NAV Collateral: The Assignability of Delaware Fund Interests

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Borrowers under net asset value ("***NAV***") credit facilities will sometimes seek to grant a direct pledge of their interests in hedge funds and private equity funds as collateral. The analysis for determining whether any such pledge is enforceable turns on whether those fund interests can be assigned. If they cannot, the lender's security interest never attaches, and upon a default, the lender is left without recourse to the interests or their proceeds.[1] This article describes the laws that govern assignability and the practical steps a lender should take to ensure that collateral consisting of such fund interests is enforceable.

No Assignment, No Security Interest

One of the elements necessary to establish an enforceable security interest is causing that security interest to "attach" to the collateral, and attachment has certain prerequisites under the Uniform Commercial Code (the "***UCC***"). One prerequisite is that the property is not subject to an enforceable prohibition on the assignment of the property by the borrower. If the borrower cannot transfer the fund interest (e.g., because the pledged entity's governing documents forbid it) the borrower cannot create a valid security interest in the property. Put simply, without the power to assign, there is no security interest.

The UCC Override and the 2018 Amendments

Sections 9-406 and 9-408 of the UCC provide an override stating that a contract term forbidding assignment of an account or general intangible is ineffective to the extent that it would block the creation or attachment of a security interest. So, even if the pledged fund's LPA/LLCA prohibits a pledge of interests, the override in Sections 9-406 and 9-408 erases that restriction for security-interest purposes. Fund interests are typically "general intangibles," so on paper, Section 9-408 looks like it should do exactly this.

However, the 2002 amendments to the Delaware UCC added carve-outs to Sections 9-406 and 9-408, so that the overrides do not apply to "a security interest in an ownership interest in a general partnership, limited partnership, or limited liability company." Delaware adopted this same carve-out in its entity acts (DRULPA and DLLCA). So for a Delaware fund interest, the override is switched off by statute, and you fall back to the basic rule: the interest is collateral only to the extent that it's actually assignable.[2]

The Analysis for Delaware LP and LLC Fund Interests

To determine whether the interest is "assignable," you would need to review the limited partnership agreement or limited liability company agreement governing the pledged fund interests (the "***Governing Documents***"). Since Delaware's entity acts, which govern all limited partnerships and limited liability companies (DRULPA and DLLCA (the "***Acts***")), both open with the phrase "unless otherwise provided in the partnership agreement" (or its LLC equivalent), assignability is made the rule absent contrary language in the Governing Documents. The Acts also state that an assignment is treated by default to be an assignment solely of economic rights and not the right to control or "to exercise any rights or powers of a partner," so unless explicitly provided in the Governing Documents, only economic rights are deemed to have been assigned.

Putting those two baseline rules together produces a simple test:

(a) if the Governing Documents are silent on assignability, or affirmatively permit assignment of economic rights, the lender can take a security interest in the borrower's economic rights;

(b) if the Governing Documents explicitly permit assignability of control rights, the lender can also take a security interest in the borrower's economic rights; however,

(c) if the Governing Documents restrict the assignment of economic rights, or if the lender wants a security interest in control rights that the Governing Documents do not make assignable, the lender must first obtain the consents required under those Governing Documents in order to attach a security interest. This is why we so often see general partner or managing member consents delivered in NAV credit facilities.

The securities-account workaround.

To bypass the need for conducting an assignability analysis, many market participants instead prefer to hold fund interests in a securities account, which changes the analysis in a helpful way. Under this setup, a custodian (the "securities intermediary" in the UCC's language) becomes the registered owner of the LP or LLC interest, which requires the acquiescence of the LP or LLC, and then credits the interest to a securities account. The account holder (the "entitlement holder") can then pledge its interest in the account (technically a "security entitlement" under the UCC, rather than a general intangible) to a lender, and the lender can perfect that security interest by control via a tri-party control agreement among the borrower, the lender, and the securities intermediary.

The borrower's pledge of the account bypasses the issue of assignability completely, since that restriction governs transfers of a fund *interest*, and the interest hasn't moved—only a pledge in the account in which those interests are held is being granted.

One important diligence caveat: some securities intermediaries will "hold" LP or LLC interests for their customers without ever becoming the registered owner. In that case, the interests cannot be credited to a securities account and are not necessarily assignable. A lender must therefore confirm not only what the LPA and LLCA say, but also how the intermediary actually holds the interests—making sure that interests shown on account statements are genuinely registered in the intermediary's name, and thus eligible for the treatment described above.

Key Takeaways

Pulling it all together, an LP or LLC can effectively consent to the creation of a security interest in its interests in one of three ways:

1. **In its governing agreement** — by expressly providing for assignability of the interests (or, by staying silent on the point, permitting an assignment of economic rights).
2. **By express consent** — the entity, or its general partner or managing member, can consent to the creation of the security interest directly.
3. **Through a securities account** — by agreeing to re-register the interests in the name of a securities intermediary for credit to a securities account.

Before extending borrowing base credit against Delaware LP or LLC interests, lenders (and their counsels) must conduct thorough diligence to ascertain that at least one of these boxes has been checked.

[1] Note that, even if an asset is unassignable, the borrower can grant a security interest in proceeds that it receives from the asset. The main problem with this approach is that if the asset itself is not collateral, then the lender's security interest will not attach to proceeds that the borrower receives after filing a bankruptcy petition. By contrast, if the lender has a valid, perfected security interest in the asset, that security interest automatically attaches to proceeds, even if they are received after a bankruptcy petition.

[2] One note on New York law, since it is often the governing law for NAV credit agreements, as well as the related security agreement: New York has not enacted the model UCC's 2018 amendments to Sections 9-406 and 9-408, and under New York law LP and LLC interests remain eligible for the UCC's assignability override provisions (subject to the usual exceptions and qualifications). However, lenders should not take comfort from this when lending against Delaware LP and LLC interests, even if the security agreement is governed by New York law, because in this context a court would very likely apply Delaware law to determine the applicability of Sections 9-406 and 9-408. Unlike the UCC's provisions on perfection, which are subject to specific choice of law provisions, Part 4 of the UCC (which contains Sections 9-406 and 9-408) contains no choice of law rules and would defer to non-UCC choice of law to determine the parties' rights. See Official Comment 3 to Section 9-401. A lender should assume that a court would apply Delaware law to the assignability of a Delaware LP or LLC.