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**Creditors Not Precluded From Recovering Debtors' Commercial Tort Litigation Recovery
Through Security Interest**

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INTRODUCTION

Title 11 of the United States Code (the "Bankruptcy Code") provides valuable protections for secured creditors. A secured creditor of a chapter 7 debtor is entitled to distribution of any debtor property (or its value) in which they have an interest before any other creditors are paid.¹ Even if the debtor has filed under chapter 11 or 13, a secured creditor is still entitled to receipt of their collateral or its value.²

Under Article 9 of the Uniform Commercial Code ("UCC"), commercial tort claims and their proceeds may collateralize secured liens.³ Hence, creditors believing they are secured by a debtor's commercial tort litigation proceeds may expect to receive the protections the Bankruptcy Code grants secured creditors. However, creditors' receipt of those protections is contingent upon the answers to two important questions. One, did the proceeds arise from commercial tort or breach of contract litigation? Two, are the proceeds properly attached to the creditor's interest and therefore part of the creditor's collateral to begin with?

¹ See 11 U.S.C. § 725 (2018).

² See *id.* § 1129, 1325 (providing if the debtor converts their chapter 13 case to a chapter 7 before completion, a secured creditor's lien may "snap back" and thus be paid in its entirety).

³ See U.C.C. § 9-109(d)(12).

This article, in examining those two questions, will answer in the affirmative the larger question of whether, in bankruptcy, a creditor may recover a debtor's commercial tort litigation recovery through a security interest. Part I will analyze the two most common tests courts use to distinguish commercial tort actions from breach of contract actions. Part II will analyze the UCC's requirements for a collateral description which includes the proceeds of a commercial tort action.

I. The Legal Tests for Determining Whether a Cause of Action is a Breach of Contract Claim or Commercial Tort Claim.

Before finding a creditor may recover a debtor's commercial tort litigation proceeds, a court must determine whether the claim resulting in the proceeds was actually a commercial tort claim. This is because a creditor cannot recover said proceeds under a commercial tort theory when the proceeds actually arose from a breach of contract claim. Two tests courts commonly use to distinguish commercial tort actions from breach of contract actions are the "Gist of the Action" doctrine and "Economic Loss" rule.

A. The "Gist of the Action" doctrine precludes plaintiffs from recasting ordinary breach of contract claims into tort claims.

The "Gist of the Action" doctrine bars tort claims:

(1) [A]rising solely from a contract between the parties; (2) where the duties allegedly breached were created and grounded in the contract itself; (3) where the liability stems from a contract; or (4) where the tort claim essentially duplicates a breach of contract claim or the success of which is wholly dependent on the terms of a contract.⁴

⁴ eToll, Inc. v. Elias/Savion Adver., Inc., 811 A.2d 10, 19 (Pa. Super. Ct. 2002) (citations omitted) (revising doctrine as first refined in Bash v. Bell Tel. Co. of Pa., 601 A.2d 825, 829 (Pa. Super. Ct. 1992)).

The “Gist of the Action” doctrine thus maintains “the conceptual distinction between breach of contract claims and tort claims [by] preclud[ing] plaintiffs from recasting ordinary breach of contract claims into tort claims.”⁵

In determining whether a duty allegedly breached is grounded in tort or contract, a court looks to violations of tortious or societal obligations as well as the boundaries of contractual obligations.⁶ A debtor’s fraudulent misrepresentation claims sound in tort when they arise out of fraudulent actions, not contractual duties.⁷ Conversion claims sound in tort because they involve property being taken “without consent [and] lawful justification.”⁸ Breach of fiduciary duty claims are commercial tort claims when the fiduciary duty at issue goes beyond the parties’ contractual obligations.⁹

B. The “Economic Loss” rule bars tort damages when there is no independent tort duty and purely economic loss.

The “Economic Loss” rule was originally developed in California state courts for use in products liability cases, but is now a general rule with multiple sub-variations.¹⁰ One of the newer sub-variations distinguishes commercial tort claims from breach of contract claims, barring plaintiffs from recovering damages under tort law when there is no independent tort duty and the only harm suffered is purely economic.¹¹

⁵ *In re Main St. Bus. Funding, LLC*, 642 B.R. 141, 148 (Bankr. D. Del. 2022) (quoting *eToll, Inc. v. Elias/Savion Advert., Inc.* at 14).

⁶ *See id.*

⁷ *See id.* at 149.

⁸ *Id.*

⁹ *See id.* at 151.

¹⁰ *See Indem. Ins. Co. of N. Am. v. Am. Aviation, Inc.*, 891 So. 2d 532, 536–38 (Fla. 2004).

¹¹ *See id.*

Some jurisdictions are unwilling to implement the “Economic Loss” rule in non-products liability and non-strict liability cases.¹² However, others find the rule an invaluable tool for “maintain[ing] the boundary between contract law and tort law.”¹³ For example, bankruptcy courts in Vermont and Kansas have implemented the rule in deciding whether to dismiss “contract claims garbed in negligence clothing.”¹⁴

C. Applying “Gist of the Action” and “Economic Loss” together: A new method of preventing plaintiffs from recovering in tort on contract claims.

The “Gist of the Action” doctrine and “Economic Loss” rule can also be applied simultaneously, and the results of this combination resemble those arising from application of only one test.¹⁵ Applying both tests, a court found a debtor’s fraudulent misrepresentation claim sounded in tort and, therefore, the debtor could recover on it.¹⁶ The court held such because the debtor’s reliance on the creditor’s misrepresentations proximately caused their having to file for bankruptcy.¹⁷

II. Commercial Tort Proceeds Attachment Requirements Under the UCC.

Under Article 9 of the UCC, commercial tort claim proceeds may serve as original collateral, but there are specific statutory requirements for a collateral description including them which may bar their attachment.¹⁸

A. Article 9 of the UCC requires specific, contemporaneous commercial tort claim collateral descriptions.

¹² See *Tiara Condo. Ass'n v. Marsh & McLennan Cos.*, 110 So. 3d 399, 407 (Fla. 2013) (finding that the expansion of the “Economic Loss” rule outside of products liability had become “unwise and unworkable in practice,” and thereby returning the rule to use only for its original purposes in the state of Florida).

¹³ *In re Montagne*, Adversary No. 08–1024, 2010 WL 271347 at *9 (Bankr. D. Vt. Jan. 22, 2010) (citation omitted).

¹⁴ *Id.* at *9, 16; see *In re Bryant Manor, LLC*, 434 B.R. 629, 635–37 (Bankr. D. Kan. 2010).

¹⁵ See *In re 400 Walnut Assoc. L.P.*, 506 B.R. 645, 664–67 (Bankr. E.D. Pa. 2014).

¹⁶ See *id.* at 665.

¹⁷ See *id.*

¹⁸ See U.C.C. § 9-109(d)(12), 9-108(e) cmt. 5, 9-204(b)(2) cmt. 4.

“A description only by type of collateral . . . is an insufficient description of . . . a commercial tort claim” for purposes of attachment.¹⁹ Although Article 9 clearly states this requirement, it has barred many security agreements from being recognized as attaching commercial tort claims and proceeds.²⁰ For example, courts in New Mexico and Delaware found creditors did not have security interests in debtors’ commercial tort claim proceeds due to their security agreements’ collateral descriptions including “‘all commercial tort claims’ . . . the overgeneralized ‘type of collateral’ identification . . . insufficient [under Article 9].”²¹

Accordingly, “[a] security interest does not attach under . . . an after-acquired property clause to . . . a commercial tort claim.”²² “In order for a security interest in a tort claim to attach, the claim must [exist] when the security agreement is authenticated.”²³ Thus, proceeds of a commercial tort claim which itself arose after the effective date of a security agreement are not included in said security agreement.²⁴ Nor do the proceeds of a commercial tort settlement attach to a creditor’s interest when there is no attachment until after the settlement date.²⁵

B. Perfecting a secured lien is not a cure for failed attachment under a general collateral description or after-acquired property clause.

Perfecting a “secured” lien on a debtor’s commercial tort proceeds does not cure defective attachment under an impermissibly general collateral description or after-acquired property clause in a collateral description.²⁶ A financing statement indicating a creditor’s collateral includes “[p]roceeds from any lawsuit due or pending” is inadequate for use in

¹⁹ See *id.* § 9-108(e).

²⁰ See, e.g., *In re S-Tek 1, LLC*, 635 B.R. 860, 866 (Bankr. D.N.M. 2021); *Polk 33 Lending, LLC v. Schwartz*, 555 F.Supp.3d 38, 43 (Bankr. D. Del. 2021).

²¹ *Polk 33 Lending, LLC v. Schwartz* 555 F.Supp.3d at 43; see *In re S-Tek 1, LLC* 635 B.R. at 866.

²² U.C.C. § 9-204(b)(2).

²³ See *id.* § 9-204(b)(2) cmt. 4.

²⁴ See *In re Main St. Bus. Funding, LLC* 642 B.R. 141, 153 (Bankr. D. Del. 2022).

²⁵ See *Bayer CropScience, LLC v. Stearns Bank Nat’l Ass’n*, 837 F.3d 911, 915 (8th Cir. 2016).

²⁶ See, e.g., *Shirley Med. Clinic, P.C. v. United States*, 446 F. Supp. 2d 1028, 1034 (S.D. Iowa 2006).

perfecting a security interest in commercial tort claim proceeds.²⁷ A financing statement including commercial tort claim proceeds must comply with the UCC's attachment restrictions in Article 9 before the secured interest at issue can be perfected.²⁸

CONCLUSION

Two concerns may come between a secured creditor and their recovery of a debtor's commercial tort litigation proceeds. The first is that commercial tort claims and their damages may be barred when they are entirely grounded in the contractual relationship between the parties at issue.²⁹ However, as long as there is an independent tort duty underlying a commercial tort claim, a court will find it legitimate under the "Gist of the Action" doctrine and "Economic Loss" rule.³⁰ Creditors should avoid securing their liens with proceeds from commercial tort claims resting on shaky tortious foundations. The second concern is that a creditor believing they have a valid security interest in a debtor's commercial tort proceeds may not actually have one due to the collateral description in their security agreement not meeting Article 9 requirements.³¹ Yet, the UCC explicitly lays out its requirements, and creditors should ensure they meet them.³²

²⁷ *Id.* ("Proceeds from any lawsuit due or pending' is clearly a[n impermissible] description by type of collateral.").

²⁸ *See* Polk 33 Lending, LLC 555 F.Supp.3d 38, 42–43 (Bankr. D. Del. 2021).

²⁹ *See In re Montagne*, Adversary No. 08–1024, 2010 WL 271347 at *9 (Bankr. D. Vt. Jan. 22, 2010).

³⁰ *See In re 400 Walnut Assoc. L.P.* 506 B.R. 645, 667 (Bankr. E.D. Pa. 2014).

³¹ *See* U.C.C. § 9-109(d)(12), 9-108(e) cmt. 5, 9-204(b)(2) cmt. 4.

³² *See id.*