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SECURED TRANSACTIONS

Woodbridge Case: Assignability Of Promissory Notes

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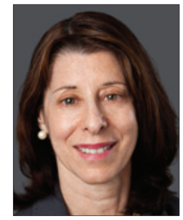

For better or worse, 2018 did not see a large number of notable cases addressing secured transactions issues. One case that did generate attention was the decision of Judge Kevin J. Carey in the Delaware bankruptcy proceeding of Woodbridge Group of Companies, LLC (see *In re Woodbridge Group of Companies, LLC et al.,* 2018 WL 3131127 (Bank. D. Del., June 20, 2018)).

The *Woodbridge* case upheld a provision in a promissory note prohibiting transfers. In so doing, it not only unsettled the robust bankruptcy claims trading market, but was roundly criticized by commentators for its analysis of UCC §§9-406 and 9-408, admittedly among the most complex and inscrutable provisions in UCC Article 9.

Background

The Woodbridge Group of Companies, LLC and its affiliates (Woodbridge) were real estate development companies that became embroiled in a $1.2 billion Ponzi scheme. In December 2017, shortly after the Securities and Exchange Commission sued the company's CEO, the hundreds of debtor companies comprising the Woodbridge companies filed for bankruptcy.

To fund its activities, Woodbridge had raised capital through the issuance of short-term notes, mostly to mom-and-pop-type investors. In 2016 and 2017, it issued three promissory notes to Florida residents Elissa and Joseph Berlinger (the Berlingers) in the principal amount of $25,000 each. On Feb. 13, 2018, the Berlingers sold their notes to Contrarian Funds, LLC (Contrarian), a distressed debt investor. On March 1, 2018, Contrarian filed a proof of claim against Woodbridge in the amount of $75,000. Woodbridge objected to the claims based on the anti-assignment language in the promissory notes and the related loan agreement.

The promissory notes and loan agreement expressly prohibited assignment without written consent of the borrower, but further, and importantly, went on to state that any attempted assignment without such consent would be null and void. The latter became a lynchpin for the court's decision to prohibit the assignment.

At issue before Judge Carey were three questions. *First*, does Delaware law permit anti-assignment clauses that restrict the power to transfer? *Second*, does the debtor's breach of the promissory notes render the anti-assignment provisions unenforceable? *Finally*, and most importantly for this column, assuming the anti-assignment provisions are contractually valid, does the UCC override them?

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The Decision

Validity of Restrictions on Assignment. The court first addressed

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the validity of the anti-assignment language.

Contrarian argued that restrictions on transferability are disfavored as a matter of public policy and so the prohibition was not legally valid. The court agreed that such restrictions are generally construed narrowly, but distinguished between narrow construction and "wholesale obliteration."

The court then turned to the Woodbridge loan documents, focusing on the provision rendering null and void any assignment without borrower consent. According to the court, this provision limited the *power* to assign rather than the *right* to assign. In Judge Carey's view, an assignment violating a restriction on the *right* to assign would result in contract damages but would not render the assignment unenforceable, whereas the restriction on the *power* to assign could effectively bar the assignment itself.

Judge Carey brushed aside any notion that the court was attempting to "police the claims trading market," noting that distressed claims traders are highly sophisticated and capable of performing the due diligence needed to alert them as to any limitations on assignment.

The court concluded that the anti-assignment clause was, as a contractual matter, a valid, clear and unambiguous restriction on the *power* to assign the notes.

Breach by Non-Assigning Party. The court then rejected Contrarian's argument that the debtors' payment defaults under the promissory notes caused the restrictions on assignment to be unenforceable. Stating that it is "axiomatic" that a non-breaching party cannot succeed to greater rights than it had pre-breach, the court held that the noteholder (whether the Berlingers or Contrarian) remains subject to the restriction on assignment notwithstanding the debtors' breach.

UCC Override of Anti-Assignment Provisions. Finally, the court turned to Contrarian's assertion that §9-408 of the UCC overrides the promissory note restriction on assignability as a matter of law.

Section 9-408 and its companion statute, §9-406, have confounded practitioners and jurists alike for years. Both sections override contractual prohibitions on transferability and liens, albeit in different ways. Both sections render ineffective any limitation on assignment or transfer of, or creation, attachment or perfection of a security interest in, certain types of assets. Section 9-406 allows the assignee/secured party to enforce the counterparty's obligations. Section 9-408 ("override-lite") does not.

Section 9-406 (with certain exceptions for health care insurance receivables) applies to accounts, chattel paper, payment intangibles (a type of general intangible) and promissory notes *but not to sales of payment intangibles or promissory notes* (other than in enforcement of remedies post-default). Section 9-408 applies to general intangibles (but in the case of payment intangibles, only to *sales* of those intangibles), health-care-insurance receivables and *sales* of promissory notes.

Contrarian asserted (correctly) that §9-408 applied to sales of promissory notes. The debtors countered (incorrectly) that §9-408 only applied to assignments of a security interest in a promissory note.

To bolster its argument, Contrarian looked to §§1-201(b)(35) and 9-109(a)(3), as well as Comment 5 to §9-109 of the UCC. Contrarian pointed out that the definition of "security interest" under UCC §1-201(b)(35) includes any interest of a "buyer" in a promissory note in a transaction subject to Article 9 of the UCC. Then to show that the Berlingers' conveyance of the notes was subject to Article 9, Contrarian referred to UCC §9-109(a)(3), which expressly includes within the scope of Article 9 a sale of promissory notes. Finally, Contrarian cited Comment 5 to UCC §9-109, which confirms that Article 9 applies to both sales and security interests but does not have rules to distinguish between the two.

The court flatly rejected Contrarian's arguments and the notion that sales of promissory notes are also classified as security interests. In so doing, it focused on Comment 4 to 9-109, which states that Article 9 sometimes distinguishes between sales of receivables and sales that secure an obligation, but leaves to courts the issue of how a particular transaction is to be classified. In the judge's view, if all sales of promissory notes are security interests, then there is nothing for courts to decide.

The court then adopted the argument advanced by Woodbridge that since UCC §9-406 explicitly applies to certain sales of promissory notes, §9-408 cannot also apply to the sale of notes without rendering §9-406 superfluous. Under this theory, §9-408 only overrides grants of security interests in promissory notes. Since Contrarian did not hold a security interest (meaning (as characterized by the court) it had not "lent any money to the Berlingers"), the court ruled §9-408 to be inapplicable.

Analysis

The court was, not surprisingly, confused by the provisions of §§9-406 and 9-408.

Sales are included within the definition of "security interest." But that doesn't mean Article 9 fails to distinguish between them. It clearly does, as noted in Comment 4 to 9-109. And it falls to courts to determine whether a transaction, regardless of how denominated or documented, is, as a matter of state law, a secured financing or a true transfer of title. There are sections of Article 9 that apply solely to sales (e.g., 9-309 (automatic perfection on sales of promissory notes) and 9-601(g) (rights available to buyers of promissory notes).

The court overlooked the statement in Comment 5 that terminology such as "security interest" and "debtor" is merely a drafting convention adopted to reach the Article's coverage of certain sales transactions as well as security interests but has no relevance to distinguishing sales from other transactions.

The court somehow read §9-406 to be the relevant provision governing sale of a promissory note, stating that "[§] 9-406 endorses the enforceability of anti-assignment provisions in the sale, or assignability, of promissory notes, whereas [§] 9-408 is applicable only to grant of security interests." It is not clear why it could not read §9-406 as applying solely to the two specific instances it covers, which is disposition or the acceptance of collateral under UCC §§9-610 and 9-620 of the UCC respectively, and leave §9-408 to cover all other sales of promissory notes.

Conclusion

The takeaways from the *Woodbridge* case are several. It stands as a cautionary note to practitioners to either use (or avoid) language declaring prohibited transfers to be null and void. It also emphasizes to claims traders the need to properly diligence assignment provisions in notes and other instruments.

The *Woodbridge* case has been appealed to the Federal District Court and appellate briefs were filed in November 2018. No decision has been issued as of the date of submission of this article. Three issues were raised on appeal: (1) whether 9-408 rendered the anti-assignment clauses ineffective, (2) whether the clauses prohibited assignments of causes of actions and claims or just notes and rights under the loan agreement (an issue disposed of by the lower court partly on the basis of a somewhat cryptic reading of the Restatement (Second) of Contracts) and (3) whether the court erred in allowing the debtors to enforce the clauses after they breached.

Ultimately, at least in regard to §9-408, the decision by Judge Carey to prohibit Contrarian from asserting a proof of claim was likely correct. Even if §9-408 is found to override the promissory note restriction, Contrarian's rights as an assignee under §9-408 would not allow it to enforce the note or exercise the rights of the owner as against the debtors (as it would under §9-406). That raises the additional and important issue of whether an assignee of a promissory note that relies on §9-408 would ever be able to file a proof of claim against a bankrupt obligor, a question whose answer unfortunately remains unclear.