"CURRENT MORTGAGE INDEMNITY PROBLEMS"
by Jennifer McDermott and Nick Atkins, Lovell White Durrant

1. Introduction

1.1 One of the first questions that occurred to us after being asked to talk about "Current Mortgage Indemnity Problems" was whether something was missing from the title, that something being a question mark. While we can say from our own experience that insurers' mortgage indemnity problems are by no means at an end; they are we believe very much under control. So far as the underwriting of new domestic mortgage indemnity business is concerned: rates have been revised, cover has been restricted and policy wording has been considerably tightened. Also, possibly even more importantly, the lending institutions have improved significantly their lending procedures. On the commercial side, remedial action has meant that little or no new commercial mortgage indemnity business is being underwritten. However, we are aware of insurers who are confidently dipping their toes back into the commercial mortgage indemnity market. As far as claims are concerned, many commutations have been agreed between insurers and lenders and the arguments on both sides have been well rehearsed; insurers have now got to grips with and understand the problems.

1.2 By way of contrast to that rather optimistic opening statement, we propose in this paper to concentrate upon some of the recurring problems that we have encountered in dealing with mortgage indemnity disputes. We shall start with commerical policies and then move on to domestic risks. In doing so, we shall highlight what is, we think, an increasingly important issue, namely, recoveries from negligent valuers. After a dispute has been resolved between lender and insurer, attention rather inevitably tends to focus on the possibility of making a recovery from the valuer or the solicitor who was involved in the original lending transaction. This is certainly one of the current trends in relation to mortgage indemnity issues.

1.3 For those who are not familiar with mortgage indemnity business, the purpose of mortgage indemnity insurance policies, both commercial and domestic, is in essence to protect the lender against a fall in the property value which results in the proceeds of sale of the property being insufficient to cover the

outstanding debt (ie, principal plus interest) in the event of default by the borrower. The insurance allows a lender to advance a greater sum that it would otherwise.

1.4 The lender is the insured. In the case of the insurance of a residential portfolio for a building society, the lender will also, expressly or by implication, be the insurer's underwriting agent and will decide not only which loans should be advanced but also whether they should be covered by the insurnace. In residential cases the borrower will generally pay the premium by an addition to the mortgage cost.

1.5 Mortgage indemnity insurance is by no means a new invention. In the context of domestic lending it started in at least the 1930's. However, it come to the fore in the 1980's lending explosion when restrictions on banks and building societies were lifted, with the result that new products appeared, including:

(i) commercial;

(ii) mortgage pools; and

(iii) development finance.

1.6 It has been said that this product came to be marketed as a "guarantee", hence mortgage indemnity guarantee insurance or, more commonly, "MIG". The use of the word "guarantee" is rather curious and the argument has been made by lenders that mortgage indemnities are not policies of insurance but are actually contracts of guarantee. The purpose of this argument being to try to deprive insurers of rights to avoid for non-disclosure. However, we think that the answer must be that, because (inter alia) the insurer is engaged by the lender not the borrower and is paid a premium for assuming the risk, they are policies of indemnity insurance and, therefore, contracts of the utmost good faith imposing full duties of disclosure on the insured lender.

2. "Large Ticket" Commerical Mortgage Indemnity Policies

2.1 These generally cover one-off commercial property purchase transactions, examples of which appear in the case of *Banque Bruxelles Lambert SA*

("BBL") v Eagle Star and Others (*Times,* 8th March 1994), judgment in which was delivered by Phillips J on 21st December 1993 in relation to the negligence of valuers and about which we shall say more later.

2.2 The insuring clause in a typical commercial indemnity policy provides as follows:

"... if any of the following events occurs:-

(a) the Property is sold following an Event of Default and pursuant to a power of sale contained in the Security Documents; or

(b) the Property is sold, the net proceeds are applied in repayment or prepayment of the Outstanding Debt and the Borrower has not paid any remaining balance of the Outstanding Debt within 21 days of formal demand by the Insured or by or on behalf of the Banks; or

(c) the Property is sold by agreement to or to the order of any competent authority after a power of compulsory purchase or other compulsory acquisition has become exercisable in relation to the Property and the net proceeds are applied in repayment or prepayment of the Outstanding Debt; or

(d) the Property is compulsorily purchased or otherwise compulsorily acquired;

the (Insurer), if the proceeds of the sale arising pursuant to the sale referred to in (a), (b) or (c) or if the compensation proceeds arising in connection with the events referred to in (d) are less than the Outstanding Debt at the time at which the same arise, will pay the amount of the deficit to or to the order of the Insured within 30 days of receipt of a written statement from the Insured or by or on behalf of the Banks stating which of the above events has occurred and stating the amount of the deficit".

2.3 Points to note are that:

(a) The amount of the claim may only crystallise once the property has been sold or the policy may include a "deemed sale" provision.

(b) The policy covers, within the definition of Outstanding Debt, rolled-up interest.

(c) The amount of cover provided under this clause was unlimited (ie, cover was "from the ground up"). Many commercial mortgage indemnity policies provided just "top-slice" cover ie, an indemnity covering the difference between, usually, 70% and 90% of valuation. Other policies would provide "bottom-slice" cover ie, for 0% to 60% or 70% of valuation.

(d) The policy period would usually be for a fixed term mirroring the term of the loan with a claim being triggered by the lender taking steps to enforce its security during the policy period.

3. Avoidance for material non-disclosure/misrepresentation

3.1 An insured is of course under a duty to disclose to the insurer (subject to any modification by agreement) any matter which it knows or should have known and which would have caused a prudent underwriter to decline the risk or to have written it on different terms *(CTI v Oceanus)*. In *Pan Atlantic v Pine Top* the Court of Appeal held that the prudent underwriter must have viewed the matter as "probably tending to increase the risk". (At the time of preparing this paper the House of Lords has not yet delivered judgment in that case.)

3.2 Applying such tests of materiality, insurers have argued that they may avoid a MIG policy because, for example, the lender did not disclose the highly material fact that:

(1) it had failed to underwrite the loan properly; or

(2) in a case where the insurer was providing "top-slice" cover only, the lender had subsequently placed "bottom-slice" cover with another insurer for the balance of the risk thereby leaving the lender without any retention; or

(3) the valuation upon which the loan and the insurance were based was excessive, especially when compared to a recent sale price of the property; or

(4) there may have been material misrepresentations made by or on behalf of the lender as to why the sale price was far less than the valuation, for example, along the unlikely lines that a blue chip company suddenly had to sell a property investment for liquidity problems or that a local authority had to sell a property at far less than market value to ease poll tax problems.

3.3 In the light of the very wide scope of the duty of disclosure, MIG policies may attempt to limit to define the extent of the common law duty by using what is known as a "deemed disclosure clause". An example of such is:

"In fulfilment of its duty of disclosure (and so that its duty shall be deemed fulfilled):-

(a) the Insured confirms that it has carried out before the date of this Indemnity (both in its capacity as an agent and as an original lender) such investigations and made such enquiries in relation to the Borrower and the Property in accordance with the standard property lending criteria observed by it (i) in carrying out credit analysis and document negotiation in relation to secured property lending transactions and (ii) when proposing to enter into loan and security documentation similar to the Security Documents, in each case, without the benefit of an indemnity or insurance policy providing cover of the type or to the extent of that provided by this Indemnity and it is not, as a result of such investigations and enquiries, aware of any fact or circumstance which it would, in accordance with its usual procedures as an agent, disclose to a member or prospective member of the syndicate of banks of which it was agent in relation to the Security Documents and which it has not disclosed to the Company;"

3.4 In essence, the insured is confirming that it has carried out the investigations it would normally carry out and that it is not, as a result, aware of anything which it would usually disclose to members of a syndicate of banks of which it was agent. Arguably, it also means that if the insured employs an agent, such as a valuer, it must select the agent prudently. It may be that this type of clause is really doing no more than the common law duty of disclosure. However, the precise effect of this type of clause has yet to be judicially tested. This is in many ways rather disappointing not least because it leaves

unresolved the following dilemma: the deemed disclosure clause requires the lender effectively to act in underwriting the loan as if it had no mortgage indemnity insurance. Yet, the lender would argue that the reality is that without the benefit of such insurance it would not have contemplated entering into the transaction ie, mortgage indemnity protection was taken because loans of 90% of valuation were being advanced in circumstances where without insurance the bank would not have lent more than 70% of valuation. The insurer's answer to this dilemma is, of course, that this is entirely a problem for the lender. The deemed disclosure clause makes it clear that investigations are to be carried out and, at the very least, the lender should carry out the investigations that it would usually undertake if it were lending 70% of the valuation (continuing the earlier example).

3.5 It is worth noting in passing that problems may arise from the seemingly innocuous provision in the deemed disclosure clause to the effect that the lender will have acted "in accordance with the standard property lending criteria observed by it". It is often very difficult to work out whether the lending institution did have any criteria (or at any rate any comprehensive written criteria) which were supposed to be applied let alone which criteria were actually followed and, therefore, this can be a useful line of enquiry and attack for the insurer.

3.6 On the other hand, lenders argue that they are not under a duty to disclose (either at common law or under a "deemed disclosure" clause) matters:

(1) which the insurer is presumed to know because they are reasonably clear to him from information in his possession;

(2) which the insurer ought to know in the ordinary course of business; and

(3) as to which the information he has already received suggests a doubt or puts him on enquiry and he does not seek any further information.

3.7 Insurers must of course beware of waiver arguments being raised by insureds in defence to claims to avoid cover. If, for example, an insurer knew or arguably ought to have known of the very low sale prices of the properties in question or took some steps to investigate the accuracy of the valuations

obtained, these facts might be used by an insured lender to support a waiver argument.

3.8 An insurer must be careful not to affirm a policy. This may happen if its conduct on discovering the undisclosed facts lulls the insured into believing that it does not intend to exercise its avoidance rights and thereby waives its right to do so. The classic example would be if the insurer, knowing of the problem, accepted premium or exercised inspection rights without a full reservation of rights.

3.8 Quite apart from the deemed disclosure clause there may be other ways in which an insurer can reduce its liability under a mortgage indemnity insurance policy, for example:

(1) if there is a clause excluding liability for professional negligence and that can be established (as to which see paragraphs 3.9 to 3.22); and/or

(2) if the insured did not act prudently (as to which see paragraphs 3.23 to 3.26).

Assumption of value/professional negligence exclusion clause

3.9 Taking the first of these situations. One of the most difficult problems in mortgage indemnity insurance is "what is the position if the valuation of the property was wrong?". The valuation lies at the heart of the whole transaction. The point is an extremely important one because the purpose of the policy (so far as insurers were concerned) was to protect lenders against default by the borrower and not to provide professional indemnity cover against default by the borrower and not to provide professional indemnity cover against negligent valuations. Many policies attempt to address this issue through an "Assumption of Value" and a "Professional Negligence Exclusion" clause. Typical wordings are as follows:

Assumption of value clause:

"(i) No liability shall arise under this indemnity in respect of such part of any deficit as may be attributable to the assumption specified in sub-

paragraph (ii) hereof (or any of them) proving to be false;

(ii) The assumptions ... are that at the date of this indemnity, the ... valuation ... fully and accurately for the purposes of the insured as mortgagee:-

(a) values the property ..."

And the professional negligence exclusion clause (and note that this applies to negligence by solicitors just as much as valuers):

"**Exclusions:**

(i) No liability shall arise under this policy in respect of such part of any deficit as may be attributable to the negligence or fraud of any professional adviser of the insured."

3.10 If, therefore, it can be proved that the valuation was not accurate or was made negligently by the professional valuer, then it should be possible at least to reduce the indemnity payable by the insurer by the amount of the deficit attributable to the inaccurate or negligent valuation. Also, arguably, a breach of an assumption of value clause may entitle an insurer to avoid the policy. That said, actually proving that the valuation was wrong will generally be an expensive business for insurers.

3.11 The recent judgment of Phillips J in *BBL v Eagle Star* deals extensively with when a valuer will be held to have been negligent and in such event the amount of damages that will be recoverable. The decision has yet to be fully reported but is (subject to any appeal), the main, if not the only, judgment which touches on some of the important issues which arise from commercial mortgage indemnity policies. The background to this decision was a dispute between BBL and Eagle Star concerning policies which Eagle Star had issued to cover loans made by BBL ranging in amount from £4.77m to £92.7m. These loans were made to shelf companies or "SPV's" ("Single Purpose Vehicles") in connection with the purchase of the freehold of various office blocks. In due course, the property market crashed, the borrowers defaulted, the security proved inadequate and substantial claims were made on Eagle Star. Eagle Star avoided for non-disclosure of material facts, namely, that the valuations were over-valuations and that BBL had failed to carry out proper

investigations in connection with the proposed loans. These claims were hotly contested by BBL and 50 or so days into the trial terms of settlement were agreed. However, BBL and Eagle Star continued with claims against one of the valuers who had been involved in the transactions. The judgment of Phillips J was concerned with this part of the case.

3.12 In an important ruling on what will amount to a negligent valuation Phillips J held that:

"All the experts were agreed that where a property has just been sold, the sale price is potentially the most cogent evidence of the open market value of that property. Provided that the property was properly exposed to the market and competently marketed, the market price will demonstrate the market value. The experts were also agreed that the fact that the property has just been sold does not relieve the valuer of the need to consider comparables. The conclusion that the valuer draws from comparables will be part of the material upon which he bases his valuation. If the comparables suggest a value that differs significantly from the sale price agreed, the valuer has to consider all the evidence in order to decide why the discrepancy exists."

And later and more explicitly:-

"... a valuer who gives an open market valuation without considering the implications of a recent sale in the market of the property being valued is, in my judgment, negligent."

3.13 Because the valuer in that case, John D Wood Commerical Limited, did not consider recent sales in the market when valuing certain properties, that company was held by Phillips J to have been negligent. We should say at once that John D Wood Commerical Limited is entirely unrelated to the well-known residential valuers of the same name. To put what Phillips J said into context the details are as follows:

Property	Sale Agreed	Sale Price	Valuation	Valuation date	Accurate valu(	Maximum competent valuation
Trevelyan House	9/3/89	£25.5m	£44.35m	11/4/89	£27.5m	£30m
Cambridge Circus	13/4/89	£73m	£103m	20/6/89	£75m	£80m
Crusader House	30/5/89	£59m	£82m	30/7/89	£60m	£63m

3.14 Having concluded that the valuers were negligent, what then was the amount of damages recoverable? Phillips J's judgment reviewed the authorities in this area extensively. One of the important points which he had to decide was whether the lender could hold the valuer responsible for that part of its loss which was attributable to the collapse in the property market.

3.15 Phillips J accepted that the entire transactions simply would not have got off the ground had the valuations been correct. So, BBL argued that "but for" the negligent valuations they would not have entered into the loans and, therefore, were entitled to recover the amount lent, plus interest, less the sum received when the properties were eventually sold. However, Phillips J said that it was hard to imagine that the damages recoverable from the valuer should be more than the difference between the negligent and accurate valuations. In particular, he held that the damages had to be discounted by the fall in the property market which had been the major cause of the losses sustained and for which the insurance had been taken out in the first place. In awarding damages to BBL in respect of its claims against the valuers, that part of the losses attributable to the collapse in the property market had to be discounted.To work out what the discount was in monetary terms involved taking what should have been the correct valuations and subtracting from this the valuations of the properties as at the date of the assessment of damages. So, for example, on the Trevelyan House property, the loss attributable to the collapse in the property market was £7.5 million being the difference between the accurate value of £27.5 million at the time of the valuation and the agreed valuation of £20 million at the date of the assessment of damages. The £7.5 million then had to be deducted in calculating the loss.

3.16 Whether or not this part of the judgment is correct and will stand the test of time is a subject of some contention, not least because of another recent High Court judgment. This is the unreported decision of 10th December 1993 of Gage J, sitting in the Sheffield District Registry, in *United Bank of Kuwait v Prudential Property Services Ltd.* Gage J (unlike Phillips J in *BBL v Eagle Star*) decided that he was bound by the decision of the Court of Appeal in *Baxter v Gapp* [1939] 2 KB 271 and held the valuers liable for the loss attributable to the fall in the property market. It remains to be seen how these conflicting decisions will be resolved.

3.17 It is, however, interesting to note that Fawcus J in a decision which was reported only briefly in the Financial Times on 22nd May 1994 *(Nyckeln Finance v Stumpbrook Continuation Ltd)* stated that he preferred to follow the reasoning of Phillips J rather than Gage J. Accordingly, in the *Nyckeln* case the valuers were held not to be liable for that part of the lender's loss which was attributable to the collapse of the property market. This decision of Fawcus J is of further interest in that it is a striking example of how a lender's damages will be substantially reduced in a claim against a negligent valuer if the lender fails to act reasonably in mitigating its loss.

3.18 A final point to mention on this is that in *Mortgate Express Limited v Bowerman & Partners* (*Times,* 19th May 1994) Arden J ruled (following Phillips J in *BBL v Eagle Star*) that a lender could not hold a negligent solicitor, who failed to notify the lender that it might be lending too much as the solicitor was aware that the property had recently been sold for less, liable for a loss resulting from a fall in the market value of a property. In that case, it was held that the solicitor should have performed a role similar to a valuer and alerted the client to circumstances casting doubt on the value of the property. It remains to be seen whether the same principle will be held to apply to solicitors who are negligent in different ways, say by failing to register charges over properties and delaying forced sales. This case does, however, open the way to other professionals relying on the *BBL v Eagle Star* case to reduce damages awarded against them.

3.19 Having decided that the valuers were not to be held responsible for losses which were attributable to a fall in property prices, two further questions arose in the *BBL v Eagle Star* case:

(1) were the valuers entitled to a credit in respect of the payment which the lender, BBL, had received from its mortgage indemnity insurer? and

(2) could the award of damages against the valuers be reduced because the lender had been contributorily negligent?

The answers which Phillips J gave were, respectively, "no" the mortgage indemnity payment is to be ignored and "yes" if there is contributory negligence then damages are to be reduced. Gage J in *Union Bank of Kuwait v Prudential Property Services Ltd* similarly held that the amount of damages recoverable from a negligent valuer could be reduced if there was contributory negligence on the part of the lender.

3.20 It is to be noted that in *BBL v Eagle Star*, BBL accepted that the valuers were entitled to raise a contributory negligence argument in defence to a claim for breach of contract. BBL did, however, reserve its right to challenge this on any appeal. In the event, Phillips J found that the valuers had contracted with the intermediary rather than with BBL. Hence, BBL's claims lay in tort so that in principle contributory negligence arguments were undeniably open to the valuers. The question whether contributory negligence may be relied on in defence to a claim for breach of contract was considered by the Court of Appeal in *Barclays Bank plc v Fairclough Building Limited* (*Times,* 11th May 1994). In that case, the Court of Appeal held that a defendant to a breach of a contract claim which did not depend on a failure to take reasonable care may not raise arguments of contributory negligence in its defence. This decision does not, therefore, answer the question in the context of valuer's negligence claims.

3.21 It was argued, on behalf of BBL, relying on *Banque Kaiser Ullman v Skandia* [1991] 2 AC 249 ("the gemstones case") that it had not been contributorily negligent because it reasonably believed that the loans were backed by 100% insurance. However, Phillips J. held:

"If a Plaintiff must be considered as if uninsured when the loss is assessed (which was the result of his decision that the valuers could not have the benefit of any mortgage indemnity payment) he cannot logically rely upon the existence of insurance to argue that he was not negligent in incurring the loss. Insurance transfers the risk from the Plaintiff to his insurer, who acquires

rights of subrogation when he indemnifies the Plaintiff. The insurer then stands in the shoes of the Plaintiff. If the risk is one that it was negligent to incur, the fact that the Plaintiff has transferred it to the insurer should not rebound to the insurer's benefit. In my judgment the principle of "res inter alios acta" requires me to ignore the existence of the mortgage indemnity's when considering the issue of contributory negligence".

3.22 The question was, therefore, whether BBL had acted as a reasonably competent merchant bank should have in dealing with these transactions. Phillips J held that BBL had been reasonably competent in the following respects:

(1) in lending up to 90% of the valuation – the 10% margin being sufficient;

(2) in suitably securing interest payments; and

(3) in not requiring the parent standing behind the borrowing "SPV's" (ie, shelf companies) to inject cash.

3.23 However, he held that BBL should have obtained a specific and convincing explanation of the disparity between the recent sale prices and valuations. For that reason, BBL had been contributorily negligent. Phillips J held BBL's failure to have been a "serious lapse" but, in his view, the valuer's conduct was more serious as it was the professional valuer. Accordingly, he reduced BBL's damages by 30% for contributory negligence.

Reduction in insurer's liability if insured acted imprudently?

3.24 Can liability be reduced if the insured acts imprudently? It seems to be a common belief in the insurance industry that there is a common law duty on the insured to "act as a prudent uninsured". Does this duty exist as a matter of law? The answer is, we believe, "yes" and "no"! The answer is "no" in the sense that there are no legal authorities which explicitly support this proposition but "yes" in that there is a strong case for saying that there is a duty for an insured to act reasonably in mitigating its losses. The only authorities we have found which come anywhere near are an old marine reinsurance case, *Scottish Metropolitan Assurance Company Limited v*

Groom [1924] 19 LL.L.R 131 and certain comments in another reinsurance case, *Phoenix General Insurance Co. of Greece S.A. v Halvanon Insurance Co. Ltd.* [1985] 2LL. L.R. 599.

3.25 In *Groom,* the answer successfully defended the shipowner's claim and sought to recover some of the defence costs from reinsurers. This attempt failed, Bailhache J saying:

"... it is the duty of the original underwriter to do the best he can to act as though uninsured, and acting so, if he then pays costs for defending a claim of this sort he does it for himself as well as, of course, incidentally for the reinsuring underwriter".

3.26 In *Phoenix v Halvanon* Hobhouse J said:

"The faculative/obligatory nature of the transaction which imposes no restriction on the reassured's right to choose whether to cede or not to cede, without giving the reinsurer any equivalent right, does necessitate that the reinsured should accept the obligation to conduct the business involved in the cession prudently, reasonably carefully and in accordance with the ordinary practice of the market."

3.27 These cases do not seem to us to afford any basis for saying that an insurer's liability is to be reduced if the insured lender acted imprudently *unless* there is a specific provision in the policy to that effect ie, a clause along the lines of a "deemed disclosure" provision requiring the lender to act in underwriting the loan as if it were uninsured.

4. Reinsurance issues

4.1 Most commercial mortgage indemnity policies are, in turn, reinsured. It is, therefore, important for the insurers to fulfill their duties of material disclosure to their reinsurers, not only when the policy is placed but also if they hope to make a claim. The difficulty is that, on the one hand, the insurer must make full disclosure as the claim progresses to the reinsurer but, on the other hand, will not want to give the reinsurer ammunition to argue against him that there might have been material non-disclosure when the original reinsurance was placed. The usual dilemma!

5. Domestic mortgage indemnity insurance

5.1 Many of the UK's largest composite insurers are involved in this market and have suffered problems as a result. It is probably fair to say that for many years, domestic mortgage indemnity insurance was seen as being something of a loss leader, the purpose of which was to ensure that the building society would suggest to borrowers that they placed their household insurance with the insurer. Plainly, this benefit did not outweigh the burdens of the recent problems which have faced the domestic MIG market but which are now, hopefully, either under control or coming under control.

5.2 Basically, the schemes work as follows:

(1) If a borrower wants to take out a mortgage for an amount that exceeds a specific percentage of the value of the property (usually about 75% of valuation), the building society will insist on having mortgage indemnity insurance protection.

(2) The premium is paid by the borrower (usually by an addition to the mortgage).

(3) The building society is the insured.

(4) The building society (rather than the insurer) determines which advances should be subject to MIG insurance cover.

(5) If the borrower defaults and after the security has been realised there is a shortfall, the insurer will generally pay a proportion of the building society's loss, subject to the application of buy-out clauses (which allow an insurer to opt to crystallise its liability by paying a claim prior to the property being sold).

(6) Generally, there is no reinsurance.

(7) Upon payment of the indemnity or part of it, the insurer may assume subrogation rights to pursue borrowers.

5.3 As already stated, the insured acts as the underwriter both in making the loans

and deciding whether the loan should be subject to MIG cover. An agency relationship arises between insurer and lender which may be expressed in the underwriting authority agreement or else may be implied from the factual position. The importance of establishing agency is, of course, that an agent may be under even more onerous fiduciary duties than an insured.

5.4 The main problems that we have encountered in respect of these schemes are that a few years ago huge losses started to arise under them, the fall in the property market exposed just how many imprudent advances had been made by lenders. For example, in the course of investigating a dispute between an insurer and a building society we found a loan where the monthly repayments were no less than six times the borrower's monthly income!

5.5 The usual arguments are open to insurers to avoid the policy on grounds of material non-disclosure/misrepresentation, but often this is difficult to establish because the original scheme dates back to, say, the 1960's and it is very difficult to establish exactly on what basis it was placed. A more fruitful area, therefore, has been to analyse, with the help of experts, a sample of the mortgage files and to attack the prudence of the loans and the lender's failure properly to mitigate the ensuing losses because of their inadequate arrears procedures. In this regard, it is often enormously difficult to decide how many loans to sample – a portfolio may consist of tens of thousands of risks with thousands of outstanding claims. it is sifficient to review 100 or 500 or 1,000 risks? There is no satisfactory answer to this – it can only be said that it will depend upon the characteristics of the portfolio in question. Sampling of risks will provide ammunition for use in negotiations with the lender over a commutation agreement – the usual basis of which is that the insurer will pay only a proportion of each claim. We have also examined, again with the help of experts, whether there has been a sufficiently high degree of imprudent lending by the insured to enable the insurer to argue that there was a fundamental breach of the agency contract. Needless to say, the evidential burden to establish this would be extremely high.

5.6 The defence we have met from insureds in this situation is for them to argue that for many years the insurers allowed them to do exactly what they wanted and never asked any questions and that, therefore, the insurers affirmed the policy and/or waived all rights to now take points on quality of lending and/or arrears procedures. But, as already said, these arguments ignore the fact that

the insurers believed that the insured agents were acting prudently and in conformity with their duties. As soon as the insurers realised that they were not, when a huge number of claims started to come in, the insurers took steps to investigate the situation, subject to a full reservation of rights.

5.7 The final point that we would make is a topical one concerning subrogation rights. (Although we should preface these remakrs by saying that, in our experience, by and large, insurers are not in fact pursuing wholesale subrogation claims against individual borrowers who have defaulted on their mortgages.) The Insurance Ombudsman has received a complaint about a subrogation claim under a domestic mortgage indemnity policy (*The Observer,* 14th November 1993). This has come from a former home owner against whom an insurance company has attempted to pursue subrogation rights seeking to recover money paid out to the insured building society under the MIG policy. The difficulty for the Ombudsman is that he does not have jurisdiction in this dispute because the borrower is not the policyholder. The question, however, whether the borrower ought to be immune from a subrogation claim, is a nice one. It has been suggested that, prima facie, it is arguable that the MIG policy is for the joint benefit of the building society and the borrower relying on the Court of Appeal's decision in *Mark Rowlands Ltd v Berni Inns Ltd* [1986] 1 QB 211.

5.8 The *Berni Inns* case was a landlord and tenant case where the landlord convenanted to insure the building against fire. As a result of the tenant's negligence the building burned down. The landlord's insurers paid the claim and then sought to exercise rights of subrogation against the tenant. The insurer's claim failed, in summary, for the reason that the landlord had contracted with the tenant to insure the property on behalf of the tenant against the tenant's negligence.

5.9 It seems to us that the argument that the borrower is entitled to the benefit of MIG insurance, does not work for, inter alia, the following reasons. First, a mortgage indemnity policy is plainly for the *sole* benefit of the lender. If the borrower wants to take out mortgage payment protection he may do so in the form of life, redundancy or sickness cover. Secondly, the analogy with the situation in the *Berni Inns* case is not apposite because there is no contractual relationship regarding the benefit of MIG policy between the lender the the borrower in the *same way* as there was between the landlord and the tenant.

Thirdly, if a MIG policy is for the joint benefit of the borrower what would be the position if, when a borrower was in arrears, the insurer elected to operate the "buy-out" clause prior to the property being re-possessed and sold? Would the lender be obliged to apply the proceeds from the MIG policy to the credit of the borrower's account, thereby clearing any arrears and putting the account into credit?

6. Conclusion

6.1 The main reason why insurers had their fingers burnt in the mortgage indemnity insurance market was the combination of the boom in lending of the 1980s and of lenders (and insurers) failing to underwrite these risks adequately. Each was relying on the other. However, as we said at the beginning, the problems have, touch wood, largely been remedied.

SUBROGATION UNDER MORTGAGE INDEMNITY GUARANTEES AN ALTERNATIVE VIEW

by Giles Morgan - Head of Legal Services Alliance & Leicester

I had the privilege of reading, albeit with increasing alarm, a copy of Professor Adams' article on this subject prior to its publication in the issue dated . I am most grateful to Professor Adams for the opportunity to do so.

My alarm stems from the fact that if the arguments put forward by Professor Adams are correct, it is a recipe for the unscrupulous to avoid their proper obligations on the one hand, and for further substantial increases in premiums damaging the chances of a sustained recovery in the housing market, on the other. I hope that the comments set out below will show why a Court can, and should, be very reticent in following the decision in *Mark Rowlands Limited v Berni Inns Limited (1986) 1Q.B211, (1985) 3 All E.R.473* ("the Mark Rowlands case") in relation to mortgage indemnity insurance ("MIG").

It is undeniable that the scenario outlined by Professor Adams is typical of the majority of residential loans made by lending institutions, particularly building societies. However, it is important, in my view, to put the reference to "...insistence