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Growing Foreclosures Resulting from Subprime Mortgage Crisis Could Negate Mortgagee Coverage Under Home Fire Insurance Policies Requiring Notice of "Increases in Hazard"

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The sharp rise in home foreclosure rates has undoubtedly been the most high profile consequence of the existing subprime meltdown. Foreclosure rates were higher in the third quarter of 2007 than they have been at any time since 1972.[1] What many lenders may not realize, however, is that burgeoning foreclosures may also imperil home fire insurance coverage for mortgagees.

A recent decision by the Court of Appeals of Tennessee, *U.S. Bank N.A. v. Tennessee Farmers Mut. Ins. Co.*, No. W2006-02536-COA-R3-CV, 2007 WL 4463959 (Tenn. Ct. App. Dec. 21, 2007), demonstrates the danger that foreclosure can pose to a mortgagee's coverage. The dispute in *U.S. Bank* arose from a home foreclosure that commenced in August 2002, when the plaintiff/appellee, U.S. Bank, sent the borrower a letter informing her of the initiation of foreclosure proceedings. On October 1, 2002, the borrower declared bankruptcy, and the foreclosure proceedings were stayed. Then, on April 12, 2003, the borrower's home was destroyed by a fire (allegedly caused by her husband's illegal methamphetamine lab). *Id.* at *2-*3.

After the fire, U.S. Bank sought to collect on a Personal Fire and Extended Coverage Insurance Policy that the borrower had obtained from Tennessee Farmers Mutual ("Tennessee Farmers") as a condition for obtaining the original loan. That policy contained a "standard mortgage clause" stating that the insurer would protect the interest of the mortgagee (U.S. Bank) in the insured property and that such protection "[would] not be invalidated by any act or neglect of any insured person, breach of warranty, ***increase in hazard***, change of ownership or foreclosure, ***if the mortgagee has no knowledge of these conditions.***" *Id.* at *1-*2 (emphasis added). The clause went on to list the duties of the mortgagee in order to retain coverage, one of which was to "notify [the insurer] of any change of ownership or occupancy ***or any increase in hazard*** of which the mortgagee has knowledge." *Id.* at *2 (emphasis added). The language of the standard mortgage clause mirrors Tennessee statutory law, which also bars cancellation of a mortgagee's coverage due to foreclosure, provided that the mortgagee gives notice to the insurer of any change in ownership or occupancy or ***increase of hazard*** (emphasis added). *See* Tenn. Stat. Ann. Section 56-7-804.

Tennessee Farmers denied the claim on the grounds that it had not received notification of the foreclosure proceedings. U.S. Bank then sued, alleging breach of contract and violation of several different statutes, including Section 56-7-804. *U.S. Bank*, 2007 WL 4463959 at *3. Based on well-established Tennessee precedents,[2] U.S. Bank argued that the commencement of foreclosure proceedings did not constitute a change in ownership or occupancy or an increase in hazard, and so it had no duty to notify Tennessee Farmers in order to retain coverage. *Id.* at *11-*12. The trial court agreed, and granted summary judgment to U.S. Bank. *Id.* at *3.

The Tennessee Court of Appeals reversed, holding that commencement of foreclosure proceedings constitutes an "increase in hazard" that must be reported under both the standard mortgage clause and Section 56-7-804. *Id.* at *9-*10. The court noted that "increase in hazard" is generally synonymous with any "increase of risk of loss." *Id.* at *5. It then reasoned that because foreclosure generally increases the level of "moral

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hazard"– i.e. the risk that the insured borrower will intentionally damage or destroy the underlying property in order to obtain proceeds to satisfy the debt – foreclosure proceedings trigger an increase in risk from the point at which the borrower becomes aware that the process has commenced. *See, e.g. id.* at *7 ("Experience has taught insurance companies that, when property owners become financially unable to take care of their secured obligations, or are so neglectful of them that … foreclosure must be resorted to, the likelihood of fire becomes greater.") (internal citations omitted). The *U.S. Bank* court also emphasized that the standard mortgage clause before it, unlike policies at issue in other cases, required notification in the event of "any" increase in hazard, no matter how inconsequential. *Id.* at *8.[3] Accordingly, U.S. Bank lost the protection afforded by the fire coverage because it failed to notify Tennessee Farmers that foreclosure proceedings had commenced.

The holding in *U.S. Bank* constitutes a potentially significant, and arguably unwarranted, expansion of the definition of "increase in hazard." The court of appeals itself acknowledged that this term generally has not been interpreted to include foreclosure by many other courts, which typically have limited it to concrete, physical conditions.[4] Moreover, those cases the court of appeals cited that *do* permit cancellation of a fire insurance policy due to foreclosure almost all involved explicit contractual provisions to that effect.[5] *See U.S. Bank*, 2007 WL 4463959 at *6-*7. U.S. Bank, on the other hand, was seeking to enforce precisely the opposite type of provision – one that explicitly *barred* cancellation due to foreclosure. The court of appeals' decision to permit an insurance company to avoid its contractual obligations based upon the nebulous concept of "moral hazard" has the potential to increase significantly the financial exposure of many ostensibly covered financial institutions holding interests in mortgage debt in a way these institutions almost certainly could not have anticipated.

Mortgage lenders can take certain steps that should help minimize the risk of an *ex post* deprivation of coverage due to foreclosure. Ideally, care should be taken at the outset to insist on policy language that minimizes the unfair risk to the mortgagee and those who share in the mortgagee's interest. For example, an express definition of what constitutes an "increase in hazard" would help covered entities to understand their disclosure obligations. The insurer is in the best position to draft its policy provisions more clearly, and it is unreasonable to expect covered entities to determine what events are likely to increase risk on an *ad hoc* basis. Policy language should at least specify that an increase in hazard triggering the mortgagee's duty to notify the insurer be "substantial," otherwise virtually any adverse circumstance of any type and any magnitude could result in cancellation of coverage.

If nothing else, it is imperative that risk managers for mortgage lenders and other covered entities, particularly those holding substantial amounts of subprime debt, review and understand the fire and other hazard insurance policies that protect their financial interests to insure compliance with their disclosure obligations in the event of foreclosure. Care should also be taken to review all applicable state laws, which may govern not only the permissibility of policy cancellation but also premium increases in these types of events.

[1] *See* Michael Phillips, et al., "Battle Lines Form Over Mortgage Plan," *Wall Street Journal*, Dec. 7, 2007, at 1.

[2] *See e.g., Phila. Fire & Marine Ins. Co. v. Fields,* 13 Tenn.App. 485, 1931 WL 1538, at *3 (1931) (citing *Southern Ins. Co. v. Estes*, 62 S.W. 149, 150-51 (Tenn. 1901)).

[3] *Compare Anderson v. Kentucky Growers Ins. Co., Inc.*, 105 S.W.3d 462, 466 (Ky. Ct. App. 2003) (analyzing clause that required notification only in the event of a "substantial" increase in risk).

[4] *See, e.g. West v. Green*, 226 So.2d 302, 306-07 (Ala. 1969) (plain meaning of "increase of hazard" does not include foreclosure); *Trustees of Schools v. St. Paul Fire & Marine Ins. Co.*, 129 N.E. 567, 569 (Ill. 1921) (same).

[5] *E.g. Neil Bros. Grain Co. v. Hartford Fire Ins.*, 1 F.2d 904, 905 (9th Cir. 1924) (clause explicitly permitted cancellation in the event of foreclosure); *Peterson v. Hudson Ins. Co.*, 15 P.2d 249, 250 (Ariz. 1932) (same); *Hole v. Nat'l Fire Ins. Co. of Hartford, Com'n,* 252 P. 263, 264 (Kan. 1927) (same); *Newark Fire Ins. Co. v. Pruett*, 227 P. 823 (Colo. 1924) (clause explicitly permitted cancellation for failure to provide notice of foreclosure).

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