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Code to Code

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Perfecting Security Interests in a Debtor's Insurance Policy



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The First Circuit Bankruptcy Appellate Panel (BAP) in *In re Montreal, Maine & Atlantic Railway Ltd.*¹ alerts secured creditors to the risk of draconian results from not properly perfecting security interests in a debtor's insurance proceeds. The BAP decision affirmed an order of the U.S. Bankruptcy Court for the District of Maine that concluded, in the context of approving a settlement between a debtor and its insurance carrier pursuant to Rule 9019 of the Bankruptcy Rules, that a debtor's secured creditor did not have a properly perfected security interest in an insurance settlement payment tendered by the insurance carrier under Maine's version of Article 9 of the Uniform Commercial Code (UCC) and applicable common law regarding insurance policies.

This article will first provide a brief primer on the provisions of UCC Article 9 that were at the center of the BAP and bankruptcy court decisions. It will then examine the BAP and bankruptcy court decisions. The article will conclude with some practice tips for secured creditors who intend to perfect a security interest in a debtor's insurance proceeds.

A Primer: Attachment and Perfection under Revised Article 9

The UCC was drafted to provide "its own machinery for expansion of commercial practices ... [and] intended to make it possible for the law embodied [therein] to be applied by the courts in light of unforeseen and new circumstances and practices."² UCC Article 9 is the body of nonbankruptcy law generally implicated when a creditor and debtor seek to utilize the debtor's personal property as collateral to secure loan repayment obligations. Article 9 has undergone major revisions, which cul-

minates in the issuance of a revised Article 9 (the "Revised Article 9").³

Revised Article 9, like its predecessor, provides the mechanism for attaching and perfecting security interests on personal property collateral.⁴ The drafters summarized attachment and perfection — the two key events in the creation of a security interest — as "deceptively simple."⁵ "Attachment generally occurs when the security interest is effective between the creditor and the debtor.... Perfection occurs when the creditor establishes his or her 'priority' in relation to other creditors of the debtor in the same collateral."⁶

As debtor/creditor practitioners will readily concede, Revised Article 9 is anything but simple, since it contains a multitude of exclusions and exceptions. Some exclusions and exceptions are the result of legislative tinkering by the states when they each adopted Revised Article 9, the nature of the particular personal property in which a security interest is being perfected, and/or some combination of the two.⁷ For example, under § 9-313, a secured creditor would perfect a security interest in "negotiable documents, goods, instruments, money, or tangible chattel paper by taking possession of the collateral."⁸ Under § 9-314, a security interest in "deposit accounts, electronic chattel paper, or letter-of-credit rights is perfected by control," with the concept of control governed by the relevant provision of Revised Article 9.⁹ Under § 9-311(a)(2), a secured creditor must rely on a state's certificate of title stat-

³ U.C.C. § 9-101, Official Comment 2; see also C. Scott Pryor, "Revised Uniform Commercial Code Article 9: Impact in Bankruptcy," 7 *ABI Law Review* 465 (1999).

⁴ See generally U.C.C. §§ 9-201 to 9-210, 9-301 to 9-342 and 9-601 to 9-628.

⁵ "UCC Article 9, Secured Transactions (1998) Summary," Uniform Law Commission, available at [www.uniformlaws.org/ActSummary.aspx?title=UCC%20Article%209,%20Secured%20Transactions%20\(1998\)](http://www.uniformlaws.org/ActSummary.aspx?title=UCC%20Article%209,%20Secured%20Transactions%20(1998)) (emphasis added; last visited March 2, 2015).

⁶ *Id.*

⁷ See Mark E. MacDonald, Jr., "Enforceability of Limits on Security Interests in Property Licenses," 24 *ABI Journal*, March 2005, at 32.

⁸ U.C.C. § 9-313(a).

⁹ U.C.C. § 9-314(b); see also § 9-312(b)(1).

¹ 521 B.R. 703 (B.A.P. 1st Cir. 2014).

² U.C.C. § 1-103, Official Comment 1.

utes to properly perfect its security interest in automobiles, trailers, mobile homes, boats or the like.¹⁰ To be sure, more than 17 years after the Uniform Law Commission's initial adoption, and more than a dozen years since its enactment by the states (the author thinks that it was adopted in all 50 states), Revised Article 9 "still contains traps for unwary or careless secured creditors."¹¹

Insurance under Revised Article 9

Revised Article 9 excludes from its coverage transfers of "an interest in or an assignment of a claim under a policy of insurance, other than an assignment by or to a health care provider of a health care insurance receivable and any subsequent assignment of the right to payment, but Sections 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds."¹² Revised Article 9 made changes to its predecessor's seemingly comprehensive exclusion of insurance claims from Article 9 coverage insofar as "[s]ubsection (d)(8) narrows somewhat the broad exclusion of interests in insurance policies under former Section 9-104(g). [Revised Article 9] now covers assignments by or to a health care provider of 'health care insurance receivables' (defined in Section 9-102)."¹³

According to one commentator, early drafts of Revised Article 9 attempted to significantly expand the reach of an Article 9 security interest in insurance well beyond health care insurance receivables.¹⁴ However, insurance industry lobbyists opposed the potential inclusion of insurance as *original collateral*.¹⁵ The primary concern of insurance industry representatives related to elevating the insurer's status to that of a primary obligor. "In essence, the insurers wanted to be able to determine with certainty whom to pay to discharge their obligations under their policies.... The Drafting Committee agreed ... that some of these concerns were unwarranted [and] voted five to three in favor of including insurance within the scope of Revised Article 9."¹⁶

The end result narrowed "somewhat the broad exclusion of interests in insurance policies under former Section 9-104(g) [to the extent that Revised Article 9] now covers assignments by or to a health care provider of 'health-care insurance receivables.'"¹⁷ In addition to health care insurance receivables, § 9-109(d)(8) provides that the insurance exclusion does not apply with respect to proceeds under § 9-315 and priorities in proceeds under § 9-322.¹⁸ These carve-outs remain unchanged from the original Article 9.¹⁹ Pursuant to § 9-315(a)(2) and (c), a security interest attaches to any identifiable proceeds of the collateral as long as the original security interest in the collateral was and remains properly perfected

under Revised Article 9.²⁰ Similarly, § 9-322 provides for the maintenance of the priority of a security interest in proceeds as long as the secured creditor properly maintained its perfection in the collateral and, subsequently, the proceeds of the collateral.²¹ Most insurance-related claims remain outside the scope of Revised Article 9.²²

The BAP and Bankruptcy Court Decisions The Bankruptcy Court Decision

Wheeling & Lake Erie Railway Co., the secured lender, attached and properly perfected its security interest in all of the debtor's "inventory, accounts, and payment intangibles (as those terms are defined in the Uniform Commercial Code) whether now owned or hereafter acquired or arising and all proceeds including insurance proceeds thereof," pursuant to a security agreement by and between the secured lender and the debtor, Montreal, Maine, & Atlantic Railway Ltd., and a properly filed UCC financing statement.²³ The security interest secured a line-of-credit note in an amount not to exceed \$6 million.²⁴ The debtor and secured lender agreed that the security agreement would be governed by the laws of the state of Maine.²⁵

In July 2013, a train operated by the debtor derailed, causing the "death of 47 people, damage to or destruction of several nearby structures, and significant environmental damage."²⁶ Following the accident, the debtor and its affiliate made claims under an insurance policy that was issued by the debtor's commercial lines carrier (the "carrier") for property damage and the loss of business income and other expenses caused by the accident.²⁷ The carrier initially denied coverage for the debtor's claim.²⁸

Approximately one month after the accident, the debtor filed for chapter 11 protection.²⁹ In December 2013, the debtor and carrier sought bankruptcy court approval of a settlement whereby the carrier agreed to pay the debtor and its affiliate \$3.8 million in consideration of a full release of the carrier under the insurance policy.³⁰ The secured lender objected to the settlement agreement, arguing that the settlement "impaired its security interest" because the settlement proceeds would not be paid to the secured lender.³¹

In overruling the secured lender's objection to the settlement, the bankruptcy court concluded that the secured lender "[did] not hold a valid and enforceable security interest in the [settlement payment] under either the Maine UCC or Maine's common law [and, specifically, the secured lender] did not properly perfect a security interest in the business interruption policy or its proceeds."³² The secured lender appealed the bankruptcy court's decision.³³

10 U.C.C. § 9-311(a)(2).

11 Jeffrey C. Toole, "UCC Article 9: More than Ten Years Later, Traps for the Unwary Still Linger," *Clev. Metro. B. J.*, January 2012, at 27.

12 U.C.C. § 9-109(d)(8); former Article 9 also included the predecessors of §§ 9-315 and 9-311. See former U.C.C. § 9-104(g); David B. Young, "The Rights of Secured Creditors to Proceeds of Business Interruption Insurance under UCC Article 9," 26 *U.C.C. L. J.* 204, 210 (1994).

13 U.C.C. § 9-109, Official Comment 13; see also Pryor, *supra* n.3, at 465; Lawrence R. Ahern, III, "'Workouts' under Revised Article 9: A Review of Changes and Proposal for Study," 9 *ABI Law Review* 115 (Spring 2001).

14 Stephen L. Harris and Charles W. Mooney, Jr., "How Successful Was the Revision of UCC Article 9? Reflections of the Reports," 74 *Chi.-Kent L. Rev.* 1357, 1374 n.73 (1999).

15 "Insurance payments designed to compensate for damage to or destruction of collateral ... are known as derivative proceeds." Young, *supra* n.12, at 210.

16 Harris and Mooney, *supra* n.14, at 1357.

17 *Supra* n.13.

18 See U.C.C. § 9-109(d)(8).

19 Barkley Clark, "UCC Survey: Secured Transactions," 43 *Bus. Law.* 1425 (1988).

20 See U.C.C. § 9-315.

21 See U.C.C. § 9-322.

22 Pryor, *supra* n.3, at 465; see also Harris J. Diamond, "Tracing Cash Proceeds in Insolvency Proceedings under Revised Article 9," 9 *ABI Law Review* 385, 404 (Spring 2001).

23 See *In re Montreal Me. & Atl. Ry. Ltd.*, No. 13-10670, 2014 Bankr. LEXIS 1628 (Bankr. D. Me. April 15, 2014); UCC Financing Statement, ECF No. 514-2 (Dec. 17, 2013); and Security Agreement, ECF No. 514-1 (Dec. 17, 2013).

24 See Security Agreement, ECF No. 514-1 (Dec. 17, 2013).

25 *Id.*

26 *In re Montreal*, 521 B.R. at 705.

27 *Id.*

28 *Id.*

29 *Id.*

30 *Id.* The settlement proposed paying the debtor 35 percent of the settlement payment and paying the debtor's affiliate 65 percent. *Id.*

31 *Id.* at 706. The secured creditor also objected to the 65/35 percent split. *Id.*

32 *Id.*

33 *Id.* at 703.

The BAP's Decision

On appeal, the secured lender argued that its properly perfected security interest in the debtor's "accounts" and "payment intangibles" included the proceeds of the insurance policy and, consequently, the settlement payment tendered by the carrier.³⁴ In essence, the secured lender argued that the debtor's entitlement to the policy proceeds allowed the proceeds to fit neatly within the definition of either "accounts" or "payment intangibles."³⁵ Although the First Circuit BAP conceded that the secured lender had a properly perfected security interest in the debtor's accounts and payment intangibles, it looked to the language of Maine's version of UCC. Section 9-109(d)(8),³⁶ discussed *supra*, and concluded that the debtor's right to "receive payment for a covered loss under" the policy was excluded from the scope of Revised Article 9.³⁷

The UCC explicitly exempts from Article 9 transactions concerning interests or claims arising under insurance policies. The Settlement Payment clearly arose from the [carrier's] Policy. Thus, regardless of whether [the secured lender] has a security interest in an "account" or a "payment intangible" as defined by the UCC, it is expressly excluded from the scope of Article 9 if — as here — it arose from an insurance policy. Consequently, [the secured lender's] security interest in the Settlement Payment was not perfected by the filing of a UCC-1 financing statement.³⁸

The First Circuit BAP also rebuffed the secured lender's slightly varied argument that the expanded definition of "account" under the Revised Article 9 created "a separate category of collateral that consists of any payment under *any* contract," including "payment 'for a policy of insurance issued or to be issued.'"³⁹ "Although the definition of 'account' includes some 'insurance related rights,'" the First Circuit BAP noted that the insurance-related language was "designed to facilitate financing by insurers and insurance agents [and had] nothing to do with an insured's right to receive payment under a policy."⁴⁰ The First Circuit BAP also noted that "a security interest in accounts and payment intangibles, without more, does not perfect an interest in an insurance policy or its proceeds."⁴¹

The BAP decision also held that under Maine common law, the secured lender needed *more* than the filing of a UCC-1 financing statement to perfect a security interest in the insurance policy.⁴² The secured lender appealed the BAP's decision to the U.S. Court of Appeals for the First Circuit, and that appeal remains pending.

Analysis

Notably, the First Circuit BAP analyzed, but dismissed as unhelpful,⁴³ the reasoning and conclusions in *MNC Commercial Corp. v. Rouse*,⁴⁴ a decision issued under

original Article 9 that was cited by the secured lender in its appellant brief. *Rouse* held that a security interest in the debtor's accounts and general intangibles should give a creditor sweeping lien rights in the debtor's business revenue that generated this collateral. In turn, if the debtor had business interruption insurance — designed primarily to replace the debtor's business revenue — a secured creditor should be entitled to those insurance proceeds.⁴⁵ Essentially, the business interruption insurance would be derivative proceeds of the debtor's interest in the underlying accounts and general intangibles.⁴⁶

Here, under the holding in *Rouse*, the secured creditor would be entitled to the policy proceeds as derivative of its security interest in the debtor's inventory, accounts and payment intangibles, including insurance proceeds, which are the debtor's "business revenues of practically every description."⁴⁷ Yet, the First Circuit BAP dismissed the *Rouse* decision because in its opinion, the secured creditor there "had a broad security interest in all of the debtor's business operations and all its income-producing assets, including its actual business interruption policy,"⁴⁸ while the secured lender's security interest here was more circumscribed, notwithstanding the inclusion of the term "insurance proceeds" (without limitation) in both the security agreement and UCC financing statement.⁴⁹ At least one commentator agrees that the rationale and conclusions in *Rouse* should be considered when a secured lender's security interest in insurance proceeds is being targeted.⁵⁰

Conclusion

Secured lenders would be well advised to carefully consider the description of insurance policies that are contained in their security agreements and UCC financing statements. It may be that a fuller description of the policies will bolster subsequent arguments that the proceeds of such policies are subject to the lender's security interests, particularly if they include business-interruption coverage.

Of course, secured lenders should also carefully consider including conditions in the loan documentation requiring that they be named as loss payees or additional insureds under the issuing insurance carriers' insurance binders and policies, and including mechanisms to monitor the status of such provisions on an ongoing basis. Given variations in the versions of Revised Article 9 from state to state and longstanding differences in the common law of the various states regarding attachment and perfection of security interests in insurance, lenders would be wise to consider the development of the law in these areas in each jurisdiction where it is active. **abi**

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34 *Id.* at 708.

35 The First Circuit BAP interpreted this argument to mean that the secured lender viewed the settlement payment as "a form of original collateral, which [it] believe[d] brings [the settlement payment] squarely within the scope of the Article 9 insurance exclusion." *Id.* at 711; *see supra* at 4.

36 11 Me. Rev. Stat. Ann. § 9-1109(4)(h).

37 *In re Montreal*, 521 B.R. at 710.

38 *Id.*

39 *Id.* at 712 (emphasis added).

40 *Id.*

41 *Id.* at 713.

42 *Id.* at 714.

43 *Id.* at 710.

44 No. 91-0615-CV-W-2, 1992 WL 674733 (W.D. Mo. Dec. 15, 1992).

45 Young, *supra* n.12, at 227 (citing *Rouse*, *supra* n.44).

46 *Id.* at 210.

47 *Id.* at 227.

48 *In re Montreal*, 521 B.R. at 710.

49 *Id.*; *see also supra* n.23 and 24.

50 Young, *supra* n.12, at 227.