The 1st Party Report

A Property & Insurance Update

Winter 2011

Timeless Values. Progressive Solutions.

Should the Insurer Issue Direct Payment to the Insured for Small Losses?

Edited By:
Elizabeth J. Satterfield

The practice of issuing payment directly to the insured for small losses to the dwelling seems to be consistent with the principle behind the option to repair: if the nominal damage never affected the mortgagee's interest, then the contractual obligation to the mortgagee presumably would be satisfied. For example, if a mortgagee were to foreclose on the insured premises immediately following a loss (before any repairs or before any insurance claim), the residual value of the home (albeit partially damaged) might still be sufficient to cover the interest of the mortgagee. Subsequent sale of the property "as-is" for an amount sufficient to cover the debt could extinguish the mortgagee's interest without any repairs being affected. The phrase "as interests appear" in the mortgage clause seems to allow for some judgment about the measure of the mortgagee's interest as it compares to the value of the property after a loss.

Based upon these changing times, the phrase "as interests appear" might allow an insurer to contend that payment for a covered loss can be made to the insured as long as the insured's interest in the property is greater than the amount of the payment. If the mortgagee's interest (determined by the balance on the mortgage at the time of the loss) is affected by the loss (i.e. the loss exceeds the insured's equity in the property and endangers the mortgagee's interest), payment should be issued to both the insured and the mortgagee. Accordingly, when an insurer issues nominal payments for minor losses at an insured premises, the insurer may not need to include the mortgagee on the payment as long as the payment is equal to or less than the insured's "equity" in the home. Effectively, this allows the insured to recover funds to repair his or her "equity" in the home without any encumbrance to the mortgagee.

This argument is consistent with other provisions commonly found in the policy, specifically the insurable interest provision (which limits liability to each insured to no more than the amount of each insured's interest). This is also consistent with evolving principles that permit an insured to recover first his or her uninsured loss before a subrogating or no-fault insurer recovers its previous payments. Notably, however, there is no case law which directly supports this contention. Moreover, taking this position might impose a burden on insurers to investigate the measure of the respective interests in the property which could be difficult depending upon the information available to the insurer (although a simple comparison between the balance on the mortgage and the dwelling limit might be sufficient to issue payment in good faith).

Without expressly relying upon the "as interests appear" language, some courts have held that payment to an insured alone for losses that are subsequently repaired would not violate the mortgagee's rights under the insurance policy. The most notable court holding in support of this notion is *Starkman v. Sigmond*, 184 N.J. Super. 600 (1982). In *Starkman*, the mortgage payments were up to date at the time a fire loss occurred. Nevertheless, the mortgagee argued that the following language in the insurance policy required direct payment to the mortgagee:

> 4. Mortgage Clause Loss, if any, under this policy, shall be payable to the mortgagee (or trustee) named on the first page of this policy, as interest may appear, under all present or future mortgages upon the property herein described, in which the aforesaid may have an interest as mortgagee (or trustee), in order of precedence of said mortgage…

The *Starkman* Court acknowledged that the mortgagee clause created a contractual relationship between the mortgagee and the insurer separate from the contract between the insured and the insurer. However, the court found that the clause did "not establish that losses are to be paid to the mortgagees, but rather [set] the order of priority for payment if there is more than one mortgagee."

The view set forth in *Starkman*, however, remains in the minority. The majority viewpoint is that a mortgagee has the right to recover from an insurer based on its indepen-

dent contractual rights under the insurance policy regardless of whether the insured repairs the property. Georgia courts have held that, because the named mortgagee enjoys independent rights under the mortgage clause, it has the right to apply them to the extent of the mortgage debt. In fact, payment to the insured alone may be especially risky in Georgia since at least one court has held that an insurance company's constructive notice of a security interest alone may be sufficient to alert and require an insurance company to include the interest holder as a payee on any insurance payment.

Thus, despite the logic of the insurance industry's approach and the support it may gather from policy language and some favorable court decisions, the weight of the case law seems to favor the mortgagee's position: all dwelling payments should include the named mortgagee.

For more information on this topic, contact Elizabeth Satterfield at 404.888.6145 or elizabeth.satterfield@swiftcurrie.com.

Extended Version originally published in *Claims Quorum*, a publication of the CPCU Society: Vol. 29, No. 1. March 2011.
Edited by: Elizabeth J. Satterfield, J.D. for this publication.

A Mortgagee's Independent Right of Recovery

Condensed By:
Jessica P. Morgan

It is common knowledge that, starting in 2008, the housing market experienced some remarkable changes. What is less widely known is that these changes have manifested themselves in the insurance industry. Where, at one time, mortgagees seemed content to wait for an insurance company's decision on a claim before asserting their rights under a standard mortgage clause, mortgagees today are more often pursuing a right to recover independent of the named insured based on the standard mortgage clause.

Often, the mortgagees rely upon language from court opinions suggesting that mortgagees enjoy an "independent right of recovery" under the policy. For example, in *Abbottsford Building and Loan Association v. William Penn Fire Ins. Co.*, the court recognized that a mortgage clause in an insurance policy serves to create two separate contracts – one between the insurer and the insured and one between the insurer and the mortgagee. The court noted that because two contracts were created, the mortgagee's contractual interest could not be negated by actions on the part of an insured who violated certain conditions of the policy and therefore precluded the insured's own recovery. Accordingly, a mortgagee has the right to recover under an insurance policy even when the insured has acted in some way that precludes the insured's recovery.

However, it does not follow from these protections that the mortgagee gains rights that are superior to the named insured's rights where there are no circumstances which would prevent a recovery by the mortgagor/insured. The mortgage clause states that the mortgagee is entitled to payment "… if we deny [the insured's] claim …." Before a denial, however, the mortgage company does not seem to have any basis for pursing a claim directly against the insurance company.

This issue was addressed squarely by the court in *Equitable Fire Ins. Co. v. Jefferson Standard Life Ins. Co.* In this case, Equitable issued to Ms. M. E. Thornton a policy for $4,000.00, covering a certain building belonging to her. The policy included a standard mortgage clause making the loss, if any, payable to the insured and Jefferson Standard Life Insurance Company. The property insured was totally destroyed

Mortgagee Issues — So What is an Insurer to Do?

By: Thomas D. Martin and
Kathleen A. Quirk

Although a mortgagee's interest in an insured property may not be harmed if the insured repairs the premises after a loss, the rights of a mortgagee described in this report mean that an insurer should carefully weigh the decision to issue payment to the insured alone. Moreover, while the insurance environment may have changed since many of the above cases discussing mortgagee rights were decided, under the majority view, an insurer's decision to make even a small payment on the dwelling without protecting the mortgagee remains a calculated risk. The recommended procedure, therefore, is to include the mortgagee(s) on all drafts issued for a covered loss.

That being said, the following may be some useful tips to assist in evaluating a mortgagee's claim where the insured has already been paid:

- Examine the mortgage documents – do they require that the premises be restored?
- Examine the premises – have they been repaired (partially, substantially or completely). If so, the insurer may be able to contend that the mortgagee's interest has not been impaired?
- Examine any foreclosure documents – if the property has been foreclosed upon, the mortgagee's subsequent

by fire. Jefferson Standard, the mortgagee, sued Equitable on its own behalf and on behalf of the named insured. But Ms. Thornton was not a party to the lawsuit.

The Georgia Court of Appeals found that the suit was improper because Ms. Thornton, and not Jefferson, was the party to the insurance contract. Under Georgia law, an action on a contract had to be brought in the name of the person in whom the legal interest in the contract was vested. Insurance contracts were no exception. Although the policy contained a standard mortgage clause, the court found that the mortgagee's rights did not ripen until the insured invalidated its interest by some act contrary to the terms of the policy.

Admittedly, the ability of mortgagees to sue on a policy independent of the borrower varies widely from jurisdiction to jurisdiction. As was noted by the Georgia court in *Equitable Fire*, "the decisions of the courts of the several States [regarding a mortgagee's independent right of recovery] are as different and divergent as the ingenuity of attorneys has found ways in which to bring suits where these clauses are involved." However, under Georgia law, the mortgagee must wait until the insured/mortgagor's rights in the policy have been invalidated.

If the mortgagee cannot bring *suit* against the insurer before the contract is invalidated by the insured's conduct, it follows naturally that the mortgagee also cannot bring a *claim* before the insured has invalidated the contract in some way. Furthermore, if, as noted above, insurance proceeds for a dwelling loss are properly payable to both the insured and the mortgagee, it follows that payment to a mortgagee alone, before the insured's claim is determined, would be inappropriate as well. A mortgagee's right to recovery should not ripen until the insured's claim has been fully evaluated and decided by the insurer.

Nevertheless, mortgagees continue to seek payment based on their "interest" before the insurer has completed its investigation into the insured/mortgagor's coverage. However, until the insurer makes a determination on coverage for the insured's claim, consideration of the mortgagee's claim is premature. Notwithstanding the foregoing, we would urge caution in responding to any mortgagee's claim pending a thorough review of the law of the jurisdiction and the content of the mortgage documents.

For more information on this topic, contact Jessica Morgan at 404.888.6148 or jessica.morgan@swiftcurrie.com.

Authored by: Kathleen "Katie" A. Quirk, J.D. and Thomas D. Martin, J.D.
Extended Version originally published in *Claims Quorum*, a publication of the CPCU Society: Vol. 28, No. 1. October 2010.
Condensed by: Jessica P. Morgan, J.D. for this publication.

To Produce or Not to Produce

By: Jeremy E. Catlin

Discovery is a crucial part of litigation. It is usually the most effective means to obtain useful and relevant information from both parties to the lawsuit and non-parties. Written discovery devices include interrogatories, requests for production of documents and requests for admissions. Experienced counsel understand that crafting written discovery requests carefully and precisely can be the difference between obtaining the important document or piece of information desired and receiving an objection to the request. Similarly, experienced counsel understand what documents are discoverable and what documents are protected and therefore objectionable.

sale of the property for an amount equal to or in excess of its interest at the time of the loss may extinguish its claim.

- Examine the interests as they appeared at the time of the loss – try to ascertain the mortgagee's interest (the balance on the loan), the value of the home (before the loss) and the insured's "equity" in the home.

In the end, paying insureds directly for smaller claims may be a calculated risk for the insurance industry. If the industry sees a significant increase in the number of mortgagee claims duplicating previous payments to the insured, then the practice may have to be re-evaluated. Frankly, however, there are some very reasonable and consumer-friendly explanations for the insurance industry's practice. The law simply may not have caught up to the practice because the disputed amounts are often too small to warrant significant litigation. That may change if the mortgage industry treats the insurance industry as a potential target for lessening some of the losses it has suffered in recent years.

For more information on this topic, contact Tom Martin at 404.888.6128 or tom.martin@swiftcurrie.com, or contact Katie Quirk at 404.888.6142 or katie.quirk@swiftcurrie.com.

Extended Version originally published in *Claims Quorum*, a publication of the CPCU Society:
Vol. 28, No. 2, March 2011
Condensed by: Jessica P. Morgan, J.D., for this publication.

Being able to distinguish between discoverable and protected documents in first party litigation, especially when bad faith is alleged, is paramount. Counsel for plaintiffs in bad faith cases have become increasing inventive in trying to obtain documents from insurers related to their handling of other similar losses. If such documents are produced, plaintiffs will attempt to use documents from these other claims or lawsuits to show that the insurer has a propensity for denying similar claims, that the claim at issue was handled differently than other similar losses or in some other way to show that the insurer took improper actions under its own guidelines. Production of documents related to other claims can rarely, if ever, be helpful and therefore should be avoided. In fact, as shown below, Georgia courts have found that documents related to other claims and lawsuits are irrelevant to first party claims, even when bad faith is alleged.

Bad faith in Georgia is governed by O.C.G.A. § 33-4-6. Under the bad faith statute and corresponding case law, bad faith is defined as "any frivolous and unfounded refusal in law or in fact to comply with the demand of the policyholder to pay according to the terms of the policy." *Johnston v. Companion Prop. & Cas. Ins. Co.*, 318 Fed. Appx. 861, 868 (11th Cir. 2009) *quoting Ga. Farm Bureau Mut. Ins. Co. v. Williams*, 266 Ga. App. 540, 597 S.E.2d 430, 432 (2004). Based on this definition, insurers should always take the position that how they acted in the handling of other claims and lawsuits is completely irrelevant and immaterial to the claim currently in litigation.

Georgia courts agree with this position. In *Moses v. State Farm Mut. Auto. Ins. Co.*, 104 F.R.D. 55 (N.D. Ga. 1984), the issues related to defendant State Farm's alleged refusal to pay chiropractic expenses and lost income to the plaintiff, and whether such refusal to pay was done in good faith under O.C.G.A. § 33-34-6. In discovery, the plaintiff requested information related to: other similar cases handled by State Farm and its employees; the procedures, policies or rules for its officers, employees, agents, attorneys or any other person involved in the handling of claims; the number of claims and lawsuits pending in Georgia against State Farm in which State Farm refused to pay the expenses of chiropractic care; the name and address of each claimant and his or her attorney, if any, who charged State Farm with bad faith in Georgia during the previous year; and the name and address of each claimant to whom State Farm refused to pay chiropractic billings for treatment within the past year.

State Farm objected to these requests and the plaintiff moved to compel responses. In siding with State Farm, the court found that the discovery requests were not relevant to the issues in the case and not likely to lead to admissible evidence. Further, the court explained that "[t]he issues in this case are limited to Defendant's conduct regarding Plaintiff's claim for insurance benefits and to the adequacy of Defendant's reasons for that conduct. Defendant's conduct regarding the insurance claims of others is of no consequence to this case." *Id.* at 57.

Going forward, keep this information in mind in first party litigation. Make sure that your counsel is aware that requests for information or documents related to other claims and lawsuits are objectionable. Furthermore, prior to litigation, if an insured requests similar information directly from the insurance company, know that the documents are protected and should not be produced, as refusing to produce there documents can prevent a lot of headaches down the line.

For more information on this topic, contact Jeremy Catlin at 404.888.6144 or jeremy.catlin@swiftcurrie.com.

Events

Annual Property & Coverage Insurance Seminar
Friday, November 4, 2011
9:00 am - 3:00 pm
Cobb Energy Performing Arts Centre
Atlanta, GA

For more information on these programs or to RSVP, visit www.swiftcurrie.com/events.

Email List

If you would like to sign up for the E-Newsletter version of The First Party Report, please send an e-mail to info@swiftcurrie.com with "First Party Report" in the subject line. In the e-mail, please include your name, title, company name, mailing address, phone and fax.

Swift, Currie, McGhee & Hiers, LLP, offers these articles for informational purposes only. These articles are not intended as legal advice or as an opinion that these cases will be applicable to any particular factual issue or type of litigation. If you have a specific legal problem, please contact a Swift Currie attorney.

The First Party Report is edited by Mike Schroder, Steven DeFrank and Melissa Kahren. If you have any comments or suggestions for our next newsletter, please email mike.schroder@swiftcurrie.com, steven.defrank@swiftcurrie.com or melissa.kahren@swiftcurrie.com.