

## **STANDARD OR OPEN? A BRIEF PRIMER ON INSURANCE DESIGNATIONS**

All banks routinely require lenders to insure collateral for the benefit of the bank. However, bankers often do not know the difference between insurance endorsements and designations on policies obtained by borrowers. This article will briefly examine several of the more common types of insurance endorsements and designations and make suggestions regarding the type of language bankers should require in policies obtained by borrowers.

### ***Real Property***

Generally speaking, there are two types of mortgage provisions for insurance policies: (i) an open mortgage clause or loss-payable clause ("Open Clause"), and (ii) a standard mortgage clause, or union clause ("Standard Clause").<sup>1</sup> An Open Clause usually states the lender shall be paid as its "interest may appear." This means an Open Clause makes the lender a mere appointee of policy proceeds. In other words, the borrower's acts can defeat the lender's right to recover under the policy. For instance, if the borrower commits arson, the lender would not receive any insurance proceeds from a subsequent loss.

The Standard Clause, on the other hand, creates a separate contract of insurance between the insurer and the lender (therefore, this clause creates essentially two separate contracts of insurance: (i) a contract between the insurer and the lender, and (ii) a contract between the insurer and the borrower). The Standard Clause usually states the lender's rights "shall not be invalidated by any act or neglect of the mortgagor or owner of the

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<sup>1</sup> John W. Steinmetz, Stephen E. Goldman and David F. Sullivan, *The Standard Mortgage Clause in Property Insurance Policies*, 33 Tort & Ins. L.J. 81 (1997).

within described property. . ." Consequently, the borrower's acts generally have no impact on the lender's right to recover under the policy.

Unfortunately, there are numerous forms used by insurance companies. Each form defines endorsements or designations differently. In Arkansas, the principal policy forms used by most insurers come from ISO Properties, Inc. ("ISO Forms"). ISO Properties, Inc. produces policy forms which the company then takes before the Arkansas Insurance Department for approval. Other companies, such as the Association for Cooperative Operations Research and Development ("ACORD"), use ISO Forms as the basis for other products. For instance, ACORD uses policy forms generated by ISO to create point of sale documents such as applications, policy binders and certificate forms, which ACORD then sells to insurers. According to an ACORD representative, all ACORD products are based on ISO Forms.

An ISO Form's typical mortgagee designation is a Standard Clause designation. In fact, the current ISO Form does not have an Open Clause designation option on its regular forms. However, a borrower could receive insurance from a company using an alternative form. This is particularly true if a borrower is an insurance risk. A bank should review the policy forms behind the insurance certificates supplied by borrowers to be sure they include a standard mortgagee clause, as such term is defined in an ISO Form.

This issue has also been addressed in Arkansas case law. The Arkansas Supreme Court has observed the difference between a Standard Clause and an Open Clause. The court pointed out, "[t]he essential element of a standard mortgage clause is that it, in effect, provides that the policy, as to the interest of the mortgagee, shall not be invalidated by any act or neglect of the mortgagor, whereas the open clause contains no

such provision. . . .under an open clause, the rights of the mortgagee [are] no greater than those of the insured." *Lucas County Bank of Toledo, Ohio v. American Casualty Company*, 256 S.W.2d 557, 558 (Ark. 1953).

The Arkansas Supreme Court discussed Standard Clauses in a recent decision.<sup>2</sup> *See Farmers Home Mutual Fire Insurance Co. v. Bank of Pocahontas*, 2003 Ark. LEXIS 624 (Nov. 20, 2003). The court noted, "[A] standard mortgage clause serves as a separate contract between the mortgagee and the insurer, as if the mortgagee had independently applied for insurance. Thus, the rights of a named mortgagee in an insurance policy are not affected by any act of the insured, including improper and negligent acts." In the *Bank of Pocahontas* case, the insured borrower failed to pay the required premium. The insurance company sent three notices to the borrower informing him of the deficiency and threatening to cancel the policy. The insurance company also sent a copy of the letters to the bank. The bank took no action and the insurance company canceled the policy. Shortly thereafter, the borrower's house burned down. The bank sued the insurance company to demand payment claiming the insurance company improperly canceled the policy by not making demand on the bank to pay the premium. The insurance company claimed the three letters copied to the bank constituted sufficient demand and notice on the bank. However, the court ultimately sided with the bank and

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<sup>2</sup> The "standard mortgage clause" language in this case stated:

This clause applies only to the mortgagee . . . and does not affect the insured's rights or duties. Declarations page of this policy, as interests may appear, under all present or future mortgages upon the property herein described in which the aforesaid may have an interest as mortgagee . . . , in order of precedence of said mortgages, and this insurance as to the interest of the mortgagee . . . only therein, shall not be invalidated by any act or neglect of the mortgagor or owner of the within described property . . . ; provided, that in case the mortgagor or owner shall neglect to pay any premium due under this policy, the mortgagee . . . shall, on demand, pay the same.

agreed the insurance company had an obligation to make a direct, formal demand for payment on the bank.

### ***Personal Property***

A mortgagee clause only insures a bank on the real estate and fixtures securing the loan, and then only to the extent of the bank's insurable interest. The policy must list the bank as a loss payee on the policy to be insured against personal property losses.<sup>3</sup> On a standard ISO Form, all parties to the policy other than the insured and the insurer are designated a "Loss Payee." However, the form allows the insurer to select one of three provisions for the Loss Payee: (i) Loss Payable; (ii) Lender's Loss Payable; or (iii) Contract of Sale. The Contract of Sale designation only applies to the person with whom the insured has entered a contract for the sale of the applicable property. Therefore, the Contract of Sale designation is inapplicable to lenders. The Loss Payable designation is the personal property equivalent of an Open Clause designation. The Lender's Loss Payable designation is the personal property equivalent of a Standard Clause designation. A bank should require a Lender's Loss Payable designation on the policy, as such term is defined in a standard ISO Form.

Lenders have to be more careful in the personal property context. While case law recognizes a lender is protected from the bad acts of a borrower under a standard mortgagee clause, the same is not true for personal property. When dealing with personal property, such as vehicles, the courts typically note whether the policy states the lender is

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<sup>3</sup> Often, standard commercial real estate insurance policies define the real estate to include personal property closely associated with the real estate. For example, a policy on a printing factory may include the printing machines even though they may be readily moveable and legally classified as non-fixture personal property. A mortgagee clause will cover personal property to the extent such property is defined by the policy as included in the real estate. A bank should check with the insurance company issuing the policy to determine which items are included in each individual policy.

covered notwithstanding the bad acts of the borrower. *See, e.g., Newcourt Fin., Inc. v. Canal Ins. Co.*, 15 S.W.3d 328, 329 (Ark. 2000) and *U.S. Fid. & Guar. Co. v. Moore*, 346 S.W.2d 524, 524 (Ark. 1961). Absent such an express designation, a court is likely to find the lender's interest is limited by the borrower's right to recover.

### ***Policy Certificates***

Every bank's loan review department should carefully review the underlying policy's obtained by borrowers. In addition, prior to closing a loan, a bank should obtain an insurance policy certificate evidencing coverage. The insurance certificate policy should include the following language:

The named mortgagee's [and/or the named loss payee's] rights under the policy are those of an additional insured and not merely an interest derived from the insured either as the designated recipient of the insurance proceeds or as an assignee of an insured's chose in action against the insurer. The rights of the named mortgagee [and/or the named loss payee] shall not be affected in any way by any act of the insured, including without limitation improper or negligent acts or omissions.

If necessary, banks should amend their standard loan agreements to require borrowers to provide the appropriate endorsements on policies acquired by the borrowers.

### ***Conclusion***

This article provides an overview of the most common insurance endorsements and designations to protect lenders with real and personal property collateral. However, this article does not present all the possible variations of endorsements. Furthermore, insurance companies do not uniformly apply the same terms for similar endorsements,

leading to confusion and misunderstandings. Banks should always take the time to discuss the endorsements with the insurance agent prior to closing the loan to be sure the policy adequately and properly protects the bank. Banks should focus less on the label given an endorsement and more to the underlying substance of the endorsement. If an endorsement is unclear, banks should question the insurance agent, ask for written clarifications and, when appropriate, seek legal consultation to help clarify the coverage provided by an endorsement.