EMERGING MORTGAGE INSURANCE COVERAGE DISPUTES

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I. INTRODUCTION

Mortgage insurance is a type of credit insurance where a mortgage lender is insured against a loss from a default by the borrower. There are several mortgage insurers in the market today, including Genworth Financial, Mortgage Guaranty Insurance Company, PMI Insurance Co., RMIC Guaranty Insurance Corp., Radian Guaranty, Inc., Triad Guaranty Insurance Corp., Old Republic Insurance Company, and United Guaranty Residential Insurance Company. All are currently feeling the effect of the mortgage crisis with higher loss ratios and reductions to capital. Accordingly, now, more than ever, mortgage insurers are relying on certain policy provisions and exclusions to deny coverage or, at the very least, reduce the claim amount.

This paper focuses on the most common coverage disputes that have arisen or most likely will arise between policyholders and mortgage insurers. Specifically, it examines provisions concerning the occurrence of default, perfecting a claim, dispute resolution, various parties' representations and warranties, and loan assignment and modification obligations.

II. EMERGING MORTGAGE INSURANCE COVERAGE DISPUTES

A. THE CLAIMS PROCESS

In order to obtain coverage, a policyholder must comply with the claims process detailed in its mortgage insurance policy. Under the claims process, a policyholder has an obligation to complete certain procedures within designated time periods. It is essential for a policyholder to have an understanding of the claims process because failure to fulfill these requirements can result in a reduction in the claim amount or forfeiture of coverage.

1. **Notice of Default**

All mortgage insurance policies contain a "notice of default" provision, which requires a policyholder to provide written notice to the mortgage insurer within a set time period when either a borrower is in default for a certain period of time or proceedings have been commenced against a borrower in default.

A typical notice of default provision provides:

> The Insured shall give the Company written notice within ten (10) days of either
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> (a) the date when the Borrower becomes three (3) months in default on the Loan or
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> (b) the date when any proceeding, including Appropriate Proceedings, which affects the Loan or the Property or the Insured's or Borrower's interest therein has been started whichever occurs first.

Some mortgage insurance policies, such as the one above, require written notice within as little as ten days when the borrower becomes in default on his or her first payment. Some policies even provide a remedy for the mortgage insurers in the event the policyholder fails to provide timely notice of default. For example, the policyholder's failure to provide timely notice of default may entitle mortgage insurers to deduct from the claim amount any interest accruing on the loan during the period between the date notice should have been given and the date notice was actually given.[1]

Mortgage insurers often raise issues with the policyholder's attempt to provide notice of default. Typically, such concerns involve whether the policyholder provided notice in a

[1] Policyholders may be able to argue that where the insurance policy provides a specific remedy such as this for a particular type of conduct this is the sole remedy available to the mortgage insurer. Mortgage insurers have been taking far more aggressive positions recently, including raising with regularity claims of rescission.

timely manner.[2] In order to avoid potential disputes over the notice of default provision, it is important for policyholders to install a system to track the period of time in which the policyholder must provide notice.

2. **Monthly Reports**

Most mortgage insurance policies contain a "monthly reports" provision that requires the policyholder to provide the mortgage insurers with monthly reports subsequent to providing notice of default. The purpose of the monthly reports is to advise the mortgage insurers of the status of the loan and servicing efforts undertaken to remedy the default. The reports must contain all of the information and documentation reasonably requested by the mortgage insurers, including, but not limited to, the condition of the property, status of borrower contact efforts, and status of appropriate proceedings. Generally, these reports must continue until the borrower is no longer in default, appropriate proceedings terminate, or the property has been acquired by the policyholder. Some mortgage insurance policies require that the monthly reports be on forms or in a format acceptable to the mortgage insurers and permit the reports to be furnished less frequently if the mortgage insurers agree in writing.

Mortgage insurers may rely on "monthly reports" provisions in order to attempt to deny or reduce coverage. Because a policyholder's failure to provide monthly reports after providing notice of default could lead to a mortgage insurer contending that it can reduce a claim amount or withhold coverage, it is important that lenders establish a system to ensure that it is providing these reports on a monthly basis. In addition, in order to ensure compliance with the

[2] Mortgage insurers typically request that courts strictly enforce these time requirements. Even when such time-limitation provisions do exist, lenders may have a viable defense to defeating a mortgage insurer's efforts to apply such provisions more literally.

monthly reports provision in all mortgage insurance policies, policyholders should request from the mortgage insurer a monthly report form in order to maintain a database of readily available monthly reports forms that are in a format acceptable to that mortgage insurer.

It is important to note that a mortgage insurer must typically show the "materiality" of a claimed failure in performance before it can avoid a claim. Failure to comply with these types of provisions may not qualify as "material" unless some prejudice can be shown due to the untimely report.

3. **<u>Filing of Claim</u>**

All mortgage insurance policies contain a "filing of claim" provision, which describes the submission of claims and the procedure for administration of claims. Because the failure to timely file a claim could result in a reduction or termination of coverage under a policy, it is critical for policyholders to understand and follow the filing of claim provision in their mortgage insurance policy.

Mortgage insurance policies generally require a policyholder to file a claim within sixty days after a specified event. The event typically varies by policy. The date a policyholder acquires the borrower's title to the property, the pre-arranged sale, or the policyholder acquires good and merchantable title to the property may, depending on the policy, start the running of the clock on filing of the claim.

It is important to note when the insurance policy is put into effect which events trigger the time within which a claim must be filed because any delay could result in a smaller claim payment or complete loss of coverage, depending on the length of the delay and the policy involved. Some mortgage insurance policies provide, for example, that if a policyholder files a claim after the 60-day time period, but within one year, the mortgage insurer must process the claim, but may be able to deduct from the claim amount interest, taxes, insurance or other expenses accruing after the 60-day time period. If the policyholder fails to file a claim within one year, however, it may be deemed to have waived any right to payment under the policy for that claim. Because some limitations provisions like these are often strictly enforced, lenders should be very mindful of them.

A policyholder must also take note of any "accelerated claim filing" provisions, as mortgage insurers may rely on such provisions in order to dispute coverage. Most mortgage insurance policies permit mortgage insurers to request that the policyholder file an accelerated claim. Under these accelerated claim filing provisions, the mortgage insurer has the right, at any time after receiving notice of default, to direct the policyholder to file a claim within an accelerated period of time, typically twenty days after notice from the mortgage insurer. Thereafter, following the policyholder's acquisition of the borrower's title to the property, the policyholder is entitled to file a supplemental claim in an amount equal to the sum of its advances not included in the initial claim.

B. DISPUTE RESOLUTION PROVISIONS

1. **Suit Limitations**

Most mortgage insurance policies contain a "suit limitations" provision, which is a clause typically used by insurance companies to shorten the statute of limitations for breach of contract claims. A typical suit limitation provision, in pertinent part, provides:

> No suit or action (including arbitration) for recovery of any claim under this Policy shall be sustained in any court of law or equity or by arbitration unless the Insured has substantially complied with the terms and conditions of this Policy, and unless the suit or action is commenced within one (1) year after the claim has been presented to the Company or the cause of action accrued, whichever is earlier.

While there are numerous arguments that a policyholder can make to avoid the forfeiture of coverage under such suit limitations provisions, these provisions should be treated very seriously, and the policyholder should address their claims with these time parameters in mind. For this reason, policyholders, to the extent possible, should consider negotiating a longer, or at least uniform, suit limitations period across its total portfolio of mortgage insurance policies in order to avoid potential disputes with mortgage insurers.

If a policyholder can negotiate the provisions, it should consider the pros and cons of various suit limitation provisions. Limitations periods may start running at different points during the claim process, and the longest limitation period in terms of years may not necessarily be the most favorable to the policyholder. For example, if a mortgage insurance policy has a one-year limitations period, the clock may not start running until the mortgage insurers has denied the claim or a cause of action accrues. In other mortgage insurance policies, however, the clock starts running when the claim is filed, the right to file a claim arises or the policyholder has substantially complied with all of the conditions under the policy. If suit limitations provisions are non-negotiable and the policyholder cannot achieve uniformity, it may look to reduce the number of mortgage insurers with which it deals.

2. **Choice of Law/Choice of Forum**

While mortgage insurance policies do not typically contain a choice-of-forum provision, many do contain a choice-of-law provision. The law that applies to a mortgage insurance policy can significantly affect a dispute over policy construction and application. The standards for rescinding an insurance policy, for example, can be very different in different states.

Without knowing the exact issues that may arise with respect to future claims, it is difficult to determine which state's laws would be more favorable in a future dispute. This is because one state may have favorable law with respect to one issue, but unfavorable law with respect to a separate issue. Nevertheless, it is important for a lender to take the applicable law into consideration as part of the purchasing process, as it could have a significant impact on the coverage available.

3. **Arbitration**

Some mortgage insurance policies contain an arbitration clause, which sets forth the circumstances and procedures under which a claim or claims may be arbitrated, instead of litigated in court.

Some mortgage insurance policies have a flexible arbitration provision in that it expressly allows the policyholder to, "at its option," elect to arbitrate any controversies, disputes, or other assertions of liability or rights under the policy. Other mortgage insurance policies require arbitration over things like valuing a claim, but permit declaratory judgment actions on matters of policy interpretation.

Disputes may arise concerning which rules apply to any arbitration. Many older mortgage insurance policy forms provide that American Arbitration Association ("AAA") title insurance arbitration rules apply. The AAA Title Insurance Arbitration Rules, however, were discontinued as of January 1, 2001, and have not been specifically replaced by new ones. Because many of the Policies specify that the mortgage insurers may designate other AAA Rules if the Title Insurance Arbitration Rules no longer exist, disputes are likely to arise concerning which rules govern.

Disputes are also likely to arise over the choice of law and location of the hearing of any arbitration. Many mortgage insurance policies provide that the arbitration is to be governed by and construed in accordance with laws of the jurisdiction in which the property is located. Considering that the properties insured by such mortgage insurance policies could be located throughout the United States, it is difficult in advance to determine which state's laws should apply to any future arbitration. This type of provision could result in different states' law applying to different claims, leading to unnecessary uncertainty, inconsistent results, and increased costs.

C. REPRESENTATIONS AND EXCLUSIONS

The majority of disputes involving mortgage insurance focus on misrepresentations in the loan origination process. Most mortgage insurance policies contain a series of provisions addressing the policyholder's representations and the mortgage insurer's remedies in the event of a misrepresentation by the borrower, broker, or policyholder. This section highlights several important provisions that will inevitably lead to disputes with mortgage insurers. The provisions are interrelated and can only be understood by carefully parsing all of the applicable policy provisions and endorsements.

All mortgage insurance policies contain a provision which details the representations deemed to be made by the policyholder (the "representation provision"). Some representation provisions impute borrower misrepresentations to the policyholder. In other words, the borrower's representations are considered representations by the policyholder.

Some mortgage insurance policies contain provisions that limit the mortgage insurers' rights to rescind the policies or deny coverage for certain misrepresentations ("incontestability provisions"). Typically, these provisions limit the mortgage insurer's right to deny claims for misrepresentations made by the borrower when certain conditions have been fulfilled. For example, even if a representation provision provides that a borrower's representations are imputed to the policyholder, an incontestability provision may provide that the mortgage insurer cannot deny a claim due to a borrower's misrepresentation if the borrower has made twelve scheduled payments.

In the event of a misrepresentation, certain mortgage insurance policies contain provisions that provide the mortgage insurers with certain remedies. Some mortgage insurance policies contain provisions which allow a mortgage insurer to cancel or rescind coverage in the event of a breach of the representation provisions. Even if the policies do not expressly provide for rescission, mortgage insurers have argued that they are entitled to rescind their policies based on statutory or common law rights to rescission. Thus, even if a policy does not expressly provide for rescission, mortgage insurers may still pursue this remedy.

Finally, all mortgage insurance policies contain exclusions which address fraud, misrepresentations, and negligence. These exclusions attempt to preclude coverage in certain instances where there has been fraud, misrepresentations or negligence in the loan process.

In securing future mortgage insurance policies, policyholders should try to negotiate with the mortgage insurers to obtain a policy that: (1) has a representation provision that does not impute a borrower's misrepresentations to the policyholder, (2) has an expansive incontestability provision which limits the mortgage insurer's right to deny, cancel or rescind coverage due to a borrower's misrepresentation and (3) contains a fraud, misrepresentation, and negligence exclusion which prevents the mortgage insurer from excluding coverage for any claim arising from a borrower's misrepresentation.

Without knowing the specific factual circumstances, it is difficult to determine whether it is favorable or unfavorable to have a provision in a mortgage insurance policy which allows the mortgage insurer to cancel or rescind coverage if a representation is false. It may appear that it is beneficial if the policies do not contain such provision. However, all states have statutes or common law which provide insurance companies rights to rescind or cancel policies even if this right is not expressly included in the policy. Thus, it may be favorable for the policyholder to negotiate a cancellation or rescission provision that is narrower than the applicable state law.[3]

Recently, courts have narrowed the types of defenses mortgage insurers have raised concerning such provisions. The United States District Court for the Central District of California, for example, has rejected a mortgage insurer's claim for poolwide rescission of coverage for thousands of loans insured under eleven mortgage insurance policies on the premise that the lender engaged in systemic fraud in the underwriting of the mortgage loans and the insurance intended to protect against the risk of default.[4] The Court found that nothing in the policies contemplated rescission on a poolwide basis. Instead, the court found that the parties bargained for rescission on a loan-by-loan basis. As a result, the mortgage insurer will have to demonstrate loan-by-loan for thousands of loans that there was fraud by the lender sufficient under the language of the policies to justify rescission of coverage as to a particular loan.

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[3] For example, courts have upheld provisions which limit the insurance company's statutory right to rescind a policy. Michael T. Sharkey, Intentional Waiver of Unintentional Misstatements, Contractual Limitations to Insurance Policy Rescission, 3 No. 8 Ins. Coverage L. Bulletin, (Sept. 2004); see e.g., In re Healthsouth Corp. Ins. Litig., 308 F. Supp. 2d 1253, 1270 (N.D. Ala. 2004); Golden Rule Ins. Co. v. Schwartz, 786 N.E.2d 1010 (Ill. 2003); State Farm Gen. Ins. Co. v. Oliver, 658 F. Supp. 1546, 1550 (N.D. Ala. 1987), aff'd, 854 F. 2d 416 (11th Cir. 1988).

[4] See Order Granting Motions to Dismiss the Amended Complaint, United Guaranty Mortgage Indemnity Co. v. Countrywide Financial Corp., Case No. CV-09-1888-MRP(JWJx) (C.D. Cal. filed Oct. 5, 2009).

In addition, courts have also rejected mortgage insurers' tortious claims against lenders for fraud, negligence, and negligent misrepresentations.[5] Based on the economic loss rule, courts have held that mortgage insurers are not able to recover in tort for breach of contractually obligated representations. While such recent decisions have favorably narrowed mortgage insurers' claims and defenses in this area, it is important for policyholders to carefully parse out all applicable policy provisions and endorsements in order to fully understand the mortgage insurance policy they have purchased or are about to purchase.

D. LOAN MODIFICATIONS, TRANSFERS, AND ASSIGNMENTS

It is critical that a policyholder understand and comply with its obligations under any mortgage insurance policy with regard to making any loan modifications or assignments, or changing servicers of the loans. This is especially important if a policyholder is considering a merger or required by the government to restructure subprime loans. Failure to fulfill such obligations could result in a reduced claim amount or even forfeiture of coverage.

1. **Loan Modifications**

Most mortgage insurance policies contain a "loan modifications" provision, which requires a policyholder to obtain advance written approval from a mortgage insurer before making any changes in the terms of a loan. Given the downturn in the economy and push by the government to restructure certain types of loans, it is important to note the steps a policyholder must take before modifying the terms of any loans insured by a mortgage insurance policy.

A typical loan modifications provision, in pertinent part, provides:

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[5] See Order Granting Motions to Dismiss the Amended Complaint, United Guaranty Mortgage Indemnity Co. v. Countrywide Financial Corp., Case No. CV-09-1888-MRP(JWJx) (C.D. Cal. filed Oct. 5, 2009); Memorandum Re: FDIC's Motion to Dismiss, Radian Insurance Inc. v. Deutsche Bank National Trust Co., C.A. No. 08-2993 (E.D. Pa. filed Oct. 1, 2009).

> Unless advance written approval is obtained from the Company, the Insured shall not make any change in the terms of the Loan, including, but not limited to, the principal amount borrowed, the Property securing the Loan, the interest rate, payment terms, or amortization schedule of the Loan . . . .

Some mortgage insurers attempt to terminate coverage to the extent a policyholder changes the terms of a loan and fails to obtain advance written approval before doing so. Some policies' loan modifications provisions provide that, if any modifications occur "without the Company's advance written approval, the Company's liability for coverage . . . shall terminate as of the date such event occurs . . . ."

Mortgage insurers often attempt to terminate coverage under mortgage insurance policies if the policyholder fails to comply with the loan modifications provisions. Therefore, it is important that the policyholder obtain advance written approval from a mortgage insurer before making any loan modifications. Even under policies that do not expressly require "written" approval, the policyholder should, as a precaution, obtain the mortgage insurers' approval in writing before making any loan modifications.

2. **Change of Insured/Loan Assignment**

If a policyholder is considering a merger, it is important to consider whether a policyholder will be entitled to coverage under the mortgage insurance policies as its corporate structure continues to change. Many mortgage insurance policies contain a "change of insured" or "loan assignment" provision, which permit the substitution of one insured for another as long as certain conditions are satisfied.

Some mortgage insurance policies contain a "loan assignment" provision providing that, if a loan is sold, assigned or transferred, the purchaser, assignee or transferee of the loan will become a beneficiary of the policy. Other mortgage insurance policies' loan assignment provisions provide that if a loan is sold, assigned or transferred by the policyholder, the purchaser, assignee or transferee of the loan will become the "intended third-party beneficiary of this Policy with respect to the related Certificate." The purchaser, assignee or transferee is then entitled, on written request to the mortgage insurer, to have assigned to it the coverage under the mortgage insurance policy with respect to that Certificate if the loan is thereafter serviced by a servicer approved in writing by the mortgage insurer.

Other mortgage insurance policies contain a "change of insured" provision, which provide that, if a loan is sold, assigned or transferred by the policyholder, coverage will continue under the policy provided that the new insured is not a natural person and the loan is serviced by a servicer approved in writing by the mortgage insurer.

Mortgage insurers may attempt to deny coverage under such "loan assignment" or "change of insured" provisions if a policyholder fails to obtain the advance written approval of the mortgage insurer before selling, assigning, or transferring a loan.

3. **Change of Servicer**

Mortgage insurance policies also contain a "change of servicer" provision, which provides that coverage will continue when a servicer is changed as long as the policyholder provides notice and obtains the mortgage insurers' approval of the new servicer. Especially if the policyholder has an upcoming merger and changes to the corporate structure may result, it is important for the policyholder to be aware of such change of servicer provisions in order to avoid an inadvertent breach that could potentially result in forfeiture of coverage.

While most mortgage insurance policies require notice of a change in servicer, the timing of the notice may vary slightly between policies. Favorable change of servicer provisions require that the policyholder give notice within thirty days after the transfer of the servicing rights. Other mortgage insurance policies provide that "prior notice" of the sale, assignment or transfer of the servicing rights must be given to the mortgage insurers. Because the term "prior notice" is not typically defined in such policies, mortgage insurers would most likely contend that notice must be given prior to the actual change of servicer. Other mortgage insurance policies however, require "written notice of the new Servicer" and that the "new Servicer [be] approved in writing," which seem to indicate that notice and written approval may be obtained after the transfer of servicing rights under those policies.

Under most mortgage insurance policies, coverage can be forfeited by the retention of a non-approved servicer by way of an exclusion or other policy provision. Most mortgage insurance policies contain a non-approved servicer exclusion. Although the language may differ, most non-approved servicer exclusions preclude coverage for a claim when, at the time of default or thereafter, a servicer is not approved by the mortgage insurer. However, the exclusions also contain exceptions when the mortgage insurer withdraws its approval of a servicer. Favorable non-approved servicer exclusions provide that the exclusion "shall not apply to any Loan for which a Default occurs within 150 days after the Company withdraws approval of the Servicer for such Loan." Other non-approved servicer exclusions may provide a grace period, but require that the policyholder replace the disapproved servicer with an approved servicer within that time period. Some mortgage insurance policies, for example, provide that the policyholder must allow "ninety (90) days in which to complete a transfer of the servicing rights to the Loan to a Servicer approved by the Company."

Even if a mortgage insurance policy does not contain a non-approved servicer exclusion, they may exclude coverage if the policyholder does not comply with the change of servicer provision. Some mortgage insurance policies contain a "breach of conditions and insured obligations" exclusion, which could preclude coverage if the policyholder fails to provide notice to, and obtain written approval of, the mortgage insurer before changing servicers.

Relying on the foregoing provisions and exclusions, mortgage insurers will most likely attempt to deny coverage if the policyholder fails to prove written notice to the mortgage insurer of any change in servicing. In an abundance of caution, and in order to prevent such coverage disputes, policyholders should, before changing servicers or changing its corporate form or structure, provide notice to and obtain written approval from keep mortgage insurers under all of its mortgage insurance policies.

III. RESULTANT DISPUTES WITH MONOLINE INSURERS

Disputes with mortgage insurers are now commonly impacting mortgage lenders' obligations to monoline insurers. The majority of disputes center on whether the mortgage lenders breached any representations or warranties in the various transaction documents. In certain Pooling and Servicing Agreements ("PSAs"), for example, mortgage lenders represent and warrant that the loans were underwritten in accordance with applicable underwriting guidelines and that the lender had no knowledge of any fact that would have caused it to conclude on the date of origination that the loan would not be paid in full.

If a lender is found to have breached any such representations and warranties for a particular loan, it has an obligation under the PSAs to repurchase or replace that particular defective loan. Today, many of the disputes between monolines and lenders emerge after the monoline makes a payment to the certificate holder and then decides to seek reimbursement from the lender, claiming it made payments on loans where there was a breach of a representation or warranty.

Disputes between monolines and lenders have also emerged over the lenders sponsor loss coverage obligation. Under its sponsor loss coverage obligation, the lender may be required to deposit to the trustee (and into a Payment Account) the balance of any claims that the mortgage insurer fully or partially denies based on an exclusion. Notably, the sponsor loss coverage obligation will not cover any mortgage loans that are not covered by a mortgage insurance policy. In addition, the sponsor loss coverage obligation is not triggered if a claim for realized losses on a mortgage loan covered by the mortgage insurance policy is denied payment by the mortgage insurer for any other reason or is not an insured peril covered by the mortgage insurance policy. For this reason, it is important, when communicating with any mortgage insurer, to refrain from any agreement that might be construed as an acceptance of the mortgage insurer's coverage denial so that the lender does not have any sponsor loss coverage obligation that a monoline may attempt to enforce.

IV. CONCLUSION

Lenders should be mindful that while mortgage insurance is essential, insurance coverage insurers can develop upon the default of a borrower. Especially given the current state of the economy and housing market, mortgage insurers now, more than ever, will battle their policyholders in an effort to reduce insurance coverage for sizeable claims. By developing a fundamental understanding of their mortgage insurance policies and the typical coverage dispute that arise with mortgage insurers, lenders can enhance their position to secure insurance coverage. In addition, lenders should be certain to review their practices and procedures to implement consistent practices for submitting claims and ensuring they are followed, as well as standardizing their responses to coverage issues to ensure that claims are reimbursed in the full amount due under the mortgage insurance coverage.