PRESENTATION TO THE INTERNATIONAL ASSOCIATION OF SPECIAL INVESTIGATION UNITS

I. CURRENT TRENDS IN MORTGAGE FRAUD

II. THE INVESTIGATION AND DEFENSE OF CLAIMS OCCURRING IN VACANT, UNOCCUPIED AND ABANDONED BUILDINGS

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I. Current Trends in Mortgage Fraud

A. Introduction

Mortgage fraud had its origins in the dramatic and unsustainable escalation in real estate prices throughout the United States as well as the mortgage industry's lax underwriting standards in approving and issuing mortgage loans. So called "program," "stated income" or "sub-prime" loans in which mortgage companies issued mortgage loans at higher interest rates with little, if any, underwriting review, also contributed to the problem. The dramatic increase in mortgage fraud throughout the late 1990's and early 2000's resulted in the collapse of many mortgage companies and financial institutions, and caused extreme damage to the economy of the United States. By 2007 and 2008, mortgage loan originations had declined and many mortgage companies began tightening underwriting standards. Therefore, it became more difficult to perpetrate "traditional" forms of mortgage fraud.

The downward trend in the housing market and decreased availability of mortgage loans forced mortgage fraud participants to seek alternative schemes of defrauding both mortgagees, homeowners, and, by extension, insurance carriers. Foreclosures have also dramatically increased.

The federal government's recent response to the economic crisis, a massive cash stimulus, has increased liquidity in the financial system, has made mortgage loans easier to obtain and has depressed prevailing mortgage interest rates. Therefore, we anticipate that increased mortgage originations and recovery in real estate markets will again result in a spike in mortgage fraud.

Mortgage fraud is committed in a variety of ways, but typically involves mortgage brokers, appraisers and straw buyers working in concert. A flip transaction occurs when a party buys a parcel of real estate for one price (usually a substantially lower price) and then sells the property to a third party (typically a straw buyer) for a much higher price. There is nothing illegal about selling a property at a profit. Where, however, the transaction involves misrepresentations in the mortgage application, a false real estate appraisal, and/or a straw buyer, the "mortgage flip" is illegal and fraudulent.

When a successful mortgage fraud transaction occurs, and the mortgage proceeds are disbursed, the mortgagor (insured and/or ringleader) will oftentimes burn or abandon the insured property. The insurer is then presented with a claim submitted by either the named insured or the mortgagee.

B. The Mechanics of the Mortgage Fraud Transaction

How Does a Flip Begin?

The purpose of the mortgage fraud transaction is twofold. First and foremost, the transaction is designed to defraud a mortgage company by obtaining mortgage proceeds on a property which has been acquired at a sum less than the amount applied for in the mortgage. The second goal of the mortgage flip transaction is to acquire the insurance proceeds available under a policy issued on the property. This can be accomplished by either a direct claim submitted by the named insured or indirectly, by means of destroying the property and allowing the mortgagee to submit the claim.

The typical or usual mortgage fraud transaction proceeds as follows:

- The ring leader will acquire a parcel of real estate, typically at a modest price (or induces the owner of a property to sell to a third party at a substantially reduced price).
- A grossly inflated real estate appraisal on the property is obtained.
- A straw buyer is located.
- A mortgage application is completed (typically with mis-statements of the straw buyer's income, bank accounts, etc.).
- The mortgage is approved
- The closing occurs and the mortgage proceeds are distributed amongst the participants in the scam.
- The property is burned or abandoned.

Typical Participants

- Ringleader/The Straw Buyer (i.e. your named insured)
- The Mortgage Broker
- The Real Estate Appraiser
- The Agent

- **Ring Leader/The Straw Buyer**

Generally the mortgage flip transaction begins with a ringleader or organizer who may or may not be the mortgage broker. The successful scheme must include a straw buyer (who will be your named insured) with a relatively clean credit background. The reason for this is simple. Most mortgage companies utilize an applicant's credit score as the primary underwriting tool in determining whether a mortgage will be approved. While the straw buyer's employment, income, bank holdings and verification of rents can be falsified, the credit score cannot. Therefore, ringleaders are generally on the hunt for willing straw buyers. Once the ringleader finds a willing straw buyer with a relatively clean credit history, the leader will attempt to utilize the straw buyer to apply for multiple mortgages in rapid succession. Again, the reason for this is simple. If multiple mortgages can be acquired and a series of flip transactions consummated in a short period of time, the potential profit will be tripled or even quadrupled. In addition, once the straw buyer has applied for multiple mortgages over a short period of time, the mortgages will ultimately hit the straw buyer's credit report thereby disqualifying him from future credit approval. In other words, the utility of a particular straw buyer has a limited window of opportunity and, therefore, the leader will attempt to maximize the use of the straw buyer by applying for multiple mortgages with the same straw buyer in a series of rapidly executed mortgage flips.

- **The Mortgage Broker**

Once the straw buyer is located, he or she will be directed to a mortgage broker. Generally speaking, the mortgage broker will have underwriting authority with multiple mortgagees. Given the fact that the mortgage flip, by its very nature, requires a gross inflation of the value of the property and, by extension, the amount sought via the mortgage application, a straw buyer's income, employment, etc. will often have to be fabricated. Therefore, the leader will typically fabricate wage information including employment verification, wage verification, W-2 wage and tax statements, and even tax returns. The straw buyer's income will oftentimes be either doubled or tripled so as to ensure that the stated income will meet the mortgagee's underwriting criteria. The fabricated wage verification form usually identifies personnel or employment manager and a telephone number for contact by the mortgagee. Oftentimes, the employment manager/personnel director will be a plant or occasionally working with the leader to verify not only the employment but the inflated income stated on the application. Occasionally, the place of employment will be legitimate, but wages inflated. Oftentimes, bank accounts will be fictionalized or existing bank accounts balances grossly inflated. In addition, verification of rents and proof of payment of rent will also be fabricated.

- **The Real Estate Appraiser**

In addition to the mortgage application, the mortgage broker will be required to submit a real estate appraisal prepared by a certified real estate appraiser. Since the entire scheme is contingent upon a gross inflation of the value of the property the scheme must, by necessity, include an unethical real estate appraiser. A real estate appraiser will generally double or triple the market value of the property. The fraudulent appraisal, however, must be put together carefully. The property itself must have at least some exterior curb appeal, regardless of the actual structural and/or mechanical condition of the building itself. The area in which the building is located must also have some decent comparables so that the value assigned to the subject parcel does not draw attention.

Although most mortgage companies do have an internal appraisal review department, the mortgagee oftentimes does not do its own independent appraisal.

- **Agent**

Once the mortgage has been approved and a real estate closing set, proof of insurance must be produced for the closing to proceed. Therefore, and at a minimum, proof of insurance and/or a binder must be presented at the closing for the mortgagee to disburse. Occasionally, agents will be active participants in the mortgage flip rings. In other instances, the agent will be an unwitting participant and will be binding and/or issuing a policy which he believes to be legitimate. The key for the mortgage flip to be successful is the acquisition of written proof of insurance. The issue of whether the policy is later issued or cancelled based upon an underwriting review and/or inspection is of secondary importance. The reason for this is obvious. The main goal of the mortgage flip scheme is to acquire funds from the mortgagee. If a policy is issued, however, the mortgage flip will oftentimes result in the abandonment and/or destruction of the property by vandalism or fire followed by a claim.

C. CURRENT TRENDS IN MORTGAGE FRAUD

Given prevailing conditions in the real estate market and decreased liquidity in mortgage markets, the typical mortgage fraud schemes outlined in the earlier portions of this outline have curtailed. Therefore, fraud perpetrators have been forced to develop new approaches to mortgage, real estate, and insurance fraud. The dramatic increase in foreclosures has provided a particularly fertile ground for new schemes.

Foreclosure Rescue Scams

Fraud perpetrators typically scour court dockets and legal periodicals seeking to identify homes in foreclosure. Their goal is to identify homeowners with substantial equity in a property in foreclosure and/or properties with minimal residual mortgage payoff balances. The perpetrators then approach the homeowners and convince them that they can save their home from foreclosure with the assistance of the perpetrator and his proposed "rescue plan." Typically, the perpetrator will then loan the homeowner an amount sufficient to satisfy the mortgage delinquency, thereby facilitating dismissal of the pending foreclosure action. Part and parcel of the "loan" is the homeowner's agreement to either place the property into the perpetrator's land trust, or to execute a deed to the perpetrator based upon the promise that the property will be retuned to the homeowner once he or she has repaid the "loan." Once title is transferred, the perpetrator is free to dispose of the property at his discretion

Another permutation of this scheme involves a situation in which, once title is transferred to the perpetrator, the perpetrator will then payoff the entire remaining mortgage balance of the homeowner's mortgage. The perpetrator then obtains a mortgage based upon the full value of the property by means of the use of a straw buyer, and absconds with the proceeds. In the alternative, the perpetrator obtains a mortgage for the full value of the property, evicts the homeowner and either sells or burns the property. For further analysis of this scheme, see Part II of this presentation- Challenges to Insurable Interest.

Seller Assistance Scams

Given the collapse of the real estate market, there are many motivated, if not desperate, homeowners attempting to sell their property. In this scam, the perpetrator locates a desperate seller and negotiates a sale price at substantially less than the property's actual appraised or theoretical market value. The perpetrator then obtains a real estate appraisal at a substantially higher value. The property is then sold to a straw buyer in an amount equivalent to the appraised value and a mortgage in that amount is obtained. The seller then receives the negotiated price and the perpetrator absconds with the difference between the negotiated selling price and the appraised value (i.e. the face value of the mortgage loan). This scheme offers several benefits to the ring leader, including the fact that the ring leader is not required to actually obtain or take title to the property. Rather, he acts as the facilitator of the transaction.

Construction/Remodeling Loan Scams

In this scam, a distressed property is acquired at a bargain price by the ring leader/straw buyer, and the mortgage lender is persuaded to issue a construction loan in order to facilitate renovation or remodeling of a property. The Settlement Statement in this type of transaction will typically reflect a minimal contract price (e.g. $40,000) and the disbursement of a mortgage in a higher amount (e.g. $140,000) with $100,000 designated as a construction or remodeling loan. In some instances, construction loan proceeds are disbursed at closing to either the ring leader or a shell construction company. In other instances, particularly where construction proceeds are held in escrow by the mortgage lender, the ring leader/straw buyer will perform minimal repairs to the property, and then present lien waivers to the mortgagee seeking disbursement of the construction loan proceeds.

Short Sales Scheme

This scheme essentially allows the ring leader to reacquire a property which has gone into default after the successful completion of the first mortgage fraud scheme. Once the closing with regard to the first mortgage fraud scheme has been completed and the proceeds disbursed, the ringleader will typically make monthly mortgage payments for a period of several months, and then allow the loan to go into default. The ringleader then locates a new straw buyer and approaches the mortgagee to offer a "short sale" whereby the mortgage agrees to sell the property to the new buyer at a substantially reduced rate. Once the property is reacquired, the ringleader then utilizes the property to perpetrate yet another mortgage fraud scam.

Illinois Mortgage Rescue Fraud Act, 765 ilcs 940/1 *et seq.*,

In response to the rise of foreclosure rescue schemes, the Illinois legislature enacted the Mortgage Rescue Fraud Act, 765 ILCS 940/1 *et seq*. Note that a foreclosure rescue scheme is not necessarily fraudulent; there is nothing illegal in assisting a homeowner in staving off foreclosure by lending money to pay off the arrears so long as the homeowner understands the terms of the agreement and loan does not consist of predatory lending. The foreclosure rescue scheme becomes fraudulent and illegal when the "rescuer" uses the transaction to obtain title without the knowledge or consent of the homeowner. The Illinois Mortgage Rescue Fraud Act regulates foreclosure rescue schemes by mandating that such transactions may only be entered into if the "rescuer" uses a statutory contract which clearly outlines the particulars of the agreement. See 765 ILCS 940/10. It also creates civil and criminal penalties for a "rescuer" that uses a foreclosure rescue scheme to defraud a homeowner. See 765 ILCS 940/55; 765 ILCS 940/60; 765 ILCS 940/65.

D. Indicators of Potential Mortgage Flip Transaction

- Named insured indicates that they purchased the property as an accommodation to mortgage broker or in partnership with the mortgage broker or property manager.
- Insured can offer few details concerning identity of property manager, mortgage broker or seller.
- Inspection of the property reveals evidence of longstanding vacancy or unoccupancy.
- Utility service not in named insured's name/ little or no usage of gas and electric service.
- Gas and electric service terminated prior to date of loss.
- The title search reveals multiple transactions involving the same property over a short period of time.
- Credit report reveals named insured applying for and/or receiving multiple mortgages over a short period of time.
- Credit report reveals multiple credit inquiries from mortgage companies immediately prior to issuance of policy.
- During initial contacts with named insured, the insured makes reference to or concedes the following:
    - Application for multiple mortgages;
    - Acquisition of multiple mortgages and properties over a relatively short period of time;
    - Income inconsistent with total mortgage debt.

- During initial contacts with named insured, the insured makes reference to or concedes the following:
    - Title search reveals recording of a second mortgage at or just prior to the recording of the first mortgage (silent second mortgage utilized to raise cash for down payment);
    - Buyer and/or seller not represented by counsel;
    - Misrepresentations in mortgage application concerning buyer/insured's employment, employment income, bank accounts, prior addresses;

- Payments to third parties - disbursement letters or instructions to closer directing payments to third parties (including mortgage broker);

- Agent indicates policy requested and/or applied for by person other than named insured:

    - Agent has no direct contact or interface with named insured;
    - Agent has an ongoing book of business with a particular mortgage broker;
    - Agent indicates that mortgage broker requested certificate of insurance for purposes of closing;

- Following a loss, the insured cannot document mortgage payments drawn on named insured's bank account:
- Named insured indicates that silent partner, property manager and/or mortgage broker are actually making mortgage payments;
- Named insured indicates that they purchased the property as an accommodation to mortgage broker or in partnership with the mortgage broker or property manager.
- Loss occurring within a relatively short period of time after acquisition of property.
- During initial recorded statement from the named insured, named insured expresses little working knowledge of the following:

    - Details of execution of real estate contract;
    - Details of real estate closing;
    - Mortgage application process;
    - Status, condition or description of insured property;
    - Acquisition of policy;
    - Means or method of making down payment on property;
    - Purchase price of property;
    - Identity of seller.

- Settlement statement reveals “cash to borrower”

- Settlement statement reveals disbursements identified as construction or remodeling loans or disbursements made to contractors.

E. Investigative Techniques Re: Uncovering a Mortgage Flip

Where a mortgage flip is suspected, the initial investigation should encompass the following:

- Title report
- Credit report
- The following documents should be requested from the insured/mortgagee:
    - An authorization executed by the named insured releasing the complete internal application, appraisal, insurance and underwriting files from the mortgagee.
    - Financial information from the insured.
    - Tax returns.
    - Bank documents.
    - Evidence of assets and debt.

- Copies of money order, cancelled checks or other proof of payment establishing that the named insured has, in fact, been making payments on the mortgage (rather than a third party stranger to the insurance and/or mortgage contract.)

At the recorded statement or Examination Under Oath, the insured should be questioned in detail concerning the following:

- How the insured learned the building was for sale.
- The identity of the seller.
- Details of the preparation and execution of the real estate sales contract.
- Details of mortgage application process including the identity of the mortgage broker, real estate broker, etc.
- The insured's intentions with regard to the property (primary residence, investment parcel, renovations, rehabilitation, etc).
- Identity and location of other investment parcels.
- Identity of mortgagees and mortgage brokers utilized to acquire other investment parcels.
- Insured's working knowledge of physical description of exterior and interior of the building (i.e. the number of units, heating system, multiple gas and/or electric meters, etc.) Oftentimes, the straw buyer will have never actually been to the property and, therefore, will posses little if any information concerning the property.
- The issue of whether the named insured applied for multiple mortgages through the same mortgage broker within a short period of time.
- The insured's economic ability to service this and/or multiple mortgages.

    - Evidence of occupancy of the property.
    - Evidence of renovation/rehabilitation.

- Obtain an authorization executed by the named insured releasing the complete internal application, appraisal, insurance and underwriting file from the mortgagee.

II. DEFENSES TO ABANDONED AND UNOCCUPIED BUILDINGS

A. Introduction

The various mortgage fraud schemes discussed in Part I of this presentation, the collapse of the real estate market and the dramatic increase in foreclosures has resulted in a large quantity of vacant, unoccupied or abandoned buildings. This has also resulted in a dramatic increase in the number of claims arising from fire, vandalism, freeze-up and theft losses occurring at properties which have been utilized to perpetrate mortgage fraud. This portion of the paper will present various alternative strategies which may be employed in investigating and defending claims arising from vacant, unoccupied and abandoned buildings. This paper will not discuss investigative techniques which may be employed in investigating intentional losses (e.g. incendiary fires perpetrated by the named insured). Rather, this portion of the paper will focus upon alternative policy defenses which may be employed, under appropriate circumstances, to combat claims arising from what are clearly mortgage fraud scams, or which arise from vacant or foreclosed buildings.

The starting point must be an examination of policy exclusions applicable to vacant and/or unoccupied properties. These provisions have potential application to various types of losses, including incendiary fires, vandalism, and water damage arising from frozen and burst pipes

B. Common Policy Provisions

- **Vandalism Exclusions**

Most homeowners policies issued in the United States traditionally contained a policy exclusion which provided as follows:

> We do not cover loss to the property described in **Coverage A-Dwelling Protection** or **Coverage B-Other Structures Protection** consisting of or caused by:
>
> * * *
>
> Vandalism or malicious mischief if your dwelling is vacant or unoccupied for more than 30 consecutive days immediately

> prior to the vandalism or malicious mischief. A dwelling under construction is not considered vacant or unoccupied.

For reasons which will be discussed later in this paper, many current generation policies have modified the 30 day vacancy/unoccupancy period to 60 days. Furthermore, many homeowners policies specifically address losses by fire which occurs while the premises have been vacant or unoccupied for in excess of 60 days. Therefore, many current homeowners policies provide as follows:

> We do not pay for any loss caused by any act committed during the course of the vandalism or malicious mischief including any ensuing loss or fire after a residence was vacant for more than 60 consecutive days immediately prior to the loss. A residence premises being constructed is not considered vacant.

Finally, some policies (particularly landlord package policies) extend the 60 day vacancy or unoccupancy period to 90 days.

- **Freeze Up Exclusions**

The most common freeze up exclusion found in homeowners policies provides as follows:

> We do not cover loss to the property described in Coverage A-Dwelling Protection or Coverage B-Other Structures Protection consisting of or caused by:
>
> Freezing of plumbing, fire protective sprinkler systems, heating or air conditioning systems or household appliances, or discharge, leakage or overflow from within the systems or appliances caused by freezing, while the building structure is vacant, unoccupied or being constructed unless you have used reasonable care to:
>
> a. maintain heat in the building structure; or
> b. shut off the water supply and drain the system and appliances.

- **Burglary Exclusions**

Some carriers, particularly in the context of landlord package policy, are now extending the vacancy and unoccupancy clause to burglary losses. Typical provisions provide as follows:

> Burglary. There must be visible signs of forced entry to the exterior of the building or other structure. We do not pay for loss if the

> dwelling has been vacant or unoccupied for more than 30 consecutive days immediately before the loss.

C. Vacancy or Unoccupancy and the Incendiary Fire

For the past 20 years, both insurance carriers and courts have struggled with the issue of whether an incendiary fire which occurs in a vacant or unoccupied property is more properly characterized as an act of vandalism, or should be treated solely as a fire loss. One of the first decisions to address this issue was *American Mutual Fire Insurance Company v. Durrence,* 872 F.2d 378 (11th Cir. 1989). In *Durrence*, an incendiary fire occurred in a building owned by Mildred Durrence which had been unoccupied for several months preceding the subject fire. In addressing the issue of whether the loss may be more properly characterized as an act of vandalism or a fire, the *Durrence* Court stated as follows:

> Although there appears to be no clearly controlling case or stature under Georgia contract law [citation omitted], a common sense interpretation of the insurance contract's "Vandalism or Malicious Mischief" provision which contains the "vacancy" exclusion, suggests that it would apply to a fire set in a vacant house by an unknown arsonist or vandal.

The holding of the *Durrence* case and its progeny provide a powerful tool in investigating and attacking an incendiary fire which occurs in a vacant or unoccupied property, particularly when there is insufficient evidence linking the insured to the ignition of the fire (i.e. an intentional act defense).

Courts have generally relied upon the commonly accepted Webster’s Dictionary definition of vandalism as “the willful or malicious destruction or defacement of things of beauty or of public or private property.” Similarly, arson has typically been defined as the “willful and malicious burning or attempt to burn any building, structure or property of another with criminal or fraudulent intent.” Therefore, and as a starting point, the SIU investigator seeking to assert a defense founded upon the vandalism exclusion must be in possession of strong evidence establishing that the fire is, in fact, incendiary. Accidental fires or negligently caused fires started by squatters or vagrants will not suffice. *Garcia v. Farmers Insurance Company*, 122 F. Supp. 2d 926 (U.S. Dist. 2000). There must be evidence of intent, typically established through the origin and cause investigation conducted by either local authorities or a private fire investigator retained by the insurer.

Courts which have addressed the issue of whether an incendiary fire is more properly characterized as an act of vandalism (subject to the exclusion) or a fire (a specific, named peril) have generally taken two approaches. As noted above, some courts have readily accepted the premise that an intentionally set fire does, in fact, constitute the willful and malicious destruction of property (i.e. an act of vandalism). See *Durrence supra*, *Frazier v. State Farm Fire and Casualty Company,* 957 F. Supp. 816 (WD. W.

Va. 1997); *Estes v. St. Paul Fire and Marine Insurance Company*, 45 F.Supp. 2d 1227 (D.Kan. 1999).

Other Courts have focused upon the fact that the standard vandalism exclusion makes no reference to fires arising from vandalism. See *Battishill v. Farmers Alliance Insurance Company*, 136 N.M. 288, 97 P.3d 620 (N.M. Ct. App. 2004), *American States Insurance Company v. Rancho San Marco Properties, L.L.C.*, 123 Wash. App. 205, 97 P.3d 775 (Wash. Ct. App. 2004), *Mutual Fire Insurance Company v. Corwin L. Ackerman, et al.*, 162 Md. App. 1, 872 A.2d 110 (Md. Ct. Spec. App. 2005) and *Cipriano v. Patrons Mutual Insurance Company of Connecticut*, 2005 Conn. Super. LEXIS 3577 (Conn. Super. Ct. 2005) (unreported).

Other courts have focused upon the issue of whether the particular coverage involved was written on a named peril or all risk basis. For example, in *Costabile v. Metropolitan Property and Casualty Insurance Company*, 193 F.Supp.2d 465 (D. Conn. 2002), the dwelling coverage provided by the subject policy was written on an all-risk basis while the personal property coverage was written on a named peril basis. The Court noted that the named peril coverage applicable to personal property coverage made reference to both fire and vandalism. The dwelling portion of the policy, however, contained the standard vandalism exclusion. Therefore, the Court ruled that since the named peril coverage applicable to personal property named both fire and vandalism as separate perils, an incendiary fire would not be properly characterized as an act of vandalism. Also see *Coutu v. Exchange Insurance Company*, 174 A.D.2d 241, 579 N.Y.S.2d 751 (N.Y. App. Div. 1992).

D. General Considerations

- **Vacancy and Unoccupancy**

Vacancy and unoccupancy have distinct definitions. The majority of jurisdictions have defined vacancy as the absence of inanimate objects (i.e. furniture and personal property) while unoccupancy has typically been defined as the lack of the habitual presence of human beings. See *Meyers v. Merrimac Mutual Fire Ins. Co.,* 788 F.2d 468 (7th Cir. 1985).

Some policies contain vandalism exclusions which make reference only to vacancy and do not include the word unoccupancy. The absence of the word unoccupancy is problematic in that it is typically easier to establish that a home has been unoccupied rather than vacant. This is so because even where the premises have been abandoned by the insured, a residual amount of personal property is typically left in the home. Usually, however, a small amount of residual personal property will generally not be sufficient to establish that the home was not vacant. In other words, a court will typically require that the personal property be of such type and magnitude so as to be consistent with “habitual human occupation.” See *Vennemann v. Badger Mutual*, 334 F3d 722 (8th Cir. 2003).

Other jurisdictions have blurred the distinction between vacancy and unoccupancy and will consider both the absence of contents and the absence of human occupants as relevant factors.

- **The Under Construction Exception**

As noted above, the vacancy and unoccupancy exclusion contains an exception for premises "under construction." The majority of jurisdictions which have addressed this issue have held that the term "construction" does not mean repairs, maintenance, or renovation to the existing structure. See *Meyers v. Merrimac Mutual Fire Ins. Co.*, 788 F.2d 468 (7th Circ 1985), *Travelers Indemnity Company v. Will County*, 102 GA App.3d 362, 116 S.E. 2d 314 (1960), *Crescent Company of Spartenburg, Inc. v. Insurance Company of North America*, 266 S.C. 598, 225 S.E. 2d 656 (1976); *Vennemann v. Badger Mutual*, supra; *Sunrise Sports Car v. Britamco*, 782 So. 2d 1009. Therefore, remodeling or repairs will typically not be sufficient to satisfy the exception. As noted by the Court in *Meyers v. Merrimac Mutual Fire Ins. Co., supra*,

> When used in this sense, the word "construction" imports the building or erection of something that theretofore did not exist; the creation of something new rather than the repair or improvement of something already existing.

It should be noted that some policy provisions define the "under construction" exception as both construction <u>and</u> <u>renovation</u>. This issue is problematic in that renovation can be construed to encompass minor repairs and/or remodeling which would typically not be viewed by courts as "construction."

In the case of *TRB Investments, Inc. v. Firemans Fund Insurance Company*, 40 Cal. 4th 19, 29-30, 145 P.3d 472 (Cal. 2006) the Supreme Court of California adopted a broader definition of the "under construction exception" stating as follows:

> We believe the more reasonable interpretation is that the term "under construction" as used in the vacancy exclusion, was meant to be the functional equivalent of "construction, renovation or addition"…We believe that the proper inquiry for determining whether a building is "under construction" for purposes of defining an exception to the vacancy exclusion is whether the building project, however characterized, results in "substantial continuing activities" by persons associated with the project at the premises during the relevant time period.

Other cases have addressed the situation in which construction begins then terminates for in excess of 30 or 60 days followed by a vandalism loss. In *Mortgage Bancorporation v. New Hampshire Ins. Co.*, 677 P.2d 726 (Or. 1984), remodeling work was begun on a dwelling structure, but suspended for in excess of 30 days. A vandalism loss then occurred. The Court strictly enforced the 30 day vandalism exclusion contained in the policy and held that since the time period since the cessation of construction activities and the occurrence of the loss exceeded the 30 day period, the loss was excluded.

- **30 vs. 60 Days**

In the case of *Lundquist v. Allstate Insurance Company*, 314 Ill. App. 3d 240, 732 N.E. 2d 627 (2d Dist. 2000), the Second District Appellate Court voided a vandalism exclusion contained in a subject Allstate policy where Allstate had declined coverage for an incendiary fire which occurred while the premises were vacant and unoccupied. The Court noted that the standard fire insurance policy (which is incorporated by endorsement into most homeowner's policies written the United States, including Illinois, by means of regulation or statute) contained a 60 day vacancy and unoccupancy exclusion. The Court ruled that under the liberalization doctrine, Allstate could not shorten the 60 day exclusion to 30 days. The *Lundquist* case is significant in that, from our perspective, the Court's ruling reflects its implicit recognition and acceptance of the assertion that an incendiary fire does, in fact, constitute an act of vandalism for purposes of the application of the exclusion.

- **How is the 60 day period calculated?**

As with any exclusion, the insurer will typically bear the burden of establishing that the premises were, in fact, vacant or unoccupied for in excess of 60 days preceding the date of loss. In some losses (particularly vandalism losses) it is often difficult to establish exactly when a loss occurred. In the recent case of *Central Mutual Ins. Co. v. KPE Firstplace Land, L.L.C.*, 2008 Westlaw 5005535 (Tx. 2008), the Appellate Court held that a vandalism loss occurs on the date the property is actually damaged, not the date the damage is discovered or reported by the insured. Therefore, the Court required the insurer to provide evidence establishing the date of loss for purposes of calculating the 60 day vacancy and unoccupancy period. This is the only case of which we are aware which imposes such a subject burden upon the insurer.

Generally speaking, in the context of an incendiary fire or a freeze-up loss, specific and direct evidence of the actual date of loss is typically available. In a fire loss, for example, fire reports are typically generated which establish the exact date of loss. In the context of a freeze up loss, the date of loss or general period of loss can typically be established based upon climatological data.

A question has sometimes arisen as to whether an insurer may assert a vacancy exclusion for property which remains vacant or unoccupied following a covered loss. Generally speaking, the vacancy exclusion will be suspended until the insurance company either pays the claim or the insured has been granted a reasonable time period in which to effect repairs. *Hollingsworth v. State Farm Fire & Cas. Co.*, 2005 Westlaw 563414 (Pa. 2005). That being said, the insured cannot delay repairs for an indefinite period of time, particularly when the initial claim has been paid.

Finally, several cases have addressed the issue of whether an insurance company may calculate the 60 day vacancy period prior to the inception date of the policy. Courts are split on this issue. The majority of jurisdictions, however, have held that the 60 day vacancy period <u>begins</u> with the policy inception date and that periods of vacancy or unoccupancy which predate the policy inception date cannot be utilized to calculate the 60 day period. The reason for this is obvious. Courts will generally presume the insurance company, through the underwriting process, inspects the property and, therefore, should reasonably determine whether a property is vacant or unoccupied as part of the underwriting process.

- **Current Policies**

In the wake of the divergent decisions addressing the issue of whether a vandalism exclusion is applicable to an incendiary fire, many insurers have attempted to broaden the scope of the vandalism exclusion. Typical, current vandalism exclusions provide as follows:

> We do not cover loss to the property described in Coverage A-Dwelling Protection or Coverage B-Other Structures Protection consisting of or caused by:
>
> Vandalism or Malicious Mischief
> We do not pay for any loss caused by any act committed during the course of the vandalism or malicious mischief including any ensuing loss or fire after a residence was vacant or unoccupied for more than 60 consecutive days immediately prior to the loss. A residence premises being constructed is not considered vacant.

Another example is as follows:

> We do not cover loss to the property described in Coverage A-Dwelling Protection or Coverage B-Other Structures Protection consisting of or caused by:
>
> Vandalism. However, we do cover sudden and accidental direct physical loss caused by fire resulting from vandalism unless your dwelling has been vacant or unoccupied for more than 90 consecutive days immediately prior to the vandalism.

These provisions address two of the issues discussed above. First, they extend the vacancy period to either 60 or 90 days which eliminates any potential conflict with the 60 day vacancy period contained in the standard fire insurance policy. Second, the provision makes specific reference to fires which result or ensue from an act of vandalism.

- **Freeze Up Losses**

Freeze up exclusions generally come in two forms. The first type of exclusion pertains to the freezing of the plumbing system where the premises are unoccupied and the insured has failed to exercise reasonable care to maintain heat or turn off the water supply and drain the plumbing systems. The second type of provision contains no specific requirement that the premises be unoccupied at the time of the loss. Given the fact that the majority of homeowners policies are of the first type, our analysis will focus on that provision. The most common freeze up exclusion found in policies issued throughout the United States provides in pertinent part as follows:

> We do not cover loss to the property described in Coverage A-Dwelling Protection or Coverage B-Other Structures Protection consisting of or caused by:
>
> Freezing of plumbing, fire protective sprinkler systems, heating or air conditioning systems or household appliances, or discharge, leakage or overflow from within the systems or appliances caused by freezing, while the building structure is vacant, unoccupied or being constructed unless you have used reasonable care to:
> a. maintain heat in the building structure; or
> b. shut off the water supply and drain the system and appliances.

Note that the exclusion contains two basic elements: first, the premises must be vacant, unoccupied or under construction; and second, the insured failed to use reasonable care to either maintain heat or shut off the water supply and drain the plumbing system. Of some significance, however, the freeze up exclusion, unlike the vandalism exclusion, contains no specified or required period of vacancy or unoccupancy. This issue is problematic and has led to divergent court decisions.

The first group of decisions holds that an insured's temporary physical absence from the insured premises due to extended vacations or employment assignments is not sufficient to establish that the home was vacant or unoccupied. See *Krajenke v. Preferred Mutual Insurance Company*, 242 N.W. 2d 70 (Mich. App. 1976) (numerous extended vacations were not sufficient to render the insured dwelling vacant or unoccupied), *Monarch Insurance Company v. Rippy*, 369 P.2d 622 (Okla. 1962) (a three month vacation in Florida is not sufficient to establish unoccupancy).

Other courts have focused not on the duration of vacancy or unoccupancy but, rather, view the threshold issue as the reasonableness of the insured's conduct in attempting to prevent the freeze up loss. In *Evangelista v. Hingham Mutual Fire Insurance Company*, 19 Mass. L. Rep. 105, 2005 Mass. Super. LEXIS (Mass. Sup. Ct. 2005), the insureds closed their summer home for the season in December 2002. They set the thermostat for 63 degrees and left knowing that they would not return until the next summer. In January, 2003, the area experienced a deep freeze with record low temperatures. In January, 2003, the insureds received bills from the electric company showing no electricity usage for the billing periods from December, 2002, and January, 2003. In March 2003, a neighbor alerted the insureds that there were large amounts of ice and streams of water pouring from their home. In reaching its decision, the Court focused upon the fact that a reasonable person (given the extreme temperatures in January, 2003) would have either checked the home or asked someone to do it for him. Note that the period of unoccupancy was approximately one month in the *Evangelista* case.

Courts have generally held that an insurer has the burden of proof to establish, by a preponderance of the evidence, that the insured failed to exercise reasonable care to ensure that heat would be maintained in the insured premises or that the water supply was shut off and the systems drained. *Smutz v. Central Iowa Mutual Insurance Association*, 2007 Iowa App. LEXIS 1119 (Iowa Ct. App. 2007) aff'd 742 N.W.2d 605, 2007 Iowa App. LEXIS 1868. In addition, the issue of whether an insured has or has not exercised reasonable care is generally deemed a question of fact for a jury's determination. See *Cecero v. Allstate Ins. Co.*, WL 5220708 (Pa. 2008) (unpublished).

As a general rule, the period of unoccupancy should be viewed by the court in conjunction with the prevailing weather conditions, the insured's knowledge of a potential freeze up loss, and the insured's conduct. Therefore even with a relatively short period of unoccupancy (i.e., 30 to 60 days), a persuasive argument can be made that the exclusion should apply to situations where the insured is aware of extreme temperatures or is placed on potential notice of a problem (i.e., utility bills showing no electric or gas usage during the period of unoccupancy). The exclusion should also apply in situations where an insured deliberately turns off the heating system or turns a thermostat to its lowest setting preceding a period of unoccupancy.

E. CHALLENGES TO INSURABLE INTEREST

Can a legally enforceable insurable interest be created where title to the property has been acquired through fraud? In the typical mortgage fraud transaction, both the ringleader and straw buyer arguably lack an insurable interest in property because neither could be said to profit by or gain some advantage by the property's continued existence nor suffer loss or disadvantage by its destruction since the primary intent of the scheme was to collect the mortgage proceeds rather than own the property. <u>See</u> <u>Lieberman v. Hartford Fire Ins. Co.</u>, 6 Ill.App.3d 948, 950, 287 N.E.2d (1st Dist. 1972). The straw buyer may assert she has an insurable since the property was purchased using her credit and title remains in her name, but she would need to demonstrate that she a victim of the scheme to defraud rather a participant to prevail. Note that absent collusion the mortgagee in a typical mortgage fraud transaction would retain an insurable interest in the property because it financed the purchase believing the transaction to be legitimate and therefore would suffer a pecuniary loss by the damage to the insured property. In comparison, a foreclosure rescue scheme may negate both the fraud perpetrator's as well as the mortgagee's insurable interest.

When dealing with a foreclosure rescue scheme, the pivotal question will be whether the fraud was committed in a “lien theory” state or a “title theory” state. “Lien theory” presumes a mortgagee has no actual rights in mortgaged property, it only has a lien. In contrast, under “title theory” the mortgagee has paramount title over the mortgaged property. For example, Illinois follows a “lien theory” of mortgages rather than a “title theory” of mortgages. See Harms v. Sprague, 105 Ill.2d 215, 473 N.E.2d 930 (1984); see also 765 ILCS 905/1 *et seq.* Additionally, the Illinois Mortgage Act renders “every deed conveying real estate, which shall appear to have been intended only as a security in the nature of a mortgage, though it be an absolute conveyance in terms, shall be considered a mortgage.” 765 ILCS 905/5. This means that in Illinois, as in most “lien theory” states, a fraud perpetrator may never precondition his initial loan by requiring the homeowner to transfer title to the fraud perpetrator. Typically by statute this initial transfer of title to the fraud perpetrator will be treated by the court as nothing more than an equitable mortgage and title will remain with the homeowner. In a mortgage rescue scheme where the fraud perpetrator then refinances the property, this new mortgagee arguably lacks an insurable interest because the fraud perpetrator never had title in the first instance. This argument is easier to prove in a “lien theory” state because the initial transfer of title to the fraud perpetrator is void. In contrast, in a “title theory” state it would be incumbent to prove that the initial transfer of title to the fraud perpetrator was obtained by means of fraud to attack the fraud perpetrator’s insurable interest.

G. Mortgagee Claims

When addressing a mortgagee’s claim for insurance proceeds for property in foreclosure or that has been foreclosed, the sequence of events of when the loss occurred and when the foreclosure sale took place are of the utmost importance. "If the mortgagee purchases the property at a foreclosure sale before the fire loss, the amount bid at the foreclosure was for the property in an undamaged condition and the mortgagee required the insurance proceeds to restore the property to the condition it was in at the time of the foreclosure." Western Employers Insurance v. Bank of Ravenswood, 159 Ill.App.3d 22, 25 (1st Dist. 1987). This means that if the mortgagee is the successful bidder at the foreclosure sale and afterwards a fire occurs, then the mortgagee must be treated as though it was the named insured and is entitled to whatever recovery the named insured would have obtained. Compare that situation with when the fire loss precedes the foreclosure sale. "If, however, the loss precedes the foreclosure sale, the rule is different since the mortgagee has an election as to how he may satisfy the mortgage indebtedness by two different means." Western Employers Insurance, 159 Ill.App.3d at 25. Under this scenario, the mortgagee "may look to the insurance company for payment as mortgagee and may recover, up to the limits of the policy, the full amount of the mortgage debt at the time of loss." Id. The mortgagee also has an option not to look to the insurance company but to attempt to satisfy the mortgage by a foreclosure and if "the foreclosure sale does not bring the full amount of the mortgage debt at the time of the loss, he may recover the balance due under the insurance policy's owner." Id.

A direct mortgagee claim arising from a mortgage flip scheme is problematic in that the mortgagee is entitled to take advantage of the additional protection offered by the standard mortgage clause. The mortgagee is generally deemed an additional insured which has standing to submit a claim free from any defenses asserted against the named insured. In addition, the mortgage provision provides that the mortgagee's interests will be protected in the event of increase of hazard, failure of an insured to take all reasonable steps to save and preserve property after a loss, change in ownership or foreclosure "if the mortgagee has no knowledge of these conditions". Mortgagee claims arising from a flip transaction are particularly frustrating to the insurance industry in that a persuasive argument can be made that both the mortgagee and the insurer are arguably co-equal victims of the fraud scheme perpetrated by the named insured and other participants in the mortgage flip ring. There are, however, certain viable defenses to the mortgagee claim which will be explored below.

Policy Conditions

Although the mortgagee's right of recovery is typically not subject to policy defenses which may be asserted against the named insured, it must be remembered that the mortgagee must still comply with all pertinent policy conditions. Sterling Savings and Loan Assoc. v. Reserve Ins. Co., 63 Ill. App. 2d 220, 211 N.E. 2d 412.

EXAMPLES

1. Submission of a Sworn Statement in Proof of Loss.
2. Submission to an Examination Under Oath.
3. One year contractual limitation period for filing suit.
4. The mortgagee must notify the company of any increase of hazard or change of occupancy of which it become aware.
5. The mortgagee must save and preserve the property from further loss.
6. The mortgagee must notify the company of a loss in a timely fashion.

Potential Policy Defenses

Vacancy & Unoccupancy

The issue of whether a vacancy exclusion is applicable to a mortgagee claim is more complex. The insurable interest of a mortgagee does not arise by means of an ownership interest in the property itself but, rather, by means of its collateral interest in the property. Furthermore, the mortgagee's right to submit a claim is derived, in part, from the mortgage provision contained in the policy itself. The standard or union mortgage clause commonly used throughout the United States provides in pertinent part as follows:

Mortgagee

A covered loss will be payable to the mortgagees named the Policy Declarations, to the extent of their interest and in the order of precedence. All provisions of Section I of this policy apply to these mortgagees.

We will:

a) protect the mortgagee's interest in a covered building structure in the event of an increase in hazard, intentional or criminal acts of, or directed by, an insured person, failure by any insured person to take all reasonable steps to save and preserve property after a loss, a change in ownership, or foreclosure if the mortgagee has no knowledge of these conditions; and

b) give the mortgagee at least 10 days notice if we cancel this policy.

The mortgagee will:

a) furnish proof of loss within 60 days after notice of the loss if an insured person fails to do so;

b) pay upon demand nay premium due if an insured person fails to do so;

c) notify us in writing of any change of ownership or occupancy or any increase in hazard of which the mortgagee has knowledge;

d) give us the mortgagee's right of recovery against any party liable for the loss; and

e) after a loss, and at our option, permit us to satisfy the mortgage requirements and receive full transfer of the mortgage.

This mortgagee interest provision shall apply to any trustee or loss payee or other secured party.

This provision is significant in two regards. First, the preamble to the clause itself provides that all provisions of Section I (including all applicable conditions and exclusions) also apply to the mortgagee. Second, the expanded coverage available to the mortgagee extends only to "increase of hazard, intentional or criminal acts of, or directed by, in insured person, failure by the insured person to take all reasonable steps to save and preserve property after a loss, a change in ownership or foreclosure if the mortgagee has no knowledge of these conditions." Conspicuous in their absence are the words vacancy and unoccupancy.

Finally, the policy specifically provides that the mortgagee must notify the insurance company of any changes in ownership or occupancy of which it becomes aware. Therefore during the investigation of the mortgagee claim, it is important to always obtain the mortgagee's internal inspection reports in an attempt to ascertain whether the mortgagee possessed knowledge, or was placed on notice, of the vacancy or unoccupancy of the property.

In the case of *Perry State Bank v. Farmers Alliance Mutual Insurance Company*, 953 S.W.2d 155 (Mo. Ct. App. 1997) the Court held that the unoccupancy of a dwelling for 120 days prior to a loss constituted an increase of hazard which the mortgagee was required to notify the insurer. The Court also noted that the condition of the premises also constituted a change of occupancy which the mortgagee was also required to notify the insurer.

Other carriers utilize a non standard mortgage clause such as the following:

> Rights and Duties of Mortgagee. If a mortgagee is named in the Declarations, any payment for loss under Coverage A or B will be made to the mortgagee to the extent of its interest under all present and future mortgages. If more than one mortgagee is named, payment will be made in the order of priority of the mortgagees.
>
> The interest of the mortgagee under this policy will not be affected by any action or neglect by you.
> The interest of the mortgagee under this policy will terminate unless it:
>
> a. pays upon demand any premium due if the owner or mortgagor fails to do so.
> b. notifies us of any change of ownership or increase in hazard of which the mortgagee has knowledge; and
> c. pays upon demand the premium for any such increase in hazard.
>
> We will notify the mortgagee if you fail to give us proof of loss. Within 60 days after receiving such notice, the mortgagee must give us proof of loss. Policy conditions relating to appraisal, time of payment and time of bringing lawsuit apply to the mortgagee.

Based upon a review of this mortgage clause, the issue of whether the vacancy or unoccupancy defense can be asserted against the mortgagee is more problematic. Note that this mortgage clause only imposes a policy obligation on the mortgagee to report any vacancy or unoccupancy of which it becomes aware.

C. Recission

1. Recission as to Insured

Under the doctrine of recission, an insurer may rescind the policy, and declare it void *ab initio* based upon material misrepresentations made in the application or during the course of the application process. Therefore, and given the fact that a mortgage flip scheme is, by its very nature, fraudulent at core, the doctrine of recission is particularly applicable to, and useful in, this context. Although various states have taken different approaches to recission, the essential elements of a recission action have generally been recognized as follows:

a. The misrepresentation must be clearly stated in the written application;
b. The misrepresentation must be made with the actual intent to deceive the insurer;
c. The misrepresentation must materially affect the insurer's acceptance of the risk or hazard assumed (i.e. the misrepresentation must materially affect the company's underwriting review and underwriting decision concerning the policy.)

Oftentimes, in a mortgage flip situation, neither the named insured nor any of the other participants to the mortgage flip ring have any intention of actually utilizing the insured premises for a legitimate purpose. Therefore, the application for the policy itself will often contain numerous misrepresentations concerning the status, use, condition and occupancy of the premises as well as the insured's loss history. Where the SIU investigator determines that a claim arises from a mortgage flip scenario, the policy application should be obtained and reviewed for material misrepresentations. If a misrepresentation has occurred and a misrepresentation is material, the policy may be rescinded and declared void *ab initio*

Again, recission statutes in the various states impose different criteria for recission. Many of the statutes include a specific time limitation within which recission may occur. Therefore, each SIU investigator should consult his or her own state's recission statute.

2. Recission as to Mortgagee

A recission action as the mortgagee, rather than named insured, is more problematic. As noted above, the standard mortgage clause contained in most homeowners policies in use throughout the United States has generally been deemed a contract within a contract which grants independent rights to the mortgagee. Therefore a question arises as to whether a material and intentional misrepresentation made by a named insured in the application process (unbeknownst to the mortgagee) will allow recission as to the mortgagee.

There are persuasive arguments on both sides. From the insurer's perspective, if a material misrepresentation has occurred, the insurer would, most likely, not have issued the policy. Therefore, when recission lies and the policy is declared void *ab initio*, no policy is deemed to exist as to the named insured or, by extension, the mortgagee. In addition, and since the insurer has been the victim of a fraud scheme, it should not be required to honor a mortgagee claim simply because the mortgagee (like the insurer) was initially unaware of the fraud committed by the named insured/mortgagor.

Conversely, the mortgagee will argue that the insurer was in a better position to ascertain misrepresentations contained in its own application and that, therefore, the mortgagee should not be penalized by the insurer's lack of a complete investigation at the time the policy was issued.

In Craig Mattice, Jr. vs. Minnesota Property Insurance Placement, 655 N.W.2d 336 (Minn. App. 2002), the Minnesota Appellate Court rejected the insurer's attempt to rescind as to the mortgagee based upon misrepresentations made by the named insured. The Court essentially ruled that the standard mortgage clause creates a separate contract between the mortgagee and insurer and that, therefore, the intentional act of the named insured in the application process is not binding as to the mortgagee.

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Vince is a founding member and Managing Partner of Condon & Cook. He was admitted to practice law in 1975 and has represented clients in state and federal courts throughout Illinois since that time. Vince has written over one hundred articles on litigation related issues, and he has been asked to speak to multiple professional organizations regarding new litigation strategies based on changes in the law.

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