How to Best Insure a Seller Financed House

When insuring a seller financed property, there are homeowner insurance issues that need to be addressed properly by both you, the buyer, and by the seller.

We all know that a large portion of insurance company profits are generated when the carrier is able to reject claims. In order to be more certain that any existing home insurance coverage will not be denied if, and when, it is needed, take the advice in one of the two methods that follow.

First Insurance Method

(Recommended for maximum protection but will not give you legal title at the close)

Proceed with this method if you are willing to wait years until you pay off the entire Note before getting legal title. Before paying the Note in full you will have equitable title (see Appendix B for the definition of Equitable Title versus Legal Title). You will not be able to use the methods in this book, nor will you be able to use the IDT document this book recommends.

Before transferring the property to you as the buyer, a Land Trust should be created in which the seller is named as the Beneficiary. The insurer will not be aware of any ownership changes, partially because ownership transfer in a Land Trust is not required to be recorded. But even if some Trust terms became known, the original borrower's new title would not cast suspicion about a change in ownership because the new Trust's beneficiary is also the original borrower.

You and the seller have agreed to terms, but this time, instead of creating a mortgage or a trust deed, the seller is able to transfer "Beneficial Interest" in the Land Trust to you, which would give you equitable title to the house. The only record of the title change is the Trust document's Beneficial Interest entry retained only by the seller and you.

Loan payments and insurance premiums are still associated with the seller's name as the original borrower and named insured, respectively. The home loan is paid as usual and no suspicions are raised. The bank has no reason to start a Due on Sale action.

You should not be overly concerned that the seller will be receiving insurance checks in the event of a claim. Just be certain that you and the seller properly negotiate this point before the purchase (see Step 6).

Note that certain areas do not recognize Land Trusts. Research the web and contact a real estate attorney for the most current information. Use the second method (below) if Land Trusts are disallowed in your area or if you prefer not to get involved with a Land Trust.

Second Insurance Method

The second method is easier than the first, although it still removes your most valuable benefit. Instead of accepting legal title at the close, simply accept equitable title. That means you won't own the house until your final loan payment. If you only have use of the house but not ownership, you have essentially turned this seller finance into a CFD (Contract for Deed) also known as a Land Contract (refer to Section D)

Since the seller still legally owns the property, any issues the insurance company may have about ownership are seriously reduced or eliminated. However, if the insurer specifically excludes coverage for non-owner occupied properties, there is the unlikely possibility that the insurance company will research the occupancy situation and deny the claim.

Third Insurance Method

(With this method, you can still use the IDT or mortgage and get full legal title at the close)

Immediately after the purchase transfer, the seller should cancel his or her existing insurance policy. The seller is no longer the legal owner on title and is no longer 'owner occupying' the property. The insurer will discover that fact if there is a claim, so any claims against the original policy will be denied. Because of that, there will be no point in continuing to pay the premiums on the existing policy.

Note that homeowner's policies cover only properties that are used as a primary or a secondary residence.

After the seller has cancelled the existing policy, you, the buyer, should secure a new homeowner's policy in your name. If this is a "Subject To" transaction, list the seller's existing lender as an "additional insured."

If this is an AITD transaction, then list the seller as the mortgagee (lender) in order to protect his or her personal property by providing liability coverage. This will protect the seller's financial interest in the property. The seller will appreciate your suggestion and your good advice will give you negotiating leverage with other loan terms (see Step 6).

The monthly policy premiums should be included in an assigned escrow, or impound account, by a third party management firm such as Evergreen Notes for the term of your loan (see Steps 6 and 7 as well as Appendix C).

Once the new policy is in place, both the buyer and the seller should understand and accept that only the policy owner (a.k.a. the buyer as 'named insured') or the lender may file a claim. In the first method, the Land Trust generally gives that right only to the Beneficiary (your seller) who remains borrower on the loan.

An important concept is that the original underlying mortgagee, as the lender is known in judicial areas, is almost always a bank and that lender usually requires insurance protection as the first position mortgagee.

The original Promissory Note and mortgage (or deed of trust) that are in place are legal contractual agreements between the lender and the original borrower. The original mortgagee (the bank) continues to assume that the original borrower is on title and occupying and maintaining the property.

Each year on the anniversary date of the original homeowner's policy that was supplied when the property was first purchased, the original mortgagee (the bank) is going to require an updated policy declarations page and proof of payment (if it is not already escrowed).

The mortgagee will require that this declaration page be issued in the name of the original borrower.

When a property is seller financed and not placed in a Land Trust, the new homeowner's policy should be in the name of the new buyer, not in the seller's name.

This means that any policy declaration page with the original borrower listed as the 'named insured' will no longer be considered valid in the event of a claim.

Keep in mind that it is illegal for an insurance agent to knowingly fabricate a false declaration page.

The agent is not allowed to issue or maintain a homeowner's policy on a property that he or she knows is no longer owner-occupied. The agent's license is subject to revocation. He or she could face financial penalties for committing insurance fraud.

What if You, the Borrower, Submit an Insurance Claim as Owner?

In the event of an insurance claim after a seller financed purchase, the insurer's check to pay the claim will usually be made out jointly to the policy holder (you, the buyer, who is also the named insured) as well as to the mortgagee (the lender, who is also the seller in this case). This is a security measure designed to help prevent insurance fraud.

Depending on the negotiated agreement before your home purchase, your lender, who is the seller, would then endorse the check in order to allow you to deposit it in your account. Your agreement might have instead stated that you endorse the check so the seller is able to deposit it in his or her account.

If you, the buyer, filed a claim and he or she had listed the seller and original mortgagee (the bank) on his or her policy, the claim check would need to be made out to the policy owner (the

buyer) and both mortgagees (the seller and the bank) which means both mortgagees would have to endorse the check before you, the buyer, could deposit it.

Do Not Submit an Insurance Claim if...

What if you decided not to use the Land Trust? As the buyer, you might have to make it clear to the seller that his or her original insurance policy needs to be cancelled immediately. Even if, for whatever reason, that policy was not cancelled, there should never be a claim submitted against that policy.

In the event that there is an insurance claim by the original owner who sold the property to you, and the seller made the claim against his or her original policy, the following would likely occur:

The insurance carrier's claims adjuster would review the claim, investigate property records and determine that the property is not occupied by the insured. The claim would be denied and the policy would be cancelled. Here is the worst case scenario - the original mortgagee (the bank as lender) is notified and sends this case to their fraud department.

Insurance companies will gladly accept premiums but reluctantly pay claims. Don't give them your money and also give them reasons to deny your claims – or worse. While it is difficult to guarantee insurance on a house when it is seller financed, buyers and sellers will have a better chance of successfully insuring the house if one of the recommendations above are followed.