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.

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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.

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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.

Use Of Model Documents

You can use a model legal document, such as this model insurance language, in two ways. First, you can use it in a specific transaction with appropriate modifications. Second, you can use it to compare and contrast against another, similar transactional document. In either case, do not use this model document without appropriate legal and insurance advice tailored to the particular mortgaged property, the particular loan, and applicable law. Also, when you use this model language, remember to define all the generic capitalized terms somewhere.

APPENDIX

Model Insurance Requirements

A. REQUIRED INSURANCE

From the Closing Date until the Termination Date, Borrower shall maintain the following insurance policies and comply with the following obligations (those policies and obligations, collectively, the "Required Insurance").

1. Special Perils Insurance

a. Borrower shall maintain property insurance against all risks of loss to the Mortgaged Property customarily covered by "All Risk" or "Special Perils Form"[1] policies as available in the insurance market at the Closing Date [or thereafter, as evidenced by written advice from Lender's insurance advisor][2] (collectively, the "Special Perils Insurance"[3]). Special Perils Insurance shall cover at least the following perils: building collapse, fire, flood, hurricane, impact of vehicles and aircraft, lightning, malicious mischief, mudslide, subsidence, terrorism, tsunami,[4] vandalism, water damage, and windstorm.

b. Special Perils Insurance shall also cover such other insurable perils as, under good insurance practices, other commercial property owners from time to time insure against for property and buildings similar to the Mortgaged Property in height, location, nature, type of construction, and use, as evidenced by written advice from Lender's insurance advisor ("Comparable Properties").

c. Each Special Perils Insurance policy shall cover:

i. The additional expense of demolition and increased cost of construction,[5] including increased cost from any changes in Laws on Restoration;

ii. At least 100 percent of the replacement cost value[6] of the Improvements[7]; and

iii. All tenant improvements and betterments that any Lease requires Borrower to insure (the "Insured Leasehold Property").

d. Any Special Perils Insurance policy shall contain an agreed amount endorsement[8] or a coinsurance waiver and replacement cost value endorsement[9] without reduction for depreciation. If Borrower's Special Perils Insurance does not otherwise cover damage caused by acts of terrorists,[10] then Borrower shall provide that coverage under a separate policy that meets all requirements for Special Perils Insurance, providing coverage both for certified terrorist acts under the Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, 116 Stat. 2322 ("TRIA") and for noncertified terrorist acts.[11]

2. Flood Insurance

a. If any Improvements are located in an area designated as "flood prone" or a "special flood hazard area" under the regulations for the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, 42 U.S.C. §4001 et seq.[12] Borrower shall maintain at least the maximum coverage[13] for the Mortgaged Property available under the federal flood insurance plan.

b. Lender may require additional flood insurance coverage, including related Rent Loss Insurance.

c. Any insurance that this paragraph requires is referred to as "Flood Insurance."

3. Earthquake Insurance.[14]

a. Borrower shall maintain earthquake insurance in any area of increased risk as Lender or the Rating Agencies require (the "Earthquake Insurance").

b. Lender may change its requirements for Earthquake Insurance from time to time based on:

i. Review of a current probable maximum loss seismic study, to be prepared at Borrower's expense (up to once every two years), forecasting the expected damage from any event anticipated to reoccur once in 475 years, on a 90 percent-certain statistical basis;

ii. Actual and potential losses at any other locations the same Earthquake Insurance covers and sharing the policy's occurrence and annual aggregate limits of available coverage; and

iii. Expected loss of business or rental income during Restoration. Deductibles shall be satisfactory to Lender, but never more than five percent of the location insurable values.[15]

4. Boiler And Machinery Insurance

a. Borrower shall maintain comprehensive boiler and machinery insurance covering all mechanical and electrical equipment against physical damage, rent loss, extra expense, and expediting expense covering Borrower's property and any Insured Leasehold Property (the "Boiler and Machinery Insurance"[16]).

b. Borrower shall provide Boiler and Machinery Insurance on a replacement cost value basis. For each accident, Borrower's Boiler and Machinery Insurance shall cover at least the greater of:

i. Fifteen percent of full replacement cost of the Improvements; and

ii. $500,000.

5. Builder's Risk Insurance[17]

a. During any Construction, Borrower shall maintain builder's risk insurance for the full completed project insurable value of the building in which the Construction is being performed. That insurance shall meet the same requirements as Special Perils Insurance, with whatever limits and coverage extensions Lender requires (the "Builder's Risk Insurance"), unless Borrower's Special Perils Insurance already includes that coverage.

b. Any Builder's Risk Insurance shall be written on a "completed value" Form[18] (100 percent nonreporting) or its equivalent and shall include an endorsement granting permission to occupy.[19]

c. Builder's Risk Insurance shall cover:

i. The same perils that Special Perils Insurance must cover;

ii. Loss of materials, equipment, machinery, and supplies whether on-site, in transit, or stored off-site, or of any temporary structure, hoist, sidewalk, retaining wall, or underground property;

iii. Soft costs, plans, specifications, blueprints, and models;

iv. Demolition and increased cost of construction,[20] including increased costs arising from changes in Laws at the time of Restoration and coverage for operation of building Laws, all subject to a sublimit satisfactory to Lender; and

v. Rental interruption[21] (delayed opening) on an actual loss sustained basis and otherwise in compliance with Rent Loss Insurance requirements.

7. Rent Loss Insurance

As an extension to Special Perils Insurance, Flood Insurance, Earthquake Insurance, Boiler and Machinery Insurance, and Builder's Risk Insurance, Borrower shall maintain rent loss insurance[22] on an "actual loss sustained" basis ("Rent Loss Insurance"). ("Property Insurance" means all insurance the previous sentence mentions.) Borrower shall maintain Rent Loss Insurance equal to at least 12 months of Borrower's actual Gross Revenue, including percentage rent, escalations, and all other recurring sums payable by Tenants under Leases or otherwise derived from Borrower's operation of the Mortgaged Property. On and after the date of any Securitization, "12 months" shall be replaced by "18 months." In addition, Rent Loss Insurance shall be endorsed to include an extended period of indemnity[23] of 180 or 360 days, as Lender shall require from time to time.

8. Liability Insurance[24a]**.**

a. Borrower shall maintain the following insurance for personal injury, bodily injury, death, accident, and property damage (collectively, the "Liability Insurance");

i. Public liability insurance, including commercial general liability insurance[25];

ii. Owned (if any), hired, and nonowned automobile liability insurance[26]; and

iii. Umbrella liability insurance as necessary.[27]

b. Liability Insurance shall provide coverage of at least $___ million per occurrence and $___ million in annual aggregate,[28] per location.[29] If any Liability Insurance also covers other location(s) with a shared aggregate limit, the minimum Liability Insurance shall be increased to $____ million.[30]

c. Liability Insurance shall include coverage for liability arising from premises and operations, elevators, escalators, independent contractors, contractual liability (including liability assumed under Contracts and Leases [31]), and products and completed operations. All Liability Insurance shall name Lender as an "Additional Insured"[32] by endorsement.

9. Statutory Employees' Insurance

Borrower shall maintain workers' compensation and disability insurance as Law requires ("Statutory Employees' Insurance").

10. Environmental Insurance[33].

a. Borrower shall maintain environmental insurance covering unknown environmental hazards as of the Closing Date (the "Environmental Insurance") in an amount of not less than $______________ per discovery. Such coverage shall identify Lender as an "additional named insured" by endorsement.

b. The carrier shall agree that the policy shall be automatically assigned to Lender, with no further action required by any Person, if:

i. Control of the Mortgaged Property passes to Lender or its designee as the result of an Event of Default or any exercise of Lender's Remedies; or

ii. Lender or its insurance advisor otherwise at any time so requires.[34]

11. Other Insurance

a. Borrower shall maintain such other types and amounts of insurance for the Mortgaged Property and its operations as Lender or the Rating Agencies shall from time to time require, consistent with Comparable Properties.

b. Wherever any Required Insurance specifies any dollar amount, Lender may increase it periodically to reflect Lender's reasonable estimate of inflation.

12. Documentation.

a. For all Property Insurance, Borrower shall cause Lender to be named as "Lender Loss Payee" or "Mortgagee" on a standard noncontributory mortgagee endorsement (or its equivalent) naming Lender or its designee as the party to receive Insurance Proceeds.

b. Borrower shall provide such additional evidence of Lender's interest under any Required Insurance as Lender shall reasonably require from time to time,[35] including the following (the "Evidence of Insurance"):

i. An ACORD 28 certificate of insurance for all Property Insurance; and

ii. A paid endorsement or paid binder for Borrower's Liability Insurance evidencing Lender as an additional insured and otherwise evidencing compliance with the Liability Insurance requirements of the Loan Documents.[36]

13. Policy Requirements[37]**.**

a. Borrower shall obtain all Required Insurance from domestic carrier(s) authorized to do business in the State and reasonably satisfactory to Lender with:

i. A claims paying ability of not less than "A"[38] (or the equivalent) by S&P and one other Rating Agency satisfactory to Lender; and

ii. "A:X" or better financial strength rating by AM Best.

b. Lender shall not unreasonably refuse to lower these minimum ratings to reflect market conditions from time to time, based on the written advice of Lender's insurance advisor, if any lower rating shall conform to then-current practices for Comparable Properties and Securitization Requirements.

c. Borrower shall obtain Lender's reasonable approval of the amounts, deductibles, endorsements, form, insureds, loss payees, risk coverage, and sublimits for all Required Insurance.

d. Required Insurance shall contain such provisions as Lender deems reasonably necessary or desirable to protect its interest, including endorsements to negate any coinsurance. Borrower shall pay the premiums for all Required Insurance when due and payable. Borrower shall not finance premiums under any arrangement that could, upon nonpayment, lead to premature cancellation of any Required Insurance.[39]

e. Borrower shall deliver to Lender, immediately upon issuance, copies of the insurance policies (or Evidence of Insurance) for all Required Insurance, certified as true and complete by the carrier or its authorized representative. At least 30 days before any policy expires, Borrower shall deliver evidence of renewal in compliance with the Loan Documents.

f. If at any time Lender has not received satisfactory written evidence that Borrower maintains and has paid for all Required Insurance, then without limiting Lender's Remedies, Lender may (but shall have absolutely no obligation to) force place any Required Insurance or take such other actions as Lender shall deem appropriate to protect its interests. Lender's costs of doing so shall constitute Protective Advances. Lender confirms that as of the Closing Date Borrower's existing insurance coverage satisfies all requirements for Required Insurance.

14. Blanket Coverage

a. Borrower may provide any Required Insurance under a blanket policy or policies covering the Mortgaged Property and other property and assets, provided that:

i. The blanket policy otherwise meets all requirements for Required Insurance, and, except in the case of Liability Insurance, specifies how much coverage, and which sublimits, apply exclusively to the Mortgaged Property; and

ii. The amount allocated to the Mortgaged Property equals or exceeds the Required Insurance.

15. Protection Of Lender's Interest

a. Borrower shall cause its insurance carrier to give Lender the following protections.a. In each insurance policy (or an endorsement), the carrier shall:

i. Agree not to cancel, terminate, or not renew the policy without giving Lender 30 days' prior written notice (10 days' notice for nonpayment of premium);

ii. Agree not to change the deductible, coverage limit(s), or other term(s) of the policy, if the policy would thereafter cease to comply with this Agreement;

iii. Waive any right to claim any premiums and commissions against Lender, provided that the policy need not waive the requirement that the premium be paid in order for a claim to be paid to the insured; and

iv. Allow Lender to pay premiums to continue the policy upon notice of cancellation for nonpayment.

b. Every Property Insurance policy shall by its terms remain valid and insure the Lender's interest regardless of any:

i. Named insured's act,[40] failure to act, negligence, or violation of warranties, declarations, or conditions;

ii. Occupancy or use of the Mortgaged Property for purposes more hazardous than those permitted; or

iii. Exercise of any Lender's Remedies.

16. No Separate Insurance

a. Borrower may, however, carry separate insurance,[41] concurrent in kind or form or contributing upon Loss, with any Required Insurance.

b. However, Borrower may, however, carry insurance for the Mortgaged Property, in addition to Required Insurance, but only if the additional insurance:

i. Does not violate any Required Insurance, or entitle the carrier to assert any defense or disclaim any primary coverage under any Required Insurance;

ii. Mutually benefits Borrower and Lender; and

iii. Otherwise complies with this Agreement.

17. Lender's Rights; No Liability

a. Borrower irrevocably authorizes Lender, at any time, to communicate directly with Borrower's insurance carrier(s), broker(s), and Tenant(s) about any Required Insurance.

b. Borrower shall promptly upon demand deliver to Lender further written authorizations addressed to such Persons, and authorizes and directs all such Persons to communicate directly with Lender at Lender's request. Any direct communications by Lender shall not:

i. Impose any obligation or liability on Lender; or

ii. Entitle Borrower to any defense, offset, or counterclaim against the Obligations.

b. Any determination or request that Lender makes about any Required Insurance shall impose no obligation or liability on Lender. Borrower shall not rely on any such determination or request (or its absence) as an implied or express representation about the adequacy of Borrower's insurance. Borrower acknowledges that any such determination or request would be made solely for Lender's own benefit and not for Borrower's. Borrower retains sole responsibility for the adequacy and prudence of its insurance program.

[1] Property owners can generally buy three possible levels of property insurance coverage: (1) "basic," which covers fire and lightning; (2) "broad," which includes fire and extended coverage (named perils), covering a substantial list of additional hazards; and (3) "special," which covers risk of loss from all sources except a few specifically listed hazards. Category "3," the broadest, was once called "all risk" coverage, though it didn't really cover all risks.

[2] A Borrower would prefer to add the bracketed language, for protection from future insurance market "tightening." A Lender would prefer to omit this language, preserving flexibility to deal with market changes as they occur.

[3] Property Insurance is called "first party" coverage, because any claims are paid solely to the policy holder—typically the Borrower but also the Lender if properly endorsed onto the policy. In contrast, "third party" coverage protects the insured from the possible obligation to pay losses and damages due and payable to injured third parties. The latter coverage is sometimes called "casualty" coverage, a term often erroneously applied to property insurance. To avoid confusion, one should not use the word "casualty" for any insurance. In all cases, the "second" party is the insurance carrier, the company that issued the policy.

[4] A tsunami is a very large tidal wave, generally considered a risk only in coastal areas along the Pacific Ocean. Special Perils Insurance or Flood Insurance, or both, may cover this risk.

[5] Demolition and increased cost of construction coverage, also known as "law and ordinance" coverage, is actually an endorsement (an addition) to a Special Perils Insurance policy. After a loss, this endorsement extends the policy to cover any additional restoration cost the Borrower incurs from enforcement of a law or building ordinance that requires the Borrower to restore the building to a higher standard after the loss than before. For example, before a loss an older building might not have needed to comply with modern sprinkler requirements or the Americans With Disabilities Act. After the loss, when the Borrower restores, the building must meet both requirements, thus increasing the cost to restore. These endorsements cover that extra cost (deeming it part of the Borrower's loss arising from the casualty), usually subject to a sublimit.

[6] "Replacement cost value" is the amount necessary to reconstruct the building on the same site for the same use with similar materials. Replacement cost value includes building improvements to the land. It does not, however, include the market value of the building or the cost of the land.

[7] "Law and ordinance coverage" does not cover the Borrower's losses if current zoning laws are more restrictive than those when the building was built, to a point where the Borrower cannot restore the damaged building to the same size as before the loss (the "legal nonconforming use" problem). Typical Special Perils Insurance will pay only: (a) replacement cost to rebuild the building at the same location, to the extent the Borrower can rebuild it there; and (b) "actual cash value" for the part of the building that could not be rebuilt. Unfortunately, "actual cash value" reflects deductions for depreciation, obsolescence, and other factors. In the worst case, the insurance award might not cover the loan. Depending on the condition of the insurance market, Borrowers, Lenders, and their advisors can nevertheless tailor insurance coverage to make the Lender whole for the resulting "loss of economic value" (and also tailor the corresponding insurance requirements in the loan documents). The disposition of Insurance Proceeds from a major loss affecting such a building then becomes an issue between the Borrower and the Lender, outside the scope of this discussion.

[8] After a loss, an insurance carrier may impose "coinsurance" adjustments to punish a property owner that underreported the insurable value of its property. (Coinsurance provisions sometimes bear a more innocuous label, such as "proportionate reduction in indemnity" or "margin clause.") For example, if the true replacement cost value of the mortgaged property is $100 and the owner insures it for $40, this represents a 60% level of underinsurance. The insurance carrier was being shortchanged by 60% of the premiums it should have received for bearing the full risk of all possible losses that might affect the building (anywhere from 1% to 100% of its insurable value). The insurance carrier will therefore reduce any Insurance Proceeds by the same percentage, 60%. Under these facts, if the mortgaged property suffers a $30 loss, the carrier will pay only $12 (a 60% reduction, based on a 60% failure to insure). In an "agreed amount endorsement," the insurance carrier waives this adjustment and signs off on the Borrower's valuation. These endorsements can apply to Special Perils Insurance and Rent Loss Insurance.

[9] Any insured will prefer "replacement cost value" over "actual cash value." Through a valuation clause, "actual cash value" deducts some percentage from any Property Insurance proceeds for depreciation and obsolescence of the mortgaged property. "Replacement cost value" does not.

[10] Coverage for acts of terrorists does not cover losses caused by war, which are not currently insurable. Historically, the federal government has issued limited war insurance during certain periods of hostilities.

[11] The preceding sentence offers a brief reminder of the insurance markets in 2001 and 2002. Terrorism insurance was virtually unobtainable. Some servicers still required it, regardless of cost or relative benefit. During that moment in commercial real estate history, newspapers covered terrorism insurance litigation on the front page. All-day seminars devoted themselves to terrorism insurance. Courts forgot about rules against issuing injunctions in disputes that related merely to (non)payment of money. Terrorism insurance often dwarfed all other issues in loan document negotiations. Though Borrowers and Lenders often negotiated all night to do it, they usually agreed on compromise measures like the following, or some subset or variation: "Notwithstanding anything to the contrary in the Loan Documents, Borrower shall provide terrorism insurance only to the extent that: (a) by expending no more than $______ per year in incremental insurance premiums, Borrower can obtain terrorism insurance coverage of at least $______ per insured loss; (b) at the time in question, [institutional] [prudent] [reputable] owners of Comparable Properties are generally purchasing and maintaining terrorism insurance; and (c) terrorism insurance is commercially available through ordinary insurance markets upon paying premiums that are commercially reasonable under the circumstances." Although terrorism insurance has receded in importance, at least for now, some Borrowers and Lenders still negotiate over it, fearing that federal legislation on the topic may expire without being renewed.

[12] As part of the closing process, the Lender should ascertain the flood zone status of the Mortgaged Property.

[13] The National Flood Insurance Plan can cover flood losses, based on actual cash value, of up to $500,000 per commercial building (plus $500,000 for the contents of each building), but not loss of business income or rental income. Private carriers can and do issue more flood insurance. Some Lenders require it.

[14] The scope of Earthquake Insurance can vary, depending on how the policy defines "earthquake." It may and may not include mudslides, sinkholes, general earth movement, and even water-saturated land. A Lender may want to beef up these Earthquake Insurance requirements in earthquake-prone areas.

[15] For a securitized loan, deductibles beyond 5% of annual net cash flow may require corresponding reserves to cover the Borrower's exposure.

[16] Boiler and Machinery Insurance isn't really just boiler and machinery insurance. It covers: (a) explosions of boilers and pressure vessels (no surprise); (b) any mechanical and electrical breakdown of machinery and equipment in a building (essentially any building system —far beyond boilers and pressure vessels); and (c) any damage or loss from an insured event.

[17] Special Perils Insurance does not usually cover losses during significant construction, because the level and mixture of risks varies so much from (and usually exceeds) those in a completed building in operation. During major construction, a building owner plugs that gap with Builder's Risk Insurance, covering the higher/different exposure to loss during construction. Builder's Risk Insurance covers the owner's and the contractors' interests in materials installed in the structure and (if properly endorsed) in materials in transit or stored off site. Coverage can be extended to cover "soft costs" (incremental debt service, incremental architecture and engineering expenses, permits, and other expenses not directly related to construction but that the owner incurs to reconstruct). This coverage can also cover a delay in opening that results from a loss during construction. For substantial construction projects, the structuring of Property Insurance and Liability Insurance is a science in itself. A careful owner can dramatically reduce its costs by avoiding duplication and consolidating all coverage in one place, as mentioned in the introductory notes. These sample insurance provisions are not designed for a construction loan.

[18] A "reporting form" requires monthly reporting of values, creating opportunities for error and risk of coinsurance. Borrowers and Lenders usually favor a "Completed Value Form." This eliminates the reporting requirement, basing coverage instead on the value of the project as completed.

[19] Without this endorsement, if the Borrower finishes construction and allows occupancy of the building, the insurance coverage may vanish.

[20] This extra coverage is discussed above, in the context of Special Perils Insurance.

[21] A rental interruption endorsement to Builder's Risk Insurance adds Rent Loss Insurance to the package of Builder's Risk Insurance coverages.

[22] For investor-owned commercial real estate, Rent Loss Insurance covers the Borrower's loss of rental income and the need to keep paying fixed expenses even while the Mortgaged Property is out of operation, up to the coverage limits. Rent Loss Insurance helps the Borrower only to the extent that leases excuse tenants from paying rent after casualty. If the leases don't abate rent after casualty and instead the tenants just decide not to pay, Rent Loss Insurance won't help. This is why Borrowers and Lenders often want leases to abate rent after a casualty. Of course, the abatement must mesh correctly with the Borrower's Rent Loss Insurance. This coverage will pay up to the coverage limits during a recovery period starting on the date of loss and continuing until the time when, with "due diligence and dispatch," the Mortgaged Property can be restored to its condition before loss. If the Borrower owns, instead of leases, the Mortgaged Property, then the documents would instead require the Borrower to maintain "business interruption insurance," raising similar issues.

[23] An "extended period of indemnity" extends Rent Loss Insurance beyond the date when payments would otherwise end, i.e., the date when the Improvements are restored to their condition before loss. In this extension period, the insurance payments continue, up to the specified maximum, to give the Borrower more time to bring rental income (or business income, in the case of business interruption insurance) back to its level before the loss occurred. This can smooth out lost cash flow and protect the Borrower from some market fluctuations.

[24] Liability Insurance provides third-party coverage, protecting the insured (the first party) from loss from "tort" liability to third parties. "Tort" refers to damage or injury that one party causes another without a contractual relationship. A car crash creates "tort" liability. So might a banana peel on which someone slips and falls.

[25] The commercial general liability policy is the most widely used form for liability coverage. Loan documents still often refer to the "comprehensive form," which was issued in 1972 and required major modifications before Lenders could tolerate it. One still sometimes sees that policy form, but should avoid it. The "commercial form" of general liability insurance policy is broader, solving many problems of the "comprehensive form." All general liability insurance covers only bodily injury, property damage, and death.

[26] A commercial general liability policy typically excludes automobile liability. Therefore, it has become common practice to require this coverage as a separate and additional item.

[27] "Umbrella" liability insurance provides coverage beyond the "primary" liability coverage. It sits on top of the insured's basic liability coverage package: commercial general liability, automobile liability, and the employer's liability part of a workers' compensation policy. Umbrella liability insurance is usually a bit broader than the underlying coverages, considered as a whole. In contrast, "excess" liability coverage merely increases the dollar amount of particular component(s) of the underlying liability coverage. An insured Borrower (and a typical Lender) will usually prefer "umbrella" over "excess" liability coverage.

[28] Policy limits should cover the maximum liability that the Lender and its advisors think has some reasonable likelihood of occurring, taking into account the location, occupancy, risks, size, use, and other characteristics of the mortgaged property. In today's world, any commercial property should rarely carry coverage of less than $5 million to $10 million. A substantial property should carry at least $10 million to $25 million. A very large or trophy property should carry $30 million or more. These limits always depend very much on specific circumstances.

[29] Commercial general liability and umbrella liability insurance contain annual policy aggregates. For multiple-location ("blanket") insurance policies, these aggregates can and should be extended to apply on a per location basis.

[30] If the borrowing group wants to share aggregate limits of insurance among many locations, the Lender should require higher limits, because of the possibility of multiple large losses across the portfolio.

[31] An insured often enters into contracts (such as leases, management contracts, and service contracts) where the insured agrees to indemnify third parties against losses that the insured's Liability Insurance would cover, such as certain property damage, bodily injury, and death to third parties. So that Liability Insurance will back up those indemnity obligations, the insured will typically obtain "Contractual Liability" coverage in its policy. With that extra coverage, which is not automatic, the insured's Liability Insurance covers indemnity obligations arising under only certain "Insured Contracts," as defined in the insurance policy. Any "disconnect" between the policy language and the Borrower's contractual indemnity obligations can produce unpleasant surprises.

[32] By becoming an "additional insured" under the Borrower's Liability Insurance, the Lender protects itself against "vicarious liability"—liability it might indirectly suffer from the Borrower's acts and omissions for which some plaintiff can somehow directly or indirectly blame the Lender, in whole or in part. The importance of this coverage cannot

be overstated in today's world of ever-wider liability of parties that one might have thought to be "passive" and "innocent" a few decades ago. "Additional insured" status does not protect the Lender from liability for its own acts or omissions. For that protection, the Lender must maintain its own liability insurance (or self-insurance). A Lender is not entitled to "additional insured" status on the Borrower's policy automatically, but must obtain an appropriate endorsement or other documentation.

[33] Environmental Insurance can provide both first-party and third-party coverage for clean-up costs both on and off site. Environmental Insurance varies widely, depending on the specific circumstances of the specific site. It is usually written on a "claims made" basis, for some multiple of $1 million in coverage. Virtually every Environmental Insurance policy must be tailored to reflect known environmental conditions (if any) at the site and other unique circumstances. This task requires cooperation among the Lender's environmental, risk management, and insurance advisors. Because of the potential complexity and site-specific nature of this coverage, where it is needed it may be one of the longest lead time items for the closing. It will also typically be quite expensive.

[34] These requirements will not suffice for any Project that contemplates remediation. For any such Project, the clean-up contractor should provide at a minimum special coverage for environmental remediation, naming the Borrower and the Lender as additional insureds. The Borrower and the Lender may both also want coverage that assures them the cost of remediation will not exceed a certain dollar figure, so-called "cap cost insurance." The Lender will need to tailor any environmental coverage to a specific Project and specific remediation plan.

[35] The specific requirements for insurance-related deliveries at closing are covered in, for example, Joshua Stein, *What a Mortgage Lender Needs to Know About Property Insurance: The Basics*, Real Estate Finance Journal 46 (Winter 2001).

[36] Evidence of insurance can take several forms. These can include binders, typically signed by the insurance company underwriter and carrying the most gravity. Instead, one usually sees certificates of insurance. Property Insurance should only be evidenced by the recently issued ACORD Form 28 certificate, replacing (and solving some problems with) the former ACORD Form 27 certificate. The latter certificate should no longer be used for commercial transactions, though it often still is. ACORD Form 28 contains good language to confirm its correctness and the Lender's interest in the policy. Brokers will try to use an "ACORD Form 25" certificate to evidence Liability Insurance, but it contains so many disclaimers that it serves no reliable purpose. A Lender should instead try to obtain an additional insured endorsement or an insurance binder that either expressly mentions the Lender or states: "additional insured status is automatically extended where required by written contract." Some brokers have come up with their own forms to evidence a Lender's coverage, containing inappropriate disclaimers. Such forms should be avoided.

[37] Policy requirements should also reflect the Lender's guidelines and those of the Rating Agencies, if applicable.

[38] In May 2003, Standard & Poors reduced from "AA" to "A" the minimum required rating for a Property Insurance carrier in AAA-rated securitized transactions.

[39] Borrowers often propose to finance their annual insurance premium. They borrow the premium at the beginning of the policy term, then repay it over the next eight to 10 months with interest. If the policyholder (Borrower) misses a payment, the premium finance company can, and usually does, exercise its right to cancel the insurance policy. In accordance with the Standard Mortgagee Endorsement, the insurance carrier must then notify the Lender that the policy is being cancelled. The Lender must then scramble to save the policy within 10 days after receiving notice. Many Lenders regard this mechanism as unacceptable.

[40] The Standard Mortgagee Endorsement and Lender's Loss Payable Endorsement may protect the Lender from certain "bad acts" by the insured. For more on these endorsements, and some inadequate substitutes for them, *see* Joshua Stein, *What a Mortgage Lender Needs to Know About Property Insurance: The Basics*, 16 Real Est. Fin. J. 46 (Winter 2001).

[41] Nearly all insurance policies contain an "other insurance" clause, precluding recovery if another policy covers the same risk. In other words, if a carrier can find some other carrier to bear a Loss, then the first carrier may refuse to cover it. This finger-pointing can produce a mess after any Loss, to the point where the insured might have had better coverage by buying less coverage. To avoid the problem, the insured Borrower should obtain the first carrier's permission to maintain the second policy. The first carrier would agree not to try to make the second carrier the "bagholder" after a Loss. In any multi-policy insurance program, the Borrower will need to obtain this permission for all underlying insurance, excess insurance, and participating insurance. When a Lender reviews the Borrower's insurance program, the Lender must confirm that multiple carriers have appropriately recognized one another's positions, to prevent unexpected disputes among carriers (and even a denial of coverage) upon Loss.

PRACTICE CHECKLIST FOR

Model Insurance Requirements For A Commercial Mortgage Loan

Commercial buildings make good collateral so long as they are not damaged or destroyed. The lender will typically regard the borrower's obligation to insure the mortgaged property as one of the most fundamental nonmonetary obligations under any loan documents. Therefore, the loan documents should require the borrower to maintain an appropriate package of insurance coverage for the mortgaged property.

• When representing the lender in negotiating a commercial loan secured by a commercial building:

__ Start with a generic set of provisions that require the borrower to secure a variety of types and levels of insurance. This article offers such a set of provisions.

__ Tailor those insurance provisions, with help from insurance experts, to reflect a building's special characteristics. Recognize, however, that opinions on insurance products and risk management techniques can vary.

• A borrower should generally provide at least these specific types of insurance:

__ Special perils insurance;

__ Flood insurance;

__ Terrorist risk insurance (certified "TRIA" and/or noncertified "domestic terrorism");

__ Earthquake insurance;

__ Boiler and machinery insurance;

__ Builder's risk insurance;

__ Rent loss insurance;

__ Liability insurance;

__ Statutory employees' insurance;

__ Environmental insurance (sometimes); and

__ Blanket coverage (sometimes).