What a Mortgage Lender Needs to Know About Property Insurance: The Basics

Joshua Stein

Lenders know they should care about property insurance, but they and their counsel often don't understand exactly what to care about, and why.

Real estate loans rely on asset value. Mortgage lenders typically care much more about the value and reliability of their collateral than they do about their borrower's credit. Real estate lenders therefore need to think about the short list of unlikely events that might undercut their most basic assumption: the assumption that the collateral they've appraised will continue to exist so it can continue to secure their loan.

One of those unlikely events is the possibility that the collateral will burn down or be destroyed by some other casualty (a "loss"). This may not be a very likely event, but it is certainly a conceivable event. Over a large portfolio, losses may happen with some regularity. The lender's job, and the job of lender's counsel, is to make sure that even if a loss occurs the lender will have some form of acceptable security for its loan.

Lenders typically solve this problem (mitigate this risk) by requiring the borrower to maintain insurance on the collateral at all times. To many people participating in commercial mortgage closings, property insurance is a mysterious black box that usually requires some minimal attention but occasionally is the source of problems, crises, and confusion that no one fully understands. This article attempts to summarize some practical information that a lender and its advisors need to know about property insurance, and thereby dispel some of the mystery in this area.

Loan Closings

At any loan closing, everyone knows the borrower needs to have property insurance and be able to prove it to the lender. But details matter. The insurance coverage can take different forms and say different things.

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Mortgagee Clauses

As a starting point, the lender should confirm that the property insurance contains a standard "lender's loss payable endorsement" (which has been in use since 1943) or a "union Mortgagee Clause" or "New York Mortgagee Clause" (which has been in use for about a century).

The "New York Mortgagee Clause" is designed to protect real estate lenders only, whereas "lender's loss payable endorsements" are designed for a range of lenders. Some believe the "New York Mortgagee Clause" is superior. Some say the opposite. (It seems to be a principle of insurance coverage that everyone has something different to say about it.) Often a statute prescribes the form of policy and the statute will require one clause or the other. The rest of this article uses the term "Mortgagee Clause" to refer to whichever of the foregoing options applies in the particular case.

There is nothing subtle, sophisticated, or new about obtaining a Mortgagee Clause. Even a "standard" Mortgagee Clause should, however, be reviewed to confirm that it provides the intended protection.

Benefits to Lender

Why obtain a Mortgagee Clause? Answer: It can protect the lender identified in the Mortgagee Clause against the possibility that the insurance carrier will deny insurance coverage because of "bad acts" or carelessness of the borrower, who is initially the only party the policy protects. And if the insurance carrier can deny coverage against the borrower and has no greater obligations to the lender, then the insurance carrier won't have to pay anyone—borrower or lender.

Many of the defenses that an insurance carrier might assert against the borrower might be called "personal defenses." They are personal to the borrower and arise from the borrower's acts and omissions. Some examples of personal defenses: arson; a change of use of the insured premises in violation of the insurance policy; failure to comply with other covenants in the policy, an increase in the riskiness of the property, and even fraud by the insured.

Without a Mortgagee Clause, an insurance carrier can refuse to pay the lender if one of these personal defenses exists. With a Mortgagee Clause, the insurance carrier can't assert any personal defenses against the lender as the basis to deny coverage. Any personal defense becomes the insurance carrier's problem and not the lender's. If the lender doesn't obtain a Mortgagee Clause, then personal defenses are the lender's problem and not the insurance carrier's. It's that simple.

A Mortgagee Clause also requires the carrier to give the lender prior notice before terminating a policy (before its scheduled expiration date) based on the borrower's nonpayment of the premium. Typically a Mortgagee Clause obligates the carrier to provide ten days notice before early cancellation for nonpayment of premium, thirty days for any other cancellation. If a loss occurs during that notice period, then a Mortgagee Clause will very likely make the difference between the lender's being paid and the lender's not being paid under the only circumstances that matter. A Mortgagee Clause can be extremely powerful.

Inadequate Forms of Lender Protection

Borrowers sometimes try to persuade their lenders to accept something less than a full Mortgagee Clause. Here are some examples, not one of which adequately substitutes for a Mortgagee Clause:

- *Merely Saying Lender Is a "Loss Payee."* This just means the borrower assigns to the lender whatever the borrower happens to be entitled to receive, subject to whatever defenses the insurance carrier can assert against the borrower (i.e., all the personal defenses).

- *"Open Mortgage" Language.* This is a statement in the policy or an endorsement saying that the insurance carrier merely recognizes the rights of any "open mortgage." Again, this doesn't give the lender anything more than the borrower has. It is not a Mortgagee Clause and it doesn't deliver the same lender protections.

- *"As Its Interest May Appear."* This language again recognizes a lender might exist, but it (also again) does not deliver the same benefits to the lender.

- *"Additional Insured" or "Additional Named Insured."* These concepts relate to liability insurance, not property insurance.

Insurable Interest

A lender cannot recover on an insurance policy unless the lender has an "insurable interest" in whatever property the insurance policy covers. This means the lender's collateral needs to include the

insured property. As in so many other areas, lenders can avoid problems by writing a broad collateral description. Some common problems:

- *Rental Income.* The lender should list rental income specifically as part of the collateral, or else run the risk of losing any claim under the borrower's business interruption or rental insurance.

- *Personal Property.* Courts generally don't like to let a real estate mortgage lender collect any insurance proceeds from a loss of personal property. But if the collateral description clearly includes personal property, then the lender might be able to make a successful claim.

Scope of Risks Covered

A lender will want the property insurance to cover losses from as broad a range of risks as possible. Though it may sound quite impressive, "extended coverage" provides fairly narrow coverage. The "special perils form" of coverage protects against more risks. Lenders usually prefer it.

Earthquake Coverage Issues.

In California and potentially elsewhere, if the borrower agrees to provide "fire and other hazard" insurance, or even the broader "All Risk perils" or "special perils" insurance, this language still does not obligate the borrower to provide earthquake insurance. If the borrower decides on its own to provide earthquake insurance, but doesn't name the lender in the insurance policy, then the lender has no rights under that policy. If the building collapses because of an earthquake, the insurance carrier will pay the insurance proceeds to the borrower and not the lender.

These rules teach lenders at least the following lessons, both in California and potentially elsewhere:

- *Speak Up.* If you want earthquake insurance, say so specifically.

- *Mortgagee Clause.* Obtain a Mortgagee Clause for all insurance in place; don't rely on things like fairness and justice to be able to make a claim under the borrower's separate insurance policy for which the lender did not bother to obtain a Mortgagee Clause.

- *Assign All Claims.* In the loan documents, require the borrower to fully and validly assign all future claims under any and all insurance that the borrower purchases—whether or not the loan documents require that particular insurance.

Non-Mortgage Estates

A Mortgagee Clause protects a mortgagee. If a party with an insurable interest does not hold a mortgage (such as a conditional vendor, a ground landlord, a "synthetic" landlord, the holder of a "remainder" interest subject to a life estate, etc.), don't rely on the Mortgagee Clause. "Quasi-mortgagees" and non-mortgagees should tailor their insurance coverage to their role in the deal.

Premium Financing

Borrowers under financial pressure will often try to enter into "premium financing" arrangements rather than pay premiums (e.g., for a year in advance) at closing. Security for such arrangements consists of giving the premium financier the right to cancel the insurance policy if the borrower misses a premium payment.

Many mortgage lenders reject the entire arrangement. They think it creates too much jeopardy to the insurance coverage and hence potentially the lender's security. Others may tolerate premium financing, but only if the premium payments are made through a lender-controlled escrow or reserve account, and the borrower makes an extra deposit up front. Even with such measures, premium financing creates a higher risk than otherwise that the insurance may lapse prematurely for nonpayment. And it adds one more item to the lender's loan administration checklist, increasing the likelihood that the lender or its servicer will miss something or do something wrong.

Risks of Joint Checks

If a loss ever occurs, the insurance carrier will typically issue a joint check payable to both borrower and lender. This means the borrower may in theory try to "leverage" the lender by refusing to endorse the insurance check. Perhaps lenders can plan ahead to mitigate this risk by adding to the loan documents a power of attorney to endorse such check(s)—though a court might not enforce, and an insurance carrier might not honor, any such provision.

In general, lenders seem to be willing to live with some risk in this area. Perhaps their real-world experience tells them that the risk of borrower noncooperation, although conceivably possible if one thinks hard enough, just doesn't happen very

often and therefore isn't something that lenders should spend time and effort worrying about and mitigating. (Such an approach to risk is not exactly prevalent in the mortgage loan closing process.)

If a particular lender has a particular reason to be concerned about a particular borrower, though, the lender might want to think about this risk and how to mitigate it, such as by adding appropriate language to the loan documents or the insurance policy.

"Certificates" of Insurance

For closings, lenders typically accept a "certificate of insurance," which provides no meaningful protection. Brokers like to deliver these "certificates of insurance," because they can issue them without obtaining approval from the insurance carrier. Instead of accepting "certificates of insurance," lenders should try, if they can, to obtain:

- *Evidence of Insurance.* Ask for "evidence of property insurance" (ACORD form 27), followed by a copy of the actual policy endorsement in favor of the lender.

- *"Mortgagee."* Use the magic word "mortgagee," not merely "loss payee," with reference to the lender.

- *Read the Mortgagee Clause.* Understand exactly which type of Mortgagee Clause the policy contains; what the Mortgagee Clause says (is it really "standard"?); and exactly how much, and what type of, notice the lender will receive before the policy is canceled for nonpayment of premium or other breach by borrower. And ask whether the carrier's obligation to notify represents a true obligation. Or is it merely an aspiration on the lender's part **[Au: Change okay to eliminate awkward adjective??]**, with no consequences if the carrier fails to notify?

Review of Policy

Lender or its counsel (or, better, a specialized insurance consultant) should try to review the underlying insurance policy to confirm that it complies with the loan documents. One should check at least the following points, in order of importance:

- Precise **[Au: Change okay to eliminate redundancy??]** name of lender;

- Expiration date;

- Proper description and address of insured property;

- Mortgagee Clause;

- Identity and financial strength (ratings) of insurance carrier (particularly important for loans that will be securitized);

- Amount of coverage;

- Insured perils and coverage extensions and exclusions;

- Coverage issued in favor of the right borrower;

- Waiver of coinsurance or an agreed-amount endorsement;

- Deductibles (are they measured for each individual property? Or are they in the aggregate?);

- "Law and ordinance" coverage (relating to incremental cost of restoration because of changed building codes and laws, including ADA);

- Coverage for site improvements (parking lots, fences, bridges, etc.);

- Valuation formula and procedures upon a loss;

- Definition of "replacement";

- Joint check requirements;

- Special protections for insurance during any periods of construction ("non-reporting" form of builder's risk insurance, "permission to occupy," etc.); and

- Any special procedures that apply to claims by lenders.

Coverage for Rents

Property insurance can also cover loss of rents, but typically only during whatever period the carrier deems to be a "reasonable" period to rebuild. A lender or its counsel will want to think about at least the following issues:

- *Extended Period of Indemnity.* At minimal additional expense, the carrier may be willing to extend the coverage period for loss of rental income. Such an extension is usually advisable, because the basic policy might not cover an adequate period for the building to recover from the loss (physical restoration plus some period for re-leasing). A reasonable requirement, increasingly expected by the rating agencies for securitized deals, would be an additional six months of extended indemnity.

- *Rent During Restoration.* Some leases require the tenant to keep paying rent while the landlord restores the building after a loss. In effect, the lease requires the tenant rather than the landlord to insure the risk of lost rental income during restoration. Under such circumstances, the landlord's insurance carrier will refuse to make up for any lost rental income, even if the tenants refuse or are unable to pay rent during restoration. The insurance carrier will say that the risk of such refusal or inability is a credit risk rather than a consequence of the loss. A landlord may achieve a more reliable income stream during restoration by letting the tenants abate rent until the premises are restored, and looking to the insurance carrier rather than the tenants to make up the lost rental income.

- *Scope of Coverage.* Rental income coverage should cover all rental income, including percentage rent, escalation payments, pass-throughs, and so on.

Coinsurance

If the borrower underinsures the improvements, then the coinsurance clause may partly defeat any claim after a loss, in proportion to the degree by which the borrower underinsured. For example, suppose a building has a replacement value of $100 and hence should be insured for $100. And assume the borrower carried only $75 of insurance, i.e., 75 percent of the insurance the borrower should have carried. This means the borrower underinsured the building by 25 percent. Finally, assume the building suffers a $40 loss.

Before considering coinsurance, and disregarding any deductibles, the carrier would pay $40 for the $40 loss. But because the borrower underinsured by 25 percent, the carrier will reduce its payment by the same 25 percent. So instead of paying $40, the carrier will pay only $30. That's how coinsurance works. Similar concerns arise in rental income or business interruption coverage. In general, a Mortgagee Clause does not protect the lender from the impact of a coinsurance clause. Therefore:

- *Adequate Insurance.* At closing (or preferably before closing, to prevent last-minute emergencies), the lender should confirm that the borrower provides enough coverage to prevent any coinsurance problem.

- *Prevent Coinsurance.* The loan documents should (and most do) require the borrower to maintain whatever insurance will prevent any coinsurance problems.

- *Agreed Amount Endorsement.* A lender will prefer to obtain an "agreed amount" endorsement to the insurance policy, and have the carrier waive any coinsurance provisions. Although this endorsement may increase the premium, any increase is typically negligible or zero.

Legal Nonconforming Uses

If a building does not comply with existing zoning law (a "legal nonconforming use"), then if it were to burn to the ground the borrower probably could not legally restore it. Does the insurance coverage (and related language in the loan documents) adequately protect the lender's interest in this case?

The lender will want to confirm that the insurance policy will pay what it would cost to rebuild at some other location. The policy should not merely pay the cost to restore at this particular location, if restoration here is not possible. And the lender will probably want the loan documents to give the lender an unambiguous right to take the money and run—with no obligation to let the borrower restore—under these circumstances.

Flood Insurance

A lender should require flood insurance for any property located in Flood Zone A or V, particularly if the lender will securitize or syndicate the loan. Although lenders typically require only the maximum flood coverage available under the Federal Flood Insurance Program, additional flood coverage is available in the regular insurance market. Nothing at all prevents the lender from requiring it, although it is not market standard.

In some high-risk areas, federal law prohibits reconstruction of improvements damaged by flood.

Here a lender must be particularly sure that the insurance coverage adequately protects the lender's position, as the value of the underlying land after a flood loss may be problematic. (The concerns are much like those raised by a legal nonconforming use.)

The Loan Documents

The loan documents should obligate the borrower to provide all the insurance suggested above, and should also contain a variety of other insurance-related provisions to back up the protection being provided, only some of which are addressed in this article.

If the borrower doesn't provide any required insurance, the lender will want to be able to declare a default or at a minimum arrange replacement insurance. The borrower will typically ask for a "cure period" before the lender can do anything at all about the missing insurance. The concept of a "cure period" always sounds reasonable and fair. It is probably appropriate before the lender can accelerate the loan based on the borrower's failure to provide insurance.

A lender will, however, often hesitate to given the borrower any "cure period" before the lender can arrange replacement insurance, at the borrower's expense. A lender will want to have this right immediately—the moment any required insurance coverage lapses.

Loan Administration: Pre-Loss

As soon as a lender closes a new mortgage loan, the lender should think about some steps it needs to take to protect its insurance coverage, even before any loss has occurred. Here are some of the more important items for the lender's or its servicer's agenda.

Duty to Notify Carrier

A Mortgagee Clause does not mean the lender can sit back and not worry about insurance issues, obliviously assuming that all problems and issues have been shifted away from the lender. If the lender becomes aware of any potential personal defense, the Mortgagee Clause may require the lender to notify the carrier of the problem. If the lender doesn't, then the lender may lose the protections and privileges of the Mortgagee Clause. That principle has the following implications for a mortgage lender:

- *Monitoring.* The lender effectively becomes the insurance carrier's "eyes and ears" at the property. If the lender sees some situation or problem at the property that violates the insurance policy, the lender cannot necessarily stick its head in the sand. The test is normally "actual knowledge" rather than "constructive knowledge." A lender won't be deemed to know about personal defenses that the lender "should have" known about, so the insurance policy does not itself indirectly force the lender to monitor the property, although it all depends on the precise wording of the particular policy. Assuming typical language, the lender merely needs to report any problems that it actually knows about. In that case, should the lender avoid monitoring the physical collateral, to avoid becoming aware of insurance problems?

- *What to Look For.* Lender's servicing personnel need to know what to watch out for, and what to do if they see it. They should be familiar with the circumstances or events that might invalidate an insurance policy, and be alert to see whether any of these things are happening at the property. (Some of these circumstances and events are discussed above, in the context of personal defenses.)

- *Single-Interest Coverage.* A lender will typically obtain its own single-interest (or "mortgage impairment") coverage on its entire portfolio to cover the risk of a loss where the carrier can deny coverage for any reason, including personal defenses that survive the Mortgagee Clause because, for example, the lender turns out to be careless about reporting problems to the carrier.

- *Still the Lender's Problem.* Suppose a lender does become aware of a problem at the property, and does duly notify the carrier as required. Assume the borrower doesn't fix the problem. The carrier will then duly notify the lender that the carrier intends to cancel the policy. After a certain number of days, unless the lender has been able to persuade the borrower to correct the problem at the property, the carrier will cancel the policy. The insurance coverage will then fail to achieve its intended purpose. The property will be uninsured. And the loan will go into default. So whatever the borrower was

doing that violated the policy will ultimately become the lender's problem notwithstanding the Mortgagee Clause. (Among other implications, this may demonstrate the need for appropriate "carve-outs" from nonrecourse treatment.)

Arson

Arson happens. It is a recurring theme in the case law of property insurance. It usually follows extreme financial distress. If a lender becomes aware of financial problems (starting with late payments on the loan), the lender may wish to be particularly alert for signs of further trouble and may wish to work with the insurance carrier to monitor the property more closely and do whatever can be done to minimize the risk of arson or be able to identify arson when it happens. If the borrower knows that someone is watching it closely, that may be enough to keep the firebugs away.

On the other hand, the more a lender knows, the more it may be obligated to report to the insurance carrier. In some sense, the lender may have an incentive to know less rather than more. As between lender and carrier, however, arson should be the carrier's risk, unless the lender was somehow involved or knew about it before it happened.

Nonrenewal of Policies

Although a Mortgagee Clause obligates the carrier to notify the lender of any cancellation of the insurance policy, the carrier is not obligated to notify the lender that the policy will not be renewed—at least in the absence of a statute or special language negotiated with the carrier.

The lender must therefore continue to monitor insurance expiration dates and act decisively whenever any policy is about to expire but the borrower has not renewed it.

Coinsurance Prevention

After closing, the lender should periodically reassess whether the borrower continues to carry enough insurance coverage. If the coverage slips, the lender may face coinsurance problems, unless it has already prevented those problems in the wording of the initial coverage, as suggested earlier.

Threats from Lender

If a borrower is not providing the insurance coverage that the loan documents require, the lender should be careful about threatening to arrange the insurance on the borrower's behalf. Such threats can boomerang. A court may later decide a threat of this type was really a promise, and the promise was really an obligation. If the lender then fails to perform that obligation, i.e., fails to insure, then all subsequent problems become the lender's fault.

Typically a lender has no reason or need to threaten to buy insurance. If the borrower isn't providing insurance, the lender can simply give the borrower notice of that default and demand that the borrower cure its default.

The loan documents will also typically allow the lender to cure any default—whether regarding insurance or anything else—at the borrower's expense, if the borrower's don't.[**Au:** Change to "don't" ok?] As noted a moment ago, the lender will ideally be able to exercise those "cure" rights without giving the borrower notice and opportunity to cure. So the lender already has the right to buy insurance if the borrower doesn't. Threatening (or "promising") to arrange the borrower's insurance doesn't improve the lender's position. It can definitely worsen the lender's position. This threat isn't required, and all it can do is produce unpleasant surprises.

Loan Assignment

If the loan is assigned, the assignee should not rely on the assignor's insurance documentation but should instead have it reissued in favor of the assignee as soon as possible. This will assure, among other things, that any notices intended for the holder of the mortgage end up at the right place, and soon enough for the mortgage holder to do something about them.

Loan Administration: Post-Loss

If the lender's collateral is subject to a loss, then the lender needs to act promptly and pro-actively to preserve its rights under its insurance coverage.

Notice of Loss

If any loss occurs, then unless a statute or private agreement says otherwise, the carrier typically has no obligation to notify the lender of the loss. The existence of a Mortgagee Clause doesn't change that. If a lender wants to make a claim under an insurance policy, the lender will itself need to notify the carrier of the loss. This is an express requirement of any typical property insurance policy. It underscores how important it is for a lender to diligently monitor the borrower and the property. (Of course, most loan documents do require

the borrower to notify the lender of any loss, but borrowers promise to do a lot of things. If the lender were willing to rely on the borrower's promises, the lender wouldn't need security in the first place.)

Appraisals After Loss

Although a Mortgagee Clause will generally protect the lender from any personal defenses, a Mortgagee Clause still leaves the lender exposed in one important area after a loss: the appraisal process. Through that process, the borrower and the insurance carrier help determine how much the insurance carrier will pay on account of the particular loss. If the borrower participates in the appraisal process, then the lender may be bound by the outcome even if the lender had no idea the appraisal process was under way. The courts may treat the borrower as "the lender's agent" for this purpose.

A lender might want an express right to participate in the appraisal process, both under the loan documents and under a separate agreement with the insurance carrier. The situation is equivalent to an arbitration regarding rental value under a ground lease. There, a leasehold lender will insist that both the loan documents and the lease itself give the lender the right to participate.

Lenders do not commonly focus on this post-loss appraisal process. They do not typically seek a separate right to participate in, or control, the appraisal process, beyond whatever general right the loan documents may give them to participate in adjustment of a loss. Instead, lenders seem to be willing to rely on the borrower's practical business incentive to obtain the highest possible insurance proceeds in any event. Lenders seem to regard any residual risk as "background noise" not meriting further concern.

Appraisals: Beware!

Particularly if a loss occurs, the lender should be very careful about obtaining its own appraisal. Appraisals are already incendiary for borrower/lender purposes. In the opinion of the author, they are already given far more probative weight and emphasis than they should be. (An appraisal often seems to be treated as an irrefutable admission or Indubitable Truth Handed Down from the Mountaintop. In reality, it is usually nothing more than an expression of opinion by a relatively thoughtful and, one hopes, honest person who is being paid by one side or the other.)

In dealing with the insurance carrier, the lender may want to assert a high value for the damaged or lost building, whereas in dealing with the borrower and guarantors the lender may want to assert a low value. A lender must keep these strategic concerns in mind when obtaining appraisals and deciding who will see those appraisals, and when.

Claims Disputes

If a loss occurs and the carrier denies or disputes coverage, the lender should not rely on the borrower to enforce the lender's rights. This is the case because the lender and the borrower each have a different bundle of rights. Each is subject to different defenses and perhaps to a different statute of limitations. The lender's separate contract with the insurance carrier is generally better than the borrower's, thanks to the Mortgagee Clause.

If the borrower commences an action against the carrier, the lender should join the action as a separate party, asserting its own rights under its own agreement with the carrier. In the alternative, the lender should promptly assert its own rights in a separate action. In either case, the lender should consider all the usual litigation concerns, starting with the statute of limitations, which is typically short because of boilerplate in the policy.

In contrast, if a lender sits on its rights or relies on the borrower's litigation against the insurance carrier, then the lender may give the courts yet another opportunity to deliver an unpleasant surprise. If the borrower loses its litigation, but the courts decide the lender would have won if it had sued separately, then the courts may decide that the lender can't enforce its loan documents. Rationale: the lender caused the loss because it sat on its rights against the carrier, and this shouldn't be the borrower's problem. To prevent this unpleasant surprise after a loss has occurred, lenders should not rely on their borrowers to assert claims against insurance carriers. Lenders must pay attention and assert their own claims.

More generally, lenders would be well advised to add yet another paragraph of protective boilerplate to their loan documents. This new language would make clear that if a lender fails to assert claims against the insurance carrier, this does not diminish or impair the lender's rights against the borrower under the loan documents. (It is yet another example of the familiar process by which bad facts produce bad law that, in turn, produces ever-

lengthening legal documents to prevent the bad result next time.)

Foreclosure Sale After Loss

If a loss occurs, and then the lender completes a foreclosure sale, the lender needs to worry about yet another pitfall, this one potentially quite major. At the foreclosure sale, a lender can—and sometimes does—bid the entire amount of its loan at the auction for the property. If the lender makes a "full" bid of this type, then most states usually say the lender automatically loses any claim it might otherwise have been able to make under the insurance policy for the property. (This is the traditional rule in Massachusetts and New York, among other states.)

The courts rationalize this result as follows: By bidding the full amount of its loan, the lender accepted the collateral (in its present burnt-out condition) as full payment for the loan. The insurance carrier shouldn't have to pay the loan a second time. When the lender held its foreclosure sale, the lender deprived the insurance carrier of potential subrogation rights against the borrower. For all these reasons, the carrier shouldn't have to pay.

In the humble opinion of this writer, these theories are, among other things, another example of how courts use alleged concern about "subrogation rights" as the basis (or excuse) to reach a counterintuitive and illogical result, whose ultimate effect will simply be to complicate future business transactions and legal documents. (This judicial process will be well known by anyone familiar with jurisprudence about guaranties, particularly in California and particularly where the guarantor is an insider.) In the real world, "subrogation rights" are more theoretical than practical in almost every context where they arise, and the use of the word "subrogation" usually means only that the courts are about to do something strange.

More generally, the courts' treatment of this issue can probably best be understood as demonstrating the rule of law that says mortgage lenders are the only parties hated more than insurance companies—which thereby receive a windfall.

Lenders can take several steps to protect themselves from results like these:

- *Policy Terms.* Insist on appropriate lender protections in the insurance policy itself.

- *Scope of Collateral.* Include future insurance claims (arising from loss to this property) as part of the collateral, and as part of the package sold at the foreclosure sale. This way, when the lender (or anyone else) bids at the foreclosure sale, one thing they're buying is the borrower's insurance claims, including future proceeds and the future right to recover such proceeds from the carrier. (While this should solve the problem, lender's counsel should confirm that any necessary steps have been taken to create a valid security interest in the insurance proceeds, and make it clear that the assignment of insurance claims is intended to survive both a loss and a full bid at a foreclosure sale. Also, do not assume the solution suggested in this paragraph works, even though it is logically sound.)

- *Pay Attention.* Before the sale, determine whether a loss has occurred. Lenders should make sure they know about any loss. Lack of knowledge of a loss will not protect the lender from the harsh effect of the general rule.

- *Bid Strategically.* For this and other good reasons, think twice before bidding the full amount of the loan at the foreclosure sale.

General Comments and Questions

If one steps back a bit from the details of the preceding discussion, the whole area of property insurance raises some questions of a more general nature, including the following.

Low-Cost Endorsements

This article has identified a number of endorsements that lenders should routinely require and that insurance carriers will routinely issue at little or no cost (e.g., waiver of coinsurance, law and ordinance coverage, extra rental value coverage for a realistic period of reconstruction, others). Why aren't these extra little coverages automatically part of the basic policy? Why should a lender and its counsel (or insurance advisers) have to go through the trouble of needing to remember to ask for these little goodies every time?

In the view of this author, this exercise merely creates a potential pitfall for lenders and malpractice insurance companies, with no corresponding benefit to anyone, not even property and casualty insurance companies. One would expect major lenders to try to persuade the insurance industry to expand coverage so the basic insurance package automatically

includes the various low-cost "bells and whistles" recommended in this article. Has this happened?

Why All the Trouble?

For a substantial loan portfolio, a lender or its servicer may spend a reasonable amount of time and effort, and hence money, checking, monitoring, and overseeing proper insurance coverage at all times on a loan-by-loan basis. In some cases, the closing will be delayed because of a missing piece of insurance paper. After closing, crises will periodically erupt whenever a particular borrower forgets to renew its insurance on time.

As a market-wide structural question, would it make more economic sense for lenders (rather than borrowers) to maintain appropriate insurance coverage for mortgage loan portfolios? Should lenders build the cost of insurance into their loan pricing, or allocate it equitably among their borrowers? Of course, any lender will argue that they don't want to be responsible for maintaining their borrower's insurance. Lenders do, however, already bear most of the risk of insurance problems anyway.

Is there any market pressure to shift from borrower to lender the responsibility to maintain insurance? If one lender offered such a program, would it achieve a competitive advantage? For how long? Is there a business opportunity for someone to go into the "insurance servicing" business, where it would arrange portfolio-wide insurance coverage for both parties for a fee that would still leave some savings on the table for borrowers? If so, why hasn't anyone done this yet?

Isn't it likely that under the existing system the total cost of insurance premiums to all borrowers exceeds the total premiums that lenders would incur to insure all the properties in their portfolios under large blanket policies without the agony and effort of maintaining site-by-site coverage?

As a simpler variation, would it make sense for lenders to arrange their own property insurance on their entire portfolio, without worrying about their borrowers at all? Many lenders already arrange back-up "single-interest" coverage for cases where the insurance coverage falls between the cracks. Why not expand this coverage to become the only coverage for the lender, and let the borrower deal with its own insurance itself, covering only its own equity? For a lender, this would probably be less expensive, and certainly easier to administer, than dealing with insurance on a property-by-property basis.

Has the insurance industry already figured out a way to outlaw any of these techniques to reduce insurance costs?

Technology

According to possibly reliable sources, "insurance certificates" and "evidence of insurance" documents will soon join the typewriter and the record player in the dustbin of technological history. Instead, anyone anywhere will be able to check the insurance coverage of any property by pointing their web browser to a Web site maintained by the applicable insurance carrier or the insurance industry as a whole. Through the Worldwide Web, anyone will be able to confirm the amount and selected terms of insurance coverage for the property in question and confirm that the insurance is still in effect.

Any such system raises its own issues, of course (starting with privacy, security, proof, and unintended consequences), but it will be interesting to see whether and how it might develop. For now, the changes in insurance practice suggested in the last part of the article are merely possibilities and ideas. Until those possibilities and ideas become part of the ordinary course of business (which could happen tomorrow for any one lender and the day after tomorrow for the rest of the industry), lenders and their counsel will still need to think about the details of the property insurance process as it exists today. ▩