Navigating Hazard Insurance Proceeds: Lender Rights in Reverse Mortgage Foreclosures

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In July 2023, the Appellate Court of Maryland held, as a matter of first impression, that a reverse mortgage foreclosure sale did not extinguish a servicer's right to insurance proceeds. The decision came in the case of *Celink v. Estate of William R. Pyle*.

Case Background

In the case (*Pyle*), a fire destroyed a home subject to a reverse mortgage deed of trust, which then became due and payable as a result of the borrower's demise. On behalf of the secured party, the servicer foreclosed and purchased the property at foreclosure for less than the balance due on the loan. A dispute arose over how proceeds from a fire insurance policy on the property should be allocated between the borrower's estate and the secured party.

Provisions of the Deed of Trust

A provision of the Deed of Trust provided that the borrower was required to maintain fire insurance on any improvement located on the property. This provision also stipulated that if there is a loss, and restoration or repair of the property was not economically feasible, the policy proceeds were to be applied to the balance due on the note, with any excess to be paid "to the entity legally entitled thereto."

A second provision of the Deed of Trust provided that the debt can only be enforced through the sale of the property and prohibited the secured party from obtaining a deficiency judgment in the event of foreclosure.

Disputes Over Proceeds

At the foreclosure auction, the trustees purchased the property for $175,000, which was $208,108.25 less than the balance due on the loan and the costs of sale. After the foreclosure sale, the insurer of the property issued a check for the proceeds of the insurance policy in the amount of $287,531.47. The check was payable jointly to the borrower's estate and the servicer. The borrower's estate filed a civil action seeking a declaration that the insurance proceeds were payable to it.

Legal Precedents and Principles

The loss before foreclosure rule in Maryland is outlined in Thomas Adm'rs v. Vonkapff's Ex'rs. The mortgage at issue in that case stated that the borrower would maintain fire insurance on all of the improvements on the secured property and that, in the event of a loss, policy proceeds shall be immediately applied to the rebuilding so that the lender shall in case of loss by fire, be benefitted by such insurance, or participate in the benefit thereof, to the extent of his aforesaid lien.

Court's Analysis and Decision

The Court recognized that, under the literal terms of the mortgage, the insurance proceeds were to be used to repair or rebuild the damaged improvements. The Court concluded that (1) a covenant in a mortgage requiring the borrower to provide fire insurance for the secured property was for the benefit of the lender and its assignees, (2) any claim by the borrower or his successors-in-interest to the policy proceeds was "subject to the [lender's] equity," (3) the lender had the right to enforce its interest, and (4) the lender's right to do so stemmed from fundamental principles of equity and fairness.

Comparative Legal Perspectives

In *Rollins v. Bravos*, the Maryland court observed that in Maryland, "where a mortgage requires the mortgagor to insure the property against loss and the property is so insured when a loss occurs as to which the insurance applies, the proceeds of the policy of insurance must be applied to the extinguishment of the debt."

In *Wheeler & Co. v. Factors & Traders Ins. Co. of New Orleans*, the Court stated that "if the mortgagor is bound by covenant or otherwise to insure the mortgaged premises for the better security of the mortgagee, the latter will have an equitable lien upon the money due on a policy taken out by the mortgagor to the extent of the mortgagee's interest in the property [is] destroyed." The Wheeler Court noted at that time that the Thomas case was the leading case in this country on this issue.

Modern Interpretations and Restatement

The principles enunciated in *Thomas* and *Wheeler* are fully consistent with the leading modern case on this topic. The reasoning behind court decisions is reflected in the American Law Institute's Restatement (Third) of Property (Mortgages) (2007). The basic principle is set out in Restatement §§ 4.7–4.8. Section 4.7 states in relevant part (emphasis added):

Mortgagee's Right to Funds Paid Under Casualty Insurance or Taking in Eminent Domain

(a) Unless a different disposition is provided in the mortgage, the mortgagee has a right to the following funds paid on account of loss or damage to the mortgaged real estate, to the extent that the mortgagee's security has been impaired by the loss or damage …:

(1) the proceeds paid by a casualty insurer due to the occurrence of an insured loss to the real estate, if the mortgagor promised the mortgagee, in the mortgage or otherwise, to purchase the insurance[.]

Restatement § 4.8 states in relevant part (emphasis added):

Effect of Foreclosure on Mortgagee's Right to Insurance and Eminent Domain Proceeds

(a) Where a mortgagee has a right to foreclose a mortgage because the mortgage obligation is fully due and payable and the mortgagee has a right to casualty insurance or eminent domain proceeds under § 4.7, the mortgagee may either:

(1) recover from the insurance proceeds …; or
(2) foreclose on the mortgaged real estate and, to the extent that doing so does not satisfy the mortgage obligation, recover the balance from the insurance proceeds or from the eminent domain award.

Comment a to Restatement § 4.8 is particularly pertinent. It explains (emphasis added):

In the event of an insured casualty loss, the mortgagee may satisfy the mortgage obligation by two different means. It may recover on the insurance policy, up to its limits, the full amount of the mortgage obligation at the time of the loss … Alternatively, the mortgagee may proceed first to foreclose the mortgage. When this approach is followed, and the foreclosure sale does not yield the full amount of the mortgage obligation, the balance may be recovered under the insurance policy, up to its limits.

The Takeaway

In the intricate dance between property loss and foreclosure, one thing is clear: when unforeseen circumstances occur, insurance proceeds offer a valuable layer of security to a lender.

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