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Recent Case Analysis: First Circuit Confirms that Right to Payment under Insurance Policy Not Covered by Article 9 of the UCC

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When a company enters into a secured line of credit, it presumably expects to repay the lender on a timely basis. But what happens when an unforeseen tragic event results in economic collapse and bankruptcy for the borrower? If there are monies resulting from an insurance settlement with the borrower, the lender may wish to claim these proceeds to repay the loan. Unless the insurance proceeds are deemed "proceeds" of collateral, an interest in an insurance policy is outside the purview of Article 9 as recently reaffirmed by the First Circuit Court of Appeals.

In *In Re Montreal, Maine & Atlantic Railway, Ltd.,* No. 15-9003 (1st Cir. August 19, 2015), the First Circuit held in August of 2015 that a settlement of a casualty insurance claim was not Article 9 collateral in which a lender had perfected its security interest with a financing statement filing under the UCC. Since the lender had not perfected its security interest under the common law in the State of Maine, the lender, a railway company, was not entitled to the insurance settlement as collateral for its loan to the debtor, another railway company.

The case arose out of the July 2013 freight train accident in Quebec, Canada in which 72 tanker cars filled with oil derailed, sparking massive explosions and killing 47 people. The railway line that owned the train that exploded had previously entered into a secured line of credit with another railway company lender. The loan was secured by, among other things, accounts (including payment intangibles), inventory and proceeds, specifically including insurance proceeds. The lender sought to perfect its security interest by filing a UCC-1 financing statement with the Delaware Department of State, since under Maine's UCC the proper place to file was the location of the debtor, and the debtor was located in Delaware. The lender took no other action to perfect its interest in any insurance policies of the debtor.

A few months prior to the train accident, a commercial property insurance policy was issued to the debtor providing coverage in an amount greater than the loan amount and including a section purporting to provide coverage for business interruption. About a month after the accident, the debtor filed for bankruptcy under Chapter 11 of the Federal Bankruptcy Code. The casualty insurance company initially denied coverage but eventually agreed to a settlement that provided a significant payment to the debtor that was less than the full amount outstanding under the secured line of credit.

The lender then made a claim with the bankruptcy court for the amounts due to the debtor under the insurance settlement, arguing that it held a perfected security interest in all payment rights of the debtor and that the proposed settlement amount constituted proceeds of the debtor's right to payment under the policy. The bankruptcy court held that the lender's asserted security interest wasn't enforceable because Article 9 of the UCC doesn't apply to an interest in a claim under an insurance policy and the debtor hadn't perfected its interest under the common law in Maine, as would have been necessary in respect of an asset not subject to Article 9. The bankruptcy court therefore awarded the settlement proceeds to the debtor's bankruptcy estate and denied the lender's claim.

Both the bankruptcy appellate panel and the First Circuit Court of Appeals upheld the ruling of the bankruptcy court to the effect that the lender had not properly perfected its security interest in the insurance settlement under applicable law. The court pointed out that the UCC is quite clear that Article 9 excludes the “transfer of an interest in or an assignment of a claim under a policy of insurance.” The lender’s argument was that this exclusion doesn’t cover payment rights under insurance policies. The First Circuit rejected this argument stating, “the assignment of a right to payment under an insurance policy, which is inseparable from the policy itself, falls squarely within the heartland of the exclusion. … Indeed, the very purpose of the exclusion was to place this type of financing transaction beyond the reach of Article 9.”

Having determined that the rights in the insurance policy were beyond the scope of Article 9, the First Circuit determined that proper perfection in the policy would be governed by the common law of the State of Maine, as provided in the relevant security agreement. The court observed that Maine’s highest court had not addressed the common-law requirements for perfecting a security interest in insurance rights. After some analysis, the First Circuit declined to make a determination of these common law requirements under Maine law, but did conclude that since the lender did nothing more than filing a UCC financing statement, it clearly did not do enough. Accordingly, the insurance settlement remained in the bankruptcy estate of the debtor.

The holding in this case clearly indicates that insurance proceeds that are not deemed to constitute “proceeds” of collateral, such as business interruption insurance, are outside the scope of Article 9 of the UCC. To perfect in these insurance proceeds, a lender must look to applicable state common law rules. While these rules are clearly not uniform among the various state jurisdictions, they commonly require a written assignment of the beneficiary’s rights under the policy, notice to the insurer of the assignment of these rights, acknowledgment by the insurer of the assignment of these rights, and/or making the lender an additional insured or loss beneficiary under the relevant policy.

It has also become more common for lenders to enter into control agreements with the borrower and a third party “securities intermediary” under Article 8 of the UCC for purposes of purportedly perfecting a security interest in insurance policies in the same manner as security interests in investment securities are perfected. This is done by having the various parties agree to deem the insurance policy as a “financial asset” under Article 8 and depositing that financial asset into a “securities account” of the borrower that is “controlled” by the lender. Generally, when this type of perfection is attempted, the control agreement will contain the following key agreements: (i) that all property in the securities account will be treated as ‘financial assets’ under Section 8-102(a)(9) of the UCC; (ii) that the securities intermediary will act as ‘securities intermediary’ for the benefit of the borrower, as ‘entitlement holder’; and (iii) that the securities intermediary will comply with entitlement orders from the lender without further consent from the entitlement holder. The third provision is essential because it allows for perfection by control under Section 8-106(d)(2) of the UCC. In addition, after a securities intermediary is selected, the insurance policy is generally changed to reflect the securities intermediary as the new owner and beneficiary of the policy for purposes of demonstrating that the insurance policy is being held by the Securities Intermediary.

While this Article 8 perfection in respect of insurance policies (including life insurance policies in the structured settlements arena) has become more common, its efficacy in obtaining perfection is not free from doubt. There is little or no case law whereby the courts have blessed this method, and some commentators have indicated it’s not entirely clear from the Official Comment that the UCC contemplates “financial assets” that are otherwise outside the scope of Article 9. Accordingly, the most conservative method for perfecting a security interest in insurance proceeds that will not be considered “proceeds” of collateral is to conform to the requirements of applicable state common law, if the rules can be effectively determined. The requisite steps under Maine common law remain unsettled after *In Re Montreal, Maine & Atlantic Railway, Ltd.*

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