



2018 AMENDMENTS TO THE UNIFORM COMMERCIAL CODE SECTIONS 9-406 AND 9-408

- A Summary -

In 2018, the Uniform Law Commission and American Law Institute approved a narrow set of amendments to Article 9 of the Uniform Commercial Code (UCC). The amendments resolve a potential conflict between the UCC and state laws governing the management of businesses organized as partnerships or limited liability companies (LLCs).

UCC Article 9 governs secured transactions – including transactions involving the pledge of property as collateral for a loan. Sections 9-406 and 9-408 contain rules to ensure a secured lender can enforce the terms of its agreement by selling or otherwise disposing of collateral if the debtor defaults. To that end, certain restrictions on the transfer of property to be pledged as collateral are generally ineffective.

The potential conflict arises when the property pledged as collateral is an interest in a partnership or an LLC. The law governing these types of organizations includes a fundamental concept known as the “pick-your-partner principle.” This principle recognizes that co-owners of small businesses have a substantial interest in determining who the other co-owners are. If one co-owner could transfer his or her ownership interest to a stranger, the remaining co-owners would be forced into a business venture with the stranger without their consent.

The pick-your-partner principle avoids this result by dividing ownership interests into two parts: an economic interest and a governance interest. The former, which includes the right to share in any profits, is generally freely transferable personal property. The latter, which includes the right to participate in management decisions, is generally not transferable without the consent of the other co-owners. Only the transferable economic interest may generally be used as collateral in a secured transaction without the consent of the other co-owners.

The 2018 amendments to UCC Article 9 create an exception to the rules that make transfers of property pledged as collateral ineffective. Without these amendments, it was unclear whether Sections 9-406 and 9-408 could undermine the pick-your-partner principle in some instances by invalidating restrictions on the transfer of a co-owner’s governance interest. The 2018 amendments expressly exempt partnership and LLC interests from the general rule of free transferability, thereby upholding the pick-your-partner principle for small businesses.

For further information about the 2018 amendments to UCC Article 9, please contact ULC Chief Counsel Benjamin Orzeske at (312) 450-6621 or borzeske@uniformlaws.org or ULC Legislative Counsel Kari Bearman at (312) 450-6617 or kbearman@uniformlaws.org.