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Lessons from Delaware: Navigating the 2018 Amendments to Sections 9-406 and 9-408 of Article 9 of the Uniform Commercial Code

Sara T. Toner and R. Parker Havis[1], *Richards, Layton & Finger, P.A.*, Wilmington, DE

Preface

Since 2001, Sections 9-406 and 9-408 of Article 9 of the Uniform Commercial Code ("UCC") have contained provisions that void certain restrictions against assignability.[2] Interestingly, in 2002, the State of Delaware approved amendments (the "Delaware Amendments") to Sections 9-406 and 9-408 of the version of the UCC enacted in Delaware (the "Delaware UCC") which, in part, provided that the restrictions against assignability do not apply to "an interest in a partnership or limited liability company."[3] At its July 2018 annual meeting, the Uniform Law Commission enacted amendments to Article 9 of the UCC[4] modifying the "anti-assignment override" provisions,[5] thereby aligning the UCC with the Delaware UCC by excluding partnership and limited liability company interests from the override provisions. The amendments to the anti-assignment override provisions of Sections 9-406 and 9-408 adopted by the Uniform Law Commission (the "2018 Amendments") align the UCC with what has long been the case in the State of Delaware.[6]

Overview of Changes

UCC Sections 9-406 and 9-408, in relevant part,[7] include a general restriction against the anti-assignment provisions, otherwise referred to as the "anti-assignment override," of certain types of collateral, including general intangibles and payment intangibles (which are a particular subset of general intangibles).[8] The anti-assignment override renders ineffective particular

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[1] Sara T. Toner is a Director and R. Parker Havis is an associate, of Richards, Layton & Finger, P.A., in Wilmington, Delaware. Ms. Toner is the chair of the Firm's Real Estate Group. The views expressed herein are those of the authors and are not necessarily the views of Richards, Layton & Finger or its clients. The authors would like to thank Fred Mitsdarfer, an associate at Richards, Layton & Finger, for his assistance with this article.

[2] Carl S. Bjerre et al., *LLC and Partnership Transfer Restrictions Excluded from UCC Article 9 Overrides*, BUS. LAW TODAY (Feb. 7, 2019), https://businesslawtoday.org/2019/02/llc-partnership-transfer-restrictions-excluded-ucc-article-9-overrides/.

[3] Del. S.B. 413, 141st Gen. Assem., 73 Del. Laws ch. 330 (2002).

[4] THE AM. LAW INST., 2017-2018 ANNUAL REPORT 1, 13 (2018).

[5] *Id.*

[6] *See* U.C.C. §§ 9-406, 9-408 (AM. LAW INST. & UNIF. LAW COMM'N 2018).

[7] The amendments to Article 9 add new exceptions to the anti-assignment override in Sections 9-406 and 9-408 and provide for exceptions in legal restrictions on assignment beyond terms in arrangements between parties. *See* U.C.C. §§ 9-406, 9-408.

[8] Other types of collateral included in the override provision of Section 9-406 include accounts, chattel paper, and promissory notes. U.C.C. §9-406 (2018). Other types of collateral

restrictions between an account debtor and a debtor purporting to prevent the assignment or impair the creation of a security interest in the general intangibles and payment intangibles.[9] General intangibles are defined as "personal property, including things in action, other than [certain other defined collateral types, including investment property]",[10] a catch-all category that may include partnerships interests and limited liability company membership interests, [11] hereinafter, collectively "membership interests."[12] Payment intangibles are defined as general intangibles, "under which the account debtor's principal obligation is a monetary obligation."[13] Frequently, partnership interests and limited liability company membership interests are general intangibles that are not payment intangibles, as the entity owes rights associated with the membership interest rather than a defined debt.

The newly adopted subsections included in the 2018 Amendments for Sections 9-406 and 9-408 provide that particular subsections of 9-406 and 9-408 do not apply to "a security interest in an ownership interest in a general partnership, limited partnership or [LLC]" (general partnerships, limited partnerships, and LLC's collectively referred to as "Alternative Entities").[14] Furthermore, the new "Comment 10" of both Article 9 sections under the 2018 Amendments state that both entire sections "[do] not apply to an ownership interest in a[n] [Alternative Entity]."[15] The effect is that there now is both a limited exception to the override for a security interest in an ownership interest of Alternative Entities and a total exception to the override for an ownership interest of Alternative Entities. Comment 10 goes on to clarify that an ownership interest can be of an economic or governance interest, or any combination thereof; can arise under an operating agreement or an LLC agreement, or both; can be owned by a member, partner, transferee or assignee of a member or partner; and can take the form of contractual rights, property rights, other forms of rights, or any combination thereof.[16]

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included in the override provision of Section 9-408 include promissory notes and health-care-insurance receivables. U.C.C. § 9-408 (2018).

[9] U.C.C. § 9-406 (2018); U.C.C. § 9-408 (2018).

[10] U.C.C. § 9-102(42)(2018).

[11] MICHAEL T. MADISON ET AL., THE LAW OF REAL ESTATE FINANCING § 8:24 (rev. ed. 2019).

[12] The term "membership interest," as used within this article, does not appear within Delaware law governing partnerships or limited liability companies, but is intended to refer to the ownership interests in these entities. *See* 6 *Del. C.* § 15-101 et seq. (making no mention of a "membership interest" in Delaware law governing partnership); *see also* 6 *Del. C.* § 18-101 et seq. (making no mention of a "membership interest" in Delaware law governing limited liability companies). Rather, the law governing partnerships and limited liability companies defines interests in their respective entities differently. *Compare* 6 *Del. C.* § 15-101(17) (defining partnership interests in terms of economic, managerial, and other rights) *with* 6 *Del. C.* § 18-101 (10) (defining limited liability company interest in terms of the right to distributions and a share in profits and losses).

[13] U.C.C. § 9-102(42)(2018).

[14] U.C.C. §§ 9-406(k)(2018), 9-408(f)(2018).

[15] U.C.C. §§ 9-406 cmt. 10 (2018), 9-408 cmt. 10 (2018).

[16] U.C.C. §§ 9-406 cmt. 10 (2018), 9-408 cmt. 10 (2018).

The policy reason behind the existence of the anti-assignment override, which has since been weakened by the 2018 Amendments, can be found in the Official Comments to the UCC that specify that the anti-assignment override stems from "the common-law developments that essentially have eliminated legal restrictions on assignments of rights to payment as security"[17] and the apparent benefit of "enhanc[ing] the ability of certain debtors to obtain credit," [18] presumably by ensuring debtors had the ability to use more of their personal property as collateral in obtaining financing. These new limitations on the assignment override have been linked to the "pick-your-partner principle,"[19] which essentially means, in the absence of a contrary agreement among members, that a person cannot become a member of an Alternative Entity without the unanimous consent of the members.[20]

2018 Amendments as Applied to Mezzanine Financing

In secured transactions, lenders have long been aware of the plethora of issues involved in taking a security interest in a limited liability company or partnership interest. This is especially relevant in the context of mezzanine financing where, in an event of default, the lender will have the ability to convert its debt to equity. Under the typical mezzanine structure, a single-purpose Alternative Entity is wholly owned by the mezzanine borrower. The classification of the pledged interest is a key consideration for mezzanine lenders. Generally, limited liability company membership interests are classified as "general intangibles"[21] and, thus, subject to the Article 9 rules, including 9-406 and 9-408. To avoid this treatment, mezzanine lenders often require their borrowers to "opt in" to Article 8 of the UCC by providing in the Alternative Entity organic documents that limited liability company membership interests are "an investment company security."[22] By classifying the limited liability company membership interests as a security, the collateral type becomes "investment property" for purposes of the UCC, which has preferable modes of perfection, a full discussion of which is not within the scope of this article.[23] Therefore, such "opting in" to classification as an investment property would negate any potential complications under Sections 9-406 and 9-408. Section 9-406 and Section 9-408 do not apply to "investment property," but rather only to payment intangibles and general intangibles.[24] In fact, this has long been the practice in mezzanine financing involving commercial real estate.

In the context of mezzanine financing, an ownership interest in an Alternative Entity would likely be classified as a general intangible rather than a payment intangible.[25] Because the

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[17] U.C.C. § 9-406 cmt. 5 (2018).

[18] U.C.C. § 9-408 cmt. 2 (2018).

[19] Carl S. Bjerre et al., *LLC and Partnership Transfer Restrictions Excluded from UCC Article 9 Overrides*, BUS. LAW TODAY (Feb. 7, 2019), https://businesslawtoday.org/2019/02/llc-partnership-transfer-restrictions-excluded-ucc-article-9-overrides/.

[20] Daniel S. Kleinberger, *What Is a Charging Order and Why Should a Business Lawyer Care?* BUS. LAW TODAY (MAR. 6, 2019) HTTPS://BUSINESSLAWTODAY.ORG/2019/03/CHARGING-ORDER-BUSINESS-LAWYER-CARE/.

[21] MADISON ET AL., *supra* note 10, at § 8:24.

[22] *See, e.g., id.*

[23] *Id.*

[24] U.C.C. §§ 9-406(k)(2018), 9-408(f) (2018).

[25] *See* MADISON ET AL., *supra* note 9, at § 8:24.

mezzanine borrower is often the sole member of the Alternative Entity, it is likely that the Alternative Entity's "principal obligation" is not a monetary obligation, but one of governance.[26]

Assuming that limited liability company membership interests are classified as "general intangibles" rather than "investment property," as they would by default,[27] and not sub-categorized into a "payment intangible," then UCC Article 9-408 and the accompanying 2018 Amendments apply.[28] For example, consider a mezzanine financing where the mezzanine borrower and an Alternative Entity owned by the mezzanine borrower and the Alternative Entity's organizational documents contain a restriction on assignment. Initially, a mezzanine borrower would pledge its limited liability company membership interest, classified as a general intangible, in an Alternative Entity. Prior to the 2018 Amendments, the override would apply, and any restriction on transfer or assignability in an agreement between the entity and mezzanine borrower would be ineffective. The mechanics of the override would be such that Section 9-408(a) initially applies, providing that an "agreement between an account debtor and a debtor … which relates to a … general intangible … which term 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, is ineffective …."[29] The only applicable exception to this override, prior to the 2018 Amendments, was under Section 9-408(b) and concerned only payment intangibles.[30] The override would apply and the restriction on assignment or transferability would be ineffective.

However, following the 2018 Amendments, both a new specific and broad exception to the override exists in addition to Section 9-408(b).[31] The specific exception is found within Section 9-408(f) and provides that the override between a debtor and an account debtor "does not apply to a security interest in an ownership interest in a[n] [Alternative Entity]."[32] The more clear and broad explanation of this exception is then found within Comment 10 to Section 9-408 and provides that "[t]his section does not apply to an ownership interest in an [Alternative Entity]."[33] Therefore, if the organic documents of the Alternative Entity restricted transfers or assignability, the lender, attempting to foreclose under the mezzanine loan, would find any assignment made by the mezzanine borrower to be ineffective, as the override would now not apply. For example, pursuant to Delaware's Limited Liability Company Act (the "DE Act"), while a limited liability company interest is assignable, assignability can be restricted in the company's limited liability company agreement.[34] Further, unless otherwise provided in a limited liability company agreement, the DE Act provides:

> (1) [a]n assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member; (2) [a]n assignment of a limited liability company

[26] *See generally* MADISON ET AL., *supra* note 9, at § 8:24.
[27] *Id.*
[28] *See* U.C.C. § 9-408(2018).
[29] U.C.C. § 9-408(a)(2018).
[30] *Compare* U.C.C. § 9-408(a)(2018) *with* U.C.C. § 9-408(a)(2010).
[31] *See* U.C.C. § 9-408(a)(2018).
[32] U.C.C. § 9-408(f)(2018).
[33] U.C.C. § 9-408 cmt. 10 (2018).
[34] 6 Del. C. § 18-702(a).

> interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned; and (3) [a] member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of the member's limited liability company interest.[35] Unless otherwise provided in a limited liability company agreement, the pledge of, or granting of a security interest, lien or other encumbrance in or against, any or all of the limited liability company interest of a member shall not cause the member to cease to be a member or to have the power to exercise any rights or powers of a member.[36]

As a result, pursuant to the DE Act, a pledge of limited liability company interests is only a pledge of economic rights. A foreclosing mezzanine lender will not be able to assign a foreclosed limited liability company interest unless the limited liability company agreement does not preclude this type of assignment. Lastly, control rights cannot be obtained absent unanimous member consent or an express provision in the respective limited liability company agreement permitting such. In transactions governed by Delaware law, lenders have long been aware of the need to become a controlling member; for foreclosing on the LLC interests provides limited benefit to the lender if the control rights remain with the pledgor.

Comparison to Delaware's Pre-Existing Amendments

On July 27, 2002, the Delaware Amendments added that the anti-assignment override provisions do not apply to "an interest in a partnership or limited liability company."[37] The original synopsis relating to this bill was in order to allow the Delaware UCC to "conform Article 9 … to take into account changes, made earlier [in 2002] to Delaware's alternate entity statutes, that make clear that partnership and limited liability company interests are not within the ambit of Sections 9-406 and 9-408 of the Delaware [UCC]."[38] The 2002 Delaware Amendments exempted any interest in an Alternative Entity from Delaware's Sections 9-406 and 9-408 entirely,[39] apparently accomplishing the same goal of the combined 2018 Amendments subsection additions and accompanying Comment 10.[40]

Looking Toward the Benefits and Complications of the 2018 Amendments

In jurisdictions that adopt the 2018 Amendments, practitioners and lenders would be wise to consider the terms and conditions of the organic documents governing the pledged interest. For example, the Uniform Limited Liability Company Act provides that an assignment of a limited

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[35] *Id.*
[36] *Id.* at § 18-702(b)(1)-(3).
[37] Del. S.B. 413, 141st Gen. Assem., 73 Del. Laws ch. 330 (2002).
[38] Del. S.B. 413 syn.
[39] Del. S.B. 413.
[40] *Compare id. with* U.C.C. §§ 9-406 cmt. 10 (2018) *and* 9-408 cmt. 10 (2018).

liability company interest does not entitle the assignee to "participate in the management or conduct of the company's activities and affairs."[41] Prior to the 2018 Amendments, in those jurisdictions that had Alternative Entity statutes that restrict the assignability of partnership or limited liability company interests (*e.g.*, governance, economic or otherwise), lenders may have, in some instances, relied on the anti-assignment override provisions of Sections 9-406 and 9-408. But now, once the 2018 Amendments are adopted, those practitioners and lenders will need to apply the lessons that have long been in play for Delaware-law governed Alternative Entities; *i.e.*, know what the borrower's organic documents state regarding the assignability and foreclosure of pledged Alternative Entity interests and if necessary require that the borrower's organic documents be amended as a condition precedent to closing. Such amendment should expressly permit the borrower/ debtor to assign its governance and economic interests.

As a rare illustration[42] of how Delaware law has been impacting assignment overrides, *In re Mason*, a recent decision by a bankruptcy court in North Carolina, considered override restrictions as applied to Delaware-law governed membership interests of a Delaware limited liability partnership.[43] In the aforementioned case, the debtor was one of three managing members in a limited liability partnership.[44] The organic documents of this partnership stated, in relevant part, that it would be "construed and interpreted in accordance with the laws of [Delaware]."[45] In connection to a prior loan, the debtor pledged a security interest to a third party in "all right, title and interest of [the debtor] in, to and under the [partnership's organic documents] and the partnership interests owned by [the debtor]," "all dividends and distributions payable in respect of such partnership interests" and "all proceeds from the foregoing."[46] The organic documents of the partnership contained restrictions that the court considered, which consisted of, among other things, a right of first offer belonging to the other two managing members, and a limitation that any such interest be transferred only for the right to receive net profits and losses, but such interest would "not be effective to admit the [secured party] as a [p]artner."[47] The court considered the Delaware UCC which states "[e]xcept as otherwise provided in … 9-406 … [and] … 9-408 … whether a debtor's rights in collateral may be voluntarily or involuntarily transferred is governed by law other than [Article 9 of the Delaware UCC]."[48] Further, the court applied the Delaware Revised Uniform Partnership Act as such other law which governed the assignability of an interest in a limited liability partnership,[49] which provides that a transfer in violation of a restriction in the organic documents would be ineffective.[50] Further, the secured party would not have even an enforceable security interest because the debtor must have "the power to transfer rights in the

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[41] *See, e.g.*, Uniform Limited Liability Company Act (ULLCA) § 502(a)(3)(A) (2013).

[42] Examples of litigation surrounding the Delaware, and now general UCC, limitation on the assignment override are incredibly few.

[43] 600 B.R. 765, 773 (Bankr. E.D. NC 2019).

[44] *Id.* at 767.

[45] *Id.*

[46] *Id.* at 768 (quoting the personal guaranty and security agreement between the debtor and the party claiming an enforceable security interest).

[47] *Id.* at 769.

[48] *Id.* at 774, 777 n.12.

[49] *Id.* at 776 (applying 6 Del. C. § 15-503(f)).

[50] 6 Del. C. § 15-503(f).

collateral to the secured party" in order to create one.[51] The point of this case is simple: failure of a secured creditor to review organic documents of an Alternative Entity for restrictions on assignment will risk an unenforceable security interest, no longer to be saved by the assignment override as limited by the Delaware UCC and, now, the 2018 Amendments.

Conclusion

While the 2018 Amendments impose limitations on the Section 9-406 and 9-408 anti-assignment overrides, lenders who seek to avoid both the perfection and collateral classification issues inherent within Article 9 should continue the practice of opting into Article 8, as doing so will ensure that they are unaffected by the 2018 Amendments. However, for lenders engaged in transactions that are subject to Article 9 that classify Alternative Entity interests as a "general intangible," they would do well to ensure that their borrower's organizational documents do not contain anti-assignment language, as under the 2018 Amendments such language may now prove more relevant than ever before.

[51] *In re Mason*, 600 B.R., 776 (applying 6 Del C. § 9-203(b)).