Presented:

**45TH ANNUAL WILLIAM W. GIBSON, JR.
MORTGAGE LENDING INSTITUTE**

**AUSTIN
September 15-16, 2011
Four Seasons Hotel**

**DALLAS
October 13-14, 2011
Belo Mansion**

TOP TEN INSURANCE TIPS FOR MORTGAGE LENDING

Speakers:

**AUSTIN
William H. Locke, Jr.**

**DALLAS
Marilyn C. Maloney**

Austin:
William H. Locke, Jr.
Graves Dougherty Hearon & Moody, P.C.
401 Congress Avenue, Suite 2200
Austin TX 78701
blocke@gdhm.com
(512) 480-5736

Dallas:
Marilyn C. Maloney
Liskow & Lewis
1001 Fannin Street, Suite 1800
Houston, TX 77002
mcmaloney@liskow.com
(713) 651-2938

TABLE OF CONTENTS

I. INTRODUCTION 1

II. REQUIRING THE PROPER INSURANCE: PROPERTY INSURANCE 1

- A. Types of Property Insurance 1
- B. Exclusions 1
- C. Deductible 1
- D. Replacement Value; Actual Cash Value 2
- E. Specify Amounts to Avoid Co-Insurance 2
- F. Flood Insurance 2
- G. Green Insurance Products 2

III. RIGHTS OF THE MORTGAGEE TO THE BORROWER'S INSURANCE PROCEEDS 3

IV. REQUIRING THE PROPER INSURANCE: LIABILITY INSURANCE 4

- A. Viability of the Borrower 4
- B. Amount of Insurance 4
- C. Additional Insured; Waiver of Subrogation; Primary Coverage. 4

V. REQUIRING THE PROPER INSURANCE: BUSINESS INCOME AND CONTINGENT EXPENSE 5

- A. Business Income Insurance 5
- B. Contingent Business Income 5
- C. Rental Insurance 6

VI. OBTAINING EVIDENCE THAT THE PROPER INSURANCE HAS BEEN PLACED AND IS IN FORCE 6

- A. Certificates of Insurance 6
- B. The Alternatives to a Certificate of Insurance 7

VII. SELF INSURANCE ISSUES 7

- A. The Self-Insured Borrower 7
- B. What is Self-Insurance? 7
- C. Limits on Self-Insurance 7
- D. Limit the Use of Self-Insurance by Successors 8

VIII. MANAGING PROCEEDS AFTER AN INSURANCE LOSS 8

- A. Addressing the Issue in the Loan Agreement or Deed of Trust 8
- B. Considerations in the Decision to Allow Rebuilding; Replacement Value 8

IX. ISSUES ARISING AT THE TIME OF WORKOUTS 9

- A. Use of Proceeds 9
- B. Self-Insurance 9
- C. Evidence of Insurance 9

X. ISSUES ARISING AT THE TIME OF FORECLOSURE 9

- A. Considerations Prior to Foreclosure 9
- B. Loss to the Property Before Foreclosure 10

XI. RECEIVERS AND BANKRUPTCY ISSUES 11

A. Receiverships 11
B. Appointment of the Receiver; Prohibited Assignment of Policy? 11
C. Insurable Interest 12
D. Insurance Considerations Prior to Appointment 12
E. Bankruptcy 12

XII. SOURCE MATERIALS 13

I. INTRODUCTION

Mortgage lenders have many concerns when they make, monitor, and, unfortunately, foreclose on secured loans. Although insurance issues may not be the first things a mortgage lender considers, these can be just as important as the credit-worthiness of the borrower, the status of the collateral, and other credit factors. This paper will outline ten of the top issues that should be considered in the life cycle of a mortgage loan.

II. REQUIRING THE PROPER INSURANCE: PROPERTY INSURANCE

The most important insurance issue for a mortgage lender is to insure that adequate property insurance is in place to protect the value of its collateral.

A. Types of Property Insurance

Although many credit agreements, deeds of trust, leases and other contracts still refer to an "all risks" policy, that title has not been used for many years. The current property policies are identified as either Basic, Broad, or Special Form of Loss. Both Basic and Broad forms provide coverage against named perils (such as fire or windstorm) while the Special Form of Loss generally covers all risks unless they are specifically excluded. A mortgage lender will always want to require that property insurance for its collateral be covered under a Special Form of Loss Policy.

B. Exclusions

Commercial property policies contain a number of exclusions, including losses caused directly or indirectly by earth movement, water damage, including floodwaters, sewage back-up and subterranean water, power interruption away from the premises, war, revolution, and insurrection, nuclear hazard, neglect by the insured in the face of an insured peril, or enforcement of a law regulating the construction or demolition of a building. Many of these exclusions can be covered by endorsement (at extra cost) and should be considered, depending upon the location of the collateral.

C. Deductible

The coverage provided under property insurance policies is subject to a deductible, which usually applies to each occurrence of loss. Deductibles can be in the form of a flat dollar amount or be expressed as a percentage of the amount of insurance on the building or structure. Most property insurance policies written along the Gulf Coast area now contain special hurricane or windstorm deductibles. Often, insurance requirements in credit agreements, deeds of trust, and other contracts fail to specify the permissible amount of deductibles or self-insured retentions. Deductibles can greatly impact the ability of a tenant or other contracting party to rebound from a loss. A 2007 New Jersey case involving a dispute between a national tenant with large deductibles and a landlord trying to terminate an unfavorable lease shows the problems that can arise when the parties are not specific in their agreements. *Boston Market Corporation v. Hack*, 2007 WL 2349989 (N.J. Super. App. Div. 2007), August 20, 2007.

D. Replacement Value; Actual Cash Value

Claims on property insurance are paid on either an actual cash value or replacement cost basis. Actual cash value is the cost of the damaged property less depreciation. A policy that provides replacement cost coverage pays the actual amount needed to replace the damaged property after a loss, without regard to depreciation, up to a maximum amount, usually the face amount of the policy. However, in order to recover this greater amount, the property must, in fact, be repaired or restored.

E. Specify Amounts to Avoid Co-Insurance

Most mortgage insurance requirements stipulate that the policy limits of property insurance must be adequate to avoid the effect of any co-insurance. Why? Because property policies typically impose a co-insurance requirement (perhaps 80% or 90% of the value of the insured property); if the insured carries less insurance, the amount of recoveries will be reduced proportionately. The reason for this is to avoid the possibility that insureds will gamble that it would be unlikely that they would suffer a total loss of the property. If they carried less insurance (for instance, 50% of the value of the property), they could save premium costs and still be protected in the event of a partial loss of the property. By imposition of a co-insurance requirement, a property policy will reduce even a partial loss by a percentage related to the actual amount of insurance carried (compared to the 80% or 90% of value) and then apply the applicable deductible to the resulting amount. This is an unsatisfactory result for a mortgage lender.

F. Flood Insurance

Floods have caused particular problems in 2011. Perhaps by the time these materials are first presented in September, 2011, an Atlantic or Gulf Coast hurricane will have added to the flooding damage. Flood insurance is a separate peril that is typically excluded from even the Special Form of Loss insurance. The Federal Government has provided subsidized flood insurance through the National Flood Insurance Program ("NFIP"). The initial authorization of the NFIP expired several years ago and since then has been extended by multiple short-term extensions. The barrier to a long-term extension is disagreement between the House and the Senate as to such matters as the scope of coverage, steps to make up deficits in the program, and the ability of independent agents to issue flood policies. The NFIP does not include business income coverage. It only addresses direct physical loss of property and is subject to dollar limitations. As of the preparation of these materials (August, 2011), the NFIP will expire in September, 2011, unless extended.

G. Green Insurance Products

If the mortgage lender is financing a LEED® certified or other "green" building project, it may want to consider requiring the borrower to carry insurance specifically intended to provide for rebuilding to "green" standards. While the green insurance is of fairly recent vintage, a number of companies now offer it and in the proper circumstance it may be of value to a particular project.

III. RIGHTS OF THE MORTGAGEE TO THE BORROWER'S INSURANCE PROCEEDS

Both the mortgagor and mortgagee have insurable interests in mortgaged property. A mortgagor may insure the mortgaged property in an amount equal to the property's value while a mortgagee's insurable interest is limited to the amount of its secured debt. Absent a contractual undertaking to insure the mortgaged property and to insure the interest of the mortgagee, the mortgagor does not have an obligation to do so. However, it is customary in commercial financing to require the mortgagor to carry insurance for the joint interest of both mortgagor and mortgagee.

There are different types of mortgagee clauses under a property insurance policy. The primary types are the open mortgage clause and the standard mortgage clause. A clause that simply provides that insurance proceeds will be payable to a mortgagee "as its interest may appear" links the mortgagee's recovery to the right of the mortgagor to recover. This exposes the mortgagee to risks that the insurer will be afforded a defense to payment to the mortgagee based upon inequitable conduct of the mortgagor. An "open" mortgage clause provides that any loss is payable to the lender "as its interest may appear." This type clause exposes the lender to all the defenses and limitations that the insurer has against the insured mortgagor, such as failure to pay the premium or perform a condition for coverage under the policy. *See* cases and discussion at 48 A.L.R. 121 (1927) and 38 A.L.R. 367 (1925) and 3 COUCH ON INS. § 65.8. Examples of the effect of such a clause are *Commerce Bank & Trust Co. v. Centennial Ins. Co.*, 446 N.E.2d 73 (Mass. 1983) and *Pioneer Food Stores Coop., Inc. v Fed. Ins. Co.*, 563 N.Y.S.2d 828 (N.Y. Sup. Ct. 1991). In *Commerce Bank* the mortgagee claimed that it should receive the insurance proceeds regardless of whether the loss was caused by a fire set by the mortgagor. While the court did not determine the question of arson, it held that because the mortgagee was essentially merely a loss payee, it could recover only if the mortgagor would have been entitled to recover. *Pioneer* also involved suspected arson by the mortgagor; because the mortgagor would not provide financial information or submit sworn affidavits regarding the loss, the mortgagee was denied recovery. Not all borrowers facing financial difficulty consider insurance fraud as the way out of their problems, but the mortgagee of one who has taken this path will be unprotected if it is simply named as loss payee or is covered under an "open mortgage clause" type of endorsement

The standard mortgage clause was developed to protect recovery by the mortgagee even though the insurance contract between the mortgagor and the insurer might be voided because of certain omissions or acts by the mortgagor (for example, neglect, arson, concealment). A standard mortgage clause grants independent rights to the mortgagee from the insurer that can be enforced regardless of the actions of the mortgagor. A standard mortgage clause, like the open mortgage clause, provides that the loss will be payable to the mortgagee "as its interest may appear," but it goes further to provide that the insurance, as to the mortgagee, will not be invalidated by acts of the insured. Standard commercial property policies automatically extend coverage to the mortgagee as an insured through the inclusion of the standard mortgage clause. 4 COUCH ON INS. §§ 65:32 and 65.9. Examples of cases that provided payments to the mortgagee under such

clauses are *Nat. Comm. Bank & Trust Co. v. Jamestown Mut. Ins. Co.*, 334 N.Y.S.2d 1000 (N.Y. Sup. Ct. 1972) and *Foremost Ins. Co. v Allstate Ins. Co.*, 460 N.W. 2d 242 (1990). In the *National Commercial Bank* case the insurer claimed that material misrepresentations of the insured voided the policy. However, the court found that the standard mortgage clause created a separate contract between insurer and mortgagee that was not affected by the actions of the insured. *Foremost* involved yet another cases of arson by the insured, but because the policy named the mortgagee under the standard or union clause, it was entitled to recover despite the actions of the insured. John W. Steinmetz and Stephen E. Goldman, *The Standard Mortgage Clause in Property Insurance Policies*, 33 TORT & INS. L. J. 81 (1997).

IV. REQUIRING THE PROPER INSURANCE: LIABILITY INSURANCE

Liability insurance requirements are most often considered by landlords and tenants, rather than mortgage lenders and borrowers. Why? When landlords and tenants own or control portions of the same property, the possibility for injuries to persons, damage to adjoining property, and other potential sources of liability abound. The same is not true in the case of a passive mortgage lender and its borrower. Why should a mortgage lender care about the liability insurance carried by its borrower?

A. Viability of the Borrower

The primary reason for the mortgage lender's concern with this type of property is that if its borrower suffers an uninsured (but insurable) loss that is beyond its ability to absorb, its continued viability is at stake. Further, although the likelihood of a claim against a mortgagee for injuries at the mortgaged property are small, it should still require that it be named as an additional insured on the liability insurance of its borrower. This will reduce the chances that the mortgage lender's own insurance would be required to pay a claim that would be covered by the insurance required to be carried by the mortgagor.

B. Amount of Insurance

Unlike property insurance, for which the value of the mortgaged property and co-insurance concerns dictate the dollar amount of coverage required, the amount of liability insurance is often dictated by the level of risk involved in the borrower's activities. Commercial General Liability Insurance will carry both an aggregate limit for the policy period as well as sublimits for specific risks. For instance, a policy may limit recovery for a single occurrence during the policy period as well as an aggregate for the policy period. Typically, the mortgage lender will require that the borrower also carry excess liability or an umbrella policy that covers losses in excess of those stated in the CGL policy.

C. Additional Insured; Waiver of Subrogation; Primary Coverage.

As important as stipulating the amount of liability insurance to carry is to require that the lender be named as an additional insured on the borrower's policy. As an additional insured, the lender is entitled to the benefits of the policy but is not charged with obligations of the named insured (such as payment of premiums). The lender should

require that the insurer waive all rights of subrogation against the mortgage lender. This may require an endorsement to the CGL policy, although some forms may contain an automatic waiver of subrogation. Further, if the lender is an insured (such as an additional insured) under the policy the insurer cannot exercise subrogation rights against its insured. Also, since a particular risk may be covered under both the lender's and the borrower's insurance, the borrower's insurance should be required to be primary. This will avoid the possibility that the lender's insurer would also be required to respond in the event of a claim based on "other insurance" clauses present in many CGL policies. The "other insurance" clause typically shifts primary coverage to any other insurance covering the risk, which may be contrary to the risk allocation intentions of the lender.

V. REQUIRING THE PROPER INSURANCE: BUSINESS INCOME AND CONTINGENT EXPENSE

In addition to losses from direct physical loss of the property, loss of income due to inability to use the mortgaged property and loss of income due to losses suffered by suppliers or customers (without loss to the mortgaged property) are major concerns. As seen following the earthquake and tsunami and nuclear power crisis in Japan, disruptions in the supply chain around the world can have a tremendous impact on the business of landlords and tenants in the United States.

A. Business Income Insurance

Business income insurance is intended to compensate for losses associated with the interruption of the mortgagor's business due to suspension of operations as a result of physical damage to the insured's premises. Business interruption losses can be covered for a fixed period of time after the damage occurred or for the "period of restoration." The amount paid by the insurance company is based on proven actual loss of business. Business income insurance also typically covers extra expenses, such as expenses incurred to avoid or minimize the suspension of business and to continue operations either at the insured premises or at a temporary location. Policies usually include civil authority coverage, which will reimburse the insured for lost income and necessary expenses incurred because a civil authority prohibited access to the insured premises due to off-premises damage from a covered peril. By requiring its borrower to carry this insurance, a mortgage lender can increase the likelihood that its borrower will remain a viable entity following a disruption of use of the mortgaged property.

B. Contingent Business Income

While property insurance and business income insurance focus on losses to property owned by the mortgagor, contingent business income insurance may provide some relief when the insured premises are not damaged but utilities are unavailable due to damage off-site or when damage to the property of suppliers or customers causes a loss to the insured.

C. Rental Insurance

Business income rental coverage protects the landlord when a tenant's rent is abated, such as when the premises are not habitable due to damage or destruction. Many tenants, particularly small tenants, may not be able to continue to pay rent if they cannot access the premises and are not properly insured for this contingency. However, a lease could provide that a tenant's rent is abated in the event of damage to the leased premises. The landlord can insure this risk with rental insurance and include the cost in the operating expenses of the building. A lender with a lien on commercial rental property would benefit from requiring its mortgagor to carry this coverage, as it could support the viability of the project.

VI. OBTAINING EVIDENCE THAT THE PROPER INSURANCE HAS BEEN PLACED AND IS IN FORCE

Specifying adequate insurance coverages is the first step in protecting the mortgagee. The next step that the mortgage lender must take is to confirm that the insurance has been obtained and is in full force and effect, as required.

A. Certificates of Insurance

Many loan agreements, mortgages, and deeds of trust require a party to furnish a certificate of insurance as evidence of the existence of the proper insurance. Is this sufficient? Unfortunately, no. Prior to 2006, the ACORD form of certificate for property insurance did appear to be evidence of insurance and did appear to give rights against the insurer (including independent rights to notice upon cancellation). When the ACORD forms changed in 2006 to clearly state that they conferred no rights on the certificate holder, mortgage lenders and attorneys who practiced in this area attempted to negotiate with the insurers and agents to restore some enforceability to insurance certificates. Unfortunately, this did not succeed. In fact, the insurance industry began approaching state insurance commissioners and legislatures to gain support for their position that a certificate of insurance could not vary the underlying policy or grant rights that did not exist under the applicable policy. At last count, 39 states now have either insurance regulations or statutes on this point. Texas has both. Texas Department of Insurance Commissioner's Bulletin #B-0049-10 (November 24, 2010); SB 425, Texas Insurance Code Chapter 1811 (effective January 1, 2012).

The result? A certificate of insurance will not provide coverage if coverage is not provided in the underlying policy. A certificate of insurance, if incorrect, may provide a claim against the agent who issued the incorrect certificate, but it will not obligate the underwriter under the policy. *TIG Ins. Co v. Sedgwick James of Washington*, 276 F.3d 754 (5th Cir. 2002), aff'g 184 F.Supp.2d 591 (S.D. Tex. 2001); W. Rodney Clement, Jr., *Is a Certificate of Commercial Property Insurance a Worthless Document*? PROBATE & PROPERTY 46 (May/June 2010); Alfred S. Joseph III and Arthur E. Pape, *Certificates of Insurance: The Illusion of Protection*, PROBATE & PROPERTY 54 (Jan./Feb. 1995).

B. The Alternatives to a Certificate of Insurance

If a certificate of insurance does not afford independent rights against the insurer, what alternatives are available to a mortgage lender? Unfortunately, there is no good alternative to obtaining and reading the underlying policy. This obviously adds costs, particularly in instances in which multiple properties are covered under blanket policies, or properties are owned by large, national entities with operations in many locations. The lender's insurance advisor or risk management division will have to obtain and read the policy in order to discern what coverages are extended, and whether they comply with the requirements of the loan agreement or deed of trust.

VII. SELF INSURANCE ISSUES

A. The Self-Insured Borrower

Typically, loan agreements, mortgages, and deeds of trust provide very specific requirements for insurance to be carried by the borrower. Often, after these very specific requirements, the borrower is given the right to self-insure some or all of the risks listed, generally subject to consent of the lender. What concerns should be considered in granting or denying approval for self-insurance? These concerns are typically addressed by the joint decision of the risk management and credit departments because self-insurance means that only the unsecured credit of the borrower stands behind a loss or liability, except for any amounts provided by reinsurance.

B. What is Self-Insurance?

The umbrella term "self-insurance" does not indicate much about what procedures are to be followed and what protection is available. Since there is no defined term for self-insurance, the lender should recognize that it can impose conditions and limitations on what the borrower intends to carry. Ann Peldo Cargile, Stephen K. Cassidy, and Arthur E. Pape, *Are you Bare or Are you Covered; An Examination of Some Key Issues Raised by Self-Insurance*, THE ACREL PAPERS, Fall 2002 at 341. For instance, a borrower may retain extremely high deductibles or self-insured retentions, but may obtain policies of reinsurance for losses over a certain level. Deductibles and self-insured retentions each mean that only the credit of the borrower backs losses up to a certain amount. If the borrower's program includes self-insured retentions, the borrower itself handles and manages all claims and provides the defense of all lawsuits. The reinsurer is involved only when the limits have been surpassed. In such a case, obligations of defense, as well as those of indemnity, are provided by the borrower.

C. Limits on Self-Insurance

If a lender is willing to allow a borrower to self-insure, it should consider limitations and restrictions on this right. For instance, the lender could consider limits on specific deductibles and retained risks and require evidence of reinsurance from a financially responsible insurer. Since the borrower's unsecured credit alone stands behind most losses, only the most credit-worthy borrowers should be allowed to self-insure. The right to self-insure could be limited to continued compliance with financial means tests and

with compliance with other terms and conditions of the loan agreement or deed of trust. Mortgage lenders are already monitoring the borrower's financial situation, so these tests could easily fit into that review process.

D. Limit the Use of Self-Insurance by Successors

Most loans limit certain fundamental changes of the borrower, such as some mergers, without consent of the lender. Typically, a sale of the mortgaged property and assumption by the transferee will also be subject to consent of the lender. When requested to consent to such a transaction, the lender should consider whether the modified entity structure or new owner of the mortgaged property should be allowed the same rights to self-insure as were allowed to the original borrower. The credit agreement may be even more specific and limit the right to self insure to only the original borrower. This insures that the question of self-insurance is considered by the lender at the time of a merger or transfer of mortgaged property and is not overlooked in the approval process.

VIII. MANAGING PROCEEDS AFTER AN INSURANCE LOSS

A. Addressing the Issue in the Loan Agreement or Deed of Trust

All loan agreements and deeds of trust address the issue of application of insurance proceeds after a loss. Depending upon the nature of the loan, the strength of the borrower, and the lender, these provisions may give the lender absolute discretion as to whether to release insurance proceeds to the borrower for use in rebuilding or to apply to reduce or discharge the mortgage debt, or they may outline conditions under which the borrower will be entitled to receive the proceeds to rebuild the project. Scott Osborne & Julie Williamson, *Living with Loan Documents after a Casualty*, ACREL Insurance Workshop, 1994.

B. Considerations in the Decision to Allow Rebuilding; Replacement Value

If the lender has total discretion in the use of the proceeds, it will consider the viability of the project, the strength of the borrower, the lender's relationship with the borrower and its affiliates, and many other credit-driven factors. It should also consider the effect this decision will have on the amount of the recovery. Typically, the lender will have required that the borrower obtain replacement value insurance. As noted above, this provides more coverage than "actual cash value" because it provides funds necessary to replace the project, rather than taking the original cost of the insured property and then applying a reduction for physical depreciation. Obviously, since replacement value insurance provides more coverage, it is more expensive. However, receipt of replacement proceeds depends upon replacement of the project. If the project is not rebuilt, the insurer will pay only the lesser actual cash value proceeds. The lender should be aware of this as it considers whether to allow rebuilding or to require repayment of its loan.

IX. ISSUES ARISING AT THE TIME OF WORKOUTS

When a lender approaches a workout situation, it typically considers the project's viability, the strength of the borrower, the ability to obtain additional collateral or credit-worthy guarantors, and other credit-driven factors. What should it consider in terms of the borrower's insurance?

A. Use of Proceeds

Typically the lender has sole discretion whether to apply insurance proceeds to repayment of the loan or rebuilding of the project. If the borrower negotiated more favorable conditions for use of proceeds, now would be the proper time to consider revisions to the use of proceeds.

B. Self-Insurance

If the borrower was permitted to self-insure, the workout period is the time to consider whether the limitations on self insurance are sufficient, and whether the borrower is still a good candidate for self insurance.

C. Evidence of Insurance

Although mortgage lenders are very aware of the limitations of insurance certificates, many still rely upon certificates rather than requiring copies of policies and review of those policies to determine whether all coverages have been placed as required and are still in force and effect. The workout period is the time to go behind the certificate and require the actual policies and to have the lender's own insurance/risk management department determine whether the required coverages are in fact in place.

X. ISSUES ARISING AT THE TIME OF FORECLOSURE

Insurance issues need to be considered by the loan officer and foreclosure counsel at the time that the foreclosure is planned. Certainly, all of the issues raised elsewhere in this paper, are important. In addition, there are several issues unique to a foreclosure that should be considered.

A. Considerations Prior to Foreclosure

Some property insurance policies require the mortgagee to notify the insurance carrier of the commencement of foreclosure. Notice is given to the insurance carrier so that it can protect its position by purchasing the secured indebtedness or bidding at the foreclosure sale, especially if a casualty loss has occurred before the foreclosure sale. The safest practice is to notify the insurance company of a pending foreclosure sale and to notify the company of the change of ownership after the foreclosure sale.

Further, if the mortgagor abandons the mortgaged property before the foreclosure sale, the mortgagee must confirm continuation of coverage. Most property insurance policies exclude or reduce coverage after the insured property is vacant for more than a certain

period of time, often 60 days. This limitation arises from the possibility of vandalism, glass breakage, theft, and other casualties when the property is unprotected. Although a company may offer an endorsement to override the vacancy exclusion, these typically provide coverage for short term coverage at a much greater cost.

B. Loss to the Property Before Foreclosure

If the mortgaged property is damaged before the foreclosure sale, the lender will be concerned as to whether the mortgagor, the lender, or the purchaser at the foreclosure sale will receive the proceeds. In addition, it should consider whether a greater recovery be available if the proceeds are applied in reconstruction of the mortgaged property than if they are taken as a cash payment. The greater replacement cost proceeds are payable only if the property is repaired. If proceeds are applied to the mortgage debt, the lower "actual cash value" will be paid.

The lender's right to the property insurance proceeds depends on the existence of an insurable interest in the mortgaged property. A secured lender's interest in the policy is limited to the balance of the secured indebtedness. Therefore, its interest will vary depending on the action taken before the insurer disburses the insurance proceeds. If the lien is foreclosed before the proceeds are distributed, the lender's right to the proceeds may be reduced or extinguished, depending on the lender's interest remaining after foreclosure. If the lender purchases the mortgaged property for the amount of the debt outstanding, it will have no right to the insurance proceeds. *Beneficial Standard Life Insurance Co. v. Trinity National Bank*, 763 S.W.2d 52 (Tex. App.—Dallas 1988, writ denied); *Helmer v. Texas Farmers Insurance Co*., 632 S.W.2d 194, 196 (Tex. App.—Fort Worth 1982, no writ); *Norwest Mortgage, Inc. v. State Farm Fire & Casualty Co*., 118 Cal. Rptr. 2d 367 (Cal. App. 2002); *Lenart v. Ocwen Financial Corp*., 869 So.2d 588 (Fla. App. 2004); Patrick A. Randolph, Jr., *The Mortgagee's Interest in Casualty Loss Proceeds; Evolving Rules and Risks*, 32 REAL PROP. PROB & TRUST LAW J. 1 (1997); *Burning Issues: The Role of Insurance in a Real Estate Transaction*, ABA Real Property Program, 1998 Annual Meeting; Sidney G. Saltz, *Tug of War: Who Gets the Casualty Insurance Proceeds*?, PROBATE AND PROPERTY, 32 (July/August, 1999). Since the knowledge of the lender of a loss to the mortgaged property is irrelevant for purposes of determining an insurable interest, a physical inspection of the property prior to foreclosure can avoid any accidental loss of a claim to insurance proceeds. If the lender purchases the mortgaged property for less than the balance owed on the secured debt, it may recover from the insurer, as from the mortgagor, the deficiency (up to the policy limits). *Arkansas Teacher's Retirement Sys. v. Coronado Properties*, 801 S.W. 2d 50 (Ark. App. 1990); *Imperial Mortgage Corporation v. Travelers Indemnity Company of Rhode Island*, 599 P. 2d 276 (Colo. App. 1979); *Phalen Park State Bank v. Reeves*, 251 N.W. 2d 135 (Minn. 1977); John W. Steinmetz and Stephen E. Goldman, *The Standard Mortgage Clause in Property Insurance Policies*, 33 TORT & INS. L. J. 81, 102 (1997); 4 COUCH ON INS. §§ 65:12 and 65:59.

The lender may decide to postpone the foreclosure sale until after the amount payable on the insurance policy is determined. Otherwise, it risks overbidding and establishing a deficiency less than the amount of the insured casualty loss. If the lender determines that

it must foreclose before the insurance proceeds are liquidated and applied to reduce the secured debt, it should bid low enough to establish a deficiency equal to the expected insurance proceeds.

XI. RECEIVERS AND BANKRUPTCY ISSUES

A. Receiverships

In recent years the request for appointment of receivers in connection with foreclosures has increased dramatically. Lenders and servicers have resorted to receiverships to operate and even sell the property, without proceeding to a foreclosure sale. Morris A. Ellison, Lawrence M. Dudek, and Samuel H. Levine, *'Tis Better to Receive - The Use of a Receiver in Managing Distressed Real Estate*, 2009 THE ACREL PAPERS 1. The rights and obligations of the receiver are established both by applicable state or federal law and in the order of receivership. Typically, these require the receiver to post a bond to insure its faithful performance, address operation of the premises, collection of rents, maintenance of insurance and, if permitted by the court and applicable law, to sell the property and distribute the proceeds.

Surprisingly, other than the Block 37 case discussed below, there has been little discussion of the insurance issues arising in connection with receiverships, possibly because they were relatively seldom used prior to the recent financial meltdown. The cases that do address these issues date prior to 1940; since so much of insurance law hinges on the analysis of policy language and since insurance policies have continually changed over time, reliance on these early cases should be tempered with consultation with knowledgeable insurance advisors.

During a receivership, the receiver, rather than the owner or its property manager is in possession of the property and entitled to receive the rentals and operate and maintain the property. The mortgage debt remains outstanding, so the mortgagee's insurable interest remains in the property. Since the mortgage has not been foreclosed, the owner still retains its interest in the property.

B. Appointment of the Receiver; Prohibited Assignment of Policy?

The concern raised by commentators is that the appointment of a receiver may be considered a prohibited assignment of the policy that would release the insurer, absent its consent to the assignment. Unless the owner and its insurer consent to an assignment of rights under the property policy, the receiver should not assume that it is entitled to coverage under the owner's policy and should not assume that the owner's interest in the policy remains protected. The typical ISO form restricts the right of the insured to transfer rights under the policy without the insurer's consent. There is, however, at least some old authority that the appointment of the receiver does not breach this restriction, on the grounds that the possession of the receiver is for the benefit of all parties involved. *Hanson v. Royal Ins. Co.*, 257 F. 715 (6th Cir. 1919). 3 COUCH ON INS. § 40:23; 3 COUCH ON INS. § 42:27; 6A COUCH ON INS. § 92:79.

C. Insurable Interest

Often, the property insurance on the mortgaged property has lapsed or is close to expiration and the receiver must obtain insurance to protect the property. While the receiver has the authority to obtain such insurance, it is unclear whether this is on the basis of the receiver's insurable interest in the property or whether it simply has the authority to take that action on behalf of the parties (owner, mortgagee, or other creditor) who will ultimately benefit from the insurance. *Dallas Bank & Trust Co. v. Thompson et al.*, 87 S.W.2d 307 (Tex. Civ. App.—Dallas 1935); *Imperial Assur. Co. v. Livingston, et al.*, 49 F. 2d 745(8th Cir. 1931).

D. Insurance Considerations Prior to Appointment

A recent Illinois case involves a dispute over insurance as a basis for a defense against the appointment of a receiver. In *Bank of America, N.A. v. 108 N. State Retail LLC*, No. 1-09-3523, Cook County, Illinois (2010) the mortgagee sued for foreclosure of its mortgage, based upon an alleged 46 million dollar shortfall in construction funds necessary for the completion of the "Block 37" project in Chicago. The developer/mortgagor provided insurance for the project, still in the construction phase, under a wrap-program, or owner controlled insurance program ("OCIP"). Apparently, the appointment of the receiver was delayed for several weeks as the receiver attempted to obtain its own OCIP insurance or to require an assignment by the developer of its OCIP. Although receivers have been touted as an efficient way to complete projects that fall into default while still under construction, this case may be an example of issues that might make such appointments impracticable.

E. Bankruptcy

There does not appear to be any case that holds that the mere filing of a petition in bankruptcy is such an assignment of the policy as would give the insurer a right to avoid responsibility. 6A COUCH ON INS. § 92:80. However, special rules and issues arise when the borrower files for reorganization or liquidation under the protection of the Bankruptcy Code. The primary question for the bankruptcy lawyer is whether the insurance policy and the insurance proceeds are property of the bankruptcy estate. Section 541 of the Bankruptcy Code, 11 U.S.C. § 541, broadly defines the bankruptcy estate to include "all legal and equitable interests of the debtor in property as of the commencement of the case" and "proceeds ... of or from property of the estate." While cases have held that the result is that insurance policies constitute property of the bankrupt estate the important question for the secured lender is whether the proceeds of insurance also constitute property of the estate. The general test seems to focus on whether, in the absence of bankruptcy, the debtor would have had a claim to the proceeds. Property insurance policies whose proceeds are payable to a creditor pursuant to a mortgagee/loss payee rider are not property of the estate. *In the Matter of Equinox Oil Company, Inc.*, 300 F. 3d. 614 (5th Cir. 2002); *In the Matter of Edgeworth*, 993 F. 2d 51 (5th Cir. 1993); *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391 (5th Cir. 1987).

XII. SOURCE MATERIALS

The following are source materials from the authors:

The following related articles by Bill Locke found at www.gdhm.com: *Distress and Insurance: When the Going Gets Rough, Does Your Risk Get Going?* THE ACREL PAPERS (Fall 2010); *CGL Coverage of Defective Work*, THE ACREL PAPERS (Fall 2009); *Annotated Lease Insurance Specifications; Insurance Issues in Distressful Times; Additional Insured Endorsements: Typical Defects and Solutions*; *Annotated Risk Management Provisions (Focus on Texas Real Estate Forms Manual's Retail Lease)*; *Allocating Extraordinary Risk in Leases: Indemnity, Insurance, Releases and Exculpations and Condemnation (Including a Review of the Risk Management Provisions of the Texas Real Estate Forms Manual's Office Lease)*; *Risk Management*; and S*hifting of Extraordinary Risk: Contractual Provisions for Indemnity, Additional Insureds, Waiver of Subrogation and Exculpation* State Bar of Texas, ADVANCED REAL ESTATE LAW AND ADVANCED REAL ESTATE DRAFTING COURSES; *Insurance Issues in Case of Developer, Owner, Landlord, Tenant, or Contractor Default* ALI-ABA/ACREL (2011).

The following are relevant articles by Marilyn C. Maloney: *First, The Catastrophe; Then, the Fallout* ICSC, U.S. SHOPPING CENTER LAW CONFERENCE (2011); *Insurance Issues in Case of Developer, Owner, Landlord, Tenant, or Contractor Default* ALI-ABA/ACREL (2011); *Insurance Issues in Distressful Times,* STATE BAR OF TEXAS ADVANCED REAL ESTATE DRAFTING COURSE (2011); *Distress and Insurance: When the Going Gets Rough, Does Your Risk Get Going?* THE ACREL PAPERS (Fall 2010); *Liability and Property Insurance: The Basics and Hot Issues, Including the Insurance Certificate Problem*, ABA REAL PROPERTY SPRING SYMPOSIA (2010); *Critical Insurance Topics for Landlords, Tenants, and Lenders (Certificates, Endorsements and More)*, ICSC, U.S. SHOPPING CENTER LAW CONFERENCE (2009); *Planning in Advance for Disasters: Finding and Fixing the Gaps in Your Documents*, South Texas College of Law, 24th ANNUAL REAL ESTATE LAW CONFERENCE (2009) and State Bar of Texas, ADVANCED REAL ESTATE LAW (2008), materials prepared with David Weiner; *Insurance Issues for Lenders*, Louisiana Bankers Association, BANK COUNSEL CONFERENCE (2007); *Insurance Certificates and Binders - What You Can and Should Negotiate*, U.S. SHOPPING CENTER LAW CONFERENCE (1999); *Insurance Binders: Selected Issues* THE ACREL PAPERS (Spring 1997).