

Bankruptcy Court Holds Title Holder Consent Is Enough to Give Collateral Rights to Debtor to Grant Liens

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On April 28, the U.S. Bankruptcy Court for the N.D. of Oklahoma in *Kirtley v. Mabrey Bank (In re Rudick)*^[1] 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 rights in collateral to grant a security interest in that property. 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.

One of the three key elements under Article 9 of the Uniform Commercial Code (UCC) for the attachment of a lien on personal property is that the debtor granting the lien has "rights in the collateral."^[2] 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

In *In re Rudick*, individual Michael Rudick filed a voluntary petition for relief under Chapter 7 of the U.S. Bankruptcy Code. Rudick's petition included, among other things, certain personal property consisting of vehicles, tractors, boats, and trailers (collectively, the Property). Prior to the petition date, Rudick had a banking relationship with Mabrey Bank (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). 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.

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^[3], which adopts Section 9-203 of the UCC. Under Section 9-203 of the Oklahoma UCC, a security interest attaches to the collateral when:

- The debtor has signed a security agreement describing the collateral.
- Value has been given.
- 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.

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 with a contrary holding. 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 should take note of the divergent results.

Significance

It is critical that a lender understands who owns the collateral, especially if it is material to the underwriting and credit profile of a loan. In *In re Rudick*, the Bank had the benefit of the law favoring its circumstance, but the prudent approach would have been to have Rudick directly pledge the rights in the Property in his personal and not representative capacity. Notwithstanding the ultimately favorable outcome, correctly documenting this transaction would have saved the Bank the time and cost of litigating the issue with the bankruptcy trustee.

Lenders are advised to consult with their legal counsel whenever questions as to the attachment or perfection of liens are at issue. It may be “other people’s property,” but legal counsel can help a lender determine the appropriateness of such property serving as collateral.

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

[2] § 9-203. Attachment and Enforceability of Security Interest; Proceeds; Supporting Obligations; Formal Requisites., U.C.C. Text § 9-203.

[3] Okla. Stat. tit. 12A, § 1-9-203.

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