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Flood Warning: Water Is Rising on Cross-Collateral Clauses

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Flood violations are often something that can creep up on banks, mainly because banks have a tendency to be lulled to sleep on underlying risks until a triggering event occurs that makes everyone pay attention — for example, a change in the flood maps or a change in regulation, such as the recent regulatory changes with respect to private flood insurance. However, flood risk has recently surfaced after hiding beneath the waters for some time: cross-collateral clauses in mortgages and deeds of trust have recently been identified by examiners as causing loans to be underinsured as to flood insurance.

Cross-collateral agreements have been an insidious source of compliance risk in the past, but flood insurance has not been commonly recognized as a source of that risk. However, many of our clients are reporting that their examiners are questioning whether or not they have enough flood insurance for loans that are secured with deeds of trust or mortgages that contain “cross-collateral” or “dragnet” clauses.

A dragnet clause is one that states that a security agreement, such as a deed of trust or mortgage in the context of real estate, not only secures the debt of the borrower for which it is granted, but also secures all other obligations, debts, and liabilities that the borrower may owe to the lender, regardless of whether it exists at the time of the security agreement or arises after it, and despite the fact that the other debt may be totally unrelated to the debt for which the security agreement was granted.

As I am sure our banking clients know by heart, for any loan secured by improved real property or mobile homes located in an area identified by the Federal Emergency Management Agency (FEMA) as having special flood hazards, the bank must require the borrower to obtain flood insurance in an amount that at least equals the lowest of: (i) the outstanding principal balance of the loan, (ii) the maximum amount available under the National Flood Insurance Program for the type of structure insured, or (iii) the insurable value of the property.

This ordinarily is a pretty easy determination since all three of these amounts are fairly clear with respect to any given loan. However, as mentioned above, for a deed of trust or mortgage that contains a dragnet clause, the outstanding principal balance of the loan may not be limited only to the loan that is originated when the security interest is granted; it may also include any loans originated thereafter that are indirectly secured by the deed of trust or mortgage via the dragnet clause. Therefore, theoretically, each time a loan is made to that borrower subsequent to the granting of a deed of trust or mortgage with a dragnet clause, the lender will need to reevaluate the flood

insurance protecting the structures securing the debt if the insurance was previously written for the "outstanding principal of the loan."

These dragnet clauses were perhaps first identified as problems under Regulation Z with respect to the required right of rescission. The Consumer Financial Protection Bureau (CFPB), in its staff commentary for 12 C.F.R. § 1026.15(f), states as follows:

"When the creditor holds a mortgage or deed of trust on the consumer's principal dwelling and that mortgage or deed of trust contains a 'spreader clause' (also known as a 'dragnet' or cross-collateralization clause), subsequent occurrences such as the opening of a plan or individual credit extensions ***are subject to the right of rescission*** to the same degree as if the security interest were taken directly to secure the open-end plan, ***unless the creditor effectively waives its security interest under the spreader clause with respect to the subsequent open-end credit extensions***."

Therefore, in order to comply with Regulation Z, banks have included language in their deeds of trust or mortgages that states that the instrument will not secure any future advances for which a right of rescission may apply. Until now, though, these provisions have typically not been broad enough to also address any possible flood insurance violations that may occur as a result of a subsequent credit extension subject to the dragnet clause because, frankly, few have anticipated that problem, and examiners have not pointed it out.

According to anecdotal evidence we are receiving from our clients, though, those days are over. Therefore, banks should reexamine their mortgages and deeds of trust, identify any dragnet clauses they may have, and consider inserting remedial language similar to that which has been used to address the Regulation Z problem for some time. Such language needs to make clear that, notwithstanding any cross-collateral language in the instrument, any future extensions of credit will not be secured by the instrument unless the lender complies with the federal flood requirements. That language may be just the lifeboat a bank needs to escape the rushing waters of civil money penalties that are lurking on the other side of its next exam.

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