

Legal analysis to guide the mortgage industry and protect its interests.

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No Longer Does a Mortgagee Have a Duty to Notify its Hazard Insurer of the Initiation of Foreclosure Proceedings in Tennessee as an "Increase in Hazard" by Shaun Ramey

The Tennessee Supreme Court recently reversed a very unfavorable opinion issued by the Tennessee Court of Appeals. The appeal has been closely monitored by those in the lending industry who deal with hazard claims, as the lower opinion set a very dangerous precedent that could possibly have spread to other states if upheld by the Tennessee Supreme Court. The lower court's opinion, as discussed below, would have placed a tremendous burden on lenders and potentially exposed them to unrecoverable losses if upheld. The Tennessee Supreme Court, however, reversed the lower court's ruling, and in short, held that the initiation of foreclosure proceedings does not constitute an "increase in hazard," which would require a foreclosing lender to notify its hazard insurer of the initiation of foreclosure proceedings in order to maintain coverage.

On Dec. 21, 2007, the Tennessee Court of Appeals in U.S. Bank, N.A. v. Tennessee Farmers Mutual Insurance Company, 2007 WL 4463959, issued an opinion holding that the commencement of foreclosure proceedings constituted an "increase in hazard" under a standard mortgage clause in an insurance policy. The underlying dispute arose from a home foreclosure that began in August 2002, when the lender sent the borrower a letter informing her of the initiation of foreclosure proceedings. On Oct. 1, 2002, the borrower declared bankruptcy, and the foreclosure proceedings were stayed. Then on April 12, 2003, the borrower's home was destroyed by fire. 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 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 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." 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 . . . increase in hazard of which the mortgagee has knowledge."

Tennessee Farmers Mutual denied the claim on the grounds that it had not received notification of the foreclosure proceedings. Based on well established Tennessee precedents, 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. The trial court agreed and granted summary judgment to U.S. Bank.

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 under Tennessee's insurance statutes (which mirrors the standard mortgage clause at issue). The court noted that "increase in hazard" is generally synonymous with any "increase of risk of loss." It then reasoned that because foreclosure generally increases the level of "moral 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. The court also emphasized that the standard mortgage clause before it, unlike policies at issue in other cases, specifically required notification in the event of "any" increase in hazard, no matter how inconsequential. Accordingly, U.S. Bank lost the protection afforded by the fire coverage because it failed to notify Tennessee Farmers Mutual that foreclosure proceedings had commenced.

Thus, the court of appeals' decision to permit an insurance company to avoid its contractual obligations based upon the nebulous concept of "moral hazard" had many in the lending industry concerned. While some claimed that the opinion's application may not be far reaching because of the specific language in the insurance policy at issue requiring notification of "any" increase in hazard, it at the very least would require a lender to review each individual hazard policy to determine whether notification was required, per that specific policy, upon the initiation of foreclosure proceedings. Likewise, the opinion raised issues as to what acts, other than the initiation of foreclosure proceedings, could result in an increase in moral hazard. For example, would a mere payment default result in such a notification obligation? What can be said for sure is that the opinion, particularly if followed by other jurisdictions, would expose lenders in ways these institutions almost certainly could not have anticipated.

The Tennessee Supreme Court, however, has now ruled that the commencement of foreclosure proceedings does not constitute an increase in hazard and therefore, no notice is required to be given to an insurer. See U.S. Bank, N.A. v. Tennessee Farmers Mutual Insurance Company, 2009 WL 199856 (Tenn. Jan. 29, 2009). Although the Tennessee Supreme Court gave multiple reasons for its opinion, it appears that the primary reason given by the court was that a "moral hazard" cannot support a claim of an increase in hazard. More specifically, the court held that the phrase "increase in hazard" in the context of insurance is synonymous with "increase of risk of loss." Thus, an increase of hazard "requires either a change in the insured or the insured property that will increase the probability that the property will be destroyed. In contrast with a physical hazard, a moral hazard is a risk, danger or probability that the insured will destroy . . . the insured property for the purpose of collecting the insurance." The Tennessee Supreme Court found that the mere commencement of foreclosure proceedings, by itself, does not satisfy this standard.

The Tennessee Supreme Court also stated that the primary function of a standard mortgage clause is to "furnish the lienholder a reliable security in a definite sum free from any interference on the part of the insured borrower which would, to any extent, invalidate or make less adequate that security." Thus, given the general purpose of a standard mortgage clause, the court stated that U.S. Bank was essentially asking the court to write a new contract (i.e., remove that understood and bargained for security that was independent of the acts of the insured).

The Tennessee Supreme Court also recognized that the alleged reason why the home burned was because of the homeowner's own negligence in running an illegal methamphetamine lab; not because the homeowner committed arson. Thus, even if "moral hazard" was a basis for an "increase in hazard," the running of a methamphetamine lab while perhaps "immoral" was not, by definition, a "moral hazard," which has its inception in mental attitudes rather than the physical world. The court also recognized that the foreclosure proceeding had been stayed by the bankruptcy filing, and thus, there was no ongoing foreclosure proceeding at the time of the fire. Thus, the actual facts of the case did not even support the reasoning given by the Court of Appeals which, in any case, the Tennessee Supreme Court explicitly rejected.