



“VACANT” PROPERTY CAN BE PROBLEMATIC IF THE LENDER IS SEEKING INSURANCE PROCEEDS

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Although the housing market has lost some steam, the remodeling market is still sizzling. But what if that borrower starts his remodel by demolishing the property, only to find he does not have the funds to complete the remodel? Or, what if the borrower decides that the property’s value no longer warrants the expense of a remodel after demolition, so he abandons the property? Can the lender still collect insurance proceeds for the borrower’s willful destruction?

The recent case of *TRB Investments* case,¹ offers one court’s opinion. The *TRB Investments* case holds that damage to the secured real property could be excluded from insurance coverage if the damage occurs while the property is undergoing a remodel. The court’s logic is that, unless the remodel requires the “substantial and continuing presence of workers at the premises,” the property could be deemed vacant, which is an exclusion to many insurance policies. Many lenders are not even aware of the fact that they may be uninsured if the property is vacant. The *TRB Investment* case, as outlined below, confirms that vacant properties may be an important issue in the future, particularly in a flat to declining housing market.

In 1999, TRB purchased an insurance policy for a commercial building from Fireman’s Fund Insurance Company. The policy included a “vacancy” exclusion that provides as follows:

“8. Vacancy
*600 “If loss or damage occurs to a building that has been vacant for more than 60 consecutive days prior to the occurrence of that loss or damage, we will:
“a. not pay for any loss of damage caused by:
1. Vandalism;
2. Sprinkler leakage, unless you have protected the system against freezing;
3. Building glass breakage;
4. Water damage;
5. Theft, or
6. Attempted theft.
“b. Reduce the amount we would other pay for the loss or damage by 15%.
“A building is vacant when it does not contain enough business personal property to conduct customary operations.
“**Buildings under construction are not considered vacant.**”
[Emphasis added.]

The rationale behind the Vacancy Exclusion is that a vacant property carries a greater risk of damage because no one is there to deter vandalism and promptly report damage.

After the original tenant left the property, it sat vacant for more than 60 days, triggering the Vacancy Exclusion. However, TRB then rented the property to a new tenant with the understanding that the new tenant would not take possession until after TRB completed a substantial

remodel. In the middle of the remodel process, the construction crew returned to work one morning, discovering that a water heater or waterline had burst, causing over \$1,250,000.00 of damage. Yes, million!

TRB submitted a claim to Fireman’s Fund. Fireman’s Fund rejected the claim, citing

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the Vacancy Exclusion. Specifically, Fireman’s Fund argued that a remodel is not “construction” under the policy and therefore, because there was not tenant in the property, the Vacancy Exclusion applies and the claim is not covered. After attempts to informally resolve this matter failed, TRB filed suit.

Fireman’s Fund prevailed at the trial court and Court of Appeals levels. In upholding summary judgment in the insurer’s favor, the Court of Appeals reasoned that the definition of “construction” involved “the creation of something new ...” and that because a remodel did not create a new building, it did not qualify under the “construction” exception to the Vacancy Exclusion.

In a matter of “first impression” the California Supreme Court granted review and reversed the Court of Appeal’s decision.

The Supreme Court held that insurance coverage must be “interpreted broadly so as to afford the greatest possible protection to the insured, [whereas] ... exclusionary clauses are interpreted narrowly against the insurer.” Using this rule, the Supreme Court reasoned that a liberal reading of the term “construction” includes a substantial remodel. The Supreme Court added that the additional risk that the Vacancy Exclusion was intended to address, i.e., “to prevent vandalism and ensure the prompt discovery of damage,” would be satisfied so long as the remodel required the “substantial and continuing presence of workers at the premises.” In essence, the regular presence of workers on the property is “roughly equivalent to that of an occupied building, thus giving the insurer the benefit of its prior risk assessment.”

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The Supreme Court then remanded the matter to the trial court for further presentation of evidence on whether the remodel met the Supreme Court’s standard of “substantial and continuing presence of workers.” In time, we will learn whether TRB’s contractors met this standard. But, for purposes of our lender clients, the rule and the risk is set -- a remodel may exclude insurance coverage. And, perhaps more important, it highlights to our clients that a vacant property may not be insured against certain types of losses.

What does this mean for our Trustees and their clients? For the Trustee, it is simple - if the Trustee discovers during the course of foreclosure that the property is either vacant or undergoing a substantial remodel, it should disclose this information to the client so that the client can review their insurance policy to see if they are covered. Trustees should keep in mind that, when disclosing this information, you may have to educate the lenders as to why the information is important (or give them a copy of your UTA Quarterly).

What the lenders must do if they learn from their trustee or otherwise, that the property is vacant or in the middle of a substantial remodel, is a more complicated.

- First, the lender should check to see if there is force-placed coverage. Fortunately, many force-placed policies anticipate that the property may be vacant and cover such a situation. But the lender should ask their force-placed carrier to be sure.
- Second, if insurance has not been force-placed, the lender should review the borrower’s insurance policy to see if there is a similar Vacancy Exclusion as in the TRB Investments case. (Commercial policies are probably more likely to have the Vacancy Exclusion than residential policies. But, the lender should check in both instances.)
- Third, the lender should check its Standard Loss Payee Clause to see if it removes or adds a Vacancy Exclusion.
- Fourth, if the combined effect of the policy and the Loss Payee Clause provide for a Vacancy Exclusion, or if the

lender cannot tell, the lender should either force-place its own insurance, or, in the case of a remodel, verify that the remodel requires a “substantial and continuing presence of workers on the premises.”

- Fifth, to determine whether a particular remodel meets this standard, the lender should consult its in-house or outside counsel.

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Do most of our lending clients even know that they might be uninsured if the property is vacant?

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The ultimate lesson to be learned from the TRB decision is that a vacant property or one being remodeled could be uninsured against certain losses. To protect itself, the lender must familiarize itself with the particular insurance policy and loss payee clause involved in each case. Our role as Trustee or Trustee’s counsel is to educate your lender clients on this

potential risk as we suspect many lenders are unaware that they may be uninsured. You may also want to point out to the lenders that vacancy issues might not be the only problem related to a borrower remodel. But, you will have to wait until the next issue of UTA Quarterly to learn of the other insurance issues impacting remodels.

(Endnotes)

- 1 TRB Investments v. Fireman’s Fund Ins. Co., 2006 WL 3257848; 6.06 Cal. Daily Op. Serv. 10,461 (Nov. 13, 2006) 145 P.3d 472.



Robert Finlay is a partner of Wright, Finlay & Zak, LLP and a member of the UTA, CMBA, MBA and AFN. He specializes in representing lenders, foreclosure trustees and title companies in mortgage and title related litigation throughout California. As a firm, Wright, Finlay & Zak, LLP represents and advises its lending and trustee clients on a vast array of mortgage and finance issues in California and Nevada, including but not limited to, Wrongful Foreclosure actions, Judicial Foreclosures and Receiverships, Accounting disputes, lender and broker Repurchase disputes, Predatory lending issues, as well as FDCPA, FCRA, TILA, RESPA, HOEPA and other Federal and State statutory matters. Mr. Finlay can be reached at 949-477-5050 or via email at rfinlay@wrightlegal.net.