



Featured Article

BORROWER'S WILLFUL DEMOLITION OF PROPERTY: IS IT AN INSURABLE LOSS?

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In the last issue of the *UTA Quarterly*, we discussed the TRB Investments case and whether the lender was insured for a loss that occurred when the property was vacant. In this issue, we look at whether the lender is insured after the borrower, intentionally or otherwise, destroys the property. Fortunately, the seldom used case of *Home Savings of America, FSB v. Continental Insurance Co.* (2001) 87 Cal. App. 835, says yes.

We have all heard of stories, some true and some embellished, where the borrower, angry with the bank over an impending foreclosure, guts the home, leaving the lender with nothing but a shell. While the holding of *Home Savings* covers that type of scenario, it covers the more common situation where the good-intentioned borrower razes the property with the intent to build something better. But, after demolition crews reduce the existing security to its foundation, the borrower runs into financial trouble and cannot complete (or even start) their dream house. The good news is that under the holding in *Home Savings*, the lender may be insured for the loss.

In *Home Savings*, the borrowers, John and Joan Veenstra, demolished their Corona Del Mar home to develop town homes. After pouring the concrete foundation, the Veenstras went into default. During the foreclosure process, Home Savings learned for the first time that the existing house had been destroyed. To avoid the pitfalls of the full-credit bid rule¹, Home Savings credit bid \$680,000 at the foreclosure sale. The full debt at the time was \$1,059,505.18. Home Savings resold the REO for \$800,000, leaving an out-of-pocket loss of \$259,505.18.

Home Savings then made a claim under the Loss Payee Clause of the Veenstras Homeowner's Insurance Policy with Continental Insurance. Continental immediately denied the claim and Home Savings filed suit. Both sides moved for summary judgment under a variety of theories. In the end, the Court granted summary judgment in favor of Continental ruling that, because Home Savings was subject to all of the same defenses that Continental had against the insured borrowers, Continental was not obligated to pay on the claim. In other words, the lender and the borrower stand in the same shoes.

The borrowers' intentional act of demolishing the house barred both their own claim and the lender's claimⁱⁱ Home Savings appealed the ruling.

The Court of Appeals reversed and ordered that summary judgment be entered in favor of Home Savings. The Court of Appeals held that the Standard Loss Payable (Mortgagee)

Clause, like the one used by Continental, created a separate contract of insurance in favor of the lender. Accordingly, the lender's "policy of insurance" is not subject to all the same defenses that insurer has against the borrower. Instead, the borrowers' intentional demolition of the property was akin to the intentional act of any third party to an insurance contract, and did not bar the lender's claim. For purposes of Home Savings' claim, it made no difference whether the intentional act was committed by the Veenstras or some strangers off the street. They were all third parties to Home Savings' insurance coverage.

The Court of Appeals, did however, point out one important exception for our lending clients to be on the look out for. The lender's approval or ratification of the demolition could bar coverage. Since our lending clients seldom willingly give a

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borrower the okay to demolish the house, that is not much of a risk. The real risk lies where the lender learns that the property will be or is in the process of being demolished and does not object to the demolition. The lender's inaction could be viewed by a court as a tacit approval of the demolition, which would most likely constitute valid grounds for the insurance company to deny a claim.

Most of our lending clients do not know about their right to file an insurance claim when the borrower demolishes the existing structures, let alone the potential exception explained above. While the role of the trustee generally is to non-judicially foreclose on the property, from a practical standpoint, trustees often look for ways to assist the lender. Armed with *Home Savings'* case, there are several things that a trustee can do to help its lending clients.

1. If, through posting the property or otherwise, the trustee learns that the property has been demolished or otherwise destroyed (e.g. arson), notify the client. At the same time, ask the client if they have looked into making a claim under the Loss Payable Clause. If the client says no, explain that they may have a claim and suggest that they consult in-house or outside counsel.
2. In addition to a potential insurance claim, in the event of an unauthorized demolition of the property, the lender may have other legal rights that it should look into before non-judicially foreclosing. In some instances, the lender may opt to judicially foreclose and seek a deficiency judgment or even sue for bad-faith waste. While it may not be the trustee's job to advise the lender on when and where to pursue these remedies, it is appropriate to advise the client that they have their options and that they should discuss them with the appropriate counsel.
3. Many trustees already do this, but its importance is underscored by the *Home Savings* case. Had *Home Savings* made a full credit bid at the foreclosure sale, it would have been legally made whole by the foreclosure sale. Consequently, Continental could have simply denied the claim for the lack of any recoverable damages. So, regardless of whether

your client has decided to make a Home Savings type insurance claim yet, as the trustee, make sure the client does not waive its right by making a full credit bid at the foreclosure sale. Equally as important, help make sure that the amount they do bid, matches their actual loss. To do this, you may want to recommend that the lender obtain an appraisal.

Over the last seven or eight years, borrowers have seen witnessed previously unseen increase in property values. This increase in equity, coupled with a strong economy, has given many borrowers the financial ability to tear down and rebuild houses at a visible rate. But, with the quickly changing economy, many borrowers are finding themselves under water with a partially poured foundation or incomplete frame. As a result, our lending clients will find themselves taking back more and more incomplete construction projects. The *Home Savings* case may give them the right to recover these losses from the insurance company rather than bare them themselves. But, if they don't know their options, they cannot recover. Therefore, it is our job as trustees and attorneys to help the lenders help themselves.

¹The full-credit bid rule provides that a full credit bid by the lender at the foreclosure sale constitutes full satisfaction of the debt. If the debt is paid in full, there is no short fall and, barring fraud, nothing to recover from an insurance company or other third party.

²Insurance Code section 533 provides: "An insurer is not liable for a loss caused by the willful act of the insured..."

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