

Article

Insurance & Reinsurance

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Protecting Your Interest from Competing Liens

Introduction

There are significant issues for a lender whose loans are secured by life insurance to consider. Principally, these issues relate to ensuring that the lender has properly established a first priority security interest in the collateral.

This article sets out the basic legal framework regarding the protection of lenders collateralized by life insurance policies. It then goes on to provide suggestions for how a lender can best protect its security interest in a life insurance policy.

Legal Framework: The Uniform Commercial Code

Security interests in life insurance policies are governed by state law; generally, the law of the state in which the debtor is located. Although a lender and a borrower have some discretion in choosing the state law that would govern disputes between them, any such agreement would not determine which state's commercial law applied. The applicable commercial law would generally be that of the state in which the debtor or borrower is domiciled or resides.

The Uniform Commercial Code (UCC), a model code adopted in whole or part by most states, contains explicit rules for securing an investor's interest in many types of investments.¹ The UCC, however, specifically excludes "a transfer of interest in or an assignment of a claim under a policy of insurance" from its regulations.² Most states, including Delaware, Florida, Illinois, New Jersey, New York, Pennsylvania, and Utah, have adopted the UCC by statute and have retained this exclusion.³ A few states, including California, have not codified this exclusion.⁴ Accordingly, without statutory protection by state statutes under the UCC, in most instances a lender looking to secure its interest in a life insurance policy will have to rely on the state's common law; generally, case law decided before the UCC was codified in the particular jurisdiction.

Steps a Lender Should Take to Protect Its Interests

In order to both discover previous parties that may own an interest in a policy, and to ensure that it is not estopped from establishing its priority against subsequent parties, a lender should take certain steps before and immediately after accepting an interest in a life insurance policy as collateral for a loan that it issues.

Steps a Lender Should Take Prior to Accepting an Interest in a Life Insurance Policy as Collateral

A lender should investigate the ownership of, and potential interests in, a life insurance policy as thoroughly as possible before accepting an interest in a life insurance policy as collateral for a loan. Such an investigation, however, may be confounded by two factors. First, as noted above, there are generally no laws or requirements of any kind that obligate another interest holder in an insurance policy to record with, or otherwise notify, any state agency or insurer of its assignment. Second, even if the other interest holder does notify the insurer of the fact that it received an assignment of the policy, the insurer is under no legal obligation to inform any subsequent party that enquires about the policy and/or claims an interest therein that an interest in the policy has already been transferred to someone else.⁵ Nonetheless, this investigation, although difficult, should be completed in order to protect the lender's rights under equitable principles should the lender later come into a dispute with a subsequent (or previous) interest holder in the same policy. Failing to conduct an



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investigation has been held by some courts to bar a later interest holder from succeeding in an estoppel argument.⁶

Such an investigation should begin by doing the following:

1. Obtaining an assurance, in writing, from the policyholder that the policy has not already been sold;
2. Contacting the insurer to ascertain whether its records show that someone else has already obtained an interest in the policy; and
3. Checking with any certain relevant county clerk's offices for any recorded interests in the policy.

The first and most obvious step is to obtain an assurance, in writing, from the policyholder that he has not already transferred an interest in the policy to another party. The cases generally hold that a policyholder can, regardless of his representations, transfer only those interests in the policy that he actually possesses.⁷ Although any such written assurance would likely, without more, be insufficient to protect an investor against a third-party that previously obtained an interest in the policy, it should be acquired, at the very least, to bolster the lender's claim as against the policyholder if the prior interest holder prevails.

Next, the lender should make inquiry with the insurer that issued the life insurance policy, as well as the agent/broker involved in procuring the policy for the policyholder. As noted above, however, neither the insurer nor the broker has any affirmative legal obligation to share any information with a potential lender taking a security interest in a policy. Nonetheless, the lender should request such information from the insurer and agent/broker prior to taking a security interest in the policy to:

1. Attempt to obtain assurances that the policy has not already been transferred to another entity; and
2. Bolster the lender's equitable position if a priority dispute later arises.

Finally, the lender should at least check with the county clerk's office located in the county where the policy holder resided at the time the policy was issued (and any additional counties where the policy holder has resided since the policy was issued). While, as discussed above, most jurisdictions have adopted the UCC, which specifically excepts insurance policies from the types of property that may be secured under Article 9, it is possible that a prior interest holder may have filed a UCC-1 with respect to its interest in the policy with the county clerk's office and the county clerk recorded the filing without objection. Furthermore, even if there is no recorded interest in the policy, the fact that the lender conducted a search of the available records would likely serve to bolster its equitable position at a later time should it come into conflict with a prior investor with respect to the policy.

Potential lenders should recognize that, even if the above efforts are completed and no evidence of a prior assignment is found, the lender may not have priority over a prior interest holder in the policy. If the lender turns out to be a later interest holder in the policy, the grounds upon which it can attempt to divest the prior interest holder are limited. As a precondition to any such right, however, many courts have required the later interest holder to have made an effort to ascertain the ownership of the policy prior to its purchase. Failing to do so, according to these courts, necessarily undercuts any argument that the second interest holder could make to establish priority.⁸



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Steps a Lender Should Take After Accepting an Interest in a Life Insurance Policy as Collateral

After accepting a security interest in a life insurance policy, there are certain additional steps that a lender should take to protect its interest in the policy. The lender should aim to both develop definitive proof that it is the first priority interest holder of the policy and to put any potential future interest holder on notice of its interest in the policy. Any such good faith efforts may put a potential subsequent interest holder on actual or constructive notice of the lender's interest in the policy and hopefully prevent a potential subsequent third-party from attempting to obtain an interest in the policy from the original policyholder (or, at the very least, strengthen the lender's claim to the policy in the event of a challenge to its priority rights).

After accepting a security interest in the policy, an investor should, if possible, obtain the original policy from the policyholder. Case law has suggested that possession of the original policy can be relied upon in establishing priority.⁹ In addition, taking physical possession of the original policy may potentially put subsequent investors on notice that an interest in the policy has already been obtained by virtue of the fact that the policyholder no longer has it in his possession.¹⁰

Second, the lender should seek to have the insurer record in writing the lender's assignment of an interest in the policy. As noted above, the insurer is under no obligation to record the assignment or notify potential interest holders of it. Nonetheless, seeking written acknowledgement from the insurer should defeat arguments by a later interest holder that the lender did nothing to protect its interest, or actively hid its interest, in the policy.

Finally, the lender should attempt to record its interest in the policy with the county clerk's offices where the policyholder resided or was domiciled when the policy was issued (and, if the policyholder has moved or changed domiciles, in the county where the policyholder resides or is domiciled at the time of the sale). Despite the fact that the lender is not required in most jurisdictions to record its interest (and the county clerk may not accept the UCC-1 filing with respect to the interest in the policy), even attempting to record its interest should bolster the lender's equitable argument that it attempted, in good faith, to put the world on notice of its interest in the policy.

After accepting a security interest in a policy, a lender should take the above actions in an effort to prevent a legal or equitable dispute with a later interest holder, and in an effort to establish priority in the event such a dispute does arise. A later interest holder may only be able to establish priority over a prior interest holder if it shows that the prior interest holder is equitably estopped from enforcing its rights. Equitable estoppel necessarily requires proof that the prior interest holder did not adequately protect its interest in the policy. Accordingly, any and all efforts that a lender makes to put potential future interest holders on notice that the lender has an interest in the policy, whether by obtaining a copy of the original policy, notifying the insurer and/or recording the interest with the county clerk's office, should aid in its opposition to an equitable estoppel argument raised by a later interest holder against it.¹¹

Conclusion

Despite the limited protections in the law, and the uncertainty in the protection of interests in life insurance policies created by the UCC and antiquated case law, lenders that take the steps recommended above should be in a significantly better position in the event that they are drawn into a priority dispute with respect to the insurance policies in which they have a security interest. The efforts recommended above are likely to be cost-effective when



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considering the potential loss that could occur in a priority dispute.

If you have any questions about this article, please contact Julius A. Rousseau, James M. Westerlind, or Rodrigo Sanchez from Arent Fox's Insurance & Reinsurance practice.

¹ See UCC § 9-101, *et seq.*

² UCC § 9-109(8) states, in part, as follows: "This article does not apply to: ... (8) a transfer of an interest or claim in or under any policy of insurance."

³ See DEL.CODE ANN. tit. 6, § 9-109 (West 2006); FLA. STAT. ANN. § 679.1091 (West 2005); 810 ILL. COMP. STAT. ANN. 5/9-109 (West 2002); N.J. STAT. ANN. § 12A:9-109 (West 2002); N.Y. U.C.C. Law § 9-109 (McKinney 2001); 13 PA. CONS. STAT. ANN. § 9109 (West 2001); TEX. BUS. & COM. CODE ANN. § 9.109 (West 2011); UTAH CODE ANN. § 70A-9a-109 (West 2002); *In re Silicon Electro-Physics, Inc.*, 116 B.R. 44 (W.D. Pa. 1990) (finding that "life insurance policies are excluded from Article 9 of the Uniform Commercial Code.").

⁴ See CAL. COM. CODE § 9109 (West 2004).

⁵ See, e.g., *Moorestown Trust Co. v. Buzby*, 157 A. 663, 664 (N.J. Ch. 1932) ("[t]he debtor is not bound to answer inquiries concerning the assignor's title, and there can be no assurance that an intending purchaser can ascertain the encumbrance by inquiry of the debtor having notice of the earlier assignment.").

⁶ See *Salem Trust Co. v. Manufacturers Finance Co.*, 264 U.S. 182, 198 (1924) (finding that although first purchaser's failure to give notice may, in certain circumstances, be considered element in assignor's deception of subsequent purchase, "[i]n the absence of inquiry by the subsequent purchaser, the failure of the first to give notice is immaterial."); see also *Moorsetown Trust Co.*, 157 A. at 664 (noting that first purchaser's failure to give notice "cannot injuriously affect an intending purchaser who makes no inquiry of the debtor concerning the assignor's title.").

⁷ See *Hess & Skinner Engineering Co. v. Turney*, 216 S.W. 621, 623 (Tex. 1919) (noting that "subsequent assigning, in dealing with a chose in action, is chargeable with knowledge that he can get no better right than that of his assignor").

⁸ See *Moorsetown Trust Co.*, 157 A. at 664 (noting that first purchaser's failure to give notice "cannot injuriously affect an intending purchaser who makes no inquiry of the debtor concerning the assignor's title.").

⁹ See *Rose v. Amsouth Bank of Florida*, 296 F. Supp. 2d 383, 66 n.4 (E.D.N.Y. 2003) (discussed supra, suggesting that there may be exception to general rule of "first in time, first in right" when second in time assignee took physical possession of insurance policy); see also *Herman v. Connecticut Mut. Life Ins. Co.*, 105 N.E. 450, 452 (Mass. 1914).

¹⁰ In *Herman*, the Supreme Judicial Court of Massachusetts found that the failure of the first purchaser of an interest in a life insurance policy to obtain the original policy granted the policyholder an indicia of ownership that deceived the subsequent purchaser. *Herman*, 105 N.E. at 452; see also *State Bank of Mayville v. Jennings*, 138 N.Y.S. 606, 608 (N.Y. Sup. Ct., Cattaraugus County 1912) (finding that first purchaser's failure to take possession of leasehold for period of sixteen years endowed assignor with apparent ownership, thereby



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entitling second purchaser to priority of right over first purchaser).

¹¹ See Rose, 391 F.3d at 66 (“Without a showing of detrimental reliance on a misrepresentation of the [first-in-Time purchasers], there can be no estoppel.”).

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The contents of this article are offered as general information only and are not intended for use as legal advice on specific matters.

