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Fire Insurance: Clause Against Chattel Mortgages: Effect of Void Chattel Mortgage as Moral Hazard

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should be a sufficient reservation.[39] It does not seem that the addition of the *actual words* of reservation on the old note should be essential to enable the bank to controvert the accommodation party's defense. But it has been held that the retention of the note is not enough.[40] This appears to be a sacrifice of substance to form. In view of the judicial notice taken of the bookkeeping transaction itself the courts should also recognize that the retention in the bank's files of the past due note whether marked "collateral" or not can only be for purposes of security. This note has no security value "per se" in the sense that other collateral securities have value. What other security can it give than a right to proceed against the parties whose names appear on it and not on the renewal note? The judicial attitude on this subject is but a further revelation of how technical the law tends to become on almost every aspect of this problem.

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FIRE INSURANCE—CLAUSE AGAINST CHATTEL MORTGAGES—EFFECT OF VOID CHATTEL MORTGAGE AS MORAL HAZARD.—The standard fire insurance policy for Wisconsin[1] contains a provision that the insurer shall not be liable for loss or damage to any personal property covered by the policy while encumbered by a chattel mortgage unless otherwise provided by agreement.[2] In the case of *Mielke* v. *National Reserve Ins. Co.*[3] the insurance company, contending that the insured had placed a chattel mortgage on some of the property covered by the policy, sought to have that property excluded from the protection of the policy. The insured countered with the contention that the chattel mortgage was ineffective and void[4] and that therefore the provision was not applicable. While the court found that the chattel mortgage was effective at the time of loss and that therefore the property included therein was excluded from the protection of the policy, it further added that, if it had been obliged to hold the chattel mortgage ineffective and void, the property described in the instrument would,

[39] But see *Citizens State Bank of Colman* v. *Rosenwald,* (S.D. 1934) 256 N.W. 264. "The reservation of rights against the surety must be express and definite however, and the creditor must not only retain the original instrument of indebtedness but must expressly reserve the right of immediate action *thereon* at least against the surety."

[40] *National Park Bank* v. *Koehler,* 204 N.Y. 174, 97 N.E. 468 (1912); *Citizens State Bank of Colman* v. *Rosenwald,* (S.D. 1934) 256 N.W. 264. Cited n. 39 *supra.*

[1] Wis. Stats. (1933) § 203.01.

[2] Wis. Stats. (1933) § 203.01 lines 62 to 67 inclusive, "unless otherwise provided by agreement * * * this company shall not be liable for loss or damage to any property insured hereunder while incumbered by a chattel mortgage * * *."

[3] (Wis. 1934) 256 N.W. 776.

[4] The chattel mortgage covered property which would have been subject to exemption if such exemption had been claimed and the mortgagor's wife not having joined in the mortgage would have the right to claim such exemption. Since she had not claimed such exemption (and she had no reason to do so) before the time of the fire loss the court decided that the mortgage was effective to all the property covered thereby.

nevertheless, be exempted from the protection of the policy.[5] Since such a statement by the court might subsequently be deemed authoritative,[6] what might be the basis for the court's declaration becomes important.

The theory adopted[7] in the *Mielke* case is: part of the risk assumed by the insurer is moral risk; what is good moral risk[8] may so cease to be if the property subject to the policy be or become encumbered by a chattel mortgage; the chattel mortgage provision is inserted in the policy to protect the insurer from the lessening of the insured's interest[9] in the property; even if the mortgage be invalid, and its invalidity be unknown to the insured, the effect on the moral risk will be the same as if the mortgage were effective.[10] This theory resolves itself into three main classifications: one, the relationship between moral hazard[11] and chattel mortgages; two, the purpose of the chattel mortgage provision; three, the construction of that provision.

Moral hazard is described as the pecuniary interest in the insured to permit the property to burn,[12] or the possibility of loss by fires of incendiary origin,[13] or risk, danger or probability that the insured will destroy or permit to be destroyed the insured property in order to collect the insurance.[14] It has been said that the moral hazard[15] is least when the pecuniary interest of the insured in the protection of the property against fire is greatest and that the moral hazard is greatest when the insured may gain most by the burning of the property.[16] The

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[5] See *Mielke* v. *National Reserve Ins. Co.*, (Wis. 1934) 256 N.W. 776, 777.

[6] *Chase* v. *American Cartage Co.*, 176 Wis. 235, 186 N.W. 598 (1922). See *Will of Hawkinson*, 143 Wis. 136, 126 N.W. 683 (1910).

[7] "Adopted" is used because the Wisconsin Court relied upon the theory set forth in *Lipedes* v. *Liverpool, etc., Ins. Co.*, 229 N.Y. 201, 128 N.E. 160, 13 A.L.R. 556 (1920).

[8] Moral hazard is that term which is used to describe the thing which creates the risk. See BLACK, LAW DICTIONARY (3rd ed.). Hence it may be deduced that moral risk is measured by moral hazard and for practical purposes the terms are synonomous.

[9] Interest is apparently used to connote that feeling which an owner of personal property has toward the property which causes him to take care of it and protect it from destruction.

[10] The terms effective, invalid and void, have been used indiscriminatingly. In fact however they describe the instrument termed a chattel mortgage as one having no legal efficacy between the parties to such instrument.

[11] While the court in the Mielke case used the term "moral risk" it is suggested that moral hazard is more generally used. See BLACK, LAW DICTIONARY (3rd ed.).

[12] See *Columbian Ins. Co.* v. *Lawrence*, 27 U.S. 25, 49, 7 L.Ed. 335 (1829); *Connecticut Fire Ins. Co.* v. *Manning*, 160 Fed. 382, 385, 15 Ann. Cas. 338 (C.C.A. 8th, 1908); *Johnson* v. *Sun Fire Ins. Co.*, 3 Ga. App. 430, 60 S.E. 118, 119 (1908); *Glen Falls Ins. Co.* v. *Michael*, 167 Ind. 659, 74 N.E. 964, 972 (1905).

[13] See *Hartford Fire Insurance Co.* v. *Dorroh*, 63 Tex. Civ. App. 560, 133 S.W. 465, 468 (1911).

[14] See *Davenport* v. *Firemans Ins. Co.*, 47 S.D. 426, 199 N.W. 203 (1924).

[15] Moral hazard may be more than just pecuniary interest to permit the property to burn. Such items as character, habits as a careful and prudent man or reverse, known integrity or bad reputation can be elements distinct from "pecuniary interest." See BLACK, LAW DICTIONARY (3rd ed.).

[16] See *Syndicate Ins. Co.* v. *Bohn*, 65 Fed 165, 170 (C.C.A. 8th, 1894); *Schumitsch* v. *American Ins. Co.*, 48 Wis. 26, 29, 3 N.W. 595 (1879).

roots of the thought behind such definitions may be found in the ancient requirement of insurable interest.[17]

In considering the relationship between moral hazard and chattel mortgages, it is of assistance to first consider the relationship between moral hazard and real estate mortgages as the definitions of moral hazard are sufficiently broad to cover either class. In the Wisconsin fire policy there is no provision *directly* covering the effect of the mortgagor's subsequently encumbering the insured realty.[18] If such was done it would not violate the provision relating to unconditional and sole ownership[19] nor the provision relating to change in interest, title or possession.[20] The only provision left[21] is that relating to hazard, namely: "Unless otherwise provided this company shall not be liable for loss or damage occuring while the hazard is increased by any means within the control or knowledge of the insured."[22] It has been held that placing a mortgage subsequent to the issuance of the policy amounted in an increase of the hazard voiding the policy under that provision.[23] This decision has been criticized, and the conclusion reached, that mortgaging of insured realty does not constitute a moral hazard sufficient to void the policy under the hazard provision. Such conclusion was based on an analysis of the decisions in relation to statutory changes in the form of the policy and actual inquiry addressed to fire underwriters.[24]

From the insurance angle, some distinction between real estate and chattel mortgages can be inferred from mere inspection of the stand-

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[17] In the cases of *Lynch* v. *Dalzell,* 4 Bro. P.C. 431, 2 Eng. Rep. 292 (1729) and *Sadlers Co.* v. *Badcock,* 2 Atk. 554, 555, 26 Eng. Rep. 733 (1743) it was pointed out that if policies were issued to people having no interest in the subject matter, a hazardous condition would result. There would be a great temptation for nefarious commission of willful arson. The idea was expressed that such would be a public danger. See ANGELL, FIRE AND LIFE INSURANCE (2nd. ed. 1855) § 55.

[18] As long as there is no fraudulent misrepresentation in applying for the policy (Wis. Stats. [1933] § 203.01 lines 1 to 9 incl.) the only provisions at all applicable to the act of subsequently encumbering the realty are: the sole ownership clause (id. at lines 23 to 26); commencement of foreclosure proceedings clause (id. at lines 28 to 31 incl.); change in interest, title or possession clause (id. at lines 31 to 34 incl.); and finally the increase of hazard clause (id. at lines 38 to 40 incl.).

[19] *Matthews* v. *Insurance Co.,* 115 Wis. 272, 91 N.W. 675 (1902); 26 C.J. 234, 243.

[20] *Wolf* v. *Insurance Co.,* 115 Wis. 402, 91 N.W. 1014 (1902); VANCE, HANDBOOK ON THE LAW OF INSURANCE (2d ed. 1930) 719 n. 15, 16. *Contra*: *Olney* v. *Insurance Co.,* 88 Mich 94, 50 N.W. 100 (1891).

[21] The provision against foreclosure proceedings (Wis. Stats. [1933] § 203.01 lines 28 to 31 incl.) will not be considered since that provision does not relate to any problem cencerning moral hazard.

[22] Wis. Stats. (1933) § 203.01 lines 35 to 40 incl.

[23] *Lawver* v. *Globe Ins.* Co., 25 S.D. 549, 127 N.W. 615 (1910). *Cf. Petranek* v. *Bohemian Farmers' Mut. Ins. Co.,* 44 S.D. 540, 184 N.W. 798 (1921) reversing a lower court decision based on the Lawver case and granting a new trial to determine as a matter of fact whether the hazard was increased by the placing of the mortgage. *Contra*: *Huff* v. *Jewett,* 20 Misc. 35, 44 N.Y. Supp. 311 (1897); see *Sims* v. *American Cent. Ins. Co.,* 296 Fed. 115 (C.C.A. 6th, 1924); *Cooper* v. *Insurance Co.,* 139 Mo. App. 570, 583, 584, 123 S.W. 497 (1909); *Light* v. *Greenwich Ins. Co.,* 105 Tenn. 480, 58 S.W. 851 (1900).

[24] Cohen, *Encumbering Realty as Affecting the Moral Hazard in Fire Insurance* (1924) 24 Col. L. Rev. 603.

ard policy.[25] That distinction from a practical point of view should not be based on a difference between the realty and chattel mortgagor's interest in the encumbered property.[26] If the character of the insured's interest in property encumbered by a real estate mortgage does not constitute a moral hazard,[27] neither should the insured's interest in personal property covered by a chattel mortgage constitute such a hazard.[28] The decisions however hold that the placing of a chattel mortgage on personal property increases the risk, *i.e.* it creates a moral hazard.[29] It has been suggested that the force of these holdings should be discounted at least insofar as they hold such mortgaging constitutes a moral hazard as a matter of law.[30] The evidence pro and con is balanced; perhaps the tendency to hold that the placing of a chattel mortgage gave rise to a moral hazard is founded upon authority established at a time when the concept of a chattel mortgage was different from what it is today.[31]

Consider now the purpose of the chattel mortgage provision. The *Mielke* case stated that it was "inserted to afford the insurer the pro-

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[25] There is no provision relating directly to the encumbrancing of insured realty (see note 18 *supra*) while there is a direct prohibition against chattel mortgages (see note 1 *supra*).

[26] *Mielke* v. *National Reserve Ins. Co.* (Wis. 1934) 256 N.W. 776, 777. It was stated that a chattel mortgage not only works a change in title, but subjects the mortgagor to the prospect of seizure at any time when the mortgagee deems himself insecure. This is true only where the instrument itself so provides. For all practical purposes the chattel mortgagor is the owner. He enjoys the use of the chattel. He is protected in that use against third persons (even against the mortgagor if there is no special clause like that mentioned above). Note (1934) Marq. L. Rev. 248, 249, n. 1.

[27] See note 24 *supra*.

[28] There is no ground for the fear that in some mysterious way the assured would derive a profit by insuring the property to its full value, placing a chattel mortgage on it and then having it destroyed without being detected. His obligation to repay the mortgage remains in any event. Further in his proof of loss he is obliged to state his interest and the interests of others in the property and all encumbrances thereon (Wis. Stats. (1933) § 203.01, lines 133 to 140 incl.). From a theoretical or practical viewpoint it is hard to determine how the assured chattel mortgagor can make a profit. See Cohen, *Encumbering Realty as Effecting the Moral Hazard in Fire Insurance* (1924) 24 Col. L. Rev. 603, 613.

[29] *Ellis* v. *State Ins. Co.*, 61 Iowa 577, 16 N.W. 744 (1883); *Lee* v. *Agricultural Ins Co.*, 79 Iowa 379, 44 N.W. 683 (1890); *Lipedes* v. *Liverpool, etc., Ins. Co.*, 229 N.Y. 201, 128 N.E. 160, 13 A.L.R. 556 (1920) (cited in the Mielke case note 3 *supra*); see *Schwmitsch* v. *The American Ins. Co.*, 48 Wis. 26, 29, 3 N.W. 595 (1879).

[30] RICHARDS, LAW OF INSURANCE (2d. ed. 1893) 151, § 141. *Cf. Phoenix Ins. Co.* v. *Fulton*, 80 Ga. 224, 4 S.E. 866 (1887); *McCarty* v. *Imperial Ins. Co.*, 126 N.C. 820, 36 S.E. 284 (1900).

[31] In note 17 *supra* the effect of "no interest" in the property was shown. It voided the policy as to such non-interested holder. *Howard & Rychman* v. *Albany Ins. Co.*, 3 Denio 301 (N.Y. 1846). Under the concept of a chattel mortgage in England prior to 1820, the mortgagee became so absolutely the owner of the chattel that the mortgagor was completely lacking in interest. *Lockwood* v. *Ewer*, 2 Atk. R. 303, 26 Eng. Rep. 585 (1742). This of course voided the mortgagor's policy. This was changed by the registry act, the mortgagee not being an owner to any greater extent than the value of the mortgage and the mortgagor continuing as owner. *Irving* v. *Richardson*, 2 B. & Adol. R. 193, 196, 109 Eng. Rep. 1115, 1116 (1831). It is suggested that the rulings which arose under the old concept of the chattel mortgage have persisted in some form today and influenced the courts in holding that the chattel mortgage in some way should void the policy; the moral hazard theory is the old concept disguised.

tection which it has by reason of the fact that the insured is the owner and therefore interested in the property."[32] Such a reason is based on the assumption that there is an increase in the risk to the insured, i.e., existence of a moral hazard if the property becomes encumbered. The validity of this assumption, as previously discussed, is doubtful.[33] The text book writers have, however, advanced this reason.[34] Besides this reason the provision has been upheld on the ground that the parties are *sui juris*.[35] It is also suggested that it was inserted because the clause voiding the policy upon change in interest, title, or possession was not appliable to that change which was effected by the execution of a chattel mortgage.[36]

Whatever the reason, both legal and factual, may be for the existence of the chattel mortgage provision, it does exist and must be construed. Where the chattel mortgage is valid there is no difficulty: it means that the insured agrees that any personal property incumbered by a chattel mortgage shall not be within the protection of the policy.[37] The *Mielke* case can be understood to extend this construction to mean that the insured agrees that any personal property incumbered by a chattel mortgage whether valid or not shall not be within the protection of the policy. At least that is one conclusion to be drawn from the case. But it is not a logical construction. For example in the older form of policy there was a provision avoiding the policy if other insurance were placed upon the property.[38] If the other insurance so placed was invalid it did not avoid the existing policies.[39] In order to insure the required effect of the subsequent invalid policy the provision was amended to read whether "valid or not."[40] It would seem that if the legislature intended that the chattel mortgage provision should apply to valid as well as invalid mortgages, it would have used language making such construction definite.[41] The decisions construing chattel mortgage pro-

[32] See *Mielke* v. *National Reserve Ins. Co.* (Wis. 1934) 256 N.W. 776, 777.

[33] The care which an owner bestows on his personalty depends to a large extent on his personal character, it might be said that this care would be lessened to some degree after the owner has obtained insurance. The act of placing insurance in this sense itself increases the risk of loss.

[34] VANCE, HANDBOOK ON THE LAW OF INSURANCE (2d ed. 1930) 713; 4 COUCH ON INSURANCE 3146.

[35] *Georgia Home Insurance Co.* v. *Hoskins,* 71 Fla. 282, 71 So. 285 (1916). But see Wis. Stats. (1933) § 203.06 (making the standard policy compulsory). *Cf. Hudson Mfg. Co.* v. *New York Underwriters Ins. Co.,* 33 F. (2d) 460 (C.C.A. 7th, 1929).

[36] See *Niagara Falls Ins. Co.* v. *Mullins,* 218 Ky. 473, 219 S.W. 760, 762 (1927).

[37] *Moe* v. *Allemania Fire Ins. Co.,* 209 Wis. 526, 244 N.W. 593 (1932).

[38] VANCE, HANDBOOK ON THE LAW OF INSURANCE (2d ed. 1930) 729.

[39] *Phoenix Ins. Co.* v. *Copeland,* 86 Ala. 551, 6 So. 143 (1888).

[40] See Wis. Stats. (1933) § 203.01 lines 201 to 205 incl. If there be other insurance on the property covered by this policy, whether valid or not, this company shall not be liable for more than its proportionate share * * *.

[41] In *Lipedes* v. *Liverpool, etc., Ins. Co., 229* N.Y. 201, 128 N.E. 160, 13 A.L.R. 556 (1920), from which the Mielke case derives its authority, the inference is that there was something in the nature of a fraudulent misrepresentation. The usurious chattel mortgage was in existence prior to the application for the policy and the court said did the contract [as a whole] of the parties contemplate the disclosure to the insurance company of the existence of the usurious chattel mortgage. *Cf. Madsen* v. *Farmers and Merchants Insurance Co.,* 87 Neb. 107, 126 N.W. 1086 (1910) (concealment of material fact covering subject of insurance). In that case the court said that whether an alleged void chattel mortgage was a chattel mortgage or not made no difference as it constituted an incumbrance and its concealment was material.

visions where void chattel mortgages are involved are few,[42] and of little help in considering the problem. The case of *Lipedes* v. *Liverpool, etc., Ins. Co.*,[43] which holds that a void chattel mortgage avoids the policy, seems more in point than any. Most of the other cases involving an alleged invalid chattel mortgage turn on some point which does not squarely bring up the issue, such as chattel mortgages which have never taken effect because of no delivery[44] or were valid as between the parties but void as to creditors.[45] There are also some cases inferring that a void chattel mortgage is not within the chattel mortgage provision.[46]

Construed as above the *Mielke* case is not sound nor logical. The only other possible construction would be that the alleged moral hazard created by the void chattel mortgage is such a hazard as would come under the following provision: unless otherwise provided * * * this company shall not be liable for loss or damage occurring while the hazard is increased by any means within the control * * * of the insured * * *.[47] There is some justification for this construction[48] but the cases generally do not support the view that moral hazard comes within the purview of the hazard provision.[49] Under the hazard provision it is possible that a void chattel mortgage would avoid the entire policy.[50] Hence a void chattel mortgage would be more disastrous to the insured than a valid chattel mortgage which only exempts the mortgaged property from the policy.[51]

In conclusion it is suggested that by amendment to the chattel mortgage clause, changing it so that in place of voiding the policy entirely[52] it merely exempted from the policy that property which was incumbered,[53] the legislature intended to make the insurance attitude toward chattel mortages conform more closely to modern business practices and that the pronouncement set forth in the *Mielke* case is a step backward rather than forward.

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[42] See Note 13 A.L.R. 556.

[43] 229 N.Y. 201, 128 N.E. 160, 13 A.L.R. 556 (1920). The case is not clear as to whether the policy was avoided under the chattel mortgage provision or the hazard provision.

[44] 4 COUCH ON INSURANCE 3134 n. 7. (The mortgagor knew they were invalid because he had not signified his intent to make them valid.)

[45] *Secrest* v. *Hartford Fire Insurance Co.*, 68 S.C. 378, 47 S.E. 680 (1903). (Chattel mortgage declared null and void in creditors bill); *Oliker* v. *Williams Fire Ins. Co.*, 72 W.Va. 436, 78 S.E. 746 (1913) (trust deed void as to creditors not parties).

[46] *Beckley* v. *National Fire Insurance Co.*, 194 Ia. 1106, 190 N.W. 954 (1922); *Rowland* v. *Home Ins. Co.*, 82 Kan. 220, 108 P. 118 (1910).

[47] Wis. Stats. (1933) § 203.01 lines 35-40 incl. See note 43 *supra.*

[48] *Lawver* v. *Globe Mut. Ins. Co.*, 25 S.D. 549, 127 N.W. 615 (1910) (realty mortgage).

[49] *Ampersand Hotel Co.* v *.Home Ins. Co.*, 198 N.Y. 495, 91 N.E. 1099 (1910); see Cohen, *Encumbering Realty as Affecting the Moral Hazard in Fire Insurance* (1924) 24 Col. L. Rev. 603, 618. *Cf.* Statutory Interpretation (1934) 8 Tulane L. Rev. 306, (Louisiana statute provides for voiding policy for a breach of warranty as would increase the moral hazard.)

[50] The hazard provision provides that the company shall not be liable for *damage or loss* while the hazard is increased.

[51] See notes 2 and 3 supra.

[52] WIS. LAWS (1895) c. 387 s. 1.

[53] WIS. LAWS (1917) c. 127 s. 2; see *Prentiss-Wabers S. Co.* v. *Millers Mut. Fire Ins. Ass'n.*, 192 Wis. 623, 627, 211 N.W. 776, 778 (1927).