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Paul Rubin, the *Lending and Restructuring Alert*'s Editor and a partner in Herrick's Financial Restructuring, Bankruptcy and Creditors' Rights Practice Group, is a featured speaker at a timely seminar entitled "Commercial Real Estate Finance in Challenging Times" on March 18. Paul will present on the topic of "Special Problems to Consider in a Bankruptcy Scenario." For more information on this presentation, please click here.

LENDING AND RESTRUCTURING ALERT

JANUARY 2008

Beware: Assignments of Economic Interests May Be Prohibited

We want to bring to your attention a trap for lenders looking for additional credit support in the form of collateral assignments of economic interests. Lenders generally prefer to obtain pledges of the underlying equity interest (and the voting and consent rights appurtenant thereto). But in times like these, an assignment of the economic interests—such as the rights to receive dividends or distributions in liquidation in partnerships or limited liability companies—can be of real value and is usually more readily available. But beware: you may not get the security you think you're getting.

The problem: The organizational documents of a limited liability company or a partnership may prohibit an assignment of economic interests. Most lenders are aware of this and don't consider it a problem, because the Uniform Commercial Code ("UCC"), as adopted in *most* states, overrules such anti-assignment provisions[1], so you can take assignment of economic rights notwithstanding a prohibition in the organizational document.

But Delaware, whose law governs a sizeable proportion of these agreements, is different. Under Delaware's version of the UCC, as well as its Partnership Act, Limited Partnership Act and Limited Liability Company Act, if an entity's organizational documents prohibit assignments of economic interests, the provisions in those documents will control. This means that you need to ascertain which state's law will govern the assignment of the economic interests. The UCC contains mandatory choice of law rules governing the perfection and priority of security interests, which do not apply to the granting of an assignment of economic interests. Moreover, it is uncertain whether a choice of law clause contained in loan documents will be effective on this question, even though such clauses are generally enforceable. This is because it is doubtful that a lender and a borrower can dictate which law will apply to govern the relationship between the borrower and the entity in which the borrower is invested. Therefore, a lender may not be able to avoid the application of Delaware law, because the

[1] These UCC provisions are known as "anti-anti-assignment" rules. The UCC also provides anti-anti-assignment rules affecting pledges of full equity interests, but they are far less potent.

applicable law may well be determined by what attorneys refer to as a "traditional choice of law" analysis. Unfortunately, as yet there is no case law directly answering the question.

How to protect yourself: Before conditioning a forbearance or a restructuring agreement on the delivery of an assignment of economic interests, a lender should ascertain whether it is clear which state's law will govern the right to assign those interests, and particularly, whether there is cause for concern that Delaware law may apply.

Also watch out for: There are two other wrinkles that lenders must consider when taking assignment of economic rights. First, the "anti-anti-assignment" provisions discussed above apply where the entity in question has not "opted in" and elected to have its equity interests deemed to be "securities" under Article 8 of the UCC. Discussion of this concept is beyond the scope of this Alert, but lenders and their counsel need to ensure that the underlying equity interests constitute "general intangibles" and not "securities" under the UCC. Second, it is possible that an agreement to assign economic rights in a partnership or limited liability company may trigger an event of default under such entity's loan documents with its own lender. Therefore, the assignor and its lender seeking to take such an assignment need to consider whether the contemplated assignment will trigger an event of default for the entity, and if so, whether they are willing to let that happen.

For further information regarding these or other lending issues, you may **contact Stephen D. Brodie at 212-592-1452 or sbrodie@herrick.com, or Paul Rubin at 212-592-1448 or prubin@herrick.com.**

Herrick's Financial Restructuring, Bankruptcy and Creditors' Rights Practice Group represents debtors, creditors' committees, secured and unsecured creditors, trustees, financial institutions, investment banks, asset-based lenders, insurance companies, pension funds, purchasers of assets, landlords, claims traders, equipment lessors and licensors in workout, restructuring, bankruptcy, and reorganization matters. Our clients range from Fortune 500 corporations to small public and private companies. For more information on our practice, please visit www.herrick.com.