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Your lender can wipe out your equity in one move: Before loss owners need the right contract terms

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You buy a property and the lender imposes heavy insurance requirements on you. That's ok, they care as much about the property as we do, you think. You have visions of using all those good claim proceeds to restore the property to its prior glory after a loss.

But, can the lender take the claim funds, pay off the loan and walk away. Unfortunately, yes. The problem is in the "Casualty & Condemnation" section of the loan agreement.

Commercial mortgage agreements are almost all the same on this major point:

* In the event of a "casualty," the lender will receive and control the insurance claim funds as a starting point. Ok they have custody, but they must apply the funds toward the reconstruction, right?

Moving on to the next section, "Use of the proceeds of insurance:"

* For very small losses (up to a dollar amount like $250,000 or a percent of the market value like 5%), the property owner will have the right to repair the property out of the insurance funds, with few controls.

* At the next level, up to 30% of the market value, the lender may be constrained by requirements to consider in good faith the borrower's "economic interests in the property." In other words the borrower is still to be protected in the use of the funds.

* But, once the loss exceeds 30% of the fair market value, it gets very dicey for the borrower. At this level, the lender has the right to "elect, in its absolute sole discretion...to apply the proceeds of insurance collected upon any casualty...to the payment of debt..." In other words, rather than restoring the property with the claim funds, the lender simply uses them to pay off the loan.

From agreement to agreement the exact trigger, and the exact language, may vary, but the result is the same:

The lender takes the money and walks away from the borrower. So what is the borrower left with in return for its former equity in the building: the land with a smoking pile of rubble on it. The insurance which was purchased for the purpose of, and in the proper amount for, restoring the property, is now used instead to insulate the lender and only the lender from the loss, leaving the owner bare.

What is worse is that taking cash rather than restoring the property results in an actual cash value (ACV) settlement rather than a replacement cost settlement. ACV is depreciated value (with market value considerations) which might be 20 to 50% lower than replacement cost. So even though insurance was purchased at an amount to replace the property, and the intent was to replace the property, the lender has the ability to throw away 20 to 50% of the insurance settlement by deciding not to replace the property. Assuming they are rational, they would only do that if the ACV is close to the unpaid principal, and this varies from deal to deal. But ironically, the borrower who puts the most equity in (reducing the loan amount to closer to the ACV of the property) is at the highest risk from this scenario.

If the lender uses this nuclear option, the owner still has the land and the land value, less the cost of removing the debris. Every case will be different, but the more the building value outweighs the land value, the more the property owner is exposed to its equity being completely wiped out.

Will the courts ride to the rescue to remedy this unfair result. Not generally based on the cases to date. For example in a 1984 New Jersey case, General GMC Sales v. Passarella, the court held that to force the lender to apply the proceeds to the rebuilding would be to force the lender to convert its secured loan to a construction loan which it had not bargained for. In another case, English v. Fisher, Texas, 1983, the court simply refused to unravel a valid contract that was "unambiguous."

What should the property owner do? Negotiate terms of the "Casualty and Condemnation" clause to arrive at a clear statement that insurance proceeds will in all cases be used to repair or replace the property unless there is mutual agreement at the time of loss to take another approach. This is what the large REITS do now, using their clout; they are aware of the clause and they force the change in terms to require the "appropriate" use of the claim funds. Other, smaller, owners have been more passive. Why? Because they're not even aware of the lender bias in the loan agreement.

Risk is hiding in all kinds of contracts. A big part of risk management is contract management.

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