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GIVING SECURED PARTIES THE RIGHT TO VOTE PLEDGED EQUITY

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In many secured transactions, the collateral includes all or part of the equity interests in one or more entities. There are numerous reasons why parties might structure a transaction to include such equity. Perhaps the loan is made to the parent company and is intended to be secured by everything the parent owns. Perhaps the loan is made to a subsidiary whose principal asset is something to which Article 9 does not apply – such as real property – and the secured party wants, after default, to be able to conduct a reasonably quick Article 9 sale of the equity rather than a lengthy foreclosure of the real property. Or perhaps the loan is structured as a mezzanine loan, rather than as a second mortgage on real property, to avoid a default under the first mortgage.

Whatever the reason, the secured party will often want the right, after default, to exercise whatever voting or managerial rights are associated with the equity interest.[1] Article 9 does not grant a secured party the right to vote pledged equity but it does allow the parties, by agreement, to provide additional rights to the secured party,[2] and a secured party might attempt to use that permission to acquire the right to vote the debtor's interest in collateral consisting of shares in a corporation or a membership interest in a limited liability company. But getting – and retaining – those rights requires understanding and complying with the law of the state under which the entity was formed[3] and the terms of the entity's governing documents, and might depend on whether the entity is a corporation or limited liability company.

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Because so many entities are formed under Delaware law, this article focuses on the requirements of Delaware law. Many of the recommendations made below will apply to entities formed under the law of other states, but transactional lawyers should, of course, consult the applicable law to determine whether different rules apply.

Voting Stock in a Corporation

Delaware law provides two different mechanisms for a secured party to exercise the voting rights associated with pledged shares of stock in a corporation: (i) a proxy; and (ii) expressly empowering on the books of the corporation the secured party to vote the shares.[4] The Delaware Chancery Court's decision last year in *Hawkins v. Daniel*,[5] a decision affirmed last month by the Delaware Supreme Court,[6] provides some important lessons for the use of a proxy.

The Chancery Court opened its opinion by explaining that proxies are problematic and disfavored because they separate the voting rights associated with shares of stock from the underlying economic interest, something the court described as having "potentially mischievous effects."[7] As a result, a grant of proxy authority must be plain and unambiguous.[8]

A proxy is generally effective for no more than three years[9] and revocable by the shareholder. Each of these limitations would be problematic for a secured party, who would no doubt want the proxy to remain effective and irrevocable until the secured obligation is satisfied. Fortunately, a proxy can extend beyond three years if the proxy states that it lasts for a longer period.[10] It can also be made irrevocable. But, as explained by the court, "an irrevocable proxy exacerbates the risk of a divergence of interests between principal and proxyholder."[11] Consequently, Delaware law requires two things for a proxy to be irrevocable: (i) the proxy must contain plain and unambiguous language indicating that it is irrevocable; and (ii) the proxyholder must have an interest in the subject matter of the proxy relationship that is legally sufficient to support the grant of an irrevocable proxy.[12] In other words, the proxy must be coupled with an interest in either the shares themselves or in the corporation more generally.[13] A security interest in the shares would undoubtedly satisfy this requirement.

However, even an irrevocable proxy generally terminates when the owner sells the shares.[14] To address this, a shareholder can create an irrevocable proxy that binds subsequent owners of the shares. Such a proxy "runs with the shares," binding a new owner who knew of the irrevocable proxy at the time of

purchase.[15] But because this ossifies the potentially problematic severance of voting rights from the underlying economic interest, the creation of an irrevocable proxy that runs with the shares "requires particularly clear language."[16] Extrinsic evidence is not used to resolve any ambiguity in the language; instead ambiguity will be resolved in favor of the beneficial owner of the shares, with the result that the proxy will not run with the shares.[17] Language stating that a shareholder authorizes the proxyholder to vote the "[named shareholder's] shares" or "its shares" fails to satisfy this requirement because that language suggests that the proxy terminates if the shares come to be owned by someone else.[18]

It may be that these rules do not apply to a proxy granted to a secured party with a security interest in the shares. After all, if the security interest remains attached despite the debtor's transfer of the equity interest,[19] then any proxy given to the secured party remains coupled with the interest. If the transferee took free of the security interest, then the secured party probably has reason to exercise the authority granted in the proxy. Nevertheless, drafting clearly and avoiding ambiguity are always desirable, and so it would be wise to comply with these rules even when drafting a proxy for a secured party.

The upshot of all this is that there are, in essence, rules of explicitness[20] for a transactional lawyer to follow when drafting a proxy. The proxy itself must be clear and unambiguous. Beyond that, to last longer than three years, to be irrevocable, and to run with the shares the proxy must expressly state each of those things. The following language should work:

> ***Grant of Irrevocable Proxy.*** Debtor hereby grants to Secured Party a proxy to exercise, upon and during the continuance of an Event of Default, all voting rights with respect to all shares in Corporation that Debtor now owns or hereafter acquires. This proxy is irrevocable, and will remain in effect until all Secured Obligations have been indefeasibly satisfied in full. This proxy runs with the shares and binds all future owners of the shares. This proxy also runs with the security interest granted herein, and may be exercised by any assignee of the security interest.

Even when phrased properly, the proxy will apparently bind only those purchasers who are aware of the proxy at the time of purchase. Accordingly, if there is a stock certificate, the secured party should either get possession of the certificate or have a legend added to the certificate indicating that the shares are subject to an irrevocable proxy in favor of the secured party.[21]

The second method for granting voting rights to a secured party is if "in the transfer by the pledgor on the books of the corporation such person . . . expressly empower[s] the pledgee to vote thereon."[22] In other words, the corporation's books need to indicate both the security interest (the "transfer") and the pledgee's power to vote the shares. This rule appears to be designed more for the corporation's benefit than for the secured party's benefit – so that the corporation will know who has the power to vote the shares.[23] Perhaps because of that, the statute creating this process does not specify how long this power lasts, whether the shareholder may revoke this grant of authority, or whether the grant runs with the shares. That silence creates too much uncertainty for this process to be a reliable way to bestow voting rights on the secured party. Moreover, this process appears to contemplate an unconditional reallocation of voting rights as soon as the corporation's books contain the required information; it does not appear to provide for a transfer of voting rights conditioned on the shareholder's default under the security agreement.[24] For that reason alone, creation of an irrevocable proxy seems like a better approach.

Voting an Interest in a Limited Liability Company

Before discussing whether and how a secured party may exercise the debtor's voting rights as a member of a limited liability company ("LLC"), it is useful to review the rules on what rights an LLC member may assign.

As Norm Powell explained in this newsletter back in 2011, although lenders often describe the intended collateral to include all of the debtor's "membership interest" in an LLC, that is a "dangerously imprecise[] colloquialism" when applied to a Delaware LLC."[25] The Delaware Limited Liability Company Act nowhere refers to a "membership interest," and instead carefully distinguishes among a member's economic rights, control rights, and membership status.

In connection with this distinction, the Delaware LLC Act establishes two default rules relating to assignment: (i) members may assign their economic rights; and (ii) members cannot assign their control rights or membership status.[26] The LLC's operating agreement can alter either or both of these rules, but if the agreement is silent a member cannot transfer voting rights associated with membership.[27] Thus, unless the LLC operating agreement expressly provides otherwise, a secured party acquires no security interest in voting rights associated with a membership interest in a Delaware LLC.

The Delaware LLC Act does, however, authorize voting by proxy. Specifically, unless provided otherwise in the LLC operating agreement, members may vote in person or by proxy.[28] Unfortunately, nothing in the Delaware LLC Act expressly authorizes such a proxy to be irrevocable, even if the proxy is coupled with an interest. Given the long-standing judicial reluctance to enforce irrevocable proxies, it is unclear how a court would treat a proxy that purports to be irrevocable. There are no known cases on the subject.[29] A court might choose to apply the rule from the statute governing corporations,

on the theory that there is no good reason for a proxy to exercise voting rights associated with an LLC membership to be treated differently from a proxy to vote the shares in a corporation. Such an approach – which would permit a proxy with respect an LCC membership to be irrevocable – would also be consistent with the principle that commercial parties should be free to structure their contractual relationships as they wish. On the other hand, a court might regard the Delaware LLC Act's silence on the matter of irrevocable proxies – in contradistinction to express authorization in the statute governing corporations – as indicating a different legislative intent.[30]

Putting aside the uncertainty about whether a proxy with respect to the governance rights associated with an interest in an LLC can be irrevocable, the fact that the Delaware LLC Act authorizes an LLC operating agreement to disallow voting by proxy creates a potential problem. A transactional lawyer representing a secured party needs not only to ensure that the operating agreement contains no such provision when the security agreement is signed and the proxy granted, but also needs to take steps to ensure that the operating agreement cannot later be amended to invalidate a proxy previously given to the secured party. Fortunately, the Delaware LLC Act authorizes an LLC operating agreement to require the consent of a non-member to any amendment.[31] Accordingly, the transactional lawyer should insist that the operating agreement expressly permit voting by proxy, expressly permit such a proxy to be made irrevocable (at least if accompanied by an interest), and expressly provide that neither of these provisions can be amended without the secured party's prior written consent.

The Trigger

One final point merits brief discussion. Most security agreements define default to include a variety of events other than nonpayment of the secured obligation. Some of these defaults, such as a failure to generate specified earnings or to maintain a specified debt-to-asset ratio, can occur before anyone discovers them. Consequently, if a proxy granted to a secured party is conditioned on any default under the security agreement, the secured party might become entitled to exercise the debtor's voting rights – and the debtor might cease being entitled to exercise those rights – without either party being aware of that fact.

Such a situation is potentially problematic. If the debtor continued to exercise voting rights after the secured party became entitled to exercise them, actions taken by the entity might not have been properly authorized. This might not matter too much with respect to corporations because shareholders typically vote only on major matters, such as a proposed merger or proposed sale of substantially all of the corporation's assets.[32] In contrast, the members of an LLC – particularly a member-managed LLC – might need to approve many or most routine transactions. It is probably not in the interest of anyone involved – the entity, the secured party, and the debtor – to create a situation in which someone could claim that the actions previously taken the entity were not authorized.[33] Accordingly, particularly when the pledged equity is a membership in an LLC, the proxy should condition the secured party's rights not on default but on notification to the debtor after default.[34] The following language should work:

> ***Grant of Irrevocable Proxy.*** Debtor hereby grants to Secured Party a proxy to exercise, upon and during the continuance of an Event of Default and after Secured Party sends Debtor written notification of Secured Party's election to exercise the proxy, all voting and control rights with respect to all interests in Company that Debtor now owns or hereafter acquires. This proxy is irrevocable, and will remain in effect until all Secured Obligations have been indefeasibly satisfied in full. This proxy runs with the interests and binds all future owners of the interests. This proxy also runs with the security interest granted herein, and may be exercised by any assignee of the security interest.

Conclusion

A debtor can grant to a secured party the right to exercise voting rights associated with pledged shares of stock in a corporation. The best way to do so is through a proxy that is expressly irrevocable and expressly binding on a transferee of the shares. A debtor can also grant to a secured party the right to exercise voting and control rights associated with a membership in an LLC. Again, the best way to do so is through a proxy that is expressly irrevocable and expressly binding on a transferee of the interest. In addition, the LLC operating agreement should be amended to state, if it does not state already, that voting by proxy is permitted and that no amendment affecting that permission will be effective without the secured party's prior written consent. Even if all this done, transactional lawyers should bear in mind that some uncertainty remains about the effectiveness of such a proxy.

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Notes:

1. There are reasons for the secured party not to have – or at least not to exercise – the right to voting or managerial rights associated with a pledged equity interest, particularly if the interest is a controlling interest in the entity. The secured party's actions in directing the activities of the entity could form the basis for claims for equitable subordination, claims for lender liability, or claims under laws that impose liability on a person in "control." *See, e.g.*, Coppola v. Bear Stearns & Co.

499 F.3d 144 (2d Cir. 2007); Smith v. Ajax Magnathermic Corp., 144 Fed. App. 482 (6th Cir 2005) (both dealing with creditor liability under the WARN Act).

2. *See* U.C.C. § 9-601(a).

3. Although the debtor and secured party are generally free to select what law governs their contractual relationship, *see* U.C.C. § 9-301 cmt. 2; PEB Commentary No. 24 (Aug. 12, 2022), pursuant to the "internal affairs doctrine," the law of the state under which a business entity is formed governs the entity's internal affairs, such as the relationships among the entity, its officers, directors, managers, and equity holders, *see* Restatement (Second) of Conflict of Laws § 302(2). *See also* Stephen L. Sepinuck, *What Choice Do I Have? – Choice-of-Law Clauses Governing Attachment of a Security Interest*, 10 THE TRANSACTIONAL LAWYER 9 (June 2020); Carl S. Bjerre & Stephen L. Sepinuck, *Spotlight*, Commercial Law Newsletter 11 (March 2020); Landress v. Sparkman, 2020 WL 561893 (E.D.N.C. 2020).

4. *See* Del. Code, tit. 8, §§ 212(b), § 217(a). A third option involves the creation of a voting trust and the re-issuance of the shares to the trustee or trustees. *See* Del. Code, tit. 8, § 218.

5. 273 A.3d 792 (Del. Ch. Ct. 2022). The case did not involve a secured party; instead it involved a proxy issued in connection with a settlement agreement. However, the court's analysis would seem to apply equally to a proxy granted to a secured party.

6. 2023 WL 115854 (Del. 2023).

7. 273 A.3d. at 795. *See also* 2023 WL 115854, at *11-14; Restatement (Third) of Agency § 3.12 cmt. d (noting that an irrevocable proxy "distorts the allocation of voting power" because the proxy holder's interests might not be aligned with those of the shareholders).

8. *Id.*

9. *See* Del. Code, tit. 8, § 212(b). In New York, a proxy expires eleven months from its date unless the proxy provides otherwise. *See* N.Y. Bus. Corp. Law § 609(b).

10. Del. Code, tit. 8, § 212(b).

11 273 A.3d at 795.

12. *Id.*

13. *See* Del. Code, tit. 8, § 212(e). *See also* N.Y. Bus. Corp. Law § 609(f) (indicating that a proxy can be made irrevocable if the proxy holder is a pledgee, someone who has purchased or agreed to purchase the shares, a creditor of the corporation, an employee of the corporation, or another shareholder).

14. *See* Del. Code, tit. 8, § 212(e) (indicating that a proxy is irrevocable only "if, and only as long as, it is coupled with an interest.").

15. 273 A.3d at 795-96. *See also* N.Y. Bus. Corp. Law § 609(h) ("A proxy may be revoked, notwithstanding a provision making it irrevocable, by a purchaser of shares without knowledge of the existence of the provision unless the existence of the proxy and its irrevocability is noted conspicuously on the face or back of the certificate representing such shares.").

16. 273 A.3d at 796.

17. 2023 WL 115854, at *13.

18. 273 A.3d at 815-16 (discussing TR Investors, LLC v. Genger, 2010 WL 2901704, at *20 (Del Ch. Ct. 2010), *aff'd*, 26 A.3d 180, 197-98 (Del. 2011)). *See also* 2023 WL 115854, at *14-20.

19. *See* U.C.C. § 9-315(a)(1). Of course, in not all cases will the security interest remain attached following a transfer of the shares. A protected purchaser takes free of any adverse claim to the shares. *See* U.C.C. § 8-303(b).

20. *See* Stephen L. Sepinuck, *Gotcha!: Caught in the Explicitness Trap*, 8 THE TRANSACTIONAL LAWYER 1 (June. 2018). *See also* Stephen L. Sepinuck, *Court Rules that Explicitness Rule Is Fundamental Policy*, 10 THE TRANSACTIONAL LAWYER 1 (Apr. 2020); Stephen L. Sepinuck, *The Dangers of Uni-tranche Loans & the Rule of Explicitness*, 3 THE TRANSACTIONAL LAWYER 3 (Oct. 2013).

21. Obtaining possession of the certificate will not completely protect the secured party because the entity might issue a replacement certificate to the debtor if the debtor claims the certificate was lost, destroyed, or stolen, and a protected purchaser of the replacement certificate could potentially take free of the secured party's rights. *See* U.C.C. § 8-405 & cmt. 2.

22. Del. Code, tit. 8, § 217(a).

23. *See* Schott v. Climax Molybdenum Co., 154 A.2d 221, 224 (Del. Ch. Ct. 1959) (this rule "was enacted primarily to clarify voting rights as between pledgors and pledgees. It also gives the corporation a definite rule it can follow in conducting an election.").

24. To the extent that the process of recording a proxy on the books of the corporation is designed to assist the corporation – by ensuring it knows who is authorized to vote the shares – giving effect to a proxy contingent on default would frustrate that purpose. A corporation might neither know nor have reason to know of a default under a security agreement between a shareholder and a secured party.

25. *See* Norman N. Powell, *Security Interest in Delaware Limited Liability Companies*, 1 THE TRANSACTIONAL LAWYER 1, 1 (Apr. 2011). The Delaware Act does, however, refer to "[a] limited liability company interest" (which is limited to an

economic interest) *see* Del. Code, tit. 6, § 18-702(a), (b), and to "a member's interest," *id.* § 18-702(c).

26. *Id.* § 18-702(a), (b).

27. Article 9's anti-assignment rules do not override a restriction on assignment in an LLC operating agreement. This is so for three reasons. First, § 9-408(a), which applies to general intangibles (except, in some transactions, payment intangibles), overrides restrictions only in an agreement between the debtor and an account debtor. But the entity itself, which is likely to be an "account debtor" under § 9-102(a)(3), is usually not a party to its own formation documents, and the other members, for whose benefit the restriction operates, are not account debtors. Therefore, § 9-408 does not typically apply. Second, to remove any doubt, several states – including Delaware – have adopted non-uniform language to Article 9 or enacted statutes outside Article 9 to exempt interests in limited partnerships or LLCs from Article 9's anti-assignment rules. *See* Ala. Code § 10A-5A-1.06(e); Colo. Rev. Stat. § 7-90-104; Del. Code, tit. 6, §§ 9-408(e)(4), 15-104(c), 15-503(f), 17-1101(g), 18-1101(g); Ky. Rev. Stat. §§ 275.255(4), 362.1-503(7), 362.2-702(8); Tex. Bus. & Com. Code §§ 9.406(j), 9.408(e); Va. Code §§ 8.9A-406(k); 8.9A-408(g), 13.1-1001.1(B), 50-73.84(C). Finally, in 2018 the UCC's sponsoring organizations adopted a new subsection (f) to § 9-408, to except an ownership interest in a general partnership, limited partnership, or limited liability company from the scope of the section. Few states have enacted this rule to date, *cf.* 2022 Fla. Sess. Law Serv. Ch. 2022-119, but more likely will in connection with their enactment of the 2022 UCC Amendments.

Note, if the LLC has elected to have the interests of members treated as a security under U.C.C. Article 8, then those interests would be investment property to which neither § 9-406 nor § 9-408 would apply.

28. Del. Code, tit. 6, § 18-302(d). A similar provision authorizes managers to vote by proxy. *See* Del. Code, tit. 6, § 18-404(d).

The Uniform Limited Liability Company Act authorizes members to vote by proxy on any action requiring the vote or consent of members *under the Act*, § 407(d), but says nothing about voting by proxy with respect to matters requiring a vote under the operating agreement.

29. Both the Chancery Court and the Supreme Court in Daniel v. Hawkins quoted approvingly of comment b to § 3.13 of the Restatement (Third) of Agency, which discusses an irrevocable proxy relating to "securities or a membership interest." *See* 273 A.3d at 820; 2023 WL 115854, at *19. Thus, there is some weak dicta suggesting that Delaware courts would respect an irrevocable proxy for an LLC membership interest, if the proxy were coupled with an interest.

30. The Restatement (Third) of Agency would appear to be of only limited help. Section 3.12 states that a power to exercise voting rights associated with a membership interest may be made irrevocable "in compliance with applicable legislation." That appears to say nothing about what is permissible if no statute addresses the matter.

31. *See* Del. Code Ann. Tit. 6, § 18-302(e). Section 107(a) of the Revised Uniform Limited Liability Company Act provides similarly, as does the law in several other states. *See, e.g.*, Cal. Corp. Code § 17701.12(a); D.C. Code § 29-801.09(a); Fla. Stat. § 605.0107(1); Idaho Code § 30-25-107(a); Iowa Code § 489.112(1); Minn. Stat. § 322C.0112(1); Neb. Rev. St. § 21-112(a); N.J. Stat. § 42:2C-13(a); N.D. Cent. Code § 10-32.1-15(1); Utah Code § 48-3a-114(1); Vt. Stat. tit. 11, § 4003(k); Wyo. Stat. § 17-29-112(a).

32. *See, e.g.*, Stream TV Networks, Inc. v. SeeCubic, Inc., 279 A.3d 323 (Del. 2022) (because a corporation's charter required approval of Class B shareholders for any "sale, lease or other disposition of all or substantially all of the assets," the shareholders' approval was needed to transfer substantially all of the corporation's personal property to a newly formed entity controlled by the creditors that had a security interest in the assets; moreover, there is no insolvency exception to the Delaware statutory provision that requires unanimous shareholder consent to a sale, lease or exchange of substantially all of a corporation's assets).

33. There is another reason to condition the secured party's rights under the proxy on both default and notification. Doing so gives the secured party the option to exercise those rights or refrain from doing so. Before exercising the option, the secured party can assess the relevant benefits and risks, and make an informed decision.

34. Sending such a notification post-petition in the debtor's bankruptcy would likely violate the automatic stay, as an act "to exercise control over property of the estate." *See* 11 U.S.C. § 362(a)(3). But exercising voting rights post-petition would likely violate the automatic stay regardless of when notification is sent or whether notification is required. Thus, conditioning the secured party's proxy rights on notification to the debtor should not make the proxy less enforceable.

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Perfecting a Security Interest in a Commercial Tort Claim

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You are responsible for documenting a secured loan on behalf of a lender client. The collateral will include substantially all of the debtor's personal property. The debtor represents that it currently owns no commercial tort claims, so you need not describe any such claims in the security agreement. However, because § 9-204(b)(2) does not permit a security interest to attach to a commercial tort claim under an after-acquired property clause,[1] you include in the security agreement covenants by the debtor to: (i) promptly disclose any commercial tort claim that the debtor acquires after signing the security agreement; and (ii) at the secured party's request, to amend the security agreement to add such a claim to the description of collateral. You perfect the security interest by filing a proper financing statement.

Six months later, the debtor notifies the secured party that the debtor has claims against a competitor under federal antitrust law and a state statute prohibiting unfair and deceptive trade practices. With your assistance, the parties amend the security agreement. Must the financing statement be amended? This article explores that issue.

Article 9 requires that a security agreement provide a "description" of the collateral.[2] It requires that a financing statement "indicate[]" the collateral.[3] The drafters purposefully chose to use different words to signal that the requirements are different. After all, security agreements and financing statements serve different functions. A security agreement transfers property rights in the collateral to the secured party. Consequently, it needs to identify the property involved.[4] A financing statement provides notice to the public of a *possible* security interest. Because it is designed to provide only inquiry notice, it need only speak in general terms.[5]

In general, a security agreement may describe the collateral using any type of collateral defined in the UCC.[6] One exception to that rule is contained in § 9-108(e)(1), which requires greater specificity for a description of a commercial tort claim. However, by referring to a "description" of a commercial tort claim, § 9-108(e)(1) says nothing about what is required to "indicate[]" the collateral in a financing statement.

So what is sufficient in a financing statement to indicate a commercial tort claim? Section 9-504(2) expressly states that a financing statement covering all assets or all personal property is a sufficient "indication." Because that rule undoubtedly applies to financing statements, whereas § 9-108 on its face does not,[7] a financing statement that covers "all assets" is effective to indicate commercial tort claims. Accordingly, if the financing statement already on file covers "all assets," no amendment to the financing statement is needed.[8]

What about a financing statement that does not cover all assets but includes the phrase "all commercial tort claims" in the indication of collateral? There is no clear statutory answer to that question. Section 9-504 provides two safe harbors for a financing statement. Subsection (1) states that a financing statement sufficiently indicates the collateral if it provides a description of the collateral pursuant to § 9-108. But pursuant to § 9-108(e)(2), "all commercial tort claims" is not a sufficient description of the collateral. Subsection (2) of § 9-504 states that "all assets" or "all personal property" is a sufficient indication of collateral, but that safe harbor says nothing about whether "all commercial tort claims" suffices. So we are left with an interpretive issue of whether "all commercial tort claims" is a sufficient indication of collateral in a filed financing statement.

But the issue is not a particularly difficult one. The phrase "all commercial tort claims" should be effective in a financing statement. After all, the policy underlying the heightened specificity requirement in § 9-108(e)(1) – to limit security interests in commercial tort claims to situations in which the claim is either reliance collateral or proceeds – has no relevance to the inquiry notice function of financing statements.[9] Moreover, in at least one other situation, a financing statement that neither mentions commercial tort claims nor describes the collateral broadly as "all assets" is effective to perfect a security interest in a commercial tort claim. That occurs when the commercial tort claim is proceeds of collateral that the financing statement does indicate.[10] Indeed, the effectiveness of a filed financing statement to perfect a security interest in proceeds that are a type of property not indicated in the financing statement is not limited to commercial tort claims; it applies to any collateral for which a security interest can be perfected by filing a financing statement in the office in which the financing statement was filed. Accordingly, a searcher cannot rely on the specifics on an indication of collateral in a financing statement. If there is any chance that the property in which the searcher is interested might be proceeds of indicated collateral, the searcher must conduct further due diligence to determine if the property is encumbered.

Given the inquiry notice function and limited utility of the indication of collateral in a financing statement, the hassle involved in having to amend a financing statement to specifically indicate each new commercial tort claim, and the UCC's stated policy to simplify the law and facilitate commercial transactions,[11] an indication that the collateral includes the collateral type "commercial tort claims" should suffice.

Of course, all this assumes that the claims are indeed commercial tort claims. Returning to the hypothetical at the beginning of this article, recall that the debtor's new claims are for violation of federal antitrust laws and a state statute prohibiting unfair and deceptive trade practices. Are those tort claims? If not, they are general intangibles, rather than commercial tort claims.[12] As such, a financing statement that indicates the collateral as "all assets" or as including "all general intangibles" would be effective to perfect a security interest in the claims, but a financing statement indicating the collateral as "all commercial tort claims" would not be.

The fact that the claims arise under a statute, rather than the common law, and that one of them arises under federal, rather than state, law should not be determinative, and might not even be relevant. What matters instead is the basis for the claim. My (very old) Black's Law Dictionary defines a tort as what most of us understand it to be: "[a] private or civil wrong or injury. A wrong independent of contract. A violation of a duty imposed by general law or otherwise upon all persons occupying the relation to each other which is involved in a given transaction."[13]

Under this definition, the claims would appear to be tort claims.[14] They are certainly not claims arising under the law of contract or unjust enrichment, which along with tort are the three principal foundations of civil liability.[15] Moreover, antitrust has its origin in the common law, specifically in the law of restraint of trade. On the other hand, restraints of trade were historically a basis for not enforcing contracts, rather than imposing civil liability. Moreover, antitrust law generally seeks to protect the public interest, rather than private interests. So the fit under the umbrella of tort is imperfect.

The upshot of this is that some uncertainty remains as to whether the claims are tort claims, (and, hence, commercial tort claims) or general intangibles. Fortunately, the advice to the transactional lawyer remains the same. If at all possible, indicate the collateral in the financing statement as "all assets." Such an indication is effective to perfect regardless of whether the claims sound in tort or some other area of law and despite the requirement in § 9-108(e)(1) that a security agreement describe a commercial tort claim with some specificity.

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Notes:

1. A security interest does attach to later-arising commercial tort claim that is proceeds of other collateral. The 2022 UCC Amendments added § 9-204(b.1)(2) to make this clear and to effectively overrule the several courts that have erroneously ruled to the contrary. *See* In re EPD Inv. Co., 2020 WL 6937351 (Bankr. C.D. Cal. 2020); In re Puerto Rico Hosp. Supply, Inc., 617 B.R. 181 (Bankr. D.P.R. 2020); In re Alliance Ins. Group of Akadelphia, Inc., 2019 WL 1992622 (Bankr. W.D. Ark. 2019); In re American Cartage, Inc., 656 F.3d 82 (1st Cir. 2011); In re Zych, 379 B.R. 857 (Minn. Ct. App. 2007).

2. U.C.C. § 9-203(b)(3)(A).

3. U.C.C. § 9-502(a)(3).

4. As an official comment puts it, the requirement of a signed security agreement is "in the nature of a Statute of Frauds." U.C.C. § 9-203 cmt. 3.

5. *See* U.C.C. §§ 9-502 cmt. 2, 9-504 cmt. 2.

6. *See* U.C.C. § 9-108(b)(3).

7. Not only does § 9-108 deal only with what is a reasonable "description" of collateral, whereas § 9-502 requires that a financing statement "indicate" the collateral, but § 9-108(c) and 9-504(2) would be irreconcilable if they both applied to the same requirement. The former invalidates a description of collateral as "all assets" and the latter validates an indication of collateral as "all assets."

8. Similarly, if at the inception of the transaction a financing statement indicating the collateral as "all assets" will be filed, there is no need to include additional language to indicate an existing or future commercial tort claim with greater specificity.

9. *See* § 9-108 cmt. 5 (indicating that subsection (e) requires greater specificity for a description of, among other things, commercial tort claims, "to prevent debtors from inadvertently encumbering" such property).

10. *See* U.C.C. § 9-315(c), (d)(1). *See also* U.C.C. § 9-102(a)(64)(D) (defining "proceeds" to include claims arising out of the loss of or damage to the collateral).

11. *See* U.C.C. § 1-103(a).

12. *See* U.C.C. §§ 9-102(a)(13) (defining a commercial tort claim as "a claim arising in tort"); 9-109(d)(12) (excluding other tort claims from the scope of Article 9). *See also* In re Main Street Bus. Funding, LLC, 642 B.R. 141 (Bankr. D. Del. 2022) (of the debtor's claims against a consultant for fraudulent misrepresentation, conversion, civil conspiracy, unjust enrichment, breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and legal malpractice, only the unjust enrichment claim sounded in contract; all the others sounded in tort; pursuant to the "gist of the action" doctrine, the entire claim was therefore a commercial tort claim).

13. BLACK'S LAW DICTIONARY 1660 (Rev. 4th ed. 1968).

14. Other statutory claims, such as claims for infringement of patent, copyright, or trademark, would also appear to be tort claims under this definition. In contrast, a claim for breach of

a covenant not to compete would be a contract claim. A claim to avoid a preferential transfer or a constructively fraudulent transfer is more difficult to classify. But such a claim seems more closely aligned to the distributive justice principles underling unjust enrichment than to the corrective or restorative justice principles underlying tort.

15. *See* James Steven Rogers, *Restitution for Wrongs and the Restatement (Third) of the Law of Restitution and Unjust Enrichment*, 42 WAKE FOREST L. REV. 55, 56-57 (2007).

Recent Cases

SECURED TRANSACTIONS

Attachment Issues

Berkshire Bank v. Kelly,
2023 WL 188386 (Vt. 2023)
A security agreement that described the collateral as "all of Grantor's property . . . in the possession of, or subject to the control of, Lender (or in the possession of, or subject to the control of, a third party subject to the control of Lender) . . . including . . . Merrill Lynch Investment Management Account XXXX7779" was insufficient to grant a security interest in the named investment account because the lender never acquired control of the investment account.

Landcastle Acquisition Corp. v. Renasant Bank,
2023 WL 174277 (11th Cir. 2023)
Even if the manager of a law firm lacked authority to grant to a bank a security interest in the firm's certificate of deposit, the *D'Oench, Duhme* doctrine prohibits anyone from challenging the effectiveness of the security interest against an assignee that purchased the bank's assets from the FDIC when the bank failed, unless the basis for the challenge appears in the bank's own records. Accordingly, the assignee of the now-bankrupt law firm had no cause of action against the assignee of the bank loan for cashing in the certificate of deposit. Even if the manager lacked actual authority to grant a security interest in the certificate of deposit, he might have had apparent authority and the security interest was at worst voidable, not void.

PMSI Status

Agrifund, LLC v. First State Bank of Shallowater,
2022 WL 17547812 (Tex. Ct. App. 2022)
A bank that financed farmers' purchases of cotton seeds and chemicals for their 2018 crop did not have a purchase-money security interest in the crop. A PMSI is limited to goods purchased, and the farmers did not purchase the crop. Moreover the crops are not the equivalent of the seeds purchased because the seeds were merely one of several inputs necessary to produce the crop. Finally, the crop was not proceeds of the seeds because there was no sale, lease, license, or other disposition of the seeds. Accordingly, the security interest of a lender with an earlier filed financing statement against the farmers had priority in the crop over the bank's security interest.

Priority Issues

Arch Insurance Co. v. FVCbank,
881 S.E.2d 785 (Va. 2022)
A bank that had a security interest in a subcontractor's deposit accounts at the bank had priority over the surety company that issued a performance bond covering the subcontractor's performance on a project and had a security interest in the subcontractor's right to payment on the project. The bank's security interest was perfected by control. The surety's security interest was not perfected because the surety never filed a financing statement covering the right to payment or obtained control of the deposit account. The surety's right to be equitably subrogated to the subcontractor's rights could not alter priority because a subrogee's rights are no better than the subrogor's rights, and the bank had rights to the deposit account superior to the subcontractor's rights. Although the subcontractor had agreed with the surety that funds received on the bonded project would be held in trust for the surety, and the subcontractor had asked the bank to establish a trust account, the bank had denied that request and those funds were commingled with other funds in the deposit account. For the same reasons, the surety had no claim for conversion or unjust enrichment.

Enforcement Issues

Vivos Acquisitions, LLC v. Health Care Resource Network, LLC, 2023 WL 113046 (E.D. Va. 2023)
Although the debtor had not breached by failing to pay at the time that the secured parties, who had a security interest in the membership interests in a limited liability company, sent notification of breach, the debtor had materially breached by: (i) granting an interest in the profits of the company; (ii) using company funds to pay closing costs; and (iii) granting another security interest in the membership interests. It did not matter that, at the time they sent the notification, the secured parties were unaware of these breaches. Accordingly, the secured parties' assignment of the membership interests to themselves was justified. However, because the security agreement authorized the secured parties after default to either sell the membership interests or "retain" and become the full owner of them, the secured parties had no right to enforce the secured

obligation after reassigning the membership interests, as that would be a double recovery.

Stichting Juridisch Eigendom De Veste Beleggingsfondsen v. Capstone Credit, LLC, 2022 WL 18027614 (S.D.N.Y. 2022)
A secured party was entitled to summary judgment on its claim against the debtor for breach of contract and foreclosure. Although the secured party's investment was initially structured as a partnership interest, it was restructured as a secured loan to comply with the demands of a Netherlands regulator. The debtor had no defense based on its allegation that the parties acted as if the transaction were still a partnership. The documents were unambiguous and, because they required a signed writing to be amended, could not have been amended by any oral understanding. There could also be no part performance or promissory estoppel defense based on any oral promise because the debtor's actions were required under the loan documents, and thus did not unequivocally refer to an oral promise. The debtor had no defense based on breach of the covenant of good faith because that doctrine cannot be used to alter the express terms of a written agreement.

Caterpillar Financial Services Corporation v. Get 'Er Done Drilling, Inc., 286 A.3d 302 (Pa. Super. Ct. 2022)
A notification of a public internet sale, sent on October 2, which stated that the auction would begin and end on November 2, was reasonable even though the auction began on October 12 and concluded on October 26. The incorrect information did not prejudice the debtor because he did not read the notification, he had no funds with which to bid, and he had previously unsuccessfully attempted to find a buyer for the collateral. The online auction conducted over 15 days, advertised to 1.4 million account holders of the auction site, and attended by 160,000 individuals who made approximately 13,000 bids, 19 of whom made 100 bids on the collateral, was a public disposition because it reached a sufficiently broad worldwide audience and garnered a substantial number of views and bids.

Liability Issues

Minnesota Bank & Trust v. Principal Securities, Inc., 2023 WL 275997 (D. Minn. 2023)
A secured party stated claims against a securities intermediary for breach of contract, negligence, and promissory estoppel for allowing the debtor to transfer assets out of a collateralized securities account without the secured party's consent, in alleged violation of a control agreement. Even though the secured party was not a party to the control agreement, it was a third-party beneficiary of the agreement because the security intermediary's duties were owed to the secured party.

BANKRUPTCY

Property of the Estate

In re Celsius Network LLC, 647 B.R. 631 (Bankr. S.D.N.Y. 2022)
The debtor became the owner of cryptocurrency that its customers deposited into "Earn Accounts," because the terms of service – which constituted clickwrap contracts – provided that the debtor held "all right and title to [deposited assets], including ownership rights," and had the right to pledge, sell, or otherwise transfer the assets without notice to the customer, in exchange for "rewards" in the form of digital assets. Although the terms of service also referred to the transaction as a loan, on the whole it was clear that ownership was transferred to the debtor. Although the debtor might have violated securities laws or committed fraud, that could and would be dealt with in the bankruptcy claims resolution process.

Claims & Expenses

In re Alta Mesa Resources, Inc., 2022 WL 17984306 (Bankr. S.D. Tex. 2022)
The claims filed by a surety that had issued surety bonds on behalf of the debtors, but which had received no claim on the bonds from the obligees, were contingent and therefore disallowed under § 502(e)(1). Although the surety had a direct contractual right against the debtors to demand collateral, that right did not convert the surety's claim into something other than a contingent right for indemnification. The surety did, however, have an allowable claim for the unpaid premiums on the surety bonds.

GUARANTIES & RELATED MATTERS

Electronic Merchant Systems LLC v. Gaal, 58 F.4th 877 (6th Cir. 2023)
The trial court erred in dismissing a complaint against a guarantor under a 2014 agreement because, even though the merger clause in a later agreement superseded the original agreement, and therefore terminated the guaranty, it was unclear what the effect of termination was. It might have: (i) cut off the guarantor's liability for liabilities incurred after the execution of the later agreement but preserved his liability for obligations that accrued before that date; or (ii) constituted a novation that eliminated his liability for all debts.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Powercap Partners LLC v. Beaux Equities LLC, 2023 WL 116942 (N.Y. Sup. Ct. 2023)
Two commercial loans were criminally usurious because they charged interest in excess of 25%. It did not matter that the promissory notes stated that "if . . . interest in excess of said maximum legal rate shall be paid hereunder, the excess shall be applied in reduction of the principal," because such language does not prevent the notes from being usurious. Because the only loss the lender claimed was the loss of the principal amount of the loan, the lender had no claim against the debtors for fraud pertaining to the collateral; no right of action can arise from an illegal contract.

Harris v. DHM Industries, 2023 WL 187575 (Ill. Ct. App. 2023)
An Illinois trial court erred in dismissing a complaint filed by a debtor on the basis that a Utah court decision was res judicata of the matter. The debtor alleged that the defendant had violated the Illinois Mortgage Foreclosure Law ("IMFL") by requiring that the debtor form a limited liability company to hold title to real property and grant a security interest in his membership interest, and then foreclosing on the membership interest pursuant to Article 9. Although the security agreement selected courts in Utah as the exclusive jurisdiction to resolve all disputes relating to the loan documents or the transaction contemplated thereby, and a Utah court had already ruled that the defendant was the owner of the LLC, the debtor claimed that the entire contract was a fraudulent effort to evade the IMFL, and a claim of fraud is sufficient to render a choice-of-forum clause unenforceable. Moreover, the other loan documents, including the real property mortgage, did not select Utah courts as the exclusive forum and it was unclear from the record whether the forum-selection clause in the security agreement covered the mortgage.

Bank Leumi USA v. Kloss, 2023 WL 179966 (D.N.J. 2023)
A bank was not entitled to summary judgment on its claim against a supplier that, after entering into a subordination agreement with the debtor and the bank that prohibited the supplier from accepting or retaining payment until the bank was paid in full, accepted interest payments in the form of goods sold to its affiliate and a resulting setoff of the purchase price against the interest obligation. The subordination agreement provided that, in the event of a breach by the debtor or the supplier, all obligations of the debtor to the bank would become immediately due and payable. The plain language of this provision appears to provide for the bank's sole remedy.

Ainslie v. Cantor Fitzgerald, L.P., 2023 WL 106924 (Del Ch. Ct. 2023)
Covenants by former partners of a global financial services firm not to compete for one year following departure from the firm and not to solicit employees or clients for two years following departure were invalid restraints of trade under Delaware law. The covenants were unlimited in geographic scope, covered all the firm's affiliates, prohibited wide-ranging solicitation, and reached conduct that "could be considered" to be competitive. It did not matter that the partners agreed in the partnership agreement that the restrictions were "reasonable in scope and duration"or that the agreement authorized courts to limit the scope of the restriction if the court determined that the scope was too broad. Accordingly, the breach of the covenants could not be a basis for the firm to withhold a refund of the former partners' capital accounts. A term in the partnership agreement that authorized the firm to withhold a refund of a former partner's capital account if the former partner engaged in competition within four years after leaving the firm, regardless of whether doing so was a breach, was similarly subject to scrutiny for reasonableness. Because the clause in the partnership agreement applies regardless of whether the partner left the firm voluntarily or involuntarily, and because the former partners stood to lose between nearly $100,000 to just under $5.5 million, regardless of whether the firm suffered any injury, the term operated as an unreasonable restraint of trade.

Texas REIT, LLC v. Choudhri, 2022 WL 17421518 (Tex. Ct. App. 2022)
Because arbitration agreements governed by the Federal Arbitration Act cannot provide for judicial review for legal error, even though those governed by the Texas Arbitration Act may, review of an arbitration award for legal error was not available. The parties' agreement provided that "[t]he Federal Arbitration Act shall govern the interpretation, enforcement, and proceedings pursuant to the arbitration clause of this agreement," and thereby indicated the parties contracted for the FAA to govern arbitration.

Cummings Properties, LLC v. Hines, 2022 WL 17409280 (Mass. Ct. App. 2022)
A liquidated damages clause in a commercial lease that provided for payment, after tenant's default, of the present value of all remaining rent was an unenforceable penalty. Although an enforceable liquidated damages clause obviates the duty to mitigate, that does not mean the landlord can, as the landlord did in this case, relet the property to another tenant while also collecting accelerated rent from the breaching tenant.

E-Commerce Lighting, Inc. v. E-Commerce Trade LLC,
302 Cal. Rptr. 3d 218 (Cal. Ct. App. 2022)
A trial court erred in vacating, at the request of a bank that had made a senior loan to the buyer of a business, the portion of an arbitration award between the buyer and the seller that permitted their obligations to be set off against each other. Courts may correct an arbitration award if the arbitrator exceeds his or her powers and the award can be corrected without affecting the merits of the decision. In this case, the arbitrator might have exceeded his authority because setoff effectively allowed the seller to circumvent the subordination agreement to the detriment of the bank, which was not a party to the arbitration. Nevertheless, the correction affected the merits of the decision because setoff was a contested issue submitted to the arbitrator.

Emigrant Bank v. Virgo Investment Group LLC,
180 N.Y.S.3d 44 (App. Div. 2022)
Two lenders lacked standing to bring an action against third parties, alleging that such parties were alter egos of the debtor, because the loan agreement gave the lenders' administrative agent exclusive authority "to realize upon any of the Collateral or to enforce the Collateral Documents" and to exercise "any remedies available at law or in equity" after an event of default.

Kent v. Ellis,
2023 WL 34824 (D.N.J. 2023)
A forum selection clause that required "[a]ny action to enforce this Agreement" to be litigated in Colorado did not apply to an action to avoid as fraudulent the transfers made in connection with the agreements containing that clause.

United States v. Filer,
56 F.4th 4211 (7th Cir. 2022)
A lawyer was properly convicted by a jury of two counts of wire fraud for his conduct in assisting a client evade creditors, and the trial judge erred in granting a motion of acquittal after the jury's verdict. The lawyer helped the client purchase at a discount – through a straw man – a secured loan that a bank had made to the client's business, knowing that the bank had a policy of not negotiating a discount with its borrowers. The lawyer also backdated and filed confessions of judgment that the debtor signed so as to facilitate getting a quick judgment and then foreclosing on the collateral by selling it to a newly formed entity controlled by the client.

Costa Investors, LLC v. Liberty Grande, LLC,
2022 WL 17825542 (Fla. Ct. App. 2022)
An individual who, as president and manager of a limited liability company, signed a loan agreement in which the company represented that it owned property that in fact it had transferred to a subsidiary three weeks earlier, could be liable for fraud. The individual was not protected by the independent tort doctrine, which prevents recovery in tort for a contract dispute unless the tort is independent of any breach of contract, because the individual was not a party to the contract. Although the individual signed the agreement on behalf of the company, and did not personally make the misrepresentation, he could nevertheless be liable for fraud because a representative of an entity that actively participates in a tort by the entity is liable for his or her own wrongful act.

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