A Conversation About Property Insurance in Loan Closings With James Branigan and Joshua Stein

Joshua Stein

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(Stein) Why does insurance coverage delay loan closings?

(Branigan) Most people don't understand what insurance polices do, what they're supposed to do, what their limitations are and the variables that they can include. As an example, I worked on a loan for an office building built above a historic theater. The theater had frescoes, sculptured ceilings, architectural millwork, and other unique features. The valuation clauses in the insurance policy did not contemplate the special values that would have been involved had there been a loss. The standard insurance policy wouldn't have covered the whole loss as the insurer would have many arguments, i.e., to put in sheet rock in place of a fresco ceiling.

My point is that getting the right insurance coverage takes time and analysis, and isn't something you can always do the day before the closing. The same holds true for a lender looking at a borrower's insurance package. It's just not something you can rubber stamp and say you're done—or at least it shouldn't be as it requires intense scrutiny and, very possibly, remediation.

(Stein) Is a certificate of insurance adequate evidence of coverage?

(Branigan) ACORD Form 27 is the only certificate of property insurance adequate to communicate a mortgagee's interest in real property and in the proceeds of rental income or business interruption insurance.

(Stein) So property insurance should be evidenced by an ACORD 27, rather than an ACORD 25?

(Branigan) Yes, an ACORD 27 or its equivalent. The ACORD 25 certificate of insurance is okay for the liability coverage provided you've reviewed the insurance policy and found the appropriate endorsements to extend additional insured status to the lender. However, I see ACORD 25's being used to communicate the mortgagee's interest in property insurance. They shouldn't be. An ACORD 25 has so many disclaimers that anything written on it is virtually worthless.

(Stein) So why do lenders take them?

(Branigan) They just don't know any better.

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How much coverage should lenders require on properties?

(Branigan) Property insurance should be 100 percent of replacement value.

(Stein) Should a lender be willing to accept 80 or 90 percent of replacement value?

(Branigan) Some policies say that if you insure 80 or 90 percent of the value, they'll pay the amount of insurance without applying any coinsurance penalty, but it's safer to insure 100 percent of the replacement value. There's really no incremental cost to speak of.

(Stein) What's the difference between rental insurance and business interruption insurance?

(Branigan) Both cover the financial loss, or the financial exposure to loss over a period of time, if there's a casualty. Rental insurance insures the landlord's loss of rental income and business interruption insurance covers an operating business against the loss of business income because of a casualty. Coverage includes loss of net profit to the business, plus continuing business expenses, such as real estate taxes and rents, to name a few.

(Stein) With rental insurance, if a building burns down, there's a period you can't get rental income on the premises while you're dealing with the insurance company, then there's another period you're restoring the premises, and another period when you're finding new tenants. Rental insurance covers all of these?

(Branigan) Two out of three. It only covers the period from the loss until the time the owner could restore the premises to its earlier condition "with due diligence and dispatch." But it doesn't cover the time after that you might need to find a new tenant. If you want coverage for that period, too, you need to buy an "extended period of indemnity."

These days lenders are looking for at least six months of "extended period of indemnity." But the extra coverage is cheap—perhaps only $1,000 for $1 million so we often recommend buying more.

(Stein) So you're saying the additional extended period of indemnity should reflect how long it's going to take to find that new tenant. What if at the time of the casualty the real estate leasing market happens to be very bad? Will the insurance company still pay under the extended indemnity while you're out there looking for tenants that don't exist?

(Branigan) Yes.

(Stein) Should the landlord buy rental insurance or should the tenant buy business interruption insurance?

(Branigan) It depends on the deal. What does the lease say about rent abatement after a casualty? If the lease says the rent abates to the extent that the premises are damaged and untenantable, then the landlord should buy rental insurance. The tenant running a business from that space will probably still have its own business interruption insurance, though. We find that owners typically prefer to allow a rent abatement and buy rental insurance, particularly if they can pass the cost through to their tenants. This way they don't have the grief of making sure the tenant actually buys the right business interruption insurance, and they won't have to deal with the tenant or the tenant's insurer if there's ever a loss.

(Stein) You mention the grief that landlords incur when they have to police their tenants' insurance coverage. What about borrowers and lenders? Don't lenders incur a lot of grief when they have to police their borrowers' insurance coverage? Let's think outside the box for a minute. For loan closings, would it make sense for lenders to arrange insurance coverage through some kind of bulk deal, rather than having individual borrowers do it? Wouldn't this save money and avoid more grief? I'm suggesting here, I guess, a system where lenders might have an "insurance servicer" who would purchase all the insurance coverage for an entire portfolio in the ordinary course and you could stop worrying about things like insurance certificates and expiration dates and all that.

(Branigan) If lenders provided insurance, borrowers could lose control over their insurance programs. And borrowers who purchase insurance for multiple locations would suffer a loss of buying power. If real estate owners were to take two or three buildings out of a portfolio and put them into their lender's master program they might well lose the volume of business to support the rest of their portfolio.

(Stein) Wouldn't lenders who hold loan portfolios or buy through insurance servicers have similar buying power? And wouldn't they have more buying power than all but their most substantial borrowers?

(Branigan) It depends on the circumstances, but most of the owners I see want to control their own insurance program. And they also want to tailor it for their own projects, their own way of doing business. I suppose a lender could set up an insurance program that would insure plain vanilla

properties on broad terms and conditions. The drawback might be that lenders would find themselves somehow guaranteeing that the insurance program is the right package for all their borrowers.

(Stein) You'd need an insurance servicer responsible for selecting and placing the insurance, seeing it stays in place, paying premiums, and making sure the insurance complies with the lender's loan documents. Then there's insurance that ought to have been bought but wasn't. You'd have to document it so it's neither the lender's nor the insurance servicer's responsibility. And under the current regulatory framework any lender would at a minimum want to make the package entirely optional, which is probably only the beginning rather than the end of the legal and regulatory issues.

(Branigan) You've covered a lot of points. Let's look at loans under $10 million in lending value. These transactions—conduit loans—might conceivably lend themselves to a group purchasing plan sponsored by a bank or lending institution.

The downside for insurance buyers is that today they may want to package the property and liability insurance and some contingent business interruption, as well as international exposures, into one policy. The property policy typically anchors that coverage. Without the property coverage, they would pay a disproportionately high rate on some of the ancillary coverage.

(Stein) But this is a dialogue that might be worth continuing. If it makes economic sense to shift some of the insurance function away from borrowers on a property-by-property basis onto the shoulders of third-party insurance servicers who can buy in bulk for a whole portfolio, maybe someone will identify it as an opportunity and figure out how to do it.

(Branigan) And maybe not. ■