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SECURED TRANSACTIONS

Partnership, LLC Interests And Anti-Assignment Rules

Equity interests, such as stock, partnership interests and limited liability company ("LLC") interests, have been valuable as collateral for borrowers looking to obtain additional liquidity, particularly in mezzanine financings, where the primary lender to a project or operating borrower is often unwilling to allow second liens on its collateral, no matter how "silent." Residing at the intersection of organizational law, contract law and securities law, partnership and LLC interests have always presented challenges as collateral. Changes over the past several years in states' entity laws indicate a trend toward making it more difficult for debtors to pledge partnership and LLC interests. An example of this is the adoption of amendments to Texas's Business Organizations Code that became effective last month (see the discussion below). Under these amendments, restrictions on pledges or transfers of partnership or LLC interests set forth in a partnership agreement, certificate of formation or LLC agreement, will be given effect and not be overridden by the anti-assignment provisions of UCC Sections 9-406 and 9-408.[1] In this regard, Texas is following the lead of Colorado, Delaware, Kentucky and Virginia in giving priority to contractual provisions of LLC and partnership agreements restricting pledges or transfers (hereinafter, collectively "assignments") of equity interests over UCC provisions that might otherwise override such restrictions.

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Background

In general, shares of corporate stock are "securities" under Article 8 of the UCC, but interests in LLCs or partnerships can constitute either a "general intangible" under Article 9 of the UCC or a "security" under Article 8.[2] To be categorized as a "security," an LLC or partnership interest must be (or be of a type) traded on a securities exchange or in a securities market, its terms must expressly provide that it is a security governed by Article 8 or it must be an "investment company security."[3] How the collateral is properly categorized determines which rules govern perfection, priority and restrictions on assignment.

Practitioners should consider how the collateral will be classified and whether totake steps to engineer a particular classification to ensure a desire result.

A security interest in general intangibles consisting of LLC or partnership interests is perfected by filing.[4] To perfect a lien on a security, a secured party can file a financing statement, obtain control of the security or take possession of a certificated security.[5] A secured party can obtain control of a certificated security by taking "delivery" of the security and, with respect to certificated securities in registered form, having such certificates either endorsed to the secured party or in blank or registered in its name.[6] If the security is uncertificated, the creditor may obtain control if the security is registered in its name or the issuer agrees to comply with instructions from the secured party without further consent of the registered owner.[7]

The method of perfection dictates how priority of the security interest is determined. For general intangibles, priority is determined by the first-to-file rule.[8] That rule also applies to competing liens on securities perfected by filing. Obtaining control of securities, however, offers several advantages. For example, a security interest in a security perfected by control always takes priority over a competing lien perfected by filing.[9] Additionally, only perfection by control permits the creditor to achieve "protected purchaser" status. To qualify as a protected purchaser, a secured party must give value, not have notice of an adverse claim and obtain control of the security.[10] Protected purchaser status enables a creditor to acquire the interest free of any adverse claims, thereby potentially giving it better rights in the collateral than the debtor. This differs from liens on general intangibles, where lienholders take the risk of defects in the debtor's title of which they may be unaware. If an LLC or partnership interest constitutes a security, taking control of the security reduces the risk of any third party's

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becoming a protected purchaser and thereby obtaining priority.

Nevertheless, although the control mechanisms of Article 8 may provide better protections to secured parties than filing under Article 9, there are disadvantages to coverage under Article 8. Sections 9-406 and 9-408 render ineffective certain contractual and statutory restrictions on assignment of collateral, thereby greatly expanding the potential pool of collateral which would otherwise be unavailable to secured creditors. General intangibles are covered by Sections 9-406 and 9-408, but securities are not. Additionally, Article 8 can subject issuers to additional obligations, such as certain transfer restrictions and notice and registration requirements, and thus may make it more difficult to convince issuers to "opt in" to Article 8.[11]

Sections 9-406 and 9-408

Both Sections 9-406 and 9-408 override contractual or statutory restrictions on assignment in an agreement between the account debtor and an assignor. However, neither section applies to contractual or statutory restrictions by other parties or in other documents. With respect to an LLC or partnership interest that constitutes a general intangible, the issuer of the interest (i.e., the LLC or partnership) is the account debtor[12] and the member or partner is the assignor. However, an argument may be made that an LLC or partnership agreement is an agreement among the members of the LLC or partnership and not an agreement between the account debtor and assignor, and thus that Sections 9-406 and 9-408 do not apply to invalidate restrictions on transferability of interests pursuant to such agreements.[13] Practitioners need to examine applicable state partnership and LLC laws to determine whether an LLC or partnership agreement qualifies as an agreement between an account debtor and an assignor.

Notwithstanding the anti-assignment restrictions of Sections 9-406 and 9-408, several states have adopted non-uniform UCC provisions or added language to their state entity statutes that specifically exclude LLC and partnership interests from the scope of Sections 9-406 and 9-408. Most recently, Texas modified Sections 101.106 and 154.001 of its Business Organizations Code to provide expressly that Sections 9-406 and 9-408 do not apply to interests in LLCs or partnerships, including the rights, powers and interests arising under the governing documents of the entity.[14] The statute, as amended, states its express intent to permit the enforcement, as a contract among members of an LLC or partnership, of any provision of an LLC or partnership agreement that would otherwise be ineffective under Sections 9-406 or 9-408. In this regard, Texas has followed Colorado, Delaware, Kentucky and Virginia.

The Delaware Revised Uniform Partnership Act,[15] Delaware Revised Uniform Limited Partnership Act[16] and Delaware Limited Liability Company Act[17] expressly provide that Sections 9-406 and 9-408 do not apply to interests in, respectively, Delaware partnerships, limited partnerships or LLCs, including all powers and interests arising under agreements governing such interests. Additionally, Delaware's version of Sections 9-406 and 9-408 states that these sections are not applicable to "an interest in a partnership or limited liability company."[18] Similarly, Virginia's versions of Sections 9-406 and 9-408 expressly state that these sections do not apply to interests in partnerships or LLCs,[19] and, like Delaware, Virginia's Limited Liability Company Act and Uniform Partnership Act contain language exempting LLC and partnership interests from the scope of Sections 9-406 and 9-408.[20] Kentucky and Colorado have also provided in their entity statutes that the anti-assignment restrictions of Sections 9-406 and 9-408 do not apply to LLC or partnerships interests.[21]

Although some states, such as Delaware, Texas and Virginia, expressly provide in their UCC that the anti-assignment overrides do not apply to LLC or partnership interests, other states, such as Kentucky and Colorado, effectuate this result only in their entity statutes. Accordingly, when dealing with liens on LLCs and partnerships, practitioners should review state entity statutes in addition to the UCC, since the inapplicability of Sections 9-406 and 9-408 may not be evident from the UCC itself.

Restrictions on assignments of LLC and partnership interests can present complex choice of law issues. For example, assume that a debtor has an interest in a Delaware LLC that constitutes a general intangible and the LLC agreement for such entity restricts assignments of such interest. The debtor then pledges its interest pursuant to a security agreement governed by New York law. If New York's Section 9-408 is applied, the restriction on the assignment would be ineffective. If Delaware's version of Section 9-408 is applied, however, the restriction on assignment would be effective because Delaware's Section 9-408 states that such section is inapplicable to interests in LLCs.

After giving an example similar to the one described above, Official Comment 3 to Section 9-401 expressly states that "This Article does not provide a specific answer to the question of which State's law applies to the restriction on assignment." It then nevertheless suggests that an entity's jurisdiction of formation is likely to govern the enforceability of a restriction on assignment of an interest in such entity and not the law chosen by the parties to govern the terms of the security agreement. As of now, these conflicts of law issues remain unsettled.

Obtaining liens on interests in LLCs or partnerships may not entitle the secured party, upon enforcement, to succeed to all of the grantors' rights. For example, Delaware's Limited Liability Company Act states that, unless otherwise provided in the LLC agreement, an assignee of a member's LLC interest has no right to participate in the management of the business and affairs of an LLC unless all of the other members approve or the assignee complies with any procedures provided in the LLC agreement.[22] Furthermore, an assignment of an LLC interest does not entitle the assignee to become, or to exercise any rights or powers of, a member unless otherwise provided in an LLC agreement.[23] The Delaware statute, for example, states that unless otherwise provided in the LLC agreement, an assignment of an LLC interest entitles the assignee only to share in such profits and losses, and to receive such distributions and allocations, to which the assignor was entitled, to the extent assigned.[24] This suggests that, under Delaware law, a broader assignment will be carved back to such payment rights but will not be invalidated entirely. That may not be the result in a state such as Texas, which

lacks similar savings language. Accordingly, a creditor who obtains a lien on a Texas LLC interest in contravention of the LLC agreement may find itself unsecured.

Secured parties seeking to avoid the effect of anti-assignment restrictions in LLC or partnership agreements where the equity interest constitutes an Article 8 security (and thus is not eligible for protection under 9-406 and 9-408) have occasionally limited their liens to the right to dividends and distributions from such interests. Assuming such rights are not part of the "security" under Article 8, but are payment intangible or general intangibles, then under the laws of states with uniform versions of 9-406 and 9-408, such rights may be assigned notwithstanding contractual restrictions on assignment. If, however, they are considered part of the "security," then such sections would not apply and the restrictions on assignment would be given effect.

A security interest that is limited to the right to dividends and distributions, as opposed to the entire LLC or partnership interest, presents other risks. Under Section 9-203, attachment cannot occur as to collateral until the debtor acquires rights in such collateral.[25] The actual dividends or distributions, when paid or otherwise distributed, could arguably constitute proceeds of such rights. But until such payment or other distribution occurs, such property is vulnerable to attack under the Bankruptcy Code. For example, if a debtor files for bankruptcy and the secured party's security interest in distributions and dividends has not attached or attaches during the preference period, the lien could be vulnerable to avoidance as a preference pursuant to Section 547 of the Bankruptcy Code.[26] Furthermore, Section 552(a) of the Bankruptcy Code states generally that property acquired by the debtor after commencement of a case is not subject to a security interest granted prior to the commencement of the case. Section 552(b) makes an exception to Section 552(a) by stating that if a security agreement was entered into before the commencement of the case and if the security interest 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 commencement of the case. Thus, if a secured party has a security interest solely in the right to receive distributions and dividends rather than entire LLC or partnership interest, and such distributions or dividends are not deemed proceeds of such right, then any distributions or dividends received after the commencement of a case could be cut off by Section 552.

Practical Considerations

The above concerns emphasize the benefits, wherever possible, of getting the consent and cooperation of the issuer in obtaining a lien on an LCC or partnership interest. Issuer involvement—such as by "opting in" to Article 8, consenting to the assignment and agreeing to allow a transferee upon foreclosure of the pledged interest to become a member or partner in the issuer—can best position the secured party to place a lien on the entire LLC or partnership interest (as opposed to solely the rights to dividends and distributions) and reap the benefits of Article 8 coverage, including "protected purchaser" status. It also may enable the secured party to receive payments of dividends and distributions on such interests directly from the issuer, rather than seeking to obtain such payments from the debtor.

The pledging of LLC or partnership interests can also raise issues regarding legal opinions. As mentioned, some states override the UCC anti-assignment provisions in their version of the UCC while other states do so only in their entity statutes. The question of which state law governs in a transaction with parties of different states and agreements with different governing law is unsettled. In giving a legal opinion on the validity and perfection of a security interest in pledged LLC or partnership interests, debtor's counsel may have to review the laws of the state of formation of the entity whose LLC or partnership interests are being pledged. Practitioners who are unable or unwilling to opine on such matters may have to engage local counsel to do so or carve out the effect of anti-assignment clauses from the opinion. Moreover, of course, categorizing LLC or partnership interests as general intangibles (or payment intangibles in the case of dividends and distributions) or securities can affect legal opinions in that the methods of perfection and rules regarding priority differ depending on the type of collateral secured.

Conclusion

Liens on LLC and partnership interests involve a myriad of issues. These interests may constitute either Article 8 or Article 9 collateral. Practitioners should consider how the collateral will be classified and whether to take steps to engineer a particular classification to ensure a desired result. If the interests constitute Article 9 collateral, the effectiveness of anti-assignment provisions customarily contained in the agreements governing the interests and the applicability of the UCC's anti-assignment override rules may need to be considered. Finally, creditors should also be aware of the potential consequences in receiving only a limited security interest, such as in distributions and dividends, in an LLC or partnership.

1. U.C.C. Sections 9-406 through 9-409 set forth anti-assignment rules that are among the UCC's most inscrutable provisions. For an outline of them, see A. Christenfeld and S. Melzer, "How Revised Article 9 Affects Anti-Assignment Clauses," 228 New York Law Journal, No. 108, at 5 (June 6, 2002).
2. See definition of "general intangible" in U.C.C. §9-102(a); See also Official Cmt. 5(d) to U.C.C. §9-102.
3. U.C.C. §8-103(c).
4. U.C.C. §9-310.
5. U.C.C §§9-310, 9-312(b), 9-313 and 9-314.
6. U.C.C §8-106(a) and (b).
7. U.C.C. §8-106(c).
8. U.C.C. §9-322.
9. U.C.C. §9-328; See also Official Cmt. 3 to U.C.C. §9-328.
10. U.C.C. §8-303.
11. See U.C.C. §§8-204, 8-202, 8-207, 8-402, 8-405 and 8-406.
12. See definition of "account debtor" in U.C.C. §9-102(a).
13. L. Soukup, "Payment Obligations and Other Property as Collateral: Contractual Restrictions on Assignment Rendered Ineffective by Article 9," 37 UCC LJ 3, 6 (Winter 2005).
14. 2009 Tex. ALS 84; 2009 Tex. Gen. Laws 84; 2009 Tex. Ch 84.
15. 6 Del. C. §15-104(c).
16. 6 Del. C. §17-1101(g).
17. 6 Del C. §18-1101(g).
18. 6 Del. C. §§9-408(e) and 9-406(i).
19. Va. Code Ann. §§8.9A-406(k) and 8.9A-408(g).
20. Va. Code Ann. §§13.1-1001.1(B) and 50-73.84(c).
21. See KRS §§275.255(4) (stating that limitations upon the assignment or pledge of a membership interest shall be enforced notwithstanding KRS §§355.9-406 and 355.9-408), 362.1-503(7) and 362.2-702(8); See also C.R.S. §§7-90-104 (stating that Sections 4-9-406 and 4-9-408 do not apply to an owner's interest) and 7-90-109(44) (44) ("owner's interest" includes a membership interest in an LLC, the interest of a member in a cooperative, a partnership interest in a limited partnership, a partnership interest in a partnership, and the interest of a member in a limited partnership association).
22. 6 Del. C. §18-702(a).
23. 6 Del. C. §18-702(b); See also 6 Del. C. §15-502 (stating that only a partner's economic interest may be transferred).
24. 6 Del. C. §18-702(b).
25. See Official Cmt. 6 to U.C.C. §9-322.
26. 11 U.S.C.A. §547.