SUBROGATION UNDER MORTGAGE INDEMNITY GUARANTEES

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(Note: This article was prompted by a discussion which followed a talk on Mortgage Indemnity Guarantees given by Mr Nicholas Atkins of Messrs Lovell White Durrant at a B.I.L.A Luncheon Meeting on 11 February 1994. The views expressed are the author's sole responsibility).

The Scenario

The typical circumstances discussed in this article are:-

i) purchase of a domestic property by an individual with the aid of a repayment or endowment mortgage advance by a building society, bank or other institutional lender of a high proportion of the price (or valuation);

ii) insistence by the lender on the issue of a Mortgage Indemnity Guarantee ("MIG") to cover the difference between the amount advanced and the lender's "normal" or "standard" advance, the premium being charged to the borrower, normally by deduction from the loan or debit to the account; and

iii) default and sale producing less than full recovery leading to a claim upon the MIG.

Given that the mortgage will create a personal obligation of payment on the borrower, the issue arises whether the insurer under the MIG can, by subrogation, pursue a claim in debt, for the shortfall it has covered, against the defaulting borrower.

The position is little different, if at all, if the security is for a loan repayable on demand or on commercial property, although in practice the commercial borrower is often formally insolvent or at least in receivership or administration; the domestic property example has been chosen for the sake of simplicity. The domestic MIG will normally be a standard contract, often issued under some " master agreement" between the insurer and the lending institution designed to reduce the administrative burden.

On the face of it, the circumstances seem to present a classic case for subrogation, why, then, the query or controversy?

The Mark Rowlands v. Berni Inns decision

The answer lies in the Court of Appeal decision in *Mark Rowlands Ltd v. Berni Inns Ltd* (1986) 1 QB 211, (1985) 3 All ER 473). Berni Inns held a 30 year lease of the basement and ground floor of the plaintiff's building. The lease reserved an insurance rent equal to the landlord's expenditure on insurance, provided for a release of the the tenant's repair obligations if the premises were damaged by (as it happened) fire and imposed an obligation on the landlord to spend the policy proceeds in reinstatement. The entire building was destroyed by fire attributed to the defendant's negligence. The insurers paid for rebuilding and then sued the tenant, in the landlord's name, to recover its expenditure.

Stephen Brown LJ sitting as a judge of the High Court and a unanimous Court of Appeal (Kerr, Croom-Johnson and Glidewell LJJ) both dismissed the claim. Put briefly, they held that since, under the terms of the lease, the insurance had been effected for the joint benefit of the landlord and the tenant, the insurer could not make a subrogated claim against the tenant. More importantly, the Court of Appeal found that there was no claim upon the landlord on which subrogation could operate. A significant ruling was that section 2 of the Life Assurance Act 1774 does not apply to indemnity insurance. The ruling was recently upheld by the Privy Council in *Sui v. Eastern Insurance Co. Ltd.* (1994) 2 WLR 370). The MIG policy is unarguably an indemnity insurance.
The parallel of this case with the MIG scenario is obvious enough and it is proposed to explore it by reference to various arguments that have been advanced why the principles now established in the landlord and tenant field should not be carried over into the MIG relationship.

(1) For Whose Benefit?

The Court of Appeal held that there was no obstacle in law to a person with a limited interest in the insured property preventing him claiming that insurance effected by another was for his benefit to the extent of that interest. The Mark Rowlands policy did not note or purport to cover the tenant's interest (although the interest of the other tenant of the rest of the building had been noted) anymore than the MIG will mention the borrower's interest. Equally, however, neither policy, nor indeed the prime contract expressly excluded the tenant or mortgagor from benefit. It is

perhaps unlikely that either party or its lawyer consciously addressed the issue when the lease was drafted.

So what were the grounds in which benefit was found to exist in *Berni Inns?* Kerr LJ, in the leading judgement, found various grounds for the (implied) mutual intention of both parties that both should benefit. He derived that from the obligation of the tenant to pay for the insurance and the fact that on the occurrence of the insured risk the tenant was relieved of its repair obligation (and, for a 3 year period, for rent). The landlord, for its part, covenanted to insure and to use the policy proceeds in or towards reinstatement.

He found no obstacle in law to such an implied mutual intention. The objection deriving from section 2 of the 1774 Act was brusquely swept aside. The second counter-argument for the landlord (or, in reality, its insurers) that the tenant lacked an insurable interest was also dismissed fairly sharply.

Compare this situation with the MIG scenario. The arrangements between lender and borrower will undoubtedly require the latter to pay the premium, usually a single lump sum. Whether on the happening of the insured event, namely a shortfall in recovery on realisation of the security, the borrower is to be protected is thus the crucial point (unless the mere fact that the borrower was to fund the insurance is sufficient on its own to give a benefit which is by no means impossible). Whether the inference of protection for both parties can be made is vital.

The author would argue that relief of the borrower from liability in debt if the insurance is triggered can readily be found to be the implicit bargain. It must be remembered that MIG insurance is not just an optional extra, comparable, say, to unemployment or sickness insurance taken out by the borrower. The benefit of the cover is to be treated as part of the lender's security. In the case of a Building Society lender, there exists statutory confirmation of the proposition. The Code of Practice established under the Building Societies Act 1986, replacing statutory provisions found as far back as the 1939 Act, requires the service of a notice on the intending borrower to warn that the lender is taking security over and above that provided by the property itself. MIG insurance is such additional security. There is no comparable requirement for other lenders, but that does not vitiate the analysis of the function of the MIG, so the borrower can surely argue "on any default look to you double security, first the property and secondly the MIG. I am only liable for any unsecured excess after those two are exhausted".

Turning to the lender's obligations, it could hardly be denied it undertook to procure the MIG for which it collects the borrower's contribution (if by some oversight it did not, it could be liable in damages equal to the non-existent cover.) *See Naumann v. Ford* (1985 2 EGLR 70). As to the liability to spend the proceeds in reduction of the debt, though not express, it is surely implicit in the very circumstances, discussed in the previous paragraph, of the double security.

So, it is strongly submitted, the argument that the MIG was never intended to benefit borrower as well as lender is not sustainable, whatever may be retrospectively asserted.

(2) No Contractual Basis

A second argument by those who deny the applicability of the *Mark Rowland* case to the MIG scenario depends on contrasting the contractual basis for the ruling in the 1985 case with the (alleged) absence of such a nexus in the mortgage field, particularly in the domestic property sector. Admittedly, most mortgage offers are subject to instant and peremptory withdrawal before completion (although the Building Societies Ombudsman might have something to say about the unreasonable exercise of such rights). The "purchase" of the MIG by the lender at the borrower's sole expense is inevitably a condition of the offer. The purchase is presumably effective as of the date of creation of the mortgage. The completion of the lending transaction, without exercise of the withdrawal power, can be treated as creating contractual relations between the parties even if they did not exist before. The consequences of those relations has already been discussed.

In any event, the author does not concede that the absence of a formal contractual relationship - even if to the intending borrower "it certainly feels like a contract" - prevents the non-contractual arrangements satisfying the tests which led the Court of Appeal to the conclusion it reached in *Mark Rowlands v. Berni Inns*. Whether the necessary arrangements had to be contractual did not need to be discussed in that case.

(3) Insurable Interest in Borrower?

Some have argued that the borrower in the MIG scenario lacks insurable interest, whereas no-one could suggest a tenant had no such interest. In *Mark Rowlands* Kerr LJ cites the classic definition by Lawrence J in *Lucena v. Crawford* (1806 2 Bos &

P NR 269 at 302:- "A man is interested in a thing to whom advantage may arise or prejudice happen from the circumstances which may attend it...". The prejudice to the owner-borrower if the property dips below the amount of the charge upon it is manifest. The potential acceleration of the obligation to pay, in advance of any attempt to realise the security, when that situation comes about is another where the mortgage, though framed on a repayment or endowment basis, allows for service of a notice to redeem even in the absence of default. Many, probably most, domestic mortgages contain such a provision, expressly or by incorporation of standard conditions or rules. That gives a second head of insurable interest. Would the average borrower not explain the function of the MIG in exactly these terms?

(4) Buy-out Clauses

In some MIG transaction between lenders and insurers, there is provision allowing the latter to make early settlement with the former before any sale under the mortgage has been effected. The author does not know how common those provisions are, generally or in relation to domestic mortgage business. How does the existence of such a power affect the current debate? To anticipate the later argument on whether, in general terms, the lender has a claim in debt where the MIG insurer pays out to make good a deficit following sale, surely when a payment is made, under a contractual power vested in the insurer, in advance of the exercise of the remedy of sale, the mortgage debt is reduced but that does not trigger any right in the lender to call upon the borrower to match that repayment. No borrower would so bind himself. His obligation is to make payments to service the debt, whatever it may be from time to time. The buy-out (or buy-up) clause is r*e inter alios acta* so far as the borrower is concerned and forms no part of the bargain between him and the lender. At least, the proponents of this objection will have to demonstrate its incorporation in that bargain in a specific case.

Does Subrogation Arise Anyway?

Concentration on whether or not an insurer's subrogated claim would fail because the borrower has the benefit of the MIG may be missing the point in any event. Kerr LJ was at pains in *Mark Rowlands v. Berni Inns* to stress that agreement with the trial judge on the benefit issue "does not decide the real issue". That was whether the terms of the lease and the full indemnification of the landlord by the insurer prevented a claim in negligence against the tenant. Of course, if it did, there was no claim for the insurer to be subrogated to. He discussed various Canadian and

American cases, the reasoning of which he accepted, before holding there was no right in the landlord to sue. The purpose of the insurance was to compensate the landlord for damage to the property by an insured risk, whether caused by accident or negligence; once that indemnification has been achieved, the landlord could not recover damages from the tenant. Glidewell LJ, in his short speech agreeing with Kerr LJ, put the point succinctly, in saying "the risk which led to payment of the insurance moneys was one of the risks envisaged in the agreement between the parties that the plaintiffs should take out the insurance. Both receipts and loss were of the same nature".

This approach fits exactly the MIG scenario. The bargain between the parties can be rendered thus:

(i) the borrower may, voluntarily or not, default on payment so that the lender will have to enforce the security;
(ii) the security may realise less than the debt;
(iii) so the lender will take security against the risk of that loss by the purchaser of a MIG policy.

When that second security is realised, by a successful claim against the insurer, the debt is discharged. If the debt is discharged, the lender has no valid claim against the borrower so the insurer has no claim either. So far as the author is concerned, that is exactly why the insurance was paid for. It protects the lender directly and the borrower indirectly against the risks in a fall in value of the property, for whatever reason, below the mortgage debt. It is not merely to cover default by the borrower.

Litigate or Ombudsate?

The Insurance Ombudsman has informally indicated that he personally sees some possible merit in the argument that the MIG insurer may not have a subrogated claim against the defaulting borrower. Somewhat firmer views than that have later been (mis-)attributed to him. In fact, a borrower who otherwise qualified by virtue of being a UK resident insuring in a private capacity would face serious obstacles to ombudsating (the author accepts full responsibility for this neologism for pursuing a claim before an Ombudman) the issue. First, he is almost certainly not a policy holder. Claims that Berni Inns was a co-insured were swiftly abandoned in its litigation with Mark Rowlands. However, a lender who clearly is the party who has "effected a policy" (to quote from the terms of reference) might co-operate to allow

the matter to be brought before the Ombudsman. The Ombudsman's terms of reference include disputes, complaints and claims by a person with merely the benefit of policy and that issue of benefit has been discussed above. There is no claim under the policy against an insurer but there is a dispute arising under a policy, which satisfies the wording of the terms of reference. So it is not impossible that the Ombudsman could have the opportunity to give any ruling on a subrogated claim. He would rule on it either as a matter of law or as a matter of what is fair and reasonable in the light of the general principles of good insurance practice and the ABI's Statements and Codes of Insurance Practice, which is his extended jurisdiction.

Conclusion

The legacy of negative equity and sales of repossessed properties for less than the accrued debt is many thousands of potential claims by MIG insurers if subrogation does indeed give them the benefit of claims open to lenders and if such claims exist. Doubtless the parlous financial state of many dispossessed former property owners would render claims quite unprofitable, but there must exist at least a few of the "not that I can't pay, old boy, just that I won't pay" brigade against whom a judgement would allow an insurer to recoup a small part of the reported massive losses. (A ruling by the Ombudsman adverse to a borrower would not bind the borrower to pay.) Such a claim might provide the occasion for a resolution of the issues discussed in this article. Perhaps a commercial property case would be a more likely vehicle to settle the uncertainties. although the arrangements may deviate from the pattern in the domestic scenario postulated above. That claim could well be against the guarantor or, preferably for the insurer, the indemnified of an insolvent borrower. If anecdotal evidence is to be believed, thousands of former borrowers with the threat of potential claims hanging over them would welcome resolution of the issues - at least, if it were to go in their favour! This article has sought to show how and why it might.