 9-408 applies, so that the secured party cannot enforce the transferred rights against the organization. And fourth, with an ordinary security interest in a payment intangible, the relatively strong override in § 9-406 applies, so that the secured party can enforce the transferred rights against the organization. The Permanent Editorial Board for the Uniform Commercial Code (P.E.B.) is considering issuing a report that would further detail the application of both overrides to LLC and partnership interests.

C. Opting into Article 8

Neither of the Article 9 overrides applies to property that is a security as defined in UCC Article 8. This is because securities are classified by Article 9 as "investment property" rather than as general intangibles or, *a fortiori*, payment intangibles.

The term "security" generally does not include ownership interests in LLCs and partnerships, but it does include them if the "terms" of the ownership interest "expressly provide that it is a security" governed by Article 8. See §§ 8-102(a)(15), 8-103(c). Hence, one established way for transactional lawyers to avoid the overrides altogether is to have the organization "opt in" to Article 8 by adopting appropriate provisions in its organic documents. Related measures include providing for the security to be certificated or uncertificated, and preventing the organization from opting back out of Article 8 without the consent of the parties concerned.

III. The 2018 Amendments, Non-Uniform Amendments, and Choice of Law

Compared to the complex analysis in Part II, enactment of the 2018 amendments will markedly simplify the law in this area, eliminating the possible conflicts with the pick-your-partner principle that can remain despite the exceptions in §§ 9-406 and 9-408, and without the need for an Article 8 opt-in.

The 2018 amendments statutorily provide that Article 9's overrides do not apply to "a security interest in an ownership interest in a general partnership, limited partnership, or limited liability company." (In § 9-406, this language appears in a new subsection (k), which explicitly applies to subsections (d), (f), and (j). In § 9-408, the same language appears in a new subsection (f), which explicitly applies to the entire section.) A new comment to § 9-408 reads:

This section does not apply to an ownership interest in a limited liability company, limited partnership, or general partnership, regardless of the name of the interest and whether the interest: (i) pertains to economic rights, governance rights, or both; (ii) arises under: (a) an operating agreement, the applicable limited liability company act, or both; or (b) a partnership agreement, the applicable partnership act, or both; or (iii) is owned by: (a) a member of a company or transferee or assignee of a member; or (b) a partner or a transferee or assignee of a partner; or (iv) comprises contractual, property, other rights, or some combination thereof.

A new comment to § 9-406 provides that the § 9-408 comment applies to § 9-406 as well.

By excluding from the overrides "a security interest" in an ownership interest, the 2018 amendments permit outright sales of payment intangibles to go forward, as well as ordinary security interests in payment intangibles, and ordinary security interests in general intangibles that are not payment intangibles. The overrides remain in effect for general intangibles that are not LLC or partnership interests and for other classifications of personal property that are not relevant to this article.

The 2018 amendments were initially recommended by the P.E.B. in conjunction with representatives from the Joint Editorial Board on Uniform Unincorporated Organization Acts. They were then approved in accordance with the respective procedures of the UCC's two sponsoring organizations, the American Law Institute and the Uniform Law Commission. As a result, they are now a part of the UCC's official text.

At the time of this writing, it is too early for the 2018 amendments to have been enacted in any jurisdiction. On the other hand, in recent years a number of states, led by Delaware, have enacted non-uniform provisions having the same thrust. Some of the non-uniform provisions appear in the enacting states' UCC; others appear in their LLC and partnership organizational statutes; and others appear in both spots, as belt and suspenders and to ensure they will be found.

An important conflict-of-laws question can arise if a transaction involves elements from more than one jurisdiction, one of which has the unamended Article 9 overrides, and another of which has an eventual enactment of the 2018 amendments (or an existing, comparable non-uniform provision). Article 9's conflicts rule for perfection and priority of security interests in general intangibles does not apply to the treatment of transfer restrictions, because this issue is neither "perfection," "the effect of perfection or nonperfection," nor "priority." See § 9-301(1). Article 1's main catch-all conflicts rule, which leaves some conflicts questions to the agreement of the parties, would also generally be inappropriate here because transfer restrictions inherently present a three-party question that is not amenable to treatment by two-party agreement. See § 1-301(a). Accordingly, a choice-of-law clause in the security agreement or other agreement between transferor and transferee does not control, as Comment 3 to § 9-401 makes clear. Instead, one would hope that a court would apply the version of the overrides enacted by the jurisdiction in which the entity is organized, as the same Comment assumes. (The "internal affairs" doctrine in business entity law would also be consistent with such an outcome, although of course, restrictions on transfers to nonmembers or nonpartners are not strictly internal affairs issues.) In any case, the bottom line is that real certainty in this area will most promisingly have

to come from broad enactment of the 2018 amendments. The members of each state's Uniform Law Commission delegation can often be of direct help in those enactment efforts.

IV. Conclusion

The 2018 amendments will protect the pick-your-partner principle while also greatly simplifying and clarifying its interactions with Article 9. By the same token, as is often true of simple rules, the 2018 amendments may also sometimes reach more broadly than really needed, for example by preventing simple attachment and perfection, without enforcement, of a security interest in a complete ownership interest. However, those transactions can continue to go forward despite the 2018 amendments by means of, for example, the Article 8 opt-in, or other amendment or waiver of the organization's organic documents. On balance, the gains in this area from simplicity and clarity should clearly outweigh the losses from the occasional extra burden to an Article 9 transaction.