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Feature

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Secured Status of Premium Finance Company Is “Abundantly Clear”



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In the cases of *In re Alabama Aircraft Industries Inc., et al.*, before Hon. **Peter J. Walsh** of the U.S. Bankruptcy Court for the District of Delaware, the chapter 7 trustee, **Charles M. Forman**, filed a complaint to avoid certain prepetition payments made by the debtor/insured to an insurance premium financing company (IPFS).¹ Both parties moved for summary judgment.²

At a superficial level, this appeared to be just another preference action. However, with what is believed to be in the range of \$25 billion to \$30 billion in insurance premiums financed each year in the U.S., and a split of authority on the applicable legal issue, this adversary proceeding had significant implications for the insurance premium financing industry. Would the court bring this ubiquitous type of financing transaction in the crosshairs of chapter 5 of the Bankruptcy Code? Before the authors spoil the end of this story, some background is necessary.

Insurance Premium Financing

In a typical insurance policy, prepaid insurance premiums are considered “earned” by the insurer over the term of the insurance contract. Each day, as part of the prepaid premiums becomes earned, the remainder constitutes the “unearned premiums.” In a simplified example, if an annual policy costs \$365, coverage begins Jan. 1 and the insured pays the insurer \$365 on Jan. 1, the insurer earns \$1 of the premium each day, and the unearned premium decreases by \$1 each day. Continuing the example, if the policy is canceled on Jan. 31, \$31 is earned and \$334 is unearned. If the coverage is cancelled prior to the term of coverage, the insured — absent assignment of such rights — is typically

entitled to receive the unused portion of the premiums that were prepaid.

Insurance premium financing is a common secured lending transaction that allows an insured to finance its insurance premiums without having to pay the entire amount of premiums due during the policy term at the inception date of coverage. At its base, a premium-financing transaction involves three players: an insured, the insurer and the premium finance company.³ The insured pays a down payment at the inception of the loan. The premium finance company pays the remaining premiums due under the policy to the insurer, and in return, the insured makes an agreed-upon number of monthly payments to the premium finance company.

As security for the insured's payment obligation, the insured grants the premium finance company a security interest in the financed policy, including unearned premiums that would be payable to the insured after reduction or cancellation of the applicable insurance coverages. Further, the insured typically grants the premium finance company a limited power of attorney to cancel the coverages in the event of the insured's payment default.

While the exact ratio of down payment and monthly payment might vary from finance company to finance company and from agreement to agreement, premium finance companies generally structure payments under their premium finance agreements in a manner so that the insured's debt shrinks faster than the value of the unearned premiums. Thus, the premium finance company underwrites the loan knowing that if the insured defaults on its monthly payment obligation, the premium finance company can cancel

¹ *Forman v. IPFS Corp. of the South (In re Ala. Aircraft Indus. Inc.)*, Adv. Proc. No. 13-50727, 2013 WL 6332688, at *1 (Bankr. D. Del. Dec. 5, 2013). Saul Ewing LLP represented IPFS in this adversary proceeding.

² *Id.*

³ Premium-financing transactions are almost always arranged through an insurance agent or broker, who is also an important part of the transaction. For simplicity's sake, however, the authors will ignore the broker's role.

the policy and satisfy the remaining payment obligation from the unearned premiums.

The Split of Authority in Applying § 547(b)(5) to IPFCs

If a creditor is fully secured, the debtor's pre-petition payments to that creditor cannot be avoided,⁴ which is a relatively simple analysis when the value of a transferee's collateral is static. A premium finance company's collateral, however, is dynamic. Every day during the 90-day period, a portion of the unearned premiums (the premium finance company's collateral) becomes earned and thus beyond the reach of the premium finance company. The operative question for transfers to a premium finance company is this: *At what point in time* during the 90-day period is the premium finance company's security status determined?

The courts in *Schwinn Plan Committee v. Transamerica Insurance Finance Corp.* (*In re Schwinn Bicycle Co.*)⁵ and *Savage & Associates PC v. A.I. Credit Corp.* (*In re Teligent Inc.*)⁶ held that the secured status of a premium finance company should be determined as of the date of the transfer. The *Schwinn Bicycle* court employed a two-step analysis: First, determine whether the creditor was secured immediately prior to the transfer,⁷ and second, determine whether the transfer resulted in the release of an equivalent value of collateral.⁸ Applying this test, the *Schwinn Bicycle* court found for the premium finance company and held that the premium finance company was fully secured on each date prior to the transfer, and that each transfer was accompanied by a equivalent release of collateral.⁹

In *Teligent*, the court took a simpler approach. The *Teligent* court held that a premium finance company's "oversecured position is intuitively clear," even without consideration of detailed calculations regarding the unearned premiums. The court held that the premium finance company "did not face the risk that the value of its collateral would drop at a faster rate than its debt, leaving it less secured or even undersecured."¹⁰ "[T]he debt shrank at a faster rate than the value of the unearned premiums. Accordingly, the amount of the unearned premiums would always exceed the amount of the debt, provided that Teligent paid the monthly installments on or before the due date."¹¹

Faced with similar facts, other courts have come to the opposite legal conclusion. For example, in *Gray v. A.I. Credit Corp.* (*In re Paris Industries Corp.*),¹² the court ruled in favor of the trustee, who argued that unearned premiums should be valued as of the petition date.¹³ Another case

finding for the trustee on this legal issue is *Falcon Creditor Trust v. First Insurance Funding* (*In re Falcon Products Inc.*).¹⁴ Both courts employed the "add-back" method: "adding back" the total pre-petition transfers to the debt owed on the petition date, comparing it to the collateral securing the claim as of the petition date and concluding that the premium finance company was undersecured.¹⁵ *Paris Industries*, *Falcon Products* and other courts taking a similar approach rely heavily on a U.S. Supreme Court opinion from 1936, *Palmer Clay Products Co. v. Brown*,¹⁶ which held:

Whether a creditor has received a preference is to be determined, not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment *as determined when bankruptcy results*.¹⁷

Businesses need insurance coverage. Insurance premium financing is ubiquitous, even for financially distressed companies, in part because finance companies believe that they are fully secured as long as the unearned premiums exceed the amount that they are owed.

The Delaware Bankruptcy Court's Analysis in *Alabama Aircraft*

With facts similar to those in *Paris Industries*, *Falcon Products*, *Teligent* and *Schwinn Bicycle*, the trustee in *Alabama Aircraft* filed a complaint against IPFS, a premium finance company, to avoid payments made by the debtor.¹⁸ The trustee sought to avoid the last four monthly payments made pursuant to a premium financing arrangement, aggregating to approximately \$151,000.¹⁹ At the time, no court in the Third Circuit had issued an opinion on this legal issue, and the undisputed facts before the court are illustrated in Table 1.

14 *Falcon Creditor Trust v. First Ins. Funding* (*In re Falcon Prods. Inc.*), 381 B.R. 543 (B.A.P. 8th Cir. 2008).

15 *Paris Indus. Corp.*, 130 B.R. at 3-4; *Falcon Prods. Inc.*, 381 B.R. at 547.

16 *Palmer Clay Prods. Co. v. Brown*, 297 U.S. 227 (1936).

17 *Id.* at 229 (emphasis added).

18 *Forman v. IPFS Corp. of the South* (*In re Ala. Aircraft Indus. Inc.*), Adv. Proc. No. 13-50727, 2013 WL 6332688, at *1 (Bankr. D. Del. Dec. 5, 2013).

19 *Id.*

4 See 11 U.S.C. § 547(b)(5) (providing that trustee may avoid transfer if transfer allowed creditor "to receive more than such creditor would receive if — (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title"); see generally 5 *Collier on Bankruptcy* ¶ 547.03[7] (Alan N. Resnick and Henry J. Sommer eds., 16th ed.) ("Generally, payments to a fully secured creditor will not be considered preferential because the creditor would not receive more than in a chapter 7 liquidation.")

5 *Schwinn Plan Comm. v. Transamerica Ins. Fin. Corp.* (*In re Schwinn Bicycle Co.*), 200 B.R. 980 (Bankr. N.D. Ill. 1996).

6 *Savage & Assocs. PC v. A.I. Credit Corp.* (*In re Teligent Inc.*), 337 B.R. 39 (Bankr. S.D.N.Y. 2005).

7 *Schwinn Bicycle Co.*, 200 B.R. at 991 ("If a creditor is fully secured, then it follows that a payment to that creditor merely reduces the secured claim and releases from the security interest the same amount of collateral. Hence, if the creditor is fully secured prior to payment, it cannot be preferred in having received the payment.")

8 *Id.* at 992.

9 *Id.*

10 *Teligent Inc.*, 337 B.R. at 46.

11 *Id.*

12 *Gray v. A.I. Credit Corp.* (*In re Paris Indus. Corp.*), 130 B.R. 1 (Bankr. D. Me. 1991).

13 *Id.* at 3.

Table 1

Payment Amount	Date Payment Due	Transfer Date	Value of Unearned Premiums as of Date of Payment	Outstanding Balance of the Debt
\$37,974.92	12/01/10	12/02/10	\$193,008.46	\$151,899.68
\$37,974.92	01/01/11	01/19/11	\$131,469.53	\$113,927.76
\$37,974.92	02/01/11	02/04/11	\$110,956.55	\$75,979.84
\$37,974.92	03/01/11	02/04/11	\$110,956.55	\$0

Although not detailed in the *Alabama Aircraft* opinion, the trustee and IPFS stipulated that the unearned premiums as of the petition date were approximately \$95,000.²⁰ The trustee argued in the briefing that the 90-day payments should be “added back” in the analysis of § 547(b)(5), and therefore, there existed a collateral deficiency of approximately \$56,000 as of the petition date.²¹ IPFS urged the court to follow *Teligent* and *Schwinn Bicycle*, and evaluate IPFS’ security as of the date of each transfer.²²

The U.S. Bankruptcy Court for the District of Delaware found for IPFS. The court distinguished *Palmer Clay*, determining that *Palmer Clay*’s general statement — that the hypothetical chapter 7 element should be determined as of the petition date — was directed toward unsecured creditors and not binding on the court’s analysis of a secured creditor.²³ The *Alabama Aircraft* court also harkened to the *Teligent* opinion’s characterization of a premium finance company’s oversecured position as “intuitively clear.”²⁴ IPFS’s position as an oversecured creditor was “abundantly clear,” the court held, and determining a premium finance company’s secured status as of the date of the transfers “is not only the common-sense approach, but it also adequately takes into account the unique nature of a premium financing agreement.”²⁵

Implications of *Alabama Aircraft* on the Insurance Premium Financing Industry

Businesses need insurance coverage. Insurance premium financing is ubiquitous, even for financially distressed companies, in part because finance companies believe that they are fully secured as long as the unearned premiums exceed the amount that they are owed. Endorsement of the *Paris Industries/Falcon Products* approach could have reverberated throughout the multi-billion-dollar premium financing industry. As observed by a court in another district, avoiding timely monthly payments made pursuant to a premium finance agreement could “chill this common financing mechanism and diminish the ability of financially troubled companies to obtain insurance.”²⁶ The Delaware bankruptcy court’s ruling may help assure premium finance companies that these common financing mechanisms will not be unwound as avoidable preferences.

Further, the *Alabama Aircraft* opinion can be read to support a straightforward, common-sense approach to evaluating the hypothetical chapter 7 liquidation element as to a premium finance company. The *Schwinn Bicycle* court found for the premium finance company after a detailed, numbers-based analysis.²⁷ In contrast, the *Teligent* court found for the premium finance company by using a more intuitive approach.²⁸ Like *Teligent*, the *Alabama Aircraft* court took notice of the specific numbers relating to the premium finance company’s collat-

eral,²⁹ but seemed to be moved more by the “big-picture” view of the transaction.³⁰

There is still no circuit court-level law on this legal issue, and the lower-court split of authority remains. Delaware continues to be one of the most active (if not *the* most active) districts for avoidance actions. With this being the first written opinion from a court within the Third Circuit on this legal issue, *Alabama Aircraft* is a significant decision for the premium finance industry. **abi**

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20 See Letter and Stipulation, filed at adversary proceeding number 13-50727 (PJW) at docket number 26.

21 See Trustee’s Br., filed at adversary proceeding number 13-50727 (PJW) at docket number 14.

22 *Ala. Aircraft Indus. Inc.*, 2013 WL 6332688 at *3.

23 *Id.* (“Lower courts have found the creditor in *Palmer Clay* and its applicable analysis to be directed towards unsecured creditors, even though it is not explicitly stated in the Supreme Court opinion.”).

24 *Id.* (citing *Teligent Inc.*, 336 B.R. at 46).

25 *Id.*

26 *Borg-Warner Credit Corp. v. RBS Indus. Inc.*, 67 B.R. 946, 951 (Bankr. D. Conn. 1986).

27 See *Schwinn Bicycle Co.*, 200 B.R. at 983-86.

28 See *Teligent Inc.*, 337 B.R. at 46 (“AlCCO’s oversecured position is intuitively clear, even without consideration of any specific calculations.”).

29 *Ala. Aircraft Indus. Inc.*, 2013 WL 6332688 at *2 (detailing value of unearned premiums as of date of payment and outstanding balance of debt).

30 *Id.* at *3 (providing that court’s ruling is “common-sense approach,” takes into account “the unique nature of a premium financing agreement,” and that premium finance company’s secured position is “abundantly clear”).