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“Life Insurance Policies as Collateral in New York”

By Steven J. Glaser

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In this modern legal era, a creditor who wishes to take a life insurance policy as collateral presents counsel with issues that cannot be resolved by consulting Article 9 of the New York Uniform Commercial Code (UCC) (or other statutes which regulate security interests and their perfection for items of collateral), since Article 9 of the UCC expressly excludes security interests in insurance policies.<sup>1</sup> Instead, counsel must go back in time to pre-UCC law to find answers.

## Creation of Security Interest

In general, institutional lenders seek to obtain a security interest in a life insurance policy by a debtor's delivery of a written collateral assignment of the policy. Counsel will deliver the collateral assignment (or a copy) to the insurer for its endorsement and recording on its records. However, such endorsement and recording are not necessary to create the security interest and may create rights only against the insurer.<sup>2</sup> The owner's physical delivery of a policy to a creditor may also create a security interest.<sup>3</sup>

Notwithstanding Section 5-701(a)(9) of the General Obligations Law, which requires a written assignment of insurance policy and voids an oral assignment, a pledge by physical delivery of the original policy need not be accompanied by a written assignment.<sup>4</sup> Hence, counsel should obtain both a collateral assignment of the policy to be pledged as well as the actual policy itself.

## Priority of Competing Liens

Suppose the debtor has delivered a prior collateral assignment of the policy (or delivered the original policy in pledge). Since, in the case of a written collateral assignment, recording the assignment on the insurer's books is not the equivalent of perfecting a security interest under the UCC by filing and, in the case of a physical delivery of a policy in pledge there may also be no public notice, which lien will have priority? A life insurance policy is a chose in action.<sup>5</sup> Under pre-UCC law, the general rule for a chose in action was first in time, first in right and hence such prior assignment or physical delivery of the policy pledge would generally have priority over a subsequent recorded assignment. However, the doctrine of estoppel may result in a reordering of priorities.

The U.S. Court of Appeals for the Second Circuit<sup>6</sup> had occasion in 2004 to consider this issue in *Rose v. AmSouth Bank of Florida*.<sup>7</sup> There, the insured gave a written collateral assignment of a policy to the plaintiffs—Mark S. Rose and Frederic G. Rose who took an assignment as part of a split-dollar arrangement—to secure an advance to pay premiums, but apparently the plaintiffs

did not receive the original policy. Plaintiffs also could not prove that they delivered the assignment to the insurer for recording, although an insurance agent testified that he believed he had done so for the plaintiffs. Some years later, the policy owner delivered a second collateral assignment to the defendant, AmSouth Bank of Florida, to secure a loan and the defendant sent the assignment to the insurer, which duly recorded it and also stated to the defendant that it had no notice of any prior pledge.

The District Court held that the plaintiffs should be estopped to deny the priority of defendant and second assignee.<sup>8</sup> Looking to the common law of New York with respect to security interests in choses in action, the court first stated that it "is settled law in New York that, other things being equal, the first assignee has a priority over the second assignee irrespective of whether the second first notifies the debtor."

However, the court then held that a subsequent pledgee of a policy could prevail if the subsequent pledgee detrimentally relied on an act or omission of the prior pledgee. The court found an estoppel on the basis of the plaintiff's failure to insure that the insurer had notice of the assignment, coupled with the defendant's having asked for and received a representation from the insurer that it had no notice of any prior assignment.

On appeal, the Second Circuit reversed the decision of the District Court on the grounds that the plaintiffs had attempted to give notice to the insurer and that the second assignee had in fact made its loan before it received the representation of the issuer. Also, that court noted that the defendant had not taken actual possession of the policy, although the opinion does not appear to have relied on that fact.

The teaching of *Rose v. AmSouth Bank* seems to be that a pledgee of a policy should receive both a written assignment (and record it with the insurer) and physical possession of the policy being pledged and should receive a representation from the insurer that it has no notice of any prior pledge before it extends credit based on the policy as collateral. It still seems possible that a prior pledgee could prevail.

As far as the interests of named beneficiaries of a policy are concerned, a pledgee's interest in the policy will have priority so long as the pledgor has retained the right to change beneficiaries.<sup>9</sup>

#### Title and Insurable Interest

Life insurance policies may pose title and insurable interest problems which counsel will need to review even before he deals with pledge and priority issues. If the pledgor lacks title to the policy, its pledge may have no force and effect. Because of the manner in which insurance policies are sometimes assembled and issued by insurers, counsel must carefully review the policy to insure that the pledgor is in fact shown in the policy as its owner. In this author's experience, the policy issued often consists of a standard form of the insurer to which is attached a hand-written application page on which the owner and the beneficiary are supposed to be listed.

However, especially where the owner of the policy (and the pledgor) is to be a trust established by the insured, the page attached to the policy may inadvertently be the original application page

completed and signed by the insured before the insured and his counsel have designated the trust which is to be the actual owner (and pledgor). Hence, absent replacement of that page, the policy will, at least on its face, if not on the insurer's records, be titled to a person other than the pledgor of the party. As such, it is possible that the pledge may be rendered invalid (or at least pose a potential target for litigation).

As for the insurable interest issue, if the owner lacks an insurable interest in the life insured under the policy, the policy may be void.<sup>10</sup> Section 3205(a) of the New York Insurance Law defines an insurable interest as "in the case of persons closely related by blood or by law, a substantial interest engendered by affection" and in the case of other persons, a "lawful and substantial economic interest in the continued life...of the person insured, as distinguished from any interest which would arise only by, or would be enhanced in value by the death of the insured." The insurable interest problem probably raises its head most often in the case where the pledgor is either not the insured or the original owner of the policy. Under Section 3205(b)(1) of the Insurance Law, where the insured procures the policy the insurable interest must exist only when the policy is issued and may be obtained by the insured for himself (or for the benefit or ownership of any other person such as a trust for the benefit of his issue).<sup>11</sup>

If the policy is obtained by a person or entity other than the individual whose life is to be insured, Section 3205(b)(2) of the Insurance Law requires that the policy be payable to the insured or to a person then having an insurable interest in that life. However, under Section 7815(c), enacted in 2009, a policy obtained by an individual as part of a plan to assign the policy (or to name as its beneficiary) one who has no insurable interest may be invalid or voidable where the owner in fact contracts to sell the policy shortly after its issuance.

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## Endnotes:

<sup>1</sup> NY UCC §9-109(d)(8).

<sup>2</sup> *Considine v. Considine*, 255 A.D. 876, 7 N.Y.S.2d 834 (2d Dept. 1938).

<sup>3</sup> *Considine v. Considine*, supra; *In re Bickford's Estate*, 265 AD 266, 38 NYS2d 785 (3d Dept. 1942).

<sup>4</sup> Cf. *Neenan v. ITT Hartford*, 256 A.D.2d 1247, 682 NYS2d 783 (4th Dept. 1998).

<sup>5</sup> *Cornell v. Cornell*, 54 N.Y.S.2d 434 (NY Co. 1945).

<sup>6</sup> Cf. *Fortunato v. Patten*, 147 N.Y. 277 (1895).

<sup>7</sup> 391 F.3d 63 (2d Cir. 2004).

<sup>8</sup> *Rose v. AmSouth Bank of Florida*, 296 F.Supp.2d 383 (EDNY 2003).

<sup>9</sup> *Davis v. Modern Industrial Bank*, 279 NY 405 (1939).

<sup>10</sup> See, *Kramer v. Phoenix Life Ins. Co.*, 15 NY 3d 539 (2010).

<sup>11</sup> *Kramer v. Phoenix Life Ins. Co.*, supra.

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