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Foreclosure, Loss, and the Proper Distribution of Insurance Proceeds Under the Open and Standard Mortgage Clauses: Some Observations

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FORECLOSURE, LOSS, AND THE PROPER DISTRIBUTION OF INSURANCE PROCEEDS UNDER OPEN AND STANDARD MORTGAGE CLAUSES: SOME OBSERVATIONS

INTRODUCTION

The mortgage clause is a provision in the mortgagor's property insurance policy that is designed to protect the mortgagee against loss from causes covered by the policy. Basically there are two categories of mortgage clauses, and the phrases "open mortgage clause" and "standard mortgage clause" will be employed herein to designate these categories.¹

When cases involve foreclosure followed by loss or loss followed by foreclosure, the interpretation of a particular mortgage clause and the proper distribution of proceeds can prove to be difficult and confusing. These problems are accentuated when the mortgagee purchases the property for the full amount of the mortgage debt at foreclosure sale. The primary objectives in dealing with these issues are: (1) to present a brief background of open and standard mortgage clause principles, (2) to analyze representative cases and consider the soundness of the decisions, and (3) to illustrate the inequities which arise from mechanically applying a rule of law concerning distribution of proceeds in standard mortgage clause loss-foreclosure situations.

BACKGROUND: BASIC PRINCIPLES

Open Mortgage Clause

The open mortgage clause provides that "loss, if any, is payable to the mortgagee as his interest may appear, subject nevertheless to all the conditions of this policy." Under this type of clause the mortgagee is an appointee to receive the insurance funds recoverable in case of loss, recovery being limited by the extent of the mortgagor's interest.² The interest insured is the mortgagor's interest in the property; the mere fact that the policy is payable to the mortga-

¹. The open mortgage clause is sometimes referred to as a simple loss-payable clause, and the standard mortgage clause is sometimes called a union mortgage clause.

gee does not constitute insurance of the mortgagee's interest. The phrase "as his interest may appear," therefore, refers to the amount of the debt owed to the mortgagee and signifies that the insurer will pay the mortgagee only to the extent that his mortgage is a lien or charge on the premises.

Since it is the mortgagor's interest in the property that is insured, the mortgagee's right of recovery is no greater than that of the mortgagor. Thus, a breach of the policy conditions by the mortgagor which prevents recovery by him also prevents recovery by the mortgagee. Accordingly, if the mortgage debt is extinguished in any way, the mortgagee is not entitled to any insurance proceeds. The mortgagee's interest under the policy extends only to a security for his debt, and such interest ceases when the debt is extinguished. A foreclosure of the mortgaged property and the mortgagee's purchase of the property for the full extent of the debt, therefore, totally extinguish the interest. As a result, the relation of mortgagor and mortgagee, or debtor and creditor, is dissolved.

The addition of an open mortgage clause to the policy does not alter the terms of the insurance contract between insurer and mortgagor. No greater or different burden is assumed by the insurer due to the presence of the clause, because the clause merely designates

4. In Eagle Star & British Dominions v. Tadlock, 22 F. Supp. 545 (S.D. Cal. 1938) it was stated:
   The words "as their interest may appear," in insurance policies, have been before the courts repeatedly. They refer to debts owed by the insured. When a mortgagor is so designated, the clause . . . means that the insurer will pay the mortgagee "to the extent of his lien . . ." at the time of the loss.
   Id. at 547.
8. COUCH § 42:661.
to whom the loss will be paid. It follows that no original contract of indemnity between insurer and mortgagee is created by the open mortgage clause.

**Standard Mortgage Clause**

The standard mortgage clause differs appreciably from the open mortgage clause in that its terms are extremely comprehensive. Those terms which are most pertinent to the discussions below are as follow:

Loss or damage, if any, under this policy, shall be payable to the mortgagee as his interest may appear, and this insurance as to the mortgagee only therein, shall not be invalidated by any act or neglect of the mortgagor or owner of the within described property, nor by any change in the title or ownership of the property, nor by the occupation of the premises for purposes more hazardous than are permitted by this policy, provided, that in case the mortgagor or owner shall neglect to pay any premium under this policy, the mortgagee shall on demand pay the same.

At the present time most policies protecting the mortgagee contain a standard mortgage clause. Courts generally hold that this clause, unlike the open mortgage clause, operates as an independent contract between the insurer and the mortgagee, the terms of which contract are identical to those in the policy itself. Because

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14. Further provisions of the standard mortgage clause are reproduced in the Appendix, infra.
15. 43 Am. Jur. 2d Insurance § 768; see also Cooper, The Effect of the Standard Mortgage Clause in Insurance Policies, 12 Ind. L.J. 50 (1936-37).
16. A few courts have taken the position that under the standard mortgage clause the essential elements of a contract are lacking. These courts characterize the status of the mortgagee as that of a third party creditor-beneficiary. This viewpoint was expressed in Walker v. Queen Ins. Co., 136 S.C. 144, 134 S.E. 263 (1926):

The contract of insurance was . . . for the mutual benefit of both mortgagor and mortgagee, and in no sense a contract between the mortgagee and the insurance company; the mortgagee being simply a third party who, by the contract between the mortgagor and the insurance company, acquired a beneficial interest in the policy, really as additional security to the bond or note secured by the mortgage.

*Id.* at 151, 134 S.E. at 269.
an independent contract exists between the insurer and the mortgagor, the status of the mortgagee is superior to that of a mere appointee as under the open mortgage clause.

APPLICATION OF THE BASIC PRINCIPLES TO OPEN MORTGAGE CLAUSE CASES

Foreclosure and Subsequent Loss

A case cited frequently is Reynolds v. London & Lancashire Fire Insurance Co., 18 in which the open mortgage clause provided as follows: "Loss, if any, payable to M.D. Reynolds, on buildings only." Reynolds foreclosed and purchased the property for the full amount of the debt, including interest and costs. After the foreclosure but before the period of redemption 19 had expired, the dwelling house on the property was destroyed by fire. The mortgagor furnished proof of loss and performed all the necessary conditions of the policy, and the defendant insurance company paid him for all loss and damage.

In a suit against the insurer for the proceeds, the lower court held for the mortgagee. The Supreme Court of California reversed, stating:

[I]n such a case, as the mortgagee has an interest in the policy only as security for his debt, it follows that such interest ceases whenever the debt is discharged, and there is no longer the relation of creditor and debtor between him and the mortgagor. 20

The court reasoned that if the mortgagor had extinguished the debt by paying it, there could be no claim that the mortgagee retained any cause of action on the policy. Therefore, the foreclosure proceedings and the mortgagee's purchase of the property for the full

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18. 128 Cal. 16, 60 P. 467 (1900).
19. Id.
20. The term redemption as utilized herein refers to the statutory right of redemption, rather than to the equity of redemption. The former may be briefly defined as the mortgagor's right to buy back property after a foreclosure, while the latter exists only before foreclosure has occurred. The distinctions were discussed in Robertson v. Van Cleave, 129 Ind. 217, 26 N.E. 899 (1892):

The statutory right does not come into existence until after the sale; nor . . . can it be barred by a decree foreclosing a mortgage; but the equity of redemption exists prior to a [foreclosure] suit, and may be barred by a decree.

Id. at 221-22, 26 N.E. at 900.
21. 128 Cal. at 16, 60 P. at 467.
amount of the debt extinguished fully the debt, and the mortgagee no longer remained a creditor of the mortgagor. Consequently, there was no longer an enforceable debt. The mortgagee became the substantial owner of the property, and the mortgagor retained only the statutory right of redemption.\textsuperscript{22}

\textit{Loss and Subsequent Foreclosure}

In \textit{Power Building & Loan Association v. Ajax Fire Insurance Co.},\textsuperscript{23} the mortgage clause provided that any fire damage to the insured building would be payable to Power, the mortgagee.\textsuperscript{24} After a fire occurred, the mortgagee foreclosed and purchased the property. The Court of Errors and Appeals of New Jersey, reversing a lower court judgment for the mortgagee against the insurer, noted that the facts did not indicate whether the mortgagee’s purchase equalled the full amount of the mortgage debt. It was held that there could be no recovery by the mortgagee until such determination was made. If the purchase price were equivalent to the full amount of the debt, the debt would be satisfied, and the insurer’s liability to the mortgagor would be cancelled. But if the sale price did not equal the full amount of the debt, the insurance company would be liable to the mortgagee-owner for the difference between the debt and the purchase price at the sale.\textsuperscript{25}

After observing the foreclosure-loss and loss-foreclosure factual situations under the open mortgage clause, it is evident that both \textit{Reynolds} and \textit{Power} demonstrate the identical principle: once the mortgage debt is fully extinguished, either by the mortgagor’s payment or by the mortgagee’s foreclosure and purchase for the full amount of the debt, the mortgagee’s rights under the insurance contract are terminated. These cases are, therefore, in agreement with the authorities regarding the interests, rights and obligations

\textsuperscript{22} The \textit{Reynolds} court held that the purchaser at a foreclosure sale obtains a defeasible fee and that the debtor retains only a reversionary interest: “[A]fter the sale [the mortgagor] has only a right of redemption, while the purchaser has the entire beneficial interest in the property, subject to be defeated by a redemption from the sale.” \textit{Id.} at 17, 60 P. at 468.

Other courts have held that the purchaser obtains only a lien on the property. \textit{See Robertson v. Van Cleave}, 129 Ind. 217, 26 N.E. 899 (1892): “[T]he sheriff’s sale did not . . . vest title . . . , but it did evidence a lien.” \textit{Id.} at 225, 26 N.E. at 901.

\textsuperscript{23} 110 N.J.L. 256, 164 A. 410 (Ct. Err. & App. 1933).

\textsuperscript{24} \textit{Id.} at 257, 164 A. at 410.

\textsuperscript{25} The \textit{Power} court ruled: “[T]he burden rested on [the mortgagee] to show that the foreclosure sale did not produce enough to satisfy the mortgage in full, and that the mortgage debt still remained unsatisfied at least in part.” \textit{Id.} at 258, 164 A. at 411.
of the parties in an open mortgage clause situation. As previously stated, the open mortgage clause insures only the mortgagor's interest, and the mortgagee is merely an appointee to collect the proceeds. Therefore, when the mortgagor's interest is extinguished, the mortgagee retains no basis for recovery. Similarly, if the mortgage debt is dissolved, the mortgagee's interest in the policy is terminated.

The soundness of the principles demonstrated in Reynolds and Power is well settled with reference to open mortgage clauses. Concerning distribution of insurance proceeds, it is to be noted that no apparent distinction exists between foreclosure-loss and loss-foreclosure situations. Observation of the standard mortgage clause cases, however, will reveal that attempts to distinguish between foreclosure-loss and loss-foreclosure situations result in: (1) a confusing and inconsistent application of standard mortgage clause principles, (2) a disregard for the distinctions between open and standard mortgage clause terms, and (3) the possibility of an inequitable distribution of proceeds.

**APPLICATION OF THE BASIC PRINCIPLES TO STANDARD MORTGAGE CLAUSE CASES**

**Foreclosure and Subsequent Loss**

The case of Guardian Savings & Loan Association v. Reserve Insurance Co. involved a standard mortgage clause which provided that the interest of the mortgagee would not be invalidated "by any foreclosure or other proceedings . . . nor by any change in the title or ownership of the property . . . ." Because the mortgagor defaulted, the mortgagee foreclosed and then purchased at his foreclosure sale; loss occurred after foreclosure. The defendant insurance company refused payment to the mortgagee, claiming that the policy only protected the mortgagee's interest as mortgagee, not as owner. The insurer maintained that at the time of loss the mortgagor's interest had ripened into ownership and that therefore the mortgagee was not entitled to the proceeds. Apparently the insurer relied on the mortgage clause wording "as interest may appear" to

27. Id. at 78, 276 N.E.2d at 110.
28. Although the facts did not so indicate, the assumption is that the purchase price equalled the full amount of the debt, since the property was undamaged when foreclosure occurred.
29. This standard mortgage clause wording is very similar to that in open mortgage
signify that protection is only provided for the interest that was held at the time the policy was issued—that of mortgagee. The insurer argued further that since the mortgagee had not notified the insurer of the change in status from mortgagee to owner, a notice requirement of the mortgage clause was violated, thus barring the mortgagee-owner from recovery.

The lower court held that the insurer properly denied the claim of the mortgagee-owner, but the Appellate Court of Illinois reversed, ruling that by the terms of the standard mortgage clause the mortgagee's rights were not to be invalidated by a foreclosure. To support this ruling the court quoted an earlier Illinois case:

'It is admitted that by the agreement the insurance was not to be invalidated by a foreclosure, which could only apply in case the [mortgagor] became the purchaser, for the reason that if anyone else had purchased the [mortgagee] would not have had any further insurable interest.'

The terms of the standard mortgage clause, therefore, were "intended to cover the mortgagee's interest as it succeeded to ownership through foreclosure." In addition, the appellate court stated that "the entire tenor of the mortgage clause is to extend coverage under various contingencies to the mortgagee," and that the terms of the mortgage clause protect the mortgagee "irrespective of whatever interest in the . . . property the mortgagee might succeed to after foreclosure." The insurer's lack of notice argument was also rejected, because the court concluded that the notice requirement was of no real benefit to the insurer in this case.

clauses. Such similarity may account for some of the confusion in distinguishing between the two clauses.

30. See Appendix infra, where the notice requirement is reproduced.
32. Id. at 79, 276 N.E.2d at 111.
33. Id.
34. Id.
35. There has been negative reaction to the Guardian decision. See Ferrini, Mortgagee, Whose Interest Has Ripened Into Ownership Upon Foreclosure, Allowed to Recover Under Standard Mortgage Clause, INSURANCE ADJUSTER, May 1972, at 10, in which it was contended that the Guardian decision was "contrary to the interest of the insurance industry as expressed in the standard . . . mortgage clause . . . ." Id. It was emphasized that because the redemption period had expired, the mortgagee's interest had ripened into ownership. Since
In *Shores v. Rabon* the typical provisions of the standard mortgage clause were present. After the mortgagor purchased for the full amount of the mortgage debt, the loss occurred. In the mortgagor's suit to recover the proceeds, the defendant insurer's main contention was that the mortgagor-mortgagee relationship "was extinguished by the foreclosure sale and that the change of ownership and failure to give notice thereof terminated the insurance contract as to the [mortgagee]." These arguments were rejected by the Supreme Court of North Carolina. It was restated that the standard mortgage clause creates a separate and independent contract between the insurer and the mortgagee, and that "it must be assumed that insurance companies contract and fix rates in full contemplation of the risk imposed thereby." According to the court, the possibility of foreclosure "entered into the calculations of the insurer in issuing the contract." The mortgagor's insurance, therefore, was not extinguished by his foreclosure and purchase for the full debt at the sale. Acquisition of title to the insured property was characterized as an increase of interest rather than as a change of ownership, and as such was not to defeat the right of a mortgagor under a standard mortgage clause, "despite the argument that the mortgagor's interest as mortgagor had terminated, he should not have been allowed to recover insurance proceeds, since only his interest as mortgagor was insured. It was further stated that if the redemption period had not expired, the mortgagor's interest as mortgagor would have still existed and he should recover. The argument that the word "mortgagor" is a matter of convenient description was rejected.

It is submitted that the expiration of the redemption period was an important factor for justifying the recovery in *Guardian*, because it was then unnecessary to determine the parties' rights during the redemption period. The *Guardian* standard mortgage clause contained the usual foreclosure and change of title terms which were properly recognized by the court. Furthermore, open mortgage clause language was relied upon to advocate a denial of recovery to the mortgagor, employing the argument that full extinguishment of the debt by foreclosure and purchase precludes recovery by the mortgagor.

Under the theory relied upon by Mr. Ferrini, the insurer would be liable to no one in this situation. Assuming that the mortgagor had no basis for recovery because his interest had completely disappeared after expiration of the redemption period, the insurer's escape from liability in this case appears unfair in light of the fact that the event insured against did occur.

The question concerning how long the original insurance remains in force as protection for the mortgagee-owner should not be decided by reference to open mortgage clause arguments.

37. *Id.* at 794, 112 S.E.2d at 559.
38. *Id.* at 795, 112 S.E.2d at 560.
39. *Id.*
40. *Id.*
the word 'mortgagee' in that clause discloses an intention to benefit one in that capacity only . . . ."\textsuperscript{41}

The argument that the word "mortgagee" in a standard mortgage clause refers only to one who remains in that capacity was also rejected in \textit{Union Central Life Insurance Co. v. Codington County Farmers Fire & Lightning Mutual Insurance Co.},\textsuperscript{42} where the Supreme Court of South Dakota maintained:

\textit{[T]he word "mortgagee" is a mere matter of convenient description or designation, and was not intended to limit the primary agreement to pay the loss to the beneficiary "as his interest may appear." It is held that provisions dealing with change of ownership apply only to strangers of the insurance contract . . . .}\textsuperscript{43}

The \textit{Union} court also emphasized the background and construction of the standard mortgage clause:

The phraseology of the standard mortgage clause is not the product of casual or haphazard draftsmanship. . . . It has emerged from years of practical experience in writing contracts acceptable to the insurers and to mortgagors and mortgagees. Undoubtedly it was framed with knowledge of the incidents of the mortgage relation and in contemplation of the fact that a considerable percentage of the mortgagees insured thereunder would be forced to take title through foreclosure of the mortgages. It must be true that the clause was worded with full understanding that its terms, if ambiguous, would be construed most strongly against the insurer. . . . [I]f it had been intended that the protection of the mortgagee should cease with the foreclosure of the mortgage . . . . that intention would have been expressed in unequivocal words.\textsuperscript{44}

\textsuperscript{41} \textit{Id.}
\textsuperscript{42} 66 S.D. 561, 287 N.W. 46 (1939).
\textsuperscript{43} \textit{Id.} at 565, 287 N.W. at 50. The \textit{Union} court employed the third party creditor-beneficiary theory rather than the independent contract theory. \textit{See note 16, supra. Nevertheless, the court reached a result equivalent to that under the independent contract theory by maintaining that the third party theory provides the mortgagee with "independent separate rights enforceable in his own name unaffected by defenses predicated upon acts of the mortgagor." Union Central Life Ins. Co. v. Codington County Farmers Fire & Lightning Mutual Ins. Co., \textit{supra} at 563, 287 N.W. at 48.}
\textsuperscript{44} \textit{Id.} at 565, 287 N.W. at 50.
The cases immediately preceding have considered the standard mortgage clause in situations where loss occurred subsequent to foreclosure and purchase by the mortgagee. Several principles exemplified in these cases should be reiterated at this time. First, the weight of authority holds that the standard mortgage clause creates an independent contract between the insurer and the mortgagee. Second, the terms of the clause were constructed purposefully and thus should be effectuated properly. Third, the standard mortgage clause protects the mortgagee’s interest in the property, whereas the open mortgage clause refers solely to a property interest of the mortgagor. Fourth, a change in status from mortgagee to owner through foreclosure and purchase does not defeat the mortgagee-owner’s right to the insurance proceeds because the provisions of the standard mortgage clause are designed to accommodate such change in status.

Although it appears that these four principles should apply equally to factual situations in which loss occurred prior to foreclosure, the courts have not so applied them. The mortgagee who purchases for the full debt at his foreclosure sale subsequent to the loss has been denied recovery of insurance proceeds, while his counterpart who acts prior to the loss has been allowed to recover. A group of cases dealing with the standard mortgage clause loss-foreclosure situation deserves special scrutiny in order to isolate those distinguishing factors which are said to compel such contrary results. It is interesting to note that in the loss-foreclosure cases the courts have either disregarded the standard mortgage clause terms or negated them through the use of open mortgage clause reasoning.

Loss and Subsequent Foreclosure

In *Northwestern Insurance Co. v. Mildenberger* a loss by fire occurred, after which the mortgagee foreclosed and purchased for the full amount of the debt. Following the foreclosure sale both mortgagor and mortgagee claimed the insurance. Although the applicable standard mortgage clause contained the usual provisions regarding foreclosure and change of title, the St. Louis Court of Appeals reversed a lower court judgment for the mortgagee. The appellate court discussed the independent contract theory but characterized the independent contract therein as a limited one. Quoting from an earlier Missouri case, the court stated:

45. 359 S.W.2d 380 (Mo. App. 1962).
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[T]he 'union' clause operates as an independent contract of insurance, which cannot be defeated by a breach on the part of the mortgagor of the conditions of the policy . . . . Observe that, while it is an independent contract, it is such only for a limited purpose, so that the act of the mortgagor alone and of itself cannot defeat the right of the mortgagee. Nevertheless, it is not an entirely disconnected contract.46

Since the property was in a damaged condition, the court reasoned that the mortgagee should have purchased for less than the full debt. By maintaining that "[i]n no event was the [mortgagee] to collect more than the balance due on the note . . . .,"47 the court implied that if the mortgagee received insurance proceeds and also recovered in full the amount of the mortgage debt through his purchase, he would receive more than was actually due to him. The court further stated that the phrase "as its [the mortgagee's] interest may appear" refers to the amount of the debt owed to the mortgagee and not to the mortgagee's interest in the property. Accordingly, the former "can be the only interest of the mortgagee."48 Finally, the court ruled that the mortgagee's interest in the policy, as well as the creditor-debtor relationship between mortgagee and mortgagor, were terminated by "the payment of the debt by purchase at foreclosure sale for the full amount of the balance due . . . ."49

In Mildenberger it is clear that the terms of the standard mortgage clause were rendered ineffective. First, the court treated the independent contract established by the clause as a limited one. Second, the clause was interpreted as referring to the mortgagee's interest in the insured property. Furthermore, the aspect of the "double recovery" was introduced. This last factor is more fully developed in the cases which follow.

Rosenbaum v. Funcannon50 involved a mortgagee who foreclosed and purchased for the full amount of the debt, although prior to foreclosure the house on the property was almost completely destroyed by fire. In affirming the district court's denial of the mort-

48. Id. at 386.
49. Id.
50. 308 F.2d 680 (9th Cir. 1962).
gagee’s claim for recovery, the United States Court of Appeals for the Ninth Circuit ruled:

[I]t is well settled that full or partial extinguishment of the debt itself, whether prior to the loss . . . or subsequent to the loss . . . precludes to the extent thereof, any recovery by the loss-payable mortgagee for the plain and sole reason that the debt, itself, has been to that extent extinguished. 51

The precedents cited for the quotation above were Reynolds and Power, two cases that have already been discussed with regard to open mortgage clauses. In effect, the court’s ruling ignored the distinguishing characteristics between open and standard mortgage clauses and employed the open mortgage clause theory that extinguishment of the debt terminates the mortgagee’s rights to the policy. The court also expressed the theory that the value of the property to the bidder is reflected by his bid and that the mortgagee at the foreclosure sale could have bid less than the full amount of the debt since the property was severely damaged:

Presumably, [the mortgagee] bid what she thought the security property to be worth in its condition at the time of her bid. To bid more than the property was then actually worth was not required of [the mortgagee], nor would such a bid be sensible. 52

The obvious inference is that if the mortgagee has received the value of the debt through his purchase at foreclosure sale, the receipt of any additional proceeds would constitute a double recovery by the mortgagee. Thus, the court maintained that the mortgagee should have bid only up to the value of the damaged property, and that the remainder could be recovered in a deficiency judgment. 53

Another case dealing with the standard mortgage clause loss-foreclosure situation is Whitestone Savings & Loan Association v. Allstate Insurance Co., 54 in which the Court of Appeals of New York refused to allow the mortgagee to recover. The court quoted rather extensively from Rosenbaum to the effect that full extinguishment

51. Id. at 684 (citations omitted).
52. Id. at 685.
53. The court stated that “extinguishment of the mortgage . . . by the foreclosure would not have affected [the mortgagee’s] right to be paid the remainder of the debt under the policy.” Id.
of the debt terminates the mortgagee's interest. Furthermore, it was maintained by the court that the mortgagee's policy rights after loss are based on satisfaction of the debt:

The authorities are unanimous to the effect that if subsequent to the fire the mortgagee has had its debt satisfied by purchase at foreclosure either by the mortgagee or a stranger, even by bidding in of the outstanding debt, the mortgagee's rights under the policy are terminated.

The double recovery arguments introduced in Mildenberger and Rosenbaum were more fully developed in Whitestone. After stating that "the mortgagee is entitled to recover only his debt," the Whitestone court continued:

Because a mortgagee is entitled to one satisfaction of his debt and no more, the bidding in of the debt to purchase the mortgaged property, thus cutting off other lower bidders, has always constituted a satisfaction of the debt.

It was emphasized that the mortgagee had "the obvious opportunity to bid only so much of the debt as equals the value of the property . . . ." Therefore, the mortgagee "could have bid less, leaving a deficiency for which the mortgagor would be obligated . . . ." Bidding the full amount of the debt when such amount exceeded the value of the property was viewed by the court as an act that "encourages fraud, creates uncertainty as to the mortgagor's rights, and most unfairly deprives the sale of whatever . . . comes from other bidders." Thus, a kind of estoppel argument was employed to assure that the mortgagee recovers only the amount of the debt.

**ANALYSIS OF THE DECISIONS**

The open mortgage clause and the standard mortgage clause have each been considered in this note in two contexts: (1) that in which loss occurs subsequent to foreclosure, and (2) that in which loss precedes foreclosure. A single theory employed in open mortgage clause cases of both contexts appears sound: the interest in-

55. Id. at 336-37, 270 N.E.2d at 696-97, 321 N.Y.S.2d at 865.
56. Id. at 335, 270 N.E.2d at 696, 321 N.Y.S.2d at 865 (citations omitted).
57. Id. at 337, 270 N.E.2d at 697, 321 N.Y.S.2d at 866.
58. Id. at 335, 270 N.E.2d at 696, 321 N.Y.S.2d at 864.
59. Id. at 337, 270 N.E.2d at 697, 321 N.Y.S.2d at 866.
60. Id. at 335, 270 N.E.2d at 696, 321 N.Y.S.2d at 864.
61. Id. at 335, 270 N.E.2d at 697, 321 N.Y.S.2d at 866.
sured is that of the mortgagor, and the mortgagee's interest in the policy is based only on a security for his debt. Thus, once that debt is extinguished by the mortgagee's foreclosure and purchase for the full amount, the mortgagee's interest in the policy is terminated.

The mortgage clause most often employed today, however, is the standard mortgage clause, and the application of the principles in standard mortgage clause cases is somewhat confusing. When loss occurs subsequent to foreclosure and purchase by the mortgagee, the courts have allowed the mortgagee to recover. In these cases the mortgagee's interest has been characterized as an interest in the property. In addition, the terms regarding foreclosure and change of title have been construed to provide protection to the mortgagee once he becomes owner through his purchase after foreclosure.

Probably the most difficult cases to rationalize are those involving loss-foreclosure under the standard mortgage clause. As previously stated, there appears to be no reason why the outcome of these cases should differ from the foreclosure-loss cases. Yet, even in cases where all the usual standard mortgage clause terms are present, the mortgagee who forecloses and bids the full debt at sale has been denied recovery of insurance proceeds. The courts have employed various rationales to achieve such results. In Mildenberger the independent contract of insurance created by the standard mortgage clause was considered to be of limited utility, and the mortgagee's interest was said to be based upon the mortgage debt rather than upon the property. The Rosenbaum court maintained that the value of the property to the bidder is reflected by his bid and that receipt of insurance proceeds in addition to a purchase for the full debt would result in excessive recovery for the mortgagee. Whitestone employed an estoppel argument based upon the public policy of preventing a double recovery by the mortgagee. All three courts expressed the view that once the debt is extinguished by the mortgagee's foreclosure and purchase for the full amount of the debt, the mortgagee's interest in the policy is terminated.

The soundness of the above arguments is questioned. In the first place the majority of cases and authorities agree that the standard mortgage clause, unlike the open mortgage clause, creates an

62. See notes 46, 48, 49 supra and accompanying text.
63. See notes 51-53 supra and accompanying text.
64. See notes 58-61 supra and accompanying text.
independent contract of insurance between insurer and mortgagee. At least one court has declared that the effect of the standard mortgage clause is "the same . . . as if the mortgagee had taken out a separate policy . . . ." Certainly this language does not limit the impact of the clause. Second, in standard mortgage clause foreclosure-loss cases the mortgagee's interest in the policy has outlived that of the mortgagor, thus demonstrating that the mortgagee has an interest in the property, not merely in the debt. Third, although the theory that the value of the property to the bidder is reflected by his bid is correct as a general rule, its inflexible application overlooks such circumstances as mistake or ignorance in bidding. Furthermore, the estoppel theory assumes that in every case where a bid of the full debt exceeds the value of the property there are other lower bidders present. Surely this does not occur at every such sale. Finally, the three standard mortgage clause loss-foreclosure cases considered herein relied heavily on opinions from open mortgage clause cases, with the result that the standard mortgage clause terms were totally disregarded. These terms were designed to assure that the mortgagee's interest in the policy will not be invalidated by a foreclosure or subsequent change in ownership. Although they have been effectuated as unambiguous contractual terms in foreclosure-loss cases, courts generally refuse to recognize them in the loss-foreclosure sequence.

RECOMMENDATIONS

It is apparent that the area of greatest confusion with regard to mortgage clause cases is that of loss-foreclosure under the standard mortgage clause. Here the courts have struggled to construct arguments for denying recovery to the mortgagor, even to the point of completely ignoring the clause provisions. Possibly the underlying factor is that in loss-foreclosure situations the mortgagee has knowledge of the loss before he forecloses, whereas no such knowledge is available if loss follows foreclosure.

As seen above, counterarguments are available to attack holdings which deny the mortgagee's recovery of insurance proceeds in standard mortgage clause loss-foreclosure situations. Surely additional arguments could be designed to strengthen the confrontation; however, the formulation of such arguments will only further ob-

65. See notes 16, 17, 38 supra and accompanying text.
scure what should be the courts’ primary concern—the most equitable solution possible in all controversies. Mechanical application of any one rule of law will produce inequitable conclusions in many cases. Some elementary examples will serve to illustrate such inequities, and the following diagram will simplify the discussion. (For the purposes of these examples, assume: (1) that the mortgagor’s equity is $5,000, and (2) that the mortgagee’s bid is equivalent to the amount of the mortgage debt).

<table>
<thead>
<tr>
<th>Example</th>
<th>Value of land</th>
<th>Amount of mortgage debt</th>
<th>Value of house before loss</th>
<th>Value of house after loss</th>
<th>Insurance proceeds payable</th>
</tr>
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<tbody>
<tr>
<td>A</td>
<td>$5,000</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>B</td>
<td>$5,000</td>
<td>$12,500</td>
<td>$12,500</td>
<td>$5,000</td>
<td>$7,500</td>
</tr>
<tr>
<td>C</td>
<td>$5,000</td>
<td>$7,500</td>
<td>$7,500</td>
<td>$5,000</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

When $5,000 damage occurs to the house in example A, the insurer is obligated, in the absence of defenses, to pay proceeds of a like amount. If the mortgagee then forecloses and purchases for the full debt, he receives the full $10,000 value, because he obtains land and a damaged house which are equal in value to his investment. Thus, the rule denying recovery to the mortgagee would preserve the status quo, since the mortgagor also receives proceeds equal to his equity. A rule allowing the mortgagee to recover in this case would clearly result in his receiving a double recovery, while the mortgagor would experience severe financial misfortune.

Example B illustrates the situation in which a bid for the full mortgage debt exceeds the value of the property after loss. Payment of the proceeds to the mortgagor provides him with an excess of $2,500 over his equity, while the mortgagee suffers a $2,500 loss because his bid for $12,500 purchased property worth only $10,000. On the other hand, if the proceeds were paid to the mortgagee he would realize a profit of $5,000 over his investment, and the mortgagor again would lose his equity.

If the insurer in example C is obligated to pay $2,500 after the

67. The idea that generally the insurer is obligated to pay when the particular event occurs was seen in In re Knight’s Estate, 31 Wash.2d 813, 199 P.2d 89 (1948):

"Insurance," in its general sense, may be defined as an agreement by which one person, for a consideration, promises to pay money or its equivalent, or to perform some act of value, to or for the benefit of another person, upon the destruction, death, loss, or injury of someone or something as the result of specified perils.

*Id.* at 816, 199 P.2d at 91.

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loss, payment of the funds to the mortgagor will still result in a $2,500 loss to him, while the mortgagee has received $10,000 worth of property for $7,500. Payment of the proceeds to the mortgagee thus obviously causes further injustice.

The difficulties with a mechanical application of a particular rule are obvious. Nevertheless, such treatment is clearly inferred from language employed in loss-foreclosure cases. The courts appear to be striving for a rule that allows payment to the mortgagor. In Whitestone, for example, the court ruled: "None dispute that the mortgagee is entitled to recover only his debt. Any surplus value belongs to others, namely, the mortgagor . . . ."8 Yet the facts in Whitestone appear quite similar to those in example B above. The value of the premises before the loss was $18,000, and the mortgage debt was $11,500. After the loss the premises were valued at approximately $9,000, and the insurer was obligated for an equal amount. The court denied payment to the mortgagee, and then indicated that the mortgagor was entitled to the funds:

The fact that a mortgagee may not recover on the insurance does not necessarily mean that the insurer will not be obligated to pay the mortgagor . . . . [I]n the absence of defenses, it will be the mortgagor or his creditors who will recover.7

Such distribution would allow the mortgagor to receive $9,000 in proceeds, although from the facts it appears that his equity in the premises totaled only $6,500. And the mortgagee who bid $11,500 for property worth $9,000 would suffer a $2,500 loss.

Thus, inequitable results will obtain if any rule of law is mechanically applied. A more desirable solution would be reached if the courts employed their general equity powers to arrive at the fairest possible distribution of proceeds. Rather than distorting the terms of the standard mortgage clause in order to "punish" the mortgagee for bidding an amount which exceeds the value of the foreclosed property, the courts should attempt to distribute the proceeds in accordance with the parties' proportionate investments.

68. 28 N.Y.2d at 337, 270 N.E.2d at 697, 321 N.Y.S.2d at 866.
69. It is assumed that the court used the word "premises" to include house and land. See United States v. Meyer, 417 F.2d 1020 (8th Cir. 1969): "The word "premises" when used to describe an estate in land almost invariably refers to land and the tenements or appurtenances thereto." Id. at 1023.
70. 28 N.Y.2d at 337, 27 N.E.2d at 697, 321 N.Y.S.2d at 866.
APPENDIX

The following terms complete the typical standard mortgage clause.

Provided also, that the mortgagee shall notify this company of any change of ownership or occupancy or increase of hazard which shall come to the knowledge of said mortgagee and, unless permitted by this policy, it shall be noted thereon and the mortgagee shall, on demand, pay the premium for such increased hazard for the term of the use thereof; otherwise this policy shall be null and void.

This company reserves the right to cancel this policy at any time as provided by its terms, but in such case this policy shall continue in force for the benefit only of the mortgagee for ten days after notice to the mortgagee of such cancellation, and shall then cease, and this company shall have the right, on like notice, to cancel this agreement.

Whenever this company shall pay the mortgagee any sum for loss or damage under this policy and shall claim that, as to the mortgagor or owner, no liability therefore existed, this company shall, to the extent of such payment, be thereupon legally subrogated to all the rights of the party to whom such payment shall be made, under all securities held as collateral to the mortgage debt or may, at its option, pay to the mortgagee the whole principal due or to grow due on the mortgage with interest, and shall thereupon receive a full assignment and transfer of the mortgage and of all such other securities; but no subrogation shall impair the right of the mortgagee to recover the full amount of his claim.