

# Property Insurance Update



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## Double indemnity?

The importance of involving lenders in the settlement of property losses.

**The Association of British Insurers has recently reported that the cost of fire damage to insurers increased to £1.3bn in 2008, equating to a £3.4m every day and up 16% on the previous year.**



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With both individuals and businesses under increasing financial pressure, it is perhaps unsurprising that these figures are being linked to a rise in incidents of arson and fraud. Although the increase in fire losses has been highlighted as a particular concern, there is one aspect of fraudulent claims that property insurers should particularly be aware of when paying claims for property damage in the current economic climate. This relates to insured property that is subject to a mortgage and the risk that the insured borrower may abscond with the insurance proceeds without reinstating the property. The downturn in the property market, leaving many residential and commercial properties in negative equity, has made this risk more acute.

With lenders being hit particularly hard by the financial crisis, property insurers can expect them to take any action available to protect their security. One route that may be open to lenders in this situation is to seek recovery from insurers.

Lenders usually protect their security by including in their mortgage terms and conditions a provision requiring the borrower to insure the mortgaged property – the 'covenant to insure'. The insurance is either required to be in the joint names of the borrower and the lender or, if this is not possible, in the borrower's name with the lender's interest noted on the policy. The borrower may also be obliged to notify the lender of any damage to the mortgaged property and hold any policy proceeds on trust for the lender.

Where a borrower insures mortgaged property in joint names, both the borrower and the lender may be policyholders. Alternatively, the borrower may be the policyholder and the lender may be either a named insured or part of an identifiable class of insureds. In such circumstances, where the lender has a clear interest in the policy, the insurer will generally consult both the borrower and the lender prior to making any payments in respect of damage to the mortgaged property.

If the lender is neither a policyholder nor an insured, they will not be a party to the insurance and will have no rights under the policy. Nonetheless, the fact that an insurer is made aware of the existence of a lender can have an important impact on the insurer's obligations in terms of the payment of claims.

*In Colonial Mutual General Ins Co v ANZ Banking Group Ltd [1995]<sup>1</sup> the terms and conditions of a mortgage provided that the borrower should insure the mortgaged property in the name of the lender. Contrary to this, the borrower obtained insurance on the mortgaged property in his own name. On seeing this, the lender wrote to the insurer stating that they had*

*'...an interest as 2nd mortgagees over the property covered by the...policy and we would appreciate our interests being noted in your records.'*

A certificate was sent to the lender showing the lender as second mortgagee under the heading 'Other Parties interested in the Insurance'. The mortgaged property was subsequently destroyed by fire and, after a forced sale by the first mortgagee, the lender was left with a significant shortfall. The lender claimed on the policy only to discover that an indemnity had

was to ensure that, if the value of the lender's security was depreciated by the occurrence of an insured risk, the proceeds of the policy would make up the shortfall. This could only be achieved if the covenant to insure gave the lender an interest by way of charge on the policy proceeds. The charge operated as an equitable assignment of the policy proceeds to the lender.

borrower and the lender had a good claim against the insurer for what was in effect a second indemnity under the policy.

Where an insured property is mortgaged, insurers will not generally be informed of any insurance covenant in the mortgage terms and conditions. Any notice they receive of the lender's interest may be general, by way of request that it be noted on the policy or otherwise, and is unlikely to refer to an assignment. Where insurers are aware of the existence of a lender, in light of the generous approach to the lender in *Colonial Mutual*, caution should be exercised in paying out policy proceeds. A failure to consult with the lender prior to making payment to the borrower may put insurers at risk of having to provide two indemnities for the same damage.

## A failure to consult with the lender prior to making payment to the borrower may put insurers at risk of having to provide two indemnities for the same damage

already been paid to the borrower. The lender issued proceedings claiming an entitlement to the policy proceeds and that payment to the borrower did not discharge the insurer's liability under the policy.

The request that the lender's interest be noted on the policy amounted to giving notice to the insurer of the assignment. This perfected the assignment and the lender became entitled to the policy proceeds. Accordingly, the insurer could not discharge its obligations by paying the

The Privy Council held that the purpose of the covenant to insure

<sup>1</sup> 1 WLR 1140

## Stop Press

### Material change condition upheld

After a fire at a property, insurers discovered that the sprinkler system was not working as the insured's tenant had turned the system off and placed a filing cabinet against the control handle. Further, the water supply to the property had been cut off as the tenant had not paid the charges. The Court of Appeal held that there had been a material change to the facts stated in the proposal form (ie that the property was protected by a sprinkler system). The tenant's actions evidenced an intention for the system to remain out of action indefinitely such that it was not protecting the property as required by the proposal form. As turning off the system

indefinitely took the risk outside what was in insurers' reasonable contemplation at the time the policy was issued, this also amounted to a material alteration to the property. Insurers were therefore entitled to cancel the policy (*Qayyum Ansari v New India Assurance Ltd* [2009]<sup>2</sup>).

### Deliberate acts and insanity

The insured set fire to his property as part of a suicide attempt but, as the fire developed, he changed his mind and escaped unharmed. He claimed on his policy for the damage caused by the fire. Insurers declined the claim based on the fire having been caused by the insured's own deliberate or criminal conduct.

The court held that the insured could only succeed if he was not legally responsible for his actions at the time of the fire and that this should be determined in accordance with the test for insanity in criminal law. The insured therefore had to prove that he did not know what he was doing or that he did not know that what he was doing was wrong. On both the medical evidence and his own evidence, the insured had a delusional disorder and depression but nonetheless knew both what he was doing and that it was wrong. Insurers were therefore entitled to reject the claim (*Porter v Zurich Insurance Company* [2009]<sup>3</sup>).

<sup>2</sup> EWCA Civ 93

<sup>3</sup> EWHC 376 (QB)

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**Property Insurance Update** is a summary of recent developments. It should not be regarded as a substitute for advice on how to act in any particular case. For further information please contact one of the editors.

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