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Woodbridge Case Highlights Risk of Claims Traders Not Complying with Anti-Assignment Restrictions

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The current claims trading market "is robust and fruitful" allowing for liquidity for holders of claims on the one hand "and profitability for traders on the other." Judge Kevin Carey of the U.S. Bankruptcy Court for the District of Delaware made this observation recently in *In re Woodbridge Group of Companies LLC, et al.*, an important decision for the claims and loan trading community. As market participants know, the concept of "profitability for traders" is contingent on a multitude of factors and risks, the most prevalent being whether the distributions received on a purchased claim ultimately exceed the price paid for such claim.

However, there are other risks involved in purchasing claims and loans. For example, one ever-present danger familiar to sophisticated investors is highlighted in the often-noted *KB Toys* decision originally decided by Judge Carey (and affirmed by the Third Circuit). In *KB Toys*, Judge Carey held that under Bankruptcy Code Section 502(d), a "claim in the hands of a transferee has the same rights and disabilities as the claim had in the hands of the original claimant. Disabilities attach to and travel with the claim."[1]

Add to all this yet another risk, also highlighted by Judge Carey. Specifically, Judge Carey held that a purported assignment of certain promissory notes was void and of no force and effect due to the failure of the contracting parties to comply with the express provisions governing assignments in the promissory notes and related loan documents.

The decision exemplifies the importance for participants in the claims and loan trading market to carefully review and comply with express anti-assignment and transfer provisions within contracts underlying claims. Failure to do so may result in a purported sale and assignment being challenged and claims filed by purported assignees being voided, even in a situation where a borrower has defaulted on its payment obligations.

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[1] *In re KB Toys Inc.*, 470 B.R. 331 (Bankr. D. Del. 2012), *aff'd sub nom*, 736 F.3d 247 (3rd Cir. 2013). Bankruptcy Code Section 502(d) reads in pertinent part "the court shall disallow any claim of any entity from which property is recoverable … or that is a transferee of a transfer voidable … unless such entity or transferee has paid the amount, or turned over such property."

Facts of the Underlying Case

The promissory notes in *Woodbridge* included the following language:

> "14. No Assignment. Neither this Note, the Loan Agreement of even date herewith between Borrower and Lender, nor all other instruments executed or to be executed in connection therewith … are assignable by Lender without the Borrower's written consent **and any such attempted assignment without such consent shall be null and void**."

Further, the loan agreement between the borrower and the lender contained additional anti-assignment language providing that the "Lender shall not assign, voluntarily, by operation of law or otherwise, **any of its rights hereunder** without the prior written consent of [Borrower] **and any such attempted assignment without such consent shall be null and void ….**" Although common in assignment provisions relating to promissory notes and loans, the applicable loan documentation executed by the borrower in this case did not include a carve-out allowing for a lender to freely assign its rights under the promissory note and related loan documents in the situation where the borrower defaulted on its obligations.

Before the bankruptcy filing by debtor Woodbridge Mortgage Investment Fund on December 4, 2017, Woodbridge had issued three promissory notes in the principal amount of $25,000 each to Elissa and Joseph Berlinger (original creditors). Without obtaining the consent of Woodbridge, on February 13, 2018, the original creditors entered into an agreement to sell and assign the promissory notes and related rights thereunder to Contrarian Funds LLC. On March 1, 2018, Contrarian filed a proof of claim against Woodbridge asserting a secured claim in the amount of $75,000.

On March 21, 2018, following inquiries from other trading market participants, the debtors filed a notice in the bankruptcy case (relating specifically to transfers of notes) stating that "in general, the terms of the … documents governing" notes issued by the debtors "require the Debtors' consent to any [transfer]" and "render any purported [transfer] of such [notes] null and void in the absence of the Debtors' consent." The notice further provided that the debtors "reserve all rights with respect to the invalidity and ineffectiveness of any prior, current or future attempts to" transfer such notes. On April 16, 2017, the debtors filed an objection to the proof of claim filed by Contrarian seeking to disallow and expunge the purported transferred claim held by Contrarian without prejudice to the rights of the original creditors to assert such claim on their own behalf in the bankruptcy case.

Anti-Assignment Restrictions Enforceable Under Delaware Law

In upholding the debtors' claim objection and agreeing to expunge the claim asserted by Contrarian, Judge Carey noted that an anti-assignment provision within loan documentation is a valid restriction on assignment rights under both public policy and Delaware law. However, he also noted that while Delaware courts will allow for "the validity of clauses limiting a party's ability to assign its rights," generally such provisions will be construed "narrowly because of the importance of free assignability." Such tenet notwithstanding, Judge Carey noted that there is a big difference between "narrow construction" and "wholesale obliteration."

Relying upon Section 322 of the Restatement (Second) of Contracts, Contrarian argued that while assignors are limited from delegating their obligations under loan documentation, anti-assignment provisions do not restrict the ability of assignors from transferring their rights or claims underlying promissory notes. Judge Carey disagreed, finding among other things that Section 322 is not applicable because it is based on UCC Section 2-210, which applies to contracts for the sale of goods, and that instruments such as promissory notes are not "goods" as defined in the UCC.

In looking at a recent Delaware Supreme Court decision, Judge Carey noted that the "modern approach to assignment clauses is to distinguish between the *power* to assign and the *right* to assign."[2] The distinction between having the *power* to assign as compared to the *right* to assign is ultimately determined by whether the language within the assignment provisions provides that any assignment failing to comply with the assignment provisions is void.

For example, if the promissory note merely provides that it is not assignable without the consent of the borrower but does not include further language stating that an assignment done without such consent is void, then it merely restricts the "*right* to assign but not the *power* to assign." Under such circumstances where just the right (but not the power) to assign is restricted, the failure to comply with anti-assignment provisions does not invalidate the assignment (which still remains enforceable); however, such failure "generates a breach of contract action that the non-assigning party may bring against the party assigning its interest." In the case at hand, however, the anti-assignment clauses—by stating that any assignments done without consent "shall be null and void"—provided a clear intent to restrict not only the *right* to assign but also the *power* to assign, resulting in the purported note transfer to Contrarian being void.

Anti-Assignment Clause Remains Enforceable Following Borrower Breach

In his decision, Judge Carey also refuted the contention made by Contrarian that Woodbridge could not enforce the terms of the anti-assignment provisions of the promissory note because of its prior breach. He noted that a non-breaching party could not "emerge post-breach with more rights than it had pre-breach." In elaborating on this point, the ruling cited a recent decision decided by a bankruptcy court in Delaware (*In re Diamondhead Casino Corporation*, No. 15-11647 (D. Del. June 7, 2016)) holding that a borrower's breach under a promissory note could not "modify or improve [upon] a noteholder's contractual rights." In citing his *KB Toys* decision, Judge Carey noted that this conclusion is consistent with the principle that "a trade claim purchaser holds that claim subject to the same rights and disabilities … as does the original trade claimant." In this case, the disability arose under the loan documentation transfer restrictions and such disability "traveled with the transferred claim into the hands of Contrarian, and therefore, Contrarian did not have the right to file [a proof of claim]."

UCC Does Not Override Anti-Assignment Provisions

Finally, Judge Carey rejected an argument by Contrarian that the anti-assignment provision is overridden by UCC Section 9-408, which limits the effectiveness of certain terms restricting assignments. The debtors argued that the provision only prohibited restrictions on the assignment of a security interest in a promissory note, as opposed to the promissory note itself, which is what Contrarian asserted. In noting that there was "very little decisional case law on the issue," Judge Carey, relying on the statute and related comments, concluded that this provision of the UCC was not applicable. Contrarian did not hold, nor purport to hold, a security interest in the promissory note, as Contrarian had not lent any money to the original creditors to which repayment was secured by an interest in the promissory notes.

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[2] Judge Carey also noted that this distinction does not exist solely under Delaware law; and in making such statement, he cited cases, most notably, by courts in the state of New York. New York law is often the governing law for sophisticated loan documentation.

Takeaway Points

An important takeaway for participants in the secondary claims and loan trading market is to ensure careful diligence of claim/loan documentation and to be mindful of express anti-assignment and transfer restrictions within such documentation. Just because a borrower defaulted on its obligation to pay money owed to a creditor/lender does not automatically allow for such creditor/lender to be able to freely assign its right to payment on such defaulted obligations. As highlighted by this decision, failure to comply with transfer provisions may result in a purported sale and assignment being challenged and voided.

One way the hedge fund purchaser could have worked around the anti-assignment provisions within the Woodbridge loan documentation would have been by structuring the purchase via participation in lieu of by assignment. Under such circumstances, the original creditors would remain the creditor of record in the bankruptcy case, but the entire economic and beneficial interests in the claims underlying the loan documentation would have been sold to the hedge fund purchaser. None of the language within the Woodbridge loan documentation expressly restricted the ability of an original creditor to sell its claims by participation.[3]

Settling by participation, however, does not come without its own risks for claims purchasers. As noted, when settling by participation, the claims buyer will not become the creditor of record in the bankruptcy case. Hence, distributions will still be made by the debtor in the bankruptcy case to the original creditor of record who sold the participation interest. Once the original creditor receives any distributions from the claims sold by participation, the original creditor will be obligated under the participation agreement to pass along such distributions to the participation buyer. In such circumstances, then, the participation buyer will want to make sure that the original creditor selling the participation interest is both creditworthy and reliable. The participation buyer will also want to actively follow the bankruptcy case to ensure that it is ready to notify and remind the seller of the participation of its obligation to pass along any such distributions made by the debtor in the bankruptcy proceedings.

Owning a claim by participation may also affect the participation buyer's ability to control the claim in a bankruptcy case. A typical claim purchase agreement settling by participation will include a provision requiring the claim seller to take acts on the claim at the direction of the buyer, but that provision will typically include negotiated exceptions so that a claim seller will not have to follow the direction of the participation buyer. There is a certain loss of control that comes with owning a claim by participation. Care should be taken when structuring transfer documentation from the perspective of the claims buyer in order to protect against, among other things, these types of credit and control risks.

If you have any questions or comments or need any assistance with selling or purchasing claims and/or loans in the secondary market, please do not hesitate to contact Alston & Bird's Distressed Debt & Claims Trading Team.

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[3] The transfer provisions, in this case, were silent on whether consent of the borrower was needed to sell by participation. That being the case, the debtors (had they been aware of a sale of participation) may still have sought to challenge such transfer. Typically, however, when a participation interest is sold, the borrower/debtor is not notified nor aware of any such transfer. The debtor's privity remains solely with the original creditors of record, and the debtor has no relationship with the participation buyer. The participation buyer likewise just has privity, generally, with the original creditors.

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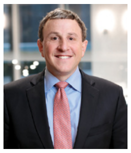

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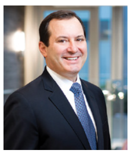

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