PROTECTING THE SECURED LENDER

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Earlier this year, the United States Court of Appeals for the Fifth Circuit explored the application of the equitable lien doctrine after a secured equipment lender sought to recover directly from its borrower's insurance company once the borrower filed a Voluntary Petition under Chapter 11. The court affirmed the district court's denial of relief to the lender. This reinforces the importance that a secured lender protect itself when entering a transaction with a borrower or lessee to avoid a total loss if the borrower or lessee files a bankruptcy petition or if the leased equipment is damaged, missing or both.

A little diligence at the beginning of a transaction may avoid the unfortunate circumstance that befell the equipment lessor in the recent decision of the Fifth Circuit Court of Appeals in Sierra Equipment Inc. v. Lexington Insurance Co., 890 F.3d 555 (5th Cir. 2018). This case reveals what can occur when an equipment lessor did not require that a lessee make it a loss-payee or additional insured on the lessee's insurance policy. The Sierra decision dealt with the application of a state (Texas) common law "equitable lien doctrine," in a situation where a lessor of equipment (Sierra Equipment) sought to recover directly from an insurance company (Lexington Insurance Company), which covered the loss and destruction of leased equipment for the lessee. The case was originally filed in state court and removed by the defendant to the United States District Court, which dismissed the case for lack of standing because Sierra was not a party to the insurance contract. The Fifth Circuit affirmed in a decision with application to both insolvency and insurance law.

As described below, after costly actions against the Chapter 11 trustee for the debtor, and eventually obtaining damaged equipment, the equipment lessor was unable to prevail in its effort to recover directly from the debtor's insurance company under Texas law. The opinion is instructive and raises the application of the "equitable lien" doctrine, which according to the court's decision, assists parties who are who are intended to be covered under an insured's policy, but are not named as additional insureds or loss payees in the policy.

Background

Commencing in 2008 after an initial thirty-six-month lease expired, LWL Management, Inc. (LWL), as lessee, entered into an equipment lease with Sierra, as lessor. According to Sierra's court filings, LWL was in the business of renting, selling and servicing tower cranes and material hoists. Part of the lease transaction included permitting LWL to sell certain leased equipment and subsequently compensate Sierra by transferring equipment of equal or greater value back to Sierra. With respect to insurance, the Master Security Agreement by and between Lewis Crane of Dallas, L.P. (an affiliate of LWL) and Sierra's predecessor stated: "12. Insurance. (a) Borrower shall at all times during the term of each Note and at Borrower's own cost and expense, maintain (i) insurance against all risks of physical loss or damage to the Equipment for the full reimbursement value thereof, and (ii) commercial general liability insurance (including blanket contractual liability coverage and products liability coverage) for personal and bodily injury and property damage per occurrence as stated in each Collateral Schedule."

With respect to insurance, the Collateral Schedule No. 03 stated: "4. Insurance. Lessee shall arrange and pay for commercial general liability insurance in an amount satisfactory to Lessor, but not less than $20,000.000."

The Bankruptcy Case

On Nov. 18, 2009, LWL and certain of its affiliates filed Voluntary Petitions under Chapter 11 of the Bankruptcy Code. A Chapter 11 trustee was appointed shortly after the bankruptcy filings. During its

Chapter 11 case, LWL obtained an insurance policy from Lexington Insurance Company, but it did not include Sierra as an additional insured or loss payee.

In February 2010, Sierra filed its Motion for Relief from Stay to obtain equipment that it alleged it owned and was leased to LWL. In March 2010, when the Chapter 11 trustee filed an emergency motion to approve limited authorization for the use of cash collateral, Sierra objected stating that the Debtor LWL was still in possession of Sierra's equipment and Sierra did not know if the equipment was sold. In May 2010, the Trustee for LWL and Sierra entered into an agreed Order on the Motion for Relief from the Automatic Stay granting Sierra relief as to certain equipment without prejudice to Sierra's right to assert an interest in other equipment.

In June 2010, the Trustee filed a motion pursuant to Section 363(b) of the Bankruptcy Code to sell certain equipment to Sierra. In July 2010, Sierra filed a complaint in an adversary action against the Trustee of LWL alleging that the equipment exchanged pursuant to the leases with LWL was in fact Sierra's equipment and the sole and exclusive property of Sierra. Sierra settled the action with the Trustee and the claims were dismissed with prejudice. During the bankruptcy proceeding, Sierra inventoried the equipment that it recovered and discovered that much of it was damaged, lost or destroyed. While Sierra was active in LWL's bankruptcy case, it recovered very little from the bankruptcy estate.

The Case Against the Insurance Company

Well over a year after the final decree had been entered in the bankruptcy case, Sierra brought suit against Lexington in Texas state court for policy proceeds to the extent of its loss arguing that Sierra was the rightful owner of the equipment and therefore entitled to such proceeds. The case was removed to federal district court and the court granted judgment for Lexington holding that Sierra did not have standing to pursue an action against Lexington as it was not named in the policy, nor did the lease or other agreements between the parties evidence an intent that it was to be named as a loss payee or additional insured. Sierra appealed to the Fifth Circuit.

On May 15, 2018, the United States Court of Appeals for the Fifth Circuit applied Texas law under the Erie doctrine and noted that a stranger to an insurance policy (Sierra in this case) ordinarily cannot maintain a suit to recover proceeds from the policy. However, Texas has established an "equitable lien" doctrine which provides that equity will treat the policy as having had a provision allowing a stranger to sue on the policy if the lease charges the lessee with the duty to obtain language allowing a loss to be payable to the lessor. This lease did not have that language.

Sierra argued that notwithstanding this problem, it had standing to recover because the lease required LWL to deliver the policy to Sierra and obtain a policy satisfactory to Sierra; and this showed that "the insurance benefits to the lessor is self-evident." Citing several Texas cases, the Fifth Circuit rejected such a broad application of the equitable lien doctrine. It concluded: "Texas courts have consistently considered whether the parties agreed to the inclusion of a loss payable clause in the insurance policy in deciding whether to apply the equitable lien doctrine." Since no such language appeared in the lease, Sierra did not have standing to sue Lexington.

In contrast, approximately 38 years prior to the Fifth Circuit opinion, the Tenth Circuit Court of Appeals issued a decision that granted an equitable lien on insurance proceeds from a fire insurance policy to a mortgagee in Brown v. First National Bank, 617 F.2d 581 (10th Cir. 1980). In Brown, the insurance policy did not contain a loss-payee or mortgage clause naming the mortgagee, but the security agreement showed the parties' intention that the property owners would insure the collateral for mortgagee's benefit.

The district court held that the mortgagee had a continuously perfected security interest in the insurance proceeds within the meaning the Oklahoma Statute 12 A Section 9-306, expressly rejecting the ruling to the contrary by a bankruptcy judge, and the appeal ensued. The Court of Appeals wrote that it was influenced by the 1972 amendment to Section 9-306(1) to provide that "insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than party to the security agreement." Brown v. First National Bank, 617 F.2d at 584.

Application to Practice

Secured lenders and lessors are perpetually seeking sources of recoveries from third parties after a borrower or lessee has filed for bankruptcy or otherwise cannot satisfy the debt (guaranties, letters of credit, etc.). Insurance is certainly one of these sources if collateral or leased property has been damaged, lost or destroyed.

The equitable lien doctrine can provide a source of recovery as long as the note, security agreement, lease or other instrument is worded in such a way that the intention to cover the lender or lessor is apparent on its face even though the insurance policy does not contain specific language naming the lender or lessor as a loss payee or additional insured. However, the saga of Sierra Equipment shows that some courts construe this doctrine narrowly, thus depriving the lender or lessor from recovery.

The better practice is to make sure the note or lease provides for the lender or lessor to be the intended beneficiary and that the policy itself has commensurate language noting the lender or lessor as a loss payee or additional insured. Otherwise relief through the equitable lien doctrine may be too little too late.