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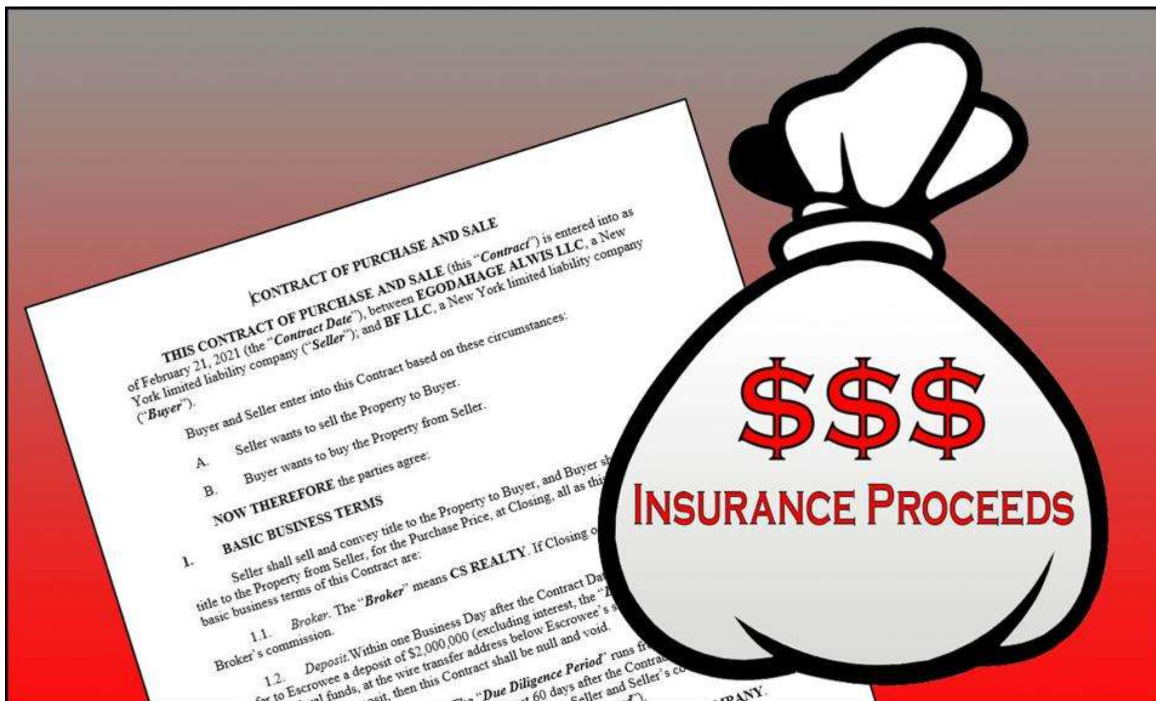
What If A Property Under Contract Burns Down?

Joshua Stein Contributor

Real Estate

I write about commercial real estate negotiations, deals and legal issues.



Insurance policies might cover the loss and they might not. RANJAN SAMARAKONE

Commercial real estate documents need to deal with all kinds of hypothetical eventualities, so that if some possible risk actually hits, the parties know what will happen. In a perfect commercial real estate world, the documents allocate every hypothetical risk in a sensible way and the parties go about their business accordingly.

One risk that can – and occasionally does — befall any building is the possibility of a fire or other damage. If that happens while the property is under contract to be sold – which also sometimes happens — who owns that risk and what will the parties need to do?

Under ancient legal principles, the risk of a fire between contract and closing belonged to the buyer, because the buyer became the "equitable owner" of the property the moment the contract was signed. That principle would require the buyer to obtain a tailored insurance policy for the period between contract and closing – not necessarily practical or cheap.

A uniform law in many states goes to the opposite extreme: If any "material" damage occurs, then the buyer doesn't have to close and gets its deposit back. The contract and the buyer both go away, at the buyer's option. Sometimes, that allocation of risk makes sense, although the contract will often define what "material" means.

Today's buyers and sellers often aren't happy with any of the legal principles described above. Instead, they often negotiate something more customized in their contracts. A seller will typically want the buyer to close no matter what, with no escape hatch even if "material" damage occurs. A buyer might be willing to agree to that, but usually doesn't like the idea of paying a complete purchase price and not receiving a complete building.

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In response, a seller will often offer to keep its property insurance in place until closing. If damage occurs before closing, the seller will transfer to the buyer all rights to recover insurance proceeds for the damage, and the seller will pay for the deductible under the insurance policy. The buyer can then deal with the insurance process and ultimately end up with a rebuilt building.

That sounds practical and reasonable, except that it usually doesn't work. Insurance policies typically say the insured party cannot assign the insurance policy. But under this sequence of facts, the insured party wouldn't be assigning the insurance policy, just a claim under the policy. Does that work? Many real estate lawyers think it does: although the seller can't assign the policy, it's okay to assign a claim under the policy.

Unfortunately, the fine print of the insurance policy often says otherwise. The seller can't assign the policy and also can't assign a claim under the policy. So if damage occurs between contract and closing, the parties may face uncertainty and litigation, which is exactly what they wanted to avoid when they negotiated to allocate the risk of damage.

To prevent this problem, buyer and seller need to start by understanding the exact terms of the seller's insurance policy. If necessary, the seller might try to get its insurance company to agree to allow an assignment of any possible insurance claim to the buyer. Whether that will succeed depends on the flexibility of the insurance company (typically very limited) and the seller's leverage, probably a function of how much insurance it buys.

If that doesn't work, the seller may need to agree to stick around after the closing to pursue any insurance claims and oversee restoration of the property after damage – a quite unappetizing prospect for most buyers and sellers. Even if the parties decide to go down that road, they still must assure that the insurance policy will respond appropriately.

Other possibilities may also present themselves, depending on the circumstances of the particular transaction, the flexibility of the seller's insurance company, the nature of the building and the buyer's plans for it after closing, and the parties' tolerance for risk.

Whatever the parties do about this issue, it's definitely not as simple as just agreeing that the seller will transfer its insurance claims to the buyer at closing.

Joshua Stein

I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

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