The Private Mortgage Insurer's Action For Rescission For Misrepresentation: Limiting A Potential Threat To Private Sector Participation In The Secondary Mortgage Market

Franklin D. Cordell
Washington and Lee University School of Law

Follow this and additional works at: https://scholarlycommons.law.wlu.edu/wlulr

Part of the Banking and Finance Law Commons, and the Insurance Law Commons

Recommended Citation
NOTES

THE PRIVATE MORTGAGE INSURER’S ACTION FOR RESCISSION FOR MISREPRESENTATION: LIMITING A POTENTIAL THREAT TO PRIVATE SECTOR PARTICIPATION IN THE SECONDARY MORTGAGE MARKET

The national secondary mortgage market experienced tremendous growth during the 1970s and 1980s.1 The highly successful and well-established Federal National Mortgage Association (FNMA),2 Government National Mortgage Association (GNMA),3 and Federal Home Loan Mortgage Corporation (FHLMC)4 set the stage for this period of growth by establishing a stable and standardized market in both government insured and conventional mortgage loans.5 Private mortgage banking concerns recognized an opportunity to enter an increasingly lucrative market and began pooling, packaging, and selling mortgage loans to secondary investors throughout the country.6

This growth in private market activity gave rise to a need for private mortgage guaranty insurance on the loans that the mortgage banking concerns securitized and sold on the secondary market, as potential investors in the secondary market looked to the presence of private mortgage insurance as evidence that an impartial underwriter had examined the quality of the underlying loans and determined the risk of default to be within insurable

---


2. See infra note 24 and accompanying text (discussing nature and function of FNMA).

3. See infra note 25 and accompanying text (discussing nature and function of GNMA).

4. See infra note 26 and accompanying text (discussing function of FHLMC and impact of recent federal legislation on FHLMC).

5. See FHLMC Citizen’s Guide, supra note 1, at 8-11 (describing role of federally sponsored agencies in establishing modern secondary mortgage market).

6. See infra note 30 and accompanying text (discussing increase of private sector involvement in secondary mortgage market).
limits. In response to this need, the private mortgage insurance industry provided more varied and flexible forms of insurance than that available from government mortgage guaranty agencies such as the Federal Housing Administration (FHA) or the Veterans Administration (VA). Consequently, private mortgage insurance assumed an important role in the efficient operation of the national secondary mortgage market.

Economic conditions in the early 1980s led to record numbers of defaults by mortgage borrowers and claims on private mortgage insurance policies. In particular, the widely publicized 1985 failure of Equity Programs Investment Corporation (EPIC) resulted in the default of approximately $1.5 billion of mortgage debt. After the EPIC default and other less notable failures, some of the private mortgage insurers sought to rescind insurance policies covering the loans on the grounds that the mortgage lenders procured the insurance through misrepresentations about the risk associated with the loans involved. In the majority of reported cases, the insurers sought rescission against original mortgage lenders who still held the mortgage loans in their own portfolios. In two recent cases, however, including the litigation arising out of the EPIC default, the private mortgage insurers

7. See infra note 31 and accompanying text (discussing role of private mortgage insurance in secondary mortgage market).
8. See infra notes 31-35 and accompanying text (discussing role of private mortgage insurance in secondary mortgage market and flexible nature of private mortgage insurance).
9. See infra notes 50-52 and accompanying text (discussing economic distress experienced by private mortgage insurance industry in 1980s).
10. See infra notes 80-99 and accompanying text (describing EPIC investment program and subsequent failure).
12. See supra note 11 (reporting cases involving insurer seeking to rescind mortgage insurance policy against original mortgage lender for misrepresentations by lender or borrower).
attempted to rescind policies issued on loans that the mortgagee subsequently had sold to secondary investors.\footnote{13}

Mortgage insurers' attempts to rescind coverage in cases in which mortgage originators have sold insured loans on the secondary market after the issuance of the policies have called into question the proper role of private mortgage insurance in the secondary mortgage market.\footnote{14} An examination of the history of the secondary mortgage market and of the private mortgage insurance industry's role in the secondary market reveals that the ability of private entities to participate in the market depends in large part on the ability of secondary investors to place confidence in the private mortgage insurers' underwriting efforts.\footnote{15} The economic climate of the 1970s and 1980s, combined with intense competition among private mortgage insurance companies, has caused underwriting standards within the mortgage insurance industry to decline.\footnote{16} This phenomenon threatens the continued utility of private mortgage insurance as an enhancement of privately issued securities in the secondary mortgage market.\footnote{17} Existing principles of contract law allow courts to limit the insurer's right to rescind an insurance contract if the insurer fails to underwrite reasonably the supposedly insured risk.\footnote{18} Courts should apply this limitation on the equitable action for rescission to encourage adherence to prudent underwriting standards, to impose upon mortgage insurers a heightened duty of inquiry into the quality of the insured loans if the mortgagor intends to sell the loans on the secondary market, and, consequently, to preserve the integrity of privately issued securities in the secondary mortgage market.\footnote{19}

\begin{itemize}
\item \footnote{13} See Verex Assurance, Inc. v. John Hanson Sav. and Loan, Inc., 816 F.2d 1296, 1298 (9th Cir. 1987) (private mortgage insurer seeking rescission of mortgage insurance policies against secondary purchasers of insured loans on grounds of misrepresentations by mortgage originator); In re EPIC Mortgage Ins. Litig., 701 F. Supp. 1192, 1253 (E.D. Va. 1988) (private mortgage insurers obtaining rescission of mortgage insurance policies against secondary market investors on grounds of misrepresentations by original mortgage lenders); \textit{infra} notes 80-119 and accompanying text (describing details of EPIC litigation); \textit{infra} note 131 (discussing John Hanson).
\item \footnote{15} See \textit{infra} note 31 and accompanying text (discussing function of private mortgage insurance as credit enhancement in secondary mortgage market).
\item \footnote{16} See \textit{infra} notes 53-64 and accompanying text (discussing forces contributing to decline of private mortgage insurers' underwriting standards during 1970s and 1980s).
\item \footnote{17} See Bus. Law, supra note 14, at 974 (describing potential effect upon secondary mortgage market of decline in investor confidence in private mortgage insurance); \textit{infra} note 31 and accompanying text (discussing role of private mortgage insurance in secondary mortgage market).
\item \footnote{18} See \textit{infra} notes 69-79 and accompanying text (discussing contract doctrines that courts use to limit insurer's action for rescission for misrepresentation in insurance application).
\item \footnote{19} See \textit{infra} notes 152-63 and accompanying text (arguing that courts should apply contract law principles to limit mortgage insurers' right to rescission for misrepresentation in insurance application if applicant has sold insured loan on secondary mortgage market).
\end{itemize}
The modern secondary mortgage market came into being during the depression years of the 1930s as a result of the federal government's desire to restore confidence in the residential housing market and to make home ownership more attainable.\textsuperscript{20} To accomplish these goals, Congress created the Federal Housing Administration (FHA) in 1934.\textsuperscript{21} The FHA insures mortgage loans that meet certain predetermined lending guidelines.\textsuperscript{22} In 1944 Congress authorized the Veterans Administration (VA) to begin a similar loan guarantee program.\textsuperscript{23}

The existence of government-insured mortgage loans gave rise to the creation of the FNMA;\textsuperscript{24} GNMA,\textsuperscript{25} and FHLMC.\textsuperscript{26} These agencies are charged with the buying and selling of FHA and VA insured loans as well as conventional loans.\textsuperscript{27} Selling mortgage loans to third party investors allows the original mortgage lender (the originator) to convert the right to receive a stream of payments of principal and interest into a single infusion of cash. The ability to convert a long-term obligation into cash allows mortgage lenders to reinvest these funds at higher interest rates during times of inflation and generally provides lenders more flexibility in managing their loan portfolios.\textsuperscript{28}

\begin{itemize}
\item \textsuperscript{20} See FHLMC Citizen's Guide, supra note 1, at 8-11 (discussing history and purpose of federally sponsored secondary mortgage market agencies); Malloy, supra note 1, at 992 (discussing depression era origins of secondary mortgage market).
\item \textsuperscript{22} See infra note 33 and accompanying text (discussing FHA and VA loan eligibility guidelines for various programs).
\item \textsuperscript{23} 12 U.S.C. § 1715n (1988).
\item \textsuperscript{25} See FHLMC Citizen's Guide, supra note 1, at 9 (describing formation and functions of FHLMC and GNMA). In 1968 Congress created the GNMA by dividing the FNMA into two entities, one continuing under the FNMA name and the second becoming the GNMA. Id.; National Housing Act of 1934, 12 U.S.C. §§ 1716-1716b (1988) (authorizing division of FNMA).
\item \textsuperscript{27} See FHLMC Citizen's Guide, supra note 1, at 9 (discussing functions of FHLMC and FNMA); Malloy, supra note 1, at 994 (discussing origin and functions of federally sponsored secondary market agencies). The GNMA purchases only FHA and VA insured loans less than one year old, while the FNMA and FHLMC deal in both conventional loans and older federally insured loans. Pittman, supra note 1, at 499-500.
\item \textsuperscript{28} See Malloy, supra note 1, at 1013 (discussing benefits to mortgage lenders and investors of participation in secondary mortgage market). During periods of increasing interest rates, mortgage lenders faced a liquidity problem because the lenders issued large amounts of long-term mortgage debt at low interest rates, yet were dependent on the short-term credit
Because participation in the secondary mortgage market benefits mortgage lenders, the government dominated market experienced explosive growth during the 1970s and early 1980s. By the late 1970s private entities, chiefly savings and loan associations and similar mortgage lenders, began entering the secondary mortgage market by packaging conventional loans and selling them to private investors and to the federal secondary market agencies. Because private investors required that the loans in which they were to invest be insured against loan should the borrower default, the market forced mortgage originators to procure insurance on mortgage loans before selling the loans in the secondary market. The FHA and VA insurance programs fulfilled this need in the federally sponsored secondary market since the market's inception. The regulations associated with the federal insurance programs unduly restricted the types of loans that private issuers could make and sell in the secondary market. Private mortgage originators,
consequently, sought to replace federal insurance with more flexible private insurance. Private mortgage insurers were able to tailor their product to the needs of individual lenders by offering services such as twenty-four hour turnaround time on policy applications and by insuring only a portion of the loan value at a correspondingly lower premium.

Because of the greater flexibility that private mortgage insurance provides, lending institutions eagerly have enlisted private insurers to provide insurance on mortgage loans, particularly on those loans that the originator intends to package and sell in the secondary market. In a typical conventional mortgage transaction, a lending institution requires the borrower to obtain private mortgage insurance if the loan amount exceeds eighty percent of the purchase price of the home. Although the borrower pays the premiums on the policy, the lender, rather than the borrower, is the insured party. The mortgage insurance policy generally covers twenty to twenty-five percent of the loan amount on the assumption that any deficiency after foreclosure will not exceed this amount. Should the borrower default on the loan, the lender will acquire title to the property and file a claim with the insurer. A standard policy normally gives the insurer the option either to pay the lender the face value of the policy and allow the lender to retain the property or to pay the lender the entire mortgage amount and take title to the property. The insurer normally will not take title to the property unless the insurer believes that the housing market will permit the insurer to sell the property at a price high enough to recover the payment of the entire mortgage amount plus expenses of foreclosure.
The secondary mortgage market benefits home buyers as well as mortgage originators. The ability to sell loans in the secondary market encourages mortgage lenders to increase the supply of funds available for mortgage lending, thereby decreasing the cost of mortgage loan funds to prospective home buyers. Commentators have estimated that the existence of an efficiently operating secondary mortgage market may reduce the cost of home mortgage credit by up to two percent. In addition, the emergence of a national market in mortgage pass-through certificates and debt instruments collateralized by mortgages facilitates the flow of funds from areas where surplus funds exist, such as the northeastern states, to areas experiencing a shortage of funds available for housing loans, such as the southern and western states.

The availability of private mortgage insurance is important to the ability of private entities to issue mortgage-backed securities in the secondary mortgage market. If private mortgage insurance is in place on the mortgage loans, then third party investors may be reasonably confident that an economic downturn in a particular area will not render their investment.

43. See K. Lore, supra note 1, at 1-30 to 1-33 (describing generally benefits derived from existence of secondary mortgage market).

44. See id. (describing benefits to home buyers and mortgage lenders from operation of secondary mortgage market); Lance, Balancing Private and Public Initiatives in The Mortgage-Backed Security Market, 18 REAL PROP. PROB. & TR. J. 426, 427 (1983) (describing potential for secondary mortgage market to reduce cost of mortgage credit); Malloy, supra note 1, at 999 n.1 (discussing benefits to home buyers of operation of secondary mortgage market); Nelson, Special Report: Secondary Mortgage Market Update, U.S. BANKER, Feb. 1984, at 24, 30 (estimating that efficiently operating secondary mortgage market could reduce home mortgage credit cost by up to two percent).

45. Lance, supra note 44, at 427. But see Pittman, supra note 1, at 542-43 (discussing studies suggesting that effect of increased activity in secondary mortgage market on cost of mortgage credit to homeowners may be less substantial than previously thought).

46. See FHLMC Citizen's Guide, supra note 1, at 3 (defining mortgage pass-through certificates and other mortgage-backed securities). Mortgage pass-through certificates are a common type of mortgage-backed security that provide the investor with a monthly cash flow. Id. Pass-through certificates give the investor an undivided fractional interest in a pool of mortgage loans. Id. The mortgage originator or other secondary market firm collects the borrower's payments of principal and interest and passes the payments through to investors on a pro rata basis. Id.; Malloy, supra note 1, at 1003-12 (discussing mechanics of mortgage-backed securities); Pittman, supra note 1, at 499-512 (describing specialized mortgage-backed securities and mortgage-collateralized debt instruments); Senft, Determining the Yield, in The HANDBOOK OF MORTGAGE BANKING 473, 499-500 (J. Kinney & R. Garrigan eds. 1985) (discussing function of mortgage pass-through certificates and other common mortgage-backed securities).

47. See FHLMC Citizen's Guide, supra note 1, at 3 (discussing ability of secondary mortgage market to make mortgage loan funds consistently available throughout country regardless of local economic conditions); K. Lore, supra note 1, at 1-2 (same); Malloy, supra note 1, at 1014-15 (discussing ability of secondary mortgage market to facilitate correction of regional imbalances in demand for mortgage credit); Seiders, The Future of Secondary Mortgage Markets: Economic Forces and Federal Policies, 3 HOUSING FIN. REV. 319, 324-25 (1984) (same); Conte & Schellhardt, Big Secondary Market in Mortgages Smooths Flow of Housing Funds, Wall St. J., July 11, 1983, at 1, col. 6 (discussing function of secondary mortgage market as conduit for national distribution of mortgage funds).
worthless. This function of mortgage insurance allows investors who are geographically distant from the loan originator and the mortgaged real estate to invest in mortgage-backed securities, confident that the insurer has taken steps to ensure that the underlying loans are solid and that the risk involved is within insurable limits.48

Recent developments both within the private mortgage insurance industry and in the courts threaten the continued vitality of private mortgage insurance as a credit enhancement in the secondary mortgage market.49 The private mortgage insurance industry suffered losses throughout most of the 1980s because of the high number of defaults that accompanied the economic downturn of that period.50 During this period private mortgage insurers paid on claims in excess of premium and investment income earned, and, consequently, the industry as a whole reported net operating losses in the years 1985 through 1987.51 These losses resulted at least in part from a decline in underwriting standards within the mortgage insurance industry.52

Underwriting standards declined during the late 1970s and early 1980s for three reasons. First, competition was fierce among private mortgage insurers during this period.53 Because insurers offer virtually identical policies and premium rates,54 competition among the companies shifted to other aspects of the transaction.55 Lowering underwriting standards became a primary means of competition.56 An individual insurer knew that if the insurer declined to insure a loan of marginal quality because the loan failed

48. See supra note 31 and accompanying text (discussing credit enhancement function of private mortgage insurance in secondary mortgage market).
49. See infra notes 53-64 and accompanying text (describing decline of underwriting standards in private mortgage insurance industry); infra notes 101-119 and accompanying text (describing issues raised by litigation surrounding failure of EPIC).
50. See MICA FACT BOOK, supra note 1, at 22, 24 (describing losses sustained by private mortgage insurance industry during early 1980s); Greenhouse, The Mortgage Insurers' Woes, N.Y. Times, Sept. 18, 1985, at D1, col. 3 (describing forces contributing to record losses in mortgage insurance industry during 1980s).
52. See Greenhouse, supra note 50, at D1 (stating that mortgage insurance industry's losses during 1980s were due in part to relaxation of formerly conservative underwriting practices).
53. See Browne, supra note 32, at 641-45 (describing competition among private mortgage insurers and between private mortgage insurers, government mortgage guaranty agencies, and lending institution self-insurance programs).
54. Id. at 641. The typical private mortgage insurance policy premium is one-half of one percent of the loan amount initially and one-fourth of one percent annually for ten years. Id.
55. See MOODY'S REPORT, supra note 51, at 14 (noting that nonprice competition within private mortgage insurance industry caused fluctuations in underwriting standards).
56. See Browne, supra note 32, at 641 (discussing nonprice competition within the mortgage insurance industry and consequent decline of underwriting standards).
to meet the insurer's underwriting standards, another insurance company almost certainly would be willing to insure such a marginal loan to increase its premium income. This phenomenon put downward pressure on underwriting standards.

A second reason for the decline of underwriting standards was that interest rates increased spectacularly during the late 1970s and early 1980s. This increase in interest rates encouraged mortgage insurers to issue as many new policies as possible so that the insurers could invest the cash earned through premium payments at the ever-increasing interest rates, thereby maximizing both premium and investment income. Driven by a desire to maximize cash inflow, mortgage insurers further relaxed their underwriting standards.

Third, mortgage insurers commonly maintained compensating balances with lending institutions active in originating mortgage loans during the 1970s. The lending institutions agreed to insure loans with a particular

57. Id.
58. Id.
60. Cf. Insurance Co. of N. Am., Inc. v. United States Gypsum Co., 870 F.2d 148, 150 (4th Cir. 1989). United States Gypsum involved an insurer's attempt to rescind a casualty insurance policy because of the applicant's alleged misrepresentations and omissions. The Fourth Circuit noted that high interest rates during the years 1979 to 1983 encouraged insurance companies to issue large numbers of insurance policies without regard to prudent underwriting practices to maximize revenues for reinvestment at higher interest rates. Id. This practice sometimes is referred to as "cash flow underwriting." Id.; see also Priest, Overaggressiveness of Mortgage Insurers Haunts Industry, AMERICAN BANKER, July 25, 1986, at 7 (discussing relationship between deterioration of underwriting standards within private mortgage insurance industry during late 1970s and early 1980s and high inflation levels during same period).

Housing prices also increased dramatically during the inflationary period of the 1970s and early 1980s. STATISTICAL ABSTRACT OF THE UNITED STATES 478 (U.S. Dept. of Commerce 1989) (reporting average annual increase in median purchase price of existing one-family homes during 1980s). In CenTrust Mortgage Corp. v. PMI Mortgage Insurance Co., No. 1 CA-CV 88-522 (Az. Ct. App. Div. 1 1989), a mortgage lender appealed a decision of the Maricopa County Superior Court that allowed a private mortgage insurer to rescind mortgage insurance policies on grounds of misrepresentations that the lender made in the policy applications. See CenTrust Mortgage Corp. v. PMI Mortgage Ins. Co., No. C551517, slip op. at 5 (Super Ct. Maricopa County, Ariz., Dec. 16, 1987) (available from Super. Ct. Maricopa County, Ariz.) (holding of trial court allowing insurer to rescind policies). On appeal the mortgage lender argued that the increase in housing prices during the late 1970s encouraged mortgage insurers to relax their underwriting standards. CenTrust Mortgage Corp.'s Opening Brief at 4, CenTrust (No. 1 CA-CV 88-522). According to the mortgage lender, when an insured loan went into default during the period of increasing property values the mortgage insurer would opt to purchase the property rather than pay the claim in cash. Id. The increasing property values allowed the mortgage insurers to hold the property for a time, and then sell it at a price high enough to avoid incurring a loss. Id.

61. See Browne, supra note 32, at 641 (describing practice of private mortgage insurers of maintaining compensating balances with customer lending institutions and resulting detrimental effect on insurers' underwriting standards).
mortgage insurer in return for maintaining these compensating balances.\textsuperscript{62} This practice relaxed underwriting standards because the continuing business relationship between the insurer and the lender encouraged the insurer to accept a particular lender's loans without due regard for the insurer's normal underwriting standards.\textsuperscript{63} The maintenance of compensating balances with mortgage lenders virtually has been eliminated in recent years, however, due to remedial federal regulation and state legislation.\textsuperscript{64}

The decline in underwriting standards experienced during the early 1980s becomes critically important when an insured party makes a claim after a borrower defaults on an insured mortgage loan. Should the insurer believe, upon receiving a claim, that the lender misrepresented material facts about the risk of default, the insurer may attempt to avoid liability on the policy either by bringing an action for rescission of the policy or by raising the misrepresentations as a defense to an insured's suit to compel payment on the policy.\textsuperscript{65} The degree of care that the insurer exercised during the underwriting process is important both to the court's contract law analysis and to the continued value of mortgage insurance in the secondary mortgage market.\textsuperscript{66}

An insurer generally may rescind a policy that an applicant has obtained by misrepresentations in the application because an insurance policy is a conditional contract.\textsuperscript{67} Misrepresentation by the insured constitutes a breach of the terms of the contract and relieves the insurer of its duty to perform under the contract.\textsuperscript{68} In cases in which the insured has not knowingly misrepresented facts in the application process or in which the misrepresentations did not actually cause the insurer to issue the policy, however, courts have developed doctrines that bar the insurer from rescinding policies

\textsuperscript{62.} Id.
\textsuperscript{63.} Id.
\textsuperscript{64.} See \textsc{Federal Home Loan Mortgage Corp.}, \textit{Eligibility Requirements for Private Mortgage Insurers} § 150.2 (1987) (prohibiting FHLMC-qualified private mortgage insurers from placing compensating balances with customer mortgage lenders); \textsc{Mortgage Guaranty Insurance Model Act} § 4.11 (National Association of Insurance Commissioners 1984) (prohibiting mortgage insurers from maintaining compensating balances at lending institutions for which mortgage insurer has insured loans).
\textsuperscript{65.} See \textit{generally} Brennan & Hanson, \textit{Misrepresentation in the Application as the Basis for Rescission of a Property Insurance Policy}, 21 \textsc{Tort & Ins. L.J.} 451 (1986) (discussing insurer's option of bringing suit for rescission or defending suit for nonpayment of claim); \textit{supra} note 11 and accompanying text (describing cases involving mortgage insurers' attempts to rescind policies for misrepresentations by applicant).
\textsuperscript{66.} See \textit{infra} notes 67-79 and accompanying text (discussing relationship between quality of insurer's underwriting effort and contract doctrines applied to limit insurer's action for rescission).
\textsuperscript{68.} R. Keeton & A. Widiss, \textit{supra} note 67, § 5.7, at 590.
because allowing rescission in these cases would lead to inequitable results.69

The first doctrine that operates to limit the insurer’s right of rescission stems from the requisite elements of the equitable remedy of rescission. To obtain rescission for an applicant’s misrepresentation, an insurer must show that the insurer relied reasonably on the misrepresentation in entering into the insurance contract.70 Thus, if an insured party negligently omits or misrepresents a material fact in the application, a court may preclude the insurer from obtaining rescission if the insurer could have discovered the falsity through reasonable investigation.71 However, if the insured acted fraudulently rather than negligently, courts generally will not allow the insured to claim as a defense to a rescission action that the insurer acted unreasonably .72

The second principle that operates to limit an insurer’s right of rescission for an applicant’s misrepresentation is the equitable doctrine of estoppel. Similar to the reasonable reliance element of the action for rescission, a court may apply estoppel doctrine to charge an insurer with knowledge regarding the insured that the insurer could have discovered by conducting a reasonable investigation.73 Under this form of estoppel doctrine, a court may bar an insurer from rescinding an insurance policy if the insurer induces an insured to rely reasonably on the insurer’s actions or omissions, and the

69. See Note, Waiver, Election and Estoppel in Virginia Insurance Litigation, 48 VA. L. REV. 416, 416 n.3 (1962) (discussing inequitable results of insurers’ actions for rescission and rise of doctrines limiting such actions).

70. See A & E Supply Co. v. Nationwide Mut. Fire Ins. Co., 798 F.2d 669, 672 (4th Cir. 1986), cert. denied, 479 U.S. 1091 (1987) (stating that insurer must reasonably rely on misrepresentation); New York Life Ins. Co. v. Strudel, 243 F.2d 90, 93 (5th Cir. 1957) (describing requirement that insurer’s reliance on misrepresentations by insured be reasonable); RESTATEMENT (SECOND) OF CONTRACTS § 164(1) (1982) (stating that contract is made voidable for misrepresentation if recipient of misrepresentations was justified in relying on misrepresentations).

71. See Insurance Co. of N. Am. v. United States Gypsum Co., 870 F.2d 148, 153-54 (4th Cir. 1989). In United States Gypsum, a suit by a casualty insurer, the Insurance Company of North America, to rescind a property insurance policy for alleged negligent failure of the insured, United States Gypsum, to disclose certain pre-existing risks, the Fourth Circuit stated that the insurer was under a duty to act reasonably to protect its own interests. Id. The court also noted that if an insurer acts unreasonably in the underwriting process in order to maximize revenues, the insurer must accept the consequences of its underwriting decision. Id.

In Stephens v. Guardian Life Ins. Co. of America, 742 F.2d 1329 (11th Cir. 1984), a case involving life insurance in which the insurer sought to avoid the policy on grounds that the insured failed to disclose a pre-existing heart condition in the application, the Eleventh Circuit stated that the policy would remain in force if the insurer had notice that would induce a prudent person to inquire further into the representations made in the application. Stephens, 742 F.2d at 1333.


73. See Columbian Nat’l Life Ins. Co. v. Rodgers, 116 F.2d 705, 707 (10th Cir. 1940) (stating that insurer can be charged with knowledge of facts available by investigation if put on notice of those facts), cert. denied, 313 U.S. 561 (1941).
insured changes position as a result of the insured’s reliance. In applying this form of estoppel, courts often state that if the facts disclosed in the insurance application put the insurer on ‘‘inquiry notice,’’ and the insurer fails to conduct a reasonable follow-up inquiry into the questionable facts, the court will preclude the insurer from denying coverage.

The doctrine of estoppel or inquiry notice and the reasonable reliance element of the action for rescission allow courts to prevent insurers from engaging in a practice sometimes known as ‘‘post-claim underwriting.’’ This practice occurs when an insurer issues policies after only superficial underwriting to realize large amounts of premium income, and then attempts to deny coverage on the grounds of misrepresentation by engaging in aggressive investigation of the risk after the insured makes a claim. Courts often criticize this practice as unfair because post-claim underwriting allows an insurer to accept income generated from questionable policies while knowing that the insurer may, at a later date, raise inaccuracies in the application as a means of avoiding liability on at least some of the purportedly insured risk.

74. See J. Appleman, Insurance Law and Practice § 9088, at 559 (1986). According to Appleman:

Where an insurer, or its agent, has knowledge, actual or imputed, of facts under which the express terms of the policy render it void, or unenforceable from its inception, and then issues the policy, the issuance is equivalent to an assertion by the insurer that such facts do not invalidate the policy, and if the insured acted in good faith, the insurer is thereby estopped after loss from claiming that such acts avoid its liability thereunder.

75. See J. Appleman, supra note 74, § 9086, at 547:

[If] the insurer has knowledge of facts which would put a reasonable man on inquiry, or which, if pursued, would give the company actual knowledge of the circumstances, and it failed to make such inquiry or to pursue such facts, it will be deemed to have waived its rights. Thus the insurer may be charged with knowledge of facts it ought to have known.

76. See, e.g., Major Oil Corp. v. Equitable Life Assurance Soc’y of United States, 457 F.2d 596, 604-05 (10th Cir. 1972) (applying equitable estoppel to charge insurer with knowledge of pre-existing medical problems of insured if reasonable investigation would have revealed such information). Courts often use the reasonable reliance element of the insurer’s action for rescission and the equitable doctrine of estoppel interchangeably in similar or indistinguishable fact patterns to impose upon the insurer a duty to undertake a reasonable examination of the applicant when put on inquiry notice. Compare Columbian Nat’l Life, 116 F.2d at 708 (framing decision explicitly in terms of estoppel) with New York Life Ins. Co. v. Strudel, 243 F.2d 90, 93 (5th Cir. 1957) (framing decision on fact pattern similar to Columbian in terms of failure to reasonably rely on misrepresentations). Whichever doctrinal label a particular court chooses, the principles at work are substantially the same in most cases, except where the applicant’s alleged misrepresentations were fraudulent, and the party claiming estoppel is not the original applicant. See infra notes 134-47 and accompanying text (describing application of equitable estoppel in cases in which insurer seeks rescission after inadequate underwriting against party other than original applicant).

SECONDARY MORTGAGE MARKET

However, as courts generally will not deny a claim of rescission if the insured committed fraud rather than negligent misrepresentation, courts likewise will not permit an applicant to raise the affirmative defense of estoppel when the misrepresentations were fraudulent. This prohibition against the use of estoppel by a party guilty of fraud may not apply, however, if the party asserting the estoppel is not the same party that fraudulently obtained the insurance. This characteristic of the estoppel defense is particularly important in the mortgage insurance setting, because if a mortgage insurance applicant, an originator, sells insured mortgages, or securities backed by insured mortgages, to a secondary market investor, the insured party and the party guilty of fraud will no longer be the same party.

The 1985 failure of Equity Programs Investment Corporation (EPIC) brought the decline of mortgage insurance underwriting standards as it relates to the availability of rescission for an insurance applicant's misrepresentation to the attention of the courts and the participants in the secondary mortgage market. The sequence of events leading to this widely noted failure illustrate the competing interests and policies at issue in applying existing insurance law to the unique relationship between the private mortgage insurance industry and the secondary mortgage market.

In 1974 EPIC, a northern Virginia-based company, began a real estate syndication program designed to take advantage of the secondary mortgage market and the then-favorable tax treatment of limited partnerships. Under the investment program, EPIC acted as a general partner and formed limited partnerships with individual investors as limited partners. These limited partnerships acquired residential model homes from builders of large housing developments. The partnerships then leased the homes back to the builder.

“place a large number of policies at little cost and realize high profits from the sales” and allows “the passage of time to root out the bad risks”); Southern United Life Ins. Co. v. Caves, 481 So. 2d 764, 768 (Miss. 1985) (stating that insurer cannot make intensive investigations into insured’s medical history after inadequately underwriting risk); Reserve Life Ins. Co. v. McGee, 444 So. 2d 803, 811 (Miss. 1983) (stating that insurer cannot gloss over investigation of insured’s medical history at time of underwriting and then investigate intensively after insured makes claim).

78. See Goodwin v. Hartford Life Ins. Co., 352 F. Supp. 907, 914 (W.D. Pa. 1973) (stating that, because estoppel is equitable doctrine, to apply estoppel in favor of insured generally requires that insured have acted in good faith).

79. See infra notes 134-51 and accompanying text (discussing application of estoppel doctrine if insured party has not made misrepresentations).


82. Id.

83. Id.
This sale and lease-back arrangement allowed builders in need of cash to liquidate assets that otherwise would have been unproductive until the builders completed an entire development and sold the model homes.

EPIC Mortgage, Incorporated (EMI), a subsidiary of EPIC, made the mortgage loans to the partnerships to finance the purchases of the homes. EMI made the loans on a nonrecourse basis, which effectively limited the EPIC limited partners’ liability to the amount of the limited partners’ capital contributions and any appreciation in the value of the homes. After originating the loans, EMI packaged the loans and sold them either as whole loans or in the form of pass-through certificates to financial institutions throughout the country. EMI procured private mortgage insurance policies on the loans before selling the loans to third party investors. As part of the application process, EPIC provided the insurers with a great deal of documentation relating to the structure of the EPIC organization and the nature of the risk associated with the rather unusual plan.

According to the EPIC plan, the limited partnerships were to sell the homes at a profit after the fourth or fifth year, thereby ending the partnerships’ obligations under the mortgages. For a time the plan operated as intended, but eventually EPIC became unable to sell the partnership properties at prices sufficient to retire the mortgage debt. Rather than to acknowledge that the failure to sell the homes posed a threat to the viability of the program, EPIC chose to conceal the facts from investors in an attempt to keep the program alive. EPIC began selling the older partnership properties to newly formed EPIC limited partnerships at prices high enough to pay off the old loans and return a profit to the old investors. In addition, EPIC began to appropriate funds from the new partnerships to satisfy the obligations of the older partnerships. Eventually EPIC increased

84. Id.
85. Id. at 1199. In the early years of the EPIC program the rent that the builders paid was greater than the market rate and greater than the mortgage payments due from the partnerships, and EPIC, consequently, termed these partnerships “income partnerships.” Id. at 1198. In the later years of the program EPIC partnerships purchased production homes and leased the homes to the general public at rent levels below the amount of the necessary mortgage payments. Id. at 1199. The later partnerships functioned as tax shelters for the limited partners because of the negative cash flow. Id.
86. Id. at 1203; see also supra note 46 and accompanying text (describing mortgage pass-through certificates).
87. EPIC, 701 F. Supp. at 1208.
88. Id. at 1203, 1215-16. In EPIC the principal document supplied to the insurers was known as a Private Placement Offering Memorandum (PPOM). Id. The PPOM was a lengthy document that described in detail the structure of the EPIC program and the risk associated with the limited partnerships. Id.
89. Id. at 1204.
90. Id. at 1224-27.
91. Id.
92. Id. at 1228-30.
93. Id.
94. Id. at 1229.
acquisitions of new properties to generate more loans and to increase the resulting cash inflow. The partnerships, consequently, became interdependent, and the EPIC program became essentially a giant "pyramid" scheme.

In August 1985 the EPIC pyramid collapsed, sending over 350 partnerships into default on mortgage loans totalling approximately $1.4 billion. In the wake of this massive default, the investors and mortgage insurers learned that EPIC and EMI had been egregiously mismanaged. EPIC officials had misrepresented the stability and structure of the EPIC program to limited partners, third party investors, and mortgage investors in an attempt to prop up the failing scheme.

The case of *In re EPIC Mortgage Insurance Litigation* followed the EPIC default. In *EPIC* the United States District Court for the Eastern District of Virginia considered whether the mortgage insurers could rescind mortgage insurance policies issued on loans that the originator sold to the third party investors on grounds of the originator's misrepresentations made in the procurement of the policies. The plaintiffs in *EPIC* were two large private mortgage insurance companies. The defendants were third party investors who had purchased whole loans or pass-through certificates in pools of mortgage loans that EPIC and EMI originated, packaged, and

---

95. Id. at 1230.
96. Id.; see also Girard, *supra* note 80, at 81-82 (describing interdependent nature of EPIC limited partnerships). A "pyramid" or "Ponzi" scheme is a fraudulent practice in which early investors receive proceeds of later investors' contributions, and the later investors will receive payments only if the interdependent scheme grows indefinitely. Girard, *supra* note 80, at 81.
97. *EPIC*, 701 F. Supp. at 1201; see also Nash, *EPIC Seen Halting All Payments*, N.Y. Times, Aug. 22, 1985, at D1, col. 6 (describing failure of EPIC to make interest payments due on $1.4 billion of mortgage debt).
98. See Girard, *supra* note 80, at 84-90. EPIC officials represented that the partnerships were not interdependent, that partnership funds were not commingled, and that EMI was successfully selling partnership properties after the prescribed period. *EPIC*, 701 F. Supp. at 1221-22; see also Valentine, *Fugitive Head of Md. S & L is Indicted*, Washington Post, Jan. 31, 1989, at B1, col. 2 (describing criminal indictment of principals of EPIC for fraud in connection with management of EPIC-affiliated savings and loan).
102. *EPIC*, 701 F. Supp. at 1192, 1197. In *EPIC* the defendant third party investors brought a counterclaim against a plaintiff mortgage insurer for direct and aiding and abetting violations of the antifraud provisions of the federal securities laws, 17 C.F.R. § 240.10b-5 (1988) and 15 U.S.C. § 77q(a) (1982). *EPIC*, 701 F. Supp. at 1197. The district court held that the certificates of participation in insured mortgage loan pools that EMI sold were not securities for the purposes of the federal securities laws. *Id.* at 1247-49. The court further held that the defendants had failed to establish that Foremost had committed any of the requisite elements of a violation of the antifraud provisions. *Id.* at 1247-52. Consequently, the court held for the plaintiff Foremost on the defendants' counterclaims. *Id.* at 1253.
The private mortgage insurers brought suit against the investors seeking rescission of the policies when, in the aftermath of the August 1985 default, the extent of EPIC's misrepresentations came to light. The plaintiff mortgage insurers sought rescission of the policies as to the third party investors on the grounds that the loan originator, EPIC, had procured the policies by fraudulent misrepresentations regarding the nature of the loans and the operation of the EPIC program as a whole.

The investors raised two principal defenses to the mortgage insurers' action for rescission. First, the investors argued that the insurers unreasonably relied on EPIC's representations. According to the investors, the documentation EPIC provided to the insurers contained various "red flags" that would have put a reasonable insurer on notice that the EPIC loans were unstable and based on a precarious, interest rate-sensitive scheme, and the insurers' failure to make a reasonable inquiry after being put on notice should preclude rescission.

Second, the investors argued that the insurers were estopped from denying coverage under the mortgage insurance policies on the grounds that the investors relied reasonably on the presence of the insurance by assuming that the insurers carefully had underwritten the underlying risk. According to the investors, the insurers knew that third party investors would rely on the insurers' underwriting in purchasing the EPIC loans and pass-through certificates, thus making the investors similar to third party beneficiaries of the insurance contracts, rather than mere assignees. The investors argued that the mortgage insurers were estopped from rescinding the policies because the insurers failed to make a reasonable examination of the loans before issuing the policies, which in turn caused the investors to change their position after relying on the insurers' representations.

In resolving these arguments, the district court made two legal rulings that could change significantly the role of private mortgage insurance in the secondary mortgage market. First, the court found that mortgage

104. Id. at 1197-98. One of the EPIC defendants, the First National Bank of Maryland, did not own EPIC pass-through securities for its own account, but rather served as custodial trustee for certain savings and loan associations who had purchased EPIC pass-through certificates. Id.

105. Id. at 1218.

106. Id. at 1197.

107. Id. at 1243.

108. See Brief of Appellants at 15-17, 32-36, Foremost Guar. Corp. v. Meritor Sav. Bank, No. 88-3163 (4th Cir. filed May 30, 1989) (arguing for investors on appeal that EPIC disclosure documents contained information that would have put reasonable insurer on notice that risk of default was extraordinary).

109. See id. at 36-40 (arguing for investors on appeal that insurers were estopped from denying coverage).

110. Id.

111. Id.

112. See BUS. LAW., supra note 14, at 972, 974-75 (outlining EPIC litigation and discussing potential significance of court's holdings in secondary mortgage market and private mortgage insurance industry).
insurers were entitled to conduct only "review underwriting," in which the insurers only review the applications for obvious omissions or mistakes and need not make any further inquiry into the veracity of the supplied information. Consequently, the court held that the mortgage insurers acted reasonably in issuing the insurance policies and were entitled to rely solely on the representations, oral and written, that EPIC made in procuring the insurance.

Second, the court found that the third party investors attained no special status as transferees of the insured loans. The court found that the investors were not analogous to third party beneficiaries of the insurance contracts but were mere assignees of those contracts. Consequently, held that the investors as assignees were susceptible to all defenses that the insurers had against the assignor, EPIC. Accordingly, the court rescinded the policies held by the investors. The investors appealed the district court's ruling to the United States Court of Appeals for the Fourth Circuit.

The view, typified by the EPIC court's holding, that private mortgage insurance is indistinguishable from standard forms of insurance, fails to consider the practical realities of the mortgage insurer's role in the secondary mortgage market. Private mortgage insurance differs from traditional forms of insurance in two major respects. These differences dictate that courts should apply the exceptions to the availability of rescission in a different manner in the mortgage insurance setting. First, the private mortgage insurer does not issue policies on the basis of a discrete, standardized form application for each individual policy, as is the practice in the traditional life or casualty insurance setting. Instead, the mortgage insurer issues a master policy that sets out the general provisions of the insurance contract and agrees to insure individual loans after receipt of a brief written statement for each loan.


114. EPIC, 701 F. Supp. at 1242-46.

115. Id. at 1246-47.

116. Id.

117. Id.

118. Id. at 1253.


120. See Browne, supra note 32, at 640 (describing mechanics of master policy in private mortgage insurance transaction).

121. MICA FACT BOOK, supra note 1, at 6 (describing nature of master policy and subsequent approval of individual loans).
is able to examine all documentation available to the mortgage originator and thus has far more opportunity to investigate the nature of the underlying risk than does a typical life or casualty insurer.\textsuperscript{122} Thus, mortgage insurers have extraordinary access to information relating to the risk to be insured, a fact that bears directly on the reasonableness of the insurer's underwriting effort.\textsuperscript{123}

Despite the fact that mortgage insurers have unusually complete access to information regarding the level of risk associated with the loans to be insured, mortgage insurers assert that they are entitled to conduct only "review underwriting."\textsuperscript{124} According to mortgage insurers, review underwriting consists of only a cursory review of the insurance application to check for any obvious mistakes or omissions.\textsuperscript{125} During oral arguments before the Fourth Circuit in the \textit{EPIC} case, the appellee mortgage insurers asserted that the insurers' underwriting function was "almost administrative" and involved little or no substantive evaluation of risk of default.\textsuperscript{126} These assertions ignore both the representations of the insurers themselves\textsuperscript{127} and the legal requirement that insurers must evaluate responsibly the risk they insure before courts will grant rescission for misrepresentation in the

\textsuperscript{122} \textit{See} Home Guar. Ins. Corp. v. Numerica Fin. Serv., Inc., 835 F.2d 1354, 1358-59 (11th Cir. 1988) In \textit{Numerica} the Eleventh Circuit held that mortgage insurers are not entitled to protection of a Florida insurance rescission statute because of the mortgage insurers' unique ability to examine information relating to risk associated with loan transaction. \textit{Id.} at 1359. The \textit{Numerica} court emphasized that traditional life or casualty insurers issue policies solely on the basis of discrete, standardized applications, while mortgage insurers have the ability to examine the original loan documentation and also may seek further information from the lender. \textit{Id.} at 1358-59.

\textsuperscript{123} \textit{See supra} notes 70-79 and accompanying text (discussing importance of reasonableness of insurer's underwriting effort to application of contract doctrines limiting insurer's action for rescission).

\textsuperscript{124} \textit{See} MICA FACT Book 1988, \textit{supra} note 1, at 6 (stating that mortgage insurers underwrite on review basis and take no responsibility for investigating risk of default because of lender's misrepresentations).

\textsuperscript{125} \textit{See} Brief of Appellee at 7-8, Foremost Guar. Corp. v. Meritor Sav. Bank, No. 88-3163 (4th Cir. filed May 30, 1989) (arguing that private mortgage insurers should be entitled to conduct review underwriting).


\textsuperscript{127} \textit{See, e.g.,} \textit{Mortgage Insurance Companies of America, Fact Book and Directory} 5 (1983-84 ed.) [hereinafter MICA FACTBOOK 1983-84] (stating that private mortgage insurance companies' "independent third party underwriting protects the lender as well as the investor should the mortgage subsequently be sold in the secondary market"). Private mortgage insurers represent in their promotional materials that their underwriting effort exceeds mere review underwriting:

Yes, we are tough underwriters. We reject those loans that don't meet our standards.

We're selective about the lenders we deal with, too. But our tough underwriting helps you in the long-run. And we're in the business for the long-run.

application. The view that insurers have no duty to investigate the veracity of loan originators' representations if irregularities in preliminary application materials put the insurers on inquiry notice, consequently, is inconsistent both with familiar principles of insurance law and with the unique function of private mortgage insurance.

The second major difference between mortgage insurance and traditional insurance is that mortgage insurers often issue policies on loans with the knowledge that the applicant mortgage lender intends to package the loans and sell them to investors in the secondary market. Thus, unlike traditional insurers, mortgage insurers know that third parties who are strangers to the insurance contract will rely on the presence of the policies as evidence that an impartial underwriter has examined the risk involved and determined the risk to be within insurable limits. This characteristic, peculiar to mortgage insurance, makes estoppel doctrine particularly applicable to situations such as the EPIC case in which the party claiming the defense is the third party investor rather than the original applicant.

Under general contract law, assignees stand in the shoes of their assignors and are susceptible to any defenses that the promisor may have against the assignors. If courts treat secondary purchasers of insured mortgage loans as mere assignees of the insurance contract, then the secondary purchasers' position will be no better than that of the mortgage originator. Thus, in cases in which the loan originator would be unable

128. See supra notes 70-75 and accompanying text (discussing legal limitations on insurer's action for rescission for misrepresentation); Mortgage Guaranty Insurance Model Act § 3.16(c) (National Association of Insurance Commissioners 1984):

No policy or mortgage insurance excluding policies of reinsurance, shall be written unless and until the insurer shall have conducted a reasonable and thorough examination of (i) the evidence supporting credit worthiness of the borrower and (ii) the appraisal report reflecting market evaluation of the property and shall have determined that prudent underwriting standards have been met.

Id. 129. See MICA Factbook 1983-84, supra note 127, at 5 (stating that one role of private mortgage insurance is to protect secondary investor if originator sells loan in secondary market).

130. See supra note 31 and accompanying text (discussing credit enhancement role of private mortgage insurance).

131. See Verex Assurance, Inc. v. John Hanson Sav. & Loan, Inc., 816 F.2d 1296, 1305 (9th Cir. 1987) (holding that secondary mortgage market investor raised genuine issues of material fact as to application of estoppel doctrine to preclude mortgage insurer from rescinding policies against secondary investor for loan originator's misrepresentations in obtaining policies); infra notes 134-51 and accompanying text (discussing application of estoppel if party guilty of misrepresentation is not same party claiming estoppel).


133. See supra notes 115-19 and accompanying text (discussing EPIC court's holding that secondary market investors are assignees of mortgage insurance policies and are susceptible to mortgage insurer's defenses against mortgage lender).
to avoid rescission because the originator committed fraud rather than negligent misrepresentation, the secondary investor likewise would be subject to rescission.

However, if a party claiming under an insurance policy is not the party guilty of misrepresentation in obtaining the insurance but rather is in the nature of a third party beneficiary, courts have held that insurers are estopped from rescinding an insurance policy against that innocent third party. The United States Court of Appeals for the Eighth Circuit illustrated this idea in *Aetna Insurance Co. v. Eisenberg*.134 In *Eisenberg* the court considered whether an insurance company could rescind a casualty insurance policy issued on garments that an insured furrier stored in his storage and cleaning firm on the grounds that the furrier misrepresented the value of the insured furs.135 The furrier applied for the insurance and paid the premiums, but the beneficiaries of the policy were the individuals who stored their furs with the furrier.136 The insurance contract required the furrier to report periodically to the insurer the value of the furs currently stored,137 and the insurer determined the premiums due according to the value of the furs in storage.138 After a fire damaged a large number of the insured furs, the insurance company conducted an investigation which revealed that, to reduce the required premiums, the furrier underreported the value of the stored furs.139 The insurer then brought suit against the furrier seeking to rescind the policies on the grounds of the misrepresentations.140 The owners of the insured furs intervened in the action claiming that, even if the insurer were entitled to rescind the policies as against the furrier, the insurer was estopped from denying coverage as against the third party owners of the furs.141

The Eighth Circuit first noted that, although the insurance contract ostensibly insured the furrier, the contract was actually a third party beneficiary contract in favor of the owners of the stored furs.142 The court then made two holdings that shed light on the issues presented in the mortgage insurance setting. First, the court found that, because the insurer had ample opportunity under the provisions of the policy to examine the insured furs as well as the defendant's records but failed to do so, the insurer was estopped from denying knowledge of the defendant's misrepresentations.143 Second, the court found that the defendant's customers had relied upon the presence of the insurance in allowing the defendant to store

---

134. 294 F.2d 301 (8th Cir. 1961).
136. Id. at 302-03.
137. Id. at 304.
138. Id.
139. Id.
140. Id. at 302.
141. Id. at 302, 305.
142. Id. at 305-06.
143. Id. at 307.
the customers' furs and that the insurer knew that the policies were intended to so induce business for the furrier. 144

Applying these findings to the facts of the case, the Eisenberg court held that the insurer could obtain rescission for misrepresentation against the insured furrier, but was estopped from raising the furrier's misrepresentations as grounds for rescission against the innocent third parties. 145 The court held that the individual customers had reasonably relied upon the insurer's representations that the furs would be insured and that the customers had detrimentally changed their position by storing the furs with the defendant. 146 For these reasons, the insurer's defense against the applicant was cut off as against the innocent third parties. 147

Although the facts of Eisenberg differ from the normal mortgage insurance situation in that the mortgage originator actually assigns the policy to the secondary investors, this difference is insignificant when the practical relationships of the parties are compared. In the mortgage insurance setting, as in Eisenberg, the insurance applicant procures insurance principally to induce third parties to place trust in the applicant, either by purchasing mortgage-backed securities or by purchasing storage services. 148 In both instances, the insurer and the insured represent the presence of insurance to third parties in such a manner as to induce trust, and both are aware that third parties will rely on the presence of insurance in their decision making process. 149 Finally, in both Eisenberg and the mortgage insurance setting, the insurer has the ability to protect against misrepresentations by making a reasonable inquiry into the risk. 150 The estoppel doctrine illustrated in Eisenberg and similar cases, 151 therefore, permits courts to prevent mort-

---

144. Id. at 304. The Eisenberg court found that the defendant advertised extensively that the plaintiff insurance company would insure furs stored at the defendant's place of business and that the plaintiff supplied advertising materials to facilitate these representations. Id. This promotional activity is analogous to the role of private mortgage insurance in the secondary mortgage market and to the representations made by the mortgage insurers in that setting. See supra note 127 and accompanying text (describing mortgage insurers' representations about underwriting efforts).

145. Eisenberg, 294 F.2d at 308.

146. Id.

147. Id. In addition to holding that the insurer was estopped from rescinding the policies against the customers, the Eisenberg court also found that the furrier was the insurance company's agent for the purposes of soliciting insurance business. Id. at 309-10. The court, however, made clear that the insurer was estopped, without regard to the agency relationship, from rescinding the policies against the customers. Id. at 308-09.

148. See supra note 31 and accompanying text (describing function of mortgage insurance in inducing investor confidence in mortgage-backed securities).

149. See supra note 31 and accompanying text (noting that one function of private mortgage insurance is to secure secondary market investors against loss because of borrower's default).

150. See supra notes 120-23 and accompanying text (discussing extraordinary ability of mortgage insurer to inquire into information pertinent to risk of default).

151. See Levy v. Empire Ins. Co., 379 F.2d 860, 863 (5th Cir. 1967) (holding insurer of debentures estopped from denying formation of insurance contract against purchasers of
gage insurers from rescinding mortgage insurance policies against innocent secondary market investors if the insurer failed to inquire reasonably into the nature of the risk insured.

To ensure the continued viability of private mortgage insurance as a component of private entity involvement in the secondary mortgage market, courts should impose a duty on mortgage insurers to engage in reasonably diligent underwriting of risk before issuing policies. The efficient operation of a national secondary mortgage market allows funds available for mortgage lending to flow from regions where surplus funds exist to regions experiencing a shortage of available funds, such as the rapidly growing southwestern states. Mortgage lenders benefit from the liquidity and flexibility that the secondary mortgage market provides, and home buyers benefit from the consequent increase in supply of mortgage credit. If mortgage insurers are able to conduct only review underwriting when issuing policies and then aggressively investigate the risk associated with the loans only after an insured makes a claim, the privately sponsored segment of the secondary mortgage market will be unable to function effectively.

Mortgage insurers argue that investors in the secondary mortgage market should bear the full risk of loss resulting from mortgage originators' misrepresentations. While investors undoubtedly should be responsible for a portion of the risk, this argument ignores a fundamental tenet of risk allocation in a market economy. This tenet holds that if risk of loss must fall on one of two equally innocent parties, the secondary market investor or the private mortgage insurer in the EPIC fact pattern, the risk should rest with the party that is best able to appreciate the nature of the risk and to guard against the risk. Mortgage insurers by their very nature are more
able to investigate and appreciate the risks associated with particular loans.\textsuperscript{158} Mortgage insurers indeed hold themselves out as experts in risk evaluation and are able to influence the lending policies of mortgage originators by setting and enforcing internal underwriting standards.\textsuperscript{159} Secondary market investors, on the other hand, often are geographically distant from the properties involved and must be able to rely on the mortgage insurer's greater access to relevant information if the private segment of the secondary mortgage market is to continue to act to remedy regional imbalances in the supply of mortgage credit.\textsuperscript{160} Thus, when a mortgage insurer attempts, after inadequate underwriting, to shift the full risk of default to the secondary market investor, courts should intervene to place that risk upon the mortgage insurer, where properly it lies.

Mortgage insurers further argue that, because the marketplace already offers heightened protection against an originator's or borrower's infidelity, courts should not hold that standard private mortgage insurance policies cover risk of default due to fraud or misrepresentation. This extended protection is known in the industry as a "fraud bond"\textsuperscript{161} and is available at an increased cost. If a party desires even greater protection against fraud, the party can have a particular loan investigated more extensively, again at a higher cost. This investigative service is known as "contract underwriting."\textsuperscript{162}

The availability of fraud bonds and contract underwriting gives rise to an argument that the law should not impose a duty of inquiry upon mortgage insurers if the operation of market forces would reach the same result. According to this reasoning, as loan originators and secondary investors learn that mortgage insurers easily can avoid standard mortgage insurance policies on grounds of misrepresentation by originators or borrowers, originators and investors simply will buy fraud bonds or contract underwriting.

\textsuperscript{158} See supra notes 120-23 and accompanying text (describing unique ability of mortgage insurers to obtain information regarding risk to be insured).

\textsuperscript{159} See supra note 127 and accompanying text (discussing representations of private mortgage insurers that underwriting process involves stringent, substantive evaluation of risk).

\textsuperscript{160} See supra note 47 and accompanying text (discussing ability of efficiently operating secondary mortgage market to alleviate geographical imbalances in demand for mortgage credit).


\textsuperscript{162} Id. (describing contract underwriting); see also Brief for Appellees at 8-9, Foremost Guar. Corp. v. Meritor Sav. Bank, No. 88-3163 (4th Cir. filed May 30, 1989) (describing fraud bonds and contract underwriting).
Thus, insurers could argue that the mortgage insurance industry presently is a two-tiered system, with different levels of protection available at different premium levels. According to this argument, to impose a general duty to underwrite against fraud would only turn the current two-tiered system into a one-tiered system at a uniformly higher price, thereby eliminating the choice of degree of coverage available to loan originators and secondary market investors.

This argument considerably overstates the effect of the application of the law of rescission and equitable estoppel doctrine to the mortgage insurance industry. Properly applied, the contract doctrines of reasonable reliance and equitable estoppel would not impose absolute liability upon mortgage insurers in every instance in which the mortgage originator or borrower attempts to defraud an insurer. To the contrary, mortgage insurers would remain free to rescind policies, even against secondary investors, so long as the mortgage insurer took reasonable steps to protect itself and the investor by examining the information to which the insurer has such extraordinary access.  

Courts would determine what constitutes a reasonable inquiry, a task that courts long have performed in the traditional insurance setting. Far from imposing the full risk of fraud on the mortgage insurer, application of these principles would prevent the inequitable practice of post-claims underwriting and would exert pressure on mortgage insurers to maintain underwriting standards commensurate with the insurers' representations and the secondary market investors' reasonable expectations. Thus, the existence in the marketplace of heightened protection against fraud on the part of the originator or borrower does not alter the conclusion that mortgage insurers should have a duty to examine diligently the extent of the risk of default due to misrepresentation even under a standard mortgage insurance policy.

The price of standard mortgage insurance undoubtedly will rise should courts apply contract doctrines to limit the mortgage insurer's action for rescission against secondary market investors. Mortgage insurers then might choose to offer a reduced form of coverage at a reduced price, a form of coverage that explicitly does not involve any substantive evaluation of the risk associated with the loan. In this manner the mortgage insurance industry would develop as a two-tiered system in which, unlike under the present system, the premium structure of the insurance policies offered would bear a rational relationship to the level of underwriting involved and to the representations of the mortgage insurers. Under such a two-tiered system,
mortgage originators and secondary market investors would be free to decide
upon which party the risk of loss due to misrepresentation would fall before
the transaction takes place, and no uncertainty as to where the risk of
misrepresentation lies would exist.

Private mortgage insurance plays an important role in the issuance of
privately issued mortgage-backed securities in the secondary mortgage mar-
ket. Insurers issue policies with the knowledge that third party investors
look to the presence of mortgage insurance as evidence that an independent
underwriter reasonably has examined the stability of the insured loans.
In this way, mortgage insurance serves a credit enhancement function in
the secondary market. Because of nonprice competition within the mort-
gage insurance industry and the soaring interest rates of the late 1970s and
early 1980s, insurers have relaxed their underwriting standards so far as to
threaten the important and accepted credit enhancement role of private
mortgage insurance. Courts should apply existing principles of contract
and insurance law to induce insurers to exercise reasonable care in under-
writing the risk of default and to prevent the inequitable practice of post-
claim underwriting. If the law allows mortgage insurers to conduct su-
perficial underwriting and then walk away from policies when a claim
reveals the true nature of the risk, private entity participation in the
secondary mortgage market will decline, and home buyers will suffer from
the resulting decrease in funds available for mortgage lending.

FRANKLIN D. CORDELL

165. See supra note 31 and accompanying text (discussing function of private mortgage
insurance in secondary mortgage market).
166. See supra note 127 and accompanying text (describing private mortgage insurers' represen-
tations regarding role of insurance in sale of insured loans in secondary mortgage
market).
167. See supra note 31 and accompanying text (describing role of private mortgage
insurance in secondary mortgage market).
168. See supra notes 52-64 and accompanying text (describing decline of underwriting
standards in private mortgage insurance industry).
169. See supra notes 70-79 and accompanying text (describing contract doctrines that
courts may use to limit mortgage insurers' action for rescission and to induce prudent,
meaningful underwriting).
170. See supra notes 42-46 and accompanying text (describing benefits to home buyers of
efficiently operating secondary mortgage market).
ADDENDUM

On October 6, 1990, the United States Court of Appeals for the Fourth Circuit rendered its decision in the mortgage insurers' appeal of the Eastern District of Virginia's holding in EPIC. The Fourth Circuit, in Foremost Guaranty Corp. v. Meritor Savings Bank, 1990 U.S. App. LEXIS 13414 (4th Cir.), reversed the district court's grant of rescission to the mortgage insurers. In reversing the district court's holding, the Fourth Circuit held that the mortgage insurers were not entitled to rely on the EPIC officials' oral representations regarding the financial condition and structure of the complex and risky EPIC plan. According to the court, the mortgage insurers had in their possession documents provided by EPIC that directly controverted the EPIC officials' oral representations. Had the mortgage insurers undertaken a reasonably diligent investigation of these materials, the insurers would have discovered that conditions were not as reported by the principals of EPIC. Thus, the court held that the insurers will be charged with the knowledge that would have resulted from a reasonable investigation, thereby preventing the insurers from satisfying the reasonable reliance element of an action for rescission.

Although the Fourth Circuit held for the policyholders in reversing the district court's decision, the opinion, authored by Judge Widener, does not address the potential impact of the decision upon private entity participation in the secondary mortgage market. Instead, the court chose to decide the case on narrow and familiar principles of insurance law without pausing to comment on the broader implications of the opinion. Despite the absence of any discussion of the utility of private mortgage insurance in the secondary mortgage market, the opinion nevertheless represents a vindication of the principle that when insurers undertake to evaluate and insure a given risk, they indeed must engage in a reasonably diligent investigation into the actual nature of the insured risk. It seems clear that the Foremost opinion is a victory for private participants in the secondary mortgage market and, if indirectly, for home buyers throughout the nation.