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California Wildfires: Residential Mortgage Servicing and Property Insurance Proceeds

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The wildfires in California have had, and will continue to have, a devastating impact on Los Angeles area communities. As evacuation orders were lifted, and residents were allowed to return to their neighborhoods, impacted homeowners are beginning the process of how, and even whether, to rebuild. In making this determination, many homeowners will be impacted by the availability of property insurance proceeds and outstanding mortgage debt. Recently, National Mortgage News reported estimates of outstanding mortgage debt on single family homes impacted by the LA wildfire could total $11 billion.

This article discusses the complexity of the legal issues raised at the intersection of the standard deed of trust and property insurance highlighting the following:

- Insurance provisions of the standard Fannie Mae/Freddie Mac Deed of Trust
- The standard mortgage clause in homeowner property insurance policies
- How insurance proceeds are paid where the property is subject to a mortgage
- Application of insurance proceeds to the loan balance when repair is not "economically feasible" or will lessen or impair the Lender's security interest
- Interest on insurance proceeds
- Impact of insurance proceeds on loss mitigation options

Paragraph 5 of the standard Fannie Mae/Freddie Mac Deed of Trust in California contains provisions regarding property insurance. Section (a) of paragraph 5 requires the borrower to procure insurance in the types and amounts required by the Lender for the "improvements now existing or subsequently erected on" the secured property. Section (b) of paragraph 5 requires this property insurance to contain a "standard mortgage clause" that "must name Lender as mortgagee." The importance of the standard mortgage clause in a homeowner property insurance policy is that it creates, by operation of law, an independent or separate contract of insurance between the Lender and the insurer up to the amount of the secured debt. This separate contract requires the insurer to include the mortgagee identified on the policy as a payee on certain insurance proceeds checks and can expose the insurer to liability if it fails to do so.

The standard homeowner policy will typically provide coverage for the following categories of loss: the dwelling, other structures (such as a detached garage or pool house), additional living expenses (referred to as fair rental value under FAIR plan policies), and personal property. For insurance proceeds issued under the dwelling or other structures coverage, the mortgagee clause of the homeowner policy, and the language of the Deed of Trust, will require that the mortgagee be included as a payee. Pursuant to Paragraph 5(d) of the

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standard Deed of Trust, the Lender may hold insurance proceeds pending inspection of the property and disburse the proceeds to the borrower in a single payment or a series of payments as work progresses. If an insurer inadvertently includes a mortgagee as a payee on insurance proceeds checks for additional living expenses or personal property, however, the mortgagee should endorse the check and return it to the borrower. Funds for personal property or additional living expenses should not be held by the mortgagee.

Next, section (d) of paragraph 5 directs how certain insurance proceeds should be utilized. The Deed of Trust specifies that insurance proceeds "will be applied to restoration or repair of the Property, if Lender deems the restoration or repair to be economically feasible and determines that Lender's security will not be lessened by such restoration or repair." There is no guidance within the Deed of Trust and very limited case law interpreting the phrase "economically feasible" or discussing under what circumstances the "Lenders' security will not be lessened by such restoration or repair." California case law recognizes that whether the Lender's security will be lessened or impaired is subject to a duty of good faith and fair dealing.

If the Lender determines, subject to the duty of good faith and fair dealing, that repair or restoration is not economically feasible or the Lender's security is impaired or would be lessened, then the insurance proceeds "will be applied in the order that Partial Payments are applied in paragraph 2, section (b) as follows: interest and then to principal due under the Note, Escrow Items, late charges, any other amounts then due under Deed of Trust, and then to reduce principal. Deed of Trust 2(b). It bears noting that property insurance provides coverage only for the value of improvements (and personal property) and does not insure the value of the underlying land. Since a portion of the value of the secured property is the land itself, property insurance proceeds are not designed to satisfy the mortgage and may not be sufficient to satisfy a mortgage in full.

Lenders and servicers should also consider the applicability of California Insurance Code section 2051.5, which allows borrower policyholders to decide whether to use their insurance proceeds to rebuild at a new location or to purchase an already built home at a new location rather than to restore the insured property. If the borrower elects to rebuild in another location, California law requires that property insurers pay the full benefits that would have been owed if the policyholder were to rebuild the property at the secured loss location. These full benefits include payment of replacement cost, including any extended replacement cost coverage, if the policy has those coverages. The Insurance Code does not appear to contain any limitation on the Lender's right to have insurance proceeds applied to the loan balance if the borrower elects to rebuild or purchase in another location.

In addition, under current California law, servicers or lenders must pay interest to borrowers on funds held in escrow for the payment of property taxes and insurance premiums. This interest requirement does *not* apply currently to insurance proceeds the servicer or lender holds in escrow pending repair or rebuilding. *Gray v. Quicken Loans, Inc.*, 61 Cal. App. 5th 524 (2021). Legislation proposed by Assemblymember John Harabedian (D-Pasadena) and Governor Newsom on February 10, 2025 would amend state law to require lenders and servicers to pay borrowers the interest earned on post-loss insurance proceeds.

Though less common in practice, the Deed of Trust also authorizes the Lender to make a claim on the borrower's property insurance policy if the borrower fails to do so. Deed of Trust 5(d). The Lender may also make, negotiate, and settle an insurance claim if the borrower abandons the property and does not respond within 30 days to communication from the Lender that the insurer has offered to settle a claim. Deed of Trust 5(e). Given the extent of the property damage in wildfire impacted areas, it will be important for mortgage

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servicers to ensure that their borrower communications are reasonable under the circumstances, and should take into account, for example, that impacted borrowers are likely not receiving mail at the insured property.

Finally, if the repair is not economically feasible and the insurance proceeds will not be sufficient to satisfy the outstanding balance of the loan, the Lender may need to consider available loss mitigation options such as short sale or deed in lieu of foreclosure. If the Lender pursues loss mitigation options or proceeds to foreclosure, available insurance proceeds must be taken into account in determining the short sale price of foreclosure bid price. If the Lender fails to take the insurance proceeds into account and makes a full credit bid at foreclosure, the Lender generally waives any right to the insurance proceeds; when the lender's debt is satisfied by a full credit bid, recovery of insurance proceeds is precluded on the theory of double recovery.

The legal complexity of property insurance, the standard mortgage clause, and Paragraph 5 of the uniform Deed of Trust, particularly when combined with the scope of damage caused by the LA wildfires as well as statutory and regulatory considerations, requires lenders and servicers to proceed with caution in communicating with borrowers, making decisions regarding potential application of insurance proceeds to the mortgage debt, and calculating short sale prices or credit bids in the event of necessary loss mitigation.

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