Model Insurance Requirements For A Commercial Mortgage Loan

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Commercial buildings make good collateral for a lender. They make even better collateral when properly insured against damage and destruction.

REAL ESTATE LOANS START FROM the fundamental assumption that the borrower's building will continue to exist. As long as the building exists, it can produce rental income so the borrower can pay debt service.

A fire or other loss affecting the borrower's building can undercut this very fundamental assumption and throw the loan into default rather quickly—unless the borrower has maintained an appropriate package of insurance coverage for the mortgaged property.

Similarly, if the building burns down or suffers some other damage without appropriate insurance coverage, the value of the mortgaged property will probably drop, quite possibly to the point where it will not support repayment of the principal of the lender's loan.

For those and other reasons, any mortgage lender will typically

regard the borrower's obligation to insure the mortgaged property as one of the most fundamental nonmonetary obligations under any set of loan documents.

This article offers a set of standard insurance requirements that any mortgage lender might want to use in its loan documents for substantial loans. These requirements are reasonably complete, straightforward, thorough, and lender-oriented, without being excessive. They approach insurance as a prudent risk manager would, if that risk manager wanted to protect the mortgaged property and its cash flow in a manner consistent with typical expectations in commercial real estate.

Extensive footnotes explain why some of these insurance provisions say what they say, other ways to approach some issues, and gaps that may still need filling for some loans.

NONGENERIC INSURANCE REQUIREMENTS • Beyond the generic insurance requirements in the model language offered here, loan documents for a substantial commercial loan will often require other insurance based on characteristics of a specific building, such as particular occupancies, construction techniques, zoning issues, nearby risks, special hazards, and the terms of major leases (particularly on rent loss or business interruption insurance and restoration). A lender's insurance advisors should identify and tailor these requirements as appropriate.

Expectations about insurance requirements can vary widely. Every insurance expert seems to have a different view about what any insurance program must include and whether a particular set of insurance provisions is adequate or seriously flawed. Any insurance expert can usually suggest improvements in any insurance requirements or any insurance program. There's always something to add. Many such suggestions, whether for modifications or additions, are often perfectly valid. Differences of opinion about insurance reflect the complexity, multiple facets, and constantly changing nature of the insurance market.

CONTEXT FOR MODEL INSURANCE LANGUAGE • The provisions offered here reflect recent developments in the law, the markets, and the world of insurance. The authors have not tailored this model language specifically for securitized loans or for any particular transaction. This language must always be checked against the specific circumstances of the mortgaged property and the rating agencies' current requirements and expectations. Some further introductory comments:

Future Changes

Insurance markets and mortgage lenders' expectations change over time as the business world becomes aware of new risks or of the true magnitude of older risks previously thought small. These sample

insurance provisions seek to respond to the marketplace and lenders' expectations at time of writing, but will inevitably become out of date. The authors intend to maintain these insurance provisions over time, as a current benchmark, taking into account changes in markets. The authors will distribute updated copies periodically to their clients and, upon request, to others.

Policy Boilerplate

The last few decades have seen the courts create numerous new theories of liability. Enterprising plaintiffs' lawyers usually fashioned these theories, sometimes with help from "public interest" organizations. A gold rush of claims against insurance companies usually followed each new theory. In response to each such gold rush, the insurance industry created new or improved exclusions from coverage in subsequent insurance policies—for example, the "pollution exclusion" and more recently new limits on coverage for "toxic mold" risks. Terrorism coverage followed a somewhat similar path, at least until federal legislation made the issue go away, at least for now. Some of the latest new policy limitations are buried in the boilerplate of insurance policies. A lender will often want to unearth and understand those limitations as part of the process of closing a loan. In some cases, the lender can (and may want to) require the borrower to pay an additional premium to solve the problem. That entire process falls outside the scope of this discussion, but will often matter a great deal for any particular loan.

Rating Agency Requirements

The requirements of the rating agencies for securitized loans change over time. Anyone who closes securitized loans must stay current with those changes (a comment by no means limited to insurance). For example, on May 1, 2003, based in part on difficulties in the insurance market, Standard & Poors ("S&P") lowered the required rating for property insurance carriers in AAA-rated transactions to "A," thus matching the requirement for liability insurance carriers. At the same time, S&P made other changes in its insurance requirements.

References To Rating Agencies

Wherever this model language refers to the Rating Agencies, that reference can usually be omitted for portfolio loans, but only after confirming that some other appropriate requirement is added (or already exists) to assure that the matter in question will satisfy the particular lender's requirements.

Best's Ratings

This model language requires insurance carriers to have an A.M. Best rating of at least "A:X" The first letter refers to the company's "quality," as Best measures it, ranging from A++ (the highest) all the

way through F (in liquidation) and S (suspended). The second letter refers to the company's "financial size category" ("FSC"), again as Best measures it—a combination of the company's capital, surplus, and " conditional reserve." FSC requirements for any loan should take into account a particular company's potential exposure to loss. FSC ratings can range from I ($10 million FSC) to XV (over $2 billion FSC). Typically a lender will require a rating of at least A:X (i.e., FSC of at least $500 million and quality level of "Excellent"), but may accept a smaller company for a smaller exposure. As an example, earthquake and windstorm coverage are difficult to place and relatively little coverage can usually be obtained. Many lenders would settle for smaller companies for these risks, but not lower their "quality" standards.

Construction

This model language includes very limited requirements on builder's risk insurance—intended only for incidental additions to buildings, and perhaps limited renovations of existing structures. If a borrower undertakes substantial construction, or for any construction loan, the construction-related language here will not suffice. Instead, a comprehensive construction-related insurance program will usually need to be designed, taking into account whatever insurance the contractors and subcontractors bring to the table. Because the borrower ultimately pays for all parties' insurance, the borrower will often want to wrap all insurance for any large project into a single policy, a so-called controlled insurance program ("CIP"). This will often cost less than many separate but overlapping policies from many separate parties. It can also simplify any claim processing. The insurance process for any construction job will also often include a coordinated bonding program. Again, the topic falls outside the present discussion.

"Claims Made" Policies

For a while, the insurance industry tried to convince its customers to accept "claims made" policies, where the carrier covered only any claims made against the insured during the life of the policy. Because of the limited nature of these policies, they have generally fallen into disuse, except in two areas: environmental risk and professional liability. A typical real estate lender will not accept claims-made coverage outside these two areas.

Coverage Levels

The minimum coverage requirements offered here are purely illustrative, reflecting typical requirements of some lenders. Any determination of minimum coverage requirements requires careful analysis of the risks associated with the particular mortgaged property.