Lender's Edge Newsletter

January 2018

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Are Lenders Entitled to Insurance Proceeds when Foreclosing?

by Meredith A. Hoberock and Nicholas A. Griebel

A lender's right to insurance proceeds after foreclosure depends on the type of loss payable clause contained in the insurance policy and the timing of the loss. **Lenders should be mindful of these issues when seeking insurance proceeds in the context of foreclosure and should consider the following:**

- Require borrowers to covenant in the mortgage that the lender is entitled to the insurance proceeds.
- Obtain an insurance policy with a loss payable clause, preferably a "standard" clause.
- Collect insurance proceeds prior to foreclosing if the loss occurs prior to foreclosure.
- Remember (a) the lender's interest in the insurance proceeds is terminated if the full debt amount is satisfied following foreclosure; and (b) the lender's recovery is limited to the deficiency amount if the foreclosure bid is less than the full debt.
- When the loss occurs after foreclosure, some courts have permitted the lender to recover the insurance proceeds.
- Obtain insurance following a foreclosure sale or confirm with the insurer that the coverage will continue.

Clause Types

In addition to requiring a borrower to covenant that it will maintain casualty insurance for lender's benefit, it is best practice for a lender also to require the borrower to obtain an insurance policy with a loss payable clause in lender's favor. **In the context of foreclosure, a lender's right to insurance proceeds depends on the type of clause.**

In an "open" or simple loss payable clause the lender's recovery right is derivative of the borrower's interest and, thus, the lender is subject to all defenses the insurer may have against the insured borrower, such as failure to pay premiums. No new contract is created between the insurer and the lender. If the loss occurs after foreclosure when there is an open loss payable clause, the borrower is entitled to the insurance proceeds during the redemption period.

The "standard" or New York loss payable clause is more favorable to lenders. This clause provides that the proceeds are payable to the lender as its interests may appear, but eliminates the defenses the insurer may assert resulting from the borrower's actions and provides full lender protection during foreclosure.

Time of Loss

Loss Before Foreclosure

If a loss occurs before foreclosure, the lender is only entitled to the proceeds amounting to a deficiency after foreclosure, and the borrower is entitled to the remainder. The lender's bid represents the damaged property's value and, therefore, once the debt is satisfied, the lender would be unjustly enriched by the additional recovery of proceeds representing undamaged property.

With an open loss payable clause, if the purchase price at the foreclosure sale was equal to the full debt amount, the debt would be satisfied and the insurer's liability to the lender would be discharged. However, if the purchase price did not equal the full debt amount, the insurer is liable to the lender for the difference.

With a standard loss payable clause, the lender is simply the owner's creditor at the time of loss. The lender may elect to satisfy the debt either by payment from the insurer or by foreclosing on the property. If foreclosure is pursued, and a deficiency remains, the lender may recover the deficiency from the insurer. However, once the debt is fully satisfied through the foreclosure sale, the lender's interest in the policy proceeds is terminated. Accordingly, it is best practice for lenders to collect insurance proceeds before the foreclosure sale.

Loss After Foreclosure

If a loss occurs after the foreclosure sale and before the redemption period expires, and there is an open loss payable clause, then post-foreclosure losses are not covered because the lender has an interest in the policy only as security for its debt. There is no longer a creditor relationship after the debt has been discharged.

If the policy contained a "standard" clause, a lender may recover post-foreclosure losses. In this situation, the foreclosure occurs when the insured property was undamaged and the lender is considered the property owner at the time of loss and thus entitled to recover the full amount of the covered loss. This result is based on the idea that there is an independent contract between the lender and insurer. **Some authority suggests the standard mortgage clause should cover the lender only as its status as lender and not after the lender becomes the property owner.**

Maintaining Privilege When Communicating with Professionals

By Nick Griebel, Bradley Gardner, Llynn White

When a loan begins to deteriorate, or actually defaults, lenders routinely need to communicate with counsel, outside vendors, investors and other professionals to determine the best course of action. Many of those communications involve sensitive information, including workout strategies, that lenders may sometimes want to keep private.

What steps can lenders take to maximize the possibility that these types of communications are not discoverable in the event of litigation?

Communications with Counsel

In the United States, the attorney-client privilege is sacred. The privilege is intended to promote "full and frank communications between attorneys and their clients."[1] An attorney's effective representation of his or her client is dependent on knowing everything that relates to the matter at issue.[2] When the attorney's client is a corporation, the privilege extends to communications between the attorney and employees of corporations.[3]

For lenders communicating with counsel, the key to keeping communications privileged is ensuring that the attorney-

[1] *Upjohn Co. v. United States,* 449 U.S. 383, 389, 101 S. Ct. 677, 682, 66 L. Ed. 2d 584 (1981).

[2] *Id*

[3] *Id*., at 396-97.

client communications are not divulged to third parties.[4] **Today, with electronic communication being so prevalent, email poses a significant risk to the attorney-client privilege.** Lenders should take great care when forwarding emails to individuals outside the client organization and when selecting recipients on emails that include counsel.[5]

When communicating with in-house counsel, lenders should bear in mind that only legal advice, not business advice, is privileged.[6] In-house counsel often serve dual roles and sometimes have multiple titles that reflect those roles. Where the primary purpose of a communication with in-house counsel is to provide legal advice, it is privileged, but where the primary purpose is business advice, the privilege does not protect the communication.[7]

The privilege also generally applies to loan servicers working on behalf of CMBS trusts and similarly structured investment vehicles, as the servicers are acting as the lender's agent.[8] But lawyers and servicers should be careful to examine the content of such communications before coming to the conclusion that they will be privileged: if the communication is clearly one that is made for the benefit of the trust itself, the privilege should apply. However, if the communication is made with regard to the servicer's interests (rather than the Trust's interests), the extent of the privilege may be limited. The communication may be privileged to the extent the lawyer was acting as counsel to the servicer; it may not be privileged as to the trust itself.

Communications with Vendors

When enforcing a defaulted loan, it often is necessary to engage other professionals such as appraisers, accountants, and inspectors to assist with evaluation of the loan, the obligors, the collateral, or other matters affecting enforcement or workout. For those professionals to do their jobs effectively, the ability to freely communicate and share information may be paramount. The law generally does not protect communications between the lender and the lender's third-party vendors; privileges (like the attorney-client privilege) are less regularly found in the law to protect such communications. However, the law generally protects the lawyer's communications with such professionals when the involvement of those professionals is to help the lawyer render legal advice.[9] **The key consideration is whether the communication with the third-party vendor, or the agent's involvement, was necessary for the attorney in providing legal advice.** [10]

The work-product doctrine is relevant to this issue. Under the work-product doctrine, a lawyer's mental impressions, as she strategizes in anticipation of litigation on behalf of her client, are generally protected and are not discoverable by the client's adversaries. By extension, if the lawyer (as opposed to the client) engages a third-party vendor to assist her in strategizing in anticipation of litigation, her communications with that vendor should be protected by the doctrine. An important exception applies to the doctrine, however; when the attorney and client conclude that the third-party vendor's work will actually be used in the litigation (or if they conclude to actually call the third-party vendor as a witness), then the vendor's work is discoverable.

Thus, generally, the best way to ensure that communications with, and documents prepared by, professionals like appraisers, accountants and inspectors are protected is to have them engaged by and work

4 *United States v. Ryans*, 903 F.2d 731, 741 (10th Cir. 1990).

5 *United States v. ChevronTexaco Corp.*, 241 F. Supp. 2d 1065, 1075 (N.D. Cal. 2002).

6 *See Pennsylvania Transp. Auth. v. Caremarkpcs Health*, L.P., 254 F.R.D. 253, 260 (E.D. Pa. 2008).

7 *Id.*

8 *Stopka v. Am. Family Mut. Ins. Co.,* 816 F. Supp. 2d 516, 529 (N.D. Ill. 2011); *Zimmerman v. Superior Court*, 220 Cal. App. 4th 389, 403, 163 Cal. Rptr. 3d 135, 145 (2013); *Bowne of N.Y. City, Inc. v. AmBase Corp.*, 150 F.R.D. 465, 490 (S.D.N.Y. 1993); *Memory Bowl v. N. Pointe Ins. Co.*, 280 F.R.D. 181, 185 (D.N.J. 2012).

9 *Lawrence E. Jaffe Pension Plan v. Household Intern.*, Inc., 244 F.R.D. 412 (N.D. Ill. 2006) (The complexities of modern existence prevent attorneys from effectively handling clients' affairs without the help of others, and the attorney-client privilege must include all the persons who act as the attorney's agents); *Cavallaro v. U.S.,* 284 F.3d 236 (1st Cir. 2002) (Generally, disclosing attorney-client communications to a third party undermines the privilege, but an exception to this general rule exists for third parties employed to assist a lawyer in rendering legal advice).

10 *In re Lindsey,* 158 F.3d 1263 (D.C. Cir. 1998) (In considering whether a client's communication with his or her lawyer through an agent is privileged under the intermediary doctrine, the critical factor is that the communication be made in confidence for the purpose of obtaining legal advice from the lawyer); *Cavallaro v. U.S.*, 284 F.3d 236 (1st Cir. 2002) (That an accountant was "useful" to a lawyer in providing legal assistance is not all that is required under the *Kovel* exception to rule that disclosure to third party destroys attorney-client privilege; rather, the involvement of the accountant must be nearly indispensable or serve some specialized purpose in facilitating the attorney-client communications).

through the lender's attorney(s).[11] If the lender (or one of its non-attorney agents) communicates directly with the retained professional, there is a risk that the court may find that such communications, and any reports prepared by such professional, are discoverable.[12]

Communications with Investors

In certain situations, such as those involving CMBS trusts, various stakeholders have consent rights or must be consulted in connection with any enforcement decisions by the lender or its servicer. Because of the stakeholder's rights, it may be necessary to share privileged information with them or to involve them in communications with counsel. Protection of such shared information relies on the common interest exception to waiver with the **primary justification for the preservation of the privilege in this scenario being that the parties share a commonality of interest and the privileged communication furthers that interest.**[13] Thus, for the common interest exception to waiver to apply to protect confidential, privileged material that is disclosed to a third party, a two-part showing is required: (1) the party who asserts the doctrine must share a common legal interest with the party with whom the information was shared; and (2) the statements for which protection is sought must have been designed to further that interest.

Conclusion

The attorney-client privilege is a fundamental cornerstone of American jurisprudence. However, the privilege only applies when legal advice is sought, not business advice. As a general rule, the privilege may be inadvertently waived when confidential information is divulged to third parties. However, confidential communications with third parties will not waive the privilege when the third party is an agent of the attorney and its involvement is indispensable in enabling the lawyer to provide legal advice. Further, such confidential communications with third parties may not waive the privilege when the third party is one that shares a common legal interest and the subject communication furthers that common interest. This framework provides protection to lenders in communicating with counsel, vendors, and investors.

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[11] "What is vital to the privilege is that the communication be made in confidence for the purpose of obtaining *legal advice from the lawyer*." *U.S. v. Richey,* 632 F.3d 559, 566 (9th Cir. 2011) (citing *United States v. Gurtner,* 474 F.2d 297, 299 (9th Cir.1973) (emphasis in original) (quoting *United States v. Kovel*, 296 F.2d 918, 922 (2d Cir.1961)).

[12] *U.S. v. Kovel*, 296 F.2d 918 (2d Cir. 1961) (Attorney-client privilege requires that communication be made in confidence for purpose of obtaining legal advice from lawyer, and if what is sought is only accounting service, or accountant's advice rather than lawyer's, no privilege exists); *In re Lindsey,* 158 F.3d 1263, 1280 (D.C. Cir. 1998) ("When an agent changes a message in a way not intended simply to ensure complete understanding (as in the case of a translator), the agent is not acting consistently with [the sole purpose of obtaining legal advice from a lawyer]; by changing the message, the agent injects himself or herself into the chain of communication, rather than effectuating the client's purpose of receiving advice from his or her lawyer.").

13 *HSH Nordbank AG New York Branch v. Swerdlow*, 259 F.R.D. 64 (S.D.N.Y. 2009) (Common interest doctrine prevented waiver of the attorney-client privilege as to communications between counsel retained by administrative agent for five lenders who participated in syndication of $192 million loan for a residential condominium development, and the lenders, relating to timing and conduct of litigation to collect on loan guaranties, though lenders were not parties to the litigation and counsel communicated directly with lenders because lenders were not represented by their own counsel; administrative agent, who was also a lender, shared a common interest in enforcing the guaranties, loan agreement identified administrative agent as the only party capable of enforcing or exercising any of the rights or remedies under any of the loan documents, and loan agreement contemplated that administrative agent's counsel would effectively represent the interests of the various lenders, which interests the agreement presumed to be identical).

Authors:

Bradley R. Gardner
Associate
816.360.4385
bgardner@polsinelli.com

Nicholas A. Griebel
Associate
314.622.6613
ngriebel@polsinelli.com

Meredith A. Hoberock
Associate
816.218.1243
mhoberock@polsinelli.com

Llynn K. White
Shareholder
314.552.6804
lwhite@polsinelli.com

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