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Practice Update

California Wildfires: What Is the Lender's Obligation to Release Insurance Proceeds for the Repair and Restoration of Real Property?

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At this juncture, it is difficult to assess the breadth of damage and loss of life that has occurred as a result of the devesting fires in California. Based on initial reports, it is possible that entire communities have been destroyed and certain areas may never be rebuilt to previously levels of occupancy. This will result in an as yet undetermined but significant loss in the value of real property in the Los Angeles area, which risks impairing lenders' security.

Lenders will be inundated with borrower requests for release of insurance proceeds for the repair and restoration of improvements. Typically, this request is approved by lenders, as a reconstructed property would enhance the lender's security, not impair it. However, as a result of the destruction of the California fires and the unpredictability of the rebuilding of neighboring properties, a reconstructed property may not adequately protect the secured lender.

It is common knowledge that lenders making secured real property loans require loss payee endorsements to the borrower's casualty policy, so that the lender will control the disbursement of loan proceeds in the event of a loss. *Schoolcraft v. Ross*[1]

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is the seminal California Court of Appeals case that addressed the circumstances in which a lender must release fire insurance proceeds to allow for repair and restoration. In *Schoolcraft*, the court held that a beneficiary of a deed of trust must (i) act in accordance with the implied covenant of good faith and fair dealing and (ii) must permit fire insurance proceeds to be utilized for the cost of rebuilding when the security is not impaired.[2] In *Schoolcraft*, the plaintiff presented evidence that the home could be reconstructed for $14,100, and upon completion the property would have a fair market value of $20,000. The lender refused to distribute the insurance proceeds to the borrower and the borrower eventually defaulted on the loan. The court found that the beneficiary of the deed of trust failed to act in accordance with the implied covenant of good faith and fair dealing, since beneficiary's security was not impaired, and damages were awarded to the plaintiff.

Schoolcraft was later codified in Section 2924.7 of the California Civil Code, which reads, "The provisions of any deed of trust or mortgage on real property which authorize any beneficiary, trustee, mortgagee, or his or her agent or successor in interest, to receive and control the disbursement of the proceeds of any policy of fire, flood, or other hazard insurance respecting the property shall be enforceable whether or not impairment of the security interest in the property has resulted from the event that caused the proceeds of the insurance policy to become payable."[3] While not apparent from the text of the statute, the historical note clarifies that the language is not intended to abrogate the holding in *Schoolcraft*, but rather is meant to carry it forward. The statute should therefore be interpreted to mean that when the security is not impaired as a result of a loss, a lender may control the disbursement of the proceeds,[4] provided it makes them available to pay the costs of restoration on demand by the borrower (assuming, in accordance with the statute, that the deed of trust or mortgage so provides).[5] This ultimately derives from the implied covenant of good faith and fair dealing articulated in *Schoolcraft*, since it would be inequitable to allow a lender to retain proceeds, likely forcing the borrower into default and allowing lender to then recover the property through foreclosure and potentially seek a deficiency judgment.[6]

While in *Schoolcraft* the rebuilding process would have resulted in an improved value of the security, the current situation in California remains unpredictable, where entire neighborhoods have been destroyed. If a home was damaged but survived the fires, but is in a neighborhood where every other home was destroyed, is that property truly able to be occupied? Infrastructure will likely need significant repairs, and the toxicity of the neighborhood might remain for years.

So is the value of a rebuilt property higher or lower than it was prior to the fires? The *Wall Street Journal* reports, "The Palisades fire affected some of the wealthiest neighborhoods in Los Angeles, where Zillow estimates half of the nearly 10,000 homes are valued at $3 Million or more."[7] Looking at a home that was damaged or destroyed by the fires and had a $3 million valuation prior to the loss, if it has a mortgage of $2 million and it is rebuilt, given the condition of the neighborhood, the home might only be worth $1.5 million upon completion, putting the lender under water. This is only a hypothetical, but these are difficult issues lenders will have to confront over the next several months and years.

The grey area that will have to be addressed is the definition of the term "impairment of security," which is the standard articulated in the *Schoolcraft* case. One California court, citing *Schoolcraft*, developed the "debt equivalency rule," which states that if the estimated value of the rebuilt property exceeds the value of the outstanding debt, there is no impairment of security.[8] This will challenge any lender's underwriting department, as the definition does not give any consideration to a loan to value ratio (LTV). So in theory, where a lender makes a loan with a 75% LTV, under the "debt equivalency rule," a court could find that there's no impairment of security where the LTV is 90% (or higher) after restoration of the property. The rule established by this California court will be put to a test in the months and years to come.

In light of the unprecedented damage to some of the wealthiest communities in the United States, it is probably best to characterize the current situation as "fluid." Lenders are advised to remain vigilant and watch for court rulings and changes to state and municipal law that might affect their obligations to disburse loan proceeds under their loan documents.

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[1] Schoolcraft v. Ross, 81 Cal. App. 3d 75, 146 Cal. Rptr. 57, 58 (Ct. App. 1978)

[2] *Id.* (Emphasis added)

[3] Cal. Civ. Code § 2924.7 (West)

[4] § L59 LOSS PAYABLE, 3 California Ins. Law Dictionary & Desk Ref. § L59 (2024 ed.)

[5] § 13:80. Rights to insurance proceeds—Prior to foreclosure, 5 Cal. Real Est. § 13:80 (4th ed.)

[6] *Id.*

[7] Wall Street Journal, January 18, 2025, 9:00 p.m. ET, U.S. Section, by Juanje Gomez, Andrea Fuller, Kate King, and Sarah Krouse (digital version)

[8]People Ex Rel Dep't of Transportation v. Redwood Baseline, Ltd., 84 Cal. App. 3d 663, 669, 149 Cal. Rptr. 11, 15 (Ct. App. 1978)
