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Supreme Court of Arkansas Rules that Standard Mortgage Clause in Insurance Contracts Protects Mortagees from Acts of their Mortgagors

By Geoffrey D. Kearney

On December 16, 2009, the Ludwicks' home burned down. During the course of investigating the claim for their loss, Nationwide Mutual Insurance Company, their insurer, discovered that while the Ludwicks had disclosed the occurrence of a fire at an "outside shop" in 2007, they had

failed to disclose two other fire losses that occurred in 2008 and 2009.

Nationwide voided the policy, refunded the Ludwicks' premiums, and denied their claim. As the court recognized, such rescission is uncontroversial, as Arkansas law allows rescision when an insured has made a material misrepresentation or omission of previous fire losses. Ferrell v. Columbia Mut. Cas. Ins. Co., 306 Ark. 533, 537, 816 S.W.2d 593, 595 (1991) (citing Old Colony Life Ins. Co. v. Fetzer, 176 Ark. 361, 3 S.W.2d 46 (1928)). The gravamen in this case, however, is not the denial of the Ludwicks' claim. Rather, the center of the dispute is that Nationwide denied the claim made by Citizens Bank and Trust Company, the Ludwicks' mortgagee (as well as an additional insured on the policy), under the theory that because the Ludwicks' bad acts had voided their policy ab initio, Citizens was also barred, regardless of the presence of a standard mortgage contract.

Under these circumstances, what effect the rescission of a mortgagor's dwelling fire policy has on the right of its named mortgagee and additional insured to make a claim is "an issue of first impression that is of significant public interest", thereby bringing the case within the jurisdiction of the Supreme Court of Arkansas pursuant to Arkansas Supreme Court Rules 1-2(b)(1), (b)

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(4), and (d)(2) (2013) on a certification from the Court of Appeals. Nationwide Mut. Fire Ins. Co., 2014 Ark. 20, 1.

The opinion's citation of Couch on Insurance, which sets forth a general rule that is also the Arkansas rule, provides a helpful introduction (or refresher) regarding standard mortgage clauses:

"Under the standard or union mortgage clause, an independent or separate contract or
undertaking exists between the mortgagee and the insurer, which cannot be defeated by improper or negligent acts of the mortgagor, whether done or permitted prior or
subsequently to, or at the time of, the issuance of the policy.

The means of accomplishing this protection is some form of language that the insurance with respect to the mortgagee shall not be invalidated by the mortgagor's acts or neglect. The words 'any acts' as used in a standard mortgage clause do not refer merely to acts prohibited by the contract or to a failure to comply with the terms
of the contract, but literally embrace any act of the mortgagor."

4 Couch on Insurance § 65:48 (3d ed.) (footnotes omitted).

As such, a standard mortgage clause is

essentially “a separate contract between Appellant and Appellee.” Nationwide Mut. Fire Ins. Co., 2014 Ark. 20, 6. Under such a clause, it is “as if the [Appellee] had independently applied for insurance.” Id. (citing Farmers Home Mut. Fire Ins. Co. v. Bank of Pocahontas, 355 Ark. 19, 24, 129 S.W.3d 832, 835 (2003)). In sum, then, the rule of law is that under a standard mortgage clause, the mortgagee and insurer are in privity of contract, any claim made by the mortgagee is made pursuant to that relationship and not the contract between the mortgagor and insurer, and the acts of a mortgagor-insured do not affect its mortgagee’s right to make a claim. There are two agreements, related but, at least in one important way, unconnected, and even though one comes into existence because of the other, it cannot be extinguished because of the other. Under this legal framework, the court rejected all of Nationwide’s arguments.

Nationwide’s argument that “rescission voids a policy regardless of whether the policy’s mortgage clause is a standard mortgage clause” and can be invoked only in cases of “denials of claims, cancellation, and nonrenewals” fails because it “overlooks the effect of our law treating the mortgagee as having an independent contract unaffected by the acts of the insured.” Nationwide Mut.

Fire Ins. Co., 2014 Ark. 20, 6. The arguments that Citizens is bound by the conditions of the policy (namely language regarding "concealment or fraud") and has failed to abide by it and that the decision is not a denial, making terms and conditions related to denial of claims irrelevant, were similarly futile.

This case appears to put to bed any ambiguities as to whether a mortgagor's bad acts, without more, have any effect on the right of a mortgagee to make a claim when the policy has a standard mortgage contract. Somewhat interestingly, one issue to which the parties stipulated was that the clause in question was a standard mortgage clause. Though the opinion does not specify, it seems likely that the other possibility for the provision was a loss payable clause, under which, unlike a standard mortgage clause, defenses related to mortgagor conduct actually are available. Black's Law Dictionary 1576 (3rd ed. 1968). While, prospectively, insurers might make changes in their policies or underwriting procedures, they will probably also be much less likely to stipulate to the characterization of an supposed standard mortgage clause. Further, now that it is clear they cannot impute actions taken by insured-mortgagors to their mortgagees, insurers might also be more likely to allege improper conduct by

the mortgagee as a defense against paying the mortgagee of a mortgagor whose claim has been barred.

This case has the potential to have relevance to litigants on either side in the insurance law context.