

REAL ESTATE AND FIRST PARTY COVERAGE ISSUES  
An Introduction

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## I. First Party Coverage

- a. The Obvious -- First party coverage focuses not on liability to a third party arising from conduct emanating from a property, but on the property itself and protecting a person or entity that has a stake (*i.e.* insurable interest) in the value of the property from any diminishment in the value of the property. ***In the additional insured context, the goal is to protect the additional insured's stake in the property with someone else's coverage.***

## II. Insurable Interest Requirement for Coverage

- a. A person has an insurable interest in property when, “he would profit by or gain some advantage by its continued existence and suffer some loss or disadvantage by its destruction.” *Phillips v. Cincinnati Ins. Co.* 60 Ohio St. 2d 180, 181 (Ohio 1979).

- b. Insurable interest is sometimes defined by statute:

“‘Insurable interest’ as used in this Section means any lawful and substantial economic interest in the safety or preservation of the subject of the insurance free from loss, destruction, or pecuniary damage.” LSA-R.S. 22:614(B)

- c. Requirement that one must have an insurable interest in the covered property to be given a claim to the insurance proceeds. Without insurable interest, contract is deemed a void wager.

“An insurable interest is the relationship or connection a person must have with the subject matter of an insurance policy in order to insure it. The insurable interest doctrine developed over the course of several centuries in response to certain public policy concerns related to insurance. The foremost historical justification for the insurable interest requirement was to prohibit wagering contracts in the guise of insurance. Odd as it may strike us today, insurance as an instrument of wagering was a common and accepted practice in mid-eighteenth century England. Parliament, responding to the pernicious effects of this practice, passed a series of statutes beginning in the middle of the eighteenth century requiring as a prerequisite for the validity and enforceability of an insurance contract that the insured have an interest in the contract's subject matter. While the historical anti-wagering foundation of the insurable interest doctrine remains valid, other public policy objectives have greater resonance today. The distinction between wagering and insurance is now so firmly established in public perception, that the justification for the insurable interest doctrine

is more readily apprehended today as the prevention of unproductive and wasteful commercial transactions, the limitation of insurance to true indemnity, and the deterrence of the fraudulent destruction of insured property.” *Delk v. Markel American Ins. Co.*, 81 P.3d 629 (Okla. 2003)

“Requirement of an insurable interest in insured property is for purpose of preventing use of insurance as a means of wagering, since one who has no protectable interest in insured project is not allowed to gamble upon the possibility of its destruction.” *Nelson v. New Hampshire Fire Ins. Co.*, 263 F.2d 586 (9th Cir.1959).

- d. Potential Additional Insureds who could have insurable interest:
1. An entity with custody or possession of the property coupled with economic interest (*e.g.*, lessor, tenant, bailee).
  2. The property owner.
  3. Mortgagor, mortgagee or secured creditor (including judgment creditor)– up to the amount of the security interest. *Altus Bank v. State Farm Fire and Cas. Co.*, 758 F.Supp. 567, 571 (C.D.Cal.1991) *affd*, 979 F.2d 854 (9th Cir. 1992) (under California law, “[a] mortgagee's insurable interest under an insurance policy is limited to the amount of the debt”).
  4. Assignee. *See Dorman & Wilson, Inc. v. General Acc. Ins. of Amer.*, 133 F.3d 906 (2d Cir. 1997) (unpublished) (“However, an insurable interest can be assigned, and an assignment of a mortgage or insurable interest terminates the assignor's, but creates the assignee's, rights to insurance proceeds.”).
  5. Guarantors or sureties.
  6. Contractors and sub-contractors. Those who have performed work on the property may have an insurable interest to the extent they have not been paid for the work.
  7. Purchaser prior to close of escrow. Prospective purchase w/option.
  8. Spouse. Depending on the manner in which the property is held (*e.g.*, community property, property held in trust).
  9. Partners of partnership.

10. Shareholders. *See Providence Washington Ins. Co. v. Stanley*, 406 F.2d 735 (5th Cir. 1969).
  11. For discussion of insurable interest in context of contaminated property, see presentation by Rod Taylor.
- e. Insurable interest broader than mere ownership interest.
- “The clear holding of this decision of the Supreme Court of the United States is that an insurable interest in a thing, does not require title or a security interest. By not requiring any ownership interest in the property, the Court was able to envision a multitude of relationships that create insurable interests, including ‘agent, factor, bailee, carrier, trustee, consignee, mortgagee, and every other lien-holder.’” *ABB Power T & D Co., Inc. v. Gothaer Versicherungsbank VVAG*, 939 F.Supp. 1568 (S.D. Fla 1996) quoting *Hooper v. Robinson*, 98 U.S. 528, 538 (1878).
- f. Exceptions to insurable interest:
1. The interest must be a lawful and enforceable right.
  2. Example -- Mortgagee with usurious rate contract.  
  
“Because, however, a usurious mortgage is void, and the mortgagee, therefore, has no right to collect principal or interest, no loss will occur if the property is destroyed.” *Focus Inv. Assoc. Inc. v. American Title Ins. Co.*, 992 F.2d 1231 (1st Cir. 1993) citing *Phalen Park State Bank v. Reeves*, 312 Minn. 194 (Minn. 1977).
  3. Unsecured creditor.
  4. Contingent interest may or may not create an insurable interest. *See* Cal. Ins. Code §283 (“A mere contingent or expectant interest in anything, not founded on an actual right to the thing, nor upon any valid contract for it, is not insurable.”); *but see Booker T. Theater Co. v. Great American Insurance Co. of New York*, 369 Mich. 583 (1963), (held that a mortgagee or lienholder had an insurable interest as to a contingent indebtedness).
  5. Escrow company has no insurable interest. *Lewis v. Shawnee State Bank*, 226 Kan. 41 (1979).

- g. Timing of insurable interest for valid claim:
  - 1. At time of procurement of insurance. *Allstate Ins. Co. v. McGee*, 157 Ga. App. 53 (1981).
  - 2. At time of loss. *Century Corp. v. Phoenix of Hartford*, 157 Mont. 16 (Mont. 1971).
  - 3. Both at time of procurement and at time of loss. Some jurisdictions require insurable interest at both periods. *Belton v. Cincinnati Ins. Co.*, 577 S.E. 2d 487 (SC App. 2003).
  
- III. Protecting a party that has an insurable interest in the property through another's insurance.
  - a. Various forms of coverage endorsements:
    - 1. Additional Insured endorsement – more common in general liability or builder's risk context.
      - i. No standard form for first party property coverage, as opposed to liability coverage.
      - ii. Importance of wording. Scope of protection, amount of protection.
      - iii. Additional insured provision used primarily where coverage is being added for an entity after the issuance of the policy or where the additional insured has an interest in only part of the property:
    - 2. Loss Payable Endorsement – more common in context of first party property coverage.
      - i. Simple or open loss payee clauses (aka ordinary loss payable clause) – under this type of clause lienholder's right of recovery is no greater than the policyholder's right and is subject to any defenses that could have been raised against policyholder or any other insured.
      - ii. Standard or union loss payee clauses (aka lender's loss payable clause or standard mortgage clause) – creates privity of contract between loss payee and insurer and shields lienholders from defenses insurer might have

against policyholder or other insurer. Can cover both real and personal property.

“Mortgage clauses fall into two forms, the open or simple mortgage clause and the standard or union mortgage clause. The simple mortgage clause merely provides in effect that the proceeds of the policy shall be paid first to the mortgagee as his interest may appear; but the so-called standard or union mortgage clause is somewhat more specific in that it also provides that the mortgagee shall be protected against loss from any act or neglect of the mortgagor or owner, so that it shall not defeat the insurance so far as the interest of the mortgagee is concerned.” *May v. Market Insurance Company*, 387 So.2d 1081 (La. App. 1980) citing Couch on Insurance § 42:648 (2d ed. 1963).

- iii. Burden to demonstrate type of loss payee clause may be placed on loss payee. *In re Rose Investments, Inc.*, 1996 WL 596328 (Bankr. N.D. Ill. 1996) (“Standard or union loss payee clause “substantially enhances the risk exposure of an insurer. Those seeking its protections bear the burden of proving that they have sought and obtained such coverage.”).

3. Mortgage Clause:

- i. ISO provides mortgage holders standard provision that includes: mortgage holders exclusive right to payment, coverage for mortgage holder even in event where insured would not be covered, and the right to notice of cancellation of the policy

4. Distinctions between the types of coverage afforded by these provisions:

- i. Unlike standard or union loss payee clauses, additional insured provisions tend not to provide the additional insured with coverage in the event of acts by the named insured that negate coverage. Mortgage clause provides coverage despite insured’s conduct.
- ii. Mortgage clause typically provides for exclusive payment to mortgagee. Loss Payee clause can provide for exclusive payment to loss payee or shared rights with insured.

Additional Insured clause typically provides insured the right to share in proceeds of insurance.

- iii. Mortgage clause and certain loss payee clauses provide for notice to mortgagee and loss payee. Additional Insured and simple loss payee endorsement do not provide for notice.
  - iv. Potential advantage of being additional insured rather than loss payee is limitation of insurer's subrogation rights. This issue arises often in the builder's risk context. See discussion below.
- b. Landlord -- Lease requiring procurement of insurance and inclusion as loss payee or additional insured. Be specific as to dollar amounts, identification of additional insured, proof of insurance, and notice of amendments or cancellation of policy. Seek the broadest coverage grant, including coverage for landlord's own negligence.
1. States may also have insurance requirements. See Cal. Civ. Code §1940.5 (landlord cannot refuse to rent to tenant with waterbed provided tenant procures property damage insurance, among other things).
- c. Purchaser – request proof of being added on seller's policies as additional insured or proof that policy affords coverage for prospective buyer. Review policies to ensure sufficient coverage in case of fire or other event that could destroy property. Determine whether policy provides for actual cost or replacement value. There should be a contract of sale provision available that would cover the prospective buyer.
- d. Mortgagee or other lienholder.
1. Covenant in deed of trust, mortgage, or other security instrument regarding protection of security interest, such as the procurement of fire insurance policy payable to beneficiary. See *Lee v. Murphy*, 253 Cal. App. 2d 205 (1967).
  2. Policy should provide that payment be made to mortgagee not policyholder – *i.e.*, loss payable provision.
  3. Coverage should apply even in event where policyholder's claim would otherwise be denied.
  4. Require notice regarding policy termination or any other substantive change to policy, such as limits.

5. Require proof of insurance in dollar amount sufficient to cover mortgagee's interest in property plus any other interest in property that might have higher priority.
  6. Difference between standard mortgagee and additional insured clause is that mortgage clause affords mortgagee more protection vis-à-vis notice, payment in event of loss, and coverage where the insured would not otherwise have coverage.
  7. Senior lienholders entitled to proceeds of insurance prior to junior lienholders.
  8. Expressly state the type of hazard coverages to be provided: *i.e.*, fire, flood, earthquake or have a broad provision requiring lienholder to be named loss payee on all insurance procured. Failure to require certain types of peril coverage or the right to share in its proceeds may limit lienholder's right to proceeds in event of peril. *See Foothill Village Homeowners Assn. v. Bishop*, 68 Cal. App. 4th 1364 , 1373 (1999).
  9. ISO form mortgage clause available. See ISO Building and Personal Property form.
- e. Contractors and Sub-contractors. Key issues include: (i) subrogation in the event property damage arises from entity's negligence, (ii) rights to defense coverage, and (iii) providing indemnity and hold harmless protection otherwise invalidated by statute or court.

IV. Potential Coverage Issues Associated with Additional Insured and Loss Payee Provisions.

- a. Defining the Additional Insured or Loss Payee.
  1. Ensure that the proper entities are identified.
  2. Ambiguities in favor of coverage.
- b. Failure to add additional insured or loss payee. Still may have coverage as third-party beneficiary – *i.e.*, contract intended for additional insured's or loss payee's benefit. *See Alexander v. Security-First Nat'l Bank of Los Angeles*, 7 Cal. 2d 718, 724 (1936) (equitable lien rights).
- c. Other Insurance Clauses. In event that other policies potentially respond, various "other insurance" clauses could be at issue providing numerous

allocation scenarios based, in part, on the jurisdiction interpreting the contracts of insurance.

1. Pro rata sharing of the loss
  2. Excess clauses
  3. Escape clauses
  4. Take steps to insure Additional Insured of Loss Payee coverage applies first by adding endorsement on own coverage making it excess to additional insured coverage or having insurer waive rights to access other insurance.
- d. Sufficiency of Limits.
1. Replacement Cost – the amount to repair, rebuild or replace the property.
  2. Actual Value – typically replacement cost minus depreciation.
  3. Be wary of provisions that reduce coverage to actual value where repair or replacement is not carried out within reasonable time: See e.g. *National Tea Co. v. Commerce and Industry Ins. Co.*, 119 Ill. App. 3d 195 (1983).
  4. Dilution of limits by other entities entitled to insurance coverage. Seek exclusive or priority rights to insurance. See discussion above regarding the difference between Loss Payable, Mortgagee, and Additional Insured clauses.
- e. Election of remedies, deficiency judgment statutes and extinguishment of obligation through foreclosure.
1. Certain foreclosure actions taken by mortgagees may extinguish the underlying obligation and mortgagee's rights under loss payable provisions. For discussion, see *Bohn v. Louisiana Farm Bureau Mutual Ins. Co.*, 482 So. 2d 843 (La) writ den'd, 486 So. 2d 750 (La. 1986).
- f. Subrogation in Builders' Risk Policies.
1. Where policy covers materials, but does not identify entity as additional insured, insurer may retain subrogation rights. *St. Paul*

*Fire & Marine Ins. Co. v. L.E.S. Subsurface Plumbing Co., Inc.*,  
699 N.Y.S. 2d 31 (1999)

2. Where builder's risk policy adds subcontractor as additional insured, insurer usually cannot seek subrogation from subcontractor's policies. *Chubb Ins. Co. v. DeChambre*, 2004 WL 583198 (March 24, 2004) (unpublished); *Baugh-Belarde Constr. Co. v. College Utilities Corp.*, 561 P.2d 1211 (Alaska 1977).
3. Possibility of having insurer waive subrogation rights.
4. For thorough discussion of subrogation in the context of builder's risk policies, see "Insurance Subrogation of Insurer Compensating Owner or Contractor for Loss Under 'Builder's Risk' Policy Against Allegedly Negligent Contractor or Subcontractor," at 22 A.L.R.4th 701.