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Lenders beware: Your language can be costly

July 16, 2014 | **ARTICLES**

here is a very subtle but significant distinction between naming a secured lender as a "lender's loss payee" instead of a "loss payee" that lenders should be aware of.

In secured lending transactions lenders go to great lengths to protect their collateral. Lenders routinely require that their borrowers properly insure all collateral to preserve the value of the collateral. In addition, secured lenders require that each insurance policy (for non-real estate collateral) name the lender as an additional insured and as a lender's loss payee to further protect the lender's rights in the collateral.

However, in the rush to the closing table, many lenders will accept insurance certificates naming them as a loss payee. Recent case law has highlighted that being named as a "lender's loss payee" instead of a "loss payee" could be the difference between a secured lender being able to enforce an insurance policy or recovering nothing under an insurance policy.

A recent case affirmed by the Sixth Circuit (Westfield Ins. v. Talmer Bancorp 2013 WL 5812027, October 30, 2013) stated that a secured lender named as a loss payee on a borrower's insurance policy is not afforded certain rights that are available to a lender's loss payee as a result of borrower fraud. Being named as a loss payee under a borrower's insurance policy does not provide a secured lender any independent rights of recovery if an insured borrower breaches the terms of its policy.

A breach (and subsequent voiding of a policy) can occur for any number of reasons including, but not limited to, fraud, intentional destruction of property or a failure to provide proof of loss. As a "loss payee" a lender is only viewed as an appointee to receive insurance funds to the extent of its interest and a breach by the policyholder prevents recovery by a lienholder. As a "lender's loss payee" a lender is generally able to enforce a policy even if the policy if voided as a result of actions taken by the borrower (Westfield, 2013 WL 5812027 at page 2).

In the Westfield case, the borrower's insurance policy named People's State Bank (the "Bank") as "loss payee" with respect to inventory and "mortgagee" with respect to a warehouse. After the warehouse was burglarized, the borrower made a claim for recovery for certain damage to the warehouse and stolen personal property. Westfield Insurance Company ("Westfield") requested a sworn proof of loss statement. Borrower submitted its claim and proof of loss listing the Bank as mortgagee only and specifically indicated that no party held a security interest in the inventory that was stolen. Westfield issued two checks, one payable jointly to the borrower and the Bank for the damage to the warehouse (per the mortgagee clause) and one payable to the borrower only for the value of stolen inventory.

The Bank challenged the payment to the borrower for the value of stolen inventory citing that it was named as "loss payee" and that the check should be re-issued and payable to borrower and Bank jointly. Westfield refused and

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filed for declaratory judgment based upon the fact that the borrower fraudulently misrepresented the Bank's interest thereby voiding the insurance policy. The district court agreed with Westfield and the Sixth Circuit affirmed. The borrower's fraud (i.e. misrepresenting the Bank's security interest (or lack thereof) in the inventory) voided the policy and consequently the Bank's right to recover under the policy.

Had the bank been named as a lender's loss payee, it would have been able to enforce the policy, despite the fact that it was voided, and recover under the policy for the value of the stolen inventory.

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