

**Report of the Permanent Editorial Board
for the
Uniform Commercial Code**

**Application of UCC Sections 9-406 and 9-408 to
Transfers of Interests in
Unincorporated Business Organizations**

Draft for Public Comment

June 16, 2021

Comments on this draft must be submitted by no later than August 15, 2021.

Comments may be submitted by email to UCCComments@ali.org

**This draft has been approved for publication by the PEB
subject to revisions based on comments received.
The PEB reserves the right to withdraw this proposed Report.**

PREFACE TO PEB COMMENTARY

The Permanent Editorial Board for the Uniform Commercial Code acts under the authority of the American Law Institute and the Uniform Law Commission (also known as the National Conference of Commissioners on Uniform State Laws). The PEB has resolved to issue supplemental commentary on the UCC from time to time. The supplemental commentary of the PEB generally will be known as a *PEB Commentary*, to distinguish it from the Official Comments to the UCC. A *PEB Commentary* may be denominated a commentary, a report, or otherwise as determined by the PEB.

The Resolution states that:

The underlying purposes and policies of the *PEB Commentary* are those specified in UCC Section 1-103(a). A *PEB Commentary* should come within one or more of the following specific purposes, which should be made apparent at the beginning of the Commentary: (1) to resolve an ambiguity in the UCC by restating more clearly what the PEB considers to be the legal rule; (2) to state a preferred resolution of an issue on which judicial opinion or scholarly writing diverges; (3) to elaborate on the application of the UCC where the statute and/or the Official Comment leaves doubt as to the inclusion or exclusion of, or application to, particular circumstances or transactions; (4) consistent with UCC Section 1-103(a)(2), to apply the principles of the UCC to new or changed circumstances; (5) to clarify or elaborate upon the operation of the UCC as it relates to other statutes (such as the Bankruptcy Code and federal and state consumer protection statutes) and general principles of law and equity pursuant to UCC Section 1-103(b); or (6) to otherwise improve the operation of the UCC.

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I. Introduction

A. *Issue*

Article 9 of the Uniform Commercial Code (the “UCC”) contains several provisions that facilitate the full or partial assignability and transferability¹ of specified types of property in transactions to which Article 9 applies.² Building on common-law concepts of free alienability of property and on policies implemented in former § 9-318(4),³ §§ 9-406⁴ and 9-408⁵ fully or partially override in specified ways restrictions on certain transfers of rights in certain types of personal property.⁶ These sections contain provisions that can override in some circumstances both transfer restrictions imposed by law (including statutes) and transfer restrictions imposed by agreement.

These sections can affect transfer restrictions involving ownership interests⁷ in certain unincorporated business organizations, typically limited liability companies, limited partnerships, and general partnerships. 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 of an interest in one of these types of entities has the right to decide who the owner’s co-owners may be through the use of contractual and legal restrictions on who may obtain an ownership

¹ In Article 9, “assignment” and “transfer” may mean, depending on the context, the sale of a property interest or creation of a security interest in a property interest to secure an obligation. U.C.C. § 9-102 cmt. 26 (2010). The provisions of Article 9 quoted in this Report usually use the word “assign” (and its derivatives), while the text of this Report uses the word “transfer” (and its derivatives). As indicated in the definition of “transfer” in **Appendix A** to this Report, the terms should be understood interchangeably for purposes of this *Report*. See PEB Commentary No. 21 Use of the Term “Assignment” in Article 9 of the Uniform Commercial Code (March 11, 2020), 75 BUS. LAW. 2246 (Summer 2020).

² U.C.C. § 9-406 cmt. 5 (2010).

³ *Id.*

⁴ Subsections 9-406(a), (b), and (c) have provisions that are not germane this Report. References in this Report to § 9-406 do not include those subsections.

⁵ U.C.C. § 9-407 has comparable provisions concerning assignments of leases of goods. Those provisions are not relevant to this *Report* and are not discussed in it.

⁶ The types of property to which these overrides may apply are “accounts” (including health-care-insurance receivables), “chattel paper,” “general intangibles” (including “payment intangibles”), and “promissory notes,” each as defined in U.C.C. § 9-102(a).

⁷ The term “ownership interest” and certain other terms used in this Report are defined in Appendix A.

interest in the organization.⁸ Thus, it is important to understand the extent to which §§ 9-406 and 9-408 affect transfer restrictions with respect to ownership interests.⁹

B. Summary

The transfer restriction “override” provisions of §§ 9-406 and 9-408 apply as a general matter to a security interest (that secures an obligation) in an ownership interest in an unincorporated business organization. The transfer restriction “override” provisions of §§ 9-406 and 9-408 do not apply, however, to many other transactions involving these ownership interests. For example, they do *not* apply to:

- as a general matter, sales of ownership interests;¹⁰
- gifts of an ownership interest;
- transfers by operation of law of an ownership interest; and
- a sale of an ownership interest or a security interest in an ownership interest to secure an obligation where the ownership interests are “securities” governed by Article 8.

When §§ 9-406 and 9-408 do apply to the transfer of an ownership interest:

- These sections override only a transfer restriction otherwise enforceable by the organization (and only to the extent stated in the relevant section); and

⁸ This principle is implemented in uniform acts for unincorporated business organizations. *See, e.g.*, 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”). [all cites to uniform entity acts will be updated to the latest version of a final act when this *Report* goes final (assuming that happens)]

⁹ In 2018, the Uniform Law Commission and the American Law Institute approved amendments to UCC §§ 9-406 and 9-408 that generally exclude interests in partnerships and limited liability companies from the anti-assignment overrides of those sections. In states that adopt those amendments, in circumstances where that state’s version of these sections applies, the analysis in this Commentary would not be relevant as to security interests in interests in those types of entities. Some states have non-uniform statutory provisions that make those two sections of Article 9 inapplicable to transfer restrictions that relate to interests in partnerships and limited liability companies organized under the laws of those states. *See, e.g.*, Delaware UCC §§ 9-406(i)(5) and 9-408(e)(4).

¹⁰ This conclusion assumes that, as discussed below, typically an ownership interest would be characterized as a “general intangible,” but not as a “payment intangible.” As discussed below, the overrides *would* apply to the sale of (i) an ownership interest, *if* the interest is a “payment intangible,” and (ii) the sale of only the economic rights associated with an ownership interest in an unincorporated business organization (which would typically be a “payment intangible”). The overrides would not apply to a sale of a governance right alone, if such a transaction were to occur, because the governance rights standing alone would be a general intangible, but not a payment intangible.

- These sections leave intact a transfer restriction enforceable by another owner or other person.

Where §§ 9-406 and 9-408 do limit transfer restrictions otherwise enforceable by the organization:

- With regard to transfer restrictions on the sale of economic rights¹¹ (which are associated with an ownership interest) or their use as collateral, the UCC provisions do not create greater transferability than typically exists under the default rules of partnership and limited liability company statutes (in the absence of a more restrictive agreement); and
- With regard to transfer restrictions on the use of ownership interests as collateral, as a general matter the UCC provisions permit a security interest to be created, attach, and become perfected notwithstanding such restrictions, but these sections do not allow the secured party to enforce the ownership interest against the organization nor require the organization to recognize the transfer.

C. *Organization of the Balance of this Report*

This Report:

- Briefly describes the role of transfer restrictions in the law and practice of unincorporated business organizations;¹²
- Explains how the UCC's approach to transfer restrictions applies in relation to that law and practice; and
- Analyzes and applies the relevant parts of § 9-406 and § 9-408 to transactions within the scope of Article 9 that involve transfers of ownership interests.

II. 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.¹³ These statutes¹⁴ typically provide that an

¹¹ Partnership and limited liability statutes often refer to economic rights as “transferable interests.” See, e.g., Uniform Limited Partnership Act, § 102(25).

¹² The analysis in this Report assumes that restrictions imposed by agreement in this context are enforceable under law other than the UCC.

¹³ 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.

owner may freely transfer the owner's economic rights relating to an ownership interest to a non-owner absent an agreement to the contrary among the owners. However, they also provide that the owner may not freely transfer its governance rights relating to the ownership interest to a non-owner absent an agreement among the owners permitting that transfer. Thus, for a transfer that includes governance rights to be effective, the other owners must consent, protecting the pick-your-partner principle.

The operating agreements of many limited liability companies and many partnership agreements contain contractual transfer restrictions. Sometimes the contractual transfer restrictions do no more than repeat the statutory restrictions on the transfer of governance rights, but many restrictions 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 transfer of certain economic rights even though under the relevant statutory provisions the economic rights are otherwise freely transferable.

III. The Effect of UCC Article 9 on Transfer Restrictions

A. Scope of UCC Article 9

As discussed in the Introduction, §§ 9-406 and 9-408 potentially apply to transfer restrictions. Those sections apply, however, only to transactions within the scope of Article 9. Article 9 does not apply to most outright transfers of ownership interests.

With limited exceptions that are not germane to this *Report*, Article 9 applies to:

- Transactions, regardless of their form, in which personal property (including an ownership interest) secures payment or performance of (*i.e.*, is collateral for) an obligation;¹⁵ and
- The sale¹⁶ of certain kinds of payment rights.¹⁷

Article 9 does *not* apply, however, to the *sale* of other types of property including, most importantly for purposes of this *Report*, general intangibles that are not also payment intangibles. As discussed in some detail below, the economic rights of an owner standing alone normally constitute a payment intangible.¹⁸ Depending on the terms of

¹⁴ Typically the applicable law for these matters will be the law of the state under which the entity was formed. See U.C.C. § 9-401, Comment 3; *Restatement (Second) of Conflict of Laws* §§ 208 and 294 [add cross-reference to Commentary on choice of law on these issues]

¹⁵ U.C.C. § 9-109(a)(1).

¹⁶ 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 in note [17]. See U.C.C. § 1-201(b)(35).

¹⁷ Article 9 applies to the sale of accounts, chattel paper, payment intangibles, and promissory notes. U.C.C. § 9-109(a)(3).

¹⁸ If a general partner's or managing member's economic rights serve primarily to compensate that person for the provision of services to the organization, 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

an interest in an entity, the owner's ownership interest may be a general intangible that is or is not a payment intangible.

Thus, Article 9 applies to:

- a transaction in which an owner's ownership interest (typically a general intangible, whether or not a payment intangible), governance rights (typically a general intangible) or economic rights (typically a payment intangible) serve as collateral for an obligation *and*
- the sale of economic rights (rights that are principally a right to be paid money) (typically a payment intangible).

Article 9 does *not* apply to the sale of:

- an ownership interest (when it is a general intangible that is not a payment intangible) or
- only governance rights (typically a general intangible).

B. *An overview of sections 9-406 and 9-408*

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

C. *Sections 9-406 and 9-408 do not apply if the ownership interest is "investment property"*

As will be explained below, an ownership interest will typically be a "general intangible,"¹⁹ unless the ownership interest is "investment property." Sections 9-406 and 9-408 do not apply at all to a transfer of investment property because investment property cannot be a general intangible.²⁰ Thus determining whether an ownership interest falls

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 Report does not address the application of those sections to accounts.

¹⁹ As explained below, for purposes of this Report the key constructs are "general intangibles" and a subset of that construct - "payment intangibles." U.C.C. §§ 9-406 and 9-408 together also apply to the sale of accounts, chattel paper, payment intangibles, and promissory notes. An ownership interest does not fit into the chattel paper or promissory note categories. As discussed in note 18, *supra*, in limited circumstances an owner's economic rights might constitute an account, but this Report does not address that possibility.

²⁰ U.C.C. § 9-102(a)(42) (defining "general intangible" as *inter alia* "personal property ...other than ...investment property").

within the category “general intangible” or the category of “investment property” is pivotal to considering the application of § 9-406 and § 9-408 to such transfers.

Article 9 defines “investment property” to include a “security,”²¹ a term generally defined in UCC § 8-102.²² That definition, though, is qualified by a special provision in § 8-103 pertaining to “[a]n interest in a partnership or limited liability company.”²³ Under that special provision a partnership or limited liability company interest is a “security” if the terms of the interest “expressly provide” that it is a security governed by Article 8.²⁴ In such a case, those terms, often referred to as “opt-in” provisions, will result in the ownership interest being categorized as a “security” under Article 8.

If the ownership interest is categorized as a “security” under Article 8, the ownership interest will be “investment property” under Article 9.²⁵ As “investment property,” the ownership interest is excluded from Article 9’s pivotal category of “general intangible”²⁶ and, thus, excluded from the scope of §§ 9-406 and 9-408.

The operation of this special provision means that the parties to a partnership agreement, operating agreement, or other similar agreement can completely exclude the ownership interests from the scope 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).²⁷

²¹ U.C.C. § 9-102(a)(49).

²² 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)).

²³ 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).

²⁴ U.C.C. § 8-103(c). A partnership or limited liability company interest can also be a “security” if: (i) the interest is dealt in or traded on securities exchanges or in securities markets; or (ii) the interest is an investment company security. It is unusual for an ownership interest in a partnership or limited liability company to fit into either of those two categories because, subject to a narrow range of exceptions, such entities lose their favorable tax classification if their interests are publicly traded. *See generally* Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law*, ch. 16 (Warren Gorham & Lamont/RIA 2004; Supp. 2020-2) [update].

²⁵ 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).

²⁶ U.C.C. § 9-102(a)(42) (defining “general intangible” as *inter alia* “personal property ...other than ...investment property”).

²⁷ The balance of this Report will assume that the relevant unincorporated business organization has not “opted in” to Article 8.

D. *The meaning of “general intangible” and “payment intangible”*

The operation of Article 9 depends on a set of defined terms that categorize the property interests involved. For purposes of this *Report*, the key terms are “general intangible” and “payment intangible,” with the latter being a subset of the former.²⁸

Article 9 defines the term “general intangible” by stating what it is *not*. An item of personal property is a general intangible only if it does not fit into any of the other types of personal property identified by Article 9. Thus, “general intangible” is the residual type of personal property under Article 9.²⁹ A general intangible is also a “payment intangible” if the obligor’s “principal” obligation is a monetary obligation.³⁰ The obligor on a general intangible (including a payment intangible) is the “account debtor.”

In the context of a partnership or limited liability company:

- An ownership interest, which comprises both economic and governance rights, might or might not be a general intangible that is not a payment intangible. The owner’s economic rights consist of the owner’s right to receive distributions from the organization. If the owner’s governance rights (and the organization’s obligation to honor those rights) are such that the monetary obligation is not the *principal* obligation of the account debtor (*i.e.*, the organization), the ownership interest would not be a monetary obligation and the interest would likely be a general intangible that is not a payment intangible.
- An owner’s economic rights, considered alone, typically constitute a payment intangible because, as the term is used in this Commentary (*see* Appendix), an owner’s economic rights with respect to an organization consist of a right to payment of a monetary obligation of the organization.

E. *Sections 9-406 and 9-408 may not apply to a sale of an ownership interest*

As discussed above in Section III(A), neither § 9-406 nor § 9-408 applies to a transaction involving the *sale* of an ownership interest where the ownership interest is a general intangible that is not a payment intangible. Sales of general intangibles that are not payment intangibles are outside the scope of Article 9.

Example 1: The Revised Uniform Limited Liability Company Act (2013) provides, as default rules, a variety of transfer restrictions.³¹ Assume a member seeks to sell all or

²⁸ U.C.C. § 9-102(a)(42).

²⁹ U.C.C. § 9-102(a)(42).

³⁰ U.C.C. § 9-102(a)(61).

³¹ These restrictions include (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. Revised Uniform Limited Liability Company Act (2006) §§ 401(d)(3), 502 and 503. [Update to 2013 version]

part of its ownership interest to a non-member.³² If that interest is a general intangible that is not a payment intangible, Article 9 does not apply to the sale of the ownership interest and thus neither § 9-406 nor § 9-408 overrides the statutory transfer restrictions.

F. *Sections 9-406 and 9-408 do not apply to a gift or, as a general matter, a transfer by operation of law of an ownership interest*

Sections 9-406 and 9-408 do not apply 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:

- Article 9 applies primarily to (i) transactions in which, by contract, personal property serves as collateral for an obligation and (ii) contractual sales of certain payments rights including payment intangibles.³³ Neither of these situations is present in the case of a gift. If property is the subject of a gift, there is no obligation for which the property is collateral. Further, 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 Because there is no “price” in the case of a gift, there is no “sale.” Accordingly, §§ 9-406 and 9-408 do not apply to override any restrictions on transfer of an ownership interest by gift.
- Similarly, because Article 9 does not generally apply to a transfer of an ownership interest 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

IV. The Application of Section 9-406

A. *General*

Section 9-406’s override rules do not apply to a transaction involving an ownership interest unless *each* of the following applies:

³² Whether statutory transfer restrictions apply to sales by a member to another member is a complex question, depends on the precise wording of the applicable LLC statute, and is beyond the scope of this Report. See Uniform Limited Liability Company Act (2013) § 501, cmt.

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 Report 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 Report, 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.

- The restriction is in an agreement;
- The principal obligation of the issuer under the ownership interest is monetary, so the ownership interest constitutes a payment intangible;
- The transaction creates a security interest that secures an obligation; and
- The transfer restriction is otherwise enforceable by the organization as an agreement between it and the owner.

B. *Text of subsections 9-406(d) and (e)*

Subsections 9-406(d) and (e) state:³⁶

(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:

- (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 9-620.³⁷ (emphasis added)

C. *Subsection 9-406(d) applies only to a transfer restriction created by an agreement*

Subsection 9-406(d)'s override applies only to a "term"³⁸ in an "agreement."³⁹ Thus it has no application to a legal restriction on transfer, such as one that might appear in a partnership statute or a limited liability company statute.⁴⁰

D. *Subsection 9-406(d) applies only if the transfer restriction is otherwise enforceable by the "account debtor" in an agreement between the debtor and the account debtor*

Even if the transfer of an ownership interest is within the scope of Article 9, § 9-406 applies only if the transfer restriction is otherwise enforceable by the unincorporated

³⁶ The text will vary in those states that have adopted the revisions to §§ 9-406 and 9-408. See note 9.

³⁷ All emphasis here and throughout this Report is added.

³⁸ "Term" is defined in § 1-201(b)(3).

³⁹ "Agreement" is defined in § 1-201(b)(4).

⁴⁰ § 9-406(f) applies to legal (non-contractual) restrictions applicable to accounts and chattel paper.

business organization (which Article 9 refers to in this context as the “account debtor”) as a party to the agreement creating the restriction.

This latter condition to the application of § 9-406 - that the organization be a party to the agreement with the owner transferring the ownership interest - arises because the language of § 9-406(d) confines the application of the subsection to circumstances involving “an agreement between an account debtor [the organization] and an assignor [the owner transferring the ownership interest].”

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 organization (the partnership or the limited liability company) is the “account debtor” where it owes its owners monetary and non-monetary obligations.⁴¹

If a partnership is not a party in a contractual sense⁴² to its own partnership agreement or a limited liability company is not a party in a contractual sense to its own operating agreement containing the transfer restriction, the restriction would not be in an agreement between the organization and the owner and, thus, not enforceable by the organization.⁴³ By its terms, subsection (d)(1) does not apply to a transfer restriction enforceable only by other owners that are parties to the agreement, including any requirement for the consent of the other owners to a transfer. This is because the other owners are not obligors (“account debtors”) with respect to the owner’s economic rights.⁴⁴ As a result, subsection (d)(1) would have no effect on the restrictions enforceable by the other owners in an agreement described in the preceding sentences.

⁴¹ Revised Uniform Limited Liability Company Act (2006) §§ 404, 401(a), and 502. [update and check cites; add LP cites]

⁴² See notes 38-40, *infra*.

⁴³ An organization 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).

⁴⁴ Even if the organization 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 is otherwise enforceable by the organization. Likewise, while subsection (d)(2) can apply to an agreement containing transfer restrictions if the organization is a party to the agreement, by its terms the subsection: (i) applies only to 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.

E. *Subsection 9-406(d) applies only if the transfer involves a payment intangible*

Subsection (d) refers to payment intangibles but not to general intangibles that are not payment intangibles. Accordingly, the subsection applies only to transfer restrictions on an owner's economic rights by themselves and to transfer restrictions on an ownership interest only if that ownership interest is a "payment intangible."

F. *Subsection 9-406(d) applies only if the transfer is a security interest to secure an obligation*

Article 9 applies to the outright sale of a payment intangible, which is referred to as a "security interest."⁴⁵ However, subsection (e) excludes from the operation of subsection (d) a sale of a payment intangible. Thus, the only security interests in payment intangibles covered by subsection (d) are those securing obligations and not those that are a sale of a payment intangibles.

G. *Example of the application of subsection 9-406(d)*

Even in those cases in which the organization itself is a party to the partnership agreement or operating agreement along with the other partners or members, only the organization is an "account debtor" with respect to the economic rights and thus § 9-406(d) affects the agreement only to the extent that it provides rights to the organization. Subsection 9-406(d) has no effect on the agreement to the extent that it provides rights to the other owners.

Example 2: A limited liability company is a party to its own operating agreement. The operating agreement:

- A. requires unanimous member consent for any transfer of an ownership interest;⁴⁶
- 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; and
- C. provides that a transfer in violation of the stated transfer restrictions is a breach of the operating agreement.

To the extent that the transfer restriction in Point A relates to a sale of the ownership interest, Article 9 does not apply at all (and, thus, the override in § 9-406 does not apply), assuming the ownership interest is a general intangible that is not a payment intangible.

As to the right of first refusal described in point B, UCC § 9-406(d)(1):

⁴⁵ U.C.C. § 9-109(a)(3).

⁴⁶ Such a consent requirement would be valid under most LLC statutes. [cite]

- renders ineffective the *company's* right with respect to the creation, attachment, perfection, or enforcement of a security interest in only the member's economic rights securing an obligation (assuming that those economic rights are a payment intangible);⁴⁷
- due to § 9-406(e), has no effect on the company's right with respect 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 the economic 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 with respect to an outright sale of the member's economic rights;
- § 9-406 has no effect with respect to a sale of the member's ownership interest or governance rights (assuming that they are general intangibles that are not payment intangibles), 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" provision as it applies to the creation of a security interest in only the member's economic rights to secure an obligation (assuming that those economic rights are a payment intangible)⁴⁸ to the extent that the breach otherwise creates rights for the company; subsection (d)(2) has no effect on the "breach" provision to the extent that the breach creates rights for the other owners (because they are not account debtors with respect to the economic interest).⁴⁹

Thus, the effect of § 9-406(d) is limited to transactions to the extent *each* of the following is satisfied:

- an owner grants a security interest in only its economic rights, its ownership interest (if that ownership interest is a payment intangible) or, if its ownership interest is a general intangible that is not a payment intangible, to the extent the ownership interest is a payment intangible (i.e., to the extent the ownership interest comprises economic rights);
- the security interest secures a loan or other obligation; and

⁴⁷ The same result would occur *if* the security interest to secure an obligation were in the member's entire interest and that interest were a payment intangible.

⁴⁸ The same result would occur *if* the security interest to secure an obligation were in the member's entire interest and that interest were a payment intangible.

⁴⁹ The remedies available to the other owners arising from a breach would be determined by law other than Article 9.

- the transfer restriction is otherwise enforceable by the organization because of an agreement between the owner and the organization containing the transfer restriction.

V. The application of section 9-408

A. General

Section 9-408's override rules do not apply to a security interest involving an ownership interest unless *each* of the following applies:

- Either, (i) the ownership interest is a general intangible that is not a payment intangible and the security interest secures an obligation, or, (ii) the ownership interest is a payment intangible and the security interest is a sale of the payment intangible; and
- The transfer restriction is otherwise enforceable by the organization based on an agreement between the owner and the organization containing the transfer restriction or because of a statutory or other legal restriction that requires the consent of the organization.

B. Text of subsections 9-408(a) and (b)

Section 9-408(a) and (b) state:⁵⁰

(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. (emphasis added)

C. *Subsection 9-408(a) applies only if the transfer restriction is enforceable by the "account debtor"*

As noted above, the account debtor with respect to an ownership interest (including an economic interest) is the organization itself. Thus, § 9-408(a), like § 9-406(d), is applicable only to the extent that the agreement containing the transfer restriction includes the organization as a party. Even then, § 9-408(a), like § 9-406(d), does not affect transfer restrictions with respect to an ownership interest (including an economic interest) to the extent the transfer restrictions are enforceable by the other owners that are parties to

⁵⁰ The text will vary in those states that have adopted the revisions to §§ 9-406 and 9-408. See note [•].

the agreement (who are not “account debtors” for this purpose) rather than by the organization. This is because the other owners are not “account debtors” with respect to those interests or rights.

D. *Subsection 9-408(a) applies to a payment intangible only if the transfer involves a sale of the payment intangible*

Section 9-408(a) applies to a payment intangible only if the transaction is a sale⁵¹ of the payment 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.

E. *Subsection 9-408(d) confirms the limited scope of the override provisions where § 9-408(a) applies*

If § 9-408(a) does apply, it overrides restrictions only on “the creation, attachment, or perfection of a security interest.” The override does not extend to *enforcement* of a security interest. Restrictions pertaining to the *enforcement* of the security interest are not affected for transactions governed by § 9-408.⁵² Thus, when § 9-408(a) applies, the restriction does not prevent a security interest from coming into existence or the perfection of that security interest, but the override does not go so far as to require the organization to recognize the security interest or its enforcement. This is because creation and attachment affect the existence of the security interest as between the debtor and the secured party, 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, but creation and perfection do not, of themselves, affect the organization. Section 9-408(d) confirms that the organization does not have to recognize the security interest or the enforcement of the security interest.

F. *Examples of the application of subsection 9-408*

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

Example 3: The operating agreement of a limited liability company to which the company is a party precludes a member from transferring its ownership interest without the consent of the other members. The member grants to Secured Party a security interest in the member’s ownership interest as collateral for an obligation. If the restriction is otherwise enforceable by the limited liability company as party to

⁵¹ However, as noted above, § 9-406 would apply if the transaction involves a security interest in a payment intangible where the security interest secures an obligation.

⁵² § 9-408(d)(6).

the operating agreement with the owner, § 9-408(a) overrides the transfer restriction with respect to the limited liability company to the extent described above (*i.e.*, to the extent it impairs creation, attachment and perfection of the security interest but does not override the restriction with respect to enforcement 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.

Example 4: Same facts as Example 3 except that the member defaults under its security agreement with Secured Party. Section 9-408(a) has no effect on the restriction to the extent that the restriction limits the effect of Secured Party's enforcement of its security interest, including its remedy of collection under § 9-607, its remedy of disposition under § 9-610, and the secured party's 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 5: The operating agreement of a limited liability company to which the company is a party prohibits members from transferring any part of their ownership interest, including their economic rights, without the consent of the other members. A member sells only its economic rights to Buyer. If the payment rights constitute a "payment intangible", the sale is governed by Article 9 and, in UCC parlance, the sale creates a "security interest" (even though the transaction is an outright transfer of the member's economic rights) Thus § 9-408(a) renders the contractual transfer restriction, to the extent that it would otherwise be enforceable by the company, ineffective with respect to the company to prevent the sale from taking place as between the member and Buyer. However, as in Example 4 the provision does not override the transfer restriction to the extent of permitting Buyer to enforce the sale against the limited liability company. Thus, the transfer restriction, if effective under other law, remains effective, even as applied to the company, to deny Buyer the right against the company to collect from the company any distributions to which the member is entitled or to require the company to recognize Buyer as the owner of the economic rights. More fundamentally, § 9-408(a) does not apply to a transfer restriction to the extent that it is enforceable by other owners that are parties to the agreement containing the restriction because those other owners are not "account debtors."

To emphasize these points as well as points made earlier in this *Report*, consider an example that is a variation of Example 2 under § 9-406(d).

Example 6: A limited liability company is a party to its own operating agreement. The operating agreement:

- A. requires unanimous member consent for any transfer of an ownership interest;

B. subjects any sale, creation of a security interest to secure an obligation, or other transfer of a member's ownership interest to a right of first refusal, first in favor of the limited liability company and then in favor of the other members; and

C. provides that any attempt to make a transfer in violation of the stated transfer restrictions is a breach of the operating agreement.

In the case of a sale by a member of an ownership interest, subsection (a) has no effect at all if the ownership interest is a general intangible that is not a payment intangible because Article 9 (and, thus, § 9-408) does not apply to sales of general intangibles that are not payment intangibles.

In the case of a security interest in the ownership interest securing an obligation (assuming that the ownership interest is a general intangible that is not a payment intangible), subsection (a) has the following effects:

- Subsection (a) 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; and
- Subsection (a) overrides the "breach" characterization described in point C as it applies to the creation, attachment or perfection of the security interest, but only insofar precluding enforcement by the company.

In the case of a security interest in the ownership interest securing an obligation, the effect of subsection (a) is subject to the following limits:

- it has no effect on the requirement that other members consent to the security interest, because the other members are not "account debtors" with respect to ownership rights;
- it does not render ineffective the company's right of first refusal as applied to the enforcement of the security interest;⁵³
- it has no effect on the other members' rights of first refusal, because the other members are not "account debtors" with respect to ownership rights;
- it does not override the "breach" characterization as it applies to the enforcement of the security interest insofar as the transfer restriction is enforceable by the company; and

⁵³ Section 9-408(a) would not create any obligation 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 § 9-607. Nor would § 9-408(a) override the company's right of first refusal if the secured party sought to exercise its right of disposition under § 9-610 or its right of acceptance under § 9-620. *See also* § 9-408(d).

- it 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.⁵⁴

G. *Subsection 9-408(c) applies to legal restrictions*

Section 9-408(c) states:⁵⁵

(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.

As noted above, § 9-408(a) applies only to transfer restrictions in an agreement. Section 9-408(c) applies to non-contractual, legal transfer restrictions, including those in the act that governs the unincorporated business organization (unless there is a statutory provision to the contrary). The analysis for § 9-408’s effect on legal restrictions is the same as for transfer restrictions contained in an agreement between the owner and the organization. As with § 9-408(a), § 9-408(c) has no effect on a non-contractual, legal restriction that requires the consent of the other owners for a transfer.

VI. Conclusion

The transfer restriction “override” provisions of §§ 9-406 and 9-408 do not apply to (i) many transactions involving a security interest in an ownership interest that secures an obligation and (ii) to sales of ownership interests, when the ownership interest is a general intangible that is not a payment intangible.

⁵⁴ Once again, the remedies available to the other members arising from a breach would be determined by law other than Article 9.

⁵⁵ The text will vary in those states that have adopted the revisions to §§ 9-406 and 9-408. See note [•].

APPENDIX A

In this *Report*, 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,”⁵⁶ 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 the member’s economic rights.⁵⁷
- “*Transfer*” includes a security interest, assignment, conveyance, deed, bill of sale, lease, mortgage, encumbrance, gift, and transfer by operation of law.⁵⁸
- “*Transfer restriction*” means a restriction on the transfer of an 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.

⁵⁶ 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.

⁵⁷ See note [•], *supra*.

⁵⁸ Uniform Limited Partnership Act (2001) § 102(21); Revised Uniform Limited Liability Company Act (2006) § 102(20).