The Educator

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The Standard Mortgage Clause

In this issue of the Educator, we look at the Standard Mortgage Clause and try to answer the following question.

> *Is the payment by the insurer to the mortgagee of any part of the loss award under the insurance policy the sole precondition for the insurer to claim a right of subrogation under the Standard Mortgage Clause?*

Scenario

> The claimant made a claim under a fire insurance policy issued by the ABC Insurance Company. The insurer denied the claim on the grounds that the claimant had voided the policy by failing to notify it of a material change in the risk and that they had vitiated their right to recover by making wilfully false statements in their claim.
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> The first ground for repudiation of the claim was that the claimant voided the policy by failing to notify the insurer of a material change in the risk, namely, a change in the occupancy of the premises. The second ground was that the claimant had made wilfully false statements with respect to their contents claim, thus vitiating their right to recover.
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> The property insured was subject to a mortgage. The mortgagee submitted a claim seeking payment of the mortgage under the Standard Mortgage Clause, andthe insurer paid most of the claim. The claimant commenced an action against the insurer seeking a declaration that the insurance policy was valid and binding.
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> The insurer, tit-for-tat, brought an action against the claimants, relying on its right of subrogation under the Standard Mortgage Clause, claiming the sum that it paid the mortgagee on the mortgage.

Preconditions

This scenario raises the question of whether the subrogation right of an insurer under the Standard Mortgage Clause in an insurance policy may be exercised simply upon the insurer paying the loss award to the mortgagee without the insurer establishing that it has no liability to the insured.

In answering the question above, there are two preconditions to an insurer's entitlement to subrogation under the Standard Mortgage Clause.

- First, the insurer must make payment of the loss award, or part of it, to the mortgagee.

- Second, the insurer must establish a claim that it has no liability to the mortgagor insured.

This conclusion flows from the construction of the Standard Mortgage Clause and is not dependent on the specific facts of this case.

In their defence, the claimant pleaded that the Standard Mortgage Clause "is onlytriggered by the insurer not being liable to them for the fire loss".

It can be argued that an insurer is entitled to judgment against an insured for the monies paid to a mortgagee pursuant to a Standard Mortgage Clause, even if the insured's claim was denied on the basis of a material change in risk. When the insurer has paid the mortgagee it is entitled to judgment against the insured for the amount paid to the mortgagee.

When the insurer's right to subrogate arises, of course, depends on the language of the Standard Mortgage Clause. Before turning to a close reading of that language, it is useful to begin with a general survey of the function and effect of the Clause within the policy.

Two contract theory

In the Caribbean, the Standard Mortgage Clause has been a standard part of fire insurance policies for well over a century. In ***Guerin v. Manchester Fire Assurance Co.*** (1898), the Supreme Court of Canada observed that the Clause "appears . . . to have been introduced into policies of insurance in the United States of America by the Mutual Insurance Company of New York, in the year 1860".

The Standard Mortgage Clause, though part of the policy between the insurer and insured, constitutes a second and separate insurance contract between the insurer and the mortgagee. It is consistent with the general scheme of insurance law as it is practised in the Caribbean. As such, the development of insurance law must necessarily take place within its own particular socio-economic context, namely the Caribbean insurance practice.

The two contract theory, firmly embedded in British and by extension, the Caribbean insurance practice, protects the mortgagee's interest in the insured property even when the insured has done something to void the policy. The separate contract between the insurer and the mortgagee remains in force even when the policy itself has been voided by an act, neglect, omission or misrepresentation attributable to the mortgagor, owner or occupant of the property.

Thus, when the insured mortgagor voids the policy, for example, by doing something that materially changes the risk, the Standard Mortgage Clause protects the mortgagee by maintaining the insurance of the mortgagee's interest in force. The insurer must pay the mortgagee's loss to the extent of the policy limits even when the mortgagor insured has voided the policy.

Therefore, the terms of the mortgage clause supersedes any policy provision in conflict therewith, but only as to the interest of the mortgagee, and any loss under the policy shall be made payable to the Mortgagee. As such the policy remains in force as to the interest of the mortgagee despite any act, omission or misrepresentation of the mortgagor or any change in use that increases the risk.

Right of Subrogation

The insurer becomes legally subrogated to all the rights of the mortgagee against the insured to the extent of the payment it has made to the mortgagee.

So, whenever the Insurer pays the Mortgagee any loss award under this policy and claims that -- as to the Mortgagor or Owner-- no liability therefor existed, it shall be legally subrogated to all rights of the Mortgagee against the Insured; but any subrogation shall be limited to the amount of such loss payment and shall be subordinate and subject to the basic right of the Mortgagee to recover the full amount of its mortgage equity and in priority to the Insurer; or the Insurer may at its option pay the Mortgagee all amounts due or to become due under the mortgage or on the security thereof, and shall thereupon receive a full assignment and transfer of the mortgage together with all securities held as collateral to the mortgage debt.

The right, therefore, of the insurance company to be subrogated to the rights of the mortgagee must depend upon whether they had or had not a good defence against the mortgagor, the person in whose name the insurance was effected. If they had a good defence, the money paid to the mortgagees would be so paid by reason of the agreement and that alone, if they had not, the money paid would necessarily go in discharge of the mortgage, as the policy was effected for the mortgagors benefit and at his expense.

Assignment

Importantly, an insurer is not entitled to subrogation or an assignment of the mortgagee's rights, unless the insurer establishes that it has no liability to the named insured mortgagor due to the mortgagor's breach of the insurance contract. This is the rule because so long as the insurer has an obligation to the mortgagor, as well as the mortgagee, the mortgagor has the right to have the insurer's payment to the mortgagee applied to reduce the amount of its mortgage debt.

And, the insurer cannot extinguish the mortgagor's right to have insurance monies reduce its debt by assuming the rights of the mortgagee and initiating a foreclosure action against the mortgagor to recoup amounts paid to the mortgagee. But, where an insurer is liable to a mortgagee, but is not liable to a named insured mortgagor due to the mortgagor's breach of the insurance contract, the mortgagor is not entitled to have the insurance proceeds applied to reduce the mortgage debt.

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