

Permanent Editorial Board for the Uniform Commercial Code

PEB COMMENTARY NO. _____
Application of UCC Sections 9-406 and 9-408 to Transfers of Interests in
Unincorporated Business Organizations

Draft for Public Comment

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Comments on this draft must be submitted by no later than April 2, 2012.

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INTERESTS IN
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INTRODUCTION

Article 9 of the Uniform Commercial Code (the “UCC”) contains several provisions that facilitate the assignability of specified types of property in transactions to which Article 9 applies.¹ Building on common-law concepts of free alienability of property and on policies implemented in former § 9-318(4),² § 9-406 and § 9-408 override in specified ways restrictions on certain transfers of rights in certain types of personal property.³ These sections contain provisions that can override both transfer restrictions imposed by law (including statutes) and transfer restrictions imposed by agreement. However, commentators have noted that a fundamental characteristic of the law and practice related to unincorporated business organizations is the “pick your partner” principle by which an owner can decide who the owner’s business partner or partners may be through the use of those very transfer restrictions.⁴ Thus it is important to examine the extent to which § 9-406 and § 9-408 have an effect on contractual and statutory transfer restrictions with respect to interests in unincorporated business organizations.

This examination is especially important because, apparently as a result of a perception that § 9-406 and § 9-408 are at odds with the types of transfer restrictions that are common in the context of unincorporated business organizations,⁵ some state legislatures have enacted statutory provisions that make those two sections of Article 9 inapplicable to transfer restrictions that relate to partnerships and limited liability companies organized under the laws of those states.⁶ However, as the following analysis demonstrates, § 9-406 and § 9-408 do not override otherwise effective transfer restrictions in a manner that undermines the “pick your partner” principle.

¹ U.C.C. § 9-406 cmt. 5 (2001).

² *Id.*

³ *I.e.*, “accounts,” “chattel paper,” “general intangibles” (including “payment intangibles”), and “promissory notes” as defined in U.C.C. § 9-102(a).

⁴ *See* Revised Uniform Limited Liability Company Act (2006) § 502 cmt. (discussing the “pick your partner” principle and its fundamental importance to the law of unincorporated business organizations); *see also* the Prefatory Comment referring to the “pick your partner” principle as “fundamental” to the law of unincorporated business organizations. A few unincorporated business organizations do not depend on transfer restrictions. *See e.g.* Uniform Statutory Trust Entity Act (2009), § 601(a) (stating that “[a] beneficial interest in a statutory trust is freely transferable”).

⁵ The examples used in this Commentary involve general and limited partnerships and limited liability companies, but the analysis is generally applicable to unincorporated business entities whose ownership interests are not freely transferable.

⁶ *See, e.g.*, Del. Code Ann. tit. 6 § 18-1101(g); Va. Code Ann. § 13.1-1001.1.B (both providing that U.C.C. §§ 9-406 and 9-408 “do not apply to any interest in a limited liability company”). To determine which state’s partnership or limited liability company law governs the effect of U.C.C. §9-406 and § 9-408 on a transfer restriction, *see* Official Comment 3 to U.C.C. § 9-401.

This Commentary (i) describes the role of transfer restrictions in the law and practice of unincorporated business organizations⁷; (ii) explains how the UCC's approach to transfer restrictions applies in relation to that law and practice; and (iii) analyzes and applies the relevant parts of § 9-406 and § 9-408 to transactions within the scope of Article 9 that involve transfers of interests in unincorporated business organizations.

The Commentary also contains, as an appendix, a chart that provides an overview of the effect of § 9-406 and § 9-408 on the different types of transactions and different types of property involved in the analysis.

In this Commentary, unless the context indicates otherwise:

- “*Agreement*” means a partnership agreement among the partners of a general or limited partnership or an operating agreement among the members of a limited liability company.
- “*Economic rights*,” sometimes referred to in the statutes governing unincorporated business organizations as a “transferable interest,”⁸ means the partner’s or member’s right to receive distributions from the general or limited partnership or a limited liability company. The term does not include any of a partner’s other rights *qua* partner in a general or limited partnership or any of a member’s other rights *qua* member of a limited liability company; in particular, the term does not include governance rights of a partner or member.
- “*Governance rights*” means an owner’s rights *qua* owner to participate in management, obtain information, sue derivatively, and seek judicial dissolution. The term includes all rights flowing from a person’s status as owner other than economic rights.
- “*Owner*” means a partner in a general or limited partnership and a member of a limited liability company.
- “*Ownership interest*” means all of a partner’s rights *qua* partner in a general or limited partnership and all of a member’s rights *qua* member of a limited liability company. The term includes the partner’s or member’s governance rights as well as the partner’s or member’s economic rights.⁹

⁷ The analysis in this Commentary assumes that restrictions imposed by agreement in this context are enforceable under law other than the UCC.

⁸ Revised Uniform Partnership Act (1997) § 502; Uniform Limited Partnership Act (2001) §§ 102(22), 701; Revised Uniform Limited Liability Company Act (2006) §§ 102(21), 501. The original Uniform Limited Liability Company Act (1996) used the term “distributional interest.” Uniform Limited Liability Company Act (1996) § 501.

⁹ In both contracts and statutes, the terms “partnership interest” and “membership interest” can be used in an ambiguous manner, sometimes referring to all of an owner’s rights and sometimes only to an owner’s right to receive distributions. As used in this Commentary, the term “ownership interest” means all of an owner’s rights, but the Commentary frequently refers to a “complete ownership interest” to emphasize that the interest

- “*Transfer*” includes a security interest, assignment, conveyance, deed, bill of sale, lease, mortgage, encumbrance, gift, and transfer by operation of law.¹⁰
- “*Transfer restriction*” means a restriction on the transfer of a complete ownership interest, or any part thereof, including an owner’s economic rights or governance rights, regardless of whether the restriction is created by law or by agreement. The term includes a requirement that one or more other owners consent to the transfer.

I. TRANSFER RESTRICTIONS UNDER THE LAW AND PRACTICE OF UNINCORPORATED BUSINESS ORGANIZATIONS

Statutory transfer restrictions and statutory validations of contractual transfer restrictions (as discussed below) implement the “pick your partner” principle in the law of unincorporated business organizations.¹¹ These statutes typically provide that, while an owner of an interest in a limited partnership or limited liability company may freely transfer the owner’s economic rights to a non-owner absent agreement to the contrary among the owners, the owner may not freely transfer its governance rights to a non-owner. For a transfer that includes governance rights to be effective, the other owners must consent, thus preserving the “pick your partner” principle.

Many partnership agreements and operating agreements also contain contractual transfer restrictions. Sometimes these transfer restrictions merely repeat the statutory restrictions on the transfer of governance rights, but many agreements go further. For example, a partnership or operating agreement might provide a “first refusal” or other “buy-sell” mechanism or otherwise limit or even prohibit the assignment of economic rights even though under the relevant statutory provisions the economic rights are otherwise freely transferable.

This Commentary addresses both the statutory transfer restrictions and transfer restrictions arising from an agreement. As the analysis demonstrates, Article 9 has only a limited, benign effect on transfer restrictions.

comprises both governance and economic rights. Of course, the analysis applicable to a transaction involving a complete ownership interest or economic rights would apply to a transaction involving the transfer of a portion of the complete ownership interest or economic rights. This Commentary generally does not address transactions in which an owner seeks to transfer some or all of its governance rights without also transferring some or all of its economic rights. Such an unusual transaction would involve a general intangible that is not a payment intangible, and the analysis in this Commentary relating to such general intangibles would be applicable.

¹⁰ Uniform Limited Partnership Act (2001) § 102(21); Revised Uniform Limited Liability Company Act (2006) § 102(20).

¹¹ The statutory transfer restrictions first appeared in a uniform act in the Uniform Partnership Act (1914) § 27, and have since been replicated in the Uniform Limited Partnership Act (1916) §§ 19 and 25; the Revised Uniform Limited Partnership Act (1976 and 1985) §§ 702 and 704; the Uniform Limited Liability Company Act (1996) §§ 502 and 503; the Revised Uniform Partnership Act (1997) § 503; the Uniform Limited Partnership Act (2001) § 702; the Revised Uniform Limited Liability Company Act (2006) § 502.

II. THE EFFECT OF UCC ARTICLE 9 ON TRANSFER RESTRICTIONS IN THE LAW AND PRACTICE OF UNINCORPORATED BUSINESS ORGANIZATIONS

A. Scope of UCC Article 9

As discussed in the Introduction, § 9-406 and § 9-408 have potential applicability to transfer restrictions. Those sections apply, however, only to transactions within the scope of Article 9. Thus, at the outset, it is important to identify which transfers of interests in unincorporated business entities are governed by Article 9.

With limited exceptions that are not germane to this Commentary, Article 9 applies to all transactions, regardless of their form, in which personal property (including a complete ownership interest, an owner’s governance rights, and an owner’s economic rights) secures payment or performance of (*i.e.*, is collateral for) an obligation.¹² Article 9 also applies to the sale of certain payment rights – accounts, chattel paper, payment intangibles, and promissory notes.¹³ Article 9 does not apply, however, to the sale of other types of property including, most importantly for purposes of this Commentary, general intangibles that are not payment intangibles. As a matter of vocabulary, Article 9 uses the term “security interest” to include not only an interest in personal property that secures payment or performance of an obligation but also the interest of a buyer of the payment rights listed above.¹⁴ As discussed in some detail below, the economic rights of an owner normally constitute a payment intangible,¹⁵ while the owner’s complete ownership interest is a general intangible that is not a payment intangible, as are an owner’s governance rights. Thus, Article 9 applies to a transaction in which an owner’s complete ownership interest (a general intangible), governance rights (a general intangible) or economic rights (a payment intangible) serve as collateral for an obligation *and* also to the sale of only economic rights (a payment intangible). Article 9 does not apply to the sale of a complete ownership interest (a general intangible) or of only governance rights (a general intangible).

B. An Overview of Sections 9-406 and 9-408

As noted above in Section II(A), Article 9 applies not only to transactions in which personal property is collateral for an obligation but also to the sale of some payment rights. As a result, § 9-406 and § 9-408 have potential applicability not only to transactions in which a complete ownership interest or an owner’s governance or economic rights secure an obligation but also to transactions in which only economic rights are sold.

¹² U.C.C. § 9-109(a)(1).

¹³ U.C.C. § 9-109(a)(3).

¹⁴ *See* U.C.C. § 1-201(b)(35).

¹⁵ If a general partner’s or managing member’s economic rights serve primarily to compensate that person for the provision of services to the entity, it could be argued that the economic rights constitute an “account” under Article 9. *See* U.C.C. § 9-102(a)(2). *See also*, U.C.C. § 9-109(d)(3) (excluding from scope of Article 9 assignment of claim for wages, salary, or other compensation of employee). The application of U.C.C. §§ 9-406 and 9-408 discussed below is somewhat different as applied to accounts as compared to payment intangibles. This Commentary does not address the application of those sections to accounts.

As a general matter, § 9-406 applies to transfer restrictions that limit the use of economic rights as collateral for an obligation and § 9-408 applies to transfer restrictions that limit the sale of such rights. Section 9-408 also applies to restrictions that limit the use of a complete ownership interest or of only governance rights as collateral for an obligation. Neither section applies to restrictions on the sale of a complete ownership interest or of only governance rights because such sales, as discussed above in Section II(A), are not governed by Article 9. As demonstrated by the detailed analysis below, as a general matter, § 9-406 overrides transfer restrictions to a greater extent than does § 9-408.

However, the actual effect of § 9-406 and § 9-408 cannot be understood “as a general matter.” Rather, a proper understanding requires consideration of the subsidiary issues addressed below.

C. A Preliminary Question: Is the membership interest “investment property”?

As will be explained below, § 9-406 and § 9-408 are irrelevant to a transfer of an ownership interest unless the ownership interest is a “general intangible.” Thus, determining whether an ownership interest is within the category “general intangible” is pivotal to the application of § 9-406 and § 9-408 to such transfers.¹⁶

The term “general intangible” is defined by what it is *not*. An item of property is a general intangible if (and only if) it does not fit into any of the other types of personal property identified by Article 9. As a practical matter, it is usually obvious that an interest in an unincorporated business entity does not fit into most of the Article 9 property types. However, an ownership interest in an unincorporated business entity may, under some circumstances, qualify as “investment property.” By definition, since property that is “investment property” cannot be a general intangible,¹⁷ the applicability of § 9-406 and § 9-408 depends on whether the ownership interest fits within the category of “investment property.”

Article 9 defines “investment property” to include a “security,”¹⁸ a term defined in Article 8.¹⁹ Article 8 contains both a general definition of “security” and a special provision pertaining to “[a]n interest in a partnership or limited liability company.”²⁰ Under that special provision, § 8-103(c), a partnership or limited liability company interest “is not a security” unless: (i) the interest is dealt in or traded on securities exchanges or in securities markets; (ii) the interest is an investment company security as defined in § 8-103(b); or (iii) the terms of the

¹⁶ As explained below, for purposes of this Commentary the key constructs are “general intangibles” and a subset of that construct - “payment intangibles.” U.C.C. § 9-406 and § 9-408 also apply to the sale of accounts, chattel paper, and promissory notes. An ownership interest clearly does not fit into the chattel paper or promissory note categories. As discussed in note 15, *supra*, an owner’s economic rights might constitute an account, but this Commentary does not address that possibility.

¹⁷ U.C.C. § 9-102(a)(42) (defining “general intangible” as *inter alia* “personal property ... other than ... investment property”).

¹⁸ U.C.C. § 9-102(a)(49).

¹⁹ U.C.C. §§ 9-102 (a)(49) (defining “investment property” as *inter alia* “a security” and §9-102(b) (incorporating by reference the definition of “security” in §8-102)).

²⁰ U.C.C. §§ 8-102(a)(15) (providing a definition “except as otherwise provided in Section 8-103”) and 8-103(c) (providing a special rule for partnership and LLC interests).

interest “expressly provide” that it is a security governed by Article 8.²¹ It is unusual for an ownership interest in a partnership or limited liability company to fit into either of the first two categories because, subject to a narrow range of exceptions, such entities lose their favorable tax classification if their interests are publicly traded.²²

In contrast, an ownership interest in a partnership or limited liability company can fall into the third situation described in § 8-103(c) if the terms of the ownership interest expressly provide that the ownership interest is a security governed by Article 8. In such a case, those terms, often referred to as an “opt in” provision, will result in the ownership interest being categorized as a “security” under Article 8 and, accordingly, “investment property” under Article 9.²³ As “investment property,” the ownership interest is removed from Article 9’s pivotal category of “general intangible”²⁴ and, thus, excluded from the ambit of both § 9-406 and § 9-408.

As a result, the parties to a partnership agreement, operating agreement or other agreement can exclude the ownership interests from the ambit of § 9-406 and § 9-408 by including in the terms governing the ownership interests an Article 8 “opt in” provision under U.C.C. § 8-103(c).

D. The Two Key Article 9 Property Definitions.

The operation of Article 9 depends on a set of defined terms that categorize the property interests involved. For purposes of this Commentary, the relevant terms are “general intangible” and “payment intangible,” with the latter being a subset of the former.²⁵

As noted above, “general intangible” is the residual type of personal property under Article 9; property is a general intangible if it is not any of the other defined types of property.²⁶ A general intangible is also a “payment intangible” if the obligor’s principal obligation is a monetary obligation.²⁷ Article 9 refers to the obligor on a general intangible (including a payment intangible) as the “account debtor.”²⁸

In the context of a partnership or limited liability company:

- A complete ownership interest, which comprises both economic and governance rights, is a general intangible that is not a payment intangible. The owner’s economic

²¹ U.C.C. § 8-103(c).

²² See generally Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law*, ch. 16 (Warren Gorham & Lamont/RIA 2004; Supp. 2010-1).

²³ U.C.C. §§ 9-102(a)(49) (defining “investment property” as “a security”); 9-102(b) (incorporating by reference the definition of “security” in § 8-102); 8-102(a)(15) (identifying additional rules for applying “security” to specified types of property); 8-103(c) (providing a special rule for partnership and LLC interests).

²⁴ U.C.C. § 9-102(a)(42) (defining “general intangible” as *inter alia* “personal property ...other than ...investment property”).

²⁵ U.C.C. § 9-102(a)(42).

²⁶ U.C.C. § 9-102(a)(42).

²⁷ U.C.C. § 9-102(a)(61).

²⁸ U.C.C. § 9-102(a)(3). A person may be an account debtor even if the person is not obligated on an account. The person may instead be obligated on chattel paper or a general intangible. *Id.*

rights consist of the owner's right to receive distributions from the entity but, because the owner's governance rights (and the entity's duty to honor those rights) are typically viewed as at least equally important,²⁹ the *principal* obligation of the account debtor (*i.e.*, the entity) would not be a monetary obligation.

- *A fortiori*, an owner's governance rights are a general intangible but not a payment intangible.
- An owner's economic rights, when considered separately from the owner's governance rights, constitute a payment intangible.³⁰

E. Sections 9-406 and 9-408 Do Not Apply to (i) a Sale of a Complete Ownership Interest or of only Governance Rights or (ii) a Gift or, as a General Matter, a Transfer by Operation of Law of All or Part of a Complete Ownership Interest

As discussed above in Section II(A), neither § 9-406 nor § 9-408 applies to a transaction involving the sale of a complete ownership interest or of governance rights not associated with economic rights. This is because sales of general intangibles that are not payment intangibles are outside the scope of Article 9.³¹

Example 1: The Revised Uniform Limited Liability Company Act (2006) provides, as default rules, that: (i) after formation of a limited liability company, no person can become a member without the consent of all the existing members; (ii) a member cannot transfer any rights other than economic rights without the consent of the other members; and (iii) a transferee of only economic rights obtains no governance rights whatsoever.³² A member seeks to sell its complete ownership interest (both governance and economic rights) to a non-member. Neither § 9-406 nor § 9-408 applies to the statutory transfer restrictions because Article 9 does not apply to the sale of a general intangible. Thus, Article 9 does not interfere with the effectiveness of these statutory provisions insofar as they limit the sale of the member's complete ownership interest. The same analysis applies if the member seeks to sell only the member's governance rights.

²⁹ U.C.C. § 9-102 cmt. 5(d) provides guidance on the distinction between payment intangibles and other general intangibles. A right to the payment of money may be buttressed by ancillary covenants but will still constitute a payment intangible if the right to receive money is the principal right. In the context of a complete ownership interest, this Commentary assumes that the governance rights are more than mere ancillary covenants buttressing the economic rights.

³⁰ Several uniform acts contemplate debt (perhaps in the form of an instrument) being issued as a distribution. *See* Uniform Limited Liability Company Act (1996) § 406, Uniform Limited Partnership Act (2001) § 508, and Revised Uniform Limited Liability Company Act (2006) § 405. However, the issuance of an instrument does not mean that the *right* to a distribution is an instrument (and, thus, not a general intangible or payment intangible). Rather, once the distribution is made by the issuance of debt (whether evidenced by an instrument or not), the distributee is an ordinary creditor of the entity. *See* Uniform Limited Liability Company Act (1996) § 405(c), Uniform Limited Partnership Act (2001) § 507, and Revised Uniform Limited Liability Company Act (2006) § 404. Applying Article 9 to the debt instruments and other debt obligations of the entity is neither unusual nor problematic in the law and practice of unincorporated business organizations.

³¹ *See* U.C.C. § 9-109(a); *see also* U.C.C. § 9-408 cmt. 4 (2001).

³² Revised Uniform Limited Liability Company Act (2006) §§ 401(d)(3), 502 and 503.

Example 2: Same facts as Example 1, except the member seeks to sell one-half of the member's complete ownership interest. The result is the same. Neither § 9-406 nor § 9-408 applies to the statutory transfer restrictions.

Example 3: The operating agreement of XYZ, LLC prohibits the transfer of any governance rights (defined in the operating agreement) to any non-member without the consent of XYZ's manager and members owning 60% of the interests in profits owned by members. A member seeks to sell the member's complete ownership interest to a non-member. Neither § 9-406 nor § 9-408 applies to the contractual transfer restrictions. Thus, Article 9 does not interfere with the effectiveness of this contractual prohibition insofar as it limits the sale of the member's complete ownership interest. The same result obtains if a member seeks to sell all or part of the member's governance rights.

Example 4: Same facts as Example 3, except the member seeks to sell one-half of the member's complete ownership interest. The result is the same. Neither § 9-406 nor § 9-408 applies to the contractual transfer restrictions.

Sections 9-406 and 9-408 also are irrelevant to a transfer of all or part of an ownership interest by gift or to transfers by operation of law, such as by court order or upon the death of the owner. This is because Article 9 applies primarily to (i) transactions in which, by contract, personal property serves as collateral for an obligation and (ii) sales of certain payments rights including payment intangibles.³³ Neither of these situations is present in the case of a gift. When property is the subject of a gift, there is no obligation for which the property is collateral. Moreover, even if the ownership interest that is transferred constitutes a payment right, there is no "sale" of the payment right in the case of a gift. A sale consists of the passing of title from the seller to the buyer for a price.³⁴ Since there is no "price" in the case of a gift, there is no "sale." Accordingly, § 9-406 and § 9-408 do not apply to any restrictions on transfer by gift, regardless of whether the restrictions apply to economic rights, governance rights, or a complete ownership interest.

Similarly, because Article 9 does not generally apply to a transfer of a complete ownership interest or an owner's governance or economic rights by operation of law, such as by court order or upon the death of the owner, § 9-406 and § 9-408 do not apply to those situations.³⁵

³³ See U.C.C. §§ 9-109(a)(1) and (3).

³⁴ See U.C.C. § 2-106(1), made applicable to Article 9 by U.C.C. § 9-102(b).

³⁵ The qualifier "generally" is used here and elsewhere in this Commentary in this context, because Article 9 does apply to certain security interests arising by operation of law. See U.C.C. §§ 9-109(a)(2), (5) and (6). However, a security interest arising by operation law in original collateral under Article 9 is only in goods, "items" as defined in Article 4, "documents" as defined in Article 5, or "securities" or other "financial assets" as defined in Article 8 (defined in Article 9 as "investment property"). See U.C.C. §§ 9-110, 4-104(a)(9), 4-210, 5-102(a)(6), 5-118, 8-102(a)(9), 8-102(a)(17), 9-102(a)(49) and 9-206. Conceivably, these types of property could be exchanged for the types of interests discussed in this Commentary, and the security interest could attach to those interests through a proceeds analysis under U.C.C. § 9-315. It would be quite unusual for a security interest in economic rights, governance rights or an ownership interest to arise in that manner.

III. ANALYSIS AND APPLICATION OF THE PERTINENT PORTIONS OF SECTIONS 9-406 AND 9-408

If the transfer of an interest in an unincorporated business entity (other than an interest constituting investment property) is within the scope of Article 9, an analysis of §9-406 and § 9-408 is necessary in order to determine whether the effectiveness of any statutory or contractual restriction on that transfer is limited by Article 9. In Part B of this Section, each statutory provision is quoted in relevant part and is followed by an analysis. First, however, the meaning of one more Article 9 term must be addressed.

A. Another Key Article 9 Definition: Account Debtor

Both § 9-406 and § 9-408 express their overrides with regard to certain transfer restrictions for the benefit of the “account debtor.” To understand how these sections affect transfer restrictions, it is essential to identify the account debtor.

In pertinent part, § 9-102(a)(3) defines “account debtor” as “a person obligated on ... [a] general intangible.” Thus, as to all or part of an ownership interest, the entity (the partnership or the limited liability company) is the account debtor. With regard to economic rights, *i.e.*, the right to receive distributions, the obligation runs from the entity to the members.³⁶ With regard to governance rights – which, together with the economic rights, comprise the complete ownership interest – again the entity is the obligor.³⁷

A partner’s or member’s co-owners may also owe duties to the partner or member but these co-owners are not account debtors with respect to any part of the partner’s or member’s ownership interest. This analysis is correct even though, under the relevant partnership and limited liability company law, the owners, rather than the entity, have the right to grant or withhold consent to transfers. In other words, with respect to an owner’s economic and governance rights, the “account debtor” typically is distinct from some of the persons whose rights are protected by transfer restrictions under the law and practice of unincorporated business organizations.³⁸

B. Section 9-406(d) and (e)

Section 9-406(d) and (e) state:

(d) **[Term restricting assignment generally ineffective.]**... a term in an agreement between an account debtor and an assignor ... is ineffective to the extent that it:

³⁶ Revised Uniform Limited Liability Company Act (2006) §§ 404 and 502.

³⁷ *See, e.g.*, Revised Uniform Limited Liability Company Act (2006) § 410(a)(2) (addressing information rights of members and stating that “[t]he company shall furnish to each member” specified information).

³⁸ *See Newcombe v. Sundara*, 274 Ill. App. 3d 590, 654 N.E. 530 (1995) (finding that former U.C.C. § 9-318(4) did not apply to override a transfer restriction in a limited partnership agreement that required the general partner to consent to a limited partner granting a security interest in his limited partnership interest, because the general partner was not an “account debtor” under former Article 9).

(1) prohibits, restricts, or requires the consent of the account debtor ... to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, the ... payment intangible ...; or

(2) provides that the assignment or transfer or the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the ... payment intangible.

(e) **[Inapplicability of subsection (d) to certain sales.]** Subsection (d) does not apply to the sale of a payment intangible ... other than a sale pursuant to a disposition under section 9-610 or an acceptance of collateral under section 9-620.³⁹

Section 9-406(d) applies to a transfer of an economic right only if and to the extent that the entity is a party to the agreement containing the transfer restriction, because the language of § 9-406(d) confines the subsection to situations involving “an agreement between an account debtor and an assignor.” Rarely, if ever, is a partnership a party to its partnership agreement, and it is atypical for a limited liability company to be a party to its operating agreement.⁴⁰

Moreover, because subsection (d) refers to payment intangibles, but not to general intangibles that are not payment intangibles, the subsection applies only to transfer restrictions on an owner’s economic rights. The subsection has no effect at all on restrictions limiting the transfer of an owner’s complete ownership interests or governance rights.

Even if the entity is a party to the agreement containing a transfer restriction on economic rights, § 9-406(d)(1) renders the restriction ineffective only to the extent that the restriction runs to the benefit of the account debtor, i.e., the entity. By its terms, subsection (d)(1) simply does not apply to a transfer restriction that runs to the benefit of other owners that are parties to the agreement, including any requirement for the consent of the other owners, because the other owners are not obligors with respect to the economic rights.

Likewise, while subsection (d)(2) can apply to an agreement containing transfer restrictions if the entity is a party to the agreement, by its terms the subsection: (i) applies only to

³⁹ The language “other than a sale pursuant to a disposition under section 9-610 or an acceptance of collateral under section 9-620” was added in the 2010 amendments to Article 9 (which have an effective date of July 1, 2013). U.C.C. § 9-406(f) [not quoted here] overrides transfer restrictions created by “a rule of law, statute, or regulation,” but its application is limited to accounts and chattel paper and thus it is inapplicable to the types of assets – general intangibles (including payment intangibles) - that are the subject of this Commentary.

⁴⁰ An entity may still be bound by the partnership agreement or operating agreement by statute even though it has not manifested assent to the agreement or otherwise bargained for it. *See, e.g.*, Revised Uniform Limited Liability Company Act (2006) § 111(a) (providing that “[a] limited liability company is bound by and may enforce the operating agreement, whether or not the company has itself manifested assent to the operating agreement”); Del. Code Ann. tit. 6 § 18-101(7) (providing that “[a] limited liability company is bound by its limited liability company agreement whether or not the limited liability company executes the limited liability company agreement”). However, such a statutory provision does not create an “agreement” as that term is used in U.C.C. § 9-406 or § 9-408. *See* U.C.C. § 1-201(b)(3) (“ ‘agreement’, as distinguished from ‘contract’, means the bargain of the parties *in fact*, as found in their language or inferred from other circumstances....”)(emphasis added).

an owner's economic rights (payment intangible), and (ii) does not affect any remedy of other owners that are parties to the agreement for breach of a transfer restriction contained in it.

These points are worth emphasizing. Even in those unusual cases in which the entity itself is a party to the partnership agreement or operating agreement along with the other partners or members, only the entity is an "account debtor" with respect to the economic rights and thus § 9-406(d) affects the agreement only insofar as it provides rights to the entity and has no effect on the agreement to the extent that it provides rights to the other parties.

Example 5: A limited liability company is a party to its own operating agreement. The operating agreement:

- A. uses the words of the company's governing statute and requires unanimous member consent for any transfer of a complete ownership interest;
- B. subjects any sale, creation of a security interest to secure an obligation, or other transfer of a member's economic rights to a right of first refusal, first in favor of the limited liability company and then in favor of the other members;
- C. provides that any attempt to make a transfer in violation of the stated transfer restrictions is a breach of the operating agreement; and
- D. recites that the limited liability company is a party to the operating agreement.

To the extent that the transfer restriction in Point A relates to a sale of the complete ownership interest, Article 9 does not apply at all since the sale would be a sale of a general intangible, and Article 9 does not apply to a sale of a general intangible that is not a payment intangible. But, in any event, § 9-406(d)(1) has no effect on any of the transfer restrictions described in point A, whether the restriction relates to a sale of the complete ownership interest or to a security interest in the complete ownership interest securing an obligation, because subsection (d) does not apply to general intangibles that are not payment intangibles.

As to the right of first refusal described in point B, subsection (d)(1):

- renders ineffective the company's right as applied to the creation, attachment, perfection, or enforcement of a security interest in the member's economic rights securing an obligation;
- due to § 9-406(e), has no effect on the company's right as applied to a sale of the economic rights by the member; and
- has no effect on the other members' rights of first refusal because the other members are not account debtors with respect to either economic rights or governance rights.

As to the provision in point C making a transfer in violation of a restriction a breach of the operating agreement:

- because of the limitation in § 9-406(e), subsection (d)(2) has no effect on the “breach” characterization as applied to an outright sale of the member’s economic rights;
- § 9-406 has no effect on the provision as applied to a sale of the member’s complete ownership interest or governance rights, because Article 9 does not apply to the sale of general intangibles that are not payment intangibles; and
- § 9-406(d)(2) overrides the “breach” characterization as it applies to the grant of a security interest in the member’s economic rights to secure an obligation, but only insofar as the provision runs to the benefit of the company; subsection (d)(2) has no effect on the “breach” characterization to the extent that the breach creates rights for the other owners (who, by definition, are not account debtors with respect to the economic interest).⁴¹

Thus, the effect of § 9-406(d) is limited to transactions in which an owner grants a security interest in its economic rights as collateral for a loan or other obligation. Section 9-406(d) is further limited by the fact that it applies only to transfer restrictions concerning economic rights in an agreement between the owner and the entity, not to transfer restrictions among the owners *inter se*. Thus, as against the entity, only in these limited circumstances may the secured party exercise its remedies under part 6 of Article 9 notwithstanding the transfer restriction in favor of the entity. Those remedies would include the remedy:

- under § 9-607(a)(1) to collect distributions that would otherwise be paid to the owner;
- under § 9-610 to sell or otherwise dispose of the owner’s economic rights in the entity;⁴² and
- under § 9-620, with the consent or failure to object of the owner and other persons with an interest in the economic rights, to accept the economic rights in whole or in some cases partial satisfaction of the secured obligation.⁴³

These remedies do not materially affect the “pick your partner” principle; they concern solely economic rights. Indeed, these Article 9 remedies provide no greater transferability than

⁴¹ The remedies available to the other owners arising from a breach would be determined by law other than Article 9.

⁴² Prior to the 2010 amendments to U.C.C. §§ 9-406(e) and 9-408(b), U.C.C. § 9-406(e) was susceptible to the interpretation that U.C.C. § 9-406(d) would not apply to a sale of a payment intangible under U.C.C. § 9-610. The 2010 amendments clarify that U.C.C. § 9-406(d) does apply to the sale.

⁴³ Prior to the 2010 amendments to U.C.C. §§ 9-406(e) and 9-408(b), U.C.C. § 9-406(e) was susceptible to the interpretation that U.C.C. § 9-406(d) would not apply to the secured party’s acceptance of a payment intangible under U.C.C. § 9-610 in whole or partial satisfaction of the secured obligation. The 2010 amendments clarify that U.C.C. § 9-406(d) does apply to the acceptance.

do the default rules under both partnership and limited liability company statutes, which, as explained above, leave entirely unrestricted an owner's right to transfer economic rights. Moreover, the remedies, when applicable, do not affect the rights of other owners that are parties to the agreement containing the transfer restriction.

C. Section 9-408(a) and (b)

As noted earlier, § 9-408, rather than § 9-406, applies to a transfer restriction to the extent that the transfer is either a sale of the owner's economic rights or the grant of a security interest in the owner's ownership interest or governance rights as collateral for an obligation.

Section 9-408(a) and (b) state:

(a) **[Term restricting assignment generally ineffective.]** ... a term in ... an agreement between an account debtor and a debtor [*i.e., an owner*] which relates to ... a general intangible... and ... prohibits, restricts, or requires the consent of ... the account debtor to, the assignment or transfer of, or creation, attachment, or perfection of a security interest in, the ... general intangible, is ineffective to the extent that the term:

(1) would impair the creation, attachment, or perfection of a security interest; or

(2) provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the ... general intangible.

(b) **[Applicability of subsection (a) to sales of certain rights to payment.]** Subsection (a) applies to a security interest in a payment intangible ... only if the security interest arises out of a sale of the payment intangible ... other than a sale pursuant to a disposition under section 9-610 or an acceptance of collateral under section 9-620.⁴⁴

As noted above, the account debtor with respect to an ownership interest, governance rights, or an economic interest is the entity itself. Thus, § 9-408(a), like § 9-406(d), is inapplicable unless the agreement containing the transfer restriction includes the entity as a party. Even then, § 9-408(a), like § 9-406(d), does not affect transfer restrictions with respect to an ownership interest, governance rights, or an economic interest to the extent the transfer restrictions run in favor of the other owners that are parties to the agreement rather than the entity. This is because the other owners are not account debtors with respect to those interests or rights.

Moreover, when § 9-408(a) does apply, it overrides restrictions only on “the creation, attachment, or perfection of a security interest.” Because the override does not extend to enforcement of a security interest, § 9-408(a) is benign as to the “pick your partner” principle. Indeed, as further elaborated in § 9-408(d)(6), restrictions pertaining to the *enforcement* of the security interest are not affected for transactions governed by § 9-408 (as opposed to § 9-406).

⁴⁴ The language “other than a sale pursuant to a disposition under section 9-610 or an acceptance of collateral under section 9-620” was added in the 2010 amendments to Article 9.

Creation and attachment affect the existence of the security interest as between the debtor and the secured party as a matter of contract, and perfection affects the priority rights of the secured party as against other creditors of the owner, such as a lien creditor, a trustee in bankruptcy, competing secured parties, and other purchasers. Accordingly, as to the concerns of the entity (the limited partnership or the limited liability company) and the other owners, § 9-408(a) is a non-issue.

Consider first two examples pertaining to transactions with respect to a complete ownership interest (a general intangible that is not a payment intangible).

Example 6: The operating agreement of a limited liability company to which the company is a party precludes a member from transferring its complete ownership interest without the consent of the other members. The member grants to Secured Party a security interest in its complete ownership interest as collateral for an obligation. With regard to the company, § 9-408(a) overrides the transfer restriction to the extent described above (*i.e.*, to the extent it impairs creation, attachment and perfection of the security interest). Section 9-408(a) has no effect on the rights of the other members that are parties to the operating agreement. The same analysis applies if the security interest pertains only to governance rights.

Example 7: Same facts as Example 6 except that the member defaults under its security agreement with Secured Party. Although, as described in Example 6, § 9-408(a) overrides the transfer restriction insofar as it prevented creation, attachment or perfection of the security interest, the section has no effect on the restriction to the extent that it limits Secured Party's enforcement of its security interest, including its remedy of collection under § 9-607, its remedy of disposition under § 9-610, and its remedy of acceptance of collateral under § 9-620.

Consider next the application of § 9-408(a) to the outright sale of an owner's economic rights.

Example 8: The operating agreement of a limited liability company to which the company is a party precludes members from transferring any part of their ownership interest, including their economic rights, without the consent of the other members. A member sells its economic rights to Buyer. Because, in UCC parlance, the sale creates a security interest, § 9-408(a) renders the contractual transfer restriction, to the extent that it runs in favor of the company, ineffective to prevent the sale from taking place as between the member and Buyer. As in Example 7, however, the provision does not override the transfer restriction to the extent that it restricts enforcement by Buyer of that security interest. Thus, as further elaborated in § 9-408(d), the transfer restriction remains effective, even as applied to the company, to deny Buyer the right to collect from the company any distributions to which the member is entitled. Indeed, the company has no obligation to recognize Buyer as the owner of the economic rights.⁴⁵

⁴⁵ There may be a concern that, if the owner has transferred all of the owner's economic rights in the limited liability company, the owner would have no further economic incentive to exercise governance rights in the

More fundamentally, § 9-408(a) does not apply to a transfer restriction that runs in favor of other owners that are parties to the agreement containing the restriction. Because transfer restrictions in agreements invariably give rights to the other owners, § 9-408(a) has limited practical effect.

To emphasize these points as well as points made earlier in this Commentary, consider an example that is a variation of Example 5 and an analysis of the example under § 9-408(a).

Example 9: A limited liability company is a party to its own operating agreement. The operating agreement:

- A. uses the words of the company's governing statute and requires unanimous member consent for any transfer of a complete ownership interest;
- B. subjects any sale, creation of a security interest to secure an obligation, or other transfer of a member's complete ownership interest to a right of first refusal, first in favor of the limited liability company and then in favor of the other members;
- C. provides that any attempt to make a transfer in violation of the stated transfer restrictions is a breach of the operating agreement; and
- D. recites that the limited liability company is a party to the operating agreement.

In the case of a sale by a member of a complete ownership interest, subsection (a) has no effect at all. A sale of a complete ownership interest is a sale of a general intangible, and Article 9 itself does not apply to a sale of a general intangible.

In the case of a security interest in the complete ownership interest securing an obligation, subsection (a):

- has no effect on the other members' rights described in point A to consent to the security interest, because the other members are not account debtors with respect to ownership rights;
- renders ineffective the company's right of first refusal described in point B as applied to the creation, attachment, or perfection of the security interest;

best interest of the limited liability company and the other members. However, many limited liability company statutes now expressly authorize non-economic members. Revised Uniform Limited Liability Company Act § 401(e), Del. Code Ann. tit. 6 § 18-301(d). Also, under most statutes governing partnerships and limited liability companies, an owner that sells all of its economic rights may be expelled or will cease to have governance rights. *See, e.g.*, Revised Uniform Limited Liability Company Act (2006) § 602(4)(B); Del. Code Ann. tit. 6 § 18-702(b)(3). Certainly, an operating or partnership agreement may so provide. Moreover, a non-economic member will continue to be subject to the implied covenant of good faith and fair dealing and in some circumstances to fiduciary obligations as well.

- does not render ineffective the company’s right of first refusal as applied to the enforcement of the security interest;⁴⁶
- has no effect on the other members’ rights of first refusal, because the other members are not account debtors with respect to ownership rights;
- overrides the “breach” characterization described in point C as it applies to the creation, attachment or perfection of the security interest, but only insofar as the provision runs to the benefit of the company;
- does not override the “breach” characterization as it applies to the enforcement of the security interest insofar as the provision runs for the benefit of the company; and
- has no effect on the “breach” characterization to the extent that the breach creates rights for the other members, because the other members are not account debtors with respect to ownership rights.⁴⁷

D. Section 9-408(c)

Section 9-408(c) states:

(c) **[Legal restrictions on assignment generally ineffective.]** A rule of law, statute, or regulation that prohibits, restricts, or requires the consent of a[n] ... account debtor to the assignment or transfer of, or creation of a security interest in, a ... general intangible, ... is ineffective to the extent that the rule of law, statute, or regulation:

- (1) would impair the creation, attachment, or perfection of a security interest; or
- (2) provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the ... general intangible.

Section 9-408(c) applies to non-contractual, legal transfer restrictions, but the analysis for subsection (c) is the same as for subsection (a). Even if § 9-408(c) applies, its override of transfer restrictions does not apply to transfer restrictions that run in favor of the other owners

⁴⁶ U.C.C. § 9-408(a) would not create any duty of the company to pay to the secured party any distributions from the company otherwise payable to the member, or otherwise to recognize the secured party, if the secured party sought to exercise its right of collection under U.C.C. § 9-607. Nor would U.C.C. § 9-408(a) override the company’s right of first refusal if the secured party sought to exercise its right of disposition under U.C.C. § 9-610 or its right of acceptance under U.C.C. § 9-620. *See also* U.C.C. § 9-408(d).

⁴⁷ Once again, the remedies available to the other members arising from a breach would be determined by law other than Article 9.

and, in any event, does not override restrictions on enforcement. Thus, the scope of § 9-408(c) is very limited.

IV. CONCLUSION

The transfer restriction “override” provisions of § 9-406 and § 9-408 do not apply to sales of complete ownership interests or governance rights or to gifts or, as a general matter, transfers by operation of law of a complete ownership interest, governance rights or an economic interest because such sales, gifts, or, as a general matter, transfers by operation of law are outside the scope of Article 9. Nor do the provisions apply to ownership interests that are “securities” governed by Article 8.

When § 9-406 and § 9-408 do apply to the transfer of a complete ownership interest or a governance or economic interest, these sections override transfer restrictions that run in favor of the entity under an agreement to which the entity is a party or that are imposed in favor of the entity by statute or other rule of law. But § 9-406 and § 9-408 leave intact transfer restrictions that run in favor of the entity’s other owners. Therefore, the override provisions have little or no effect on the transfer restrictions that protect the “pick your partner” principle under the law of unincorporated business organizations.

Sections 9-406 and 9-408 can affect transfer restrictions that operate in favor of the entity itself, but even those effects are benign. With regard to restrictions on transfer of economic rights, the UCC provisions result in no greater transferability than exists under the default rules of all partnership and limited liability company statutes. With regard to restrictions on the use of complete ownership interests as collateral, the UCC provisions permit a security interest to be created, attach, and become perfected notwithstanding such restrictions, but this result has no effect on the entity because the transferee does not acquire enforcement rights free of the transfer restriction.

The chart in the appendix to this Commentary summarizes the effect of § 9-406 and § 9-408 on legal and contractual transfer restrictions in the various contexts discussed in this Commentary.

APPENDIX

Article 9 classification of property subject to a transfer restriction	Effect of §§ 9-406 and 9-408 on a transfer restriction that would limit use of the property as collateral	Effect of §§ 9-406 and 9-408 on a transfer restriction that would limit sale of the property	Effect of §§ 9-406 and 9-408 on a transfer restriction that would limit a gift of the property or, as a general matter, a transfer of it arising by operation of law
Investment property	Neither section is applicable	Neither section is applicable	Neither section is applicable
Payment intangible (economic rights and sometimes referred under the uniform laws for unincorporated business organizations as a “transferable interest”)	<p>Section 9-406(d) overrides contractual transfer restrictions with and in favor of the entity, including contractual transfer restrictions on enforcement</p> <p>No effect on contractual transfer restrictions in favor of the other owners</p>	<p>Section 9-408(a) overrides contractual transfer restrictions with and in favor of the entity that would otherwise prevent creation, attachment, or perfection</p> <p>No effect on contractual transfer restrictions on enforcement</p> <p>No effect on contractual transfer restrictions in favor of other owners</p> <p>Section 9-408(c) overrides legal transfer restrictions that would otherwise prevent creation, attachment, or perfection</p> <p>No effect on legal transfer restrictions</p>	Neither section is applicable

<p>Article 9 classification of property subject to a transfer restriction</p>	<p>Effect of §§ 9-406 and 9-408 on a transfer restriction that would limit use of the property as collateral</p>	<p>Effect of §§ 9-406 and 9-408 on a transfer restriction that would limit sale of the property</p>	<p>Effect of §§ 9-406 and 9-408 on a transfer restriction that would limit a gift of the property or, as a general matter, a transfer of it arising by operation of law</p>
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on enforcement

<p>General intangible that is not a payment intangible (economic rights and governance rights)</p>	<p>Section 9-408(a) overrides contractual transfer restrictions with and in favor of the entity that would otherwise prevent creation, attachment, or perfection</p> <p>No effect on contractual transfer restrictions on enforcement</p> <p>No effect on contractual restrictions in favor of other owners</p> <p>Section 9-408(c) overrides legal transfer restrictions that would otherwise prevent creation, attachment, or perfection</p> <p>No effect on legal transfer restrictions on enforcement</p>	<p>Neither section is applicable</p>	<p>Neither section is applicable</p>
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