

# MEMO

**To:** Real Estate Lenders

**From:** Mark A. Andersen

**Date:** 01/01/09

**Re:** Lender's Duty to Notify Insurance Company of Commencement of Foreclosure Proceedings

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## **I. Background**

This memo is written in response to a recent appellate court opinion published in the State of Tennessee, and cited as *U.S. Bank v. Tennessee Farmers Mutual Insurance Company*, 2007 WL 4463959 (Tenn.Ct.App.) (*Permission to Appeal Granted* May, 2008). The specific concern highlighted by this Tennessee court opinion is whether lenders have an affirmative duty to notify insurance companies of foreclosure proceedings, on the theory that the mere commencement of foreclosure proceedings increases the risk of fire and, therefore, constitutes an "increase in hazard" under the standard mortgage clause. If so, the failure to notify an insurance company of the commencement of foreclosure proceedings may excuse the insurance company from paying a claim in the event of a casualty loss. Most standard mortgage clauses under policies for fire and extended insurance coverage require the lender to notify the insurance company of "any increase in hazard" of which the lender has knowledge.

Under the facts of this Tennessee case, the debtor borrowed money to purchase a home, and granted a deed of trust to the lender to secure the loan. The lender was listed as mortgagee under a standard mortgage clause for purposes of the insurance coverage on the home. The debtor defaulted on the loan and the lender foreclosed. Debtor filed for Chapter 13 bankruptcy one month later, staying the foreclosure proceedings. The insurance policy was in effect during the time period in question. At no point was the insurance company notified of the foreclosure proceedings. Several months later, the home was destroyed by a fire (the appellate record includes allegations that the fire was caused by the debtor's spouse while making methamphetamine). The lender submitted a claim under the insurance policy. The insurance company declined to pay the claim, and the lender filed a lawsuit.

## **II. Legal Issue**

Under Kansas law, do lenders have an affirmative duty to notify insurance companies of the commencement of foreclosure proceedings? The answer is yes.

Although the reported court opinion cited above was published in the State of Tennessee, the significance of this case is that the Tennessee court relied almost entirely on an old Kansas Supreme Court opinion, *Hole v. National Fire Insurance Company of Hartford Conn.*, 122 Kan. 328, 252 P. 263 (1927). According to the Kansas Supreme Court, insurance on property in default and in process of foreclosure involves greater risk. The Kansas Supreme Court in the *Hole* opinion stated as follows:

*“The reason for a provision for forfeiture on commencement of foreclosure is increase of hazard. 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, likelihood of fire becomes greater. Under conditions otherwise satisfactory, insurance on property covered by mortgage in good standing is as safe as insurance on unencumbered property. Insurance on property covered by mortgage in default and in process of foreclosure involves greater risk. . . . Hazard is increased by commencement of foreclosure, whether the loss be payable to owner or to mortgagee.”*

## **III. Conclusion**

During the past several months, we have seen an increase in loan defaults and real estate foreclosure filings reported by several of our firm’s real estate lender clients. This trend is likely to continue for the foreseeable future. During this period of increased loan defaults and foreclosure filings, real estate lenders are well advised to not overlook the importance of notifying insurance companies of the commencement of foreclosure proceedings. Failure to do so may prove fatal to the lender’s claim, and excuse the insurance company’s obligation to pay, in the event of a casualty loss.

Each real estate lender should have a foreclosure due diligence checklist which should include, among other things, the affirmative duty to notify the insurance company of the commencement of foreclosure proceedings. The notice should be given in writing by the lender, with the confirmation and/or acknowledgment of receipt retained in the lender’s file.