

UCC Insurance vs. Credit Insurance — *A Look at Two Risk-Shifting Alternatives for Lenders*

This article discusses the similarities and differences between credit insurance and UCC insurance. How and when to use credit insurance or UCC insurance can be a complex decision process, as both serve very different purposes and are significantly different in terms of cost.

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For an initial observation, credit insurance falls within the general category of “risk-shifting” insurance, whereby the chance or probability of loss is shifted to the insurance carrier. As such, credit insurance is under the umbrella of true property and casualty insurance where the matter insured will definitely occur at some probability of occurrence, and the economic purpose is to spread the risk over a large pool of insureds. Fire insurance is the classic example. Some number of homes will burn down each year. The probability of occurrence may be slight but the result, if it occurs, is catastrophic. The insurance carrier understands the probability of occurrence through extensive factual data and prices the coverage to fund the actuarial risk and make a profit.

As property and casualty insurance, credit insurance typically carries an annual premium and has a specific term of coverage, usually one year. Claims need to be made within some specified claim filing period that may or may not be coextensive with the period of coverage. Renewal is permissible within stated conditions.

UCC insurance, on the other hand, is akin to land title insurance and is more aptly considered as risk elimination insurance. Subject to what is said below, risk elimination insurance follows the paradigm of insuring the results of the review of an information database, such as county land title records or state UCC central filing office records, and ensuring the accuracy and completeness of the search and review process. If the insurance carrier that is conducting the review process effectively does its job, as a theoretical matter there should never be a claim. For this reason, UCC insurance is usually issued for a single premium and for the life of the indebtedness secured by the subject collateral, rather than for an annual premium for a stated term for credit insurance.

However, human and mechanical error affects the purity of risk elimination insurance, and there are claims arising out of insuring the accuracy and completeness of the search and review process. Additionally, the typical full coverage UCC policy¹ also provides significant “risk-shifting” coverage, such as insuring over filings in the gap between an initial search and the filing date if the closing occurs before receipt of a search to reflect the lender’s UCC-1 financing statement. The risk of a filing in the gap cannot be eliminated through more effective review of the initial search. Rather the probability of occurrence is shifted to the insurance carrier as

risk-shifting insurance. Notwithstanding such attributes of risk-shifting insurance, UCC insurance retains the model of risk-shifting insurance of a single premium for the life of the indebtedness. Given the risk-shifting coverages of UCC insurance, it is perhaps incorrect to categorize UCC insurance as either risk shifting or risk elimination, but a combination of both types of coverage to provide the financial institution an effective risk management tool.

To adequately compare and contrast credit insurance and UCC insurance, we need to establish the fact pattern in which the two types of coverage contend. If credit insurance is being used by the seller of inventory on an unsecured basis for stated trade terms to offset its own risk of bad debt, UCC insurance is not applicable. UCC insurance is designed to insure the priority of a lender’s security interest in specified personal property collateral types or categories. If there is no secured financing

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transaction, UCC priority lien insurance is inapplicable.² However, if a creditor to the seller of inventory on an unsecured basis is looking to credit insurance to enhance the underwriting eligibility of the debtor’s accounts receivable, then a comparison of UCC versus credit insurance is appropriate. Given this background, how does credit insurance and UCC insurance work?

UCC insurance generally insures the attachment, perfection and priority of security interests in personal property. All of the larger land title insurance companies now offer various versions of UCC insurance,

and, although there are significant differences among certain aspects of the policies, in general they try to do the same thing.

Although the probability of loss through the failure of lien priority as a result of incorrect filing, error in documentation, or similar reason for a given lender in a specific transaction may be small statistically, the insured peril involved, the loss of priority, can have a significant adverse effect on the lender. A homeowner does not insure his or her home based on the probability of a fire occurring, but because of the significance of the loss if a fire does occur. “My house has never burned down” is not a very sound argument for not insuring your home against fire. Given the thin profit margins available to lenders in today’s competitive loan market, a loss of lien priority and the resulting reclassification of a secured lender as an unsecured creditor in a bankruptcy proceeding can have a very significant impact on the lender’s net income. UCC insurance, as any casualty insurance product, substitutes a small certain expense (the premium) for a large uncertain loss, transfers risk, protects against uncertainty and reduces anxiety. By analogy to fire insurance, “We have never lost our first priority security interest due to filing office error” is not a very sound argument for not insuring the priority of the lien.

Personal property, that is the subject of UCC insurance, is generally any property that is not real property. Covered collateral, therefore, includes not only all movable collateral such as equipment or inventory, but also intellectual property, including patents and trademarks and copy-rightable matters (but not copyrighted matters which are excluded from the UCC by federal preemption of the Copyright Act), software and software embedded in goods, general intangibles such as contract rights, payment intangibles and investment property such as common stock in corporations. Also covered by the UCC is personal property that has become so affixed to the real property that an interest in the personal property arises under real property law — fixtures. Unless you are just dealing with dirt and stuff embedded in the dirt, like a commercial building, your transaction probably involves personal property. Whether the personal property is reliance collateral is up to you, but if it is, then UCC lien priority insurance may solve many a risk problem facing you as a lender secured by personal property or a buyer of personal property assets.

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In addition to the basic lien priority coverage, UCC insurance covers many of the risks associated with the perfection of a security interest through the central state filing system, such as the authorized execution of the lien granting document by the debtor, mis-indexed filings, unauthorized termination statements filed against the financing statement record, the correctness of the debtor name, filing in the appropriate jurisdictions and similar matters. Additionally, the coverage insures over the gap between the initial search report date and the date of your filing, coverage especially useful to asset-based lenders who traditionally will not advance until they receive a search to reflect. UCC insurance thereby allows the asset-based lender to advance in the gap without waiting for the search to reflect.

One of the significant distinctions between UCC insurance and real property “title” insurance is that UCC insurance is, generally, not “title” insurance. Except for certain specific types of personal property, which are the subject of civil registries of one sort or another, such as vessels and aircraft, there is no methodology for a buyer or a lender to determine whether a seller of a television actually owns the television he or she is purporting to sell or use the collateral. Therefore, UCC insurance typically excludes from coverage any loss resulting from the failure of the insured security interest to attach to any of the collateral by reason of the debtor not having rights in the collateral. This exclusion comes as little surprise to the commercial lawyer because the commercial lawyer understands that there is no effective title mechanism for personal property and a personal property “title” insurer would be taking an unacceptable risk to say, “The debtor actually owns the televisions in the warehouse.” This exclusion is, however, removed in transactions where the collateral is equity interests in Registered Organizations such as corporations and limited liability companies;³ the equity interests are securities for purposes of Article 8 of the UCC, and investment property under Article 9; and the insured a “Protected Purchaser” under Article 8. In these transactions UCC insurance is true “title” insurance insuring the ownership of the pledged equity interests.

With the exception of the “rights” in the collateral exclusion, most of the other exclusions in the typical UCC policy are relatively straightforward. Because there is no “post-policy” exclusion in most UCC policies, the policies contain a number of exclusions that operate as a matter of law, such as a sale of inventory in the ordinary course of business will strip the security interest from the inventory and attach the security interest to the proceeds of the sale. Not a surprising result — saves seeking releases from Nordstrom’s creditors when you buy a shirt. Other exclusions are also of little surprise, such as a change in applicable law and matters suffered, assumed or agreed to by the insured. UCC policies tend to be non-evasive in ongoing operation, with no continuing reporting required of the insured and no requirement that the insured monitor its debtor to keep the policy in effect. The insured certainly will want to monitor its debtor for credit reasons, but the UCC insurance carrier doesn’t force ongoing requirements to maintain the policy. Once you are insured in first position, you are insured in first on a continuing basis for the life of the indebtedness and until there is a refinance. As such, the UCC insurance automatically runs to the benefit of assignees, a very useful feature for lenders that do not hold loan positions.

UCC insurance is also true indemnity insurance. If there is a claim affecting the insured priority of the lender’s security interest, the insurance carrier has a duty to defend. Often this cost of defense will be worth the UCC insurance premium. Given the scope of Revised Article 9, trustees and creditor committees will be looking to challenge security interest perfection in order to free up assets for the reorganization process. The nearest deep pocket will always be fair game. Fortunately the cost of defense is not deducted from the coverage amount of UCC insurance policies.

So, how much does UCC insurance cost? The land title companies that offer UCC insurance have, typically, nationally filed rates. As regulated entities, insurance carriers must file their rates with many state insurance regulatory agencies. The rates are usually denominated as a certain amount per \$1,000 of insured coverage. As mentioned above, the premium is a single premium for the life of the indebtedness covered by the policy, whether a revolving or term facility. Typically, a UCC policy will cover the least of the maximum insured amount, the amount of indebtedness outstanding at date of claim, or the value of the collateral outstanding at

date of claim. The rationale for UCC insurance is that the policy will put the insured in the position it would have been in if the insured security interest in the collateral had been first in priority as insured. Let's assume that the loan line amount and the amount of coverage is \$10 million. Regardless of the level of gross sales or the number of receivable turns of the insured's debtor, the coverage is based on the line amount or the value of the pledged collateral at a point in time. Given the nationally filed rates and a \$10 million insured amount, the single premium would be approximately \$5,375 plus any search and filing costs and expenses, which are usually insignificant.

Credit insurance is structured quite differently than UCC insurance, covers a very different risk and is vastly more expensive than UCC insurance. In our example, a lender (the loss payee or additional insured) is providing a revolving credit facility to a seller of inventory (the insured under the credit insurance policy, called the debtor), which line of credit is secured by the debtor's accounts receivable. Credit insurance is designed to cover non-payment of short-term trade receivables, those due in less than one year. Credit insurance typically covers the insured against credit losses due to non-payment of amounts due from a covered buyer for shipments of covered products made during the policy term. The terms of sale for accounts to qualify as approved accounts receivable are usually set forth in a schedule to the credit insurance policy, and deviation from the approved terms of sale would disqualify such accounts from coverage. Further, because credit insurance is an evaluation of the debtor's account debtors by the insurance company, typically the insurance company will assign credit limits to each of the debtor's approved customers. This credit worthiness valuation process for the insured account debtors is inherent in credit insurance.

Credit insurance covers the lender for the insolvency of account debtors and often for protracted default due to slow pay of a covered account debtor. That being said, a number of real concerns are not typically covered by credit insurance. First of all, credit insurance does not cover contract risk. A dispute between the lender's debtor and an account debtor over whether the goods conformed to the contract is not covered. Losses due to the insolvency of an account debtor where the amounts owed by the account debtor were not scheduled by the account debtor or allowed pursuant to a court order in the bankruptcy or other relief proceeding of the account debtor are not covered. Covered losses are often circumscribed by a definition of "qualifying loss" that limits covered loss to a unpaid "net invoice value," defined as the gross invoice value less credits or similar allowances, expenses saved by non-payment, amounts received and interest charges. Finally, losses from shipment made after the account debtor becomes insolvent are typically not covered. To a certain extent credit insurance requires a clairvoyant debtor or lender.

Unlike UCC insurance, credit insurance requires extensive interaction between the insured/debtor/lender and the credit insurer during the term of the credit insurance policy because credit analysis is not static. For example, during the term of the credit insurance policy, the insurance company retains the right to change or cancel the credit limit of account debtors for future shipments. There are also extensive procedures and timing requirements for the filing of claims. The debtor is also precluded from making any agreement or accepting any proposal from an account debtor that could affect the credit insurer's ability to collect debts of the account debtor.

Typically, the term of a credit insurance in one year and covers account debtor insolvency occurring within the term of the policy and for some stated period, such as six months, thereafter. Credit insurance is also typically neither assignable nor cancelable during the term by the insured.

The calculation of the premium for credit insurance is also somewhat complex. Let's assume in our \$10 million revolving loan transaction, based upon an 85% advance rate against eligible receivables, there are sufficient eligible receivables to secure the entire line amount. Let's also assume that receivables turn every 60 days and those eligible receivables for the line equal qualifying receivables for credit insurance. Total eligible receivables would, on an annual basis, equal \$11,764,705 times 6, or \$70,588,230. The premium for credit insurance is generally less than 1% of gross sales depending on the trading history and historical debt loss of the debtor, its trade sector and its customer base. Let's assume for this example that the credit history of the debtor's accounts receivable supports a credit insurance premium of 0.5% applied to the gross invoice value of qualifying receivables during the policy period, or, in our example, \$352,941 for the one-year coverage period against gross sales of \$70,588,230.

Typically, a UCC policy will cover the least of the maximum insured amount, the amount of indebtedness outstanding at date of claim, or the value of the collateral outstanding at date of claim.

In addition to the premium, there are other financial requirements under a typical policy of credit insurance. There is often a deductible, which can run upwards of 7% of the coverage amount. Also, there can be significant collection fees charged to compensate the credit insurer for efforts made to collect unpaid receivables from insolvent account debtors on whom the carrier has paid a claim before any collected amounts are returned to the debtor or lender. These collection charges can be upwards of 15% of amounts collected, and often 50% on collected amounts less than some stated number, such as \$1,000.

Now, let's assume to reach a comparison of the aggregate premium for credit insurance and the premium for UCC insurance that the credit facility has a five-year duration. Putting aside collection and other charges, the aggregate premium for credit insurance of \$352,941 per year for the five-year duration of the credit facility would equal \$1,764,705, as compared with the one-time UCC insurance premium of \$5375. But in a way we are comparing apples and cumquats. But the difference in cost between credit and UCC insurance may not be cost justified in many transactions.

Credit insurance, subject to all the qualifications discussed above, covers the lender for credit risk associated with non-payment by an insolvent account debtor. That's very useful coverage for the lender to the insured if 1.) the insured's account debtor has no recoverable assets, and 2.) the insured is a very weak credit risk for the lender and the lender is looking to the receivables as the sole source of loan repayment. However, if the account debtors are not judgment proof and without assets and the borrower is a going concern with sufficient projected cash flow to sustain its level of operations and indebtedness, credit insurance is a very expensive way of risk management.

UCC insurance is certainly not credit insurance. It will not reimburse the insured for loss due to the insolvency of a debtor's account debtor. If an asset based lender to a debtor of a revolving credit facility secured by

the accounts receivables of the debtor is concerned about country risk or the credit worthiness of the debtor's account debtors and the accounts receivable are the sole source of repayment for the lender, perhaps credit insurance is a useful although expensive way to shift credit risk. However, if the issue is the attachment, perfection and priority of the lender's security interest in the assets of the debtor, and the concern is primarily with a trustee in bankruptcy or priming creditors, and the debtor is a going concern with continuing sales and the lender has various acceptable exit strategies assuming it is a secured creditor in first position, UCC insurance is a significantly less expensive way to shift the risk of filing office error, fraud, missed senior creditors, failure to file continuation statements, lack of due organization or authority of the debtor and so on, from the lender and its counsel to an insurance company.

In summary, credit insurance and UCC insurance serve different purposes but they do intersect at the margin. Credit insurance covers the insolvency of the account debtors of the lender's debtor. As such, credit insurance covers, to some extent, the credit risk to the lender of the insolvency of the debtor's account debtors in an asset based revolving credit facility. Credit insurance doesn't cover the priority of the lien in the assets of the debtor, including the accounts receivable, or would not defend a challenge to such priority by a trustee in bankruptcy or a creditors' committee. UCC insurance, on the other hand, covers the attachment, perfection and priority of the lender's lien in the assets of its debtor. UCC insurance would defend a challenge to the priority of the lender's lien. UCC insurance, however, wouldn't hedge the lender's concern of being undersecured in the debtor's bankruptcy.

If the lender is not totally relying on the collectability of the receivables, such as a factor, UCC insurance, at .003% of the cost of credit insurance in our example above, may be the cost effective alternative to expensive credit insurance or doing nothing and relying solely on the representations and warranties of the debtor. One can self-insure or, for a moderate one-time premium, insure lien priority against quantifiable risk in a cost-effective manner. Although not the answer to all credit underwriting issues, UCC insurance is an available and useful risk management tool. In addition to providing a cost-shifting mechanism for the preparation, filing and tracking of financing statements and a means to augment or replace expensive legal opinions from borrower's counsel, UCC insurance can assist the lender in managing its overall credit risk in a cost effective manner. **abfj**

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ENDNOTES:

- 1 The reference here is to full coverage UCC insurance policies that cover the attachment, perfection and priority of the insured's secured security interest in defined collateral, and not insured search or insured filing products that provide more limited coverage, such as the accuracy of the information provided by the central filing office, thereby insuring over filing office error. Such policies do not typically provide the expansive risk-shifting coverage provided by full UCC insurance coverage.
- 2 This article considers only the UCC lender's policy that insures the priority of a lender's lien in specified collateral. There are other UCC related insurance products that serve other functions. For example, a UCC buyer's policy insures the lien status of acquired assets at date of acquisition – insuring that the assets being acquired in an asset acquisition or indirectly through a merger or entity acquisition are free of liens except as stated in the policy. Other examples include the New York cooperative interest policy that insures the ownership in cooperative associations and the vacation interest policy that insures the ownership of non-deeded timeshare interests. On the other hand, the vessel-under-construction insures the priority of the security interest of the financing buyer in the stuff comprising the vessel under construction at the shipyard and front ends a vessel ownership policy, and a PPSA policy that insures the priority of a lender's security interest in the common law provinces of Canada.
- 3 As defined in UCC § 9-102(70).