

UPDATE:
TENNESSEE SUPREME COURT REVERSES LOWER COURT RULING
THAT INITIATION OF FORECLOSURE IS
“INCREASE IN HAZARD” UNDER INSURANCE CONTRACT

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In a recent decision, the Tennessee Supreme Court reversed a Court of Appeals ruling holding that a mortgagee is required to give notice of the commencement of foreclosure proceedings to an insurer as such proceedings constitute an “increase in hazard” under both the standard mortgage clause in an insurance policy and Tennessee Code § 56-7-804.² In reversing this holding, the Supreme Court found that the plain and ordinary meaning of the term “increase in hazard” does not include an increase in a moral hazard, such as the commencement of foreclosure proceedings. Thus, failure to notify the insurer of the initiation of foreclosure proceedings will not invalidate a mortgagee’s protection under an insurance policy absent a clear contractual provision to the contrary. *U.S. Bank, N.A. v. Tenn. Farmers Mut. Ins. Co.*, No. W2006-02536-SC-R11-CV, 2009 WL 199856 (Tenn. Jan. 29, 2009).

U.S. Bank, N.A. (“U.S. Bank”) held a mortgage on certain residential real estate. The mortgagor obtained a Personal Fire and Extended Coverage Insurance Policy (the “Policy”), listing U.S. Bank as mortgagee, from Tennessee Farmers Mutual Insurance Company (“Tennessee Farmers”). The Policy contained a standard mortgage clause (the “Clause”), under which Tennessee Farmers agreed to protect U.S. Bank’s interest in the insured property and that such protection would not be cancelled due to, among other things, an increase in hazard of which U.S. Bank was unaware. In return for this protection, the Clause required U.S. Bank to notify Tennessee Farmers of any increase in hazard of which U.S. Bank did have knowledge. Nothing in the Policy specifically required U.S. Bank to notify Tennessee Farmers of the commencement of foreclosure proceedings against the mortgagor.

After the mortgage went into default, U.S. Bank initiated foreclosure proceedings and notified the mortgagor of such through various letters sent by both U.S. Bank and its attorneys. Tennessee Farmers was not so notified. The foreclosure proceedings were stayed after the mortgagor filed for bankruptcy and were never completed. The house was destroyed by fire approximately six months later.

U.S. Bank subsequently submitted a claim to Tennessee Farmers under the Policy, and Tennessee Farmers refused to pay. Following this refusal, U.S. Bank filed a lawsuit against Tennessee Farmers alleging, among other things, breach of contract and arguing that Tennessee Code § 56-7-804 (the “Statute”) prohibited Tennessee Farmers from refusing to pay U.S. Bank’s claim based on the occurrence of foreclosure. The Statute contains almost identical language to the Clause. The trial court granted U.S. Bank’s motion for partial summary judgment as to the effect of the Statute. The Court of Appeals

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² An article on the Tennessee Court of Appeals opinion in this case appeared in December 2008’s edition of the ABA Real Property, Trust and Estate Law Section *eReport*.

reversed the trial court, holding that the initiation of foreclosure proceedings constituted an increase in hazard under both the Clause and the Statute such that U.S. Bank's failure to notify Tennessee Farmers of the foreclosure proceedings constituted grounds for invalidation of the Policy. The Tennessee Supreme Court agreed to hear U.S. Bank's appeal of the Court of Appeal's decision.

On appeal, the Court began its analysis of both the Clause and the Statute by setting out the general rule that, in the absence of ambiguity, the terms of a contract and the language of a statute should be given their plain and ordinary meaning. *U.S. Bank*, 2009 WL 199856 at *3. The Court then addressed the specific issue of whether the commencement of foreclosure proceedings was an "increase in hazard" of which U.S. Bank was required to provide notice to Tennessee Farmers or risk invalidating its coverage under the Policy. *Id.* at *4-*5. In reviewing similar cases from other jurisdictions, the Court found that other courts have generally held that foreclosure proceedings alone do not constitute the type of increase in hazard that requires notice to the insurer by the mortgagee. *Id.* at *5-*6. Courts have typically reached a different result only where the insurance contract specifically requires the mortgagee to provide notice of foreclosure proceedings to the insurer. *Id.* at *6. Based on those cases, the Court concluded that the plain and ordinary meaning of the Clause did not require U.S. Bank to provide notice of the initiation of foreclosure proceedings to Tennessee Farmers. *Id.* The Court observed that requiring such notice, in the absence of a specific foreclosure notice provision, would be the equivalent of the Court's rewriting the Policy, which is not an appropriate judicial function. *Id.* at *7. Therefore, U.S. Bank's failure to provide notice of the initiation of foreclosure proceedings to Tennessee Farmers did not void the Policy for failure to provide notice of an increase in hazard. *Id.*

As the language of the Statute parallels that of the Clause and creates the same protections and obligations, the Court found there to be no substantive difference between the two and found no reason to construe the two differently. *Id.* at *8. As with the Clause, the Court held that the plain and ordinary meaning of the phrase "increase in hazard," as used in the Statute, does not include moral hazards, which are increases in the risk that the mortgagor will destroy the insured property with the intention of collecting the insurance proceeds. *Id.* at *9. The commencement of foreclosure proceedings is one such moral hazard. *Id.* Rather, increases in hazard under the statute include only physical hazards, which are changes in the use or physical condition of the insured property that increase the risk assumed by the insurer. *Id.* Just as the Court declined to judicially rewrite the Policy, it also declined to amend the Statute judicially by expanding the plain and ordinary meaning of the phrase "increase in hazard" to include moral hazards. *Id.* Thus, a mortgagee is not required by either the Statute or a standard mortgage clause to provide notice to an insurance company of the commencement of foreclosure proceedings in the absence of a specific policy provision to the contrary. *Id.*

Although the Tennessee Supreme Court ruled favorably for the mortgagee in this case, the lower court's ruling cites decisions from other jurisdictions supportive of that court's position. Whether this latest Tennessee decision will inspire insurance companies to include language in their policies specifically identifying commencement of foreclosure as an "increase in hazard" remains to be seen. Where a provision in the insurance contract clearly identifies foreclosure as an increase in hazard, a casualty occurring during an unreported foreclosure may not be covered. Mortgagees should recognize that various circumstances may impair their casualty coverage and provide written notice of known circumstances which fall or may fall within the category of an "increase in hazard" to the insurance company.