

# The Transactional Lawyer

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## The Enforceability of an Assignment of Bankruptcy Voting Rights

**Kenneth D. Downey**

Parties to a subordination agreement frequently wish to restrict the junior lender's ability to frustrate the senior lender's decisions about how to deal with the debtor in bankruptcy. As a result, a subordination or intercreditor agreement may purport to prohibit the junior lender from objecting to a § 363 sale, or from filing adverse motions that would affect the interests of the senior lender. A subordination agreement may also purport to assign to the senior lender the junior lender's right to vote on any reorganization plan.

However, the validity of an assignment of voting rights is questionable. Section 510(a) of the Bankruptcy Code expressly states that subordination agreements are enforceable in bankruptcy to the same extent they would be enforceable under non-bankruptcy law, but § 1126 expressly gives the holder of each claim the right to accept or reject the plan. To date, no Circuit Court of Appeal has weighed in on this issue by ruling on the validity of an assignment of bankruptcy voting rights. The few bankruptcy court decisions on the issue are split roughly equally. Compare *In re 203 N. LaSalle Street P'ship*, [246 B.R. 325](#), 331 (Bankr. N.D. Ill. 2000); *In re SW Boston Hotel Venture, LLC*, [460 B.R. 38](#) (Bankr. D. Mass. 2011), *vacated on other grounds*, [2012 WL 4513869](#) (1st Cir. BAP 2012); *In re Croatan Surf Club LLC*, [2011 WL 5909199](#), at \*2 (Bankr. E.D.N.C. 2011) (all declining to enforce a subordination agreement's

assignment of voting rights), with *In re Coastal Broad. Sys., Inc.*, [2012 WL 2803745](#) (Bankr. D.N.J. 2012) *aff'd*, [2013 WL 3285936](#) (D.N.J. 2013); *In re Aerosol Packaging, LLC*, [362 B.R. 43](#), 47 (Bankr. N.D. Ga. 2006) (both enforcing a subordination agreement's assignment of bankruptcy voting rights); see also *In re Avondale Gateway Center Entitlement, LLC*, [2011 WL 1376997](#) (D. Ariz. 2011) (subrogation clause in intercreditor agreement allowed senior creditor to step into the shoes of the junior creditor and vote its claim in the debtor's bankruptcy); *In re Curtis Center Ltd. P'ship*, [192 B.R. 648](#) (Bankr. E.D. Pa. 1996) (senior creditor to whom the junior creditor's voting rights were assigned in a subordination agreement could vote the junior's claim); *In re Inter Urban Broad. of Cincinnati, Inc.*, [1994 WL 646176](#) (Bankr. E.D. La. 1994) (debtor had no basis for objecting to senior lender's voting of junior lender's claim pursuant to subordination agreement). Given this uncertainty, this article briefly explores how a transactional lawyer representing a senior lender may wish to deal with this issue.

### One Ineffective Technique: Choice of Forum

One solution that will not work is to choose in the subordination agreement a forum that has ruled that an assignment of bankruptcy voting rights is enforceable. That is because the assignment of bankruptcy voting rights will be a core issue litigated in the bankruptcy court, not in a forum chosen by the competing creditors. See 28 U.S.C. § 157(b)(2)(L). Even a choice of forum clause in the loan agreements will probably not work because the venue for bankruptcy is governed by statute, not by agreement. See 28 U.S.C. § 1408 (venue lies where the debtor's domicile, residence, principal place of business, or principal assets are located).

If the parties to a subordination agreement end up in a jurisdiction that refuses to enforce an assignment of bankruptcy voting rights, there is probably little the attorney for the senior creditor can do to counter that. It seems likely that the courts would not only rule that the junior lender may vote its own claim, but also that because the assignment of voting rights is unenforceable, the senior will have no claim for breach of contract against the junior who does choose to vote its claim.

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### *Drafting the Voting Rights Provision as a Power, Not an Agency Relationship*

In the event the debtor ends up in bankruptcy in a jurisdiction less hostile to an assignment of voting rights, parties to a subordination agreement should draft the assignment as an “irrevocable power given as security,” not as an agency. Lenders may be tempted to draft the clause granting the senior lender the right to vote the junior lender’s claim as an agency. For example, the clause might state that the junior lender irrevocably appoints the senior lender as its agent for the purpose of voting the claim in any bankruptcy proceeding of the borrower. The problem with drafting the clause in such a manner is that an agency is revocable by the principal even if the appointment purports to be irrevocable. *See Ravallo v. Refrigerated Holdings, Inc.*, [2009 WL 612490](#), at \*4 (S.D.N.Y. 2009); [Restatement \(Third\) of Agency § 3.10](#) (2006).

To avoid this problem, the voting rights clause should be drafted as a grant by the junior lender to the senior lender of the junior lender’s power to vote. The Restatement of Agency refers to such a grant as “a power given as security.” *See Restatement (Third) of Agency § 3.12*. Such a power is distinguished from an agency because it is not for the benefit of the grantor of the power (*i.e.*, the putative principal), it is for the benefit of the holder of the power (*i.e.*, the putative agent). *See id. at cmt. b* (providing “[a] power given as security creates neither a relationship of agency . . . nor actual authority . . . , although the power enables its holder to affect the legal relations of the creator of the power”); *see also In re Coastal Broad. Sys., Inc.*, [2012 WL 2803745](#) at \*8 (enforcing an assignment of bankruptcy voting rights phrased as a grant of a power of attorney).

A grant of such a power must normally be for consideration, but no doubt there is consideration – detriment to the senior lender – in connection with the making of the loan and the execution of the subordination agreement. Some jurisdictions require that the power be “coupled with an interest,” a somewhat old and convoluted requirement that may have outlived its purpose or usefulness. *See Restatement (Third) of Agency § 3.12 cmt. c*. However, even in its most restrictive meaning, that requirement should be satisfied by the senior lender’s interest in the loan, in the collateral securing the loan, and in any bankruptcy proceeding involving the borrower as the debtor.

To document the existence of the coupled interest, the subordination agreement should contain a recital specifying the interests. While recitals are not generally operative provisions of an agreement, they can help educate the judge called upon to interpret or rule on the effectiveness of the agreement, and they might estop one party from arguing the opposite. *See Paloian v. Grupo Serla S.A. de C.V.*, [433 B.R. 19](#), 32 (N.D. Ill. 2010); *see also Jones Apparel Grp., Inc. v. Polo Ralph Lauren Corp.*, [791 N.Y.S.2d 409](#) (App. Div. 2005).

The one drawback to this approach comes from Bankruptcy Rule 3018(c). That rule states that a creditor’s vote on a plan of reorganization must “be signed by the creditor . . . or an authorized agent.” Some of the courts ruling that § 510 conflicts with § 1126 have also ruled that § 510 conflicts with Rule 3018(c). In other words, because the senior lender is not acting for the junior lender’s benefit when the senior lender votes the junior lender’s claim – and thus is not a true agent of the junior lender – the senior lender cannot consistently with Rule 3018 vote the junior lender’s claim. *See In re Croatan Surf Club*, [2011 WL 5909199](#) at 3; *203 N. LaSalle Street P’ship*, [246 B.R. at 331-32](#). However, none of the courts enforcing an assignment of voting rights has discerned a problem with Rule 3018(c). More importantly, it is not clear that the Rule’s brief reference to the word “agent” was intended to refer to traditional common-law agency relationships to the exclusion of similar devices, such as a power of attorney. *See* Bankr. Rule 9010(a) (authorizing a creditor to perform any act not constituting the practice of law “by an authorized agent, attorney in fact, or proxy”).

### *Remedy of Specific Performance*

The Restatement of Agency acknowledges that a power granted as security should be enforceable through specific performance. [Restatement \(Third\) of Agency § 3.12 cmt. b](#). This is because “it will often be difficult or impossible for the holder to prove quantifiable damages or to obtain a substitute performance.” *Id.* Nevertheless, transactional lawyers drafting such a clause might wish to expressly provide for specific performance of the grant of the right to vote. While it is unclear whether an express statement in the subordination agreement about equitable remedies will be given effect, there is no downside risk to including it.

*Suggested Language:*

To support and secure Senior Lender's interest in the Loan, in the Collateral, and in any bankruptcy proceeding in which Borrower is the debtor or debtor in possession, Junior Lender hereby irrevocably appoints Senior Lender its attorney in fact for the purpose of voting, and irrevocably grants Senior Lender the power to vote, Junior Lender's claims against the Borrower in any such proceeding. Because damages for any attempted revocation of or interference with this appointment or grant would be difficult to prove, Senior Lender may enforce this appointment and grant by specific performance.

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## The Dangers of Uni-tranche Loans & the Rule of Explicitness

*Stephen L. Sepinuck*

Borrowers in structured finance deals frequently issue debt obligations comprised of multiple tranches. In such deals, the owners of the senior tranche typically are paid first, have a senior lien on the collateral and, because of their reduced risk, receive a lower interest rate. A few borrowers who prefer to have only one set of loan covenants may insist on signing a single loan agreement, with the lenders creating the priority structure and waterfall of payments through their own intramural agreements. Such a structure – referred to as uni-tranche because, from the debtor's perspective, there is only one loan – presents a risk for the senior lenders.

In *In re Ionosphere Clubs, Inc.*, [134 B.R. 528](#) (Bankr. S.D.N.Y. 1991), the court ruled that because the loan indenture granted a single lien to the agent for holders of three different series of certificates, the entire loan was to be evaluated as a whole for the purpose of determining eligibility for postpetition interest under § 506, even though “there were three

separate Trustees appointed to represent three separate and distinct truncations of debt which have differing interest rates, staggered maturity dates and different levels of priority,” and even though each trustee filed a separate proof of claim. This ruling, while somewhat old, has never been repudiated and indeed has been cited approvingly in the recent past. *See, e.g., In re Washington Mutual*, [461 B.R. 200](#), 244 (Bankr. D. Del. 2011), *vacated on other grounds*, [2012 WL 1563880](#) (Bankr. D. Del. 2012).

The import of this ruling is readily understandable through the following example:

Three groups of lenders each loaned Borrower \$100 million. Group A has the senior lien and the right to be paid first. Group B has a second-priority lien on the same assets and the right to be paid second. Group C has a third-priority lien and is paid last. When the debtor files for bankruptcy protection, the outstanding loan balances are unchanged and the collateral is worth only \$175 million.

In a traditional multi-tranche loan, Group A is oversecured and is entitled to postpetition interest on its \$100 million secured claim. *See* 11 U.S.C. § 506(b). Group B is undersecured, with the result that it has a \$75 million secured claim and a \$25 million unsecured claim. Group C has a \$100 million unsecured claim. Neither Group B nor Group C is entitled to postpetition interest. In a uni-tranche transaction, the results are the same for Groups B and C but quite different for Group A. Because there is only one lien, the entire \$300 million claim is deemed to be undersecured. As a result, Group A is not entitled to postpetition interest on its claim from the estate.

### *Drafting to Solve the Problem*

Senior lenders in a uni-tranche transaction – such as Group A in the example above – can contract around the problem. Instead of relying on their right to receive postpetition interest *from the estate*, they can seek to recover postpetition interest *from the junior lenders*. They do this in the intercreditor agreement by requiring the junior lender group or groups to pay over all payments they receive on the debt until senior lenders are paid in full, with interest. There is a drafting issue with respect to such a clause, however: the so-called “Rule of Explicitness.” The Rule of Explicitness is a judicial reaction to the perceived unfairness in allowing the senior lenders to collect postpetition interest out of the distribution to the junior lenders. As one court noted, “[o]wing simply to the protracted nature of

bankruptcy proceedings, a junior creditor's share of the recovery could be greatly reduced or eliminated while a senior creditor receives all of the recovery, more recovery in fact than the senior creditor would have been entitled to against the estate." *In re Southeast Banking Corp.*, [212 B.R. 682](#), 686 (S.D. Fla. 1997). Courts following this rule have required express reference to "postpetition interest"; a reference merely to interest until the debt is paid in full is not sufficiently explicit to subordinate the junior lenders' distribution to the senior lenders' claim for postpetition interest.

Whether the Rule of Explicitness survives is a question on which courts disagree. The Eleventh Circuit has ruled that the Rule was a creation of federal law that has been abrogated by the enactment of § 510(a) of the Bankruptcy Code. *In re Southeast Banking Corp.*, [156 F.3d 1114](#) (11th Cir. 1998). However, the court certified to the New York Court of Appeals the question whether the Rule was part of state law. After the Court of Appeals concluded that the Rule of Explicitness is indeed part of New York law, *In re Southeast Banking Corp.*, [681 N.Y.S.2d 468](#) (N.Y. 1998), the Eleventh Circuit applied the Rule. *In re Southeast Banking Corp.*, [179 F.3d 1307](#) (11th Cir. 1999).

In contrast, the First Circuit has ruled that enactment of § 510(a) extinguished the Rule of Explicitness and, because states are not free to adopt rules of contract interpretation that apply only in bankruptcy, the Rule of Explicitness is a dead letter. *In re Bank of New England Corp.*, [364 F.3d 355](#) (1st Cir. 2004). Nevertheless, after further proceedings, the senior lenders in that case still lost on their claim to collect postpetition interest because the evidence did not establish that the parties to the subordination agreement intended it to subordinate the junior lenders' claim to the senior lenders' claim for postpetition interest. See *In re Bank of New England Corp.*, [646 F.3d 90](#) (1st Cir. 2011). See also *In re K-V Discovery Solutions, Inc.*, [2013 WL 4550279](#) (Bankr. S.D.N.Y. 2013) (indenture did not subordinate notes to a claim for postpetition interest on a later loan; discussing but expressly not based on the Rule of Explicitness).

The upshot of this is that a uni-tranche loan should expressly refer to postpetition interest if the deal is for the senior lender to recover that ahead of the junior lender's right to recover principal.

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## Recent Cases

### SECURED TRANSACTIONS

*In re ProvideRx of Grapevine, LLC*,  
[2013 WL 4000936](#) (Bankr. N.D. Tex. 2013)

Language in security agreement granting a security interest in specified patent applications along with "corresponding rights to patent and all other intellectual property protection of every kind" was limited to IP associated with the patent applications, particularly given that the other portions of the agreement addressed only patent and patent-related rights. However, because the term sheet that preceded the loan stated that the debtor "shall provide the [secured party] with a senior security interest in the IP assets owned" and the note expressly indicated that the loan was made pursuant to the term sheet, the debtor had granted a security interest in all its IP assets. It was immaterial that the security agreement and financing statement did not expressly cover non-patent IP assets. Because "general intangibles" would have been an acceptable term in a security agreement and is broader than the phrase "IP assets," use of "IP assets" was an effective description of the collateral.

*In re Residential Capital, LLC*,  
[2013 WL 4069512](#) (Bankr. S.D.N.Y. 2013)

Creditors' Committee raised a cognizable claim that certain assets initially identified as Excluded Assets, and therefore unencumbered by security agreement, remained unencumbered when the assets ceased to be Excluded Assets after the transaction with an unrelated creditor was terminated; the security agreement lacked a traditional savings clause through which previously excluded property automatically becomes subject to the security interest once the reason for the exclusion is removed.

*In re LDB Media, LLC*,  
[2013 WL 4865125](#) (Bankr. M.D. Fla. 2013)

Lender did not have a security interest in the equipment located in the debtor's news trucks because the security agreement merely identified the trucks and did not mention equipment located in them. Even if lender had a security interest in the equipment located in the debtor's news trucks, the lender's financing statement that simply referenced the trucks would not have been sufficient to perfect. Even if the financing statement had referenced equipment in the trucks, that might not have been sufficient because a description of collateral by its location is not dependable.

*In re WL Homes, LLC,*

[2013 WL 4019397](#) (3d Cir. 2013)

Although parent corporation may not have had sufficient rights in the deposit account of its wholly owned subsidiary to grant a security interest in the deposit account, the subsidiary consented to the use of the deposit account as collateral because the CFO of the parent, who signed the security agreement on behalf of the parent, was also the president of the subsidiary and thus knowledge of and consent to the transaction were properly imputed to the subsidiary.

*McDonald v. Yarchenko,*

[2013 WL 3809512](#) (D. Or. 2013)

Lender did not comply with term in LLC operating agreement requiring prior written consent of majority of the five non-transferring members to debtor's encumbering his membership interest because fax purporting to express consent of two members was signed by at most one of them and letter that stated consent was given by another member at the time the lender made the loan was signed six years later. However, the debtor waived the right to challenge the validity of the transfer by signing the agreement to encumber his interest.

*American Bank, FSB v. Cornerstone Community Bank,*

[2013 WL 4309622](#) (6th Cir. 2013)

Bank that made loan to finance insurance policy and had a security interest in the unearned premiums had priority in the deposit account of the insurance broker into which the loan was deposited over the rights of the depository that had swept the account to cover an obligation of the broker because the Tennessee Premium Finance Company Act gives a security interest in unearned premiums priority over subsequent purchasers. As a result, the depository was liable for conversion.

*In re HW Partners, LLC,*

[2013 WL 4874172](#) (Bankr. E.D. Wash. 2013)

First lender that acquired a security interest in mortgage notes and recorded an assignment of each mortgage but which did not take possession of the notes or file a financing statement lost priority in the proceeds of the real estate to the second lender who, after the debtor accepted replacement notes and mortgages, perfected its interest in the replacement notes by filing a financing statement and later taking possession of them. Priority is governed by Article 9, not by real estate law, and then second lender had priority as the first to file or perfect even if the replacement notes were proceeds of the original notes and thus collateral for the first lender.

*Fenway Fin., LLC v. Greater Columbus Realty, LLC.,*

[2013 WL 4516008](#) (Ohio Ct. App. 2013)

Transaction labeled as a sale of accounts by real estate agent was really a secured loan because the agent retained all risk of loss, the transaction documents refer to an advance and describe the agent as the "debtor," granted the factor a security interest in all of the agent's current and future accounts, deposit accounts, and general intangibles to secure the agent's obligations, the factor filed a financing statement listing the agent as debtor, and the agent retained the right to any surplus over the amount advanced plus interest. As a result, the transaction was governed by an Ohio statute that prohibits real estate brokers from paying an agent's commission to a creditor of the agent. Section 9-406 did not override this statute because the more specific statute prevails over the more general unless the general is later in time and manifests an intent to prevail, and § 9-406 was not later in time.

*McDonald v. Yarchenko,*

[2013 WL 3809512](#) (D. Or. 2013)

By sending a written proposal and receiving no objection thereto within 20 days, the secured party conducted an effective acceptance of the collateral – the debtor's 1/6th interest in an LLC – in full satisfaction of the secured obligation even though the collateral was worth at least \$407,000 and possibly as much as \$1.6 million while the secured obligation was only about \$12,000.

*BNP Paribas Mortgage Corp. v. Bank of America,*

[2013 WL 2452169](#) (S.D.N.Y. 2013)

Bank that served as indenture trustee, collateral agent, depository, and custodian in connection with \$1.6 million secured loan to corporate borrower had no duty as collateral agent under the security agreement or as indenture trustee under the indenture to follow the lenders' instructions to sue itself for breach of its duties under the depository agreement or custodial agreement because a person cannot bring an adversarial claim against itself, even when acting in different capacities. Moreover, the security agreement and indenture did not require such action because they limit the bank's obligation to those available under the law, and under the law an entity cannot sue itself. The bank also had no duty to assign the claim against itself because an assignor can assign only the rights it has and the bank had no right to sue itself. The bank was not liable for negligently failing to prevent the fraud perpetrated by the borrower's corporate parent because the bank had no duty independent of its contractual obligations and such claims were barred by the economic loss doctrine.

**BANKRUPTCY**

*In re K-V Discovery Solutions, Inc.*,

[2013 WL 4550279](#) (Bankr. S.D.N.Y. 2013)

Indenture that provided for notes to be subordinated to principal and “interest, including, with respect to the Credit Facility, all interest accrued subsequent to the commencement of any bankruptcy or similar proceeding, whether or not a claim for post-petition interest is allowable as a claim in any such proceeding,” did not subordinate notes to post-petition interest on later loan. Although the indenture defined “Credit Facility” to consist of a specified loan agreement “as . . . may be amended, modified, restated, renewed, replaced, refinanced or restructured,” the original credit facility was amended several times and then replaced by a facility that was later paid off with cash on hand, and only several months afterwards did the debtor acquire the current senior loan. The temporal gap in the existence of a senior loan coupled with the fact that the proceeds of the current loan were not used to pay off the earlier senior loan, indicates that the current loan is not a “replacement” of the earlier credit facility and thus not entitled to priority with respect to postpetition interest.

*In re Tires N Tracks, Inc.*,

[2013 WL 4525219](#) (Bankr. N.D. Ill. 2013)

Although judgment creditor with a citation lien under Illinois law – created by serving a citation to discover asserts – initially had priority over another judgment creditor with a later citation lien, it lost that priority when, after the debtor filed for bankruptcy protection, it released the citation. The creditor’s release of the citation lien was not mandated by the automatic stay, and hence was voluntary, and the Bankruptcy Code did not fix priorities as of the petition date.

**LENDING & COMMERCIAL CONTRACTING**

*Frankford Cross. Shopping Ctr. v. Pho Partners, LLC*,

[2013 WL 1800115](#) (W.D.N.Y. 2013)

Individual guarantor who, contemporaneously with the execution of a commercial lease, executed a broadly worded guaranty covering “the full and faithful performance and observance of all the covenants, terms, and conditions of the Lease” was bound by the forum-selection clause in the lease. Forum-selection clause that required disputes to be determined by “the state, county or city courts in which Owner’s principal office is located,” rather than “court in the state, county, or city in which Owner’s principal office is located” did not permit litigation in federal court.

*Gaia House Mezz LLC v. State Street Bank and Trust.*,  
[720 F.3d 84](#) (2d Cir. 2013)

Clause in loan agreement providing that time is of the essence made deadlines material and thus the borrower’s failure to obtain a temporary certificate of occupancy on the date specified in the agreement was a material breach. As result, the borrower was not entitled to the contractual waiver of \$4 million in accrued interest, even though the lender had waived previous defaults.

*Adelaar v. Sprout Foods, Inc.*,

[2013 WL 3168663](#) (S.D.N.Y. 2013)

Even though written agreement under which corporation issued shares lacked the allegedly agreed-to “full ratchet anti-dilution” protection and contained a merger clause, the stockholder could admit evidence of mutual mistake to reform the agreement.

*Tri-State Truck Ins., Ltd. v. First Nat’l Bank of Wamego*,

[2013 WL 4046559](#) (10th Cir. 2013)

Loan agreement in which the borrower expressly consented to the lender’s sale of participation interests and to allow the buyers thereof to enforce the debt could be enforced by a buyer of a participation that also became the administrative agent for the loan. However, a related loan agreement that lacked such express consent could not be enforced by the new administrative agent that lacked a participation interest.

*Avenue CLO Fund, Ltd. v. Sumitomo Mitsui Banking Corp.*, [2013 WL 3853175](#) (11th Cir. 2013)

Pursuant to terms of Disbursement Agreement, disbursing agent had no duty to investigate or verify the borrower’s certification that the requirements or conditions to the disbursement of funds were fulfilled, even if the agent had information inconsistent with the borrower’s certification. However, the disbursing agent could not rely on a certificate if the agent had actual knowledge to the contrary and had a duty to determine whether conditions not covered by the borrower’s certificates were satisfied. Trial court erred in granting summary judgment for disbursing agent on lenders’ claim for breach of the Disbursement Agreement because material facts were in dispute about whether events could reasonably be expected to have a Material Adverse Effect and whether the disbursing agent had actual knowledge of this fact when it disbursed funds. For the same reason, summary judgment was not appropriate on the lenders’ claim against the disbursing agent for gross negligence.

*Mayfair Wireless LLC v. Celico Partnership*,  
[2013 WL 4657507](#) (D. Del. 2013)

Putative owner of patent could not enforce it because there were two unsubstantiated links in the chain of title. First, there was no bill of sale demonstrating that a secured party purchased the patent application at a public sale, and thus no one taking from that secured party could prove ownership. Second, a subsequent secured party (who also allegedly purchased the patent at a public sale after default) purportedly received its security interest when the parent company of the putative owner authenticated a security agreement, but even if state law permits a parent company to encumber the assets of its subsidiary, the Patent Act requires written evidence of assignment from the patent holder, and there was none.

*Shao v. Li*,  
[2013 WL 3481411](#) (N.Y. Sup. Ct. 2013)

Assignment of LLC interest in violation of a term in the LLC operating agreement was a breach but nevertheless valid because the agreement did not state that assignments in violation of the clause were void or invalid.

*M & M Inv. Group, LLC v. Ahlemeyer Farms, Inc.*,  
[2013 WL 5375416](#) (Ind. 2013)

State could, without violating due process, issue a deed to a tax sale purchaser even though the mortgagee was not notified of the sale because the mortgagee did not, pursuant to a state statute, annually request a copy of any notice of tax sale.



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