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Client Alert

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Bankruptcy Court Blocks Claims Trade

On June 20, 2017, the United States Bankruptcy Court for the District of Delaware (the "Court") issued an opinion in the bankruptcy cases of Woodbridge Group of Companies (collectively, the "Debtors"), sustaining the Debtors' objection to a proof of claim filed by Contrarian Funds LLC ("Contrarian"), who had acquired the claim through a trade. The Court determined that an anti-assignment clause in the underlying debt instrument on which Contrarian's claim was based nullified Contrarian's right to assert that claim in the bankruptcy cases.[1]

BACKGROUND

Prior to the filing of the chapter 11 cases, Debtor Woodbridge Mortgage Investment Fund 3A, LLC ("Woodbridge") issued three promissory notes to Elissa and Joseph Berlinger each in the principal amount of $25,000 (the "Notes"). Each Note contained an anti-assignment clause providing that neither the Note nor any other instruments executed in connection therewith was assignable by the lender without the borrower's written consent and any such attempted assignment without such consent was null and void. The related loan agreement contained additional anti-assignment language providing that the lender could not assign, voluntarily, by operation of law or otherwise, any of its rights without Woodbridge's prior written consent, and any such attempted assignment without such consent would be null and void. Subsequent to the petition date, the Berlingers assigned the Notes and rights thereunder to Contrarian. Contrarian then filed a proof of claim asserting a $75,000 secured claim against Woodbridge.[2]

DECISION

The Court was presented with the following three issues: (1) whether an anti-assignment clause contained in a promissory note is a valid restriction on assignment rights under Delaware law; (2) whether a non-breaching party to a promissory note in payment default is still bound by an anti-assignment clause when seeking to enforce the note in bankruptcy through a proof of claim; and (3) whether the UCC overrides and nullifies an anti-assignment clause in a promissory note.

First, the Court found that the anti-assignment clause was permissible under Delaware law and that nothing in the Bankruptcy Code or overarching bankruptcy policy impairs a bankruptcy court from enforcing applicable non-bankruptcy law that may restrict claim transfers. Delaware law narrowly construes anti-assignment clauses because of the importance of free assignability, but, as the Court noted, such narrow construction does not equate to "wholesale obliteration."[3] Delaware law also distinguishes between the power to assign and the right to assign. Here, because the anti-assignment provision contained language providing that any assignment would be void, the provision restricted the *power* to assign (as opposed to merely the *right* to assign) and, thus, the assignment was null and void (as opposed to being merely a breach of contract).[4]

In reaching its conclusion, the Court rejected Contrarian's argument based on section 322(1) of the Restatement (Second) of Contracts, which provides a general rule that allows anti-assignment provisions to restrict an assignor's ability to delegate duties but not rights under a contract. The Court held that section 322(1) applies to contracts for the sale of goods, not promissory notes or other instruments. Additionally, the Court was not persuaded by Contrarian's argument that sustaining the objection would cause disruption in the claims trading market. Citing its prior decision in *In re KB Toys, Inc.*, the Court noted that, in its experience, buyers of debt are "highly sophisticated entities fully capable of performing due diligence before any acquisition."[5]

Next, the Court found that a prior breach of the Notes by the Debtors did not render the anti-assignment clause unenforceable. The Court reasoned that, under basic contract principles, a non-breaching party can either stop performance and presume the contract is avoided, or continue performance and sue for damages, but "[u]nder no circumstances may the non-breaching party stop performance *and* continue to take advantage of the contract's benefits. It is axiomatic that a non-breaching party may not emerge post-breach with more rights than it had pre-breach."[6] The same limiting principle, which had been cited by Judge Carey in his *KB* Toys decision,[7] applied to Contrarian, as the assignee. Because the Berlingers did not have the right to assign the Notes and rights thereunder to Contrarian, the Court found that Contrarian did not have the right to file the proof of claim.

Finally, the Court found that section 9-408 of the UCC, which prohibits certain restrictions on collateral assignments, did not nullify the anti-assignment provision. Contrarian argued that section 9-408 overrides all anti-assignment provisions, whereas the Debtors argued that section 9-408 only prohibits restrictions on the assignment of a security interest in a promissory note. The Court ultimately sided with the Debtors.

CONCLUSIONS AND LESSONS LEARNED

The opinion serves as a helpful reminder that, while courts are inclined to narrowly construe anti-assignment and other similar clauses, policy preferences for free assignability do not serve to nullify properly drafted anti-assignment provisions. It is not clear whether the use of a participation, as compared to an assignment, might have led to a different result. The record is also not clear whether Contrarian had a clause in its transfer document that required the assignor to give the assignee the economics of the claims transfer in the event the assignment was avoided. Buyers of debt should obviously keep assignment restrictions in mind when performing their due diligence. And, their claims transfer agreements should be reviewed in light of this decision.

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[1] *In re Woodbridge Group of Companies, LLC*, No. 17-12560 (Bankr. D. Del. June 20, 2018).
[2] *Id.* at *2-3.
[3] *Id.* at 4.
[4] *Id.* at 4-5.
[5] *Id.* at 3-4 (citing *In re KB Toys, Inc.*, 470 B.R. 331, 342 (Bankr. D. Del. 2012), *aff'd sub nom.*, 736 F.3d 247 (3d Cir. 2013)).
[6] *Id.* at 8.
[7] *In re KB Toys, Inc.*, 470 B.R. at 343.