

Commercial Law Newsletter

Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees



February 2019

IN THIS ISSUE

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FEATURED ARTICLES

Customer Due Diligence: Good Business and Law Enforcement Tool

By Cheryl M. Lott

USEFUL LINKS AND WEBSITES

SUBMISSIONS FOR UCC LAW JOURNAL

Dear Readers:

As the Editor in Chief of the Uniform Commercial Code Law Journal (UCC Law Journal), I am delighted to invite you to submit articles for consideration. The Journal, which is published quarterly by Thomson Reuters, has a proud and distinguished tradition. Professor Louis Del Duca, who was without a doubt one of the great minds in the field of commercial law and a mentor to so many, served as the Journal's first Editor in Chief, and it is truly a privilege to follow him.

Over its history, thus far, the Journal has published articles written by many of the leading academicians and practitioners in the field of commercial law, and Principal Attorney Editor Lisa Ovsiovitch and I are very interested in hearing from prospective authors in both groups. The Journal welcomes articles relating to various aspects of the Uniform Commercial Code that may include, but are in no way limited to, such topics as each of the UCC articles, contract law, commercial arbitration, damages, the Sarbanes Oxley Act, the Truth in Lending Act, alternative payment systems in the modern era, commercial issues in gaming systems, issues related to prepaid accounts, issues

Joint Report from the Chairs

Dear Members:

Please email either of us if you have any ideas for either of the Committees or wish to participate in any project, subcommittee or leadership role. The Committees have a number of projects underway. Our subcommittees and task forces are very active and always welcome input. Please do not hesitate to volunteer!

We hope you enjoy this issue, and invite you to get involved in your committee(s).

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Featured Articles

CUSTOMER DUE DILIGENCE: GOOD BUSINESS AND LAW ENFORCEMENT TOOL

By Cheryl M. Lott

Manafort conviction. Cohen plea deal. Bank Fraud. Tax evasion.

Department of Justice Investigations. FBI investigations. IRS Investigations. Secret Service Investigations. The list goes on.

The Federal Government has many different investigatory tools at its disposal. Financial institutions' internal Bank Secrecy Act / Anti-Money Laundering ("BSA/AML") programs

related to the 2010 Article 9 Amendments, issues related to the UCC and bankruptcy, litigation, secured lending, issues related to trusts and trustees, searching and filing issues under Article 9, the CISC, etc.

The next deadline for submitting articles to be considered for publication is April 1, 2019. I would be glad to provide additional information, including Thomson Reuters' Submission Instructions and Specifications, to anyone who is interested in having an article published in the Journal. Articles should be submitted by e-mail if possible, and the preferred format is Microsoft Word.

Very truly yours,

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VIEW CURRENT REPORTS AND
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fit squarely into this. But why, when the government has so many law enforcement resources at its finger tips? The answer is that financial institutions are in a unique position to gather information necessary to make sound business decisions, and this same information can prove useful to law enforcement efforts. This is why various regulators are focused on financial institution compliance and the integrity of BSA/AML programs.

There are numerous prongs/pillars of a BSA/AML compliance program. This article will focus on Customer Due Diligence ("CDD") programs and will touch upon some of the internal investigation and reporting aspects that flow from CDD programs.

I. Some BSA/AML Basics

The Bank Secrecy Act is the common name for a collection of regulations whose purpose is to set the framework for financial institutions to collect information that has "a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism."

The Secretary of the Treasury has delegated implementation, administration, and enforcement to the Financial Crimes Enforcement Network ("FinCEN"). FinCEN regulates not only the more commonly known currency transaction reporting ("CTR") and Suspicious Activity Reports ("SARs"), but also the basic gathering of customer information and transaction monitoring. This is known as Customer Due Diligence ("CDD"), which includes the customer identification process ("CIP"), and what is known as Know Your Customer ("KYC").

To comply with the KYC requirements of CDD, a financial institution must run various searches and collect basic information about its customers. Those who pose a higher risk require more detailed information and may require a higher level of scrutiny and Enhanced Due Diligence ("EDD"). A customer's higher risk rating can be based on the customer's net worth, type of business, source of wealth, loan levels, deposit amounts, whether they are considered a politically exposed person, or a variety of other factors.

CDD / EDD also requires certain levels of corroboration of the information based on the customer's risk rating. One of the consistently challenging areas of KYC is the detailed source of wealth for higher-risk rated customers. This is often times the most difficult area of CDD / EDD because it is a sort of grey area in that there is no explicit guide to determine when enough information is enough. In the end, the financial institution should have enough information so that it feels comfortable that (1) the funds are from legitimate sources, and (2) that the institution is comfortable maintaining the relationship. This aspect of CDD / EDD is also difficult because, in the age of identity theft, phishing, malware, etc. customers are more hesitant to volunteer additional information and may question why financial institutions request additional information.

II. Financial Institutions and Information Gathering

Recently financial institutions and their internal processes have gained more notoriety because of the Manafort trial. Although financial institutions do not have the resources of the Department of Justice, the FBI, or the IRS, financial institutions do have powerful tools that can assist law-enforcement in detecting illegal activity. CDD and EDD-What does that mean? As always, the answer is it depends. It depends on the types of services the financial institution offers, some of which may pose a higher risk. Regardless of the services an institution offers, however, it is clear that financial institutions must engage in the CDD, and sometimes EDD, process.

CDD and EDD provide financial institutions with the ability to collect information directly from customers that federal regulatory and investigatory agencies do not have. Financial institutions have the ability to gather information before they ever open accounts, and they have the ability to monitor these accounts, track payments, and request more information if the institution deems it necessary to maintain the relationship. Indeed, financial institutions can request additional information not only at account opening, but

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whenever it conducts a periodic review of its accounts. Other non-standard activity might also trigger special reviews. A financial institution is able to collect information regarding the account's intended use, change in use, increased deposits, increased transfers, etc. This information is not readily available to regulatory or investigatory agencies on their own.

III. Source of Wealth: A Critical Element of the KYC

The KYC process is not new. The detail of the source of wealth is always a contentious area. When it comes to the source of wealth and corroboration, the rule remains, "Trust but Verify." But the question that is still a source of great debate is how much information is enough. Indeed, there is no bright line rule but rather, whether the institution is comfortable with the amount of information it has. This is why corroboration is critical. The more corroboration an institution has, the more comfortable the institution can be with the account. But not all corroboration is equal. Learning from prior enforcement actions and congressional subcommittee testimony, independent sources of verification are the best types of corroborating documentation. The reason is clear. Take, for example, the recent Manafort trial and Cohen plea. Per the summaries of trial testimony, Mr. Manafort provided false documentation of his financial wherewithal to obtain loans from various financial institutions. Michael Cohen pled guilty to a similar charge: providing false information in connection with obtaining a credit decision.

Trust but *verify*.

Obtaining independent corroboration can be difficult. This is especially so when an institution is dealing with individuals or privately held companies. Institutions, however, must make an effort to obtain such corroboration.

When one cannot verify the information from the current or prospective customer, the financial institution, via its various levels of CDD, EDD, and compliance, must determine whether the information it has makes the institution sufficiently comfortable with the customer. This is a difficult question to answer. There are some easy situations in which the explanation for the source of wealth simply does not make sense. If this is the case, the institution should consider exiting an existing relationship, or forgoing a new relationship all together.

The obligation to gather information continues throughout the life of the account and may lead the institution down other investigatory paths. For example, if something odd is noted during the course of a periodic review, an institution may initiate an account activity review ("AAR"). If this review raises additional issues, the matter might be referred to the financial intelligence unit ("FIU") for a determination on whether a SAR should be submitted. This too is ongoing. An institution should update a submitted SAR when additional information comes to light or if the financial institution decides to end an existing relationship.

IV. After SAR Submission

SAR submission and update is not the end of the road when it comes to reporting and dealing with the regulatory and investigatory agencies. Regulators and investigators have similar interests but, generally, different purposes when reviewing an institutions BSA/AML compliance program and reporting. The regulator tends to focus more on the soundness of a financial institution's programs, while the investigator tends to focus more on the potential wrong doer – the bad customer or bad employee.

A. Regulators

A regulator's focus is generally the strength of the BSA/AML program. If an existing client relationship is terminated, regulators may be interested in understanding how the now former customer was able to obtain an account and maintain that account in the first instance. Was there any indicia of a problem with this customer or his/her banker earlier on? For this reason, the implementation of the CDD and EDD procedures is crucial. Not only must the basic information gathering procedures be in place, but the quality assurance

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procedures, and then audit procedures must likewise be implemented and tested. The audit procedure is crucial. The audit function includes testing the CDD and EDD procedures by auditing customer files to insure that all necessary information was collected, and that this information supports the legitimacy of the account. If an audited file is missing information, then the audit team should report that to the financial institution via proper channels, and the financial institution should do its best to remedy these issues as soon as possible. The institution may still have to disclose the issue to a regulator, but certainly it is better when the institution discovers and addresses the issue before a regulator uncovers the issue on its own.

B. Investigators

Investigators tend to have their eye more focused on the potential commission of a crime. Again, as we saw with the Manafort trial and Cohen plea, this can take different forms. Investigations do not only involve money laundering for terrorists or drug cartels. Investigations also involve claims of tax evasion, bank fraud, and a host of other possible crimes, including fraud, or any other violation of law. The information financial institutions gather during the ordinary course of business, can prove crucial. Indeed, financial institutions can conduct transaction history reviews as part of the regular account reviews to determine whether there are any anomalies noted that require additional documentation. Financial institutions can also conduct account activity reviews if deemed necessary to understanding the banking relationship. These reviews provide information that investigators may not be able to obtain elsewhere. Financial institutions maintain information regarding where deposits or payments originate, where transfers are going, and to whom funds are transferred, among other things.

This brings us to how it is that investigators come to have this information. Investigators may get information via SARs. They may also issue grand jury subpoenas to obtain information on investigatory subjects. The investigation that leads to grand jury subpoenas may have emanated from an institutions own SARs, another institutions SARs, or from an investigation completely separate from any SAR reporting.

When dealing with SARs and grand jury subpoenas, there are a few important things to note. First, when a SAR is filed, the BSA prohibits the financial institution and its personnel from confirming or even acknowledging that a SAR was filed. This is, at least in part, to maintain the confidentiality of the investigation and to prevent the suspect from learning of the investigation.

Second, when dealing with grand jury subpoenas, financial institutions must maintain the secrecy of the subpoenas and the information that is produced pursuant to such subpoenas. Financial institutions are barred from confirming or denying whether they have been served with grand jury subpoenas. Federal Rule of Civil Procedure, rule 6 expressly prohibits disclosure of any documents that were produced pursuant to a grand jury subpoena if those documents might reveal the nature of the grand jury's investigation.

Given the above, financial institutions must be very cautious in disseminating information related to SARs and grand jury subpoenas.

V. Conclusion

The BSA/AML procedures provide financial institutions with powerful tools to insure not only that the financial institution is reporting information as required, but also to insure the soundness of the financial institution. The better the institution is at detecting improper account use, the better off the financial institution will be because it will hopefully avoid troublesome accounts. Thus, an institution should be well invested in its CDD, EDD, and compliance programs. While these programs may not be revenue generators, they can certainly result in cost avoidance on poorly selected customers, and regulatory fines.

RECENT AMENDMENTS TO DELAWARE'S ENTITY LAWS WILL ALLOW FORMATION OF REGISTERED SERIES OF LLCs STARTING IN 2019, PERMIT DIVISIONS OF LLCs, AND EXTEND STATUTORY RATIFICATION TO NON-STOCK CORPORATIONS, AMONG OTHER CHANGES

By Norman M. Powell, John J. Paschetto, and Justin P. Duda (Young Conaway Stargatt & Taylor, LLP)

The Delaware legislature recently adopted amendments to the State's entity laws that, among other things, allow a Delaware limited liability company ("LLC") to "divide" itself into new LLCs, simplify the formation of for-profit LLCs intended to produce public benefits, and make the statutory ratification process to cure defective corporate acts available for use by Delaware non-stock corporations. In addition, beginning August 1, 2019, Delaware LLCs will be able to form "registered series." While having most of the advantages of LLC series that can currently be established, registered series will also be "registered organizations" under Article 9 of the UCC, with the result that a secured party will be able to perfect security interests in most assets of such series by filing a financing statement in Delaware. Aside from the amendments relating to registered series of LLCs, all of the amendments discussed below took effect on August 1, 2018.

Amendments Affecting Delaware LLCs and LPs

Registered Series of LLCs

The Delaware LLC Act (the "DLLCA") has permitted the establishment of series of LLC members, managers, interests, and assets since 1996. One of the attractive features of LLC series is that if certain statutory conditions are met, the assets associated with a given series are shielded from claims of creditors against other series of the LLC or against the LLC as a whole. 6 Del. C. § 18-215(b).

Yet LLC series have created challenges for anyone trying to situate them within the framework of UCC Article 9. A series established under the current DLLCA does not meet the UCC's definition of "registered organization" because such a series is not formed or organized "by the filing of a public organic record" with the state. UCC § 9-102(a)(71). Thus, it is unlikely that a security interest in the assets of a series can be perfected simply by filing a financing statement in Delaware, as would be the case with assets of a Delaware corporation, LLC, or other registered organization. Instead, one may need to file in the state where the series' place of business or chief executive office is located, treating the series in the same way one would treat a common law partnership. Continuing the analogy, limited liability partnerships, a subset of general partnerships, are formed without the need for any filing with a secretary of state or similar public office, but acquire limited liability features only by way of such a filing. Limited liability partnerships are therefore not registered organizations—their filings are prerequisites not to existence, but rather to the attribute of limited liability. See Permanent Editorial Bd. for the Unif. Commercial Code, PEB Commentary No. 17: Limited Liability Partnerships under the Choice of Law Rules of Article 9 (June 29, 2012).

Amendments to the DLLCA, taking effect August 1, 2019, will help resolve the series-perfection issue by enabling Delaware LLCs to form series that will constitute "registered organizations" under Article 9. The amendments will distinguish between a "protected series" and a "registered series." The term "protected series" will be used to refer to a shielded series of the type that can currently be established. Del. S.B. 183, 149th Gen. Assem. §§ 1, 20 (2018) (amending 6 Del. C. §§ 18-101(14), 18-215). "Registered series" will refer to a series formed by the filing of a certificate of registered series with the Delaware Secretary of State. Id. §§ 1, 21 (amending 6 Del. C. § 18-101(15) and adding § 18-218(d)). Since a registered series will accordingly be formed "by the filing of a public organic record" with the state, it will be a registered organization under UCC Article 9, and secured parties will therefore be able to perfect security interests in most types of assets owned by a registered series by filing a financing statement with the Delaware Secretary of State.

The certificate of registered series must provide the name of the LLC forming the registered series and the name of the registered series itself. Id. § 21 (adding 6 Del. C. § 18-218(d)). The name of a registered series must begin with the full name of the LLC, need not include the word "Series," and must meet the existing requirement of distinctness from the names of other entities on the records of the Secretary of State. Id. § 21 (adding 6 Del. C. § 18-218(e)). The requirement that the registered series' name start with the LLC's name should help ensure that someone searching in Delaware on, for example, the word "borrower" for liens recorded against Borrower LLC will also find liens recorded against any registered series of Borrower LLC, such as Borrower LLC Fund X, Borrower LLC Fund Y, etc. The amendments will also permit the reservation of registered-series names just as the DLLCA already permits the reservation of LLC names. Id. § 4 (amending 6 Del. C. § 18-103(a)). Unlike the certificate of formation for a Delaware LLC, a certificate of registered series will not be required to identify a registered agent in Delaware. Instead, the registered agent of an LLC will also be the registered agent for any registered series formed by the LLC. See id. §§ 5, 7 (amending 6 Del. C. §§ 18-104(d)-(e), 18-105).

A registered series will not necessarily have the asset-shielding characteristics of a protected series. For a registered series to be shielded, it will need to satisfy the same conditions as those currently in place for shielded series, i.e., the records maintained for the series must "account for the assets associated with such series separately from the other assets of the [LLC], or any other series thereof," plus the LLC's certificate of formation must provide "[n]otice of the limitation on liabilities" of the series, and the LLC agreement must

permit the formation of series. Id. § 21 (adding 6 Del. C. § 18-218(b)-(c)). Neither the certificate of formation nor the LLC agreement, however, must refer specifically to registered series or to DLLCA § 18-218 for the foregoing conditions to be met. Id. § 21 (adding 6 Del. C. § 18-218(a)-(b)).

In keeping with a registered series' status as a registered organization, the amendments will provide for the filing of a certificate of amendment to amend a certificate of registered series and the filing of a certificate of cancellation to cancel a certificate of registered series after the series has been dissolved and wound up. Id. § 21 (adding 6 Del. C. § 18-218(d)(3), (7)). The Secretary of State will issue—as requested and appropriate—a certificate of good standing for a registered series. Id. § 21 (adding 6 Del. C. § 18-218(d)(9)). The annual Delaware tax on registered series will initially be set at \$75 per series and will be due on June 1, the same date when the annual tax payable by the LLC (currently set at \$300) is due. Id. § 30 (amending 6 Del. C. § 18-1107).

Protected series will be able to convert into registered series of the same LLC and vice versa. Id. §§ 22, 23 (adding 6 Del. C. §§ 18-219 (protected series converting to registered series), 18-220 (registered series converting to protected series)). Also, two or more registered series of the same LLC will be permitted to merge. Id. § 24 (adding 6 Del. C. § 18-221). No series will be permitted to convert or merge under any other provisions of the DLLCA. Id. § 20 (amending 6 Del. C. § 18-215(a)).

LLC Division

The amendments make possible for the first time the “division” of a Delaware LLC into multiple Delaware LLCs and the allocation of assets and liabilities among such LLCs without causing thereby a transfer or distribution for purposes of Delaware law. According to the terminology used in new DLLCA § 18-217, the LLC effecting the division is the “dividing company” and will be the “surviving company” if it survives the division. The LLC or LLCs created in the division are “resulting companies” and, together with the surviving company (if any), are also “division companies.” 6 Del. C. § 18-217(a).

To divide, an LLC (the dividing company) must first adopt a plan of division. 6 Del. C. § 18-217(g). By default, the plan must be approved by a majority in interest of the dividing company's members. 6 Del. C. § 18-217(c). The plan must set forth how interests in the dividing company will be dealt with in the division (e.g., cashed out, exchanged for other interests, or left outstanding), how the assets and liabilities of the dividing company will be allocated among the division companies, the names of the surviving company (if any) and the resulting companies, and the name and address of a “division contact.” 6 Del. C. § 18-217(g). The division contact is an individual residing in Delaware or an entity formed under Delaware law that, for six years following the division, will provide to any requesting creditor of the dividing company the name and address of the division company to which the creditor's claim was allocated under the plan of division. Id. If the dividing company will be a surviving company, the plan of division may also effect any amendment to the operating agreement of the dividing company, unless its operating agreement prohibits an amendment specifically in connection with a division, merger, or consolidation. 6 Del. C. § 18-217(f).

The division is effectuated by filing with the Delaware Secretary of State a certificate of division containing, among other things, the name of the dividing company, whether the dividing company is a surviving company, the name of each division company, and the name and address of the division contact. 6 Del. C. § 18-217(h). When the certificate of division is filed, a certificate of formation must also be filed for each resulting company. Id. The operating agreement of each resulting company becomes effective upon the effectiveness of the division. 6 Del. C. § 18-217(i).

The effectiveness of the division causes the assets and liabilities of the dividing company to be allocated among the division companies pursuant to the plan of division. 6 Del. C. § 18-217(l). The allocation does not constitute a transfer or a distribution for purposes of Delaware law. 6 Del. C. § 18-217(l)(8), (m). Likewise, the division does not by default constitute a dissolution of the dividing company even if it is not a surviving company. 6 Del. C. § 18-217(d)). Instead, when the dividing company is not a surviving company, its existence will merely “cease” upon the division. 6 Del. C. § 18-217(l)(1).

In addition to the requirement of a division contact, a number of provisions in Section 18-217 should help protect creditors of a dividing company. A division “shall not be deemed to affect the personal liability of any person incurred prior to such division with respect to matters arising prior to such division[.]” 6 Del. C. § 18-217(b). Also, if the division is judicially found to constitute a fraudulent transfer, then each division company, including by definition the surviving company (if any), “shall be jointly and severally liable on account of such fraudulent transfer notwithstanding the allocations made in the plan of division[.]” 6 Del. C. § 18-217(l)(5). Finally, if any liabilities of the dividing company are not allocated under the plan of division, they will be the joint and several liabilities of all the division companies, again including by definition the surviving company (if any). 6 Del. C. § 18-217(l)(6).

Division will be available to any Delaware LLC formed on or after August 1, 2018, unless the LLC's operating agreement provides otherwise. For a Delaware LLC formed earlier, division will be deemed to be governed by the provisions of any written agreement to which the LLC is a party (including its operating agreement) that was entered into before August 1, 2018, to the extent that such provisions restrict, condition, or prohibit a merger of the LLC or transfer of its assets. 6 Del. C. § 18-217(o).

Use of Blockchain by LLCs and LPs

In 2017, the General Corporation Law for the State of Delaware (the “DGCL”) was amended to confirm that blockchain (or “distributed database”) technology could be used by corporations to satisfy certain statutory record-keeping and notice requirements. This year, similar amendments have been made to the DLLCA and the Delaware Revised Uniform Limited Partnership Act (the “DRULPA”), to provide certainty regarding the use of blockchain and other “networks of electronic databases” by LLCs and LPs. Del. S.B. 183 syn., 149th Gen. Assem. (2018) (regarding LLCs); see also Del. S.B. 182 syn., 149th Gen. Assem. (2018) (regarding LPs). Specifically, unless the operating agreement provides otherwise, blockchain may now be used by LLC members and managers, or by LP partners, in appointing proxies and in providing consent in lieu of voting at a meeting. 6 Del. C. §§ 18-302(d), 18-404(d) (regarding LLCs); 6 Del. C. §§ 17-302(e), 17-405(d) (regarding LPs). Blockchain may also be used by an LLC or LP in maintaining its records, provided that the form in which the records are kept “is capable of conversion into written form within a reasonable time.” 6 Del. C. § 18-305(d) (regarding LLCs); 6 Del. C. § 17-305(c) (regarding LPs).

Statutory Public Benefit LLCs

A new subchapter, Subchapter XII, has been added to the DLLCA to provide express statutory authorization for the formation of public benefit LLCs. 6 Del. C. §§ 18-1201 to 18-1208. As with the blockchain amendments just discussed, the amendments authorizing public benefit LLCs follow similar amendments made previously to the DGCL. See 8 Del. C. §§ 361-368 (enabling the formation of public benefit corporations, originally adopted in 2013).

A public benefit LLC formed under Subchapter XII is termed a “statutory public benefit” LLC because Subchapter XII does not provide the exclusive means for “the formation or operation of a limited liability company that is formed or operated for a public benefit (including a limited liability company that is designated as a public benefit limited liability company)[.]” 6 Del. C. § 18-1208. Accordingly, a statutory public benefit LLC (an “SPB-LLC”) is a “for-profit” LLC that not only is “intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner[.]” but also complies with the other requirements of Subchapter XII. 6 Del. C. § 18-1202(a).

Unlike a Delaware public benefit corporation, an SPB-LLC need not include in its name any language or abbreviation indicating that it is a public-benefit entity. Its certificate of formation must only state in the heading that the LLC is an SPB-LLC and set forth the specific public benefit or public benefits that the SPB-LLC will promote. *Id.* In addition, the operating agreement of an SPB-LLC “may not contain any provision inconsistent with” Subchapter XII of the DLLCA. *Id.* The amendments do not set forth any special approvals that must be obtained for an existing LLC to become an SPB-LLC. By contrast, the DGCL provides that a non-public-benefit corporation must obtain the approval of two thirds in interest of its stockholders to become a public benefit corporation. 8 Del. C. § 363(a). However, an SPB-LLC may not cease to be an SPB-LLC (including by amending its certificate of formation to remove the public-benefit language) without the approval of two-thirds in interest of the members. 6 Del. C. § 18-1203.

The definition of “public benefit” for, and the special standards applicable to, an SPB-LLC are similar to those set forth in the DGCL for a public benefit corporation. A public benefit is “a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests” aside from the SPB-LLC’s members qua members. 6 Del. C. § 18-1202(b). The persons who manage the SPB-LLC are required to manage it “in a manner that balances the pecuniary interests of the members, the best interests of those materially affected by the [LLC’s] conduct, and the specific public benefit or public benefits set forth in its certificate of formation.” 6 Del. C. § 18-1204(a). Two percent in interest of the members may sue the SPB-LLC derivatively to “enforce” the balanced-management requirement, but no member or manager shall have any monetary liability for failing to meet that requirement. 6 Del. C. § 18-1206; 6 Del. C. § 18-1204(a).

Moreover, in making a decision that implicates the balanced-management requirement, the persons who manage the SPB-LLC will be deemed to have satisfied their fiduciary duties if the decision is informed, disinterested, and “not such that no person of ordinary, sound judgment would approve.” 6 Del. C. § 18-1204(b). No member or manager of the SPB-LLC shall, “by virtue of the public benefit provisions” in the operating agreement or in Subchapter XII, have a duty to any person on account of an interest in the SPB-LLC’s stated public benefit or an interest “materially affected” by the SPB-LLC’s conduct. *Id.*

SPB-LLCs are subject to reporting requirements similar to those governing Delaware public benefit corporations. The SPB-LLC must provide to its members at least once every two years a report stating the objectives established to promote its stated public benefit, the standards adopted to measure its progress in promoting such public benefit, “[o]bjective factual information based on those standards regarding” its success in meeting its objectives, and an assessment of such success. 6 Del. C. § 18-1205.

Other Amendments to the DLLCA and DRULPA

A new section, modeled on DGCL § 284 as amended this year, has been added to the DLLCA to empower the Delaware Court of Chancery to cancel the certificate of formation of an LLC “for abuse or misuse” of the LLC’s “powers, privileges or existence[.]”

upon motion of the Delaware Attorney General. 6 Del. C. § 18-112(a). The Court of Chancery may also appoint trustees or receivers to wind up the affairs of such an LLC and make other orders respecting its assets, members, and creditors. 6 Del. C. § 18-112(b).

The fee for filing a corrected certificate with the Delaware Secretary of State has been changed. When any certificate filed with the Secretary of State under the DLLCA or DRULPA is to be corrected, one may make the correction by filing either a certificate of correction or a corrected version of the erroneous filing. Formerly, the fee for filing a corrected version was the same as the fee for whatever type of filing was being corrected, while the fee for filing a certificate of correction was \$180 regardless of the type of filing being corrected. Pursuant to the amendment, the fee for a corrected version is now the same as the fee for a certificate of correction. 6 Del. C. § 18-211(b) (regarding LLCs); 6 Del. C. § 17-213(b) (regarding LPs).

Amendments to the DGCL

Changes to Statutory Ratification

Section 204 of the DGCL, which took effect in 2014, sets forth self-help procedures by which a corporation can ratify and thus validate a “defective corporate act.” 8 Del. C. § 204(a). Defective corporate acts include the over-issuance of shares and any other act “purportedly taken by or on behalf of the corporation that is . . . within the power of a corporation under subchapter II of [the DGCL], but is void or voidable due to a failure of authorization” required by the DGCL or the corporate documents. 8 Del. C. § 204(h)(1). Subchapter II of the DGCL deals with the scope of the powers that may be exercised by a corporation formed under the DGCL. See 8 Del. C. §§ 121-127.

Several important amendments have been made this year affecting § 204. First, the § 204 validation procedures can now be used by non-stock corporations, which include almost all nonprofit corporations formed in Delaware. Previously, § 204 applied only to corporations that issue stock. Now—as a result of amendments to DGCL § 114, which contains the general rules for “translating” stock-corporation provisions to apply them to non-stock corporations—§ 204 can be employed by non-stock corporations as well. 8 Del. C. § 114. The amendments to § 114 also enable non-stock corporations to make use of DGCL § 205, which provides for, among other things, court review of validation efforts undertaken pursuant to § 204.

Second, the 2018 amendments have resolved an issue raised by a 2017 decision construing the term “defective corporate act” as used in § 204: *Nguyen v. View, Inc.*, C.A. No. 11138-VCS, 2017 WL 2439074 (Del. Ch. June 6, 2017). As noted above, a defective corporate act is one “within the power of a corporation” but void or voidable “due to a failure of authorization.” In *Nguyen*, the Court of Chancery held that an act was not “within the power of a corporation” for purposes of § 204, where the act was taken by the defendant corporation despite the plaintiff stockholder’s deliberate refusal to provide the necessary authorization. The holding of *Nguyen* therefore seemed to make the efficacy of § 204 depend on whether the failure to authorize a purported defective corporate act was intentional or inadvertent.

The 2018 amendments have now made clear that the underlying reason for a failure of authorization—including a deliberate withholding of consent—is not relevant to whether an action constitutes a defective corporate act under § 204. This clarification was accomplished by amending the definition of “defective corporate act” to provide that the determination whether an act was “within the power of a corporation” is to be made “without regard to the failure of authorization” that the corporation is attempting to remedy under § 204. 8 Del. C. § 204(h)(1). Accordingly, if, for example, a corporation sold substantially all of its assets even though its majority stockholder had deliberately refused to provide the approval needed under DGCL § 271, the fact that the stockholder had deliberately withheld approval would not cause the sale to be outside “the power of a corporation” such that the sale could not be a defective corporate act ratifiable under § 204. Nevertheless, as the accompanying legislative synopsis makes clear, the amendments do not change the Court of Chancery’s power, under DGCL § 205, to find a given instance of § 204 ratification ineffective based on equitable or other considerations. Del. S.B. 180 syn., 149th Gen. Assem. (2018).

Third, § 204 has been amended to make clear that its procedures can be used to ratify defective corporate acts when ratification would otherwise require a stockholder vote but the corporation has no “valid stock” outstanding. 8 Del. C. § 204(c)(2). Fourth, § 204 now provides that where stockholder approval is required for ratification, and the defective corporate act to be ratified “involved the establishment of a record date[.]” notice must be given to holders of valid and putative stock as of the record date rather than as of the time of the defective corporate act, as is the case in other circumstances. 8 Del. C. § 204(d). Fifth, such notice may now be given by means of a public filing with the Securities and Exchange Commission if the corporation’s stock is listed on a national securities exchange. 8 Del. C. § 204(g). And sixth, language has been added to provide that the failure to obtain authorization in compliance with disclosures in a proxy or consent solicitation statement can give rise to a defective corporate act ratifiable under § 204. 8 Del. C. § 204(h)(2).

The amendments to § 204 are effective only as to defective corporate acts “ratified or to be ratified pursuant to resolutions adopted by a board of directors on or after August 1, 2018.” Del. S.B. 180 syn., 149th Gen. Assem. (2018).

Changes to Appraisal

The amendments have made certain adjustments to the interplay between the appraisal statute and the provisions, added to the DGCL in 2013, that make possible a merger without a stockholder vote when the merger follows a successful tender offer (i.e., a so-called “intermediate-form merger”). 8 Del. C. §§ 251(h), 262.

First, the amendments have extended the appraisal statute’s so-called “market-out exception” to make it available in the case of intermediate-form mergers. The market-out exception already provided, in sum, that a stockholder will not have appraisal rights as a result of a merger if the stockholder’s pre-merger stock was publicly traded or held of record by more than 2,000 holders, and if the stockholder was not required to accept in the merger anything other than stock in the surviving corporation, stock in another corporation whose shares are publicly traded or held of record by more than 2,000 holders, and cash solely in lieu of fractional shares. 8 Del. C. § 262(b). Under the appraisal statute as previously drafted, the market-out exception could never apply to intermediate-form mergers. The 2018 amendments have reversed this, such that the market-out exception can apply to intermediate-form mergers just as it can to most other kinds of mergers.

Second, the appraisal statute has been amended to clarify that the statement of dissenting shares supplied by the surviving corporation must take into account shares not tendered into a tender offer that preceded an intermediate-form merger. The appraisal statute provides that within 120 days after a merger, any stockholder that has properly demanded appraisal will be entitled to receive from the surviving corporation, upon request, a statement of the number of shares not voted in favor of the merger and with respect to which appraisal has been demanded, and the number of holders of those shares. 8 Del. C. § 262(e). As amended, the appraisal statute now requires that the statement by the surviving corporation also include the same information regarding shares not tendered in a tender offer in advance of an intermediate-form merger and with respect to which appraisal has been demanded. *Id.* The amendments to the appraisal statute are effective only as to mergers “consummated pursuant to an agreement entered into on or after August 1, 2018.” Del. S.B. 180 syn., 149th Gen. Assem. (2018).

Other DGCL Amendments

Under DGCL § 284, the Court of Chancery has jurisdiction to revoke a certificate of incorporation “for abuse, misuse or nonuse of its corporate powers, privileges or franchises.” 8 Del. C. § 284. This section has been amended to provide that the Delaware Attorney General has the exclusive authority to seek such a revocation. (As discussed above, a section tracking amended DGCL § 284 was added to the DLLCA by the 2018 amendments.)

Finally, the DGCL has been simplified in two respects regarding tax-exempt corporations. The amendments have removed the requirement that a tax-exempt corporation include “the specific facts entitling the corporation to exemption from taxation” in the annual franchise tax report it files with the Delaware Secretary of State. 8 Del. C. § 502(a). In addition, the amendments have removed the obsolete requirement that upon the revival of a tax-exempt corporation under DGCL § 313, the Secretary of State issue a certificate that the corporation has been revived. 8 Del. C. § 313(b).

NOVATION UNDER NEW YORK LAW

By Glen F. Strong

Since the decision by the Sixth Circuit in *In re Fair Fin. Co. v. Textron Fin. Co.*, 834 F.3d 651 (6th Cir. 2016), there has been a great deal of interest in the factors that could result in an amended and restated agreement constituting a novation as opposed to merely a modification of a prior agreement. Since so many commercial transactions are governed by New York law, I thought that it would be useful to examine the elements of a novation under New York law.

A “novation” is actually a special kind of “substituted contract.” According to the Restatement (Second) of Contracts, a “substituted contract is a contract that is itself accepted by the obligee in satisfaction of the obligor’s existing duty” and which “discharges the original duty” and a “novation” is “a type of substituted contract that has the effect of adding a party, either as obligor or obligee, who was not a party to the original duty.” See RESTATEMENT (SECOND) OF CONTRACTS §§ 279, 280 cmt. a (AM. LAW INST. 1981). As the court explained in *National Am. Corp. v. Federal Republic of Nigeria*, 448 F.Supp. 622 (S.D.N.Y. 1978), “a substitute contract operates as its name implies as an immediate discharge and satisfaction of existing claims in return for the new contract, even though performance is to commence in the future. Should a breach later occur, the creditor is limited to his rights under the substitute agreement.” *Id.* at 643. The Restatement (Second) of Contracts notes that courts frequently use the term “novation” when the broader term “substituted contract” is what is really meant to be referenced. See RESTATEMENT (SECOND) OF CONTRACTS § 280 Reporters Note cmt. a (AM. LAW INST. 1981). Since “novation” is the terminology used by many of the courts, in this article I use the term “novation” when referencing any substituted contract, even if the substituted contract is between the same parties and is not adding a party.

Pursuant to New York case law, the elements of a novation are: (1) a valid previous obligation, (2) an agreement by the parties to a new obligation, (3) extinguishment of the old contract, and (4) a valid new contract. See *Kinsella v. Merchants Nat’l Bank and Trust*

Co. of Syracuse, 34 A.D.2d 730 (N.Y. App. Div. 1970); *Wasserstrom v. Interstate Litho Corp.*, 114 A.D.2d 952 (N.Y. App. Div. 1985); *Flaum v. Birnbaum*, 120 A.D.2d 183 (N.Y. App. Div. 1986); and *Warberg Opportunistic Trading Fund L.P. v. GeoResources, Inc.*, 151 A.D.3d 465 (N.Y. App. Div. 2017). The issue of novation usually arises where a party is being sued on a contract and the defendant raises a defense that there was a new contract which constituted a novation of the prior agreement, with the result that the defendant cannot be held liable under the prior agreement because that prior obligation has been extinguished and replaced with a new contract. See *KIOP Forest Ave, L.P. v. Southern Smokehouse of Staten Island, Inc.*, 28 Misc.3d 1214(A) (N.Y. Civ. Ct. 2010).

In most instances where the issue of novation arises, there was a valid previous obligation. However, if a valid prior agreement does not exist, there cannot be a novation. Also, if the purported new agreement is not a valid new contract then there cannot be a novation. This is demonstrated in *Wasserstrom v. Interstate Litho Corp.*, 114 A.D.2d 952 (N.Y. App. Div. 1985). There, the court held that one reason a novation did not occur was that there was no valid new contract. The court stated that “defendant never agreed to the new contract, as is clearly evidenced by its refusal to sign it. Thus, a valid new contract was never created.” *Id.* at 954. In addition, like any contract, there needs to be consideration in order for the new contract to be a valid contract. However, in most cases where there is a novation, consideration is not an issue since “discharge of the original contract usually constitutes sufficient consideration for the substituted contract.” *Id.* at 955.

In most instances where the issue of novation arises, the main dispute is not whether or not there is a valid previous obligation or a valid new contract, but rather whether the parties agreed to extinguish the prior obligation. As the court stated in *Holland v. Fahnestock & Co.*, 2002 WL 1774230 (S.D.N.Y. 2002), “[t]he key element of a novation is that the parties unequivocally intended to extinguish and discharge the prior obligation. If, in fact, there was an agreement to extinguish the prior obligation, then the other party is not permitted to make a claim under the prior agreement but instead is limited to making a claim under the new contract.” *Id.* at *9. The intention of the parties can be demonstrated either by the documents themselves or by the circumstances surrounding the negotiations. “Intention, of course, may be demonstrated conclusively by the documents, in which case the conclusion is one of law, or by the circumstances surrounding the negotiations, at which point it becomes an issue of fact.” *National Am.*, 448 F.Supp. at 643.

As the court stated in *Yahaya v. Hua*, 1989 WL 214481 (S.D.N.Y. 1989), “[t]o establish a novation, there must be a clear and definite intention on the part of all concerned parties that such is the purpose of the agreement.” *Id.* at *4. Likewise, as the court stated in *Wang v. Chen*, 1992 WL 7840 (N.Y. Sup. Ct. 1992), “[n]ot only must the intention to effect a novation be clearly shown, but a novation must never be presumed.” *Id.* at *6 (quoting *Beck v. Manufacturers Hanover Trust Co.*, 481 N.Y.S.2d 211, 218 (N.Y. Sup. Ct. 1984)).

So, in order for there to be a novation, it must be clearly established that it was the intent of the parties that the prior obligation be completely discharged and replaced with the new contract.

It is instructive to review the language and circumstances of the agreements where courts interpreting New York law have found a novation and the language and circumstances of the agreements where courts interpreting New York law have found that there was not a novation. In *National American Corporation v. Federal Republic of Nigeria*, the second agreement contained the following language: “Each of the parties hereto hereby releases and discharges the other from all . . . claims and demands whatsoever which each of them now has or . . . had or may have” *National Am.*, 448 F.Supp. at 644.

The court determined that this language indicated the intent to discharge the obligations under the prior agreement and replace them with the new contract, which constituted a substituted contract.

In *Old Oak Realty v. Polimeni*, 232 A.D.2d 536 (N.Y. App. Div. 1996), the court found that the use of the language “paid in full” was sufficient to conclude that the parties intended: (i) to extinguish the old obligation under their prior contract; and (ii) to replace that old contract with a valid new contract. Thus, the court held that a novation occurred. In *Flaum v. Birnbaum*, 120 A.D.2d 183 (N.Y. App. Div. 1986), the debtor had originally signed a note for \$140,000 which was guaranteed. Later, the debtor borrowed an additional \$100,000 and executed a new note in the amount of \$240,000. This new note was not guaranteed, but it was secured by new collateral. The court held that these facts constituted a novation which resulted in: (i) the extinguishment of the obligations under the original note; and (ii) the replacement of those obligations with the obligations contained in the new note.

As indicated above, under New York law, for there to be a novation, it must be clearly shown that the parties intended to extinguish the original agreement and replace it with a new agreement. If the intent is not clear, then the courts will typically not find a novation. In *Trans-Orient Marine Corp. v. Star Trading & Marine, Inc.*, 736 F.Supp. 1281 (S.D.N.Y. 1990), *aff’d in part and rev’d and remanded in part*, 925 F.2d 566 (2d Cir. 1991), one of the parties argued that there was a novation because certain provisions of the second agreement were different from the provisions of the original agreement. In that case, both the old agreement and the new agreement covered the same commodity shipments. The new agreement, however, contained the following provisions that differed from the old agreement: (i) the term of the new agreement was one year instead of five years; and (ii) the amounts to be paid as commissions under the new agreement were reduced. The court stated that “the inconsistencies are insufficient to indicate Trans–Orient’s ‘clear and definite intention’ to novate. Moreover, a novation must never be presumed.” *Id.* at 1284.

In *Abuelhija v. Chappelle*, 2009 WL 1883787 (S.D.N.Y. 2009), in a dispute between Dave Chappelle and his agent, Mustafa Abuelhija, Abuelhija argued that a second contract (which provided for greater payments from Chappelle to Abuelhija) was a novation of the first contract and superseded the first contract. Abuelhija pointed to two provisions of the new contract which he claimed proved that there was an intent for there to be a novation. The first provision was a standard merger clause in the miscellaneous section which stated: “This Agreement contains the entire understanding between the parties, and supersedes all understandings of the parties hereto relating to the subject matter herein, and cannot be changed or terminated orally.” *Id.* at *6. The court felt that a standard merger clause

was not sufficient to show intent to extinguish the prior agreement. “An intent to extinguish earlier contractual obligations cannot be inferred from a standard merger clause simply because the parties to the later agreement also entered an earlier contract on a related topic. The merger clause does not evidence a ‘clear expression’ of intent to extinguish a separate and distinct written contract.” *Id.* The second provision provided for retroactive participation rights. The court stated that “even if this provision creates some doubts about whether the profit participation rights under the 2002 Agreement survive the adoption of the 2004 Agreement, a mere reference to ‘retroactive’ participation rights is clearly insufficient to extinguish all of the obligations created under the 2002 Agreement which concerns much more than profit participation.” *Id.* Accordingly, the court determined that there was no novation.

In the case of *In re Cohen v. Treuhold Capital Group*, 422 B.R. 350 (E.D.N.Y. 2010), the parties had entered into a letter agreement in January 2007 to resolve certain disputes regarding real property. Because certain of the parties requested additional time to repay the obligations, the parties entered into a Settlement and Forbearance Agreement in April 2007. The April 2007 Settlement and Forbearance Agreement contained a merger clause which provided that “[a]ll prior understandings and agreements between the parties herein whether oral or written (including, but not limited to, that certain letter agreement dated January 12, 2007 among Metropolitan, Cohen and Wissak), are superseded by this Agreement, which fully and completely expresses the agreement between the parties hereto with respect to the subject matter hereof.” *Id.* at 364.

Certain parties argued that this merger clause indicated that there was a novation, with the result that they could not be sued under the January 2007 letter agreement, but only under the subsequent April 2007 Settlement and Forbearance Agreement. The court noted:

Appellants contend that the April 2007 Settlement Agreement was a novation because it explicitly was intended to replace the January 2007 Agreement between the parties. The Appellants point to the presence of a merger clause in the April 2007 Agreement as indicative of the parties’ intent to create such a novation. *Id.* at 374.

The court, however, did not think that this language was sufficient evidence of the intent of the parties to create a novation. The court stated:

Moreover, even if the language in the merger clause did weigh in favor of the parties’ intention to effectuate a novation, there is contrary evidence that the parties intended to create an executory accord. The April 2007 Agreement is labeled a ‘Settlement and Forbearance Agreement,’ and the language of the Agreement itself contemplates an executory accord.” *Id.* at 374–375.

The court also explained that “[a]lthough a merger clause certainly provides some evidence of parties’ intent to form a novation, the presence of a merger clause is not determinative of the novation inquiry.” *Id.* at n.7. The court then determined that the April 2007 Agreement was not a novation.

While there are very few New York law novation cases involving amended and restated agreements, one helpful case is found in the Second Circuit. In *Banque Nationale de Paris v. Batmanghelidj*, 108 F.3d 1369 (2d Cir. 1997), the Second Circuit had to determine whether an amended and restated promissory note was a novation which superseded the prior note or was merely a modification of the prior note. In 1989, the debtors executed a Revolving Credit Note in favor of Banque Nationale de Paris. In 1990, the debtors executed an Amended and Restated Note and then in 1991 executed a Second Amended and Restated Note. The Revolving Credit Note and the First Amended and Restated Note each provided for the non-exclusive jurisdiction of courts in the State of New York. However, in the Second Amended and Restated Note, the submission to jurisdiction provision was revised to instead provide for the non-exclusive jurisdiction of courts in the District of Columbia. When Banque Nationale de Paris sued the debtors in the United States District Court for the Southern District of New York, the debtors objected. They claimed that they had not consented to the jurisdiction of courts in New York, only to the jurisdiction of the courts in the District of Columbia. The district court looked at the submission to jurisdiction provisions in the Revolving Note, the Amended and Restated Note and the Second Amended and Restated Note and interpreted the clauses together. The debtors claimed that the court should only have looked at the submission to jurisdiction clause contained in the Second Amended and Restated Note because it was intended to replace the prior notes, not modify them.

On appeal, the Second Circuit looked at the language in the Second Amended and Restated Note. The Second Amended and Restated Note stated: “This Second Amended and Restated Note is not intended to be, nor should it be construed as, a novation of the existing loan evidenced by the ... Note and the First Amended and Restated Note, but rather is an extension, increase and modification of the existing loan.” *Id.* at 1369.

The court interpreted this language as an indication that only a modification was intended and not a novation:

Although it is well settled that when parties enter into an agreement that expressly supersedes a prior agreement, the prior agreement shall be void, (citation omitted), it is equally clear that when a new agreement merely modifies an earlier agreement, any provisions of the earlier agreement that are consistent with the modified version will survive. (citations omitted). In the present case, we agree with the district court that the Second Amended Note, by its clear terms, modified, rather than superseded, the terms of the Note. Accordingly, the two different forum selections clauses should be read together to the extent that they are compatible. *Id.*

Issues could potentially arise, however, when the amended and restated agreement contains, not only amendment and restatement language, but also language, such as a merger clause, which provides that the amended and restated agreement “supersedes” all prior agreements. This appears to have been the case in *Fair Finance* (interpreting Ohio law), where, while the amended and restated agreement contained amendment and restatement language, it did not explicitly state that it did not constitute a novation and also contained a merger clause which stated that the amended and restated agreement superseded all prior oral or written agreements relating to the subject matter thereof. Stating that the new or amended and restated agreement supersedes the prior agreement seems inconsistent with the intent that such agreement not constitute a novation. As the Second Circuit stated in *Health-Chem Corp. v. Baker*, 915 F.2d 805 (2d Cir. 1990), “The word “supersede” has been defined at various times to mean ‘set aside,’ ‘annul,’ ‘displace,’ ‘make void,’ and ‘repeal.’ (Citations omitted). When the parties to a contract enter into a new agreement that expressly supersedes the previous agreement, the previous agreement is extinguished, thereby reducing the remedy for breach to a suit on the new agreement.” *Id.* at 811. If an agreement supersedes a prior agreement, then the prior agreement is extinguished, which seems inconsistent with the intent that there not be a novation. If the intent of the parties is that there not be a novation, using language which provides that a new agreement supersedes a prior agreement runs the risk of adding ambiguity regarding the intent of the parties. However, unlike the court in *Fair Finance*, courts interpreting New York law have not been as quick to find that a merger clause indicated that the parties intended a novation. As indicated above, the courts in *Abuelhija v. Chappelle* and *In re Cohen*, interpreting New York law, determined that the presence of merger clauses providing that the new agreement “supersedes” all prior agreements was not sufficient to prove intent of a novation. However, if it is the intent of the parties that a new or amended and restated agreement not constitute a novation, it would be advisable to clearly state that the new or amended and restated agreement is not intended to constitute a novation and also to avoid including provisions which purport to provide that the new or amended and restated agreement “supersedes” the prior agreement.

In summary, under New York law the elements of a novation are: (1) a valid previous obligation, (2) an agreement by the parties to a new obligation, (3) extinguishment of the old contract, and (4) a valid new contract. In order to effect a novation, the intent of the parties to effect a novation must be clearly shown and a novation is never presumed. If the parties to a new or amended and restated agreement clearly indicate that such new or amended and restated agreement is not intended to constitute a novation of the prior agreement, then courts interpreting New York law should respect that intent.

UCC Spotlight

By [Carl S. Bjerre](#) and [Stephen L. Sepinuck](#)



The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code or related commercial laws. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence. Instead, it is to shine a spotlight on analytical errors, and thereby provide practitioners and judges with reason to disregard the decisions.

In re Woodbridge Group of Companies, LLC, 590 B.R. 99 (Bankr. D. Del. 2018)

Contractual restrictions on assignment present a clash of two fundamental principles of American law: freedom of contract and freedom to alienate property. The former suggests that contracting parties should be able to construct their relationship as they see fit, with either or both parties being bound by an agreement not to assign their rights. The latter suggests that contractual rights, like any other property, should be freely transferable so as to facilitate commerce.

Article 9 of the U.C.C. comes down rather firmly on the side of free alienability of property through its rules that override many contractual restrictions on assignment. Unfortunately, the sections containing these rules are very detailed and somewhat opaque, and that probably caused the court in this case to badly misinterpret them.

The facts of the case are relatively simple. Prior to bankruptcy, the debtor issued three promissory notes expressly providing that the lender's rights were not assignable, and that any such attempted assignment would be null and void. After the bankruptcy petition, and despite this clause, the holders of the notes purported to sell them to a buyer, which then filed a proof of claim. The debtor objected to the claim.

The court first concluded that Delaware law generally allows contracting parties to restrict assignment, provided the language used deals not merely with the right to assign, but also with the power to assign. In *re Woodbridge Group of Companies, LLC*, 590 B.R. 99, 103-04. The language in the notes satisfied this requirement because it included language expressly indicating that an attempted assignment was “void.” The court then ruled that the fact that the debtor had breached the notes by failing to pay did not affect the prohibition on assignment. Neither of these conclusions is objectionable.

The court then addressed the anti-assignment rules in U.C.C. Article 9, and concluded that they did not override the restriction on assignment. It therefore sustained the debtor's objection to the assignee's claim. Unfortunately, in so ruling, the court applied the wrong section and misread the section that it did apply.

Before further discussing the court's reasoning, it is useful to understand how Article 9 does deal with this type of situation.

First, § 9-109(a)(3) provides that Article 9 applies to a sale of a promissory note. So, regardless of whether the promissory notes are sold or used as collateral for a loan – that is, regardless of whether a note holder assigns the notes outright or as security for an indebtedness – Article 9 applies to that transaction. In sales of promissory notes, the interest of the buyer is nonetheless called a “security interest,” for terminological convenience, because most, although not all of, Article 9's rules apply to such sales. U.C.C. § 1-201(b)(35).

Second, Article 9 contains several sections dealing with contractual restrictions on assignment, each applicable to different collateral or to different types of transactions in such property. The two most important, and the two at issue in this case, are § 9-406 and § 9-408. The scopes of these sections do not overlap – that is, to no transaction will both sections apply – but they are a bit convoluted. The following chart depicts them (a more detailed version of this chart, also covering legal restrictions on assignment, appears in PRACTICE UNDER ARTICLE 9 OF THE UCC (ABA 2d ed. 2013)).

	Accounts & Chattel Paper	Payment Intangibles & Promissory Notes	General Intangibles	Health-Care- Insurance Receivables
Contractual Restriction on Sale	§ 9-406(d)	§ 9-408(a), (d)	Unaffected by Article 9	§ 9-408(a), (d)
Contractual Restriction on Encumbrance	§ 9-406(d)	§ 9-406(d)	§ 9-408(a), (d)	§ 9-408(a), (d)

Determining which section applies can matter because the rules have differing effects. When § 9-406 applies, it both overrides a contractual restriction on assignment and permits the assignee to enforce the obligation against the counter-party. In contrast, when § 9-408 applies, it overrides the contractual restriction on assignment, but does not permit enforcement by the assignee. In other words, it does not require the counter-party “to recognize the security interest [or to] pay or render performance to the secured party.” U.C.C. § 9-408(a),(d)(3).

Unfortunately, the court erred at every step in its analysis of how Article 9 applies to the assignment of promissory notes.

The court first balked at the idea that the sale of a promissory note necessarily creates a security interest. The court looked to § 9-109 comment 4, which states that “[a]lthough this Article occasionally distinguishes between outright sales of receivables and sales [sic, ‘transfers’] that secure an obligation, neither this Article nor the definition of “security interest” . . . delineates how a particular transaction is to be classified. That issue is left to the courts.” The court then wrote that “[i]f, as [the assignee] assumes, the drafters of the UCC intended for there to be a bright line rule, classifying all sales of promissory notes as security interests, the courts would have nothing to decide.” *Id.* at 108.

That is not correct. All sales of promissory notes are indeed termed “security interests,” as noted above. This, however, does not leave the courts with “nothing to decide,” because in order to determine whether some rules within Article 9 apply, a court must distinguish between a security interest that is an outright sale and a security interest that secures an obligation. Most notably for purposes of this case, and as the chart above indicates, for promissory notes the characterization of a transaction as a sale or as a secured borrowing affects whether § 9-406 or § 9-408 applies. The distinction is also relevant to whether the assignor has a right to a surplus or obligation for a deficiency, see U.C.C. § 9-608(b), and, somewhat indirectly, to whether the assignee must proceed in a commercially reasonable manner when exercising collection rights, see U.C.C. § 9-607(c).

The court then proceeded to deal with whether § 9-406 or § 9-408 applies, and concluded that if, as the assignee argued, § 9-408 applied, that would “render § 9-406 superfluous.” *Id.* at 108. That too was incorrect. As noted above, the two sections have different, non-overlapping scopes. Section 9-406 applies to, among other things, a transaction in which a security interest is granted in a promissory note to secure an indebtedness. Section 9-408 applies to a sale of a promissory note, as is provided by both § 9-406(e) and § 9-408(b). The court cited to § 9-406(e) but seems to have interpreted it as an exception to Article 9's invalidation of contractual restrictions on assignment, rather than as simply as a statement of § 9-406(d)'s scope.

Finally, wrapping up its muddled analysis, the court wrote, “[i]n short, § 9-406 endorses the enforceability of anti-assignment provisions in the sale, or assignability, of promissory notes, whereas § 9-408 is applicable only to grants of security interests.” *Id.* at 109.

Everything in this statement is wrong. The latter portion of this statement seems to be saying that, as applied to promissory notes, § 9-408 applies to security interests that secure an obligation, not to security interests that are sales, when in fact the opposite is true. The first part of the statement is even worse. Section 9-406 does not apply to the sale of a promissory note (other than a disposition conducted pursuant to § 9-610 or an acceptance under § 9-620) and, more important, it does not “endorse the enforceability of anti-assignment provisions . . . in a promissory note.” On the contrary, when it applies, § 9-406 overrides contractual restrictions on assignment more fully than does § 9-408. In short, either § 9-406 does not apply to a transaction, or it obliterates a restriction on assignment. It never “endorses” a restriction on assignment.

The court’s U.C.C. errors were several and serious. And because of these U.C.C. errors, the court did not reach a further interesting issue, this time of bankruptcy law: when a promissory note has been effectively sold, but state law provides that the buyer cannot enforce (see discussion of § 9-408(a) and (d)(3) above), which party has the allowable claim in bankruptcy: the buyer or the seller?

McCarthy Improvement Co. v. Manning & Sons Trucking & Utilities, LLC,
2018 WL 3009021 (D.S.C. 2018)

McCarthy Improvement Co. was the general contractor handling a highway improvement project in South Carolina. McCarthy hired a subcontractor to haul the needed trucks and deliver and fill the dirt. The subcontractor, in turn, used its rights to be paid by McCarthy as collateral for a loan from Southstar Capital, LLC. Southstar notified McCarthy to make payments directly to Southstar on invoices from the subcontractor, and McCarthy did so.

Among the payments that McCarthy made to Southstar were about \$65,000 in “surcharges” billed by the subcontractor that McCarthy later claimed were not permissible under the subcontract. While seeking repayment from the subcontractor, McCarthy also filed a complaint against Southstar directly, asserting claims for repayment based on mistake and unjust enrichment. Southstar moved to dismiss, arguing that McCarthy had failed to state a claim. The court here granted that motion, concluding that UCC Article 9 required McCarthy to assert its claim only against the subcontractor, not Southstar. In the process, the court misconstrued the applicable Article 9 provisions and deprived McCarthy of the opportunity to pursue non-UCC remedies against Southstar.

The court’s major error was in thinking that the starting point for analysis of McCarthy’s claim must be in Article 9 itself, rather than in the common law of restitution. Specifically, the court looked to U.C.C. § 9-404(b), which provides that “the claim of an account debtor against an assignor may be asserted against an assignee under subsection (a) only to reduce the amount the account debtor owes.” McCarthy was indeed an account debtor (because it was obligated to the subcontractor for services rendered, see U.C.C. § 9-102(a)(2), (3)), and Southstar was an assignee (because the subcontractor, as assignor/debtor, had transferred its rights to Southstar as security, see U.C.C. § 9-102 cmt. 26). However, § 9-404(b) is fairly limited: it is a partial response to the fact that many assigned contracts carry potential obligations running not just from the account debtor to the assignor, but also from the assignor to the account debtor. Under § 9-404(a), the account debtor is entitled to reduce its obligation to the assignee by the amount that the debtor owes to the account debtor, but under subsection (b), the account debtor is denied a net contractual recovery from the assignee. In short, the assignee does not become a net contractual obligor to the account debtor merely because it receives the assignment. Cf. U.C.C. § 3-305(a)(3) (similar rule for holders, other than holders in due course, of a negotiable instrument); U.C.C. § 9-402 (security interest alone does not subject secured party to liability in contract or tort for debtor’s acts or omissions). Section 9-404(b) says nothing about whether the assignee who has already received payment from the account debtor must return it. After all, in such a situation, the assignee ends up at worst even, and not a net obligor. Consequently, the limitation in § 9-404(b) should not have defeated McCarthy’s claim.

Subject to particular facts that are discussed below, payors are generally entitled to restitution for payments that were either made by mistake or induced by a material misrepresentation. See Restatement (Third) of Restitution and Unjust Enrichment §§ 6 & cmt. c, 13 & cmt. g. The mistake may concern either the existence of a questionable contract or the extent of a contract that is conceded to exist; and the representation may be made by either the transferee itself or a third party (for example, the subcontractor here). U.C.C. § 9-404(b)’s limitation on an account debtor’s ability to assert a “claim” against an assignee does not interfere with these restitutionary principles because, as is made explicit in § 1-103(b), “the principles of law and equity, including . . . the law relative to . . . misrepresentation, . . . mistake, . . . and other . . . invalidating cause supplement [the UCC’s] provisions” unless displaced by particular provisions. The court did consider whether Article 9 displaced the law of restitution in this context, but incorrectly concluded that the answer was yes based on an inapposite precedent and an overbroad notion of when a displacement exists.

Read carefully, § 9-404(b) presents no conflict with the law of restitution because, as indicated above, § 9-404(b) is more limited than the court seems to have believed. Subsection (a) provides, in pertinent part, that the assignee’s rights are subject to “all terms of the agreement between the account debtor and assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract,” and in that context, subsection (b)’s phrase “the claim” clearly refers back to subsection (a)’s “any . . . claim in recoupment arising from the transaction.” Hence subsection (b) does not limit all affirmative claims of an account debtor, but only

claims in recoupment, i.e. contract-based claims that are technically distinct from defenses. McCarthy's restitution claims were not claims in recoupment, and in fact restitutionary claims are often said to be "off" rather than "on" the contract altogether.

Ultimately, Southstar's liability on McCarthy's claims should have turned on elements of equity concerning Southstar's knowledge of the relevant facts and whether Southstar had changed position (e.g. by making new advances) based on the subcontractor's invoicing of McCarthy. See Restatement (Third) of Restitution and Unjust Enrichment. But by treating U.C.C. § 9-404(b) as dispositive, the court deprived the parties of the chance to explore those elements.

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