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Contract Fairness Requirements and Lender-Placed Insurance

Many states have a requirement that contracting parties treat each other with a minimum amount of fairness. Sometimes that requirement takes the form of a court's refusal to enforce "unconscionable" clauses in a contract. *Schnuerle v. Insight Communications*, 376 S.W.3d 561 (Ky. 2012). And sometimes the fair treatment requirement is imposed by the routinely applied contractual obligation of "good faith and fair dealing." *Littlejohn v. Parrish*, 163 Ohio App.3d 456, 460-1 (Hamilton Cty. App. 2005) ("An Arizona appellate court has held, '[I]n every agreement there is an implied covenant of good faith and fair dealing so that neither party may do anything that will injure the rights or interests of another party to the agreement.' And the California Supreme Court has recognized that '**[w]here a contract confers on one party a discretionary power affecting the rights of the other, a duty is imposed to exercise that discretion in good faith and in accordance with fair dealing.**' Numerous other state supreme courts have held that there is an implied duty of good faith and fair dealing in every contract. Some courts have relied on the Restatement Second of Contracts, which states, 'Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.' The Supreme Court of Connecticut has adopted the Restatement view.").[1] (bold added, citations omitted).

This post explores the application of the "good faith and fair dealing" requirement to lender-placed insurance situations. "Lender-placed", "creditor-placed", or "force-placed" insurance is an insurance policy obtained by a mortgage servicer to cover collateral when the borrower/owner's insurance has lapsed or is inadequate. For the uninitiated, a helpful definition can be found in the Real Estate Settlement Procedures Act at 12 U.S.C. Section 2605(k)(2) which states "... the term 'force-placed insurance' means hazard insurance coverage obtained by a servicer of a federally related mortgage when the borrower has failed to maintain or renew hazard insurance on such property as required of the

borrower under the terms of the mortgage.”

In my experience, virtually all mortgages require borrowers to maintain adequate insurance on their property. If the policy lapses or is canceled and the borrower does not secure adequate replacement coverage, most mortgages allow the lender to purchase insurance for the collateral and “force-place” it at borrower’s cost. These standard provisions allow the lender to protect its financial interest in the property (its collateral).^[2]

The lender-placed insurance business has attracted attention in recent years. The attention has primarily focused on the rates charged for lender-placed policies and whether insurers and lenders are making excess profits.^[3] Lender-placed insurance premiums may be much higher than the property insurance the borrower could have purchased on its own. In addition to being more expensive, the lender-placed insurance policies may offer less coverage by not covering the borrower’s personal property or providing liability coverage. So, the lender may be in a position to (i) spend more of the borrower’s money on insurance than appears to be required, (ii) generate profit, and (ii) get the borrower less coverage than was provided by the insurance the borrower secured directly. This situation is ripe for abuse that generates a sense of unfairness.

With that background, consider this common situation: a borrower’s property insurance lapses or is cancelled and so the lender obtains forced-placed insurance covering only the lender’s interest in the collateral. A foreclosure action is filed. In its answer, the borrower contests the insurance premium charges as pleaded by the lender as part of its damages, while also counter-claiming for breach of the lender’s duty good faith and fair dealing.^[4] These pleadings give borrower’s counsel an opportunity to assert that lender’s strict compliance with the contract’s words is not all that is required and so typical contractual summary judgment processes are not applicable because the case is not a mere legal issue of contract construction. Beyond the increased difficulty in winning summary judgment based on contract language, lender’s counsel may find it is more difficult to easily win dismissal of borrower’s counter-claim using certain common defenses because “it has been expressly

held that [borrowers'] claims [related to forced-placed insurance] for breach of the implied covenant of good faith, and unjust enrichment, are not preempted by the National Bank Act." Wall, Litigation and Prevention of Insurer Bad Faith, Third Edition (July 2019 Update) section 11.25 titled *Defenses in force-placed insurance cases*;[5] citing *Williams v. Wells Fargo Bank*, 2011 WL 4901346 (U.S.D.C. S.D. Fla. Oct. 14, 2011) ("Plaintiffs' allegations that Wells Fargo Bank, a party to the mortgage contracts, acted in bad faith in contravention of Plaintiffs' reasonable expectations under those contracts, sufficiently allege a claim for breach of the implied covenant.")

Borrowers alleging that the lender breached its duty of good faith and fair dealing are using many of the same words as contract parties who make other equitable "fairness" arguments like unconscionability or unjust enrichment.[6] Those equitable arguments are not automatically losers just because the borrower agreed that insurance could be placed by the lender and the borrower benefitted from the coverage. See *Wilson et al. v. Everbank, N.A. et al.*, 77 F.Supp 3d 1202, 1207-8 (U.S.D.C. S.D. Fla. 2015) where the court said:

Courts presiding over force-placed insurance class actions have consistently rejected this argument. See Hamilton, 6 F.Supp.3d at 1318-1319 (allegations that defendant insurers colluded to "force-place excessively-priced insurance as part of an elaborate scheme to maximize profit" was sufficiently inequitable despite the fact that "plaintiffs were aware of the consequences of failing to maintain their own insurance, but they also received 'valuable' coverage"); Persaud, 2014 WL 4260853 at *14 ("Defendants' alleged retention of benefits, including inflated premiums, commissions, and service fees, would be inequitable."); Cannon v. Wells Fargo Bank N.A., 917 F.Supp.2d 1025, 1053 (N.D.Cal.2013) ("That the force-placed insurance was triggered by Plaintiff's conduct does not negate allegedly inequitable conduct by Defendants."). So too here, Plaintiffs have sufficiently alleged that it would be inequitable for the Insurer Defendants to retain the benefits conferred through Defendants' kickback "scheme".

For commercial lawyers who advise clients or litigate these topics, the question is how do courts actually apply the good faith and fair dealing requirement? What is the applicable test? When faced with the need to enforce unambiguous contract terms (like terms that permit force-placed insurance) and still apply equitable considerations, courts have struck a balance. In one representative case, the court said:

Implicit in every contract in Kentucky is the covenant of good faith and fair dealing. This covenant has been interpreted to “mean that contracts impose on the parties thereto a duty to do everything necessary to carry [the contract] out.” Instructive of the interpretation of the covenant of good faith and fair dealing is the commentary to [KRS § 355.1–304](#), which imposes an obligation of good faith in the performance to contracts within the Uniform Commercial Code. It states:

[t]his section does not support an independent cause of action for failure to perform or enforce in good faith. Rather, this section means that a failure to perform or enforce, in good faith, a specific duty or obligation under the contract, constitutes a breach of that contract or makes unavailable, under the particular circumstances, a remedial right or power. This distinction makes it clear that the doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed, and enforced, and does not create a separate duty of fairness and reasonableness which can be independently breached.

[KRS § 355.1–304](#); see also [Advanced, LLC v. Pitney Bowes Credit Corp.](#), No. 05–464–JBC, 2006 WL 1007467, at *3 (E.D.Ky. Apr. 17, 2006) (analyzing the commentary to [U.C.C. § 1–304](#), . . . , and noting that “[c]ourts have utilized the good faith duty as an interpretive tool to determine the parties’ justifiable expectations in the context of a breach of contract action, but that duty is not divorced from the specific clauses of the contract and cannot be used to override an express contractual term”).

James T. Scatuorchio Racing Stable v. Walmac Stud Management, 941 F.Supp.2d 807 (U.S.D.C. E.D. Ky. 2013). (some citations and quotation marks omitted) (bold added). In other words, Kentucky courts, like most others, find that this implied duty cannot be used to change the terms of the parties' written agreements, but it can be used to limit the acts of a party to whom the contract has vested discretionary powers, such as obtaining force-placed insurance.

I highlighted a sentence in the first paragraph of this post and the last sentence in the above quote because they lead to the same key conclusion. Or, as another court said: " ' . . . although the implied covenant of good faith and fair dealing may in those cases require the parties to carry out their implied promises in good faith, the implied covenant of good faith and fair dealing does not *itself* establish new, independent rights or duties not agreed upon by the parties.' In other words, the covenant of good faith and fair dealing may require parties to exercise their *existing* contractual rights and duties fairly and in good faith, but it does not impose any *new contractual* duties upon the parties apart from the obligation to perform existing duties fairly and in good faith." (italics original, citations omitted). *Kinzel v. Bank of America*, 850 F.3d 275, 283-4 (6th Cir. 2017).^[7] Although the *Kinzel* case applies Utah state law, its lessons echo the general rule as does this "[a]lthough a party exercising contractually apportioned discretion may not exercise that discretion 'for a reason outside the contemplated range—a reason beyond the risks assumed by the party claiming the breach,' a party does not breach the implied covenant simply because it 'may not have followed the golden rule.'" *Id.*, (citations omitted).

One more hopefully useful variant, but consistent explanation of courts' decision making, can be found in *Hoffman v. Nutmeg Music, Inc.*, 2018 WL 4471708 (U.S.D.C. D. Conn. Sept. 18, 2018). That court expressed that same idea as this:

New York recognizes the covenant of good faith and fair dealing as implied in all contracts. The covenant 'encompasses promises which a reasonable person in the position of the promisee would be justified in understanding were included' in a contract. '[N]either party shall do anything

which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.’ ‘Where a contract contemplates the exercise of discretion, this pledge includes a promise not to act arbitrarily or irrationally in exercising that discretion.’

(citations omitted).

The Lesson: In the vast majority of contract situations, Party A would not contract with Party B if they believed Party B was going to cheat or take advantage of them. Party A, however, cannot successfully claim that it is being cheated if it explicitly agreed to a particular contract term. So, unless a particular action is explicitly agreed or prohibited, Party B must act with fairness and not take excessive advantage of the situation in a way to which both contracting parties clearly would never have agreed. But Party B is not required to act in Party A’s best interests. When lender-placed insurance is necessary, a lender can recover its administrative costs and make a commercially reasonable profit. Too much profit, however, is an invitation to problematic litigation and an invitation to have a judge or jury subjectively consider the lender’s actions.

A practice tip post-script. Mortgages commonly state that a borrower’s failure to keep the property insured is a default justifying acceleration of the periodic payments. If, however, the mortgage provides for a default when property is uninsured and forced-placed insurance obviates the uninsured condition, the mortgagee may not declare a default based on the borrower’s failure to obtain insurance. *Johnson v. Homeq Servicing Corp.*, 2005 WL 2899632 (Ky. App. Nov. 4, 2005) (“Thus the force-purchase of hazard insurance does not operate as a waiver of any subsequent failure to comply with the insurance (or any other) provision of the security instrument. However, the non-waiver provision cannot be construed allowing appellee to purchase insurance with appellant’s funds and at the same time declare the property to be uninsured [making the borrower in default].”). (emphasis added).

A continuing mortgage default in this situation depends on the language of the mortgage. Lender’s counsel should not just assume that the existence of lender-placed insurance is a current mortgage default permitting foreclosure. In addition to the above-discussed

common law concepts, lender's counsel must also stay informed of other guardrails affecting lender-place insurance as might be imposed by federal law and regulations, and occasionally state law.

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[1]With respect to banks in Indiana, *Old National Bank v. Kelly*, 31 N.E.3d 522 (Ind. App. 2015).

[2]A similar situation may exist for car loans. See, *Ralston v. Chrysler Credit Corp.*, 1999 WL 76956 (Lucas Cty., Ohio App. Sept. 30, 1999) ("The cost of this "force-placed insurance" was added to the owner's car payment.").

[3]For more information, see the website of the National Association of Insurance Commissioners at https://content.naic.org/cmte_c_lender_placed_ins_ma_wg.htm

[4]Since the forced-placed coverage is probably contractually permitted, the borrower asserts that how the lender exercised its rights was done in bad faith or was not fair.

[5]From the same publication, see section 9:35 titled *Forced-Placed Insurance: The most frequently alleged claims and causes of action, including alleged bad faith*.

[6] Often asserted when the lender gets a commission on the lender-placed policy's premium, borrower-plaintiffs will use pejorative terms "kickbacks" and "forced-placed."

[7] The Kinzel case involves claims that loan collateral liquidation was mishandled.

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