Volume 11 | Issue 3 Article 8

1957

The Interest of Mortgagors and Mortgagees in Fire Insurance Policies

Oscar Jr. Fields

THE INTEREST OF MORTGAGORS AND MORTGAGEES IN FIRE INSURANCE POLICIES

The purpose of this comment is to trace the development of the law of insurance as it pertains to the interests of mortgagors and mortgagees in fire insurance policies, with a discussion of the various types of mortgage clauses, Article 6.15 of the Texas Insurance Code, and subrogation aspects involved.

TYPES OF MORTGAGE CLAUSES

The first clause put into an insurance policy for the purpose of protecting the security of a creditor was what is known as the simple or open mortgage clause. In case of loss or damage to the insured property, such a clause simply instructed the insurance company to pay the proceeds due under the policy to the mortgagee, as his interest might appear. Almost without dissent the courts of this country have held that the effect of such a clause is merely to designate the mortgagee appointee of the funds which would in the absence of the mortgage clause be payable to the mortgagor or owner; the result is that anything rendering the policy void in the hands of the mortgagor in the same manner defeats any rights the mortgagee had under the policy.[1] This is true because there is no privity of contract between the mortgagee and the insurance company under such a clause, hence the mortgagee must recover solely through his mortgagor by showing that the mortgagor has abided by the conditions of his policy.[2]

Apparently the possible injustices to the mortgagee under the open mortgagee clause brought about the introduction of the standard or union mortgage clause. The latter clause is usually worded to the effect that any loss under the policy shall be payable to the mortgagee as his interest may appear and further that the interest of the mortgagee shall not be invalidated by any act or neglect of the mortgagor or owner of the property. In the vast majority of jurisdictions the courts have held that the clause operates as independent insurance of the mortgagee's interest, creating a separate and distinct contract between the insurance company and the mortgagee.[3]

[1] Hamburg-Bremen Fire Ins. Co. v. Ruddell, 82 S.W. 826 (Tex. Civ. App. 1904); 29 Am. Jur., *Insurance* § 552 (1940); Annot., 38 A.L.R. 367 (1925).

[2] Franklin Ins. Co. v. Wolff, 23 Ind.App. 549, 54 N.E. 772 (1899); Inland Finance Co. v. Homes Ins. Co., 134 Wash. 485, 236 Pac. 73 (1925).

[3] Georgia Home Ins. Co. v. Golden, 127 Tex. 93, 91 S.W.2d 695 (1936); Camden Fire Ins. Ass'n v. Harold E. Clayton and Co., 117 Tex. 414, 6 S.W.2d 1029 (1928);

The courts which follow the minority rule hold that a separate contract between the mortgagee and the insurance company is not created by the standard mortgage clause; such courts apply a third party beneficiary theory, stating that the mortgage clause constitutes the mortgagee a third party beneficiary.[4] The distinction, however, would seem to be little more than technical because under either rule the courts have given almost complete protection to the mortgagee from acts and neglects of the mortgagor.

Under the independent contract construction of the standard mortgage clause most jurisdictions hold that the mortgagee is protected from acts and neglects of the mortgagor occuring both prior and subsequent to the issuance of the policy as well as prior and subsequent to the loss.[5] Applying this rule, the Court in *Georgia Home Ins. Co. v. Golden*[6] held that even though the policy was void in its inception as to the mortgagor, the mortgagee was not precluded from recovery. In that case, the mortgagor knew at the time he purchased the policy that the insured premises was to be burned down, but the mortgagee was ignorant of the fraud.

When the mortgagor takes out a fire policy on the mortgaged premises with the standard mortgage clause in favor of the mortgagee, the mortgagee thereby gains a vested interest in the policy. The act of the mortgagor in tearing up the original policy and having the insurer issue another not protecting the mortgagee is not effective to defeat the rights of the mortgagee under the first policy because the mortgagee cannot be deprived of his vested interest in the first policy without his consent.[7] In the *Security Co. v. Panhandle Nat'l Bank*[8] case the Court in holding that the mortgagee has such a vested interest overruled finally the argument that the mortgagor owns the property minus only the mortgagee's lien and therefore should be able to control the insurance policy covering the mortgaged premises.

BACKGROUND AND CONSTRUCTION OF ARTICLE 6.15

The predecessor of Article 6.15,[9] Article 4931, Texas Revised

Rio Grande Nat'l Life Ins. Co. v. Hardware Dealers Mut. Fire Ins. Co., 209 S.W.2d 654 (Tex. Civ. App. 1948) *error ref. n.r.e.;* Boston Ins. Co. v. Rainwater, 197 S.W.2d 118 (Tex. Civ. App. 1946); Feldman v. Costa, 171 S.W.2d 200 (Tex. Civ. App. 1943) *error ref. w.o.m.;* Vance, INSURANCE § 130 (3d ed.); 29 Am. Jur., *Insurance* § 553 (1940); 24e Tex. Jur., *Insurance* § 392 (1956); Annot., 45 A.L.R. 598 (1926).

[4] See, *e.g.*, Walker v. Queen Ins. Co.,—S.C. 144, 134 S.E. 263 (1926).

[5] See note 3, *supra.*

[6] 127 Tex. 93, 91 S.W.2d 695 (1936).

[7] Security Co. v. Panhandle Nat'l Bank, 93 Tex. 575, 57 S.W. 22 (1900).

[8] *Ibid.*

[9] Tex. Ins. Code art. 6.15 (1951).

Civil Statutes (1926), stated in substance that " . . . any act of neglect of the mortgagee or owner" shall not invalidate the interest of the mortgagee in the policy. In *Camden Fire Ins. Ass'n v. Harold E. Clayton and Co.*[10] the mortgagor took out a fire insurance policy on his car, which policy contained a loss payable clause in favor of the mortgagee. Subsequently, the mortgagor took out another policy on the car, violating the "other insurance" clause of the original policy and rendering it void as to the mortgagor. The automobile was destroyed by fire and the mortgagee sued under the loss payable clause of the original policy. He was allowed to recover. The Court interpreted Article 4931 to mean "any act *or* neglect of the *mortgagor.*" Under this construction of Article 4931, the Court concluded that the acts of the mortgagor invalidating the original policy could not invalidate the interest of the mortgagee in the policy.

In 1951 Article 6.15 was promulgated for the purpose of codifying the holding of the *Camden* case, interpreting Article 4931. Article 6.15 provides:

> The interest of a mortgagee or trustee under any fire insurance contract hereafter issued covering any property situated in this state shall not be invalidated by any act or neglect of the mortgagor or owner of said described property or the happening of any condition beyond his control, and any stipulation in any contract in conflict herewith shall be null and void.

Article 6.15 is incorporated by operation of law, even if not expressly incorporated, in all fire insurance policies on any property situated within the State of Texas where the policy purports to insure the combined interest of the mortgagee and the mortgagor.[11]

Article 6.15 creates a separate and independent contract between the mortgagee and the insurance company, the validity of which depends solely on the acts of the mortgagee.[12] The following quotation from the case of *Rio Grande Nat'l Life Ins. Co. v. Hardware Dealers Mut. Fire Ins. Co.*,[13] which interprets Article 4931, is relevant because Article 6.15 is a restatement of the judicial interpretations of Article 4931:

> The statute covers two things against which an insurance company is not permitted to contract as affecting the mortgagee. They are (1) any act or neglect of the mortgagor and (2) the happening of any con-

[10] 117 Tex. 414, 6 S.W.2d 1029 (1928).

[11] Feldman v. Costa, 171 S.W.2d 200 (Tex. Civ. App. 1943) *error ref. w.o.m.*

[12] Citizens State Bank v. American Fire and Cas. Co., 198 F.2d. 57 (5th Cir. 1952); note 3, *supra.*

[13] 209 S.W.2d. 654 (Tex. Civ. App. 1948) *error ref. n.r.e.*

dition that is beyond the control of the mortgagee and it places no burden whatever upon him.

By applying the separate and independent contract theory, the mortgagee's rights under the policy remain unaffected by certain acts of the mortgagor. For example, if the mortgagor obtains a policy by fraud so that it is void as to his interest, the mortgagee's rights under the policy are not affected unless the mortgagee has knowledge of the fraud.[14] Also, if a subsequent purchaser of the mortgaged property procures new insurance in violation of the "other insurance" clause of the policy taken by his grantor, the rights of the mortgagee under the original policy are not destroyed and recovery has been allowed to the extent of one-half from each company.[15] If the insurance company and the mortgagor make a settlement, the mortgagee's rights under the policy are not destroyed in the absence of his knowledge of and consent to the settlement.[16] From these instances it is clear that only the acts of the mortgagee himself can affect or destroy the separate and independent contract created by Article 6.15 between the mortgagee and the insurance company.

The separate and independent contract theory also has effect upon the operation of other clauses of the policy. An example is the situation where the mortgagee acquires title to the mortgaged property through a forced or voluntary sale. Then the change of ownership provision of the policy does not affect the mortgagee's rights under the policy, even though no notice of change of ownership is given.[17] The reason for this result is that the change in ownership is merely regarded as an increase in the mortgagee's interest and not a change in ownership as contemplated by the policy.

SUBROGATION ASPECTS INVOLVED

Where the mortgagee takes out a fire insurance policy on the mortgaged property at his own expense and covering only his interest, it is generally held that the insurance company, on paying the mortgagee an amount at least equal to the amount of the mortgage debt, is subrogated to the rights of the mortgagee against the

[14] Georgia Home Ins. Co. v. Golden, 127 Tex. 93, 91 S.W.2d. 695 (1936).

[15] Union Assurance Soc'y Ltd. v. Equitable Trust Co., 127 Tex. 618, 94 S.W.2d. 1151 (1936).

[16] Scottish Union and Nat'l Ins. Co. v. Field, 18 Colo.App. 68, 70 Pac. 149 (1902); 29 Am. Jur., *Insurance* § 1253 (1940); Annot., 38 A.L.R. 388 (1925).

[17] Ft. Scott Bldg. and Loan Ass'n v. Palatine Ins. Co., 74 Kan. 272, 86 Pac. 142 (1906); 29 Am. Jur., *Insurance* § 651 (1940); Annot., 45 A.L.R. 599 (1926).

mortgagor.[18] Such a rule should not be stated, however, without mentioning the holding in *Kost v. Resolute Underwriters of Rhode Island Ins. Co.*[19] In that case, the mortgagee took out a fire insurance policy covering only his interest. Loss then occurred, the insured property being partially destroyed, after which the mortgagor rebuilt. The mortgagee then assigned his rights under the policy to the mortgagor, who brought suit against the insurer. The insurance company previously had denied liability to the mortgagee, presumably because the mortgagee sustained no loss since the mortgagor had rebuilt. The insurance company argued the defense of circuity of actions, *i.e.*, that the assignment destroyed the right of subrogation they would have had if they had paid the mortgagee. The policy here involved was on the standard three party form but as written covered only the mortgagee's interest. The court held in favor of the mortgagor, saying that the defenses set up by the company would under proper circumstances be good against the mortgagor where the three party contract was involved. These defenses, said the court, were allowed to alleviate the harshness of what is now Article 6.15, which puts a heavy burden on the insurer under a three party contract by making it liable to the mortgagee regardless of the wrongful conduct of the named insured, the mortgagor. When the insurer has to pay the mortgagee under such a contract, the courts then allow the company to be subrogated to the rights of the mortgagee against the mortgagor if the mortgagor has breached policy provisions so that he no longer has any rights under the policy. Here, the court said only the mortgagee and the insurance company were parties to the contract with the result that Article 6.15 was not applicable. The court was impressed by the fact that if the insurer were not liable to the mortgagor, it had incurred no liability, yet had received premiums. The point is that language in the case could be cited for the proposition that the insurer will have no right of subrogation where the two part contract—mortgagee, insurance company—is involved.

It is submitted, however, that the effect of the case should be limited to these peculiar facts and that the insurer should have subrogation rights under these two party contracts except where it has denied liability to the mortgagee because of some fact which does not void the policy, such as the mortgagor's repairing the property.

[18] Phoenix Ins. Co. v. First Nat'l Bank, 85 Va. 765, 8 S.E. 719 (1889); Baker v. Monumental Sav. and Loan Ass'n, 58 W. Va. 408, 52 S.E. 403 (1905); 29 Am. Jur., *Insurance* § 1351 (1940).

[19] 211 S.W.2d. 758 (Tex. Civ. App. 1948) *error dism.*

In the *Kost* case the court seemed to feel that since no policy provisions had been breached and the policy was still in effect, the insurance company ought to pay someone.

Different problems arise where the policy is issued at the request and expense of the mortgagor when the policy also purports to cover the interest of the mortgagee. In such a case subrogation did not exist under the old simple or open mortgage clause. The doctrine did not apply because, as previously shown, the right of the mortgagee to recover depended upon the mortgagor's fulfilling all conditions of the policy. A breach by the mortgagor also defeated the right of the mortgagee to recover under the open mortgage clause. If there was no breach and the insurer paid the mortgagee, the insurer was not subrogated to the rights of the mortgagee because the mortagor, not having breached any of the provisions of the policy, was still an insured and entitled to receive the benefits of any payments made for loss of the insured property.[20]

The same rules but different considerations apply when the policy contains the standard mortgage clause or a clause such as that provided in Article 6.15. Under such a clause in a policy procured by the mortgagor, virtually all jurisdictions recognize that before the insurance company can be subrogated to the rights of the mortgagee upon paying him the amount of the loss, the mortgagor must have no claim against the insurer under the policy.[21] That is, the mortgagor must have forfeited his rights under the policy so that he is no longer an insured. This fundamental requirement was stated in *Aetna Life Ins. Co. v. National Union Fire Ins. Co.*[22] in words to the effect that where the insurance company has paid the mortgagee for loss by fire to the mortgaged property, the right of subrogation depends on whether the policy has been procured by fraud. If it has not been so procured, the payment by the insurance company to the mortgagee cancels and discharges the mortgage as fully as though it were paid and discharged by the mortgagor himself. In other words, the insurance company's right of subrogation depends upon its legal liability to the mortgagor.

Once it is determined that the mortgagor has forfeited all his rights under the policy, thereby creating the possibility of subroga-

[20] Burton Lingo Co. (Fire Ass'n of Philadelphia, Intervenor) v. Patton, 15 N.M. 304, 107 Pac. 679 (1919); Annot., 41 A.L.R. 1274 (1926).

[21] Girand Fire and Marine Ins. Co. v. Farmer, 53 S.W.2d. 1015 (Tex. Comm. App. 1932); Home Ins. Co. v. Boatmer, 218 S.W. 1097 (Tex. Civ. App. 1920), *aff'd*, 239 S.W. 928 (Tex. Comm. App. 1922); Washington Fire Ins. Co. v. Cobb, 163 S.W. 608 (Tex. Civ. App. 1914); 29 Am. Jur., *Insurance* § 1352-53 (1940).

[22] 98 Neb. 446, 153 N.W. 553 (1915).

tion, the majority of jurisdictions hold that in the absence of a specific provision in the policy for subrogation, the insurer will not be subrogated to the rights of the mortgagee even after payment to him.[23] These courts reason that the insurance is on the property; therefore, the mortgagor or owner should get credit for any amount paid. The cases which follow the minority rule hold that when the insurer pays the mortgagee under a standard mortgage clause, it should be subrogated to the mortgagee's rights regardless of whether there is an express provision for subrogation in the insurance contract.[24]

The effect of the majority rule in these cases is to make subrogation depend entirely on contract and to deny that legal or equitable subrogation is applicable to this type of case. The ultimate result, of course, is that the mortgagor receives benefit from a policy under which he is no longer an insured due to his own act or neglect. Such an unjust result should be justification enough for applying the doctrine of legal subrogation in favor of the insurer.

In seeking to hold the mortgagor under its subrogation rights, the insurer must plead and prove a state of facts entitling it to subrogation. A mere claim of non-liability to the mortgagor apparently is insufficient.[25]

If the court determines that the right of subrogation exists in the insurer, it is generally held to exist subject to the mortgagee's right to recover the amount of the debt in full. This is especially true when the mortgage clause provides that the subrogation rights therein granted shall not impair the mortgagee's right to sue.[26] In the case of *Lervold v. Republic Mut. Fire Ins. Co.,*[27] the court construed the phrase "shall not impair the mortgagee's right to sue" to mean the mortgagee's right to recover was not to be impaired and held that the insurance company's right of subrogation was subordinate to the right of the mortgagee to recover in full.

---

[23] Tarrant Land Co. v. Palmetto Fire Ins. Co., 220 Ala. 428, 125 So. 806 (1930); Milwaukee Mechanics Ins. Co. v. Ramsey, 76 Ore. 570, 149 Pac. 542 (1915); Fields v. Western Millers Fire Ins. Co., 290 N.Y. 209, 48 N.E.2d. 489 (1943); 29 Am. Jur., *Insurance* §§ 1352-53 (1940); 24e Tex. Jur., *Insurance* § 400 (1956); Annot., 146 A.L.R. 442 (1943).

[24] First Nat'l Bank v. F. & M Ins. Co., 104 Kan. 278, 178 Pac. 413 (1919); Combs v. American Ins. Co., 296 Ky. 535, 177 S.W.2d. 881 (1944). The Texas courts have never definitely supported one rule or the other. However, the case of *British Am. Assur. Co. v. Mid-Continent Life Ins. Co.,* 37 S.W.2d 742 (Tex. Civ. App. 1931), does mention the minority rule with favor even though the court indicated that the rule might go somewhat further than they would wish to go.

[25] Loewenstein v. Queens Ins. Co., 227 Mo. 100, 127 S.W. 72 (1910); New Birnswick Fire Ins. Co. v. Girdner, 28 S.W.2d. 193 (Tex. Civ. App. 1930); 29 Am. Jur., *Insurance* § 1353 (1940); 24B Tex. Jur., *Insurance* § 400 (1936); Annot., 52 A.L.R. 278 (1928).

[26] Lervold v. Republic Mut. Fire Ins. Co., 142 Kan. 43, 45 P.2d. 839 (1935); Annot., 106 A.L.R. 679 (1937).

[27] 142 Kan. 43, 45 P.2d. 839 (1935).

The Texas courts are in accord with the view expressed in the *Lervold* case with at least one case that could be authority for the rule that the insurance company can have no subrogation rights until the mortgagee has been paid the full amount of the debt.[28]

CONCLUSION

It may be said that the law on this subject is fairly well settled with conflicts remaining in only a few areas. The problems and injustices that arose under the simple or open mortgage clause are cured today by the provisions of Article 6.15 of the Texas Insurance Code, which are incorporated into the Texas Standard Fire Insurance Policy used by all insurers in the state.

Oscar Fields, Jr.

[28] National Ben Franklin Fire Ins. Co. v. The Praetorians, 67 S.W.2d. 333 (Tex. Civ. App. 1934) *error ref.*; British Am. Assur. Co. v. Mid-Continent Life Ins. Co., 37 S.W.2d 742 (Tex. Civ. App. 1931).