

Mortgagee's Rights & Obligations Under Insurance Policies with a Standard Mortgage Clause

By: Charles R. Franklin
Belongia Shapiro & Franklin, LLP

Introduction

Ordinary v. Standard Mortgage Clauses

Under an “ordinary mortgage” or “loss payable” clause, a mortgagee is only entitled to the amount of recovery in accordance with the mortgagee’s interest, but the mortgagee is not protected against acts by the mortgagor.

- The amount recoverable is limited by the mortgagor’s right or ability to recover. Therefore, if the damage is a result of the mortgagor’s wrongdoing or neglect, the mortgagee will be unable to recover.

The “standard mortgage clause” protects the mortgagee from any acts or neglect of the owner/mortgagor.

- Standard clause is generally construed as a separate contract between the mortgagee and the insurer.
- Standard clause is now near universally used in mortgages.
- Particular Acts That Do Not Impact Mortgagee’s Rights Under the Policy
- Generally, the nonpayment of premium does not affect a mortgagee’s rights, although in Illinois, a mortgagee may be required to make the payments in the place of the mortgagor.
- Mortgagor’s cancellation of policy
- Intentional Act (i.e., arson)*
- Fraud or Misrepresentation*
- Increase of Risk or Change in Ownership*
- Failure to File a Proof

- Failure to Cooperate

*Unless done with the knowledge/acquiescence of the mortgagee.

The standard mortgage clause protects the mortgagee's interest in the property by securing the payment of the balance of the mortgage note through the insurance in the event of damage or destruction of the insured property.

Rights

Right to Recover

A standard mortgage clause provides the mortgagee with the right to recover from a loss on a property regardless of the actions of the mortgagor. The mortgagee is normally subject to all of the conditions and exclusions of the policy except those invalidating coverage in reason of acts on neglect of the insured. To be able to recover, the mortgagee must be in possession of a mortgage on the insured property in question.

Mortgagee's right to recover is limited by the amount of the remaining secured debt. A seller is entitled to insurance proceeds to the extent of his or her interest in the insured property.

The mortgagee is only insuring its security interest on the property in question, in contrast to the mortgagor who is insuring the property itself.

If the mortgagee has assigned or sold its interest (i.e., is no longer a mortgageholder), it may be denied insurance proceeds, because the mortgagee's insurable interest is the indebtedness and once that has been satisfied, that interest expires.

Similarly, partial extinguishment of the debt through loss precludes recovery to the extent the debt was extinguished.

If the mortgagee receives the full value of its note from the insurer, then it must relinquish the note and its right to foreclose.

Any value over the mortgagee's note should be returned to the mortgagor or junior lienors.

The mortgagee's recovery may be limited by defenses the insured would have against the mortgagor, although a standard mortgage clause generally has fewer defenses that can be raised in opposition.

Limitations on the Right to Recover

A mortgagee's right to recover is not unconditional and can be limited in certain circumstances.

For example:

- The mortgagee's knowing participation in a fraudulent transaction;
- The mortgagee's knowledge of an increase of hazard/change of risk (long time vacancy, unoccupancy, abandonment).
- The mortgagee's rights are subject to all terms and conditions of the insurance contract except those expressly waived or inconsistent with the mortgagee's status as mortgagee; or
- Where the mortgagee has prejudiced the insurer's right to subrogation.

Rights Related to Transfer of the Property

Sale of a mortgage to a third party does not result in the extinguishment of the mortgage debt and permits the third party to stand in the shoes of the original mortgagee and assert the original mortgagee's rights.

This includes the right to insurance proceeds, as if the purchaser knows they will not receive the proceeds, the incentive to purchase is diminished.

If the assignee bids at the foreclosure sale, this extinguishes the mortgagee on the property, then the assignee has no claim to the insurance proceeds.

Obligations

Recognizing the Right of the Insured Party to Rebuild or Repair

In the case of loss on the property, there may be a disagreement between the mortgagee and mortgagor whether to apply the insurance proceeds to rebuilding or replacing the damaged property or whether they are to be paid to the mortgagee against the remaining balance.

In Illinois, between the mortgagor and mortgagee, the mortgagor has a recognized right to recover the insurance proceeds to be able to rebuild the damaged property. (Illinois does not recognize prepayment penalties in residential settings, but does allow for them in the commercial setting).

Repairs by the mortgagor do not necessarily bar the mortgagee's right to recovery because the contract between the mortgagee and the insurer is a separate contract and the mortgagor's repairs were not undertaken for the benefit of the mortgagee. (The mortgage may provide that the lender is to be paid regardless or has the ultimate say if it is to keep the insurance proceeds).

Notifying the Insurers In Changes of Ownership or Risk

To ensure the mortgagee retains the right to loss payment, the mortgagee must inform the insurer of any changes of which it is aware or knows in either:

- Ownership of the or occupancy in the premises in question; and
- Any substantial increase of hazard or change in risk to the premises.

Failure to do so can bar recovery, but is not automatically fatal to a mortgagee's claim. Knowledge can be actual or constructive based on a reasonable man/due diligence and prudence standard.

Complying with the Policy Provisions

A mortgagee's right to recover is not barred by the mortgagor's failure to comply with policy terms after a loss.

Assignees of Parties "Not the Insured"

The right to recover may be assigned by the insured named on a policy, even after a loss.

Failure to notify the insurer of a change in title ownership does not necessarily preclude the paying of insurance proceeds from property loss.

The mortgagee's assignee stands in the shoes of the mortgagee, this creates a new contract between the insurer and the assignee enforceable by the assignee.

If the insurer accepts this assignment routinely or cannot demonstrate why it should not accept it, an absence of formal consent does not defeat the claim.

Use of a standard mortgage clause does not affect the mortgagee's right to make an assignment because even though the effect of a standard mortgage clause is to make a separate contract between the insurer and mortgagee, it does not involve a relationship so personal as to be unassignable.

A clause providing that the loss be payable to a mortgagee requires the claimant to have mortgage on the property. Therefore, creditors, even though secured may not

be paid in assignment if they do not have a mortgage on the property in question, but equitable lien holders may assert a claim for proceeds.

The Standard Mortgage Clause & Foreclosure Actions

Effect of Foreclosure

The general thought behind the standard mortgage clause is that it creates a separate contract of insurance between the insurer and the mortgagee, thus the acquisition of the property by the mortgagee actually *increases* the mortgagee's interest.

If the policy provides that losses are payable to the mortgagee based on the interest in the property, the right to recover is not invalidated by a foreclosure or sale and even the mortgagee's own purchase of the property at the foreclosure sale will not preclude recovery for a loss within the statutory redemption period provided in Illinois.

Once a mortgage debt has been satisfied at a foreclosure sale, the mortgagee has no right to the insurance proceeds from a subsequent loss because the mortgagee cannot collect more than the value of their claim or the amount of their security interest in the property.

Where a mortgagee spends money to secure and protect a mortgaged premises after a loss, provided the deed allows such actions, those costs are recoverable (but not foreclosure costs, attorneys fees, etc.).

Timing of Foreclosure

Even post-foreclosure, a mortgagee may be entitled to the policy proceeds.

- If the period of redemption is not over, the mortgagor is still not entirely divested and the transaction not entirely complete.
- If the mortgagor's debt was not satisfied by the foreclosure sale.

Recovery is limited by the timing of a crucial set of facts: the foreclosure sale and the loss.

- If the loss occurs post-foreclosure sale, recovery is allowed, and the mortgagee will be made whole as the property is no longer valued at the purchase price at the sale.
- This presumes the mortgagee has purchased the subject property at the foreclosure sale.

- If the loss occurs prior to the foreclosure sale, the mortgagee can satisfy the mortgage debt by foreclosure. If this option is taken then the mortgagee may pursue the balance due from the insurer if the foreclosure sale does not cover the entire mortgage debt.

Mortgagee's Procurement of Insurance Coverage on the Mortgaged Property

When a mortgagee procures its own insurance on the mortgaged property at its own expense and for its own benefit – through some sort of first mortgage policy or gap policy or E & O policy, the mortgagee can recover the insurance proceeds for its own use and benefit.

The proceeds are not considered payments on the mortgage, even when the mortgagee's only insurable interest is that of a mortgagee.

Conclusion

There are considerable protections for mortgagees under the standard mortgage clause and general insurance law. An insurer confronted with competing claims to its proceeds must be familiar with, and recognize the power of, the mortgagee under the standard mortgage clause when dealing with them – read the policy, know the law, and call me!

Charles R. Franklin is an attorney at Belongia Shapiro & Franklin LLP and has practiced since 1980. His practice involves, among other things, 1st and 3rd party insurance defense, coverage issues, and subrogation, representing both insurers and policy holders. He can be reached at cfranklin@belongialaw.com or 312-582-1603.