LENDER'S INTEREST IN CASUALTY POLICY PROCEEDS

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Insurable Interest of the Mortgagor and the Mortgagee

- Mortgagee only has insurable interest up to the amount of the mortgage
- Mortgagor may insure the property up to property's value
- Mortgagor has no interest in proceeds of mortgagee's policy, and vice versa.

Lender Requirements

To avoid the borrower and lender needing separate policies, lenders typically require borrowers to do two things:

1. Covenant to maintain fire insurance for the benefit of the mortgagee.
2. Obtain a fire insurance policy with a loss payable clause in favor of the lender.

The “Open” Loss Payable Clause

- This clause recites that any loss is payable to the lender, “as its interest may appear.”
- This exposes the lender to all the defenses and limitations the insurance company may have against the borrower.

The “Standard” Loss Payable Clause

- Also called the “New York” or “Union” form of loss payable clause
- Provides that the proceeds are payable to the lender as its interests may appear but also eliminates the defenses and limitations that the insurance company may have against the borrower for payment of a loss otherwise covered by the policy.

The "Standard" Loss Payable Clause

- "This insurance, as to the interest of the mortgagee only, shall not be invalidated by any act or neglect of the mortgagor or the owner of the within described property, nor by any foreclosure or other proceedings or notice of sale relating to the property, nor by any change in the title or ownership of the property, nor by the occupation of the premises for the purposes more hazardous than are permitted by this policy, provided, that in case the mortgagor or owner shall neglect to pay any premium due under this policy, the mortgagee shall, on demand, pay the same."

Ownership vs. Security Interest

- If the fire policy has a loss payable clause in favor of lender – lender has contractual right to policy proceeds up to the value of the mortgage.
- This is not a security interest! The proceeds belong to the lender.
- If mortgagor files for bankruptcy protection, the policy proceeds are not property of the debtor.

The Effect of the UCC

- A lender cannot create and perfect a security interest in a fire insurance policy under the UCC.
- Section 9-109(d) excludes insurance policies from Article 9.
- However, insurance proceeds do constitute “proceeds” of personal property that may have been subject to a perfected security interest.
- But the claim of a party with a loss payable clause in a policy wins in a contest against someone with a perfected security interest in the collateral

Equitable Lien

- If mortgagor has a duty to obtain insurance for the benefit of the mortgagee, the proceeds are subject to an equitable lien n favor of the mortgagee.
- This should always prevail over other creditors

Other Issues

- If there are multiple mortgagees, the proceeds will be divided between the mortgagees based upon the relative priority of their respective liens.
- If there is a lessee of the mortgaged property, the lender's rights to the proceeds depend on the relationship of the lender to the lease arrangement.

Effect of foreclosure

- Effect depends on three variables:
  - Did the loss occur before or after foreclosure completed?
  - Did the policy contain an open or standard form of loss payee clause?
  - If property was sold at foreclosure, was there a deficiency?

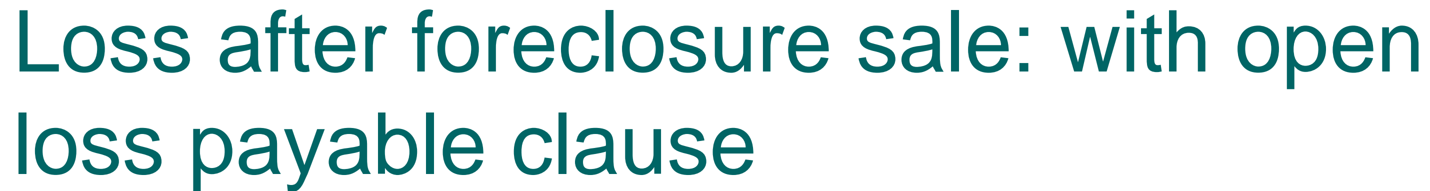
Loss prior to foreclosure sale

- Normal disbursement rules of policy apply
- Amount to be paid to lender is fixed as of the date of the loss
- Amount to be paid to lender is amount owed to the lender.
  - But if lender has a judgment on debt, this may limit amount to be recovered.
- Proceeds in excess go to borrower

- Both types of loss payable clause will terminate lender's right to collect proceeds if there is no deficiency after the foreclosure sale.
- If policy includes standard loss payable clause, lender may be able to recovery the deficiency
  - Theory: clause creates a separate insurance contract with mortgagee
  - Lender may have to obtain a deficiency judgment to avoid argument that debt has been fully repaid

What should lender do?

- Collect policy proceeds prior to the foreclosure sale.
- This eliminates insurance company's argument that mortgagee's interest has been reduced or eliminated by the sale.



Loss after foreclosure sale: with open loss payable clause

- Type of loss payable clause determines whether any recovery for the lender
- If policy has an open loss payable clause, no recovery of post-sale losses.
- Coverage under open clause is only for lender as lender, and not as owner of property.

Loss after foreclosure sale: with standard loss payable clause

- Lender may be able to recover post-sale losses if policy contained a standard loss payable clause.
  - Theory: independent insurance contract between lender and insurance company.
- Contrary authority exists
  - Theory: clause intended to provide protection for lender as mortgagee and not lender as owner of property

What should the lender do?

- Obtain separate insurance following the foreclosure sale.
- Or confirm with the existing carrier that coverage continues following the sale.

Example Provisions

- Loan commitment provisions
- Provisions for deed of trust – long term lender
- Provisions for deed of trust – construction lender
- Assignment of lease provisions