Commercial Financial Services Brief: Sometimes It Just Does Not Pay to Get Up In the Morning

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We have all had those days when, despite our best efforts and intentions, nothing seems to go right. It may be due to any number of reasons, including decisions by courts which may have an effect on your legal rights or remedies. Two such decisions were recently handed down by a United States Court of Appeals, which serve as reminders for secured lenders to continue to pay careful attention to how they document and secure their loans. Both cases illustrate that there is sometimes a fine line between a full recovery and a significant loss on what was believed to be a secured credit.

Are Accounts Receivable "Proceeds"?

In the first case, 1st Source Bank entered into a lending relationship with the debtor to assist the debtor with the financing of tractors and trailers. 1st Source obtained a security interest in the tractors, trailers, accounts, and proceeds of its collateral. Its financing statement, however, did not contain a reference to "accounts," although it did refer to "all proceeds…including rental and/or lease receipts." Later, other banks obtained a security interest in "all accounts receivable" of the debtor and filed financing statements which contained a reference to "all such accounts receivable, including after-acquired accounts receivable." After the debtor defaulted on its loan agreements with 1st Source, 1st Source foreclosed on the collateral and attempted to assert a claim in the debtor's accounts, arguing that the debtor's accounts receivable were proceeds of its collateral.

The Sixth Circuit Court of Appeals ruled the financing statement filed by 1st Source was not sufficient to perfect a security interest in the debtor's accounts receivable because "accounts receivable" are not included within the definition of "proceeds." While the Court cited a series of cases which have held that "proceeds" does not include property earned by a debtor from its use of collateral that remains in its possession, its narrow reading of the UCC definition of proceeds would seem to preclude an argument that accounts receivable can ever be proceeds under the UCC.

While the Court was interpreting Tennessee law in this case, and its decision is not binding upon a Minnesota court, secured lenders should take note since it is a decision of a federal court of appeals that may be persuasive in other courts.

In order to address the narrow issue raised in the case, lenders may want to consider including all accounts arising from the sale, leasing, licensing, or use of other collateral as original collateral in their security agreements and financing statements.

Finally, it is important to note that 1st Source got in trouble in this case because the collateral description in its financing statement was narrower than that contained in its security agreement. While the UCC permits much less detail in financing statements, it is generally a good idea to use the same collateral description in both documents. This limits the potential for loss should later creditors or a bankruptcy trustee challenge the collateral descriptions used in the loan documents.

What Do You Mean There is No Insurance Coverage for Stolen Inventory?!

In the second case, a lender obtained a mortgage on the debtor's real estate and a perfected security interest in the debtor's inventory. The lender required the debtor to obtain insurance on the real property and inventory and to name it as a mortgagee on the real property and as a loss payee on its inventory. The debtor obtained the required insurance from Westfield Insurance Co. The debtor's warehouse was later vandalized and some of its inventory stolen. In connection with submitting its claim to Westfield, the debtor failed to disclose that the lender held a security interest in its inventory, although it did disclose that the lender held a mortgage on the real property. Westfield issued a jointly payable check for the damage to the real property, but issued a check only to the debtor for the stolen inventory. The debtor failed to remit the insurance proceeds to the lender. After the lender's successor made a demand upon Westfield to issue a new check jointly payable to the debtor and the lender, Westfield brought a declaratory judgment action arguing that it owed nothing to the lender due to the debtor's fraud in connection with the proof of loss.

The Sixth Circuit Court of Appeals ruled that because the debtor misrepresented the lender's interest in the personal property when it submitted a proof of loss to Westfield, the policy did not protect the lender under Michigan law. Unlike the standard mortgagee clause, the policy gave the loss payee no independent right of recovery if the insured breaches the policy's terms. Instead, under the policy's "loss payable" provision, the secured lender is merely an appointee to receive the insurance proceeds. As a result, since its rights under the policy were dependent upon the debtor's actions and since the debtor's submission of a fraudulent proof of loss barred coverage, the lender could not recover under the insurance policy.

A similar result could follow in Minnesota if a secured lender is not careful. If the secured lender needs greater protection than that typically afforded by a loss payee provision (such as that in the Westfield policy), the alternative is a "Lender Loss Payable" endorsement (ISO Form CP 12 18 06 95). This endorsement gives the secured lender the same rights and protections as a mortgagee or a lender covered by a standard form mortgage clause. A mortgage clause is typically part of standard property policies; whereas the Lender Loss Payable endorsement must be added to the policy to protect the creditor's collateral interest in

personal property. The Westfield policy did not have a Lender Loss Payable endorsement and the secured party suffered the consequences.

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