PRE-FORECLOSURE SALE LOSSES: A TRAP FOR THE UNWARY MORTGAGEE

by *Steve Sowell**

Property in foreclosure occassionally suffers a casualty, such as a fire. Depending upon when the casualty takes place during the foreclosure process and how a mortgagee reacts to it, the mortgagee may find that it has acquired nearly worthless property while both extinguishing the mortgagor's liability and waiving its right to insurance proceeds.

In the typical foreclosure scenario, the mortgagor defaults on payments and the mortgagee commences foreclosure by advertisement. The mortgagee bids in the full amount of the outstanding debt at the sale, there being no other bidders. The mortgagee receives a sheriff's deed to the property and then waits out the redemption period. If the mortgagor does not redeem, the mortgagee markets the house to recover its losses.

A casualty can occur in one of three periods during foreclosure: before sale, after sale but before the redemption period expires, or after the redemption period expires. The rights and obligations of the mortgagor and mortgagee differ significantly depending on the period in which the casualty occurs. Generally, the rights of the parties to an insurance policy are fixed as of the date of the casualty.[1] It is when the loss takes place before the sale that the mortgagee must exercise the greatest caution.

Most mortgages require a mortgagor to maintain insurance on the property, naming the mortgagee as a named insured and/or loss payee, in an amount not less than the balance due on the mortgage. Most mortgages also provide that, in the event of foreclosure and sale of the property, the mortgagor assigns his interest in any insurance policy to the mortgagee.[2] Thus, if a loss occurs after a foreclosure sale, the mortgagee has the right to collect the insurance proceeds,[3] both by virtue of being a named insured[4] under the insurance policy and by virtue of its status as assignee of the mortgagor's interest in the policy.

However, legal title does not vest at once on the date of the sheriff's sale but, instead, at the expiration of the redemption period.[5] As a result, the mortgagee may be obligated to apply the insurance proceeds to redemption of the property if the redemption period has not expired. If the insurance proceeds exceed the amount necessary to

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redeem, the mortgagee should retain so much of the proceeds as is necessary to redeem (and file a redemption receipt) and pay the difference, if any, to the mortgagor. If the insurance proceeds are not sufficient to redeem in full, the mortgagee should be able to require the mortgagor to come up with the difference before applying the proceeds to redemption. If the mortgagor does not redeem, then both the property and the insurance proceeds should belong to the mortgagee.

When the loss takes place after the redemption period expires, the mortgagee owns the property free and clear of the mortgagor's interest. After an initial adverse opinion,[6] the Michigan Court of Appeals has held that the foreclosure sale is not a sufficient transfer to allow an insurance company to claim that a policy of insurance obtained prior to the foreclosure has been terminated by a clause prohibiting transfer of the property. Thus, the mortgagee typically makes claim for the proceeds, rebuilds the property, and markets the property to recoup the debt.

Bidding the full amount of its debt at a sheriff's sale has the legal effect of extinguishing the debt;[7] the mortgagee obtains title to the property (by virtue of the sheriff's deed) in exchange for the debt. The mortgage itself is extinguished by the sale.[8] Because the full amount of the debt was bid at the sale, there is no longer any debt for which the mortgagor can be liable. By the same token, since the mortgagee's claim against the insurance proceeds is merely security for repayment of the debt,[9] if the debt has been satisfied, the mortgagee no longer has a right to insurance proceeds.

What happens when this law is applied to a pre-foreclosure loss? If the mortgagee fails to take into account the diminution in value of the property because of the loss and bids in the full amount of its debt, the mortgagee may acquire property worth substantially less than the amount of the debt while at the same time extinguishing the debt. Even the "assignment of insurance" clause in most mortgages is of no avail because such assignment is intended to be security for a debt, and the debt no longer exists.[10]

This rule was first announced in **Smith v General Mortgage Corp**,[11] but was held to have prospective effect only, and the court in that case set aside the sale to fulfill the expectations of the parties. Subsequent decisions have refused to set aside sales when the mortgagee knew of the loss prior to the sale and proceeded to bid in the full amount of the debt.[12]

To illustrate the possibilities, assume a mortgage indebtedness of $40,000 on property worth $60,000. The mortgagor defaults and the mortgagee commences foreclosure. Shortly before sale the house burns to the ground, reducing the value of the property to $30,000. If the mortgagee does not take the loss into account when bidding, it will bid $40,000 for property worth only $30,000, thereby incurring a loss when the property is resold. Under the rule announced in **Smith v General Mortgage Corp**, the mortgagee will not be able to recover the loss from either the mortgagor or the insurance proceeds.

A mortgagee's better course of action is to adjust the bid downward to the fair market value of the property after the loss, thereby causing a deficiency.[13] Under the scenario proposed above, the mortgagee would bid in not more than $30,000 at the sheriff's sale, representing the fair market value of the property after the loss. Ten thousand dollars of the debt remains after the sale, so the mortgagor retains personal liability for the deficiency, and the mortgagee has first claim to the insurance proceeds, up to the amount of the deficiency.

An even better course of action is to delay the sheriff's sale until the loss has been adjusted and the insurance proceeds applied either to reduction of the debt or rebuilding of the property.[14] If the proceeds are applied to reduce the debt, the proceeds may be sufficient to both reinstate the loan and pay down a substantial portion of the principal, in which case there is no longer need for foreclosure. If the proceeds are applied to rebuilding the property, it should restore the property at least to its fair market value prior to the loss, thereby greatly increasing the amount to be realized at a sheriff's sale and subsequent resale.[15]

Suppose the casualty takes place before the sale and the mortgagee doesn't become aware of it until after the sale. Can the sale be set aside? The answer depends in large part upon when the casualty takes place in relation to the sale and what steps the mortgagee takes to inform itself of the condition of the property.

If the loss takes place immediately prior to the sale such that the mortgagee did not have a reasonable opportunity to discover the loss, the mortgagee has a good chance of convincing a court to set aside the sheriff's sale. In **Federal Land Bank of St. Paul v Edwards**,[16] the Supreme Court of Michigan allowed a mortgagee to set aside a sheriff's sale and restore the mortgage (and thus claim insurance proceeds) when the buildings on the property were destroyed by fire the day before the sale unbeknownst to the mortgagee.

On the other hand, if the sale occurs sufficiently in advance of the sale that the mortgagee should have inspected the property and discovered the casualty, a court will probably not set aside a sale.

FHA/VA guidelines require a monthly inspection of property. Through bad timing, it is possible for a loss to take place immediately after an inspection and a sale to take place nearly one month later but before the next scheduled inspection. It is difficult to say what a court would do in that situation. A prudent mortgagee will, upon receipt of a sale date from the foreclosure attorney, notify its inspection company to make its next inspection of the property as near to the sale date as possible.

What if the casualty loss is completely inside a building so that it is not obvious during the typical "windshield" inspection of the property? Mortgagees have no right of possession to the property until foreclosure of the mortgage and expiration of the redemption period,[17] and thus have no right to enter a house. If the casualty truly is not discoverable by an outside inspection prior to the sale, a court might set the sale aside under the authority of the **Edwards** case, since the mortgagee was under a mistake of fact as to the condition of the property.[18] A casualty loss on property in foreclosure should raise a red flag to a mortgagee, because of the potential for significant loss if the foreclosure sale is not handled appropriately. While any casualty reduces the mortgagee's chances of full recovery, the exercise of caution will serve to minimize the loss.

ENDNOTES

1. **Pink v Smith**, 281 Mich 107, 274 NW 727 (1937); **AZ Root v Republic Insurance Co**, 82 Mich App 446, 266 NW2d 842 (1978).
2. The 1985 HUD form of mortgage provides, in paragraph "Sixth" that "[i]n event of foreclosure of this mortgage or other transfer of title to the mortgaged property in extinguishment of the indebtedness secured hereby, all right, title and interest of the Mortgagor in and to any insurance policies then in force shall pass to the purchaser or grantee." The Michigan FHA form of mortgage provides, in paragraph 4 that "[i]n the event of foreclosure of this Security Instrument or other transfer of title to the Property that extinguishes the indebtedness, all right, title, and interest of Borrower in and to insurance policies in force shall pass to the purchaser." Most other forms of mortgage contain similar provisions. However, it might be better if these mortgages provided that any *claims* under the policies, rather than the policies themselves, are assigned. **See United States v Lititz Mutual Insurance Co**, 694 F Supp 159 (MD NC 1988).
3. See Mortgagee – Recovery on Fire Insurance, 19 ALR4th 778.
4. A standard mortgage clause creates a separate contract of insurance between the insurance company and the mortgagee just as if the mortgagee had applied for the insurance entirely independent of the mortgagor. **Citizens State Bank of Clare v State Mutual Rodded Fire Ins Co of Michigan**, 276 Mich 62, 267 NW 785 (1936); **Gibson v Group Ins Co**, 142 Mich App 271, 369 NW2d 484 (1985). The mortgagee's claim to the proceeds is superior to the competing claims of the mortgagor. **Better Valu Homes Inc v Preferred Mut Ins Co**, 60 Mich App 315, 230 NW2d 412 (1975).
5. MCLA §600.3130, MCLA §600.3236; **see**, also, **Bankers Trust Co of Detroit v Rose**, 322 Mich 256, 33 NW2d 783 (1948).
6. Compare **Consolidated Mortgage Corp v American Security Ins Co**, 69 Mich App 251, 244 NW2d 434 (1976), to **Citizens Mortgage Corp v Michigan Basic Property Insurance Association**, 111 Mich App 393, 314 NW2d 635 (1981).
7. **Bank of Three Oaks v Lakefront Properties**, 178 Mich App 551, 444 NW2d 217 (1989).
8. **New York Life Ins Co v Erb**, 276 Mich 610, 268 NW 754 (1936).
9. **Heritage Federal Savings Bank v The Cincinnati Insurance Company**, 180 Mich App 720, 448 NW2d 39 (1989).
10. **Heritage Federal, supra** n 9; **Emmons v Lake States Insurance Company**, 193 Mich App 460, 484 NW2d 712 (1992).
11. 402 Mich 125, 261 NW2d 710 (1978).
12. **Heritage Federal, supra** n 9; **Emmons, supra** n 10.
13. A mortgagee who bids in the property for less than the amount of the debt does not waive the remainder of the debt if the mortgagor redeems. **Bankers Trust Co of Detroit v Rose**, 322 Mich 256, 33 NW2d 783 (1948).
14. The current FNMA/FHLMC standard mortgage for Michigan provides that, unless the mortgagor and mortgagee agree otherwise in writing or the mortgagee's security is impaired, insurance proceeds will be used for rebuilding the property. Older mortgages, many of which are still in effect, provide that the insurance proceeds may be used either for reduction of the indebtedness or rebuilding, at the mortgagee's option. Hybrid clauses also exist; it is necessary to review each mortgage on a case-by-case basis to determine the rights of the parties.
15. The mortgagee should be careful of a mortgagor's request to use a portion of the insurance proceeds to reinstate a loan if the mortgagor intends to rebuild the property. If the proceeds are used to reinstate the loan,

the funds available to rebuild the property are reduced by that amount. What other source of funds does the mortgagor have to complete the construction?

16. 262 Mich 180, 247 NW 147 (1933).
17. **Massachusetts Mutual Life Ins Co v Sutton**, 278 Mich 457, 270 NW 748, (1937).
18. The author had a case where a fire loss occurred wholly inside the home. The mortgagor never reported the loss but defaulted on the loan and the mortgagee foreclosed. The loss became apparent at the expiration of the redemption when the mortgagee took possession. Although the trial court upheld the sale, the Michigan Court of Appeals, in an unpublished opinion, remanded the case to the trial court to determine whether the mortgagee could have discovered the loss by due diligence. As often happens, the parties settled shortly after remand, so there was no published decision for guidance.