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After the Waters Recede: The Mortgage Servicer's Role in Navigating Insurance Claims

October 25, 2017

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Damage Caused by Harvey and Irma

- Texas Governor Greg Abbott has reported that estimated damage from Hurricane Harvey will total $150 billion to $180 billion.
- An analytic firm estimated total insured and uninsured losses from damage to properties from Hurricane Irma at $42.5-$65 billion.

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Property Insurance

- Property, or hazard, insurance is based on the concept of providing protection for an “insurable interest”
- Parties with “insurable interest”
  - Owner/Borrower
  - Secured creditors who have loaned money to the property owner also have an insurable interest in the covered property
    - Mortgages or deeds of trust will require the mortgagor to insure the property and provide coverage to mortgagee

Mortgagee Clause in Property Policy

- A typical mortgagee clause provides as follows:

"If a mortgagee is named in this policy, any loss payable under Coverage A or B will be paid to the mortgagee and you, *as interests appear*."

- "you" is the borrower
- "as interests appear" = insurable interest

Types of Mortgagee Clauses in Policies

- "Open mortgage clause" or "simple" clause
  - Mortgagee is simply a payee
  - Steps into shoes of insured

- "Standard mortgage clause," "union clause" or "New York clause"
  - Separate insurance policy between insurer and mortgagee

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Mortgagee Rights under Standard Mortgage Clause

- Benefits
  - Right to recovery of proceeds
  - May be entitled to coverage even if the Named Insured failed to meet obligations under the Policy
  - Right to notice of cancellation

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Insurance Proceeds & the Mortgage

Most residential properties will be secured by a Freddie Mac/Fannie Mae Uniform Instrument (Mortgage or Deed of Trust).

5. Property Insurance. Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss by fire, hazards included within the term "extended coverage," and any other hazards including, but not limited to, earthquakes and floods, for which Lender requires insurance. This insurance shall be maintained in the amounts (including deductible levels) and for the periods that Lender requires. What Lender requires pursuant to the preceding sentences can change during the term of the Loan. The insurance carrier providing the insurance shall be chosen by Borrower subject to Lender's right to disapprove Borrower's choice, which right shall not be exercised unreasonably. Lender may require Borrower to pay, in connection with this Loan, either: (a) a one-time charge for flood zone determination, certification and tracking services; or (b) a one-time charge for flood zone determination and certification services and subsequent charges each time remappings or similar changes occur which reasonably might affect such determination or certification. Borrower shall also be responsible for the payment of any fees imposed by the Federal Emergency Management Agency in connection with the review of any flood zone determination resulting from an objection by Borrower.

If Borrower fails to maintain any of the coverages described above, Lender may obtain insurance coverage, at Lender's option and Borrower's expense. Lender is under no obligation to purchase any particular type or amount of coverage. Therefore, such coverage shall cover Lender, but might or might not protect Borrower, Borrower's equity in the Property, or the contents of the Property, against any risk, hazard or liability and might provide greater or lesser coverage than was

TENNESSEE--Single Family--Fannie Mae/Freddie Mac UNIFORM INSTRUMENT Form 3043 1/01 *(page 6 of 16 pages)*

Section 5 – Property Insurance:

- Notice: “In the event of loss, Borrower shall give prompt notice to the insurance carrier and Lender. Lender may make proof of loss if not made promptly by Borrower.”
- Repair: “Unless Lender and Borrower otherwise agree in writing, any insurance proceeds, whether or not the underlying insurance was required by Lender, shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender’s security is not lessened.”
- Apply: “If the restoration or repair is not economically feasible or Lender’s security would be lessened, the insurance proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower.”

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Decision: Repair Property or Apply Proceeds to Balance

- **Option 1:** Any insurance proceeds shall be applied to restoration or repair of the Property.

OR

- **Option 2:** The insurance proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower

Determining Factors for Repair or Apply Proceeds to Balance

- *"If economically feasible and security is not lessened"*
  - Primary factor for repair or apply
  - "[E]conomically feasible" is "economically reasonable" or "practicable."

- *"Otherwise agree in writing"*
  - Contemplates Lender/Servicer and Borrower agreeing in writing
  - What about a unilateral decision by the borrower?

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Servicer Obligations Under Repair Track

- Standard security instrument places obligations on servicer:
  - "During such repair and restoration period, Lender shall have the right to hold such insurance proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender's satisfaction, ***provided that such inspection shall be undertaken promptly.***"
  - "Lender *may* disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed."

Servicer Obligations Under Apply Proceeds to Balance Track

- “If the restoration or repair is not economically feasible or Lender’s security would be lessened . . .”
- Insurance proceeds shall be applied to the loan
- Excess must be paid to the borrower

Case Study: The Danger of Sitting on Proceeds, *Vongohren v. Citimortgage, Inc.*

- Property sustained hurricane damage in 2011
- Insurance claim made in 2012
- Insurance company partially paid claim
- Citi obtained BPO in 2013
- Citi initiated foreclosure in 2014
- The proceeds remained unapplied

Case Study: Findings by Court

- Servicer should have applied proceeds to the loan
  - "[M]ortgage agreement shifts . . . discretion to [servicer] to ensure that repairs are 'economically feasible,' [and] that its 'security is not lessened.'"
  - "Servicer had no reason to believe [that borrowers] would resume making the payments. This alone may be sufficient, as a matter of law, to make repair economically infeasible."
  - "[T]here was no excuse for a delay in applying the disputed funds—[the servicer] knew that repair of the property was economically infeasible and would lessen its security interest in the property."

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Recap: Repair or Apply Proceeds to Balance

1. Pay attention to communication from the borrower.

2. Make a timely decision on whether repair or restoration is economically feasible.

3. Monitor accruing interest on the underlying loan while proceeds are in suspense.

Protecting Mortgagee Rights To Coverage

- Rights of mortgagee determined at time of loss
- Loss under standard mortgage clause
- Notice Conditions – Policy Specific
  - Notification to insurer if change in ownership
  - Notification to insurer if change in risk
  - Notification to insurer at “commencement of foreclosure proceedings

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Protecting Mortgagee Rights to Proceeds at Foreclosure Sale

- Extinguishment of the security instrument by foreclosure can result in forfeiture of the mortgagee's rights to insurance proceeds.

- Where the mortgagee bids the full amount of the debt at the foreclosure sale, the mortgagee forfeits any right to the insurance proceeds.

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Protecting the Mortgagee’s Rights under a Property Policy

1. Advise the insurer when the loan is referred to foreclosure.

2. Closely monitor properties scheduled for foreclosure.

3. Reduce foreclosure bid by the amount of available proceeds.

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Investigate All Available Policies

- Most properties damaged by Harvey and Irma are *not* covered by flood insurance through the National Flood Insurance Program

- Other property policies may respond
  - Standard homeowner policy
  - Wind policy

- Triage properties located in disaster areas

Flood Damage v. Wind/Rain Damage

- Flood exclusion in standard homeowner policy
- Wind damage and resulting water damage *is* covered
  - Roof damage
  - Trees falling on property
  - Broken windows
  - Breached door

- Mortgagee standing to make claim

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Flood Damage v. Wind/Rain Damage

- Challenging claim denial
- Anti-concurrent causation
  - Policy specific
  - Jurisdiction specific
- Differentiate flood from wind/rain
  - In time
  - Causation

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Recap: Challenging the Denial

1. Describe the property damage carefully.

2. Identify evidence that could support a wind damage claim.

3. Contact coverage counsel.

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For Updates on Servicing & Insurance

www.financialservicesperspectives.com

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Questions?