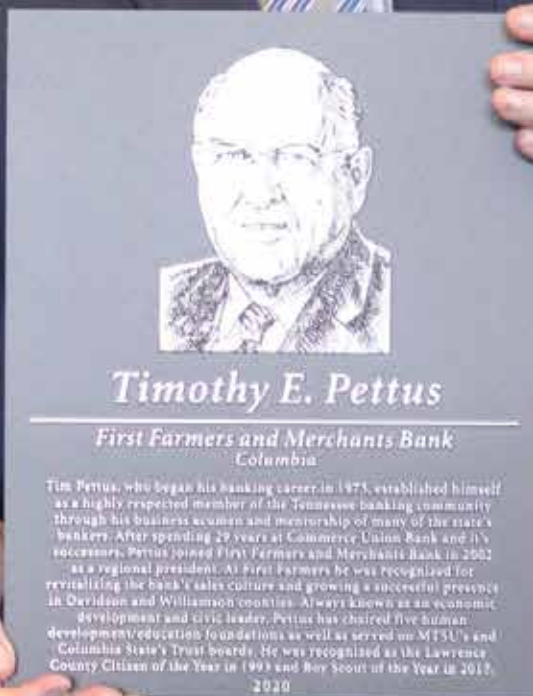


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The importance to lenders of standard mortgage clauses in insurance policies



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With all of the changes caused by COVID-19, it is easy to forget that Middle Tennessee was buffeted by tornadoes in early March 2020. Tornadoes are usually a covered casualty in property and casualty insurance policies. A lienholder bank seeking to protect its interests in collateral following such disasters should make sure that the borrower's insurance policies provide the best possible protection to the lienholder.

There are two types of insurance policy provisions designed to protect the interests of a lienholder bank—the “simple/open” and the “standard mortgage” clauses. As discussed below, ordinary residential homeowners' policies are more likely to enjoy the elevated protection of the latter than are policies covering other types of collateral.

Simple/Open Clause

A “simple/open clause” provides that the lienholder's rights are no greater than the insured borrower's rights. Under a simple/open clause, the rights of the lienholder are “wholly derivative, and cannot exceed those of the [insured,]” so the lienholder stands in the insured's shoes and is subject to the same defenses available to the insurance carrier.¹ If the insured borrower does something to invalidate the policy—such as fraud, waste or intentionally damaging the collateral—the lienholder has no rights under the policy.² Cases indicate that a “loss payee”—often used in personal property insurance—merely derives rights through the insured. The word “mortgage” often comes closer to denoting a consensual lienholder's separate insurable interest.

For obvious reasons, insurance carriers

prefer to limit potential liability by including simple/open clauses in any policy.

Standard Mortgage Clause, a/k/a Standard/Union Clause

To ensure that a lender's remedies are more robust, the lender should insist that the borrower acquire insurance with a “standard mortgage clause.” Under a “standard mortgage” or “standard/union” clause, lienholder coverage is provided regardless of the actions of the borrower.³ Thus, the lienholder “will be paid for a covered loss notwithstanding the [carrier's] right to deny the [...] claim based upon the named insured's acts or noncompliance.”⁴

The primary function of a standard mortgage clause is “to furnish to the [lienholder] a reliable security in a definite sum free from any interference on the part of the [insured borrower].”⁵ “To accomplish this purpose, specific language is included in the [policy] to prevent the policy from being invalidated by the insured's acts or neglect.”⁶ Tennessee is among those jurisdictions that recognizes the “chief distinction between the two types of clauses is that the standard/union clause establishes a contract between the insurer and [lienholder]” which cannot be invalidated by the actions of the insured borrower.⁷

In the lead Tennessee case, *U.S. Bank v. Tennessee Farmer's Mutual Insurance Company*⁸, the Tennessee Supreme Court found that the following language created a standard/union clause:

protect the [Bank's] interest in the insured building. This protection will 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 [Bank] has no knowledge of these conditions.


The threshold notion is that the insurance policy confers to the lienholder (or loss payee, often in the case of personal property) greater rights than those conferred to the named insured.

Impact of Tenn. Code Ann. § 56-7-804

The main holding of U.S. Bank is that commencement of a foreclosure does not constitute a change in risk that necessitates the mortgagee to inform the carrier about the foreclosure.⁹ But U.S. Bank is important for two other, more subtle, reasons: First, it strongly suggests that Tennessee Code Annotated § 56-7-804 creates a standard mortgage clause that must be read into every policy of “fire” insurance, particularly in homeowners’ policies¹⁰ Second, it may also suggest that this implicit standard mortgage clause applies to all property and casualty policies.¹¹ That is a conclusion most lenders will not want to test with the blunt and expensive instrument of litigation; it is far better to pay for an ounce of

prevention on the front end and ensure that the lender is covered by a standard mortgage clause in its loan documents and closing package requirements.

Next Steps

If you have any questions about loan documentation, please do not hesitate to call or email our commercial, C&I, CRE and consumer lending attorneys at www.stites.com to find the answers to your questions. 

REFERENCES

- 1 U.S. Bank v. Tennessee Farmer’s Mutual Insurance Company, 277 S.W.3d 381, 387 (Tenn. 2009).
- 2 Id.
- 3 Id.
- 4 Id.
- 5 Id.
- 6 Id. at 388
- 7 Id.
- 8 Id.
- 9 277 S.W.3d at 393.
- 10 277 S.W.3d at 391.
- 11 Id.

Homeowners sort through debris following a deadly tornado Wednesday, March 3, 2020, in Cookeville, Tenn. Although the pandemic has overshadowed the tornadoes that tore through Tennessee in early March, this event reminds borrowers to be aware of the two types of insurance policy provisions designed to protect the interests of a lienholder bank—the “simple/open” and the “standard mortgage” clauses.

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