Featured Article

Handling Insurance Claims From The Lenders' Perspective

By T. Robert Finlay, Esq. and Gino D. Palmieri, Esq. of Wright, Finlay & Zak

There is much uncertainty surrounding the recent wildfires that devastated many properties in our Southern California community. As efforts begin to rebuild the destruction and loss caused by the fires, many Lenders are looking for guidance on how to balance protecting their security with the needs of the Borrower. To determine how to strike that balance, it is important for Lenders to first understand their rights and obligations regarding the insurance proceeds. The goal of this article is to give Lenders the necessary information so they can determine how best to work with their Borrowers.

Communication is Key

Regardless of who is entitled to the insurance proceeds, whether the Borrower intends to rebuild or if the loan is in default, open communication with the Borrower is key to efficiently resolving insurance issues and avoiding future disputes over the proceeds. It is important to ask Borrowers questions like - whether they have made a claim, the carriers' response, whether the Borrower intends to rebuild, does the Borrower have a plan to make monthly payments while waiting on the insurance proceeds, has the Borrower applied for any federal, state or local grants, etc. Ideally, these discussions can help Lenders and Borrowers reach a mutually acceptable plan for handling the insurance proceeds.

> "
> ***…Lenders need to know their rights and obligations following the loss.***

Types of Insurance Coverage

Generally, Borrowers obtain their own insurance policies that are for the benefit of themselves and their Lenders. But other types of policies can come into play. Understanding the different types of coverage and how they affect the Lenders rights and obligations is an important starting point.

Borrower Insurance

Lenders are usually protected under the Borrower's insurance policy as either the "loss payee" or under a "lender endorsement". Lender endorsement provisions are generally more robust but often add additional requirements at the front end. That said, both provisions are intended to protect Lenders in the event of an insurable loss. Some important issues to consider with a Borrowers' policy include:

i. *Does the policy provide for replacement value or the cost to rebuild?* The answer may affect the amount of available insurance proceeds.

ii. *What if the Borrower's policy lapses without the Lenders' knowledge?* Often, the insurer will let Lenders know when a policy lapses. But, to protect themselves, Lenders must be vigilant in tracking their Borrowers' policies to avoid any lapses in coverage.

iii. *What if the Borrower drops the Lender from the policy?* Again, the insurer will usually notify Lenders if they are being dropped as a loss payee, but our firm has unfortunately seen instances where the Borrower drops the Lender from the policy without any notice. Again, Lenders must be vigilant in tracking policies.

iv. *What if the Borrowers' policy is insufficient to protect the Lender?* Do you increase your coverage every year to account for the increased value of your home? Probably not and neither do your Borrowers. As a result, over time, coverage often lags the cost to rebuild or replace the home. If the damage has already occurred, there is nothing a Lender can do to recover from the lack of sufficient coverage. But, to avoid this risk going forward, Lenders should review the coverage under their Borrowers' policy annually.

Force-Placed Insurance

When Borrowers fail to maintain their own insurance, Lenders will generally step in by force-placing insurance on the property. The cost of the force-placed policy is usually passed on to the Borrower, which gives both the Borrower and Lender an interest in the policy (and the proceeds).

Additional Lender Insurance

Nothing prohibits Lenders from adding coverage at their own expense. Whether it makes sense to do so is a business decision for the Lender. The proceeds of this type of policy should belong exclusively to the insured Lender and arguably do not have to be applied to the underlying loan.

REO Insurance

Coverage under most Borrower policies terminates upon transfer of title via the foreclosure sale. Therefore, its essential for Lenders to plan in advance to have their own post-foreclosure policy ("REO Policy") kick in immediately on the day of the foreclosure sale. Because the Borrower no longer has an interest in the property and the insured under the policy is the Lender, the Borrower has no interest in the insurance proceeds from the REO Policy.

Master Insurance

Some Lenders have master insurance policies that cover all sorts of situations, including damage to properties securing the Lenders' loans. To determine if the Lender has that coverage, we suggest contacting your insurance broker in advance. Assuming there is coverage, the Lender is likely to be exclusively entitled to any proceeds from the master policy.

While there may be other forms of insurance that could apply following the loss of the Borrower's property, these are the most likely types of policies. Whoever is entitled to any insurance proceeds will depend on the type of policy and the language in the Deed of Trust.

Who is Entitled to the Insurance Proceeds Following a Loss?

As mentioned above, the Lender is exclusively entitled to the insurance proceeds from an REO, Extra or Master policy. The Deed of Trust will control who is entitled to insurance proceeds from a Borrower or Force-Placed policy.

Broad Provisions Favor the Lender

Many courts have held that when insurance provisions under the deed of trust broadly assign all insurance proceeds to the Lender, despite whether or not the Lender requires the Borrower to obtain a specific type of insurance coverage, the Lender will be named as a loss payee and can collect the proceeds. Broad provisions typically take the form of "all sums due or payable… for injury or damage to such property." As one court held:

> *The deed of trust in Martin did not require the borrower to maintain earthquake insurance, but stated that if the borrower obtained insurance not required under the deed of trust, the lender must be named as loss payee and the lender could apply the funds to the secured debt or to repair the property. (Id. at p. 805.) The Martin court held that the lender was entitled to receive and control the proceeds accordingly. (Id. at p. 809.) JEM Enterprises v. Washington Mutual Bank, 99 Cal. App. 4th 638, 645 (Citing Martin v. World Savings & Loan Assn. (2001) 92 Cal. App. 4th 803, 112 Cal. Rptr. 2d 225.)*

Specific coverage provisions favor the Borrower

Typically, neither party has an interest in the insurance policy obtained by the other party that is not specified in the deed of trust. If a deed of trust that does not require a Borrower to obtain a specific form of insurance (i.e., earthquake coverage) nor broadly states that all insurance proceeds shall go to the Lender, then Borrower is entitled to the proceeds for the earthquake insurance that was not required under the deed of trust. As the court held following damage from the 1994 Northridge earthquake:

> *The court held that the provision did not apply to earthquake insurance proceeds because the paragraph containing the provision concerned only insurance required by the lender, and the lender did not require the owner to obtain earthquake insurance. (Id. at p. 327.) JEM Enterprises v. Washington Mutual Bank, 99 Cal. App. 4th 638, 645 (Citing Ziello v. Superior Court, supra, 36 Cal. App. 4th 321, 327).*

Featured Article

Provisions Giving the Borrower the Right to Use Proceeds to Repair or Rebuild

Many Deeds of Trust contain language along the following lines:

> *Insurance proceeds "will be applied to restoration or repair of the Property, if Lender deems the restoration or repair to be economically feasible and determines that Lender's security will not be lessened by such restoration or repair."*

Under this language, the Lender has the sole discretion to determine whether the repair is "economically feasible". Unfortunately, there are very few cases determining exactly what that means. However, it is likely that a court would apply the covenant of good faith and fair dealing to the contract, ensuring that the Lender must exercise its discretion in good faith. In other words, Lenders with this language in their Deeds of Trust should not unreasonably refuse to let the Borrower use the funds to repair or rebuild the property.

Other standard Deeds of Trust will contain similar language, providing that the funds can be used to repair the property so long as the Lender's security is not impaired. Under this language, so long as the land value of the property is sufficient to secure the Lender's Deed of Trust, the Lender's security interest is arguably not "impaired". As a result, the Lender is arguably required to let the Borrower use the insurance proceeds to repair or rebuild the property. But, if the land value is insufficient to cover the loan amount, then the Lender can require that the proceeds be used to pay down the loan.

Loose Ends!

Unfortunately, many Deeds of Trust and the courts that have weighed in on these issues don't answer every question that might pop up. For instance:

i. *Who is entitled to the insurance proceeds designated to cover personal property or alternative living?*

ii. *Assuming the Deed of Trust contains the rebuild language discussed above, is the Lender required to apply the insurance proceeds to pay the loan down to the point where the security is no longer impaired and then let the Borrower use the remaining funds to repair or rebuild the property?*

iii. *What if the Lender and Borrower disagree on whether the security is impaired or not or whether repair is economically feasible?*

iv. *Who is obligated to pay for the cost of the public adjuster?*

Since the answers to these questions depend on several factors, we recommend contacting your preferred counsel or our office to discuss your specific situation.

Handling the Insurance Proceeds

Now that the Lender has determined who is entitled to the insurance proceeds, the next challenge is getting the insurance proceeds and then determining what to do with the funds. Unfortunately, this is where problems, such as those discussed below, often arise.

Getting the Proceeds From the Insurer

In the case of a Borrower-purchase policy, the Lender is often in the dark as to what is happening with the claim. That is one of the reasons why it is so important to establish an open line of communication with the Borrower from the outset of the loss. Once the claim has been approved, the insurance carrier will generally send the insurance check to the Borrower, made payable to both the Borrower and the Lender.

Don't ever endorse the check and then give to the Borrower to endorse.

Sounds obvious, but it has happened (more than once)!

What if the Borrower refuses to endorse the check?

Unfortunately, this happens quite often. Depending on the language of the Lender's Deed of Trust, refusing to turn over the insurance proceeds could constitute a default under the Deed of Trust, giving the Lender the right to foreclose. The Lender can also sue the Borrower to turn over the insurance proceeds. While unlikely, the Lender can also ask the insurer to reissue the check directly to the Lender.

What if the Borrower forges the Lender's name?

Unfortunately, this too happens way too often. Ideally, the bank who is presented with the check will catch the forgery and refuse to cash it. But, if that does not happen, the Lender has claims against the Borrower, the bank and, potentially, the insurer. The key is to move quickly when this happens.

What if the insurance company refuses to timely pay (or fails to pay the full claim)?

The best solution is for the Lender and Borrower to work together to apply pressure on the insurer to timely and fully pay the claim. But, in some instances, no amount of pressure will work. In those instances, the Lender may have to sue the insurer to get paid. Unfortunately, our firm has had to do that many times over the years.

Holding the insurance proceeds pending repair or rebuild.

Lenders can hold the insurance proceeds similar to how a construction lender handles construction funds, by putting reasonable restrictions on the release of the funds, such as having to meet certain thresholds before the release of additional funds. In fact, Lenders may want to consider using a construction fund manager to handle the funds.

What does it mean to apply the funds to the loan?

Assuming the Lender is entitled to apply the insurance proceeds to the loan, the terms of the Deed of Trust will control how the funds should be applied, i.e., to advances, interest, late charges, principal, etc. Of course, there is nothing preventing the Lender from agreeing to an alternative application with the Borrower. For instance, the Lender and Borrower could agree that the funds will be held in escrow, to be applied to monthly mortgage payments as they come due.

Additional Considerations and Issues

So far, this article has addressed the standard scenario where there's a loss on a current loan. But there are some additional twists and turns that can come into play, including:

A. ***Is the Borrower still obligated to make payments while waiting for the insurance proceeds or repairing the property?*** Yes – the Borrower is still contractually obligated to make monthly payments on the loan after experiencing a partial or complete loss. Of course, making mortgage payments may be difficult, if not impossible, for Borrowers who find themselves having to pay for alternative housing. While not contractually required, Lenders may opt to work with Borrowers on a limited forbearance while Borrowers come up with a long-term plan with regards to the property. ***Note – local or state regulations are in the works that may require some Lenders to forbear from foreclosing for specific periods of time.*** Before initiating foreclosure on a property affected by the fires, we encourage Lenders to consult with counsel.

B. ***What if the loan matures while waiting for the insurance proceeds?*** Like with monthly payments, the loss of the property via fire does not alter the parties' contractual rights. As a result, the Borrower is still obligated to pay off the loan when it matures. Again, nothing prevents the Lender and Borrower from working out alternative arrangements.

C. ***Can the Lender foreclose on a property affected by the fire?*** Unless prohibited by a state or local ordinance (see A above), yes. But check with your counsel first.

D. ***If foreclosing, does the damage to the property impact my bidding strategy at the foreclosure sale?*** YES – if you only take away one thing from this article, this should be it! California (and many states) have what we call the "full credit bid rule". In a nutshell, if a Lender bids the full amount that it is owed at the foreclosure sale, it is deemed to have been made whole. Similarly, if the Lender bids, say, \$100k less than the full debt, the amount of recoverable insurance proceeds is limited to \$100k. Insurance companies regularly use this theory to limit or avoid paying on claims.

To avoid making a costly mistake, it is important for Lenders to access the damage to the property and bid an amount that is low enough to preserve their right to any insurance proceeds. But – don't bid too low. SB 1079, enacted in 2021[1], allows certain eligible bidders to *outbid* the highest bid at the foreclosure sale within 45 days following the foreclosure sale. If that happens, the foreclosing Lender cannot increase its bid (it does not qualify as an eligible bidder) and risks losing the property for less than what it may be worth. To be safe, Lenders should bid as close to the actual value of the property as possible after, of course, consulting with their counsel.

E. ***What happens if the property was lost post-foreclosure, but before the 45-day period for upbids expires?*** Under a recent revision to Civil Code § 2924m, the Borrower's insurance remains in effect during the 45-day limbo period.

Featured Article

F. ***Does the Borrower have any claim to insurance proceeds post-*foreclosure?** Generally, no. But see discussion on the full-credit bid rule.

G. ***Does the fact that the loan was in default at the time of the loss impact the insurance process?*** Generally – no. As discussed above, contractual obligations continue. That said, the language of the Deed of Trust will control. In some instances, the Deed of Trust may require that the insurance proceeds be first used to cure any default. We recommend that Lenders check the Deed of Trust and confirm with counsel as needed.

H. ***If the Lender is under-insured, can it simply sue the Borrower for the added loss?*** In most instances – no. California's anti-deficiency statutes coupled with the One-Action Rule work together to limit a Lender's right to sue the Borrower for a loss. Lenders are usually limited to the available insurance proceeds and the value of the remaining property to repay the loan.

Losing one's home to a fire or any other natural disaster is truly tragic. The devastation is often compounded by the risk of losing what is left of the property to the Lender for failing to pay the loan. To limit the impact on the Borrower, Lenders are encouraged to openly and regularly communicate with their Borrowers to achieve a mutually agreeable solution. But, to do that, Lenders need to know their rights and obligations following the loss. Hopefully, this article will help Lenders better understand what they can and cannot do with respect to their loan and the insurance proceeds, allowing them to work intelligently with their Borrowers to craft a mutually agreeable solution.

Disclaimer: The above information is tailored to California loans and is intended for information purposes alone and is not intended as legal advice. Please consult with counsel before taking any steps in reliance on any of the information contained herein.

1 Codified into Civil Code Section 2924m.

Robert Finlay is a founding Partner of Wright, Finlay & Zak. He can be reached at rfinlay@wrightlegal.net.

Gino Palmieri is an Associate Attorney at WFZ's California office. He can be reached at gpalmieri@wrightlegal.net.