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Lien on Me

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Commercial Tort Collateral: Ain't No Sunshine When It's Gone

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One of the greatest concerns a lender has after it has made a loan is collateral leakage — when an asset escapes the lender's lien — in a default or distressed scenario. In some situations, causes of action that a borrower may have against third parties may be the most valuable assets left. Moreover, the factual circumstances that gave rise to such causes of action may have been a contributing factor that led to financial distress. These causes of action are often in the form of commercial tort claims.

However, because of nuances in the Uniform Commercial Code (UCC), a lender might be surprised to find that it does not have a lien on these commercial tort claims and that it has unwittingly been the victim of collateral leakage. This article discusses some of the issues surrounding what constitutes a commercial tort claim, how a lender can obtain a perfected security interest in such claim to recapture the leakage of its collateral, and what arguments a lender may be able to make if the commercial tort claim is not specifically identified in the security agreement.

What Are Commercial Tort Claims?

A commercial tort claim is defined by UCC § 9-102(13) as a "claim arising in tort with respect to which (A) the claimant is an organization; or (B) the claimant is an individual and the claim: (i) arose in the course of the claimant's business or profession; and (ii) does not include damages arising out of personal injury to or the death of an individual."[1] These torts could be specific to business operations, including claims of fraud and unfair competition claims, but they could also arise out of traditional torts and situations of negligence (*e.g.*, destruction of a borrower's business premises due to a third party's carelessness). If such events occur, the borrower could have a valuable cause of action against the third party that commits or aids and abets the tort, and this action could be a source of recovery for the lender.

In the context of a distressed business, the borrower may have significant claims against its directors and officers (D&Os) for breach of fiduciary duty (and the proceeds payable from D&O insurance policies), and such claims may constitute a significant source of recovery for the creditors of the borrower. However, these claims often arise in the context of financial distress, and they could also represent the greatest source of leakage for the lender because of a possible lack of perfection of its security interest in these claims. Therefore, the lender is faced with evaluating its lien and, if necessary, obtaining and perfecting its security interest in this claim or potentially losing its value.

How the Lender Perfects in Commercial Tort Claims

If the lender wants to obtain a security interest in a commercial tort claim, UCC § 9-108(e) requires more specificity in the security agreement as opposed to other forms of collateral.[2] A lender simply stating in its security agreement that the security interest includes "all commercial tort claims" or "all D&O claims," or including an after-acquired property clause, is insufficient for the security interest to attach in a specific commercial tort claim.[3] Rather, the security agreement must contain additional information that provides a description of the claim.

1 U.C.C. § 9-102(13) (provides definitions for terms used throughout Article 9).

2 U.C.C. § 9-108(e).

3 *See Polk 33 Lending LLC v. Schwartz*, 555 F. Supp. 3d 38, 43 (D. Del. 2021) (holding that security interest in "all commercial tort claims (including D&O Claims)" was overgeneralized identification of collateral and failed to perfect interest under standards set forth under U.C.C. § 9-108(e)(1)); *Shirley Med. Clinic PC v. U.S.*, 446 F. Supp. 2d 1028, 1033 (S.D. Iowa 2006) (finding phrase "proceeds from any lawsuit due or pending" to be insufficient description for commercial tort claims under UCC guidelines).

For example, listing the actual event that gives rise to the tort claim (*e.g.*, an explosion at the borrower's factory) or providing even more specificity (*i.e.*, setting forth the caption of the lawsuit in which the torts are asserted) should satisfy the requirement outlined in U.C.C. § 9-108(a).[4] The security agreement need not anticipate the exact amount of the claim or the parties involved; all that is required is a descriptive component that provides enough information to the specific cause of action being encumbered.[5]

Due to the nature of the specificity that is needed, a commercial tort claim only can be adequately described after the occurrence of the events giving rise to the tort claim, and if the claim did not exist at the time of the original security agreement, it can only be added if the borrower consents. In that regard, it is possible that the borrower could refuse such an amendment. The lender may find it advantageous to include a requirement in the loan agreement to have the borrower periodically report (or on the creation or discovery) any commercial tort claims that arise and agree to timely amend the applicable security agreement to include any such commercial tort claims. Unfortunately, this will still require the borrower's cooperation and agreement, but failure to do so could be an event of default under the loan agreement, which the borrower would likely seek to avoid.[6]

If the borrower agrees to amend the security agreement, the next issue is whether to amend the original UCC-1 to explicitly include the commercial tort claim as additional collateral. For obvious reasons, if the original UCC-1 does not evidence a "blanket lien," the UCC-1 must be amended for the security interest in the commercial tort claim to be perfected. If the original UCC-1 evidences a "blanket lien," it is unclear under current case law whether a financing statement must be amended to explicitly include the newly granted security interest in the commercial tort claim.[7]

However, a best practice could be to amend the original UCC-1 to add the commercial tort claim to avoid an argument that the lender's security interest in such claim is unperfected. Even if perfection occurs, the lender should be aware that the grant of the security interest and the attachment of the lien against the commercial tort claim may be subject to a preference suit for 90 days (or one year if the lender is an insider of the borrower). It is in this preference period that the lender will remain most vulnerable. However, if a bankruptcy case is filed by the borrower, all may not be lost.

When Is a Commercial Tort Claim Not a Commercial Tort Claim?

While commercial tort claims may require heightened specificity compared to other types of collateral, if the security agreement contains a lien on "general intangibles," then the lender has a lien on all legal claims held by the borrower (other than commercial tort claims).[8] The key difference between a tort claim and a breach-of-contract claim is that a tort action is for "breaches of duties imposed by law as a matter of social policy, while contract claims pertain only to breaches of duties imposed by mutual consensus agreement between particular individuals."[9]

As previously noted, one type of claim that may arise when a lender is dealing with a distressed company is a breach-of-fiduciary-duty claim. These types of claims are typically covered by insurance, which could be a significant asset for a lender. Many courts have found that breach-of-fiduciary-duty claims sound in tort, which would require satisfying the specificity requirements to obtain a lien in commercial tort claims.[10]

Under Illinois state law, actions for breach of fiduciary duty do not sound in tort, but rather in contract, because the cause of action is guided under principles of agency, contract and equity. In addition, the Illinois Supreme Court has rejected the *Restatement (Second) of Torts* view that breaches of fiduciary duty are tortious conduct.[11] Under this interpretation, lenders who have a security interest in contract claims or general intangibles would not have to comport with the specificity requirements under UCC § 9-108(e) in order to have a lien on a breach-of-fiduciary-duty claim, since it would not be a claim "arising in tort."[12] The next time you review a security agreement governed by Illinois law and wonder why that choice of governing law provision was included, it might be because the lender is seeking to utilize a loophole for obtaining a lien on breach-of-fiduciary-duty claims without having to satisfy the applicable perfection rules for commercial tort claims under the UCC.

Conclusion

It is important to recognize that when a wrongful or negligent act injures a borrower, which is often to the lender's detriment, the lender's security interest and lien might not automatically attach to the asserted claim. A lender should require the borrower to agree to identify any potential commercial tort claim when such claim arises. Once that claim arises, the lender should work to attach its security interest and perfect its lien on the claim as soon as possible by amending its security agreement with the borrower and, potentially, amending its original UCC-1.

As a result, these steps will help reduce collateral leakage for the lender. Some additional relief might be available — even if the borrower does not consent to amending the security interest, whether the applicable governing law is Illinois, or whether the proceeds of the commercial tort claim have been delivered to a segregated account controlled by the lender. abi

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4 *See* U.C.C. § 9-108 cmt. 5 ("A description such as 'all tort claims arising out of the explosion of debtor's factory' would suffice, even if the exact amount of the claim, the theory on which it may be based, and the identity of the tortfeasor(s) are not described.").

5 *Id.*

6 *CPC Acquisitions Inc. v. Helms*, No. 07 C 702, 2007 WL 4365342, at * (N.D. Ill. Dec. 12, 2007) (finding that lender's failure to update security agreement with new claims per amendment was insufficient to grant them security interest over those claims).

7 *See In re K-Ram Inc.*, 451 B.R. 154, 165 (Bankr. D.N.M. 2011); *In re Hall*, No. 06-40872, 2010 WL 1730684, at *16 (Bankr. D. Kan. April 28, 2010); *Shirley Med. Clinic PC v. U.S.*, 446 F. Supp. 2d 1028, 1034 (S.D. Iowa 2006), *aff'd*, 243 F. App'x 191 (8th Cir. 2007).

8 *See* U.C.C. §§ 9-102(a)(42) (definition of "general intangibles"); 9-102(a) cmt. 5(d) ("'General intangible' is the residual category of personal property, including things in action.... The definition has been revised to exclude commercial tort claims.").

9 *Bash v. Bell Tel. Co.*, 601 A.2d 829, 829 (Pa. Super. 1992).

10 *See, e.g., In re Main Street Bus. Funding LLC*, 642 B.R. 141, 151 (Bankr. D. Del. June 8, 2022), *aff'd*, 2023 WL 4420519 *4-5; *Matson v. Alpert (In re LandAm. Fin. Grp. Inc.)*, 470 B.R. 759, 804 (Bankr. E.D. Va. 2012) ("Breach of fiduciary duty is a tort, and the tortfeasor is liable for all damages proximately caused by the breach.") (quoting *In re Fairfax W. Apartment Owners Ass'n. Inc.*, 1991 WL 76035, at *4 (4th Cir. May 14, 1991)); *Adelphia Communs. Corp. v. Bank of Am. NA (In re Adelphia Communs. Corp.)*, 365 B.R. 24, 62 (Bankr. S.D.N.Y. 2007) ("Breach of fiduciary duty is a tort.").

11 *Kinzer on Behalf of City of Chicago v. City of Chicago*, 128 Ill. 2d 437, 455 (1989) (citing *City of Chicago ex. rel. Cohen v. Keane*, 64 Ill. 2d 559, 565-68 (1964)).

12 U.C.C. § 9-102(13).