Fire: Put The Insurer On Notice

In A Default, There Could Be A Fight For The Check

By BRUCE J. BERGMAN

The relationship of fire insurance to the mortgage can be one of the more nettlesome aspects of a lender's or servicer's calling.

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Fire insurance upon mortgaged premises is, of course, obtained by the borrower, who is also required to have the lender named as a loss payee for its interest. When a fire loss is incurred, most often there has been no default on the mortgage and the proceeds of the policy are made payable jointly to the borrower and the lender. Then the lender doles out the proceeds to parties that perform the repair work.

The end result should be that the premises are returned to their original condition with no outlay by the lender. So far there is no problem and the usual situation noted will be well known to lenders and servicers.

Where there's smoke...

When, however, a borrower is in default on the mortgage, and this default coincides with a fire loss, the situation is different. As a matter of law (in New York, for example) the insurance company must then issue the check solely to the lender.

The basis for this maxim is apparent. It would be quite a potential windfall for an unscrupulous borrower to collect all the insurance funds while ignoring the balance of the mortgage. If the full amount is paid to the lender, either it will have received maximum protection or, if the borrower has the wherewithal, the premises could be rebuilt as part of a workout.

Obvious and clear as all this is, not every employee of every insurance company so readily recognizes the principles. Or, sometimes the insurance company might just be careless. So, when default and fire loss intersect, it well behooves a lender to make demand for payment upon the insurance company, emphasizing that the check is payable exclusively to the lender.

Remember, the law absolutely supports such a demand. *[See Sportsmen's Park v. New York Property Ins. Underwriting Association, 97 A.D.2d 893, 470 N.Y.S.2d 456 (3d Dept. 1983); Grady v. Utica Mutual Ins. Company, 69 A.D.2d 668, 419 N.Y.S.2d 565 (2d Dept. 1979); see also RPL §254(4).]*

Should the insurance company reject or ignore the demand (it has happened) they can be sued. The lender would hardly welcome that, but it is relevant to be aware that such a remedy is authorized.

On firm footing

To underscore the strength of this doctrine, as well as the necessity to notify the insurer, consider a case where the secured lender (although not a mortgagee), as part of a sale of a restaurant from plaintiff to defendant, was supposed to be a named insured, but was not. *[Rosario-Paolo Inc. v. C&M Pizza Restaurant Inc., 84 N.Y.2d 379, 618 N.Y.S.2d 766 (1994).]*

In addition to promissory notes from buyer to seller, there was a security agreement which bound the purchaser to obtain fire (and other) insurance naming the seller (plaintiff) as a beneficiary. This is analogous to the usual mortgage situation.

Likewise somewhat similar to the mortgage situation, the agreement provided that if a fire loss was incurred, but there was no default, the proceeds would be deposited in trust with the seller's attorney to pay for repairs.

The buyer obtained the requisite insurance, but failed to name the seller as a loss beneficiary. A catastrophic fire ensued for which the buyer, naturally, filed a claim. The seller thereupon clearly and unequivocally notified the insurance company of its position and its claim.

(Remember, the insurance company previously had no knowledge of the existence of the seller/lender.)

The seller prevails

Despite the note, the carrier paid the full proceeds to the purchaser. The seller sued the insurance company and, though not successful in the lower courts, ultimately prevailed in New York's highest court.

These were the telling principles which emerged:

- Although the insurance company did not have an obligation to investigate the legitimacy of the seller's claim, when confronted with apparently conflicting claims, it had a duty to preserve the insurance proceeds for the rightful owner.
- Once the insurance company had notice of the claim, it paid the buyer at its peril and assumed the risk of resisting the seller's claim.
- The seller had an equitable lien in the insurance proceeds to the extent of its loss, which here was the unpaid purchase price. (This can be analogized to the mortgage balance.)

Thus, even if a borrower neglects to name the lender as an insured - and the lender misses the error - notice to the insurance company before the loss proceeds are paid will save the day.

Remain vigilant and be rewarded! SM

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