Flaws and Risks in Mortgage Insurance Requirements and Provisions

Marie Moore
Sher Garner Cahill Richter Klein & Hilbert, L.L.C.
New Orleans, Louisiana

Charles Comiskey
CPCU, CIC, CPIA, CRM, PWCA, CRIS, CCM, CMIP
President, RiskTech, Inc.
Houston, Texas

John McNearney
Polsinelli PC
St. Louis, Missouri

INTRODUCTION

The two basic types of insurance that property owners need to maintain with respect to their property are "Property Insurance" and "Liability Insurance":

(a) Property Insurance – This coverage reimburses the insured (generally the property owner) for its own property loss – including the replacement cost or actual cash value of property that is lost or destroyed. Only damage caused by a "Covered Cause of Loss" will trigger payment. There are numerous additional types of coverage that are available by the addition of special coverage to a property insurance policy. Among them are:

i. Loss of Rents or Business Income. If this coverage is obtained, it reimburses for loss of business income or loss of rental value;
ii. Flood and Earthquake. Neither flood nor earthquake is a "Covered Cause of Loss" without a special flood insurance policy added as part of the overall Property Insurance.

None of loss of rents, business losses, flood or earthquake are recoverable without special coverage. Each is added as part of overall Property Insurance.

(b) Liability Insurance – This coverage pays defense costs and amounts that the insured becomes obligated to pay to a third party if there is an accident or occurrence on or with respect to the property that is covered by the policy.

The more important of these for lenders is the Property Insurance that protects a lender if its real or personal property collateral is damaged by fire, windstorm, flood, or other Covered Cause of Loss. However, it is also prudent for lenders to verify coverage on borrowers' Liability Insurance policies to avoid liability exposure in the event claims arise on their mortgaged property. One of the primary ways that lenders assure that their collateral is continuously insured for loss or damage is by requiring borrowers to escrow for insurance.

I. UNDERSTANDING PROPERTY INSURANCE.

Lenders understand how to protect their collateral for their real-estate or personal property secured loans. If a building has been mortgaged, the lender wants to be sure that if it burns, floods, or is otherwise damaged by insurable casualty, the lender will have insurance proceeds for rebuilding or application to the loan. Similarly, if the property is leased to a tenant and the lender is counting on the rent payment stream, the lender wants to be sure that the borrower carries insurance covering the rental income and that it will have access to this insurance.

Of course, mortgages and security agreements require that the borrower maintain insurance coverage. However, the available insurance policies have changed over the last 20 years and many mortgage and security agreement forms have not kept up with these changes. As a consequence, many forms require types of policies that now have different names, require coverages that no longer exist, and do not specify the current coverages that the lender needs. Lenders should modify their forms so that they are current, and even if they can't modify their forms, they should service their loans in a way that assures that their borrowers maintain the right kinds of coverage. See a list and comments regarding mortgage lender's insurance requirements at **Appendix I** and an example of suggestions and comments regarding a typical institutional lender's insurance language at **Appendix II** to this paper.

II. PROPERTY INSURANCE COVERAGES AND EXCLUSIONS.

Lenders should require that the borrower maintain property insurance (sometimes referred to as "casualty insurance") covering physical damage to its property caused by as many risks as are reasonable and customarily insured. The risks insured are set out in the policy – and vary depending on the type of policy issued.

1. *The Standard Forms*.

An insurance policy can be on an insurance company form or can be a "manuscript" policy, which is a policy that is customized for a particular insured. Manuscript policies are common only for large businesses. The Insurance Services Office, Inc. (ISO), publishes standard forms for its underwriter clients. ISO is an advisory and rating organization for the insurance industry. It provides actuarial services, assists insurance companies in meeting regulatory requirements and promulgates insurance forms for the industry. ISO promulgated insurance forms are the standard in the property and casualty industry.The form references in these materials are to commercial property (CP) ISO policy forms.

ISO Building and Personal Property Coverage Form #CP 00 10 is the basic form that describes the "Covered Property" – the building and property that are insured (and what is excluded). Another form is added to set out the events (risks) that will trigger the insurance company's payment obligations – the "Covered Causes of Loss." There are three types of ISO commercial property "Causes of Loss" forms:

> Basic Form covers common, listed risks, such as fire, lightning, vehicles, aircraft, and civil commotion (generally ISO Form #CP 10 10).

> Broad Form provides basic form coverage as well as coverage for listed additional perils, such as structural collapse, sprinkler leakage, and losses caused by ice, sleet or snow weight (generally, ISO Form #CP 10 20).

> Special Form (Special Causes of Loss) covers "all risks of direct physical loss" (hence the former name of this type of policy form: "All Risk") except those perils that are specifically excluded (generally ISO Form #CP 10 30).

A lender should require a Special Causes of Loss policy. However all of these forms, even a Special Causes of Loss base form, contains exclusions for ordinance or law (changes necessary if new equipment, for example, sprinklers, must be installed when the building is rebuilt), earth movement (earthquake), governmental action, nuclear hazard, utility services, war and military action, water (flood and other water-related occurrences), and fungus (mold). Endorsements to

Title search: Flaws and Risks in Mortgage Insurance Requirements and Provisions

Also available as part of the eCourse
[Current Issues in Real Estate Loan Servicing: Home Equity Amendments, Flaws and Risks in Mortgage Insurance, Foreclosure-Related Litigation, and Title Issues after Death]()

First appeared as part of the conference materials for the
52nd Annual William W. Gibson, Jr. Mortgage Lending and Servicing Institute session
"Flaws and Risks in Mortgage Insurance Requirements and Provisions"