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Following the Money – the Chaotic Kerfuffle Over Residential Insurance Proceeds that Simultaneously are the Only Rebuild Funds and the Only Mortgage Collateral

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**FOLLOWING THE MONEY—THE CHAOTIC KERFUFFLE
WHEN INSURANCE PROCEEDS SIMULTANEOUSLY
ARE THE ONLY REBUILD FUNDS AND
THE ONLY MORTGAGE COLLATERAL**

KENNETH S. KLEIN*

I. INTRODUCTION

In an average year in the United States, 30,000 homes are lost to fire, flood, or another similar disaster.¹ In 2003, one of those homes was mine.² Since that time, I have spent literally thousands of hours

* Assistant Professor of Law, California Western School of Law. As always, I could not have written anything of value without the input, suggestions, and insights of my wife, best friend, and professional colleague, Professor Lisa Black. My research assistant, Jihan Younis, was fabulous, as was the staff of the California Western Law Library. I would like to thank the students in my seminar, Legal Lessons of Katrina and Other Natural Disasters, who I learned from every day. Finally, I would like to thank the many, many survivors of Katrina and the Southern California wildfires, hundreds of whom I have met, and whose wisdom and support inspires much of what I am trying to do in this article.

1. *See infra* notes 14-17. In this article, I am using the terminology “disaster” and “natural disaster” precisely. “Disaster” refers to any loss to fire, flood, or the like. “Natural disaster” refers to those instances where the loss is caused by a weather event, such as wildfire or hurricane. For the issues this article addresses—the varying interest of banks and homeowners in the insurance proceeds—it is largely a distinction without difference except in two respects. First, as will become apparent later in this article, some banks have policies that apply differently depending upon whether the cause of the loss is a Federal Emergency Management Agency (FEMA)-declared disaster or not. Second, natural disasters often result in multiple simultaneous losses, creating different pressures on a bank both because of the larger cumulative size of the financial event, and the greater possibility of media exposure if the bank is perceived to be acting unfairly.

2. Press Release, California Dep’t of Ins., Insurance Commissioner Steve Poizner Announces Unique Agreement to Create Incentives to Increase Disaster Preparation, Fire Mitigation (June 12, 2008), <http://www.insurance.ca.gov/0400-news/0100-press-releases/0070-2008/nr052-2008.cfm> (“Joining Commissioner Poizner today [was] . . . Ken Klein of the Scripps Ranch Civic Association and a

counseling hundreds of survivors of other disasters (including wildfires, Hurricane Katrina, and the crash of a military jet into a residential neighborhood) on the unique set of emotional, financial, and legal challenges that define their road to recovery.³

One of the recurring and yet repetitively unanticipated challenges is the tug of war between homeowners and their mortgage lender/mortgage servicer over money.⁴ That challenge is the focus of this article.

A standard condition of mortgages (or, more precisely, the security instruments accompanying mortgages) in the United States is that the borrower must have casualty insurance protecting not just the borrower, but also the bank. Thus, when the necessity arises to rebuild the home, the same pot of money—the insurance proceeds—is what the homeowner needs to pay a contractor and what the bank needs to protect its loan until the house is rebuilt.

The homeowner lacks the expertise, time, or money (beyond the insurance proceeds) to handle the project on his or her own. In one sense, the money is an opportunity—homeowners find themselves unexpectedly in the role of a flower surrounded by eager bees in the form of architects, contractors, attorneys, and insurance adjusters, all willing to help. But generally that help only comes if the homeowner has control of the money.

For the bank, the initial collateral has disappeared. The primary concern is that the homeowner, given the chance, might take new primary collateral—the money—and run. Of secondary concern is that the homeowner will spend all the money, but will rebuild a home of insufficient value to adequately collateralize the loan. The insurer, much like a party who might interplead funds, is caught in the middle.

2003 Cedar fire survivor.”).

3. See, e.g., “San Diego’s Kenneth Klein to Receive State Bar’s Pro Bono Service Award,” http://www.calbar.ca.gov/state/calbar/calbar_generic.jsp?cid=10144&n=93267 (last visited Jan. 30, 2010).

4. A consequence of the now ubiquitous national secondary market in mortgages is that mortgages are sliced, diced, repackaged, and sold. See generally, GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 5.35 (5th ed. 2007). Over time, the homeowner deals with a mortgage servicer who owns, at best, a small piece of the loan. The mortgage servicer role is freely assignable, and often transfers. This article will use the simple shorthand, “the bank,” to refer to the entity that the homeowner deals with concerning the mortgage.

The insurer has an obligation to cut the checks, but also has conflicting claimants.

What is most surprising about these conflicting positions is how each time the issues arise, all of the parties seem to come to it afresh. The documents and laws that might define the solution to this Gordian knot give an incomplete answer or no answer at all, and in any event, the parties largely are unaware and unconcerned with what the law and documents provide. Perhaps because the number of homes lost annually to disasters is dwarfed by the number of annual home sales, mortgages, and insurance transactions, it seems the relevant clauses of the standard documents never change and are rarely even considered. And so year after year, in the wake of disaster, homeowners, contractors, banks and insurance companies come to the problem only after the fact, never having thought it through, and try to sort out by grit, bluff, and instinct how to proceed. What once was a highly documented contractual relationship quickly devolves into a rugby scrum.

This article will sort out the legal validity to each party's position. The issues reduce to six questions: 1. Does the bank have rights in all insurance proceeds, just the proceeds insuring the house itself (as opposed to other commonly insured losses, such as the personal belongings in the house or landscaping and other structures external to the house), or something in-between? 2. To what extent does the bank have rights in insurance proceeds if the balance of those funds exceeds the current outstanding principal balance of the mortgage. Does the bank's rights extend to the overage? 3. As to the funds the bank has rights in, is there a choice available between using the money to rebuild or to pay off/pay down the mortgage, and if there is a choice, does the bank or the homeowner hold the choice? 4. During the time the bank holds whatever money the bank gets to hold, does the money accumulate interest for the benefit of the homeowner? 5. To the extent the money is being used to fund a rebuild, at what interim junctures, if any, must the bank partially release funds? 6. What happens if the bank, while holding the funds, becomes insolvent?

Part II of this article describes the scope of the problem. Part III describes the current legal landscape. Part IV describes how parties actually are behaving, without regard to the legal landscape. Part V proposes a guide to sort out the mess.

II. THE REMARKABLE FREQUENCY OF TUG OF WAR OVER MONEY DUE TO MORTGAGED, INSURED HOMES LOST TO DISASTER

It is almost certain that virtually every home in the United States that has a mortgage also has home insurance. A consequence of the secondary markets in mortgages is that standard security instruments require property to have casualty insurance. The Federal National Mortgage Association (“FNMA”) and Federal Home Loan Mortgage Corporation (“FHLMC”) standard security instruments for the State of New York are typical of the substantive requirements: “All of the insurance policies and renewals of those policies . . . will name Lender as mortgagee and/or as an additional loss payee.”⁵ Simply put, assuming compliance with the loan documents, through the endorsement required by the mortgage, the mortgage company is an additional insured under the policy.⁶ The consequence is that any insurance proceeds checks paid under the policy should be co-written to both the homeowner and the bank (as co-insureds), and the insurance proceeds are, in the first instance, deposited into the bank’s account and are under the bank’s control.

According to the best available data, this means that annually tens of thousands of Americans may lose their home to disaster and find themselves in a tussle with their bank over the control and use of the insurance proceeds. The data comes from the bi-annual “American

5. eFannieMae.com, New York Securities Instrument Form 3033, <http://www.efanniemae.com> (click “Single Family” then “Forms and Documents,” “Legal Documents,” “Security Instruments,” and then scroll down and click “3033”) (last visited Dec. 11, 2009). I chose New York because of its obvious and commendable attempt to write its documents in plain English. The documents of the other jurisdictions are substantively identical, albeit less accessible to the non-lawyer reader. For the precise text of the standard documents for the other forty-nine states, the District of Columbia, the Virgin Islands, and Puerto Rico, see eFannieMae.com, <http://www.efanniemae.com> (click “Single Family” then “Forms and Documents,” “Legal Documents,” and then “Security Instruments,”) [hereinafter Fannie Mae Security Instruments]; for Guam, see FreddieMac.com, Guam Security Instrument Form 3052, http://www.freddiemac.com/uniform/unifsecurity.html#master_short (follow “Form 3052: Guam Mortgage” hyperlink) (last visited Jan. 27, 2010).

6. For an example of such an endorsement, see LENDER’S LOSS PAYABLE ENDORSEMENT, FORM 438 BFU (1942), available at http://www.insurance.wa.gov/insurers/rates_forms/mortgagee_forms/lendersloss_payable_endorsement_form_438Bfu_ns.pdf.

Housing Survey for the United States,” jointly published by the United States Department of Housing and Urban Development, Office of Policy Development and Research, and the United States Department of Commerce, Economics and Statistics Administration, United States Census Bureau.⁷ The most recent report, as of the time of this writing, is for 2007.

Millions of Americans live in an owner-occupied home. In 2007, there were 75,647,000 owner-occupied homes in the United States.⁸ Roughly two-thirds of owner-occupied homes have at least one mortgage. In 2007, 48,742,000 owner-occupied homes had a regular and/or home equity mortgage.⁹ At least 12,588,000 of the owner-occupied homes had two or more mortgages.¹⁰

As discussed above, having a mortgage equates to having property insurance.¹¹ Indeed, in 2007, 24,631,000 owner-occupied homes included the cost of property insurance as part of their primary mortgage payment (almost certainly, in most, if not all of these instances, because the homeowner had insufficient initial equity. Therefore, a condition of the loan was escrows for insurance premiums, taxes, and so-called purchase-money insurance).¹² But

7. U.S. DEP'T OF HOUS. AND URBAN DEV. & U.S. U.S. DEP'T OF COMMERCE, AMERICAN HOUSING SURVEY FOR THE UNITED STATES: 2007 (2008). The most recent report, as of the time of this writing, is for 2007.

8. *Id.* at 10.

9. *Id.* at 162.

10. *Id.*

11. See, e.g., eFannieMae.com, California Security Instrument Form 3005, at 6-7, <https://www.efanniemae.com/sf/formsdocs/documents/secinstruments> (follow “3005” hyperlink) (last visited Dec. 11, 2009) (“Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss All insurance policies required by Lender and renewals of such policies . . . shall include a standard mortgage clause, and shall name Lender as mortgagee and/or as an additional loss payee”); eFannieMae.com, New York Securities Instrument Form 3033, *supra* note 5 at 7-9 (“I will obtain hazard or property insurance to cover all buildings and other improvements that now are, or in the future will be, located on the Property. The insurance will cover loss or damage caused by fire . . . and any other hazards for which Lender requires coverage, including, but not limited to earthquakes and floods. . . . All of the insurance policies and renewals of those policies will include what is known as a “Standard Mortgage Clause” to protect Lender and will name Lender as mortgagee and/or as an additional loss payee.”).

12. U.S. DEP'T OF HOUSING, *supra* note 7, at Table 3-15.

even in the absence of an explicit clause in the mortgage documentation, the legal duty of a mortgagee to have insurance often exists independently.¹³

On average, in the United States 30,000 owner-occupied homes are lost annually to some sort of disaster. In 2007, 41,000 homeowners of owner-occupied units reported that they moved from their home because of a “[d]isaster loss (fire, flood, etc.).”¹⁴ In 2005, it was 22,000.¹⁵ In 2003, it was 34,000.¹⁶ In 2001, it was 22,000.¹⁷

Putting these figures together—two-thirds of owner occupied homes have at least one mortgage, and 30,000 homes annually have a disaster loss—it appears that each year roughly 20,000 mortgaged, owner-occupied homes are lost to disaster. Virtually all, if not all, of these homes will carry property insurance. Of these 20,000 homeowners, the vast majority will need their insurance proceeds if they are to rebuild. In 2007, the median value of an owner-occupied home was \$191,471.¹⁸ The median household income in an owner-occupied home was \$59,886.¹⁹ In other words, there is no reason to expect that the “median” or typical homeowner has the independent wherewithal to rebuild his or her home without the insurance proceeds. One suspects that if the homeowner did have that wherewithal, he or she might not have a mortgage.

13. RAYMOND R. KOENDERS, Annotation, *Duty of Mortgagee of Real Property With Respect to Obtaining or Maintenance of Fire or Other Casualty Insurance Protecting Mortgagor*, 42 A.L.R. 4th 188 (1985 and 2009 Supp.). Of course, one can voluntarily decide to purchase insurance even if there is no duty to do so (as renters often do). In the absence of a mortgage, however, the issues addressed in this article do not arise.

14. U.S. DEP’T OF HOUSING, *supra* note 7, at Table 3-11.

15. U.S. DEP’T OF HOUSING AND URBAN DEV. & U.S. DEP’T OF COMMERCE, AMERICAN HOUSING SURVEY FOR THE UNITED STATES: 2005, at Table 3-11 (2006).

16. U.S. DEP’T OF HOUSING AND URBAN DEV. & U.S. DEP’T OF COMMERCE, AMERICAN HOUSING SURVEY FOR THE UNITED STATES: 2003, at Table 3-11 (2004).

17. U.S. DEP’T OF HOUSING AND URBAN DEV. & U.S. DEP’T OF COMMERCE, AMERICAN HOUSING SURVEY FOR THE UNITED STATES: 2001, at Table 3-11 (2002).

18. U.S. DEP’T OF HOUSING, *supra* note 7, at Table 1. The separately published information of the U.S. Census Bureau puts the figure slightly higher, at \$194,300. U.S. CENSUS BUREAU, 2007 AMERICAN COMMUNITY SURVEY, at Table B25075, reproduced in the Statistical Abstract of the United States, Table 961, “Owner-Occupied Housing Units—Value and Costs by State: 2007,” available at <http://www.census.gov/compendia/statab/2010/tables/10s0961.pdf>.

19. U.S. DEP’T OF HOUSING, *supra* note 7, at Table 3-12.

For most of these homeowners, a storm cloud is on the horizon with their bank, because the bank will have an incentive to want the insurance money to be used to pay off the loan. In 2004, the annual review of Marshall & Swift/Boeckh—the company that manufactures the software insurers commonly use to calculate adequate insurance coverage—reported that two-thirds of all homes in the United States were underinsured by an average of 27%.²⁰ In the same time frame, other industry experts put the average degree (not frequency) of underinsurance at 30% - 40%.²¹ In 2007, Marshall & Swift/Boeckh put the figures at 58% of homes underinsured, and by an average of 21%.²² In 2007, the median outstanding principal on mortgages of owner-occupied homes was \$100,904.²³ So, if on average, homes are roughly 20% underinsured, homes are, on average, in a 47% equity position. Or put another way, an average home has \$38,000 less insurance coverage than the value of the home (which almost certainly is lower still than the cost to rebuild the home), but \$52,000 more insurance than the amount of outstanding principal owed on the mortgage.²⁴ For this reason, the new home may not be the equivalent in size or quality of the home that has been lost (so rebuilding will result in lesser-value loan collateral), and yet the insurance proceeds will exceed the balance of the equity owed on the loan (so there is enough money to pay off the loan).

The numbers will be even starker in some of the communities most prone to natural disaster. California, Texas, New York, and Florida are the four most populous states in the nation.²⁵ California,

20. Liz Pullam Weston, *The Basics: Why 2 out of 3 Homes are Underinsured*, MSN MONEY, Apr. 21, 2004, http://moneycentral.msn.com/content/Insurance/Insure_yourhome/P35340.asp; Joseph B. Treaster, *Homeowners Come Up Short On Insurance*, N.Y. TIMES, Aug 31, 2004, at A1; Rome Neal, *Millions of Homes Under-Insured*, CBS NEWS, Sept. 15, 2004, <http://www.cbsnews.com/stories/2004/09/14/earlyshow/contributors/raymartin/main643465.shtml>.

21. Treaster, *supra* note 20; Kathy Chu & Elizabeth Weise, *Wildfires Spotlight Insurance Coverage Issues*, USA TODAY, Nov. 1, 2007, at B1.

22. Chu & Weise, *supra* note 21.

23. U.S. DEP'T OF HOUSING, *supra* note 7.

24. Additional insurance proceeds likely would flow for loss of personal property, landscaping, "other structures" such as garages and driveways, alternative living expenses, and building code upgrades. All told, this might double the total amount of insurance checks.

25. U.S. CENSUS BUREAU, CURRENT POPULATION REPORTS, P25-1106,

Texas, New York, and Florida are also four of the five states experiencing the most Federal Emergency Management Agency (FEMA)-declared natural disasters.²⁶ In 2007 in California, the median home value was \$532,300;²⁷ in 2007 in New York, the median home value was \$311,000;²⁸ in 2007 in Texas the median home value was \$120,900;²⁹ and in 2007 in Florida, the median home value was \$230,400.³⁰

Especially in these states, if the bank is allowed to require that pending rebuild, the insurance proceeds must be kept on deposit with the bank, then this often would equate to the funds being at risk in the event of bank failure. Historically, the Federal Deposit Insurance Corporation (FDIC) insured deposits up to \$100,000.³¹ This is materially less than what homeowners would expect to be the typical amount of insurance proceeds on deposit with the bank. In response to the economic conditions of late 2008 and early 2009, the FDIC insurance limits were temporarily increased to \$250,000, through December 31, 2013.³² Even with these increased limits, many insurance proceeds balances will be in excess of these limits (this was true of most of the people I counseled in the wake of California wildfires). In 2009, 140 banks failed.³³

reproduced in "State Population—Rank, Percentage Change, and Population Density: 1980–2008, Table 13, *available at* <http://www.census.gov/compendia/statab/2010/tables/10s0013.xls>.

26. FEMA, "Declared Disasters by Year or State," http://www.fema.gov/news/disaster_totals_annual.fema (last visited Jan. 28, 2010). The third is Oklahoma. *Id.*

27. U.S. CENSUS BUREAU, Table B25075, *supra* note 18.

28. *Id.*

29. *Id.*

30. *Id.*

31. 12 U.S.C. § 1821(a)(1)(E) (2009).

32. *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 2008 H.R. 1425, 122 Stat. 3765; Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1632.

33. FEDERAL DEPOSIT INSURANCE CORPORATION, FEDERAL DEPOSIT INSURANCE CORPORATION FAILURES AND ASSISTANCE TRANSACTIONS, Table BF02, <http://www2.fdic.gov/hsob/HSOBSummaryRpt.asp?BegYear=2010&EndYear=200.0&State=1> (last visited Jan. 27, 2010).

III. THE CURRENT LEGAL LANDSCAPE ADDRESSING THE RIGHTS AND OBLIGATIONS OF BANKS AND HOMEOWNERS IN INSURANCE PROCEEDS

As anyone who has ever bought a house knows, it is a highly documented transaction. For this reason, in sorting out the legal landscape of the issues this article addresses, one must start with the documents. Surely, the answers lie, at least in part, somewhere in the documents.³⁴

This is not as daunting a task as it might first appear, because one consequence of the modern emergence of a robust secondary market in mortgages is a largely uniform set of documents. These documents then are supplemented by decisional law at both the federal and state levels. So an understanding of the extant legal landscape focuses on three aspects: the intentions of the standard documents as reflected in the effort to create them, the resulting actual content of the relevant clauses of the contemporary standard documents, and the additional law emerging from the legislatures and courts. For the reasons alluded to above, particular attention should be given to California, Texas, New York, and Florida.

A. *The History That Informs the Intention of Contemporary Standard Loan Documents*

The history of the modern-day Deed of Trust is well documented and largely forgotten. It is inextricably intertwined in the development of a national secondary mortgage market.

Prior to 1935, there was no national mortgage market.³⁵ In 1935 Congress created the Federal Housing Authority (FHA), but initially that did not lead to any significant movement toward standardized mortgage documentation.³⁶ Then, in 1970, Congress created the Federal National Mortgage Association (FNMA, which today is

34. One is reminded of the joke about an adult who happens upon a child digging in an enormous pile of horse manure, and asks the child what the child is doing. The child explains, "With all this horse manure, there must be a pony in here somewhere."

35. See Raymond A. Jensen, *Mortgage Standardization: History of Interaction of Economics, Consumerism and Governmental Pressure*, 7 REAL PROP. PROB. & TR. J. 397, 398 (1972).

36. See *id.*

popularly nicknamed Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC, which today is popularly nicknamed Freddie Mac).³⁷ The purpose of these entities was to “establish a secondary market for conventional mortgages, primarily single family homes.”³⁸ “[T]he policy decision was made by the two corporations that the first order of business must be the development of a standard mortgage form.”³⁹

FNMA formed a task force to draft the proposed standard documentation.⁴⁰ In drafting the standard mortgage and trust deed forms, clauses were grouped into “uniform covenants” and intended to be applicable in every state.⁴¹ Included in the “uniform covenants” is the verbiage this article is concerned with, Covenant 5, entitled “Hazard Insurance.”⁴²

The proposals of the task force met with surprising opposition.⁴³ Eventually, the proposals went to public hearing before the United States Senate.⁴⁴ One of the members of the task force⁴⁵ describes the impact of these hearings on Covenant 5:

Hazard insurance. The evolution of this provision from the original exposure draft to the final product is a good example of compromise and legal changes The original draft required the hazard insurance to be issued by a carrier satisfactory to the lender and in such amounts and for such periods as the lender might require. This clause was continued in the February 1971 draft, but the final form qualified these requirements to the extent that the lender may not require the amount of coverage to exceed that necessary to pay the sums secured by the mortgage.

....

The earliest draft provided that the insurance carrier was authorized

37. Emergency Home Finance Act of 1970, 12 U.S.C. §§ 1713, 1717 (1970).

38. Jensen, *supra* note 35, at 399.

39. *Id.*

40. *Id.* at 400.

41. *Id.*

42. *Id.* at 403, 412.

43. *Id.* at 402-03.

44. *Id.*; see also S. COMM. ON BANKING, HOUS. AND URBAN AFFAIRS, *Federal National Mortgage Association Public Meeting on Conventional Mortgage Forms*, S. DOC. NO. 92-21 (1971).

45. Jensen, *supra* note 35, at 400 n.7.

and directed to make payment for the loss directly to lender instead of to the borrower and lender jointly. This provision did not appear in the February 1971 draft nor in the final form.

With respect to the application of the insurance proceeds, the November 1970 draft provided for the lender to adjust and compromise the loss and to apply the proceeds or any part thereof at its option to the restoration of the damaged property or to reducing the loan. This provision . . . was very substantially modified in the final draft to provide that unless the lender and the borrower otherwise agree in writing the insurance proceeds must be applied to repair the property provided the repair proves to be “economically feasible.”⁴⁶

As this history reflects, the task force was imperfect in predicting all of the issues that would arise regarding hazard insurance. Further, as to the issues the task force did anticipate, despite the initial optimism,⁴⁷ FNMA and FHLMC did not agree in all particulars to precisely the same forms, although as to Covenant 5 they were in either total agreement or the differences were “insignificant.”⁴⁸ And indeed, as seen in the next section, today FNMA and FHLMC do share a uniform set of standard security instruments.

B. The Verbiage of the (Largely, but Not Entirely) Standard Loan Documents on the Six Questions Pertinent to this Article

The task force achieved its goal of nationwide, uniform covenants in security instruments.⁴⁹ FNMA and FHLMC standard security

46. *Id.* at 412-13. The various comments made to the Senate regarding who should control the application of insurance proceeds can be found at: S. COMM. ON BANKING, HOUS. AND URBAN AFFAIRS, *Federal National Mortgage Association Public Meeting on Conventional Mortgage Forms*, S. DOC. NO. 92-21, at 35, 92-94, 113, 122, 156, 166, 199, 232, 237 & 288 (1971).

47. “Senator Proxmire: . . . These standard forms . . . undoubtedly will become the standard mortgage form used by all mortgage lenders throughout the country.” S. COMM. ON BANKING, HOUS. AND URBAN AFFAIRS, *Federal National Mortgage Association Public Meeting on Conventional Mortgage Forms*, S. DOC. NO. 92-21, at 30 (1971).

48. Jensen, *supra* note 35, at 415-17.

49. 2 GRANT NELSON & DALE WHITMAN, *REAL ESTATE FINANCE LAW* § 14.3 (4th ed. 2002).

documents are available on the FNMA and FHLMC websites.⁵⁰ Because of variations in the content other than the set of uniform covenants, each jurisdiction has its own “standard” document. Within the covenant that addresses the subjects of this article— Covenant 5— there are only slight (albeit occasionally arguably substantive) variations among the standard security instruments of the fifty states (as well as the District of Columbia, the Virgin Islands, Puerto Rico, and Guam).⁵¹

The resulting verbiage is instructive on five of the questions this article analyzes. The documents are silent regarding what happens to insurance proceeds held by the bank in the event of bank insolvency.

1. The Verbiage of Standard Security Documents Addressing Whether the Bank Has Rights in All Insurance Proceeds, Just the Proceeds Relating to the Insured Structure, or Something In-between.

The standard documents provide that while the homeowner *must* protect the bank (make the bank a co-insured) on improvements to the property (the house and other fixed physical structures appurtenant to the property), to the extent the homeowner purchases broader insurance coverages (such as coverage for personal property), the bank should be a co-insured under those coverages as well.

The pertinent portions of the FNMA standard form security instruments⁵² for forty-eight states (including California, Texas and Florida), the District of Columbia, Guam, and the Virgin Islands reads as follows:

5. Property Insurance. Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss by

50. For all fifty states, the District of Columbia, Puerto Rico, and the Virgin Islands, the documents can be found at eFannieMae.com, *supra* note 5. Each of these forms explicitly states that it is both a FNMA and FHLMA document. For Guam, the same is true but the form is on the FHLMC website, and can be found at Freddiemac.com, *supra* note 5.

51. eFannieMae.com, Standard Form Security Instruments, *supra* note 5. For Guam, see Freddiemac.com, Standard Form Security Instruments, *supra* note 5.

52. eFannieMae.com, *supra* note 5. For an example of an internal link to any one of these forms in particular, see eFannieMae.com, California Security Instrument Form 3005, *supra* note 11. For Guam, see Freddiemac.com, *supra* note 5.

fire, . . . and any other hazards including, but not limited to, earthquakes and floods, for which Lender requires insurance.

....

. . . If Borrower obtains any form of insurance coverage, not otherwise required by Lender, for damage to, or destruction of, the Property, such policy shall include a standard mortgage clause and shall name Lender as mortgagee and/or as an additional loss payee⁵³

The FNMA standard documentation for New York, while worded slightly differently, is identical in content:

5. Borrower's Obligation to Maintain Hazard Insurance or Property Insurance. I will obtain hazard or property insurance to cover all buildings and other improvements that now are, or in the future will be, located on the Property. The insurance will cover loss or damage caused by fire, . . . and any other hazards for which Lender requires coverage, including, but not limited to earthquakes and floods.

....

. . . If I obtain any form of insurance coverage, not otherwise required by Lender, for damage to, or destruction of, the Property, such policy will include a Standard Mortgage Clause and shall name Lender as mortgagee and/or as an additional loss payee⁵⁴

Maine and Puerto Rico also have slightly unique, but inconsequentially different, verbiage.⁵⁵

2. The Verbiage of Standard Security Documents Addressing the Extent to Which the Bank Has Rights in Funds in Excess of the Outstanding Principal Balance of the Mortgage.

53. eFannieMae.com, California Security Instrument Form 3005, *supra* note 11.

54. eFannieMae.com, New York Security Instrument Form 3033, *supra* note 5.

55. eFannieMae.com, Maine Security Instrument Form 3020, <https://www.efanniemae.com/sf/formsdocs/documents/secinstruments> (follow "3020" hyperlink) (last visited Jan. 26, 2010); eFannieMae.com, Puerto Rico Security Instrument Form 3053, <https://www.efanniemae.com/sf/formsdocs/documents/secinstruments> (follow "3053" hyperlink) (last visited Jan. 26, 2010).

Here, the documents create mischief because the drafters only anticipated one of two issues, and the documents addressed the anticipated issue imperfectly. The plain intention of the Senate and the task force was to prohibit the bank from requiring more insurance than the amount of the loan. The standard documents are ambiguous in expressing this intention because they make no mention of the loan amount in describing the obligation to meet the lender's requirements for insurance.

Apparently the task force and the Senate did not anticipate the issue of the insurance proceeds exceeding the amount of outstanding principal on the loan. The California documents, however, do address the *obligation* of the homeowner to give the bank control of insurance proceeds in excess of the outstanding balance of the loan. The other jurisdictions are silent in this regard. Thus, the documents of all jurisdictions other than California suggest that the homeowner has the obligation to deposit the insurance proceeds with the bank, and the bank has the right to hold *all* proceeds.

The pertinent portions of the FNMA standard form California Deed of Trust reads as follows:

5. Property Insurance. . . . This insurance shall be maintained in the amounts (including deductible levels) and for the periods that Lender requires.

. . . .

All insurance policies required by Lender and renewals of such policies . . . shall include a standard mortgage clause, and shall name Lender as mortgagee and/or as an additional loss payee and Borrower further agrees to generally assign rights to insurance proceeds to the holder of the Note up to the amount of the outstanding loan balance. . . .

. . . During such repair and restoration period, Lender shall have the right to hold such insurance proceeds⁵⁶

Forty-seven other states (including Florida and Texas), as well as the District of Columbia, Guam, Puerto Rico, and the Virgin Islands have standard documents reading:

56. eFannieMae.com, California Security Instrument Form 3005, *supra* note 11.

5. Property Insurance. . . . This insurance shall be maintained in the amounts (including deductible levels) and for the periods that Lender requires

. . . .

All insurance policies required by Lender and renewals of such policies . . . shall include a standard mortgage clause, and shall name Lender as mortgagee and/or as an additional loss payee

During such repair and restoration period, Lender shall have the right to hold such insurance proceeds⁵⁷

The FNMA standard documents for New York again (and always) reads differently, but not in consequential ways:

5. Borrower's Obligation to Maintain Hazard Insurance or Property Insurance. . . . The insurance will be in the amounts (including, but not limited to, deductible levels) and for the periods of time required by Lender.

. . . .

. . . During the period that any repairs or restorations are being made, Lender may hold any Insurance Proceeds until it has had an opportunity to inspect the Property to verify that the repair work has been completed to Lender's satisfaction.⁵⁸

This is true of Maine as well.⁵⁹

3. *The Verbiage of Standard Security Documents Addressing the Choice Between Rebuilding or Paying Down the Loan.*

Here, the documents do a better job of reflecting the intention of the task force—if it is feasible to rebuild, the homeowner must rebuild.

The pertinent portions of the FNMA standard form California Deed of Trust is identical to that of forty-seven other states (including Texas and Florida), the District of Columbia, Guam, Puerto Rico, and the Virgin Islands and reads as follows:

57. eFannieMae.com, Standard Form Security Instruments, *supra* note 5; FreddieMac.com, Standard Form Security Instruments, *supra* note 5.

58. eFannieMae.com, New York Security Instrument Form 3033, *supra* note 5.

59. eFannieMae.com, Maine Security Instrument Form 3020, *supra* note 55.

5. Property Insurance.

....

... In the event of loss Unless Lender and Borrower otherwise agree in writing, any insurance proceeds, whether or not the underlying insurance was required by Lender, shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender's security is not lessened.⁶⁰

The FNMA standard documentation for New York, while worded slightly differently, is identical in content:

5. Borrower's Obligation to Maintain Hazard Insurance or Property Insurance.

....

... Unless Lender and I otherwise agree in writing, any Insurance Proceeds, whether or not the underlying insurance was required by Lender, will be used to repair or to restore the damaged Property unless: (a) it is not economically feasible to make the repairs or restoration; (b) the use of the Insurance Proceeds for that purpose would lessen the protection given to Lender by this Security Instrument; or (c) Lender and I have agreed in writing not to use the Insurance Proceeds for that purpose.⁶¹

This is true of Maine as well.⁶²

4. *The Verbiage of Standard Security Documents Addressing Whether During the Time the Bank Holds Money, Does it Accumulate Interest.*

Again, here the documents are clear—if state law requires the payment of interest, then interest is owed; otherwise, interest is not owed. The pertinent portions of the FNMA standard form California Deed of Trust, as well as forty-seven other states (including Texas and Florida), the District of Columbia, Guam, and the Virgin Islands first define the term “Applicable Law” and then use that term to address the right to interest:

60. eFannieMae.com, Standard Form Security Instruments, *supra* note 5; FreddieMac.com, Standard Form Security Instruments, *supra* note 5.

61. eFannieMae.com, New York Security Instrument Form 3033, *supra* note 5.

62. eFannieMae.com, Maine Security Instrument Form 3020, *supra* note 55.

(H) “Applicable Law” means all controlling applicable federal, state and local statutes, regulations, ordinances and administrative rules and orders (that have the effect of law) as well as all applicable final, non-appealable judicial opinions.

....

5. Property Insurance.

....

... Unless an agreement is made in writing or Applicable Law requires interest to be paid on such insurance proceeds, Lender shall not be required to pay Borrower any interest or earnings on such proceeds.⁶³

Yet again, the FNMA standard documents for New York, while worded slightly differently, are identical in content:

(I) “Applicable Law.” All controlling applicable federal, state and local statutes, regulations, ordinances and administrative rules and orders (that have the effect of law) as well as all applicable final, non-appealable, judicial opinions will be called “Applicable Law.”

....

5. Borrower’s Obligation to Maintain Hazard Insurance or Property Insurance.

....

... Unless Lender and I agree otherwise in writing or unless Applicable Law requires otherwise, Lender is not required to pay me any interest or earnings on the Insurance Proceeds.⁶⁴

The same is true of Maine and Puerto Rico.⁶⁵

5. The Verbiage of Standard Security Documents Addressing at What Interim Junctures, if any, the Bank Must Partially Release Funds.

The standard documents purport to give the bank the discretion to do whatever it wants to do with regard to holding all of the money until the end, or parsing it out in progress payments. The pertinent

63. eFannieMae.com, Standard Form Security Instruments, *supra* note 5; FreddieMac.com, Standard Form Security Instruments, *supra* note 5.

64. eFannieMae.com, New York Security Instrument Form 3033, *supra* note 5.

65. eFannieMae.com, Maine Security Instrument Form 3020, *supra* note 55; eFannieMae.com, Puerto Rico Security Instrument Form 3053, *supra* note 55.

portions of the FNMA standard form California Deed of Trust, as well as forty-seven other states (including Florida and Texas), the District of Columbia, Guam, the Virgin Islands, and Puerto Rico, reads as follows:

5. Property Insurance.

.....

... During such repair and restoration period, Lender shall have the right to hold such insurance proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender's satisfaction, provided that such inspection shall be undertaken promptly. Lender may disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed.⁶⁶

And again, the FNMA standard documentation for New York, while worded slightly differently, is identical in content:

5. Borrower's Obligation to Maintain Hazard Insurance or Property Insurance.

.....

... During the period that any repairs or restorations are being made, Lender may hold any Insurance Proceeds until it has had an opportunity to inspect the Property to verify that the repair work has been completed to Lender's satisfaction. However, this inspection will be done promptly. Lender may make payments for the repairs and restorations in a single payment or in a series of progress payments as the work is completed.⁶⁷

As usual, this is true of Maine as well.⁶⁸

C. The Statutes and/or Case Law (Such As It Is) on the Questions Pertinent to this Article

As shown above, the language of the security instruments is not

66. eFannieMae.com, *supra* note 5; FreddieMac.com, *supra* note 5.

67. eFannieMae.com, New York Security Instrument Form 3033, *supra* note 5.

68. eFannieMae.com, Maine Security Instrument Form 3020, *supra* note 55.

entirely comprehensive or satisfactory in answering the questions framed by this article. There is some additional (although disappointingly limited) guidance from statutes and case law on most of the questions.

1. *To the extent the bank has rights in funds, if the balance of those funds exceeds the current outstanding principal balance of the mortgage, do the bank's rights extend to the overage?*

Only California has standard documents that remotely suggest that the bank cannot initially hold and control all of the insurance proceeds, even in excess of the outstanding loan principal. But, as seen in the California standard documents, the verbiage is far from clear. Rather than being phrased in terms of what the bank can do, the California documents reference amounts in excess of principal with regard to what the *homeowner* must do. The homeowner must have insurance only up to the outstanding principal of the loan.

This language makes peculiar sense in light of California law. California is an anti-deficiency state—a mortgage lender of purchase money can *only* look to the property as collateral.⁶⁹ Thus, to require the homeowner to provide the lender, in the happenstance of a total loss, *more* collateral than if the house never was lost makes little sense. But the same reasoning, of course, supports the inference that the bank cannot hold money in excess of the balance, because that too is an event of over collateralization to which the bank has no right.

New Mexico has the opposite legal position – New Mexico has a state statute that seems to *require* all insurance proceeds to be deposited with the bank:

Where there is a mortgage of a single family residence securing a loan and where there are no federal regulations to the contrary, the mortgagor may require the proceeds of any insurance policy, which are payable by reason of damage to or destruction of the mortgaged property and which would otherwise be payable to the mortgagee, to be held jointly by the mortgagor and the mortgagee in an escrow account and to be applied toward the repair or replacement of the

69. CAL. CODE. CIV. PROC. § 580(b) (2010).

damaged property.⁷⁰

Is there an option whether to rebuild or repay, and if so, does the bank or the homeowner hold the option?

While the language of the security instruments would suggest that there is no rebuild/repay option – the homeowner has the obligation to rebuild unless the bank agrees otherwise⁷¹ – the case law on the point is not as clear. One view is that giving the homeowner either the obligation, or sole option, to rebuild, essentially forces the bank into the position of a construction lender exposed to un-bargained for risk.⁷² The contrary view is that there is an option to rebuild and the homeowner holds it because so long as the rebuilt structure is of adequate value as collateral, the implied covenant of good faith and fair dealing requires that the bank allow the homeowner to rebuild, if that was what the homeowner wished for.⁷³ As one scholar summarized, while the former was the majority view, the later was the position of the Restatement (Third) of Property and the likely wave of the future.⁷⁴

3. To the extent the money is being used to fund a rebuild, at what interim junctures, if any, must the bank partially release funds?

Again, the security instruments would seem clear here—the bank can fund control the insurance proceeds as the bank deems fit—but the implied covenant of good faith and fair dealing must be accounted for. One could posit an argument that because the security instruments require the homeowner to rebuild, if the bank impaired the rebuild by not releasing any funds until completion of construction then the bank would be forcing the homeowner into breach, and thereby be

70. N.M. STAT. § 48-7-10 (1978).

71. Of course, if the loan is one that allows early pay off, then by exercising this right the homeowner still holds a rebuild/repay option. What disappears is the option to partially repay the loan, because it can impair the ability to rebuild.

72. *General G.M.C. Sales, Inc. v. Passarella*, 481 A.2d 307, 312-13 (N.J. Super. 1984).

73. *Schoolcraft v. Ross*, 81 Cal. App. 3d 75, 80-82 (1978).

74. Patrick A. Randolph, Jr., *A Mortgagee's Interest in Casualty Loss Proceeds: Evolving Rules and Risks*, 32 REAL PROP. PROB. & TR. J. 1, 4, 8 (1997) (discussing Restatement (Third) of Property: Security (Mortgages) § 4.7(b) and cmt. d (1997)).

breaching the implied covenant. But even in California – the most aggressive jurisdiction in applying the implied covenant into real estate transactions—sections 1227.3 and 7462 of the California Finance Code, as well as section 2924.7(b) of the California Civil Code, permit the lender to control the disbursement of funds.⁷⁵ In other jurisdictions, most notably Texas, the implied covenant generally is not recognized in deeds of trust.⁷⁶

4. Are there Jurisdictions Where “Applicable Law” Requires the Payment of Interest?

A handful of states have statutes requiring the payment of interest on escrow and/or similar accounts. California’s law requires payment of interest on any funds held by the bank for “purposes relating to the property,” and so would include insurance proceeds held by the bank:

Every financial institution that makes loans upon the security of real property containing only a one- to four-family residence and located in this state or purchases obligations secured by such property and that receives money in advance for payment of taxes and assessments on the property, for insurance, or for other purposes relating to the property, shall pay interest on the amount so held to the borrower. The interest on such amounts shall be at the rate of at least 2 percent simple interest per annum.⁷⁷

States with very similar laws are Maryland,⁷⁸ Oregon,⁷⁹ Utah,⁸⁰ and Vermont.⁸¹

Connecticut law, by contrast, imposes the obligation to pay interest on escrows for the payment of “taxes or insurance premiums,” and so implicitly would require interest on escrows of insurance proceeds held by the bank:

75. 3 HARRY D. MILLER, MILLER & STARR CALIFORNIA REAL ESTATE 3D, “Deeds of Trust” § 10:61 n.11 (West 2000).

76. See *Lovell v. W. Nat. Life Ins. Co.*, 754 S.W.2d 298, 302-03 (Tex. App. 1988).

77. CAL. CIV. CODE § 2954.8(a) (2010).

78. MD. CODE, COM. LAW § 12-109 (2009).

79. OR. REV. STAT. §§ 86-205.3, 86-245 (2009).

80. UTAH CODE § 7-17-2 (2009).

81. VT. STAT. tit. 8, § 10404(b) (2009).

[E]ach state bank and trust company, national banking association, state or federally chartered savings and loan association, savings bank, insurance company and other mortgagee or mortgage servicing company holding funds of a mortgagor in escrow for the payment of taxes and insurance premiums with respect to mortgaged property located in this state shall pay interest on such funds⁸²

Other states with statutes providing for interest on escrowed funds, but written in language-specific escrows for taxes and/or insurance premiums, are Kentucky,⁸³ Maine,⁸⁴ Massachusetts,⁸⁵ Minnesota,⁸⁶ New Hampshire,⁸⁷ and Rhode Island.⁸⁸

Ironically, the District of Columbia and four states—Nebraska, New Mexico, Virginia, and Arizona—which do not require payment of interest, use expansive language to define escrow accounts, much as California, Maryland, Oregon, Utah, and Vermont do.⁸⁹

Ohio stands alone as a state with a statute explicitly providing that moneys held in “special accounts” are *non-interest bearing*.⁹⁰

82. CONN. GEN. STAT. § 49-2(a) (2010).

83. KY. REV. STAT. § 286.8-130 (2009).

84. ME. REV. STAT. tit. 9-A, § 9-305 (2009).

85. MASS. GEN. LAWS ch. 183, § 61 (2010).

86. MINN. STAT. § 47.20(9) (2009).

87. N.H. REV. STAT. § 384:16-C (2010).

88. R.I. GEN. LAWS § 19-9-2 (2009).

89. NEB. REV. STAT. § 45-101.05(1) (2009) (“[A]ny escrow account which may be established in connection with such loan for the purpose of assuring payment of taxes, insurance premiums, or other charges with respect to the property, prior to or upon the date of settlement, an aggregate sum in excess of the total amount of such taxes, insurance premiums, and other charges”); N.M. STAT. § 48-7-8(A) (2009) (“A monthly charge may be held in escrow by a mortgagee for the payment of taxes, insurance premiums and other charges. . . .”); VA. CODE § 6.1-4.23 (2009) (“All moneys required by a mortgage lender required to be licensed under this chapter to be paid by borrowers in escrow to defray future taxes or insurance premiums, or for other lawful purposes”); ARIZ. REV. STAT. § 6-946(D) (2009) (“If periodic payments are to be collected from the mortgagor to provide for payments by the mortgagee of taxes, assessments, insurance premiums, ground rents or other current charges against the real estate security”); D.C. CODE § 26-1115(a) (2009) (“All moneys required by a mortgage lender to be paid by borrowers in escrow to defray future taxes or insurance premiums, or for other lawful purposes”).

90. OHIO ADMIN. CODE § 1301:8-7-05(A) (2009).

5. *What Happens if the Bank, While Holding the Funds, Becomes Insolvent?*

If a bank holding insurance funds becomes insolvent, it presents real risk and potentially crimped choices for the homeowner. After all, if the funds are at risk due to the insolvency, it also means that the funds are insured by the FDIC. Thus, the amounts at issue easily can exceed FDIC limits. When that occurs, the coverage is compromised.

The funds are within the FDIC definitions of deposits of the bank. Federal law defines the terminology “escrow accounts” to include insurance proceeds held by the bank:

(a) General. This section sets out the requirements for an escrow account that a lender establishes in connection with a federally related mortgage loan (b) Definitions. As used in this section: . . . Escrow account means any account that a servicer establishes or controls on behalf of a borrower to pay taxes, insurance premiums (including flood insurance), or other charges with respect to a federally related mortgage loan, including charges that the borrower and servicer have voluntarily agreed that the servicer should collect and pay.⁹¹

The Federal Deposit Insurance Act defines “deposits” to include “money received or held by a bank . . . in the usual course of business for a special or specific purpose, regardless of the legal relationship thereby established, including without being limited to, escrow funds, funds held as security for an obligation due to the bank”⁹² In response to an email inquiry from this author, the FDIC confirmed the FDIC’s position is that insurance proceeds held by a bank pursuant to Uniform Covenant 5 were considered to be within this definition.⁹³

There is, however, the possibility that the federal statutes and regulations do not control the day. The only reported contemporary discussion of this issue is *Merrill Lynch Mortgage Capital, Inc. v. Federal Deposit Insurance Corp.*⁹⁴ In *Merrill Lynch*, a depositor

91. 24 C.F.R. § 3500.17 (2007).

92. 12 U.S.C. § 1813(l)(3) (2009).

93. Email from StarsMail@FDIC.gov to Kenneth Klein (Aug. 4, 2008) (on file with author).

94. 293 F. Supp. 2d 98, 104-105 (D.D.C. 2003).

brought suit challenging the determination of the FDIC, as receiver of a defunct savings and loan institution, that the depositor's custodial account was a general deposit, subject to pro rata recovery, and not a special deposit, subject to full recovery before other creditors. The FDIC asserted that the import of 12 C.F.R. § 330.5(a)(1) and 12 C.F.R. § 557.13 was that the FDIC has preemptive power to determine the character of deposits, and that the determinations are entitled to judicial deference.⁹⁵ The District Court of the District of Columbia rejected this argument, and instead applied the general rule that "whether an account is a special deposit or not is a matter of state law."⁹⁶

Merrill Lynch certainly will not be the last time that FDIC tests its preemption theory. And, of course, the judiciary is only engaged in the instances where an FDIC determination is challenged.

A final word needs mention concerning the scenario of bank insolvency. A homeowner would have one alternative to recovering compromised balances as the funds to rebuild. Because the same institution holds the debt and the funds, if the homeowner opts to apply the funds to the debt, then the repayment of the debt is made as 100 cents on the dollar.⁹⁷

IV. WHAT IS REALLY HAPPENING

There is scant publicly available information on how banks behave in the wake of a total loss of a mortgaged property. To the extent I have been able to access publicly available information, I will support the assertions of this section of this article with citations. Much of what I know and can report, however, comes from the hundreds of individuals I have counseled who have lost their homes (as a result of various California wildfires, as well as from Hurricane Katrina), and the scores of resulting conversations I have had on their behalf with some of their banks. This information must be dealt with in the context in which it arose – it is purely anecdotal; it arose in

95. *Id.* at 104-105.

96. *Id.* at 104.

97. FDIC, "When a bank Fails – Facts for Depositors, Creditors, and Borrowers," <http://www.fdic.gov/consumers/banking/facts/borrowers.html> (last visited Feb. 8, 2010).

scores of unrecorded conversations; it cannot be supported by citation; and it suffers from the vagaries of human memory. On the other hand, it is a large data set. In this regard, one other aspect of the information I report anecdotally bears mention – as I wrote this article I emailed to the CEOs and General Counsel of the major banks asking them to address the issues of this article, for attribution. None of them responded.

Here is what happens when an insured, mortgaged home is lost to natural disaster: For most mortgages, the bank will handle the insurance drafts through a “Loss Draft” department. Several of the major national banks—Citi, Chase, Wells Fargo—work through the same website interface – <http://www.mylossdraft.com>. That website is owned and managed by Assurant, Inc.⁹⁸ Assurant, in turn, offers a variety of services to the mortgage industry, including providing creditor-placed or force-placed homeowners insurance,⁹⁹ offering “mylossdraft” as an internet platform,¹⁰⁰ and through contract actually serving as a bank’s Loss Draft Department.¹⁰¹ While Assurant declines to confirm for which banks it is just a computer platform and for which banks it is the outsourced Loss Draft Department, the point is plain—most banks do not do their own loss draft work.

Assurant reports that over the last several years, the handling of loss drafts has gone through major changes. Most loans end up being owned in whole or part through some government-owned entity or branch—FNMA, FHLMC, Government National Mortgage Association, the U.S. Department of Veterans Affairs, etc.¹⁰² Assurant perceives that each of these government entities ultimately has controlled policies for the handling of loss drafts, and historically has had relatively rigid guidelines.¹⁰³

I condition this description as “Assurant perceives” because

98. Telephone Interview with Ronald Wilson, Vice President, Accounting and Mgmt., Assurant, Inc. (Dec. 4, 2009).

99. Assurant, <http://www.assurant.com/inc/assurant/products/specialty-services.html> (last visited Dec. 3, 2009) (“Assurant Specialty Property is a leading provider of creditor-placed homeowners insurance . . .”).

100. Assurant, <http://assurantspecialtyproperty.com/LendingSols.html> (last visited Dec. 3, 2009).

101. Telephone Interview with Ronald Wilson, *supra* note 97.

102. *Id.*

103. *Id.*

different borrowers are given different policies by different banks. So either not all banks have followed the guidelines, or the guidelines have allowed for variation bank-by-bank. However, even in Assurant's perception, in recent years mass losses of homes in events such as Hurricane Katrina have been a poor fit with these rigid guidelines.¹⁰⁴ Assurant has found that it has been able, over time, to persuade the government to recognize that each loss is unique, and needs flexibility in response.¹⁰⁵ Assurant perceives, however, that it is not the ultimate arbiter of the treatment of a loss draft.¹⁰⁶ In the absence of rigid governmental guidelines, Assurant follows the directives of the bank.¹⁰⁷ In other words, despite the near uniformity of the provisions of the security documents, different homeowners are treated differently.

For two banks—Citi and Chase—policy decisions are accessible through www.mylossdraft.com. For the remainder of banks, one learns the banks' policies by losing one's home and having to negotiate with the bank. The nearly uniform experience of homeowners in these one-on-one interactions is that no matter what the actual policies of the bank are, no matter what the documents call for, and no matter what the law requires, nothing comes to the homeowner without a fight.

A. CONTROLLING ALL INSURANCE PROCEEDS, NOT JUST THE INSURANCE ON THE DWELLING

The mechanism for the addition of the bank as an insured under the insurance policy is the "Lenders Loss Payable Endorsement." The standard security instruments nationwide call for the bank to be, at minimum, an insured on any improvements (which means, the house), and additionally require that if the homeowner opts for insurance beyond just the house, the bank will be an additional insured there as well.

In theory, those provisions could be problematic. The typical

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

residential insurance policy has a variety of coverages, including coverage for the personal property in the house, the landscaping outside the house, and other structures on the property in addition to the house.

The Lender Loss Payable Endorsement is a rider to the entire policy, and does not parse between coverage. And that is in harmony with the security documents; it is exactly what they call for. But as a consequence, the bank becomes an additional insured, and has a claim to insurance proceeds for the loss of things such as personal property which almost certainly was not part of the collateral for the loan itself.

While this is a theoretical problem, in reality the problem almost never emerges. Usually, only the insurance checks issued for loss of the dwelling and for “other structures” are co-written to the bank. One might even argue that this unilateral decision by the insurer is too cramped to the bank. After all, surely the quality of the landscaping went into the home appraisal supporting the loan. Strikingly, while only some of the insurance checks are co-written and while that almost certainly is contrary to what the loan documents call for and what is the requirement of the Lenders Loss Payable Endorsement, I am not aware of any lender actually challenging or even questioning the decision.

In sum, what actually happens is that the checks which are co-written to the homeowner and the bank cannot be cashed without the endorsement signature of both. The bank will insist that the homeowner sign the checks first, and then send them to the bank. One could cogently read the security documents as calling for precisely this sequence. As a result, all of the funds distributed through the co-written checks are, in the first instance, held by the bank.

B. Controlling Money Over and Above the Amount Owed

The first real battle comes when the total of the checks that are co-written exceeds the principal balance owed on the mortgage. For Citi, according to its published policies, as to withholding amounts above outstanding principal, the mylossdraft website directs borrowers to “call us . . . for special instructions.”¹⁰⁸

108. My Loss Draft, <http://www.mylossdraft.com> (enter password cm001, click “Yes” and then click “Property Damage Claims That Exceed Your Principal Balance”) (last visited Dec. 3, 2009).

A call to the provided number requires asking the right questions, and getting past the initial response of “we handle it on a case-by-case basis.” But, one gets the eventual answer, with persistence, that Citi will remit to the borrower any insurance proceeds that exceed the outstanding principal of the loan.¹⁰⁹ It takes minimal effort to find homeowners who complain that these policies hindered their ability to rebuild.¹¹⁰

For Chase, the website makes a distinction between losses in FEMA-declared disasters, and all other total losses.¹¹¹ For non-FEMA-declared disasters, there is an explicit policy to only withhold amounts up to the outstanding principal.¹¹² For total losses in FEMA-declared disasters, the website is silent regarding withholding remittance of amounts above the outstanding principal.¹¹³

Chase was my bank when my house was destroyed. My personal experience, as well as that of several other homeowners on whose behalf I spoke to Chase, is that Chase always initially holds funds in excess of the outstanding loan balance, but that with sufficient haranguing, Chase always gives in on this issue.

None of the other banks have publicly available policies. In my experience, all banks initially hold all the money, but most eventually give in if pushed to remit the overage. Only one—Wells Fargo—ever refused. In the course of my negotiating with Wells on behalf of one of their borrowers, Wells read to me an internal policy memo asserting that its decision whether to hold amounts in excess of the principal balance was to be made on a case-by-case basis. For the homeowner in question, Wells refused to remit.

109. Telephone Interview with Rickey Gumby, Customer Service Specialist, CitiMortgage Prop. Damage (Dec. 7, 2009).

110. *See, e.g.*, Complaints Board, <http://www.complaintsboard.com/complaints/citimortgage-c133333.html> (last visited Dec. 3, 2009); Report: CitiMortgage, CitiMortgage Insurance Claims Department stealing my money, <http://www.ripoffreport.com/mortgage-companies/citimortgage/citimortgage-insurance-claims-qffa4.htm> (last visited Dec. 4, 2009).

111. My Loss Draft, <http://www.mylossdraft.com>, (enter password ch001) (last visited Dec. 3, 2009).

112. *Id.*

113. *Id.*

C. *Rebuilding or Repaying*

In regard to the Wells borrower I just referenced—she only got her money by paying off her loan. Wells, through its conduct, essentially forced the choice. But that is not the usual experience.

The bank plainly prefers the borrower to pay off the loan and will urge the borrower to do so. But the documents in this regard are unambiguous and banks defer to the homeowner's wishes (albeit, often grudgingly). If the homeowner wishes to rebuild, and insists on doing so, the bank will not fight the issue.¹¹⁴

D. *Paying Interest*

The payment of interest turns out to be the most contentious issue. Many states simply do not require the payment of interest. In those that do, the banks are almost always unaware of it. Some banks that are aware of it argue that because they are federal banks, federal law preempts state law requiring payment of interest.¹¹⁵ Getting interest never comes easily.

E. *Fund Control*

Making interim payments on the loan is another of the issues that theoretically can be, but apparently is not, an issue. Each bank I have encountered adopts what I call the "1/3, 1/3, 1/3" policy. Under this approach, when a homeowner has a signed construction contract and file-stamped (read: approved by the building department) plans, the bank releases one-third of the held funds. When the construction is roughly half done (which generally means the foundation is poured, the house is framed, and the roof is "loaded"), the bank releases the second one-third of the funds (after an inspection to confirm the progress). When a bank inspection confirms substantial completion of construction, the bank releases the balance of the funds.

114. Telephone Interview with Ronald Wilson, *supra* note 98.

115. *See, e.g.*, Van Der Touw v. Countrywide Home Loans, Inc., Case No. BC392189, filed in Superior Court of the State of California, County of Los Angeles, June 6, 2008; Lewis v. Washington Mutual, Inc., Case No. BC392467, filed in Superior Court of the State of California, County of Los Angeles, June 10, 2008.

The policies of Citi Mortgage, Inc., as described on mylossdraft.com, are that for total loss claims exceeding \$20,000, disbursements are made on a 1/3, 1/3, 1/3 basis.¹¹⁶

The policies of Chase Home Finance, Inc., as described on mylossdraft.com, are that for total losses exceeding \$30,000, in FEMA-declared disasters, proceeds will be distributed 1/3 upfront, the balance to reach one half upon 50% completion, and the other balance upon completion.¹¹⁷

For non-FEMA-declared disasters, the same progress payments schedule applies but to a lower threshold—\$20,000.¹¹⁸

As a general matter, this approach is not problematic. Contractors are familiar with fund control and progress payments, as well as with retention. So this payment approach approximates the normal construction experience.

The outlier case is Katrina. There, literally tens of thousands of homes needed rebuilding. A homeowner cannot even get a contractor to return a telephone call if there are thousands of customers clamoring for the contractor's services. In that environment, money talks. Having the full contract price in hand in advance was a decided advantage.

F. Bank Failure

We have yet to experience simultaneous events of natural disaster and bank insolvency. We came close in 2008 and 2009, when homeowners rebuilding from California wildfires were still in progress just as major home lenders such as Countrywide failed. But in each instance, a buyer for the financial institution emerged, and so FDIC insurance was not triggered. When it happens, however (and eventually it certainly will), it is going to be ugly.

V. WHAT WE CAN EXPECT; WHAT WE CAN REQUIRE

There simply is a disconnect between what the documents intended to say, what the documents do say, what the law requires, and what folks actually are doing. The result is a series of one-off

116. My Loss Draft, *supra* note 108.

117. My Loss Draft, *supra* note 111.

118. *Id.*

negotiations each year, uninformed by reference to, or even knowledge of, the course of any similar or prior negotiations, with each party left to rely on only their personal savvy and skill. When one of those parties is a homeowner traumatized by the recent loss of everything or most everything he or she ever owned, that is not a formula for success.

We can, and should, do better. With the exception of the bank insolvency issue, all of the questions framed in this article can be clarified by minor changes to the standard security instruments. Merely going through that effort will be sufficient to focus the attention of loss departments on what the law and documents require. And, of course, nothing in the current documents forbids banks from doing the right thing in the interim.

A. Should the Bank be an Additional Insured on More Than Improvements?

The documents on this issue are written poorly, and occasionally a problem results. The problem technically is not with the security documents, but with the insurance documents. The security documents state, “If Borrower obtains any form of insurance coverage, not otherwise required by Lender, for damage to, or destruction of, the Property, such policy . . . shall name Lender as mortgagee and/or as an additional loss payee,” but the term “Property” is defined as the land together with “all the improvements now or hereafter erected on the property, and all easements, appurtenances, and fixtures now or hereafter a part of the property.”¹¹⁹ In other words, the security documents actually do not require insurance on more than the land and the improvements.

The problem is with the insurance documents. The Lender Loss Payable Endorsement makes no distinctions among coverages. It requires “any” loss or damage paid under the policy to be paid to the lender.¹²⁰

So, it appears that the scope of the Lender’s Loss Payable Endorsement is greater than any party ever asked for or agreed to. Only because of the near-uniform behavior of insurance companies in

119. eFannieMae.com, Standard Form Security Instruments, *supra* note 5.

120. LENDER’S LOSS PAYABLE ENDORSEMENT, *supra* note 6.

ignoring this provision, and the near uniform tacit acquiescence of banks in not challenging it, does the issue rarely arise.

Bank behavior in this regard is generally good. But it seems this flows more from ignorance than from grace. In the few instances I have encountered where an insurer did issue loss drafts more in conformity with the endorsement, the bank tried to hold all of those proceeds.

We should not only expect, but require, better. A homeowner's sofa, dishes, or jewelry were never primary collateral for the mortgage. Neither should be the proceeds from the loss of those items of personal property. It should never arise. The Deed of Trust should make this clear.

*B. Should the Bank be Able to Hold Funds in
Excess of the Loan Balance?*

Here, the problem most assuredly is with the security documents. The standard security documents everywhere in the nation (other than California) are notably silent on the issue of the bank fund controlling funds in excess of the outstanding balance of the loan, but quite explicitly require that all insurance checks be deposited with the bank.

That language creates a mess. The intention of the documents was to prohibit the lender from requiring insurance coverage above the amount of the loan.¹²¹ To allow the bank to hold insurance proceeds in excess of the loan balance is to allow the bank both better and more collateral than even arguably is necessary to manage risk. In this scenario, the bank literally not only bears no risk, but is also over-collateralized.

On the other hand, the bank is not allowed to move against that collateral, but rather must allow the homeowner to rebuild. Already, the bank is in an exposed position because the homeowner is likely to have less insurance than the value of the home, and new construction typically carries a higher price tag than purchasing existing construction. So, for example, a \$200,000 home might have \$150,000 in insurance and cost \$300,000 to rebuild. If the outstanding balance of the loan is \$100,000 and that serves as a cap on the funds the bank can hold to ensure an adequate rebuild, then the likelihood of an

121. Jensen, *supra* note 35, at 412-13.

adequately collateralized loan, post-rebuild, is lessened. The intention of the drafters of the standard security documents was that “the insurance proceeds must be applied to repair the property provided the repair proves to be ‘economically feasible.’”¹²²

Simply put, the bank should not be allowed to over-collateralize based on the presumption that otherwise the homeowner might breach the contract. If the bank is 100% collateralized, the bank has no exposure in the event of breach. There is not even exposure from the possibility that the homeowner will not adequately rebuild, since the bank has the right to absolute fund control in order to protect its position.

In other words, the documents already manifest (imperfectly) a sensible approach. The homeowner must rebuild; the bank has no right to be over-collateralized; but the bank can protect itself by requiring initial deposit of the entire loan balance and by not releasing any of that collateral until inspections satisfy the bank that adequate construction is progressing to fully re-collateralize the loan with real property and improvements. To the extent the loan documents are not already clear in setting forth this regimen (and they are not), the documents need to be re-written.

C. Should There be an Option to Rebuild or Repay, and if So, Who Should Have it?

Here, the documents are clear. It is just the behavior of the banks that is not. While it is true that some banks insist on the right to force repayment, those banks simply are acting in contravention of what the documents say. There is no option, much less one held by the bank—homeowners are required to rebuild unless the homeowner wishes to repay, and the bank agrees.

D. Should Money Held by the Bank Accumulate Interest?

Again, here, it would appear the documents are clear, and yet the

122. *Id.* Various comments made to the Senate regarding who should control the application of insurance proceeds can be found at: S. COMM. ON BANKING, HOUS. AND URBAN AFFAIRS, *Federal National Mortgage Association Public Meeting on Conventional Mortgage Forms*, S. DOC. NO. 92-21, at 35, 92-94, 113, 122, 156, 166, 199, 232, 237, 288 (1971).

banks do not follow the documents. Banks try to argue federal preemption. It is a ridiculous argument. There is no federal banking law absolving banks from complying with the bank's contractual obligation to pay interest.¹²³

The only juncture necessary for reform here is the several states¹²⁴ that do not have "applicable law" requiring the payment of interest. Every state should require the payment of interest on insurance proceeds held by a bank pursuant to a requirement in the mortgage.

The standard business model for a bank is that it induces a customer to place money at the bank, and then the bank uses that money to generate profit for the bank through either lending or investment. Inducement is necessary because when the bank uses the customer's money to generate profit for the bank, it puts the customer's money at risk. This is the very risk that FDIC insurance seeks to ameliorate. In the wake of the Great Depression, customers required both FDIC insurance and other inducements before depositing their money with a bank. A bank that pays interest is doing so simply as one form of inducement to have the customer choose that bank.

In the wake of a disaster, however, the homeowner has no choice of bank. The customer is required to deposit insurance proceeds with whichever bank happens to hold the loan at that moment, regardless of how solvent that bank is, or how unstable that bank's investments are. Why should the bank be allowed then to use that customer's funds to try to generate profit for the bank (in other words, put the customer's money at risk) without compensating the involuntary customer for that risk? To allow such behavior turns the concept of moral hazard on its head.¹²⁵

There is no justification to allow the bank to get money interest-free and invest it for the bank's profit. This is double-dipping at the expense of others. If the money is available to the bank for profit, the

123. For a more extended discussion of the general topic of the intersection of federal banking regulation, state consumer protection, and preemption, see Elizabeth R. Schlitz, *Damning Watters: Channeling the Power of Federal Preemption of State Consumer Banking Laws*, 35 FLA. ST. U. L. REV. 893 (2008).

124. See *infra* Part II.C.4.

125. "Moral Hazard" is the concept that to lessen the consequences of bad behavior encourages that behavior. See Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 837, 838 (1996).

bank must pay for the privilege.

*E. Should the Bank Be Able to Hold All the Money
Until the Work is Done?*

The documents here need reform. To allow the bank to hold all of the proceeds until construction is complete is to defy reality. One of the hard lessons of Katrina is that when times are good in the construction industry, a contractor will not even answer a call from a homeowner who does not have money in hand.¹²⁶ The bank simply cannot be empowered to put the homeowner in involuntary breach of the homeowner's contractual obligation to rebuild the home.

F. What Should Happen to the Money if the Bank Fails?

This is another area calling out for statutory reform. This simultaneously is the least likely problem to arise, and the most troubling if it does. So far, as the FDIC proudly trumpets, "In the FDIC's 75-year history, no customer has ever lost a single penny of insured deposits."¹²⁷ One hundred and forty banks failed in 2009. Not one of them resulted in FDIC insurance payments; rather, a solvent buyer was found every time.

The dilemma is, what will happen if there ever is an outlier instance? As noted earlier, there is a unique feature to insurance proceeds on deposit—they are the only sort of deposit where the depositor has absolutely no input on the choice of bank, and no right to transfer the funds to a different bank.

This is a unique circumstance, and for this reason, FDIC regulations should be revised to fully insure, without limit, these deposits. Until that happens, however, the security documents can, and should be, revised at least to confirm the option to protect the homeowner by paying down the loan.

G. Getting Concrete—A Proposal For a Revised Trust Deed

Working off of the Florida standard uniform covenant, here, in pertinent part, is a redline of how standard security instruments should

126. Telephone Interview of Ronald Wilson, *supra* note 98.

127. FDIC, *supra* note 97.

read:

5. Property Insurance.

Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss by fire, hazards included within the term "extended coverage," and any other hazards including, but not limited to, earthquakes and floods, for which Lender requires insurance. This insurance shall be maintained in the amounts (including deductible levels) and for the periods that Lender requires. What Lender requires pursuant to the preceding sentences can change during the term of the Loan. In no event, however, may Lender require insurance in an amount in excess of the amount of the then outstanding principal balance of this Loan. The insurance carrier providing the insurance shall be chosen by Borrower subject to Lender's right to disapprove Borrower's choice, which right shall not be exercised unreasonably. Lender may require Borrower to pay, in connection with this Loan, either: (a) a one-time charge for flood zone determination, certification and tracking services; or (b) a one-time charge for flood zone determination and certification services and subsequent charges each time remappings or similar changes occur which reasonably might affect such determination or certification. Borrower shall also be responsible for the payment of any fees imposed by the Federal Emergency Management Agency in connection with the review of any flood zone determination resulting from an objection by Borrower.

If Borrower fails to maintain any of the coverages described above, Lender may obtain insurance coverage, at Lender's option and Borrower's expense. Lender is under no obligation to purchase any particular type or amount of coverage. Therefore, such coverage shall cover Lender, but might or might not protect Borrower, Borrower's equity in the Property, or the contents of the Property, against any risk, hazard or liability and might provide greater or lesser coverage than was previously in effect. Borrower acknowledges that the cost of the insurance coverage so obtained might significantly exceed the cost of insurance that Borrower could have obtained. Any amounts disbursed by Lender under this Section 5 shall become additional debt of Borrower secured by this Security Instrument. These amounts shall bear interest at the Note rate from the date of disbursement and shall be payable, with such interest, upon notice from Lender to Borrower requesting payment. All insurance policies required by Lender and renewals of such policies shall be subject to Lender's right to disapprove such

policies, shall include a standard mortgage clause, and shall name Lender as mortgagee and/or as an additional loss payee. Lender shall have the right to hold the policies and renewal certificates. If Lender requires, Borrower shall promptly give to Lender all receipts of paid premiums and renewal notices. If Borrower obtains any form of insurance coverage, not otherwise required by Lender, for damage to, or destruction of, the Property, such policy shall include a standard mortgage clause and shall name Lender as mortgagee and/or as an additional loss payee.

In the event of loss, Borrower shall give prompt notice to the insurance carrier and Lender. Lender may make proof of loss if not made promptly by Borrower. Unless Lender and Borrower otherwise agree in writing, any insurance proceeds paid for the loss of the Property, whether or not the underlying insurance was required by Lender, shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender's security is not lessened. In the event of the insolvency of the Lender, however, the Borrower shall have the unilateral option to apply any insurance proceeds to the repayment of the Note. During such repair and restoration period, Lender shall have the right to hold such insurance proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender's satisfaction, provided that such inspection shall be undertaken promptly. Lender shall not, however, have the right to hold such proceeds in excess of the then-outstanding amount of the principal of the loan; as to all proceeds in excess of the then-outstanding amount of the principal of the loan, Lender shall immediately remit the proceeds to Borrower. Lender may disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed, but in no event may Lender retain a greater percentage of proceeds than the percentage of progress towards repair or restoration as confirmed by the Lender's inspection. Unless an agreement is made in writing or Applicable Law requires interest to be paid on such insurance proceeds, Lender shall not be required to pay Borrower any interest or earnings on such proceeds, if proceeds are segregated by Lender in a non-interest bearing account. In all other instances, Lender shall pay interest at the rate of 2% simple interest per annum, to be disbursed with the final disbursement of the loan. Fees for public adjusters, or other third parties, retained by Borrower shall not be paid out of the insurance proceeds and shall be the sole obligation of Borrower. If the restoration or repair is not economically feasible or Lender's security would be lessened, the

insurance proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower. Such insurance proceeds shall be applied in the order provided for in Section 2.

If Borrower abandons the Property, Lender may file, negotiate and settle any available insurance claim and related matters. If Borrower does not respond within 30 days to a notice from Lender that the insurance carrier has offered to settle a claim, then Lender may negotiate and settle the claim. The 30-day period will begin when the notice is given. In either event, or if Lender acquires the Property under Section 22 or otherwise, Borrower hereby assigns to Lender (a) Borrower's rights to any insurance proceeds in an amount not to exceed the amounts unpaid under the Note or this Security Instrument, and (b) any other of Borrower's rights (other than the right to any refund of unearned premiums paid by Borrower) under all insurance policies covering the Property, insofar as such rights are applicable to the coverage of the Property. Lender may use the insurance proceeds either to repair or restore the Property or to pay amounts unpaid under the Note or this Security Instrument, whether or not then due.

These revisions are not radical. There is no harm to banks in the adoption of this approach. Many of the strongest arguments against this language are the very arguments that the task force rejected half a century ago. Most of this language simply clarifies what already arguably is the law. Clarity is good for everyone, and nothing prohibits the banks from doing all of this right now, even without document revision.

VI. CONCLUSION

It would be nice if homeowners, insurers, banks, and loss departments read their contracts and knew the law. Unfortunately, they do not. Until they do, the issues described in this article will continue to arise no matter what the documents say. But if we think about what the documents and laws say, and amend them to say the right thing, then one fine day the incidence of the problems herein described may diminish. That would be a fine day indeed.