HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: CS/HB 519 Rights of Third Parties Under the Uniform Commercial Code
SPONSOR(S): Civil Justice & Property Rights Subcommittee, Leek
TIED BILLS: **IDEN./SIM. BILLS:** CS/SB 336

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Civil Justice & Property Rights Subcommittee	16 Y, 0 N, As CS	Mawn	Jones
2) Regulatory Reform Subcommittee	17 Y, 0 N	Wright	Anstead
3) Judiciary Committee	20 Y, 0 N	Mawn	Kramer

SUMMARY ANALYSIS

The Uniform Commercial Code ("UCC") is a set of laws, adopted by all fifty states, governing and providing uniformity in commercial transactions in the United States. Florida's UCC provisions are codified in chs. 670–680, Florida Statutes.

Article 9 of the UCC (codified in ch. 679, F.S.) governs secured transactions, meaning transactions involving the granting of credit secured by personal property ("collateral"), where the creditor may take possession of the collateral if the debtor defaults on the loan. In 2001, to promote the free assignability of personal property, including intangible property rights, the UCC was amended to include a general restriction on contract provisions which prohibit or restrict the creation of a security interest in certain types of collateral ("Article 9 override"), including:

- General intangibles, meaning any personal property, including things in action other than certain defined collateral types (codified in s. 9-408 of the UCC and s. 679.4081, F.S.); and
- Payment intangibles, meaning general intangibles under which the account debtor's principal obligation is a monetary obligation (codified in s. 9-406 of the UCC and s. 679.4061, F.S.).

The Article 9 override may apply where an owner in a partnership or a limited liability company ("LLC") creates a security interest in his or her ownership interest in the business, even where the business's operating agreement prohibits the owner from doing so, because such interest is generally classified as either a general intangible or a payment intangible. However, applying the Article 9 override in such instances potentially conflicts with the "pick your partner principle," which recognizes that an owner in such a business has a substantial stake in determining co-owners and should not generally be forced into doing business with someone with whom the owner did not intend to do business.

In 2018, ss. 9-406 and 9-408 of the UCC were amended to eliminate the potential conflict with the "pick your partner principle." Specifically, the amendments provided that the Article 9 override does not apply to a security interest in an ownership interest in a general or limited partnership or an LLC. To date, at least 10 states have adopted some form of these amendments.

CS/HB 519 amends ss. 679.4061 and 679.4081, F.S., to incorporate the 2018 UCC amendments. Specifically, the bill provides that the override provisions set out in those sections do not apply to a security interest in an ownership interest in a general partnership, a limited partnership, or an LLC. This removes any potential conflict between these sections and the "pick your partner principle" and promotes the freedom of the owners in a partnership or LLC to contract.

The bill does not appear to have a fiscal impact on state or local governments.

The bill provides an effective date of January 1, 2023.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Background

The Uniform Commercial Code ("UCC"), a set of laws governing and providing uniformity in commercial transactions in the United States, is a joint project between the Uniform Law Commission ("ULC") and the American Law Institute ("ALI").[1] The UCC has been adopted by all fifty states.[2] The UCC includes both general provisions and specific provisions governing sales, leases, negotiable instruments, bank deposits and collections, letters of credit, documents of title, investment securities, secured transactions, and leases.[3] Florida's UCC provisions are codified in chs. 670–680, Florida Statutes.

Article 9's Anti-Assignment Override

Article 9 of the UCC (codified in ch. 679, F.S.) governs secured transactions, which are transactions involving the granting of credit secured by personal property ("collateral"), where the creditor may take possession of the collateral if the debtor defaults on the loan.[4] In 2001, to promote the free assignability of personal property, including intangible property rights, and the ability of a debtor to obtain credit, the UCC was amended to include a general restriction against contract provisions prohibiting the creation of a security interest in certain types of collateral ("Article 9 override"),[5] including:

- General intangibles, meaning any personal property, including things in action other than certain defined collateral types (codified in s. 9-408 of the UCC and s. 679.4081, F.S.);[6] and
- Payment intangibles, meaning general intangibles under which the account debtor's[7] principal obligation is a monetary obligation (codified in s. 9-406 of the UCC and s. 679.4061, F.S.).[8]

In other words, the Article 9 override renders ineffective restrictions between an account debtor and a debtor preventing the assignment of general intangibles or payment intangibles as collateral for a debt. The Article 9 override also applies to an ordinary security interest in a complete ownership interest or in economic rights alone and to the outright sale of a payment intangible.[9]

In the context of an ownership interest in a business, the "account debtor" is the business while the "debtor" is the person holding the ownership interest. Thus, the Article 9 override would not apply to an anti-assignment clause in a contract between a business's owners themselves; it would only apply to such a clause in a contract between a business's owners and the business.

Potential Conflict with the "Pick Your Partner Principle"

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[1] Chs. 670-680, F.S.; Uniform Law Commission, Uniform Commercial Code, https://www.uniformlaws.org/acts/ucc (last visited Jan. 26, 2022).

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] Sara T. Toner and R. Parker Havis, *Lessons From Delaware: Navigating the 2018 Amendments to Sections 9-406 and 9-408 of Article 9 of the Uniform Commercial Code*, https://cdn.ymaws.com/acrel.site-ym.com/resource/resmgr/news_and_notes/february_2020/2020-02_toner_-_lessons_from.pdf (last visited Jan. 26, 2022); Florida Bar Business Law Section, *Exclusion of LLC and Partnership Interests from UCC Article 9 Override: Executive Summary*, http://www.flabizlaw.org/files/Summary%20and%20Materials%20-%20UCC%209-406%20and%209-408%20Amendments%20%28v2%29.pdf (last visited Jan. 26, 2022).

[6] General intangibles do not include accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. S. 9-102, UCC; S. 679.1021(1)(pp), F.S.

[7] "Account debtor" means a person obligated on an account, chattel paper, or general intangible, but does not include a person obligated to pay a negotiable instrument. S. 9-102, UCC; s. 679.1021(1)(c), F.S.

[8] Article 9 does not apply to the outright sale of a complete ownership interest or of governance rights alone.

[9] Carl S. Bjerre, Daniel S. Kleinberger, Edwin E. Smith, and Steven O. Weise, *LLC and Partnership Transfer Restrictions Excluded from UCC Article 9 Overrides*, https://businesslawtoday.org/2019/02/llc-partnership-transfer-restrictions-excluded-ucc-article-9-overrides/ (last visited Jan. 26, 2022).

A partnership is an association of two or more persons carrying on as co-owners of a business for profit formed under s. 620.8202, F.S., or another jurisdiction's comparable law.[10] A limited liability company ("LLC") is a business formed or existing under ch. 605, F.S., or a business that becomes subject to that chapter by operation of law, formed to protect its members from personal liability for the business's debts or other obligations.[11] An interest in a partnership or LLC is typically categorized as a general intangible as the business owes the interested party rights associated with partnership or membership rather than a defined debt.[12] However, an interest in a partnership or LLC involving economic rights may be categorized as a payment intangible.[13]

The Article 9 override may apply where an owner in a partnership or an LLC creates a security interest in his or her ownership interest in the business, or some component thereof, even where the business's operating agreement prohibits the owner from doing so.[14] However, applying the Article 9 override in such instances potentially conflicts with the "pick your partner principle" reflected in partnership and LLC law, which generally recognizes that an owner in such a business has a substantial stake in determining who the co-owners are and should not be forced into doing business with someone the owner did not intend to do business with.[15] The Florida Bar's Business Law Section illustrates the conflict as follows:

> Two individuals go into business together and form an LLC. Each owner is a 50/50 member in the LLC. Their operating agreement (like most operating agreements) restricts the ability of one member to convey or encumber his or her membership interest without the consent of the other member, in keeping with the "pick your partner principle" engrained in LLC and partnership law. If one partner unilaterally encumbered his or her 50% membership interest to secure a personal loan from a bank (in violation of the operating agreement), then arguably, Section 9-406 and 9-408 would "override" the restriction in the operating agreement. If the member defaulted on the loan, the lender could foreclose on its security interest and take ownership of the membership interest. The other member would now be saddled with a bank as its new business partner, a result not contemplated or permitted by the members' contract (the operating agreement).[16]

To avoid this conflict, some partnerships and LLCs may attempt to categorize an ownership interest in the business as a security, classified by the UCC as "investment property" rather than a general intangible or a payment intangible.[17] This allows the business to opt in to Article 8 of the UCC, governing securities, and bypass Article 9 and its override altogether. However, by opting into Article 8, the business faces the potential for increased transaction costs and the restructuring of its organization documents.[18]

<u>2018 UCC Amendments</u>

In 2018, the ULC and the ALI approved amendments to ss. 9-406 and 9-408 of the UCC to eliminate the potential conflict with the "pick your partner principle" ("2018 UCC Amendments").[19] Specifically, the amendments provide that the Article 9 override does not apply to a security interest in an ownership interest in a general or limited partnership or an LLC.[20] Several states have adopted these amendments in their UCC codification statutes, amended their partnership and LLC statutes to achieve a similar result, or employed a combination of the two, as follows:[21]

[10] S. 620.8101(7), F.S.
[11] Ss. 605.0102(36) and 605.0304(1), F.S.
[12] Toner and Havis, *supra* note 4; Florida Bar Business Law Section, *supra* note 4.
[13] *Id.*
[14] Bjerre, et al., *supra* note 8.
[15] *Id.*; Florida Bar Business Law Section, *supra* note 4.
[16] Florida Bar Business Law Section *supra* note 4.
[17] Bjerre, et al., *supra* note 8; Florida Bar Business Law Section, *supra* note 4.
[18] *Id.*
[19] Florida Bar Business Law Section, *supra* note 4.
[20] *Id.*
[21] *Id.*

State	Method	Statutes
Alabama	Amended its LLC and limited partnership statutes.	§§ 10A-5A-1.06 and 10A-9-7.02, Ala. Code
Colorado	Amended all applicable statutes.	§§ 4-9-406, 4-9-408, 7-90-104, Col. Rev. Stat.
Delaware	Amended all applicable statutes.	Title 6, §§ 9-406, 9-408, 15-104, 17-1101, and 18-1101, Del. Code Ann.
Kansas	Amended its LLC statute.	§ 17-76, K.S.A.
Kentucky	Amended its LLC and partnership statutes.	§§ 275.255, 362.2-702, 32.1-503, Ky. Rev. Stat.
Maine	Amended its LLC statute.	Title 31, § 1507, Maine Stat.
North Carolina	Amended its UCC codification and LLC statutes.	§§ 25-9-406, 25-9-408, 57D-10-02, N.C. Gen. Stat. Ann.
Ohio	Amended its partnership statute.	§ 1776.49, Ohio Rev. Code Ann.
Texas	Amended all applicable statutes.	§§ 9.406, 9.408, 101.106, and 154.001, Tex. Bus. & Com. Code Ann.
Virginia	Amended all applicable statutes.	§§ 8.9A-406, 8.9A-408, 13.1-1001.1, 50-73.84, Va. Code Ann.

Effect of Proposed Changes

CS/HB 519 amends ss. 679.4061 and 679.4081, F.S., to incorporate the 2018 UCC amendments. Specifically, the bill provides that the anti-assignment override provisions set out in those sections do not apply to a security interest in an ownership interest in a general partnership, a limited partnership, or an LLC. This removes any potential conflict between these sections and the “pick your partner principle” by allowing contract terms prohibiting the creation of such security interests to stand and promotes the freedom of the owners in a partnership or LLC to contract.

The bill provides an effective date of January 1, 2023.

B. SECTION DIRECTORY:

Section 1: Amends s. 679.4061, F.S., relating to discharge of account debtor; notification of assignment; identification and proof of assignment; restrictions on assignment of accounts, chattel paper, payment intangibles, and promissory notes ineffective.
Section 2: Amends s. 679.4081, F.S., relating to restrictions on assignment of promissory notes, health-care-insurance receivables, and certain general intangibles ineffective.
Section 3: Provides an effective date of January 1, 2023.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

   None.

2. Expenditures:

   None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

   None.

2. Expenditures:

   None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

The bill will allow a contract among business partners or a controlling statute to limit the ability of an owner in a partnership or LLC to create a security interest in his or her ownership interest in the business. The bill:

- Protects the investment of the owners in a partnership or LLC in a manner consistent with the "pick your partner principle";
- May eliminate the need for a partnership or LLC to classify an ownership interest in the business as a security, thereby reducing the business's transaction costs; and
- May reduce litigation costs related to disputes over the application of the override provisions to ownership interests in a partnership or LLC.

D. FISCAL COMMENTS:

None.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

   Not applicable. The bill does not appear to affect county or municipal governments.

2. Other:

   None.

B. RULE-MAKING AUTHORITY:

Not applicable.

C. DRAFTING ISSUES OR OTHER COMMENTS:

None.

IV. AMENDMENTS/COMMITTEE SUBSTITUTE CHANGES

On January 13, 2022, the Civil Justice and Property Rights Subcommittee adopted one amendment and reported the bill favorably as a committee substitute. The amendment changed the bill's effective date from July 1, 2022, to January 1, 2023.

This analysis is drafted to the committee substitute as passed by the Civil Justice and Property Rights Subcommittee.