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Anti-assignment Clause Enforced by Delaware Bankruptcy Court

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On June 20, the U.S. Bankruptcy Court for the District of Delaware held that anti-assignment clauses contained in certain promissory notes were enforceable under Delaware law, contract law and the Uniform Commercial Code. In *In re Woodbridge Group of Companies*, the court held that the assignment of certain promissory notes to a claims purchaser was null and void and the claims purchaser did not have a valid claim in the bankruptcy case.[1] The case has important takeaways for private equity companies, including:

- Private equity companies should perform thorough due diligence on a seller's ability to assign its assets.
- Private equity companies should review anti-assignment clauses carefully to determine whether they restrict the "right" or the "power" to assign.
- Private equity companies should obtain protections from a seller, including representations and warranties regarding the transferability of assets.

Background

In 2016 and 2017, before it declared bankruptcy, debtor Woodbridge Mortgage Investment Fund 3A, LLC, entered into a prepetition loan agreement and issued three promissory notes to Elissa and Joseph Berlinger in the principal amount of $25,000 each. The promissory notes contained the following anti-assignment clause:

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 (collectively, the "Collateral Assignment Documents") are assignable by Lender without the Borrower's written consent and any such attempted assignment without such consent shall be null and void.

The anti-assignment clause not only restricted the assignability of the notes without the borrower's written consent; it provided that any assignment without consent would be deemed null and void. The underlying loan agreement was similarly drafted.

At the end of 2017, Woodbridge filed for bankruptcy under chapter 11. During the bankruptcy case, the Berlingers assigned their promissory notes to a claims purchaser, Contrarian Funds, LLC. The Berlingers and Contrarian entered into an agreement, in which the Berlingers would "sell, convey, transfer and assign" the promissory notes and rights thereunder to Contrarian. Contrarian then filed a proof of claim in the amount of $75,000 in

Woodbridge's bankruptcy case. Woodbridge objected to Contrarian's claims on the grounds that the transfers were void and, therefore, Contrarian did not hold a valid interest to submit a claim.

Analysis

Contrarian challenged Woodbridge's objection on three grounds:

1. Delaware law does not permit anti-assignment clauses that restrict the power to transfer.
2. Woodbridge's breach of the promissory notes rendered the anti-assignment clause unenforceable.
3. The UCC overrides anti-assignment clauses.

Contrarian's first argument was that the anti-assignment clause was a restriction on the power to transfer, which is prohibited under Delaware law. Delaware law distinguishes between whether an anti-assignment clause prohibits the "right" or the "power" to assign without consent. A *right* to assign makes a prohibited transfer a breach of contract, in contrast to a *power* to assign, which makes a prohibited transfer void. In this case, the court noted that the anti-assignment clause and the loan agreement were clear and unambiguous. The express language of the anti-assignment clause provided a clear intent to restrict the power to assign, as opposed to restricting only the right to assign. Accordingly, the note transfer was void.

Contrarian's second argument was that because Woodbridge defaulted in its payment, the anti-assignment clause was void. The court held that Woodbridge's breach did not make the other provisions of the promissory notes, including the anti-assignment clause, unenforceable and that "a non-breaching party may not emerge post-breach with more rights than it had pre-breach." The court noted that, under basic contract principles, when one party to a contract feels that the other contracting party has breached its agreement, the non-breaching party may either stop performance and assume the contract is voided or continue its performance and sue for damages. Under no circumstances may the non-breaching party stop performance and continue to take advantage of the contract's benefits.

Contrarian's last argument to escape the anti-assignment clause was that UCC § 9-408 overrides any anti-assignment clauses. The UCC only prohibits restrictions on the assignment of a security interest in a promissory note and does not prohibit restrictions on assignment of rights under the promissory note itself. Contrarian did not hold, or even assert that it held, a security interest in the promissory notes. It only held an interest on the rights under the notes. Accordingly, the court found that UCC § 9-408 was inapplicable.

The Takeaway

The court rejected Contrarian's assertions and held that the anti-assignment clause was legally valid under Delaware law, contract law and the UCC. Therefore, the assignment of the promissory notes to Contrarian was null and void, and Contrarian did not have a valid claim in the bankruptcy case.

Private equity companies can take important lessons from this decision, including that they should not underestimate the importance of performing thorough due diligence on any contracts being assumed in an acquisition. In particular, private equity companies should review anti-assignment clauses carefully to determine whether they contain any restrictions on the "right" or the "power" to assign. If the latter, then the assumed contract may be null and void. Finally, private equity companies should obtain protections from a seller, including representations and warranties regarding the transferability of assets. If the seller represents that an assumed contract is transferable and it is actually not transferable, then the private equity company may have a breach of warranty claim.

Pepper Hamilton attorneys have deep experience in drafting commercial contracts and representing private equity companies. If you have any questions about what this case may mean for you or your business, please contact the attorneys at Pepper Hamilton.

Endnote

[1] *In re Woodbridge Group of Cos., LLC*, 2018 WL 3131127 (Bankr. D. Del. June 20, 2018).