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Bankruptcy Case Is Reminder on Collateral Ownership Issue

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On April 28, the U.S. Bankruptcy Court for the Northern District of Oklahoma in *Kirtley v. Mabrey Bank (In re: Rudick)* held that an entity other than the debtor may grant a lien on the debtor's property, affirming the legal standard that consent of the true property owner is sufficient to give a debtor, who lacks title in the goods, sufficient rights in collateral to grant a security interest in that property.[1]

As a result, the bankruptcy court also held the bank's security interest, perfected prior to the debtor's bankruptcy, was enforceable and had priority over the bankruptcy trustee's rights to the property.

Legal practitioners in the commercial finance industry are well aware that one of the three key elements under Article 9 of the Uniform Commercial Code, or UCC, for the attachment of a lien on personal property is that the debtor granting the lien has rights in the collateral.

The concept of rights in the collateral is distinct from title to the goods; a debtor may grant a lien under less than all of the bundle of rights that comprises title to property. Under the UCC, a debtor's "limited rights in collateral, short of full ownership, are sufficient for a security interest to attach."

The bankruptcy court in *In re: Rudick* addressed this issue.

Background

Michael Rudick filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code. Rudick's petition included, among other things, certain personal property consisting of vehicles, tractors, boats and trailers.

Prior to the petition date, Rudick had a banking relationship with Mabrey Bank and had entered into several personal loans with the bank.

Rudick also owned an Oklahoma limited liability company known as Cornerstone Concrete and Excavation LLC. Cornerstone was a separate legal entity from Rudick.

Prior to the petition date, Cornerstone had entered into a commercial loan transaction with the bank, whereby it purported to grant a security interest on the property to the bank to secure Cornerstone's loan from the bank. The bank filed liens against the property. Rudick executed the relevant bank loan documents on behalf of Cornerstone in his capacity as president of Cornerstone.

The Court's Analysis

The question is whether Cornerstone's grant of a security interest in the property had attached as of the petition date and was enforceable, which would defeat the bankruptcy trustee's rights to the property as a result of the Chapter 7 filing.

The bankruptcy trustee asserted that Cornerstone could not grant a security interest in the property because it did not own the property. The bank did not disagree that Cornerstone did not own the property, but it argued that ownership had no bearing on whether Cornerstone could grant an enforceable security interest.

The bankruptcy court noted that attachment of a security interest is governed by Section 1-9-203 of Oklahoma's Commercial Code, which adopts Section 9-203 of the UCC. Under such section, a security interest attaches to the collateral when:

- The debtor has signed a security agreement describing the collateral;
- Value has been given; and
- The debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party.

Only the third bullet point was in issue — whether Cornerstone had rights in the property or the power to transfer rights in the property to the bank. The bankruptcy court determined that Cornerstone had rights in the property based on the consent of Rudick to give Cornerstone such rights.

The bankruptcy court affirmed a precedent ruling where "an owner's permission to use goods as collateral creates rights in the debtor sufficient to give rise to an enforceable security interest," and this consent may be implicit based on facts and circumstances.[2]

Outcome

The bankruptcy court found that Rudick's signature on behalf of Cornerstone was evidence that Rudick had notice and knowledge of Cornerstone's grant to the bank and that Rudick consented to the grant. Further, the bank could rely on the representation by Rudick that Cornerstone had authority to pledge the property as security for the loan.

As such, Cornerstone had rights in the property, and the property was subject to a valid security interest in favor of the bank at the time Rudick filed his bankruptcy petition.

The bankruptcy court noted an inverse circumstance that led to a contrary holding.[3] In that case, an individual taking a personal loan and signing the relevant loan documentation in his individual behalf could not pledge rights in property owned by a company that the same individual owned.

The individual's signature alone did not evidence any consent by the company to pledge the company's property or that the individual otherwise had rights in the company's property. Lenders and practitioners alike should take note of the divergent results.

Significance and Considerations for Practitioners and Their Clients

The outcome of the *Rudick* case is in line with the established framework of the UCC that "[a] debtor's limited rights in collateral, short of full ownership, are sufficient for a security interest to attach."

Similar to how a consignee may transfer rights to a creditor in collateral to which it has no title, the UCC provides lenders with the protection needed to ensure that they receive the benefit of their bargain. *In re: Rudick* serves as a strong reminder of this general premise.

Nonetheless, practitioners should not simply rely on the general protections offered by the intentions or goals of the UCC. Instead, practitioners should ensure that transactions are always properly documented.

In the *Rudick* case, the bank had the benefit of precedent law favoring its circumstance, but the prudent approach for the bank would have been to have Rudick directly pledge the rights in the property in his personal, and not representative, capacity.

Failure to properly perfect could result in the practitioner losing its priority status in its claims against the borrower's assets and, as a result, receiving less than full or no repayment on the debtor's obligations.

Documenting the transaction is a puzzle that requires all of the pieces to fit properly, and completing the puzzle critically depends on ensuring that the right parties are included in the appropriate documentation. Knowing the correct grantor of liens involves additional considerations for practitioners.

For example, UCC-1 financing statements perfecting the lien granted in the security agreement must contain the debtor's correct name. In addition, the manner in which the name of the debtor appears on a UCC-1 financing statement varies under the UCC depending on whether the debtor is a natural person or an entity — and even further dependent on whether the entity is organized under state law or not.

Failure to ensure that the UCC-1 contains the debtor's correct name aligning to the appropriate debtor would render the UCC-1 legally defective and thus negate the perfection of the lien.

Another critical takeaway of the *Rudick* case for practitioners is the value and importance of having robust representations as to the title of the underlying collateral in the underlying documents on which a lender can rely.

It is impossible for lenders to cover every possible issue that may arise in a transaction through representations and warranties, but at the very least, lenders should always ensure that a secured financing transaction includes representations as to the title of the underlying collateral.

Furthermore, lenders should take a critical look at any attempts to undermine or soften such representations by borrowers, such as by qualifying it by materiality. Whether assets constitute a material portion of the collateral may vary over time and since this issue — whether or not the applicable party has the necessary rights in such assets — goes to the very core of whether the lien attaches, lenders should review such comments with heightened scrutiny.

Ensuring proper documentation of a transaction is also a concern for practitioners representing borrowers. Documents such as authorizing resolutions from the board of directors — or other appropriate management — of an entity debtor that provides express authorization for the grant of such liens requires the correct party to first be identified.

Often, lawyers representing borrowers are asked to render legal opinions on, among other things, the enforceability of documents, attachment of liens and perfection thereof, usually by filing of a UCC-1.

Although these legal opinions typically contain a qualification that the opining law firm does not opine on whether the debtor has title to the collateral, the practitioner representing a borrower should nonetheless be wary of any issues that may raise questions as to attachment of the liens its client purports to grant.

Lending relationships are built on mutual trust and material omissions or errors, such as the identity of the collateral's actual titleholder, on the part of borrowers or their counsel can undermine and significantly threaten the long-term success of a lender-borrower relationship.

Lastly, practitioners should take note of the inverse holding by the U.S. Bankruptcy Court for the District of Kansas in *In re: Clinkingbeard* in March 2020. The distinction in this case is significant for practitioners to understand because individuals are sometimes asked to be collateral grantors providing credit enhancement in a transaction.

In such a circumstance, whether the pledgor has title to the collateral becomes an even greater concern because determining that the individual has rights in the collateral of a company is not always simple. Supporting documentation is needed to evidence the necessary rights in collateral that, for many transactions, may constitute administrative hurdles and additional paperwork as opposed to just ensuring the correct party is signing as debtor.

Conclusion

The *Rudick* case shows why it is critical that a practitioner understands who owns its client's proposed collateral, especially if the collateral is material to the underwriting and credit profile of a loan.

Notwithstanding the ultimately favorable outcome for the bank in the *Rudick* case, correctly documenting this transaction at the outset would have saved the bank the time and cost of litigating the issue with the bankruptcy trustee.

As the court in *In re: Rudick* reminds us, while "[t]itle to goods is of little relative consequence under the [UCC], … [t]he burden of proving that an item of property is subject to a security interest is on the party asserting the interest."[4][5] Thus, lenders and their legal practitioners should always take note when collateral is titled in someone other than the debtor.

Whenever questions as to the attachment or perfection of liens are at issue, determining the appropriateness of such property serving as collateral is essential, with hopes of avoiding the scenario of the *Rudick* case.

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[1] *Kirtley v. Mabrey Bank (In re Rudick)*, No. 20-11918-M (Bankr. N.D. Okla. Apr. 28, 2022).

[2] See *Atchison v. Atchison (In re Atchison)*, 832 F.2d 1236 (1987).

[3] See *In re Clinkingbeard*, No. 19-11605, 2020 WL 1517932 (Bankr. D. Kan. Mar. 30, 2020).

[4] *In re Rudick*, No. 20-11918-M at *2 (citing *Morton Booth Co. v. Tiara Furniture, Inc.*, 564 P.2d 210, 212 (Okla. 1977)).

[5] Id.

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