

Insurance Claims and the Deficiency Judgment*

By Bruce J. Bergman



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I. Introduction

It is unfortunate that subjects this important sound like they are obscure and pedantic. This one certainly is not. Real danger lurks here because of the sometimes forgotten principle that once a foreclosure is over, if a deficiency has not been pursued, a lender's insurable interest is gone and no hazard insurance claims can be made. This is true in New

York¹ and many other states and is well worthy of explanation.

II. Sample Scenarios

First, a sample scenario, to make the point. Suppose that, just before a mortgage foreclosure sale is scheduled, a portion of the house is destroyed by fire or suffers some other hazard loss such as broken pipes causing water damage. An insurance claim is filed whereby the lender should be the sole payee because the mortgage is in default. The foreclosure sale is conducted, but a deficiency judgment is never sought. When the mortgage lender or servicer follows up with the insurance company to determine when payment will be forthcoming, they are advised that there is no insurable interest remaining and therefore nothing will be paid.

Here's an alternative scenario: Everything is the same except that the foreclosing plaintiff is due the sum of \$100,000 at the foreclosure and bids the full amount of its debt. A few days after the sale they call the insurance company and are told that since the foreclosing plaintiff bid in its full debt, they have been "paid" in full so there is nothing for insurance to compensate and no check will be sent. With one possible exception to be discussed later, the insurance company is right in both of these cases and the lender or servicer has a serious problem.

III. The Law

The applicable law (in New York and many other states) is that if a foreclosing

plaintiff bids the debt in full or, regardless of its bid, never pursues a deficiency judgment, then taking back the property is deemed to be full satisfaction of the debt. If the debt has been satisfied, then there is no insurable interest in the property.² Note too—and this has even more frequent application in the commercial case—if the mortgage documents prohibit seeking a deficiency judgment, consummation of the foreclosure sale extinguishes the plaintiff's claim to fire insurance proceeds.³

IV. Solutions

Because of the noted principles and perils, mortgage lenders and servicers should address some protective action. First, if a fire or other hazard loss is incurred prior to the foreclosure sale, consideration can be given to refraining from conducting the sale until the insurance proceeds have been paid.

Second, because there may be compelling reasons to move the foreclosure along, the sale can be held, but the servicer should authorize pursuit of a deficiency to establish the shortfall, and thus be in a position to claim insurance proceeds. If electing this latter course, it is vital to note that many states impose strict time frames during which the deficiency can be sought. In New York, for example, the deficiency motion must be

1. For a further discussion of the issue, see 3 BERGMAN ON NEW YORK MORTGAGE FORECLOSURES, § 34.08 (Matthew Bender & Co., Inc. 2000).

2. *Bellusci v. Citibank*, 611 N.Y.S.2d 958 (3d Dept. 1994); *Cohen v. New York Property Ins. Underwriting Ass'n*, 160 A.D.2d 287, 554 N.Y.S.2d 477 (1st Dept. 1990); *Builders Affiliates v. North River Ins. Co.*, 91 A.D.2d 360, 459 N.Y.S.2d 41 (1st Dept. 1983); *Equitable Life Assurance Soc'y of the United States v. Great Atlantic Ins. Co. of Del.*, 69 Misc.2d 714, 330 N.Y.S.2d 840, *aff'd*, 40 A.D.2d 773, 337 N.Y.S.2d 983 (1st Dept. 1972).

3. *First Fed. Sav. & Loan Ass'n of Rochester v. Dietz Int'l Public Adjusters, Inc.*, 143 A.D.2d 45, 531 N.Y.S.2d 801 (1st Dept. 1988).

served within 90 days of delivery of the referee's deed.⁴

Finally, if insurance proceeds are at issue, the lender or servicer should be careful never to bid above the perceived value of the property. In many states (and certainly in New York) the deficiency formula credits the borrower with the greater of the amount bid at the sale, or the value of the property on that day.⁵ Hence, every dollar bid above the value of the property diminishes, and ultimately extinguishes, the deficiency which can be claimed—even if in actuality the prop-

erty is not worth the amount of the debt. To the extent that certain investors may obligate a servicer to bid the full debt, the consequences of that need to be understood.

Having noted this very dangerous relationship between insurance proceeds and a deficiency, it should be observed that there is a recent case (in New York) which offers an exception to the rule that neglect to pursue a deficiency bars a claim to insurance proceeds. This exception arises where the mortgage itself provides that the proceeds from a fire insurance policy are first to be applied in reduction of the mortgage debt, with only the balance to be paid to the mortgagor.

If that provision appears, the lender's claim to proceeds is a contractual right, unaffected by non-pursuit of a deficiency.⁶ Whether your mortgage contains such a provision may be an imponderable, but it's worth looking for. Indeed, it is something that mortgage drafters should address with dispatch.

In the end, these nuances can be challenging, and the practical effects are critical. It's worth knowing about them.

4. In New York, the governing statute is Real Property Actions and Proceedings Law (RPAPL) § 1371. But how to measure that 90 days can become a daunting exercise. Examples and decisions are discussed at 3 BERGMAN ON NEW YORK MORTGAGE FORECLOSURES § 34.03[2] (Matthew Bender & Co., Inc. 2000).

5. RPAPL § 1371.

6. *TIG Insurance Company v. Wilshire Credit Corp.*, A.D.2d, 703 N.Y.S.2d 501 (2d Dept. 2000).