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RIGHTS TO PAYMENT IN CRYPTOCURRENCY ARE NOT LIKE OTHER PAYMENT RIGHTS

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The 2022 UCC Amendments make it clear that no currently existing cryptocurrency is "money" under the UCC. The amendments do this by redefining "money" to exclude "an electronic record that is a medium of exchange recorded and transferable in a system that existed and operated for the medium of exchange before the medium of exchange was authorized or adopted by [a] government."[1] Even under current law, no cryptocurrency other than Bitcoin fits under the UCC definition of "money," and Bitcoin almost assuredly does not either.[2]

One crucial implication of this is that an obligation to pay in such cryptocurrency is not a "monetary obligation," a term used throughout the UCC but not defined. A monetary obligation is broader than an obligation to pay "money." It includes an obligation to pay, denominated in dollars or other currency, that may or must be paid by check or funds transfer.[3] But it does not include an obligation to provide services or property, including intangible property such as cryptocurrency. Again, the 2022 UCC Amendments make this point expressly,[4] but it is no doubt also true under current law. Various important consequences follow. Consequences that transactional lawyers should be aware of now, even before the 2022 UCC Amendments go into effect. This article explores those consequences and offers some advice to transactional lawyers dealing with any obligation that must be or may be satisfied with cryptocurrency.

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PRINCIPAL ATTRIBUTES OF RIGHTS TO PAYMENT IN CRYPTOCURRENCY

Three common types of Article 9 collateral – accounts, chattel paper, and payment intangibles – are all defined as a right to payment of some type of monetary obligation.[5] A fourth – instruments – is similarly defined as a negotiable instrument (which in turn is a promise or order to pay "money") or other right to payment of a monetary obligation.[6] Because an obligation to pay cryptocurrency is not a "monetary obligation," a right to payment in cryptocurrency cannot be an account, chattel paper, instrument, or payment intangible.[7] Such a right also cannot be a "promissory note" because that term is a subset of "instruments,"[8] and it cannot be a "controllable account" or "controllable payment intangible" because those terms are subsets of "accounts" and "payment intangibles," respectively.[9] As a result, a right to payment in cryptocurrency is a general intangible (other than a payment intangible).[10]

At least nine consequences follow from this classification:

- *Description.* A security agreement will not encumber rights to payment in cryptocurrency by including in the description of collateral the terms "accounts," "chattel paper," "instruments," or "payment intangibles."[11] Instead, the description of collateral must either refer to "general intangibles" or use other appropriate language.
- *Indication.* A financing statement will not perfect a security interest in rights to payment in cryptocurrency by including in the indication of collateral the terms "accounts," "chattel paper," "instruments," or "payment intangibles."
- *Scope.* Because rights to payment in cryptocurrency cannot be accounts, chattel paper, payment intangibles, or promissory notes, Article 9 does not apply to an outright sale of such rights, although it does apply to the use of such rights to secure an obligation.[12]
- *Perfection.* Because rights to payment in cryptocurrency cannot be chattel paper, controllable accounts, or controllable payment intangibles, perfection by control will not ordinarily be possible.[13]
- *Perfection.* Because rights to payment in cryptocurrency cannot be chattel paper, instruments, or promissory notes, perfection by possession will not ordinarily be possible.[14]

- *Perfection.* Because rights to payment in cryptocurrency cannot be payment intangibles or promissory notes, the automatic perfection rules of § 9-309(a)(3) and (4) for sales of payment intangibles and promissory notes cannot apply.[15]
- *Restrictions on Assignment.* Because rights to payment in cryptocurrency are general intangibles (but are not payment intangibles), § 9-406(d) will not override any contractual restriction on transfer of the rights. Instead, if the rights are used as collateral for an obligation,[16] the far weaker override in § 9-408 would apply. Under § 9-408, the security interest would attach and could be perfected despite the transfer restriction but the secured party would not have the right to enforce the right to payment against the account debtor.[17]
- *No Holder in Due Course*. Because rights to payment in cryptocurrency cannot be negotiable instruments, there can be no Article 3 holder in due course of the rights. Similarly, a transferee of such rights cannot "take free" under rules protecting purchasers of chattel paper or instruments.[18]
- *No Discharge Rule*. Because rights to payment in cryptocurrency cannot be accounts, chattel paper, or payment intangibles, the rules in § 9-406(a)-(c) regarding how the account debtor may discharge its obligation – that is, when it must pay the debtor and when it must the secured party – cannot apply. The similar rules in § 12-106 for controllable accounts and controllable payment intangibles also cannot apply. As a result, no rule in the UCC specifies how the account debtor may discharge its obligation or under what circumstances the secured party may enforce the right to payment.[19]

Before discussing how to deal with these consequences, it is worth considering how one minor change in the facts would make matters murkier.

PAYMENTS DUE IN CRYPTOCURRENCY OR FUNDS

Contracting parties might – either because they desire to attain the consequences above or for business reasons having nothing to do with the intricacies of the UCC – blur the lines between payment in funds (*i.e.*, a monetary obligation) and payment in cryptocurrency. One way they might do so is in the manner in which the amount of the obligation is determined. For example, parties could create an obligation to pay cryptocurrency that is pegged to a dollar amount (*e.g.*, "Bitcoin with a value, as of [date], equal to $75,000") or an obligation to pay dollars equal to the value of a specified amount of cryptocurrency (*e.g.*, "U.S. dollars equivalent to the value of 2 Bitcoin on [date]"). Another way that contracting parties might blur the distinction is to create a right to payment that the account debtor can discharge by payment in either money or cryptocurrency.[20] Contracts providing for payment alternatives – funds or commodities – have been around for centuries.[21]

How the obligation must be paid – in funds vs. in cryptocurrency – matters. In contrast, how the amount of the obligation is determined seems unlikely to affect the classification. If the obligor must pay in dollars, then the obligation should be regarded as a monetary obligation even if the amount due is tied to the value of a specified amount of cryptocurrency. After all, there are a variety of obligations that are routinely regarded as "monetary obligations" even though the amount of the obligation is uncertain or contingent when the contract is made. Earn-out obligations in connection with the sale of a business and the net payment due under an interest rate swap or currency swap are a few common examples. Indeed, Article 9 itself contemplates that an account, chattel paper, payment intangible, or other monetary obligation might be subject to a partial defense that reduces the amount that the account debtor must pay to the secured party.[22] Thus, the fact that an obligation is unliquidated in amount does not prevent the obligation from being a monetary obligation.

In contrast, if payment is due in cryptocurrency, the fact that the amount of cryptocurrency is pegged to its monetary value on a specified date should not transform what is a non-monetary obligation into a monetary obligation. Were the law otherwise, a seller's obligation to provide goods or other property with a price or value equal to a specified dollar amount would be a monetary obligation, and much of the UCC is designed to avoid that result.[23]

The answer is far less clear when a contract provides – to either the account debtor or the creditor – an option to pay or to receive payment in dollars or cryptocurrency. But given all the consequences identified above that follow from the distinction between a monetary obligation and a non-monetary obligation, some definitive principle is needed to answer the question. Moreover, the answer needs to be ascertainable at the time the obligation is created. The obligation should not shift from a monetary obligation to a non-monetary obligation (or vice-versa) merely because the option to specify what property will be used to satisfy the obligation is later exercised. That could, among other things, cause a transfer of the obligation to retroactively fall inside or outside of Article 9.[24]

The best approach for classifying a right to payment in funds or cryptocurrency is to look at the obligation from the perspective of the account debtor. If the account debtor can be compelled to make payment in dollars (*i.e.*, the creditor has the option to determine what must be used to discharge the obligation), then the obligation should be regarded as a monetary obligation. The account debtor in such a situation should not be permitted to seek refuge in § 9-408's weak

override of a restriction on transfer if the only thing the account debtor must do is pay in dollars. In contrast, if the account debtor has the option to pay in dollars or cryptocurrency, then it is more appropriate to allow the account debtor to claim the benefits attendant to that option, and thus to treat the obligation as non-monetary and the right to payment as a general intangible.

WHAT IS A TRANSACTIONAL LAWYER TO DO?

To deal with the consequences identified above, transactional lawyers representing secured lenders should do each of the following:

- *Describing the Collateral.* If rights to payment in cryptocurrency are to be part of the collateral, then include in the description of collateral in the security agreement "general intangibles, "rights to payment in cryptocurrency," or other suitable language, and be sure that the indication of collateral in the financing statement contains the same language or covers "all assets."
- *Describing the Collateral.* In many split-collateral deals, the provider of the revolving loan gets priority in the debtor's accounts, inventory, and payment intangibles ("ABL Priority Collateral") while the provider of the term loan gets priority in equipment and general intangibles ("Term Loan Priority Collateral"). The priority in identifiable proceeds tends to follow the priority in the original collateral from which the proceeds were derived. A lawyer representing the provider of the revolver should be aware that rights to payment in cryptocurrency are general intangibles (but not payment intangibles). If such rights to payment are proceeds of inventory, it may be that the loan documents already define such rights as ABL Priority Collateral. However, if the rights to payment are generated from the provision of services, those rights are not proceeds of anything, and, thus, would likely qualify as Term Loan Priority Collateral. Consequently, a transactional lawyer working on a split-collateral deal should consider modifying how the different collateral groups are defined.
- *Perfection*. Be advised that filing a financing statement is the only method to perfect a security interest in rights to payment in cryptocurrency.[25] Even if the right to payment is evidenced by a signed writing, it is not an instrument or part of chattel paper.
- *Restrictions on Assignment*. In conducting due diligence, review the prospective debtor's contracts that give rise or might give rise to a right to payment in cryptocurrency. Any restriction on transfer will not prevent a security interest that secures an obligation from attaching to the rights to payment, but the secured party will have no ability to enforce that right against the account debtor. If, however, the debtor is selling such rights to payment, then Article 9 will not apply and there will be no statutory override of any contractual restriction on assignment of the rights to payment. So, the buyer might, in fact, get nothing unless the account debtors consent.
- *Collection Rights*. Because § 9-406(a) and (b) will not apply, consider requiring the debtor to include in the contracts with its customers terms that specify when and under what circumstances the customer must pay the secured party. In essence, consider requiring the debtor to make § 9-406(a) and (b) a contractual term in its agreements with customers.
- *Covenants.* Consider including terms by which a borrower represents and warrants not to have rights to payment in cryptocurrency and covenants not to create any (unless the borrower has the right to require payment in dollars). Alternatively, for a revolving loan, consider removing rights to payment in cryptocurrency from the borrowing base.

Transactional lawyers representing businesses that generate receivables should advise their clients that requiring or permitting customers to pay in cryptocurrency might impair the client's ability to use receivables from those customers to obtain financing. More specifically:

- *Structuring Payment in Cryptocurrency*. If, for business reasons, the client wishes to accept payment in cryptocurrency, then the client's agreements with its customers should not require customers to pay in that manner. The agreements could permit payment in cryptocurrency, but only if the option to specify the form of payment lies with the client, not with the customer.
- *Permit Transfer of Receivables.* The client's agreements with its customers that require or authorize payment in cryptocurrency should not contain a prohibition on the client assigning the right to payment. Better yet, such agreements should expressly authorize the client to assign the right to payment, either outright or as security.
- *Specify Assignee's Collection Rights.* The client's agreements with its customers that require or authorize payment in cryptocurrency should specify the circumstances when the customer must pay the client and the circumstances when the customer must pay an assignee of the right to payment.

CONCLUSION

It is not too soon for transactional lawyers to be concerned about rights to payment in cryptocurrency and to implement the advice provided above. Some businesses already accept payment in that manner. Moreover, the consequences of classifying rights to payment in cryptocurrency as general intangibles (but not as payment intangibles) apply under current law. The 2022 UCC Amendments might make it more clear that those consequences will in fact occur, but the consequences are not contingent on enactment of the amendments.

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Notes:

1. *See* § 1-201(b)(24) & cmt. 24, ex. 1. (amended 2022).

2. 12 THE TRANSACTIONAL LAWYER 1, 1 (Oct. 2022).

3. *Cf.* § 9-102(a)(9) (defining "cash proceeds" to include "money, checks, deposit accounts, or the like"). Were the law otherwise, and a "monetary obligation" was restricted to obligations payable only in "money" as defined in § 1-201(b)(24), the terms "account," "chattel paper," "instrument," and "payment intangible" – all of which are defined in reference to a "monetary obligation," *see infra* notes 5-7 and accompanying text – would be so narrow in scope as to be virtually meaningless, and Article 9 would be left without rules applicable to collecting most payment obligations. *See* § 9-406(a), (b) (detailing how an account debtor obligated on an account, chattel paper, or payment intangible may discharge the obligation). Moreover, "check" is defined as a type of instrument, *see* § 3-104(e), (f), which is a promise or order to pay "money," § 3-104(a), yet the vast majority of checks are paid through the bank collection process, rather than by a transfer of currency. It is inconceivable that the possibility of payment through the bank collection process could prevent a written order from being a check.

It is precisely because the term "money" is so narrowly defined that the UCC refers in many places to the broader but also undefined term "funds," *see* §§ 3-408, 3-414(f), 4-213(d), 4-215(e), (f), 4-402(c), 9-104(a)(2), (b), 9-332(b), or to "money or funds," *see* § 9-102(a)(2), (65), 9-207(c)(1), (2). The cited provisions do not include the dozens references to "funds" in the official comments. In essence, then, a "monetary obligation" is an obligation to pay funds.

4. *See* § 9-102 cmt. 12A (added 2022) ("An obligation to pay in such cryptocurrencies . . . would not be a 'monetary obligation.'").

5. *See* § 9-102(a)(2), (11), (61). The 2022 UCC amendments redefine chattel paper as a right to payment of a monetary obligation, rather than as a record or records that evidence a monetary obligation, *see* 9-102(a)(11) (amended 2022), but as the revised comments explain, "[t]his semantic change was for clarification purposes only; it does not imply a change in meaning." § 9-102 cmt. 5b (amended 2022).

6. *See* §§ 3-104(a), 9-102(a)(47).

7. *See* § 9-102 cmt. 12A ("An obligation to pay in such cryptocurrencies would not be an account, chattel paper, or a payment intangible or an obligation on an instrument because the obligation would not be a 'monetary obligation' or an obligation to pay money.") (added 2022).

8. *See* § 9-102(a)(65).

9. *See* § 9-102(a)(27A), (27B) (added 2022).

10. *See* § 9-102(a)(42).

11. This assumes that such words in a security agreement are imbued with the meaning ascribed to them in the UCC. Technically the statutory definitions apply only to uses of the defined terms in Article 9, not to their use in a private agreement. However, Article 9 expressly authorizes contracting parties to describe collateral using terms defined in the UCC, *see* § 9-108(b)(3), and, as a result, it has created a sort of usage of trade for secured transactions. Consequently, the UCC's definitions are highly probative in interpreting security agreements and courts routinely apply those statutory definitions without even considering whether the parties meant something different. *See, e.g.*, In re 3P4PL, LLC, 2020 WL 4436354, at *7 (Bankr. D. Colo. 2020) (treating each of the terms "investment property, goods, documents, inventory, equipment, general intangibles, accounts, chattel paper [and] instruments" in a security agreement's description of collateral as meaning what Article 9 defines those terms to mean); Figueroa Tower I, LP v. U.S. Bank, 2019 WL 1467953, at *11-12 (Cal. Ct. App. 2019) (treating the Article 9 definition of "general intangibles" as applicable to a Deed of Trust that used but did not define the term); Porter Cap. Corp. v. Horne, 2016 WL 4197328 (N.J. Super. Ct. 2016) (looking to the Article 9 definitions of collateral types to determine the meaning of terms undefined in a security agreement); In re Wiersma, 324 B.R. 92 (9th Cir. BAP 2005), *rev'd in part*, 483 F.3d 933 (9th Cir. 2007) (security interest attached to debtor's contract claim because it was a "general intangible" and thus fell within the description of the collateral). *But cf.* In re Eaddy, 2016 WL 745277, at *5-6 (Bankr. S.D. Ind. 2016) (suggesting that the term "accessions" in a security agreement need not have the meaning ascribed to it in § 9-335 because that definition is relevant only "to determine the priority of competing lienholders").

Many security agreements expressly incorporate UCC definitions. There are risks in doing so, however. *See* Stephen L. Sepinuck, *Traps to Avoid When Incorporating UCC Definitions into an Agreement*, 12 THE TRANSACTIONAL LAWYER 1 (Feb. 2022).

12. *Cf.* § 9-109(a)(3).

13. If the rights to payment were intermediated and held by a securities intermediary, the rights to payment could be "securities entitlements," and perfection by control of the securities account would be possible. If the rights to payment were a security, *see infra* note 14, and was uncertificated, perfection by control would also be possible. *See* §§ 8-106(c), (d), 9-310(b)(8), 9-314(3).

14. An obligation to pay in cryptocurrency apparently could be a security if issued as part of a series and if it expressly provides that it is governed by Article 8. The definition of "security" refers to an "obligation" of an issuer, not to a "monetary obligation" of an issuer. *See* § 8-102(a)(15). In such a case, perfection by delivery or possession would be possible if the security were certificated. *See* §§ 8-301(a)(1), 9-310(b)(7), 9-313(a).

15. Moreover, as noted above, Article 9 will not apply at all to the sale of rights to payment in cryptocurrency.

16. If the rights are purportedly sold, Article 9 will not apply to the transaction. As a result, nothing in Part 4 of Article 9 would override a restriction on transfer of the rights.

17. *See* § 9-408(c), (d).

18. *See* § 9-330. Although the new rule protecting "qualifying purchasers" of controllable accounts and controllable payment intangibles also cannot apply, *see* §§ 12-102(a)(2), 12-104(e), it might be possible for rights to payment in cryptocurrency to be the subject of a controllable electronic record ("CER"). *See* § 12-102(a)(1). If so, there could be a qualifying purchaser of the CER and that qualifying purchaser could take free of a claim of a property right in the CER. *See* § 12-104(e). However, although a right to payment consisting of a controllable account or controllable payment intangible is tethered to the CER to which it relates, *see* § 12-104(a), and a transfer of the CER transfers the right to payment, *see* § 12-104 cmt. 9, there is no such automatic tethering with respect to other CERs, *see* § 12-104(f) & cmt. 9. So, even though a qualifying purchaser of a CER that evidences a right to payment in cryptocurrency could take free of other claims *to the CER*, the purchaser might not take free of other claims to the *right to payment*. Other law governs that issue, and good luck to anyone trying to find such law.

19. The same is true for the obligor on a non-negotiable instrument. Article 3 does not apply to non-negotiable instruments, *see* § 3-104(b), and neither § 9-406(a) nor § 12-106 deals with instruments of any kind.

20. For example, an agreement might provide that "payment is due either in dollars (paid by check or funds transfer) or, at the option of Obligee, in Bitcoin. If Obligee fails to notify Obligor of its election to receive payment in Bitcoin at least [__] days prior to date payment is due, then payment is due in dollars."

21. In 1863, the Confederate States of America issued bonds that required payment in Pounds Sterling but gave the bondholder the right to receive payment in cotton, at a fixed exchange rate of 4,000 lbs. of cotton for £100. The bond was a 20-year obligation and required semi-annual payment. Many extant examples of the bonds have only 36 of the 40 coupons, suggesting that the first four had been clipped and redeemed prior to the end of the Civil War. Pictures of such bonds are available here.

22. *See* § 9-404(a).

23. For example, the principal reason for having a strong override of some restrictions on transfer and a weak override of other restrictions, *compare* § 9-406(d) *with* § 9-408(a), (d), is because rights to payment need to be freely transferrable and because the account debtor has little interest in whom it must pay but might care greatly about to whom it must render performance of a non-monetary obligation.

24. If a right to payment is fixed at the time of its creation – whether by requiring payment in dollars or by requiring payment in cryptocurrency – and therefore clearly is or is not a monetary obligation, that classification could change if the debtor and account debtor later agreed to modify the obligation. *Cf.* Stephen L. Sepinuck, *Anticipating Transmutations of Collateral*, 12 THE TRANSACTIONAL LAWYER 1 (June 2022).

25. This assumes that the rights to payment are not intermediated with a securities intermediary or qualify as a certificated or uncertificated security. *See supra* notes 13 & 14.

Delaware Bankruptcy Court Upholds Creditor's Proxy Rights

Stephen L. Sepinuck

An article in the February 2023 issue of this newsletter explored how to draft an irrevocable proxy granting a secured party the right to exercise voting rights associated with pledged shares of stock in a corporation.[1] In April, the Bankruptcy Court for the District of Delaware ruled in *In re CII Parent, Inc.*[2] that a secured creditor had, before the debtor filed bankruptcy, properly exercised an irrevocable proxy to change the management of the debtor's subsidiary. That aspect of the decision is a clear victory for secured creditors and is consistent with the advice in the February article. The court also ruled that the creditor had not violated the automatic stay by refusing to rescind the proxy following the bankruptcy filing. That second

aspect of the court's decision, while also a victory for the secured lender, is questionable and might be vulnerable to reversal on appeal. After briefly reviewing the court's decision, this article focuses on that second issue: whether the automatic stay impacts the proxy post-petition.

THE FACTS OF THE CASE

The debtor, CII Parent, Inc., is a Delaware corporation and the owner of 100% of the stock of Community Investors, Inc., which in turn owns 100% of the equity interests in several other entities (the "Indirect Subsidiaries"). In 2019, the debtor, Community Investors, and the Indirect Subsidiaries obtained a term loan and a revolving credit facility from a group of lenders, for which Twin Brook Capital Partner LLC acted as agent. Both the term loan and the revolver were secured by, among other things, the debtor's equity interest in Community Investors and by Community Investors' equity interests in the Indirect Subsidiaries. The loan documents included an Irrevocable Proxy Coupled with an Interest, which both the debtor and Community Investors executed. The proxies gave Twin Brook the right to vote the equity interests in Community Investors and the Indirect Subsidiaries if an event of default had occurred and was continuing.

In December 2022, during the continuance of an event of default under the Credit Agreement and following the expiration of a forbearance period, Twin Brook notified the debtor, Community Investors, and the Indirect Subsidiaries that it had exercised its rights under the proxy to: (i) amend the corporate governance documents of Community Investors and the Indirect Subsidiaries so as to remove certain directors and managers; (ii) adjust the size of each board of directors or number of managers; and (iii) appoint replacement directors or managers. Six days later, the debtor filed for bankruptcy protection under Chapter 11. The debtor then demanded that Twin Brook rescind its pre-petition actions. Twin Brook refused and the debtor brought an action for violation of the automatic stay.

THE COURT'S DECISION

Twin Brook Properly Exercised the Proxy Pre-petition

The debtor made three arguments as to why Twin Brook had not properly exercised the proxy. The Court rejected all of them.

1. No Requirement of Advance Notice

The debtor argued first that the loan documents required Twin Brook to provide advance notice of its intent to exercise the proxy.[3] The court disagreed because the loan document provisions dealing with Twin Brook's exercise of proxy rights did not expressly require advance notice (whether any specified number of days in advance or otherwise).

One relevant provision stated that Twin Brook, as Agent, "shall have the right, substantially concurrently with notice to the [debtor] . . . to exercise . . . all voting and other rights."[4] That provision stood in contrast to other terms in the loan documents that expressly required a specified number of days' advance notice before the parties could take certain actions. For example, one provision required "10 days' prior written notice" before the debtor could move collateral or change its name;[5] another provision stipulated that notice of a disposition would be reasonable "if given at least 10 days before such sale,"[6] and still another required three business days' notice prior to borrowings or conversions of loan types.[7]

Accordingly, the court concluded that the loan documents did not require advance notice and that the substantially concurrent notice that Twin Brook had provided was sufficient.[8]

2. The Grant of Proxy Rights Had Not Expired

The debtor next argued that its grant of proxy rights had expired prior to the exercise of those rights by Twin Brook. Under Delaware corporate law, a proxy expires three years after it is granted, unless the proxy provides that it lasts for a longer period.[9] The debtor argued that the three-year period had expired on May 15, 2022 – six months before Twin Brook purported to exercise the proxy.

However, the proxy provision in the loan documents stated that the proxy "shall continue in full force and effect until the Secured Obligations are Paid in Full notwithstanding any time limitations set forth in . . . the general corporation law of the State of Delaware."[10] This language, the Court concluded, was sufficient to satisfy the exception. "While duration can be expressed in terms of days, months or years, it can also be expressed or measured more generally, such as . . . by events."[11] In this case, "until" was a durational term and the point in time when the secured obligations are paid in full was a determinable event.[12]

3. The Proxy Permitted Rights to be Exercised by Written Consent

The debtor also argued that the proxy rights granted by the debtor did not include the right to take action by written consent. In other words, Twin Brook could exercise the proxy rights at a properly called meeting of shareholders, but not otherwise.[13]

The debtor's argument highlighted some inconsistencies between two relevant loan documents. The one-page proxy authorized Twin Brook "to vote any and all Equity Interests owned by the [debtor] or standing in its name, and do all things

which the [debtor] might do if present and acting itself."[14] The parties' Guarantee and Collateral Agreement, which also included proxy language, specifically contemplated the exercise of proxy voting rights "at any and all times, including . . . in any action by written consent."[15]

The court was inclined to agree with the debtor that the language in the one-page proxy, by itself, was insufficient to authorize actions by written consent.[16] However, the court ruled that the documents had to be considered together and, thus, ruled that Twin Brook had properly exercised the proxy pre-petition.[17]

Twin Brook's Refusal to Rescind its Pre-petition Actions Did Not Violate the Stay

With regard to the automatic stay, the debtor asserted that Twin Brook's post-petition refusal to rescind its pre-petition actions taken pursuant to the proxy had violated the automatic stay's injunction against "any act . . . to exercise control over property of the estate" and "any act to collect . . . a claim against the debtor that arose" pre-petition.[18] The court rejected both claims.

With respect to Twin Brook exercising control over property of the estate, the court ruled that the debtor's voting rights with respect to the shares of stock in Community Investors had ended pre-petition. In other words, even though the shares of stock were property of the estate, the voting rights associated with those shares were, due to Twin Brook's pre-petition actions, not property of the estate.[19] Consequently, there could not be a stay violation with respect to the voting rights.

Moreover, while Twin Brook's exercise of its proxy rights was undoubtedly an attempt to collect on the loans, that exercise occurred pre-petition. Whatever actions were being taken post-petition by the directors installed by Twin Brook were not the actions of Twin Brook, and therefore were not an action to collect on the lenders' pre-petition claim.[20]

ANALYSIS OF THE STAY ISSUE

The court's ruling regarding the bankruptcy stay is good news for secured creditors that pre-petition have exercised proxy rights to vote shares of pledged stock. However, the ruling could be vulnerable to reversal on appeal.

Voting Rights as Property of the Bankruptcy Estate

The court concluded that the debtor's voting rights had been transferred pre-petition and that the debtor no longer owned them. Indeed, the court so stated at least five times,[21] as if repetition helped prove the point. But the proxy, even though irrevocable, did not provide for a permanent transfer of voting rights. Instead, the proxy permitted Twin Brook to exercise voting rights only so long as the secured obligations remain unpaid. Indeed, the court itself noted that the proxy had a durational limit when ruling that the proxy was valid under Delaware law.

Accordingly, the facts are somewhat analogous to a situation in which a secured party has repossessed tangible collateral. Unless and until the secured party has conducted a disposition or acceptance of that collateral, the debtor retains property rights in the collateral,[22] and, if the debtor files for bankruptcy, the collateral becomes property of the estate.[23] Moreover, the creditor can be compelled to turn the collateral over to the debtor.[24] In other words, the property of the estate includes the possessory right that is associated with ownership of tangible collateral. The court in *CII Parent* acknowledged that the debtor's shares of stock in Community Investors were property of the estate.[25] It seems, therefore, that the voting rights associated with those shares should also have been regarded as property of the estate.

The court relied on three cases to support its conclusion that the estate did not include voting rights, but none of the cases provides much support. The first case mentioned, *In re Tominaga*,[26] did rule that a secured party had properly exercised voting rights in pledged shares pre-petition and that the debtor had failed to demonstrate any basis for post-petition turnover of control of the entities or the return of his shares. But the *Tominaga* court never said that the voting rights associated with the shares were not property of the estate and it cited no authority for its conclusion regarding turnover.

The second cited case, *In re Lake County Grapevine Nursery Operations*,[27] ruled that voting rights in a California limited liability company cannot be exercised by a secured party prior to a transfer of the membership interest. There was no proxy in the case and the entire decision interpreted the California LLC Act. The case is hardly support for any portion of the ruling in *CII Parent*, and appears to have been cited mostly for its dicta.

The final case cited was *In re Town Center Flats, LLC*.[28] It dealt with an absolute assignment of rents, which under Michigan law is apparently treated as an outright transfer, not as a transfer merely for security. The case has nothing to do with the exercise of voting rights in pledged equity.

In sum, the court's conclusion in *CII Parent* that the bankruptcy estate did not include the voting rights associated with the pledged shares is highly questionable. But that alone does not mean the court reached the wrong result. The more difficult question is whether Twin Brook had violated the stay by refusing the debtor's demand that it rescind its pre-petition actions.

Refusal to Release the Proxy or to Rescind Actions as a Violation of the Stay

Prior to the Supreme Court's 2021 decision in *City of Chicago v. Fulton*,[29] courts were divided on whether a creditor that had repossessed collateral pre-petition violated the stay by refusing to return the collateral post-petition, with the majority ruling that retaining possession did violate the stay.[30] In *Fulton*, the Court sided with the minority view and ruled that a failure to return repossessed collateral was not an act to exercise control over property of the estate, and hence did not violate § 362(a)(3) of the Bankruptcy Code. In so holding, the Court acknowledged that omissions can qualify as "acts" in certain contexts, but nevertheless ruled that the language of § 362(a)(3) "implies that something more than merely retaining power is required to violate the stay."[31]

Nevertheless, it would be a mistake to take the Court's language out of context as suggesting that the stay has no relevance to the pre-petition exercise of proxy rights with respect to pledged shares. The Court's analysis in *Fulton* was based almost entirely on the need to harmonize two provisions of the Bankruptcy Code: § 362(a)(3) and § 542(a). The former prohibits any post-petition act to exercise control over property of the estate, whereas the latter requires a person in possession of property of the estate to turn the property over to the trustee. The former has no exceptions and operates automatically; the latter has exceptions and must be initiated by an adversary proceeding. For § 542(a) to have a meaningful function, the Court concluded, § 362(a)(3) could not apply to a failure or refusal to relinquish collateral repossessed pre-petition.

However, § 542(a) has no relevance to voting rights in pledged shares of stock because voting rights are incorporeal and cannot be possessed by anyone. Consequently, there is no tension between § 362(a)(3) and § 542(a) with respect to a proxy, and the underlying rationale of *Fulton* is inapposite to the issue of whether a creditor violates § 362(a)(3) by refusing post-petition either to relinquish a proxy or to rescind pre-petition action taken pursuant to the proxy. In short, *Fulton* is not determinative of whether or to what extent the automatic stay applies to proxies, and how much guidance it provides depends on how narrowly or broadly courts are prepared to read it.

In considering the issue further, it is helpful to distinguish between three different things: (i) the secured party's pre-petition exercise of the proxy; (ii) the efficacy of the proxy post-petition; and (iii) a post-petition exercise of the proxy. The automatic stay clearly does not apply to the first, as that was pre-petition conduct. If one accepts the argument made above that the court in *CII Parent* erred and that the voting rights associated with pledged shares of stock are property of the estate, then there would seem to be a strong case that any action by the secured party to exercise the proxy would be an act to exercise control over property of the estate and, if taken post-petition, would violate the stay.

The most difficult issue is whether a secured party violates the stay by simply doing nothing: not releasing the proxy, not rescinding prepetition actions taken pursuant to the proxy, and not exercising the proxy. There is very little case law bearing on the question. Courts have, however, made it clear that inaction can violate the stay, most commonly in connection with a failure to end a pre-petition continuing garnishment.[32] Most of those decisions dealt with § 362(a)(1), (2), or (6), which prohibit, respectively, any act to continue pre-petition litigation against the debtor, to enforce a pre-petition judgment against the debtor or property of the estate, or to collect a pre-petition debt. However, a few of the cases have ruled that such inaction violates § 362(a)(3).[33] In addition, there is at least one case ruling that the automatic stay overrides even an automatic suspension of voting rights – specifically, the rights of a condominium owner to participate in votes of the condominium association.[34] Collectively, these authorities provide some support for the argument that a creditor does violate the stay by refusing to acknowledge the debtor's voting rights with respect to pledged shares or to rescind pre-petition actions taken pursuant to an irrevocable proxy to vote those shares. But they are insufficient to end debate on the issue.

ADVICE TO TRANSACTIONAL LAWYERS

Drafting the Proxy

The decision in *CII Parent* should give secured creditors comfort that a well-drafted proxy is enforceable. The advice given in the February article with respect to a proxy for shares of stock in a corporation still applies. Specifically, the proxy should:

- Be clear and unambiguous;
- Expressly indicate how long the proxy is to remain effective;
- Expressly state that the proxy is irrevocable; and
- Expressly state that the proxy runs with the shares (and runs with the security interest).

In addition, the proxy should:

- Expressly indicate that the proxy extends to actions taken by written consent; and
- Not indicate that advance notification is required.[35]

Finally, to avoid conflicting terms, the proxy should be expressed in a single document, not in multiple documents. That document could be the security agreement. But if, under the Articles of Incorporation or applicable corporate law, the proxy needs to be filed with or submitted to the corporation, it might be desirable to create a separate document. The following language should suffice:

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 without prior or contemporaneous notification, all voting rights with respect to all shares in Corporation that Debtor now owns or hereafter acquires, regardless of whether the exercise of such voting rights occurs at a meeting of shareholders, by written consent, or otherwise. This proxy is irrevocable, and will remain in effect until all Secured Obligations have been indefeasibly satisfied in full [and Debtor has no remaining right to borrow under the revolving credit facility]. 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.

Seek Relief from the Stay

If the secured party exercises a proxy pre-petition, the secured party should not assume that the automatic stay is inapplicable to the proxy post-petition. Until courts provide substantially more guidance on the issue, the secured party should immediately move for relief from the stay or, in the alternative, a declaration that the stay does not apply.

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Notes:

1. *See* Stephen L. Sepinuck, *Giving Secured Parties the Right to Vote Pledged Equity*, 13 THE TRANSACTIONAL LAWYER 1 (Feb. 2023).

2. 2023 WL 2926571 (Bankr. D. Del. 2023).

3. *Id.* at *9.

4. *Id.*

5. *Id.* at *10, n.42.

6. *Id.*

7. *Id.*

8. *Id.* at *10.

9. 8 Del. Code § 212(b).

10. 2023 WL 2926571, at *11.

11. *Id.* at 12.

12. *Id.*

13. *Id.* at *13.

14. *Id.*

15. *Id.* at *14.

16. *Id.* at *13.

17. *Id.*

18. *See* 11 U.S.C. § 362(a)(3), (6).

19. 2023 WL 2926571, at *14.

20. *Id.* at *16.

21. *Id.* at *10 ("the Proxy Notice served as that notice such that the voting rights are not property of the estate."); *id.* at *14 (assuming that notice was "required to be taken pre-petition to remove the voting rights from the property of the estate, Twin Brook's Actions were properly taken"); *id.* at *16 ("As of the petition date, therefore, Debtor did not have the right to vote the Pledged Equity"); *id.* at *17 ("Here, Debtor gave away its right to vote the Pledged Equity"); *id.* ("[The Debtor] still owns the stock and has all rights attendant to ownership (except the ones it gave away)").

22. *See* U.C.C. § 9-623 (providing that the debtor has a right to redeem collateral). *See also* § 9-203(b)(2) (for a security interest to attach, the debtor must have rights or the power to transfer rights in the collateral); §§ 9-617(a)(1), 9-622(a)(2) (providing, respectively, that disposition and acceptance transfer the debtor's rights in the collateral, and therefore implying that prior to such action the debtor still has rights in the collateral).

23. *See* United States v. Whiting Pools, Inc. 462 U.S. 198 (1983).

24. *See* 11 U.S.C. § 542(a).

25. 2023 WL 2926571 at *5.

26. 325 B.R. 653 (Bankr. M.D. Fla. 2005).

27. 441 B.R. 653, 655 (Bankr. N.D. Cal. 2010).

28. 855 F.3d 721 (6th Cir. 2017).

29. 141 S. Ct. 585 (2021).

30. A majority of courts had ruled that a creditor violates the stay by refusing to return repossessed collateral. *See, e.g.*, In re Fulton, 926 F.3d 916 (7th Cir. 2019); In re Weber, 719 F.3d 72 (2d Cir. 2013); Thompson v. Gen. Motors Acceptance Corp., 566 F.3d 699 (7th Cir. 2009); In re Knaus, 889 F.2d 773 (8th Cir. 1989). A growing minority had ruled to the contrary. *See, e.g.*, In re Denby-Peterson, 941 F.3d 115 (3d Cir. 2019); In re Cowen, 849 F.3d 943 (10th Cir. 2017); In re Hall, 502 B.R. 650 (Bankr. D.D.C. 2014).

31. 141 S. Ct. at 590.

32. *See, e.g.*, In re Krivohlavek, 405 B.R. 312 (8th Cir. BAP 2009); In re Roberts, 175 B.R. 339 (9th Cir. BAP 1994); In re

Waldrop, 2016 WL 3085877 (Bankr. W.D. Okla. 2016); In re Vaughn, 542 B.R. 589 (Bankr. M.D. Ala. 2015), *aff'd in part & vacated in part on other grounds*, 555 B.R. 803 (M.D. Ala. 2016); In re Manuel, 2014 WL 7405471 (Bankr. E.D. Mich. 2014); In re Bailey, 428 B.R. 694 (Bankr. N.D. W. Va. 2010); In re McCall-Pruitt, 281 B.R. 910 (Bankr. E.D. Mich. 2002); In re Pulliam, 262 B.R. 539 (Bankr. D. Kan. 2001); In re Daniels, 206 B.R. 444 (Bankr. E.D. Mich. 1997); In re Koch, 197 B.R. 654 (Bankr. W.D. Wis. 1996); In re Timbs, 178 B.R. 989 (Bankr. E.D. Tenn. 1994); In re Houseworth, 177 B.R. 557 (Bankr. N.D. Ohio 1994); In re Raper, 177 B.R. 107 (Bankr. N.D. Fla. 1994); In re O'Neal, 165 B.R. 862 (Bankr. M.D. Tenn. 1994). *Contra* In re Saults, 293 B.R. 739 (Bankr. E.D. Tenn. 2002).

33. *See, e.g.*, In re Krivohlavek, 405 B.R. 312; In re Vaughn, 542 B.R. 589.

34. *See* In re Gordon Properties, LLC, 435 B.R. 326, 332 (Bankr. E.D. Va. 2010) (although a condominiums association can, under Virginia law, suspend an owner's voting rights when the owner is delinquent in paying assessments, if the owner filed for bankruptcy, the automatic stay prevents further application of the suspension). *See also* In re Country Estates Nursing Home, Inc., 268 B.R. 316 (Bankr. D. Mass. 2001) (a creditor violated § 362(a)(3) by exercising the debtor's voting rights in pledged equity post-petition). *But cf.* In re Marvel Entm't Group, Inc., 209 B.R. 832 (D. Del. 1997) (§ 362(a)(3) does not stay actions by proxy holders to vote shares in the debtor, so as to replace the debtor's board of directors).

35. If the pledged equity is a membership interest in a limited liability company, rather than shares of stock in a corporation, then it might be desirable to require notification of the intent to exercise the proxy. *See* Stephen L. Sepinuck, *Giving Secured Parties the Right to Vote Pledged Equity*, *supra* note 1, at 3. In such a case, the proxy should provide that the secured party's proxy rights are triggered immediately upon the dispatch of such notification, and thus no amount of advance notification is needed.

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Recent Cases

SECURED TRANSACTIONS

Attachment Issues

In re First to Finish Kim and Mike Viano Sports, Inc., 649 B.R. 763 (Bankr. S.D. Ill. 2023)

A lender's security interest attached even though the security agreement and promissory note identified the debtor as "First To The Finish Inc.," instead of its more complete name, "First to Finish Kim and Mike Viano Sports, Inc." Even if the parol evidence rule applies to efforts to change a party's name, there was no such effort; there has always been only one entity and the error was a misnomer that did not affect the effectiveness of the security agreement. The court need not determine whether an earlier security agreement, which used the full name for the debtor, remained effective even though the entity was dissolved and then later reincorporated.

Enforcement Issues

Pinnacle Fuel, LLC v. Pure Aviation, LLC, 2023 WL 3082409 (W.D. Tex. 2023)

The choice-of-forum clause in the Supply Agreement between an oil seller and its customer applied to the customer's claims against the seller and its factor for breach and fraud. The choice-of-forum clause in the factoring agreement, to which the customer was not a party, did not apply, even though the customer had signed Notice of Purchase and Estoppel Agreements that included that clause, because the complaint related to the Supply Agreement and only the factor's counterclaims arose under the factoring agreement and associated Estoppel Agreements.

Liability Issues

Grimes v. Auto Venture Acceptance, LLC, 2023 WL 2817487 (Ky. Ct. App. 2023)

A secured party was entitled to summary judgment on the debtor's claim for failing to protect the $9,000 of personal property – including televisions, a laptop computer, cell phones, designer purses, and diamond rings – allegedly in his 12-year-old car that had no dashboard and cut GPS wires. An agreement the debtor signed included a clause by which the debtor assumed responsibility for any personal property left in the vehicle that was repossessed and stored in a reasonably safe place. This clause was effective to waive any negligence by the secured party because the car was stored in a fenced lot with razor wire and a "No Trespassing" sign that suggested there was video surveillance.

Teuza – A Fairchild Technology Venture Ltd. v. Linden, 2023 WL 3118180 (Del. Ch. Ct. 2023)
The minority owners of a corporation stated a claim for breach of fiduciary duty against the individuals who controlled the corporation on behalf of the largest shareholder, which was affiliated with the corporation's largest creditor, by alleging that the individuals, without approval from the board of directors, granted a security interest to the creditor and then used that enhanced leverage to obtain increases in the interest rate on the debt, block the board's efforts to obtain outside financing, and, ultimately, push through a sale of assets that was unfavorable to stockholders. When a company engages in a transaction in which a controlling stockholder receives a non-ratable benefit, the applicable standard of review is entire fairness. In this case, although the controller and the recipient of the non-ratable benefit are affiliated entities, not the same entity, they are controlled by the same individuals and that was sufficient at the pleading stage to draw an inference that the controller derived a non-ratable benefit. As a result, the claim could not be dismissed. The minority owners also stated a claim for aiding and abetting a breach of fiduciary duty. They did not state claims for unjust enrichment or promissory estoppel.

Holmgren v. Woodside Credit, LLC, 2023 WL 3276496 (D. Minn. 2023)
A secured party did not have a claim against the debtor for the costs incurred in re-titling the collateral – a rare Porsche – because the security agreement required the debtor to reimburse the secured party for various expenses within five days after demand therefor and the secured party never sent a demand. The secured party's counterclaim could not be a demand because it did not specify how much was due and it is difficult to reconcile the 21-day deadline for a responsive pleading with the 5-day deadline for payment.

AgCountry Farm Credit Services, PCA v. Tri-County Livestock Exchange, Inc., 2023 WL 3047798 (Minn. Ct. App. 2023)
A secured party's settlement of an adversary proceeding against the debtors, which sought a declaration that their debt to the secured party was nondischargeable based on their unauthorized sale of livestock collateral, did not affect the secured party's claim for conversion against the buyer of the livestock. The settlement agreement did not extinguish the debt; it merely resolved the dischargeability of the debtors' obligation. The fact that the settlement agreement also provided for the secured party to "release its UCC filings other than to the extent necessary to support any third-party conversion claims" also did not affect the conversion claim.

BANKRUPTCY

Avoidance Powers

In re Black Elk Energy Offshore Operations, LLC, 649 B.R. 249 (Bankr. S.D. Tex. 2023)
Investors who were the indirect recipients of intentionally fraudulent transfers could not claim a good faith defense because they were charged with the knowledge of the individual who was their subagent, and who planned the transactions while acting within the scope of the agency. Although the investors might not be criminally liable for the individual's actions, that did prevent the individual's knowledge from being imputed to the investors for the purposes of the good faith defense.

GUARANTIES & RELATED MATTERS

Pravati Capital Funding III, LP v. Law Offices of Phillippe and Associates, PC, 2023 WL 3369106 (Tex. Ct. App. 2023)
The individual who guaranteed a working capital loan to a law firm was bound by the arbitration clause in the loan agreement. Although the guaranty agreement did not expressly incorporate the terms of the loan agreement, it was clear from the context that it was made a part of the loan agreement. Both documents were executed at the same time, by the same persons, and for the same purpose, and the guaranty agreement referenced the loan agreement and was attached to it.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Strickland v. Foulke Management Corp., 290 A.3d 1259 (N.J. Super. Ct. 2023)
Because an arbitration agreement stated that "[t]he Federal Arbitration Act applies to and governs this agreement," another term in the agreement permitting an arbitration award to be vacated for errors of New Jersey law was unenforceable. Although that latter term is enforceable under the New Jersey Arbitration Act, it is not under the Federal Arbitration Act.

Rodrigues v. Alliant Credit Union, 2023 WL 3006610 (N.D. Cal. 2023)
A credit union that obtained summary judgment in its favor on a claim brought by a member for freezing the member's account during the member's divorce proceeding was not entitled to an award of attorney's fees. The account agreement provided for fees incurred in connection with any action "brought against [the member's] account" and any action brought by the credit union, but the action was not brought either against the account or by the credit union.

Apache Corp. v. Apollo Exploration, LLC,
2023 WL 3134243 (Tex. 2023)

Pursuant to long-standing Texas law, a contractual period measured "from" or "after" a specified date does not include the start date. Consequently, a three-year period in a lease measured "from" its January 1, 2007 effective date expired on January 1, 2010, not December 31, 2009. Subsequent amendments adding additional years did not change the ending date as January 1. A contemporaneous, recorded memorandum of lease, which stated that the initial lease term expired on December 31, 2009 did not evidence a contrary intent. Either the memorandum was extrinsic evidence, in which case it could be used to resolve ambiguity but not to create ambiguity, or the memorandum was to be read with the lease, but because the memorandum expressly stated that it was subject to the conditions in the lease, the end date specified in the memorandum could not alter the meaning of the lease itself.

ONH 14 53rd ST, LLC v. TPG RE Finance2, Ltd.,
2023 WL 3313640 (N.Y. Sup. Ct. 2023)

A borrower that contracted to purchase its own notes from the lender at a discount had no claim against the lender for refusing to sell the notes after the borrower failed to close by the closing date. The note purchase agreement stated that time was "of the essence" and prohibited oral modification. Accordingly, even if, as the borrower alleged, the lender had orally agreed to extend the closing date, such an agreement would not be binding. Moreover, a modification must be supported by consideration, and the borrower had not alleged any. The borrower also had no claim based on promissory estoppel because the borrower did not claim to have performed in reliance on the oral promise.

Kaloidis v. Kaloidis,
No. 654632/2021 (N.Y. Sup. Ct. Apr. 26, 2023)

An agreement to sell shares of a closely held corporation whose only asset is real property is governed by the New York Statute of Frauds dealing with sales of real property, or an interest therein, Gen. Oblig. Law § 5-703, and is void "unless the contract or some note or memorandum thereof, expressing the consideration, is in writing, subscribed by the party to be charged." Because there was no signed agreement to sell the shares of such a corporation, the complaint seeking to enforce an alleged agreement for sale had to be dismissed. No discussion of UCC § 8-113.

Spector v. Fitness & Sports Clubs, LLC,
2023 WL 3300894 (Ariz. Ct. App. 2023)

A term in a commercial lease that specified that the tenant would be in "default" if tenant breached a covenant and such breach continued for 30 days after receipt of written notice from the landlord did not apply to an action for damages after the lease term ended. The lease identified several remedies after default – including terminating the lease and re-taking possession of the premises – which the landlord did not seek to use after the lease term had ended and the tenant had surrendered the property, and those remedies were expressly in addition to all other remedies available to the landlord under law or in equity. As a result, the landlord had a claim for breach even though the landlord had not provided notice and an opportunity to cure, and thus the conditions for default had not been satisfied.

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