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Collateral Interests in Insurance: Confusing Territory

Secured lenders often look to the borrower's or guarantor's rights under insurance policies to improve their collateral position. Obtaining a collateral interest in a business interruption insurance policy may protect a lender who is dependent upon the ongoing cash flow of its borrower for debt service. Obtaining an assignment of an interest in a life insurance policy of the borrower's owner or a principal guarantor protects the lender against economic effect of the sudden loss of a member of the borrower's team essential to its success.

Despite its importance to many commercial loan transactions, the law governing lien interests in insurance is non-uniform. Since 1945, matters relating to insurance have been left to each state.[1] More importantly, all but two states have excluded liens in insurance policies from Article 9 of the Uniform Commercial Code ("UCC").[2] Because of this exclusion, concepts of creation, perfection[3] and priority of liens taken by lenders in insurance policies are wholly dependent upon the forum and the terms of the particular insurance policy involved. Nonetheless, in the context of a bankruptcy proceeding, these concepts are essential to determining the extent of a lender's secured claim under section 506 of the United States Bankruptcy Code[4] ("Code") and to determining when a lien is perfected under Code section 547(e)(1)(B) for avoidable preference purposes.

How, then, does a lender create and perfect its interest in policies of insurance? Because of the exclusion of insurance from the ambit of the UCC, it is clear that execution and delivery by the debtor of a security agreement covering general intangibles and filing a financing statement will not create an enforceable lien.[5] An important first step is to examine the policy to make sure that all of the elements required by the insurer for the creation of a valid lien are complied with.

Case law provides guidance (albeit conflicting) regarding how liens in insurance policies are created. Regarding life insurance, some courts hold that possession of the policy is required to create a lien interest,[6] while other courts hold that a policy cannot be pledged by possession.[7] In those jurisdictions where possession is not required or with respect to commercial insurance policies, execution and delivery of a collateral assignment of rights under the policy and notice to the insurer will likely be sufficient to create an interest in the policy. Commercial insurers often do not require a specific form of collateral assignment. With

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respect to life insurance policies, however, completion and delivery of collateral assignment forms provided by the insurer is often a prerequisite to a valid lien. A lender should pay particular attention to forms prepared by the insurance company to ensure that the lender is receiving the protections it seeks.

Regarding the sufficiency of notice, does notice to the debtor's insurance broker (but not the insurer directly) and receipt of a certificate of insurance showing the lender as an additional insured create an enforceable lien? Maybe—depending upon the effect of a certificate of insurance in the subject jurisdiction (which varies) and upon a court finding the broker is deemed to be an agent of the insurer with authority to bind it. Some courts have found a valid lien is created upon the execution of a collateral assignment of rights in the policy, even without notice to the insurer.[8] The one thing that is apparent is that the law is conflicting and muddled.

Nor are the rules with respect to priority of collateral interests any clearer. While a majority of courts follow the UCC's "first in time, first in right" precept, holding that senior priority of interests in a policy goes to the lender who first provides notice to the insurer, other courts rule that priority goes to first assignee regardless of notice to the insurer. These courts find that the notice requirement is for the benefit of the insurance company and not for third parties.[9]

In any case, regarding commercial policies, to fully protect itself, the lender should not rely upon a certificate of insurance but instead should obtain from the insurer an endorsement to the policy providing that the lender is a loss payee and an additional insured under the policy. The endorsement should require the insurer to provide the lender with advance notice of cancellation and an opportunity to pay premiums due. The endorsement also should provide that the lender retains the right to receive a loss payment even if the lender has commenced a foreclosure or similar action to preclude a claim that the underlying debt is extinguished. In summary, the steps a lender should take to create and perfect a valid lien in insurance policies include:

- Reviewing the policy to determine the insurer's requirements for the creation of a valid lien.
- Having the debtor execute and deliver an appropriate assignment of life insurance as collateral (usually using the insurer's form), or a collateral assignment of rights in the debtor's commercial policy.
- Taking possession of the original life insurance policy in those states which require possession.

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- Delivering notice of the collateral assignment to the insurer and receiving confirmation of receipt of the assignment.
- For commercial policies, obtaining an endorsement from the insurer naming the lender as an additional insured and loss payee.
- Ensuring that the endorsement requires the insurer to send advance notice of cancellation to the lender and permits the lender to pay premiums due, and provides that the lender is entitled to a loss payment even if foreclosure or similar proceedings are commenced.

Collateral interests in insurance policies often significantly enhance a lender's secured position, and having a valid interest in an insurance policy may be important in determining the extent of a lender's secured position, and therefore it's rights, in a bankruptcy proceeding. However, because liens in insurance are governed by state law and excluded from the UCC, there is no established, single set of ground rules for a lender to follow to create and perfect liens in the debtor's life or commercial insurance policies. Lenders must recognize this fact and carefully take the necessary steps to protect themselves.

If you have any questions on the topics discussed in this e-alert, please contact your Reinhart attorney or any member of Reinhart's Business Reorganization team.

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[1] See The McCarran-Ferguson Act of 1945 (15 U.S.C. § § 1011-1015).
[2] See Cal. Com. Code § 9109 (including all types of insurance); La. Rev. Stat § 10:9-109(d)(8) (including life insurance).
[3] "Perfection" is a concept arising under the UCC and is probably not appropriate when referring to liens in insurance policies. See Andrew Verstein, Bad Policy For Good Policies: Article 9's Insurance Exclusion, 17 Conn. Ins. L. J. 287, 309 (2011) (hereinafter "Verstein"). But see 11 U.S.C. § 547(e)(1)(B), which discusses perfection of interests in property for the purposes of preferences.
[4] 11 U.S.C §§ 101-1532.
[5] See Wheeling & Lake Erie Ry. Co. v. Keach, 521 B.R. 703 (B.A.P. 1st Cir. 2014).
[6] See In re Maplewood Poultry Co., 2 B.R. 550 (Bankr. D. Me. 1980) (applying New Jersey law).
[7] See Metro. Life Ins. Co. v. Haack, 50 F. Supp. 55 (W.D. La. 1943) (applying Missouri law).
[8] See Ketchikan Shipyard, Inc. v. Anchorage Nautical Tours, Inc. (In re Anchorage Nautical Tours, Inc.), 102 B.R. 741 (B.A.P. 9th Cir. 1989).
[9] See generally, Verstein at 310-11.

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