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Real Estate Investor Bulletin

Property Insurance in Subject-to and Wraparound Mortgage Transactions - November 15, 2007

Many of our clients have recently asked us about the best way to structure property insurance in subject-to and wrap mortgage transactions. This concern is understandable, because the consequences of mishandling property insurance can be significant: from an expensive forced-place policy or a due-on-sale call, to a potential complete loss of the property itself. It is critical, then, that every investor develop and implement a strategy ensuring adequate insurance while maintaining the benefits that subject-to and wraps deals offer.

In order to resolve the great deal of confusion and conflicting recommendations about how best to deal with insurance in these situations, I spoke at great length with an insurance agent who works regularly with real estate investors. Together, we recommend the following approach when dealing with hazard insurance for subject-to and wrap properties.

First: the original borrower's homeowner's insurance should be kept in place. As part of every conventional mortgage, the borrower pledges to maintain a homeowner's insurance policy that identifies the lender as a loss payee. Cancelling this policy, or changing the named insured, is not advisable. When it is reported that the existing policy has been modified or terminated, the lender may respond by force-placing a policy in the borrower's name. In case of a change of the named insured, there may be a resulting due-on-sale call. Simply put, changing the existing policy may raise red flags, resulting in unwanted attention from the lender.

It is very important to note that, in case there is a loss, any claim made under this policy almost certainly will be denied; coverage is dependent upon the borrower's occupancy of the property, which is rarely the case in subject-to and wrap transactions.

Even though the borrower's property insurance policy is of little value to the investor, it should be kept in place. The new titleholder to the property should be added to the existing policy as an "interested party" and the investor should have the borrower execute an assignment of insurance benefits as well as a limited power of attorney for insurance proceeds. Copies of these forms are available from our office upon request.

Second: because coverage under the existing policy will most likely be denied in case of a loss, an additional property insurance policy should be obtained.

For subject-to transactions, this should be a landlord policy bought in the name of the vested owner of the property. This ensures that a policy is in place to cover any damages. The underlying lender should not be named as a loss payee to the policy; adding the lender most likely will bring due-on-sale scrutiny to the transaction.

In wrap mortgage deals, the new owner of the property should purchase a homeowner's policy in their own name, listing the holder of the wrap mortgage as a loss payee. Again, the underlying lender should not be named in this policy.

Any and all claims should be made to the second policy and not to the underlying borrower's homeowner's insurance. Investors should never attempt to collect from both policies.

While this requires that two separate policies be maintained, we feel that this approach is the best way to structure the property insurance in wrap and subject-to transactions. By keeping the original borrower's policy in place, the insurance requirements of the underlying mortgage are met, and the investor most likely will not run into problems with forced-place policies or due-on-sale investigations on insurance grounds. By obtaining a second policy, investors are assured that there is a policy in place to cover a loss, should one occur.

-- *Stephen A. Harlan, Esq.*