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Insurance Proceeds as "Proceeds" Under Article 9

RAY D. HENSON*

[When the collateral in a secured transaction is destroyed, does the secured party's interest continue in any insurance proceeds? The Uniform Commercial Code is not clear, and several cases have suggested that insurance proceeds are not "proceeds" available to the secured party under UCC Section 9-306. Mr. Henson challenges these holdings on the ground that "there is no reason for general creditors to get a windfall in the form of insurance proceeds when they would have had no claim on the collateral had it not been destroyed."—Ed.]

To ask whether insurance proceeds are "proceeds" under Article 9 is to frame too broad a question. But in an appropriately restricted fact situation, the fair answer is yes.

The problem begins with Section 9-306(1) which says: "'Proceeds' includes whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of." When collateral has been "lost" or destroyed in an insured event, has it been "disposed of?" It clearly has not been "sold, exchanged, [or] collected" so that those verbs do not fit the facts. Two cases have now said that the Code's definition of "proceeds" does not apply to what has been called an "involuntary conversion" but only to a voluntary disposition of collateral.2

In this connection we must also examine Section 9-306(2), which provides: "Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor unless his action was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor." If we assume that loss or destruction of the property was not authorized by the secured party, must we also assume that

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1. The noun "proceeds" has no acceptable singular form in current English usage. There is perhaps no sensible explanation why words such as "proceeds," "goods," and "shorts" are always used in the plural, but they are. That being so, the verb following "proceeds" in Section 9-306 (1) in the quoted sentence should be "are" and not "is." References not otherwise identified are to the 1962 Official Text with Comments edition of the Uniform Commercial Code.

“disposition” in this provision also relates only to a voluntary transfer? Would a court boggle at finding a continuing security interest in a truck wrecked by a debtor if the truck had been subject to a security interest before its destruction? Yet the collateral has been “disposed of,” and the Code provides that the security interest continues in the collateral and in identifiable proceeds, which insurance proceeds could certainly be. If these provisions relate only to a voluntary disposition, the security interest would not continue in the wrecked truck, and that would seem to make no sense at all.

The situation is somewhat less clear, based solely on the language of the Code, when the truck is wrecked by the action of a third party or if it is stolen. In neither case is that a “disposition by the debtor” and yet the collateral has, in a sense, been disposed of and the security interest would surely be held to continue in it, for whatever that is worth. If Section 9-306(2) does not compel this result, no other section of the Code explicitly does so, but the result seems to be self-evidently correct even though the Code’s language requires stretching to reach it.

If the collateral is destroyed, is there any reason why the insurance proceeds should not be considered “proceeds” and therefore substitute collateral? The language of the Code speaks of proceeds “received by the debtor.” The receipt may, of course, be constructive in a sense. This event need not be visualized in terms of John Smith physically receiving money or a check; the concept clearly is more difficult if posed in terms of General Motors, but it need present no serious problem. However, the debtor can in no sense be said to receive insurance proceeds if a third party, not the secured party, has been named loss payee on the policy of casualty insurance, and in fact gets the proceeds, so that the issue which has often been raised—that this is purely a matter of insurance law—becomes academic on such facts. The problem we are principally concerned with arises where the debtor is himself entitled to the insurance proceeds, under the terms of the policy, and the conflicting claims are those of the secured party and other creditors.

Where insurance proceeds are clearly payable it is immaterial to the company which party receives them and they can be paid into court for a determination as between third parties. If the security agreement provides that the secured party is entitled to the insurance proceeds, as will normally be the case, this provision should be effective so far as third parties, who are not parties to the insurance contract, are concerned. The Code clearly provides for this. In old-fashioned insurance terminology, this gives the secured party an

4. Id. § 9-201: “Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors.” No other provision in the Code governs this problem or provides otherwise.
“equitable” interest in the proceeds, whereas it would have been a “legal” interest if the secured party had been named loss payee.\(^5\) If the security agreement provides for insurance payable to the secured party and the financing statement shows that the secured party claims “proceeds,” this should establish a “legal” interest in them.\(^6\) It would be of no value to anyone to require that a claim to “insurance proceeds” be made specifically on a financing statement,\(^7\) since this would simply result in such a claim being made on the form in every instance even though, as in the case of securities, the claim might be meaningless.

It is anomalous for third party creditors, whether general or lien, to have a claim to insurance proceeds of collateral when they can claim no interest in the collateral itself, and this is equally so whether the controversy arises in or out of bankruptcy. The insurance proceeds stand in place of the collateral,\(^8\) and the secured party’s interest should be equivalent, whether or not the secured party is named as loss payee in the policy, a matter as to which the third parties will have no knowledge or interest unless a windfall appears to be possible after the property is destroyed. It may be doubted that any unsecured third party creditor would attempt to assert a claim against the collateral if, for example, a truck were destroyed and the insurance proceeds were received and used to purchase a replacement which was on hand when financial disaster struck the debtor.

It begs the question and answers nothing to say “[i]nsurance moneys or proceeds flow from the insurance contract and not from the property insured.”\(^9\)

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6. The distinction between “legal” and “equitable” is often tenuous at best, but recording or filing seems to have a magic effect; that is, the interest becomes “legal” on this happening.

7. There is arguably a conceptual inconsistency between Sections 9-203(1)(b) and 9-402(3) on the one hand and Section 9-306(2) on the other. Section 9-203(1)(b) appears to require a claim to proceeds in the security agreement to enforce the security interest against the debtor, and Section 9-402(3) appears to require a notice on the financing statement for the interest to be effective against third parties (under Section 9-301(1)), and yet Section 9-306(2) provides for the automatic continuance of the security interest into identifiable proceeds when the collateral is disposed of. A failure to check the proceeds box on the financing statement form is usually an oversight of no consequence to third parties in fact, and perhaps the interest in proceeds should be restated as automatic, without requiring anything on the financing statement. This would bring the law in line with the usual expectations of all parties.

8. This is true of any other proceeds, too. There seems to be no valid reason for treating insurance proceeds differently.

That may in a sense be true, but there could be no such insurance contract if it were not for the property, and the loss will be measured by the value of the property, not the face amount of the policy, in most cases, at least if the collateral is depreciable. This is the same sort of vacuous circularity involved in asking whether the chicken or the egg came first.

Article 9 expressly does not apply “to a transfer of an interest or claim in or under any policy of insurance.” This exclusion may have been politically pressured, but the official comment to the section suggests that it was intended to apply basically to life insurance policies, where provisions for policy loans are apparently satisfactorily arranged by the companies involved. On its face, however, the exclusion would also apply if an insurance claim were assigned under a casualty policy. But this is not necessarily precisely our situation.

If a secured party is named as loss payee in a policy, the insurance company’s requirements will be met; this act in itself does not create any kind of security interest and Article 9 does not apply to it, and in the event of an insured loss, the proceeds are payable according to the terms of the policy with Section 9-306 merely stating the security consequences of the payment, if any.

If the security agreement requires an assignment of insurance but none is made and a loss occurs, whether the secured party can claim the proceeds as against the debtor is a matter of insurance law and is not resolved by the Code, but if the debtor receives the proceeds—a fortiori if the secured party receives them—they are clearly proceeds of the collateral under Section 9-306 as against the claims of third parties who have no prior interest in the collateral. This result is required by the Code and has nothing to do with insurance law.

If the security agreement does not require an assignment of insurance and if the secured party is not named loss payee but the collateral is destroyed in an event covered by insurance, the proceeds should be payable to the debtor in whose hands they are “proceeds” under Section 9-306, in which the secured

10. Uniform Commercial Code § 9-104(g).
12. The security interest is in the collateral itself. Merely naming a secured party as loss payee transfers nothing at that time because there is nothing whatsoever to transfer. The debtor can have no right in non-existent insurance proceeds to which a security interest could even attach, under Section 9-204(1). In my opinion, it is a reversion to nineteenth century legal fictions, or worse, to suggest that a security interest can be created in non-existent collateral. To say that one cannot create today a present security interest in an automobile which may or may not be acquired next week is far different from saying that one may create a presently and continuously effective security interest in collateral and in the continuing proceeds that may arise in the future under an existing installment contract where performance and payment may continue over a period of time. The problems are not analogous.
14. Id. § 9-306(2).
party has a continuing security interest if the filed financing statement claimed proceeds or if the security interest in the proceeds is perfected within ten days after the debtor receives them.\textsuperscript{15}

The provisions of the Code create no problems under insurance law, and insurance law creates no problems under the Code.

At least four cases have involved, obliquely or directly, the problem under discussion. The question was rather squarely faced in \textit{Quigley v. Caron}.\textsuperscript{16} Here the debtor entered into a security agreement covering a crop of potatoes, and the security interest was duly perfected. The potatoes were destroyed in a fire, and the $13,000 loss was covered by insurance, although the secured party's interest was not disclosed. Then a third party sued the debtor, recovered a judgment for $8,000, and in the principal case apparently sought to enforce the lien of the earlier judgment against the debtor and the insurance companies as trustees of the fund payable. The court noted that the insurance companies had no interest in the outcome of the case.\textsuperscript{17}

The Maine Supreme Judicial Court felt that Section 9-306(1) referred only to a "voluntary disposal"\textsuperscript{18} of the collateral, so the insurance proceeds could not be "identifiable proceeds" of the collateral under Section 9-306(2). Therefore, the secured party had no claim on the insurance proceeds. It is not clear from the court's opinion what happened to the balance of the insurance proceeds in excess of the third party's claim. Nor is it ever stated whether the secured party claimed an interest in proceeds of the collateral, although a failure to do so would be inexplicable in crop financing and cannot be assumed.

The court was of the opinion that a fire insurance contract was a "personal contract"\textsuperscript{19} (whatever that is) between the insured and the insurer in which a secured party, merely by virtue of being such, could claim no interest. Up to a point there is no objection to this analysis, but beyond a point there is. We reach the point of objection when the funds are clearly payable and the question is whether the secured party can claim them as substitute collateral or whether a totally unrelated third party creditor, with no interest in the collateral or its insurance, can come ahead. This is not a matter of insurance law. This is the point where the provisions of the Code determine the answer.

Maine has a statute, which the court referred to, under which a mortgagee of real or personal property can impose a statutory lien on fire insurance procured by a mortgagor.\textsuperscript{20} The fact that the secured party made no effort to enforce such a lien may have influenced the court, although it is doubtful. The

\textsuperscript{15} \textit{Id.} § 9-306 (3).
\textsuperscript{16} 247 A.2d 94 (Me. 1968).
\textsuperscript{17} \textit{Ibid.}
\textsuperscript{18} \textit{Id.} at 96.
\textsuperscript{19} \textit{Id.} at 95.
\textsuperscript{20} ME. REV. STAT. ANN. tit. 24, §§ 1521-25 (1964).
court seemed to be most strongly swayed by the Rhode Island case of *Universal C.I.T. Credit Corp. v. Prudential Investment Corp.*

The Rhode Island case involved an agile debtor whose machinations are perhaps not worth going into in detail, but the court did announce that insurance proceeds are not "proceeds" within the meaning of Section 9-306(1):

"'Proceeds' by definition under the code arises [sic] from either a sale, exchange, collection or other disposition of either the collateral or proceeds. Insurance moneys or proceeds, however, arise and are paid as the result of a contract."  

From this one might infer that a sale or exchange of property does not involve a contract, and that this distinguishes these transactions from insurance, which does involve a contract. There are many distinctions to be drawn between an insurance contract and a sale or exchange contract, but they are all "contracts," and that label is as applicable to the one as to the other. It is odd that a court would find a difference between the proceeds of a contract of sale and the proceeds of a contract of insurance based on a label erroneously applied.

The concept of proceeds is of particular value in financing sales of inventory, and no doubt any court, if certain mechanical steps were followed, would enforce a security interest in the proceeds of such a sale even though it was admitted by one and all that the secured party was not a party to the sale contract and had no interest in its terms beyond his right to proceeds. Indeed, the secured party would have no security interest in the specific goods once they were sold and could rely solely on a continuing security interest in the proceeds. But if we change the matrix of the proceeds from a contract of sale to a contract of insurance, we get bogged down in shibboleths and a meaningful analysis of the facts seems so often to be impossible.

To say that the Rhode Island court was wrong in its interpretation of the Code on the proceeds point is not the same as saying the decision was wrong. On its facts the decision was correct. The first secured party to have its claim satisfied was listed as a loss payee in the casualty policy. This payment was proper.

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24. The Code does not apply to this situation, under Section 9-104(g), and the Code's proceeds provisions apply only where the debtor receives the proceeds, which he cannot be said to do when they are by contract payable to another. See Section 9-306(2).
whom claimed proceeds on its financing statement and the second of whom did not, but did manage to have the debtor execute an assignment of the debtor's interest in the insurance proceeds after the loss had occurred. This assignment is a transaction to which the Code does not apply, and this assignee's claim was in fact more than the excess proceeds available after the loss payee's claim was satisfied. Therefore, no insurance proceeds were ever "received by the debtor," which Section 9-306(2) requires in order for the secured party to have a continuing security interest in them.

To some extent the Rhode Island court relied on a decision by the Court of Common Pleas of Allegheny County, Pennsylvania, in the case of Hoffman v. Snack. Here again, the court was wrong in its view that the proceeds at issue could not be proceeds under the Code, but the court may well have been correct in its decision that the secured party, the financer of the debtor's automobile, had no right to intervene under the Pennsylvania rules of civil procedure in an action brought by the debtor against a man who had apparently run into and demolished the debtor's uninsured automobile. Again, the debtor had not received any proceeds in which the security interest could continue, and the requirements of Section 9-306(2) were not met. The Pennsylvania court was wrong in its assumption that the secured party's interest in proceeds depended on an unauthorized sale, exchange, or other disposition of the property, but even so the Code's triggering factor—the receipt of proceeds by the debtor—had not taken place, and the case involved trial procedure.

No critical discussion of Code cases would be complete without a bankruptcy case, in this instance In re Trochelman. It appears that the debtor bought a used Renault in December 1964 and paid for an insurance policy for a period of one year, naming Sun Finance and Loan Company as loss payee, presumably because Sun was financing the purchase. On March 8, 1965, the Renault was traded for a used Chevrolet, which Sun financed and in which it perfected a security interest. On May 9, the Chevrolet was damaged in an accident. On May 10, a finance company employee persuaded the insurer to transfer the insurance coverage retroactively, effective as of March 5, from the Renault to the Chevrolet, and this was accomplished by an endorsement dated June 10. The debtor filed his petition in bankruptcy on August 20. On September 28 the loss was adjusted by the payment of $650 to Sun. The trustee sought to avoid this transfer as a preference, and succeeded.

The question whether the policy proceeds were proceeds of the collateral was

25. Uniform Commercial Code § 9-104(g).
not discussed, and the referee stated: "The finance company has not urged what would appear to be one valid argument both within the spirit of the Uniform Commercial Code and the Bankruptcy Act; namely, the substitution of collateral not effecting a diminution of net assets." Of course, while the argument might be "valid," the referee found two impediments to accepting the argument which was not made:

One is the scienter factor, to be discussed as to voidable preferences. Second, are the express terms of the Uniform Commercial Code in Section 9-204 . . . that a security interest cannot attach until the debtor has rights to the collateral. In this case, the bankrupt's rights to the fund involved did not arise until, at the earliest, the date of the casualty loss, which was within the voidable preference manifold. The fund, as such, actually was not transferred until after the bankruptcy petition had been filed . . . .

In summary, the security interest dates from 8 March 1965. The right of the bankrupt to the fund in question dates from the date of the accident, on 9 May 1965. The right of the finance company dates from the endorsement on 10 June 1965, based upon the evidence adduced. The device or fiction in the endorsement of a "retroactive effect" cannot avoid the voidable preference implications.

The referee's discussion is largely centered on accounts and inventory financing—he was apparently much impressed with the referee's opinion in the Portland case—and on Section 9-108. The issues raised by the referee are all resolved against the Code; the issues raised by the facts in the case are briefly disposed of by finding a "transfer" within the four-month preference period.

For the purposes of Section 60 of the Bankruptcy Act, a transfer of personal property "shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee." Now, what was the property which was trans-

29. Id. at 4.
31. Bankruptcy Act § 60a(2), 11 U.S.C. § 96(a)(2) (1964). To set aside a transfer of property as preferential, eight elements must be present: (1) a transfer (by way of security) of (2) the debtor's property (3) to a creditor (4) made by the debtor while insolvent (5) within four months of bankruptcy (6) on account of an antecedent
ferred here? The collateral could only have been the automobile and the transfer took place when the security interest was perfected on March 8, which was certainly before the four-month preference period began to run, but it would not have mattered had it occurred during the four-month period because the secured party would have given fresh, not antecedent, consideration.\textsuperscript{32} The secured party did not and could not claim a security interest as such in the insurance proceeds alone. There is no way to perfect such an interest under the Code, but where the insurance proceeds result from the destruction of collateral, the security interest in the collateral follows into the proceeds and is continuously perfected, with perfection dating from the original perfection of the security interest in the collateral. If, as in the principal case, the insurance proceeds go directly to the secured party and are not "received by the debtor," they cease to be "proceeds" and are a repayment of the debt, extinguishing the obligation pro tanto.\textsuperscript{33}

There is no reason for general creditors to get a windfall in the form of insurance proceeds when they would have had no claim on the collateral had it not been destroyed. The time of the insurance coverage indorsement, if there is one, is of no concern to general creditors or to the trustee representing them, for they certainly have not extended credit in reliance on insurance proceeds as a free asset when the property has not even been destroyed. They in fact know nothing of these details and have no interest in them. Moreover, retroactive insurance indorsements are not unusual, and if the one in the principal case was in fact fraudulent, no proof appears in the course of the opinion although it is obvious that the referee was not best pleased with some of the proceedings.

The four cases discussed here are believed to be the only Code cases dealing with the point under discussion. They are something of a mixed bag on their facts, but the problem whether insurance proceeds are "proceeds" under Article 9 has not yet been sufficiently analyzed and deserves some discussion. An obvious solution is to enlarge the definition of proceeds in Section 9-306(1), but a little judicial statesmanship would be a better way out. No simple revision of Section 9-306 seems to be possible when the ramifications of the problem are

\textsuperscript{32} Bankruptcy Act §§ 60a(1), b, 11 U.S.C. §§ 96(a)(1), (b) (1964). In common with so many bankruptcy cases, \textit{Trochelman} does not discuss the presence (or absence) of all of the elements listed above. The element which seems to be glossed over, or rendered meaningless, most often is the one requiring the transfer to enable the creditor to obtain a greater percentage of his debt than some other creditor of the same class.
considered, but in view of the other elaborations provided in the section it might be helpful to restate the first two subsections:

(1) "Proceeds" includes whatever is received when collateral or proceeds, including insurance proceeds, are sold, exchanged, collected or otherwise disposed of. The term also includes the account arising when the right to payment is earned under a contract right. Money, checks and the like are "cash proceeds." All other proceeds are "non-cash proceeds."

(2) Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof [by the debtor] unless [his action] the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

32 See the sixth element of a preference, id.