



**Insurance & Risk Management
Due Diligence for
Commercial Lending Transactions**

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Section I: Insurance Policy Terms & What They Mean

Scores of Property and Casualty insurance companies operate in the United States and globally. Each modifies its policies and uses its own method to define the extent of coverage it will offer. A borrower's insurance policy can result in a dizzying number of coverage options and modifications. Understanding the basics of insurance coverage is essential to securing the right policy for your lending transaction.

The following is a list of significant coverage areas for real estate-based lending transactions. It includes variations insurance companies have used to restrict, or in some cases, eliminate coverage:

All Risk Insurance Policies:

An "All Risk" insurance policy does not really cover all risks. A typical "All Risk" (or Special Perils Form) policy, covers risks of loss unless otherwise excluded, can contain upwards of twenty or more exclusions. Some of those exclusions are as follows:

- Loss of market; loss of use; damage or deterioration arising from delays caused by an insured peril (*Endorsement Available*)
- Explosion, rupture, or bursting of steam boilers, steam turbines, gas turbines and steam engines; rupture, bursting, cracking of pressure vessels, piping or apparatus; mechanical or electrical damage to equipment or electrical apparatus(*Endorsement Available*)
- Natural or man-made earth movement including, but not limited to, earthquake, landslide, mudflow, earth sinking, earth rising or shifting, subsidence, earth movement, loss by fire, explosion or sprinkler leakage ensuing from any of the above. (*Endorsement Available*)
- Flood, surface water, tidal or seismic sea wave, rising of any body of water (including the overflowing or breaking of boundaries), sewer backup, seepage or influx of water from natural or underground sources into basements or other floors. Loss resulting from, contributed to, or aggravated by any or all of the above is not covered. (*Endorsement Available*)

Flood, Earthquake & Windstorm Insurance:

Flood

Flood exclusions may also exclude coverage for sewer backup, surface water, and seepage. The Special Perils policy covers physical loss or damage by a covered peril (fire, etc.) ensuing from any of the above exclusions. For example, if a flood causes a short circuit in electrical equipment and a fire results, the fire damage is covered but the flood and short circuit damage is excluded. Flood is covered in a flood policy and short circuit is covered in a boiler & machinery policy.

Exclusions for Flood and Earthquake (or Earth Movement) are wide ranging and can include losses caused by landslide, sinkhole and mudslide. Some policies go so far as to define mudslide as “water saturation of land” and consider this event to be a flood.

If the property is located in California where mudslides are common, or in Texas and Florida where massive sinkholes have been known to swallow entire buildings, particular attention should be paid to these potential occurrences. Many insurance carriers will intentionally neglect to add coverage for these excluded perils.

Flood coverage also includes tidal or seismic sea wave (a tsunami or tidal wave caused by an offshore earthquake); water runoff or surface water; and seepage, an influx of water from natural or underground sources into basements or other floors.

The Federal Emergency Management Agency (FEMA) is responsible for determining flood hazard exposures in communities in the United States. The relative exposure to flood losses is determined by the use of flood hazard zones. The basic zones are outlined below:

Zone A – An area within the 100 year flood plain – Highest Hazard

Zone B - An area inundated by 500-year flooding; an area inundated by 100-year flooding with average depths of less than 1 foot or with drainage areas less than 1 square mile; or an area protected by levees from 100-year flooding.

Zone C - An area that is determined to be outside the 100- and 500-year floodplains.

Zone D - An area of undetermined but possible flood hazard.

Zone V – An area inundated by 100-year flooding with velocity water damage hazard

Zone X – An area that is determined to be outside the 100- and 500-year floodplains, this is the lowest hazard area.

Generally speaking, the standard that many entities operate under is that if a given property is not on a recognized flood plain (A, B or V), they do not purchase insurance for flood. We recommend that flood insurance be purchased as a part of all property insurance policies. While floods may be statistically less likely in Zone C or X, they are not impossible. To purchase insurance for locations in these low hazard areas, an entity would not have to pay a significant premium and it is possible that there would be no additional premium for the coverage.

For locations in higher flood hazard areas, a review of the building to be insured should be undertaken to help establish a reasonable minimum flood insurance level. Since floods generally will only affect the basement and lower floors of a building, an estimation of the values exposed in these levels, combined with possible business income losses due to the flood, would help us determine this reasonable minimum level of insurance. A building exposed to a Velocity Flood Zone could be undermined and completely swept away.

Windstorm

As a rule damage from wind is covered under a standard “special perils” property policy. The issue arises once a storm is given a name by the National Hurricane Center. Once this occurs, coverage restrictions included in most property policies that cover locations along the coast of the Gulf of Mexico, the Eastern Seaboard, and the Caribbean will come into play and high deductibles or outright exclusions may apply.

As a result, of these coverage restrictions, specific Named Windstorm coverage may need to be purchased for a given location. As with the flood and earthquake perils already discussed, a specific review of the location, its exposures loss and any relevant loss studies need to be reviewed to help establish an acceptable minimum level of insurance coverage.

It is also important to keep in mind that some insurers may exclude the peril of wind from their policy, whether named storms or not, if there are locations in high wind hazard areas. This needs to be reviewed carefully to ensure that adequate coverage is in place for a given property.

Additionally, wind driven rain is excluded in many commercial property policies depending on the type of construction. Especially problematic are hotels or apartments with through-the-wall heating and air conditioning units.

California (or other high hazard zone) Earthquakes:

Earthquake hazards in California require special risk management considerations. Insurance policies for properties located in this state, **as well as those located in Hawaii, the Pacific Northwest, New Madrid, and Puerto Rico**, usually carry significantly reduced limit of liability for this hazard. (Note: it may require many insurers participating on an overall insurance program to build the desired amounts of insurance) In addition, they universally impose a percentage of insurable value deductible (usually 5%). To determine the amount of earthquake insurance for California locations, an engineering study, called a seismic PML (Probable Maximum Loss) study is used to formulate an estimate of the earthquake damage expected at a given facility.

If more than one California location is included in a single property insurance policy, the evaluation must take into account that an earthquake, or several earthquakes, could potentially cause damage at multiple locations. Where multiple locations are insured in one earthquake insurance program a portfolio PML analysis should be conducted.

The following steps should help in evaluating earthquake risk:

1. A Probable Maximum Loss study should be conducted by a seismic engineering firm. This study takes into account the location of the property, its distance from a fault line, the ground composition under the building, the year and type of construction and the expected EQ intensity at the site. The survey will provide damage estimates as a percentage of total replacement cost. Damage is estimated at two confidence levels.

The most conservative level is the PML 90 level (or SUL= Scenario Upper Loss). Using engineering data, the surveyor calculates damage that can be expected during an Earthquake that recurs once every 475 years at the statistically sure 90th percentile. The less conservative level is PML 50 (or SEL= Scenario Expected Loss). At this lower confidence level, a lesser amount of damage can be expected. To arrive at the estimated property damage loss, take the damage percentage at the PML 90 level and multiply that factor by the 100% replacement cost value of the location. If, in the same policy, multiple locations in California are insured for earthquake, consider the maximum damage that might be expected if they are all affected by one earthquake event. The Portfolio PML Study should estimate damage that might be incurred among several locations from the same earthquake event.

2. Estimating Total Damage: The PML study only estimates the percentage of property damage. Forecasting the loss of business interruption or rental income is not quite as easy. Coverage limits in an earthquake insurance policy are applicable not only to property damage loss but also to business income/rental income loss. Some advisers take a position of utilizing the PML damage percentage and applying it to the annual rental income value, but this may not be the best approach to estimating potential business income loss.

Following a major earthquake, construction resources, are going to be in great demand. Resources will be deployed first to restore infrastructure and hospitals, and then to residential structures. Office buildings and shopping malls will most likely be the last to be allocated these resources.

Earthquake PML damage is broken down into one of several levels for a given site. Typically, five damage levels, from slight to major, are provided in the seismic PML study. At levels described as "slight" or "light" a conservative lender might estimate business income at a six-month level. At "moderate" levels (damage between 10 and 30%), an estimate business income loss at 9 months to 1½ years' insurable value depending on where in the range the estimate falls. When damage estimates are higher, above 30% and above 50%, some use 1 to 2 years' insurable value and 1½ to 2½ years' insurable values, respectively. This exercise should be completed for each location insured in a seismically active area. Remember that if damage exceeds a certain percentage, municipal authorities will condemn the structure.

The lender's tolerance for risk will dictate the percentages of annual rental income loss, if any, used in the calculation.

Some lenders use "Probable Loss" levels. This measure of damage is based on uniform criteria and is noted by ASTM in its publication ASTM Guide E 2026-99) "Standard Guide for the Estimation of Building Damageability in Earthquakes" as a more accurate measure. PML is not always defined by all as a 475-year event at 90% confidence levels. You must review the seismic report carefully. Probable loss estimates are further broken down as Scenario Upper Loss and Scenario Expected Loss (SUL & SEL).

The amount of earthquake insurance available from a single insurance company is usually limited. On a large Commercial insurance risks with multiple locations there will be multiple insurance policies. A program with multiple insurance policies grouped together to provide high limits is called a layered program. Special care must be taken in the review of these types of programs to ensure that the layers connect properly and that the schedules of underlying insurance are accurately stated in each successive layer.

Insurer ratings also must be researched for large earthquake programs. To assemble an insurance program with sufficiently high limits to satisfy the needs of the risk (called capacity), you may have to include insurance carriers with lower-than-normally-required ratings to assemble enough capacity.

Earthquake insurance in areas that are seismically active, such as California, is expensive, particularly during a period immediately following an earthquake. When setting the amounts of required earthquake insurance, great care must be taken to fairly analyze exposures. Being overly conservative or arbitrary in setting earthquake insurance requirements will not be popular with the lender's clients. However, if the amounts of required coverage are inadequate in a loss situation, the viability of the investor's asset will be at risk.

National Flood Insurance:

The National Flood Insurance Program was established by the US government to provide an insurance facility for the sharing of risk among residential and commercial property owners. This insurance program provides coverage for properties that are in areas that are considered high hazard (Zones A and V, the 100 year and Velocity Flood Zones respectively) and which the standard insurance markets are unwilling to insure. For commercial properties, the maximum amount of insurance currently available under the Federal Flood Insurance program is \$500,000 for each commercial building and \$500,000 for its contents (Residential properties have \$250,000 available for building and separately for contents). Coverage for business interruption or rental income loss is not provided in the federal insurance program. Losses are adjusted on an Actual Cash Value (ACV) basis vs. Replacement Cost Value (RCV). This gap in consistent policy terms leaves a portion of the loss underinsured.

Many lenders and their attorneys fail to reserve the right in the lending agreement to require Flood insurance in excess of that provided by the National Flood Insurance Program. Most insurers are able to provide excess insurance for damage to property on a replacement cost basis as well as provide extensions for business interruption or rental income loss.

During the particularly harsh 2005 hurricane season, Hurricane Katrina caused the levees protecting the City of New Orleans to weaken and fail, resulting in the total flooding of the city. The time needed for New Orleans to recover is unknown even months after the initial breach of the levees and flooding. Much of New Orleans was indicated on Federal Flood Maps as lying in "Zone B" which FEMA defines as an area of moderate flood hazard, usually between the base flood elevation and the 500 year flood levels. Zone B area are also used to

designate base flood plains of little hazard, such as those with average depths of less than 1 foot. Base flood area (aka Zone A) is one with a 1% chance of flooding in 100 years.

Since Hurricane Katrina Moody's has published a paper encouraging lenders to keep their options open by allowing the lender to require flood insurance in excess of that available in the NFIP in the lending agreements.

Occurrence and Annual Aggregate Limits Of Liability:

The perils of Flood and Earthquake are commonly written with an occurrence and annual aggregate limit of liability. The most the insurer will pay for any one occurrence, regardless of the number of locations insured in the same policy, is limited to the amount of insurance, called the *occurrence limit*. The *aggregate limit* of liability is the most an insurer will pay during an annual policy for a specific peril. For example, if Flood coverage is provided to a limit of \$10 million per occurrence and per aggregate (represented as \$10MM/\$10MM), the most the insurer will pay is \$10 million for all losses regardless of the number of occurrences or locations affected by a flood or multiple floods during a given policy year.

Percentage Deductibles:

Insurance carriers impose mandatory percentage deductibles for the perils of Earthquake in California and Windstorm in many coastal areas. These deductibles are applied against the Total Insurable Values (TIV) for a location. The deductible is calculated by adding the property and business interruption values and then multiplying by the deductible percentage. The deductible can apply against the value of several locations or a group of buildings.

California earthquake deductibles are usually five percent. In some cases they may be structured per building or per unit of insurance (i.e., building, contents, etc.). Deductible percentages can be adjusted up or down commensurate with premium credit or debit. Other factors that can affect pricing and are often related to recent losses. For example, following an earthquake event insurance premiums rise and deductibles can be set at a higher percentage. Windstorm coverage for coastal areas can have deductibles ranging from one to five percent depending on proximity to the coast and severity and frequency of the hazard.

Terrorism Insurance:

Background: Prior to September, 2001, insurance policies in the United States did not contain exclusions for damage caused by, or liability emanating from, acts of terrorism. Following the terrorist attacks on September 11, 2001, which resulted in the largest single insurable loss in history, re-insurers, followed by insurers, began excluding loss or damage caused by acts of terrorism. This created a significant crisis in the insurance and commercial lending industries. Insurance response in Standard Fire Policy States (SFP) and non-SFP states differed and insurers and the Insurance Services Office (ISO) began a frantic effort to limit the insurance industries potential loss by either total exclusion of loss caused by acts of terrorism or devising terrorism insurance endorsements that limited the insurer's liability and side-stepped state

insurance regulations. One of the earliest post 9/11 drafted ISO endorsements redefined the basic definition of a terrorist occurrence to mean all terrorist occurrences in the United States within a 72 hour period. This endorsement limited the insurer's liability for all losses resulting from all acts of terrorism (insured or not) to \$25 million. The lack of available coverage for acts of terrorism in the insurance market and the sudden demand for coverage by owners and lenders alike, contributed to a secondary terrorism insurance market. The number of insurers offering coverage was tremendously limited and premiums ranged as high as 5% of the limit of insurance provided.

It was action by insurers to restrict or eliminate coverage for acts of terrorism that eventually led to intense lobbying by the banking and real estate industries and ultimately to the enactment of Federal legislation on November 26, 2002. The Terrorism Risk Insurance Act (TRIA) provides government-sponsored re-insurance to insurance companies for the acts of *international* terrorism. The 2002 Act mandates that coverage be offered by all insurers to their policy holders for an additional premium. International terrorism acts would have to be certified by the US government for the Federal re-insurance to become effective. Acts of *domestic* terrorism were excluded under the 2002 (and 2005 extension) TRIA legislation, however, coverage for domestic terrorism was offered by some insurers for an additional premium.

The 2005 extension of TRIA was scheduled to expire on December 31, 2007. Throughout the later part of 2007, several attempts were made to get an extension bill passed. Without such an extension, the commercial lending market could have been put into a further period of uncertainty. In December of 2007, both Houses of Congress passed an extension bill; however, the House version included many provisions that would have made it very unlikely that the bill would be signed by the President. One of the bigger issues was the inclusion of Life Insurance under the act. Both houses eventually agreed that some form of the bill was better than none, so a final version was agreed to and signed by the President.

The Terrorism Risk Insurance Program Reauthorization act of 2007 contains many of the same provisions as the predecessor acts. Some of the bill highlights are:

1. There is no distinction between foreign and domestic acts of terrorism. This was a broadening of the previous act which only included domestic terrorism.
2. The coverage trigger is increased to \$100,000,000.
3. The government's share of losses remains at 85%.
4. This latest legislation will expire on December 31, 2014.

There is no coverage for Life Insurance or Nuclear, Chemical or Biological hazards

Exclusions, Perils, & Property:

In addition to the more well-known aforementioned exclusions, the "All Risk" policy also contains exclusions for the following;

- Defect in materials, faulty workmanship, faulty construction or design error.

Note: These conditions are excluded because they are not in the nature of loss from an "external cause." Example; during construction, defective materials installed in new construction may be covered by Products Liability insurance from the manufacturer or Completed Operations insurance from the contractor in the case of faulty workmanship. These are conditions that are built-in to the property and are usually covered by another type of insurance. The architect and engineer may have provided a faulty design and should have had Professional Liability insurance to cover potential defects in their design. The existence of coverage from those engaged in construction projects is often overlooked. Most architects and engineers (A&E) provide liability limits of only \$1 million to \$5 million per occurrence and in the annual aggregate for all of their projects. This amount of insurance is probably not adequate for a large project. See the construction section for more on A&E Professional Liability.

- Collapse of a structure or building is usually excluded and then added back on a restricted basis.

Note: Insurers control their exposure to this type of loss by totally excluding coverage for collapse and then adding coverage back on a restricted basis. The added coverage usually includes collapse caused by or resulting from fire and extended coverage usually termed "specified causes of loss," and loss caused by the weight of people inside buildings or rain that collects on a roof. Excluded is collapse caused by faulty design or use of defective materials or methods in construction, remodeling or renovation errors. Coverage is usually provided if these perils cause collapse during construction. The key coverage condition here is "during construction." You must assume that coverage under a property policy is not provided after construction is completed. The extent of coverage provided by insurers varies. Actual policies should be examined as part of the due diligence process.

- Ordinance and Law coverage also referred to as Demolition and Increased Cost of Construction (D&ICC) adds coverage for the cost to rebuild property that did not exist prior to a loss, but became necessary due to changes in building or other code regulating reconstruction. *(Endorsement Available) The endorsement will also include coverage to demolish the undamaged portion of the building, if local code requires such action after a loss.*

Note: The cost of reconstructing a building to conform to existing laws and ordinances following a loss is not covered in the unendorsed property insurance policy. The Property insurance policy will pay to replace damaged property that existed prior to loss, even if it was not in compliance with current building laws and/or other statutes such as the Americans with Disabilities Act. For example, the policy will not pay additional costs to install automatic sprinklers or handicapped-accessible doorways. The insurance for this additional exposure is purchased as an endorsement with separate sublimits of liability.

- Mold is generally excluded from the Special Perils or "All Risk" policies. Some policies make limited exception if the mold is the result of a loss insured in the policy, such as water

from firefighting operations that results in a mold condition. Coverage, if provided, is usually limited by time or a financial sub limit. Most policies contain absolute mold exclusion regardless of cause. Mold is generally excluded if it occurs over an extended period of time; caused by conditions such as poor ventilation or water leaks or infiltration from defective construction or foundations. For further information on mold see the environmental section of this paper.

Types of Property Excluded

Certain types of property can be excluded from coverage. Examples are; subterranean property such as pipes and electrical cables; and land, money and securities or property located more than 100 feet from the location (in some instances).

Coverage for land improvements, such as parking lots, lights, signs, trees, shrubs, and landscaping, can also be obtained. Water mains, electrical supply lines, transformers, and telephone lines are usually located below ground and coverage for these items can be negotiated in most instances.

Tenant Improvements & Betterments:

In most commercial leases, the building owner is not responsible to rebuild tenant-installed improvements and betterments, such as walls and ceilings, etc., unless the building owner signs a lease with the tenant gaining ownership of the tenant installed improvements and *assumes* the corresponding responsibility to rebuild.

Policy Conditions:

An insurance policy contains many conditions that will affect coverage. The following are some of the more noteworthy conditions.

Coinsurance

This often misunderstood term has serious ramifications on the amount of indemnity a policyholder can expect following a loss. It requires the policyholder to buy a specified percentage of the 100 percent replacement cost value of the property. Failure to maintain adequate insurance amounts to satisfy the full replacement cost value of the asset would subject the policyholder to a coinsurance penalty. See the formula that follows:

$$\frac{\text{Amt of Insurance Purchased}}{\text{Required Amt of Insurance}} \times \text{Loss} = \text{Recovery}$$

Example: The 100% replacement cost value of Property A is \$10 million. The insurance policy co-insurance provisions require that the policyholder purchase insurance in amounts not

less than 90% of the replacement cost value. In an effort to save premium dollars the policyholder purchases \$5 million worth of insurance with the idea that they would never have a loss that would exceed that amount. The insured suffers a particular loss, resulting in \$4.5 million worth of damage to Property A.

Thus, the formula is as follows:

$$\frac{\$5,000,000}{\$9,000,000} \times \$4,500,000 = \$2,500,000$$

The recovery in this example is \$2,500,000 (less any applicable deductible). Despite the fact that the amount of insurance provided was greater than the loss amount, the imposition of the co-insurance penalty resulted in a sizable reduction in loss proceeds.

The coinsurance penalty clause can be removed by deleting the clause or adding what is known as an “Agreed Amount Endorsement.” To issue this endorsement, insurers require the insured amounts to equal 100 percent of the replacement cost of the property. With the Agreed Amount Endorsement in effect the insurer pays up to the limit of liability in the policy, or a specified limit per location (refer to the policy), without imposing the coinsurance formula.

Blanket Limit of Liability

Insureds with multiple locations can buy insurance on a *blanket basis*, which is essentially negotiating a limit of liability equal to the sum of the insurable values from multiple locations. This coverage enhancement serves to assuage potential under-insurance in the event of a total loss.

Note that a blanket limit applies per occurrence and covers loss at any one location or at any combination of locations caused by a single insured occurrence. The total available limit is not necessarily the total of all values at all locations; it can be a lesser amount and usually is at least equal to the highest values at any one location or combination of locations likely to be effected by one occurrence. Also note that a blanket limit differs from a total limit made up of the values from multiple locations but subject to a maximum scheduled per location sub limit.

Business Interruption and Rental Income (Endorsement Available):

Business interruption and rental income coverage fall under the category of “time element insurance.” Many loan documents specify that rental income must be provided for 12, 18, or 24 months. Coverage on large commercial risks is purchased by submitting 12 months rental values (for premium purposes only) using the Actual Loss Sustained form. The form provides indemnity for loss of business or rental income during the period of restoration following loss. Indemnification begins at the time of the loss and continues until, with the exercising of due diligence and dispatch, the premises or business is restored to a condition that existed before loss.

Indemnity is not limited to 12 months. Whether it takes three months or 18 months to restore the property, the policy will pay the insured’s loss during the restoration period subject to certain performance conditions. One of the primary performance conditions is that the insured

must proceed with due diligence and dispatch to restore the premises to a condition that existed prior to loss. If the property is insured on a stand-alone basis, then the limit may be the amount of insurance purchased. In this case it may be desirable to increase the amount of required Rental Income insurance to whatever time it is estimated it will take to reconstruct the premises following a major loss. Policies should be carefully reviewed to determine the limit of insurance provided.

Actual Loss Sustained and Profits

Actual Loss Sustained and Profits are two types of Business Interruption/Rental Income forms. The Actual Loss Sustained form is commonly used domestically for Business Interruption/Rental Income. It indemnifies the insured's net profit and ongoing fixed expenses during the restoration period following a loss.

Extended Period of Indemnity (*Endorsement Available*)

Under the Actual Loss Sustained time element forms, Business Interruption or Rental Income payments can continue past completion of the restoration with the addition of an Extended Period of Indemnity Endorsement. This addition to the rental or business income coverage pays the insured's reduction in income from the period that restoration was completed following a loss and during the time needed to resume the normal level of business or rental income the policyholder would have earned had no loss occurred. This coverage is subject to a set number of days usually in three month increments and commonly for six months or one year. Coverage can be purchased for longer periods of time, but rarely for more than two years.

Period of Indemnity & Extended Period of Indemnity - Example

In commercial lending transactions, the Extended Period of Indemnity Endorsement is particularly useful during uncertain business environments. For example, a fire causes damage to several floors of a high-rise office building occupied by a single tenant. As most of the premises are unusable, the tenant, under the terms of the lease, vacates the damaged premises. In this example, the Business Interruption or Rental Income coverage pays the insured (the building owner) their loss of rental income during the restoration period. However the building owner is now left with a vacant floor and no tenant. The indemnity under the Rental Income Endorsement to the property policy ends when the premises are ready for occupancy. If the original tenant does not return and the landlord does not have a prospective tenant, there is no continuing coverage after the premises are "returned to a condition that existed prior to loss." If the insured purchased the Extended Period of Indemnity Endorsement, the continuing loss during the time it takes for lease-up, would be covered subject to the number of days specified in the policy endorsement.

The Profits form, commonly used outside the US, is written for a specified period of time. The policyholder selects the amount of insurance and the time during which the policy will provide indemnity.

Rental income losses can be magnified when lease termination provisions permit the tenant to vacate areas of a building not directly damaged by a loss. These types of situations may or may not be covered by rental income insurance. For example, a tenant occupies five floors of a building and a loss occurs that damages a portion of the space. The lease provisions addressing lease termination allow the tenant to terminate the entire lease. The tenant moves out of the damaged portion of the building and vacates a considerable part of the undamaged portions of the building, which is permissible under the terms of the tenant's lease. In this scenario, the building owner incurs an additional loss of rent because the tenant has vacated the undamaged portions of the building. Unless the building owner's policy has a specific endorsement the insurer may not cover the indirect loss of this rental income during the period of restoration. Furthermore, the Extended Period of Indemnity Endorsement will likely cover only additional time after restoration of the damage (subject to the period of this extended coverage) to re-lease the portion of the premises originally (directly) damaged.

Insurance does not always cover potential losses created by lease provisions. During the insurance and risk management due diligence period before loan closing, the leases of major tenants should be reviewed for acceptable restoration periods and lease termination provisions. Should an uninsurable business risk be created by a lease provision, the lender must be informed in order to resolve the business risk or purchase special insurance coverage.

Extra Expense

The policyholder can obtain the benefit of Extra Expense coverage two ways.

The first is included as part of the Business Interruption form and provides extra funds for the insured to make up lost business by spending additional money. Here, indemnity is provided in amounts equal to but not more than the amount that the rental income loss is reduced.

The second type of extra expense provides indemnity up to a specified amount for losses that exceed the rental income loss. In real estate-based risk this additional coverage might be used to rent mobile boilers for additional temporary heat should a peril destroy the heating equipment or other building service systems.

Expediting Expense

Often overlooked, Expediting Expense insurance is mainly purchased as a coverage supplement on Boiler and Machinery Insurance policies and, more recently, as a supplement of "All Risk" Property policies. Expediting Expense coverage pays for "temporary repair" of damaged property and to "expedite" rapid repair of machinery and equipment or other damaged property by providing extra funds for repair services or manufacturers to work overtime.

Liability Insurance:

Insurance professionals use the term Casualty Insurance to describe third party loss. The legal profession often uses the term Casualty Loss to describe property claims (first party loss) as discussed above. Public Liability insurance does not insure first party loss to the asset for which the loan is made but the third party liability of the ownership entity. The broad category

of Liability Insurance provides protection for the borrower in the event some occurrence exposes the borrower to a legal liability. Depending on the hazards that exist or are associated with a given property, certain basic and additional coverage should be provided. In the loan document, the amount and level of coverage should specify prudent minimums levels to be provided by a corporate entity. The following are very basic explanations of Liability Insurance coverage applicable to a real estate financing transaction:

Commercial General Liability

Typically written on an occurrence and annual aggregate basis, Commercial General Liability (CGL) covers the premises and operations of the insured and usually includes Products Liability and Completed Operations insurance. Coverage amounts are usually \$1 million per occurrence and \$2 million in the annual aggregate. A coverage enhancement on policies covering multiple locations is available to extend the aggregate limit of liability to a per location basis. Products and Completed Operations coverage should be required if the landlord provides build-out or contracting services to the tenants. This coverage is significant for contractors who insure the liability resulting from their completed work.

Commercial Automobile Liability Insurance

Commercial insured's should have some type of Automobile Liability insurance even if they do not own any vehicles. At a minimum, each borrower should provide coverage for Owned (if any), Hired and Non-Owned Automobile Liability. Automobile Liability is not covered in the unendorsed Commercial General Liability insurance policy. Automobile Liability coverage is needed by all commercial business concerns. If no automobiles are owned, then Hired and Non-Owned Automobile Liability on an "if any" basis should be purchased. Exposures are present wherever an automobile is used to service or in conjunction with a business. Exposures include; truck delivery or employee use of a personal vehicle while on company business

Workers' Compensation

Workers' Compensation should be provided for the borrower's employees working at the project site. If the borrower does not have employees working at the site, coverage should be provided on an "if any" basis. Even without employees, the potential for exposure exists. If a contractor doing work at a property was injured and did not have a Workers' Compensation policy, a potential exists to limit a liability claim by the contractor against the property owners. In some states, liability may be limited to the benefits available under the Workers' Compensation law of that state, but only if the building owner has a Workers' Compensation policy. If no Workers' Compensation policy is available, the property owner would look for coverage in their Commercial General Liability insurance policy, where liability may not be limited.

Umbrella Liability

Sometimes referred to as Excess Liability, Umbrella Liability provides coverage limits above Commercial General Liability, Automobile Liability and the Employer's Liability portion of a

Workers' Compensation policy. Umbrella Liability may also provide coverage excluded from primary policies. The amount of coverage to be specified for Umbrella Liability varies according to the amount of risk associated with any given project. The amount of Umbrella Liability insurance provided should be appropriate for the size of the structure, location or type of project to be insured.

Construction Insurance:

Construction adds a new dimension to the risk management process. In addition to public liability and Property insurance (referred to as Builder's Risk insurance in this instance) provided by the building owner to protect the physical asset and owners premises liability, insurance for the contractor and project designers liability must be considered. Amounts and types of coverage provided by these parties should be reviewed to assure acceptable levels of coverage are provided.

General Contractor/Construction Manager Insurance

The contract between the owner and General Contractor (GC)/Construction Manager (CM) specifies how the project is to be executed. It includes items such as: cost; additional charges; the architect's name; authority of the parties; the insurance to be provided by the Construction Manager/General Contractor, Subcontractors and others hired by the Contractor; and the types and amounts of surety bonding. Since the construction project is under the care custody and control of the GC/CM, these parties take the primary construction liability exposure. Thus the amounts and types of liability insurance should be adequate based upon the exposures associated with the size and location of the construction project. Both the owner and lender should be named as Additional Insureds on the GC/CM's Liability insurance policies.

Subcontractors

The amount of Liability insurance for Subcontractors (sometimes called Sub Trade Contractors) should be based on the risks associated with their particular operations. For example, in a high-rise construction project it would be appropriate to require substantial limits of insurance liability for such trades as: steel erectors; concrete; curtain wall; electricians; and crane operators because their operations are high hazard and could be the cause of large claims.

Architects and Engineers:

Architects and engineers (A&E's) engaged in the design of the building are exposed to loss in the area of professional liability. These parties commonly provide coverage in amounts of \$1 to \$5 million per occurrence and in the annual aggregate. Their Professional Liability insurance covers Errors and Omissions (E&O) made in their design of the project.

Limits of Professional Liability insurance coverage provided by A&E's are often inadequate. Consider for a moment the potential liability for repair of faulty design in a major structure (a

high-rise office building in Manhattan) and then consider how far \$1 to \$5 million in Professional Liability coverage will go to remedy a deficiency.

Supplementary coverage for the designers' Professional Liability is available in two forms. First, the owner can require the design professionals to buy either excess coverage or purchase what's known as a Design Team Errors and Omissions policy. This solution can be costly primarily due to the fact that this coverage replaces the design professionals' regular practice E&O policy. Alternatively, the owner can buy Owners Protective Professional Liability policy dedicated only to his project to protect him from loss caused by the E&O of the design professionals that exceeds the insurance limits provided in the architects and engineers regular practice policy. This is usually a more cost-effective approach as this policy responds excess over the design professionals practice policy which acts as a deductible.

The Owners Protective Design Team Policy is available in \$1 million increments to limits in excess of \$20 million per claim and in the aggregate for a project. Depending on the policy discovery period, a claim can be reported for five or more years after project completion.

Wrap-Up Insurance/Controlled Insurance Program (CIP):

Larger construction projects – generally those with hard costs in excess of \$100 million - have the opportunity to consolidate Public Liability and Workers Compensation as part of a Controlled Insurance Program or Wrap-Up. These programs, purchased by the owner or general contractor, permit substantial premium savings through group insurance purchasing. Further savings can be earned in a project that engages in good loss control and safety programs resulting in lower loss expense. This type of program insures all sub trade contractors working at the construction site, the owner, and General Contractor/Construction Manager. One high limit umbrella liability program is provided to cover all parties. When this insurance is purchased for multiple large projects at different locations, it is called a Rolling Wrap-up. Wrap-up programs often contain broader coverage than might be obtained by individual contractors. Wrap-up insurance programs offer significant premium savings for group buying of insurance, further enhanced by good loss control and safety for single and multiple large projects.

For large construction projects, a CIP, purchased by a general contractor will typically have multi-year policy terms. It is important to note that aggregate policy limits may apply annually or to the entire multi-year policy terms or length of project. Annual aggregate reinstatement is the preferred form.

Liability coverage not provided in the CIP or wrap-up includes Automobile Liability (on and offsite), Workers Compensation (in liability only wrap ups), and General Liability for offsite exposures. All parties (Owner, GC & Sub Trades) should furnish evidence of insurance coverage for these additional exposures. Professional Liability is not traditionally provided in a wrap-up insurance program.

Builders Risk Insurance:

Builders Risk policies provide insurance coverage for the increased risks associated with a building under construction. Various perils can be provided similar to the perils contained in "All Risk" policies (as opposed to Fire and Extended Coverage). Coverage extensions such as are needed in a regular property insurance policy are also needed in the builders risk policy. (i.e.: RCV; Agreed Amount/Co-insurance Waiver; D&ICC; Rental Income (*due to delayed completion*), etc.). Unique to the Builders Risk policy is coverage for off site and transit coverage and coverage for the contractors interests in work completed but not yet paid for.

Special coverage can also be provided to cover "soft costs," such as: additional interest expense; leasing and advertising costs; or added engineering expenses, incurred as a result of a loss insured in the Builders Risk policy. Coverage restrictions, such as the prohibition to occupy the premises before completion of construction, should be removed from the Builders Risk policy. All exclusions should be reviewed by your insurance adviser.

Coverage under a Builders Risk insurance policy can be purchased two ways. First is the Completed Value Builders Risk insurance policy. This coverage stipulates the total cost of the completed project and the insurer charges a premium on the full amount from the inception of the policy. The second way is based on a reporting form of builders risk insurance. With the Reporting Form Policy the values incorporated into the project are reported monthly to the insurer and appropriate premium charged. Premiums for both forms over the period of construction should be similar. The Completed Value Form is the preferred policy.

In reviewing the insurance coverage and contracts for a construction project, it is important to ensure that items such as contractors' equipment and tools are not included as coverage to be required in the builders risk policy. Insuring these items in the builders risk policy is not desirable as these items are prone to loss and can increase the owner's insurance costs substantially.

Builders Risk insurance policies, like other Property Insurance policies, can be written on either an "All Risk" or "Fire and Extended Coverage" basis. The "All Risk" policy is the preferred form.

Bonds:

On many construction projects in the private sector as well as virtually all public-entity projects, bonds may be required either by the owner or the lender. A bond is not insurance, it is a financial guarantee from a "deep pocket" that financially backs the promises made by the contractor (principal) to the owner (obligee) in a contract.

The party to the bond that backs the promises is known as the Surety (usually an insurer). The party purchasing the bond is known as the Principal (usually a contractor). The party who is the benefactor of the bond is the Obligee. Lenders and other financially interested parties are often named as Dual or Multiple Obligees.

Performance Bond

The Surety guarantees that the Principal will perform his duty according to the terms of the construction contract with the Obligee. If the Principal fails to meet his obligations under the contract, the Obligee can demand that the Surety complete these obligations in full.

Material Payment Bond

Another type of bond required in construction contracts (complementary to the Performance Bond) is the Material Payment Bond. This bond guarantees that the contractor will pay subcontractors and material suppliers for services and materials incorporated into the project. Should a material or labor lien be placed on the property, the Sureties can be called upon to satisfy the Principal's obligation to make payments and effect satisfaction and release of the lien.

In a commercial lending transaction, if a bond is required, the lender should be named along with the owner as a "Dual Obligee" on both of the above mentioned bonds.

Surety companies should be licensed in the state where the project is located and be listed in the United States Treasury Department circular of approved Sureties.

Subguard:

This is an insurance product from the Zurich Insurance Company designed to cover the cost of correcting sub contractor default. The GC's or CM's Subguard policy usually has an event limit and annual aggregate limit for all projects of the GC. Project specific limit endorsements and or project specific excess limits should be considered for larger projects.

The Subguard policy does not apply to situations where the GC/CM is acting as a true CM and is not at financial risk should a sub-trade contractor default. The policy requires the insured (usually the GC or CM) to monitor the performance of sub trades and declare and remedy the sub contractor's default and then seek reimbursement from the insurer for the cost incurred as a result of the default of the sub trade contractor. As the name implies, the product is designed for use by a General Contractor as a cost effective way to cover the incremental cost increase due to a sub contractor default. The default is managed by the GC who takes needed action to remedy the default. As a result the default is corrected in a more efficient manner than performance bonds, thereby avoiding project delay and further increased costs.

There are three ways that a Subguard policy can be written:

1. A project-specific policy with a policy term equal to the length of the project and per-claim and aggregate limits applicable to that project only. All subcontracts (unless specifically excluded) relating to the specified project are covered, even if the contracts are signed after the policy term.
2. A blanket scheduled project policy with an annual policy term and annual aggregate limits shared among all scheduled projects. All subcontracts (unless specifically

excluded) relating to the scheduled projects are covered, even if the contracts are signed after the annual policy term. For the insurer's internal accounting purposes, premiums and claims are charged to the policy year in which the subcontract was signed. If the Subguard policy is not renewed annually, premium and claims are allocated to the policy year in which the project was scheduled.

3. A blanket subcontract policy with an annual policy term and annual aggregate limits shared among all subcontracts regardless of which project the subcontracts are assigned to. All subcontracts (unless specifically excluded) signed during the annual policy term are covered. This form of the Subguard policy is less common.

The Subguard insurance product requires modification to attain the protection afforded to a lender under a Dual Obligee endorsement to the Payment & Performance Bond. Insurers historically do not allow the assignment of the Subguard policy to the owner and lender should the GC or CM default. This insurance product is underwritten based upon GC's ability to control, monitor and assist sub trade contractors to perform their obligations in a construction project. If the GC defaults and is replaced, it is unlikely that Zurich will assign the policy to the owner, lender or a new GC/CM without a properly executed Additional Financial Interest Endorsement. The benefit of the insurance can be assigned to the owner and lender through the addition of the Additional Financial Interest endorsement (see below).

Adding the "Additional Financial Interest" endorsement to the Subguard policy will provide the benefits of the coverage to the owner and lender, however; only if the GC/CM defaults for reasons of insolvency (see actual policy forms as they differ from contractor to contractor). Prior to December 31, 2007, there was a second and preferred Additional Financial Interest Endorsement form that transferred the benefits of the Subguard policy to the owner and lender in the event the GC is in default under their contract with the owner. At the end of 2007 we were advised by the Zurich Insurance Company that this preferred wording would no longer be available. We would only be able to obtain the "insolvency" form of endorsement wording starting January 1, 2008. Without the provision of the Subguard policy benefits transfer to the additional interests upon default of the GC for "cause" under their contract, Zurich has eliminated a significant benefit - that of portability of policy benefits due to a GC default for "cause".

The new, revised Additional Financial Interest Endorsement now adds the definition to the required "insolvency" trigger for transfer of the benefits of Subguard as follows:

For purposes of this endorsement, Insolvency means that any of the following steps, or equivalent steps, have been taken by or against the Insured by or in a court having jurisdictions of the Insured's affairs pursuant to the statute applicable to the insured and its creditors:

1. *Bankruptcy or insolvency is adjudicated against the Insured*
2. *Voluntary or involuntary proceedings are initiated under Chapter 7 or Chapter 11 of the Federal Bankruptcy Code of the United States or any similar statute in another country.*

3. *A court order is issued or the Insured accepts a voluntary resolution for the winding up or liquidation of the Insured's affairs.*

Therefore, these coverage triggering events must go through a legal process that could be just as burdensome and time-consuming, if not more so, as is the process for collecting on a performance bond. The lack of the equivalent of a dual obligee endorsement to a Payment & Performance Bond for the Subguard policy is a significant deficiency in the Subguard insurance product. Lenders should be aware that they should seek to Bond the GC for the full contract amount or seek other financial guarantees to protect their interests in construction projects.

It is important to keep in mind that under Subguard, the Owner/Lender is not insured for the GC/CM default or for self performed work done by the GC or their owned subsidiary company, unless specifically endorsed, under the Subguard insurance policy. A traditional Payment & Performance Bond is best suited for assuring performance of the GC/CM or their subsidiary companies to the owner and lender. In all cases, you must get the actual policy for review; coverage terms, deductibles and co payments differ for each general contractor.

Caution: With the Zurich Insurance Company no longer providing the “for cause” additional financial interest endorsement, acceptance of Subguard for a construction project becomes a larger issue, requiring the discussion alternative risk management techniques that will help alleviate the diminution of coverage that results from the loss of the preferred “for cause” additional financial interest endorsement and coverage portability.

Environmental Risks:

Most commercial lenders require an Environmental Phase One investigation as part of the due diligence process. It is usually conducted by an environmental engineering firm or insurance company engineering division and, depending on the findings; an Environmental Phase Two investigation may be warranted.

Phase Two investigation entail a closer look at the environmental hazards detected in Phase One such as contaminants in the earth, underground storage tanks, asbestos, PCBs and radioactive materials. The financial risks associated with potential environmental hazards can be mitigated, to some degree, with environmental insurance.

Property Transfer Environmental Liability Insurance

Property transfer environmental liability insurance covers environmental liability and cleanup costs unknown and undetected at the time of the Phase One environmental survey. While coverage varies by form and insurance company, it generally pays for the cleanup cost of environmental conditions discovered during the policy term and not disclosed either on the environmental Phase One survey or on the application completed by the policyholder at the time it was issued. This policy can also cover known environmental conditions disclosed on the

Phase One survey, provided there were no government orders to clean up the condition. Coverage can provide indemnity for environmental hazards on the insured property and for hazards that migrate onto the insured property from some other property.

Besides the owner, the lender also should be listed as an Additional Named Insured on the Property Transfer Environmental Liability insurance. The lender's ability to continue coverage if there is a foreclosure should be verified. Location policies (vs. blanket) should be endorsed to assign the policy to the lender in the event of loan foreclosure. At minimum have the lender named as Additional Named Insured.

Underground Storage Tanks

Underground storage tanks, such as those used for fuel, present the potential for serious environmental loss. A typical property transfer environmental liability insurance policy excludes underground storage tanks. An underground fuel storage tank may require either a special endorsement or separate policy to cover tank leakage.

Lender's Environmental Insurance Policy

Lender's environmental insurance policy protects only the lender for any cleanup costs for which he may become legally liable. Typically purchased on a blanket basis, it provides coverage for all of the lender's real estate loans. Coverage may not respond unless the lender has foreclosed on the property.

Contractors' Environmental Cleanup Insurance

Contractors hired by the borrower to clean up existing environmental pollution or hazards at the project site must have appropriate insurance naming the owner and lender as additional insured's.

Licensed abatement contractors remove asbestos or clean underground fuel storage tanks containing environmental hazards. These contractors require special insurance to cover environmental exposures. In addition to the contractor doing the actual site work, the company transporting environmentally sensitive materials from the project site also must be licensed and have appropriate insurance.

Only a licensed environmental disposal facility should be the receiver of these hazardous materials. Although it is impractical to check the insurance coverage of the trucker and disposal facility, the borrower's contractor should be able to provide the property owner with certification of proper disposal of environmentally-sensitive materials removed from the project site. The owner must keep these records on file indefinitely. Most environmental abatement contractors carry minimum levels of insurance containing Aggregate Limits for all jobs conducted by the Contractor in a given annual period.

In environmental insurance arena there are no standard forms. Therefore, the proposed coverage should be reviewed to ensure that the desired type and amount of coverage is provided.

Mold Coverage

Insurance coverage is not widely available for mold in property insurance policies; however it is available in some pollution liability insurance policies.

There are varying degrees of coverage for mold. If the area you are most concerned about is gradual water infiltration or high humidity conditions that could cause a mold condition. The only source for coverage would be the environmental liability policy. When available however limits are often restricted (usually \$25,000). Mold conditions can be caused by numerous events that may or may not have an insurance resolution. Example; design error that causes mold may open an avenue for an architects suit for defective design or product liability for a defective building material or contractors completed operations coverage for loss resulting from poor workmanship during construction.

Loss covered in the “All Risk” policy such as wind that blows out windows or firefighting operations that result in the inside of buildings becoming wet may extend to cover resulting mold if the condition is the direct result of a peril (wind or fire) insured. Depending on the cause and the period of time in which the loss develops will determine if mold is excluded, only the policy can provide that answer, or if the policy is not available the broker should be able to respond and provide the answer.

Protective Clauses for Lenders:

All basic insurance policy forms should contain or have by endorsement, protective clauses and coverage extensions. The main areas of concern are on the property and liability insurance policies:

Property Insurance

The lender's interest in property insurance is protected via the Standard Mortgagee Clause (a/k/a the Standard New York Mortgagee Clause). Its language:

- defines “mortgage holder” to include trustee;
- provides that the insurer will pay for covered loss to each Mortgagee listed on the policy declarations in the order in which they appear;
- provides that the mortgage holder has the right to receive payment even if the mortgage holder started a foreclosure or similar action

If the insurer were to deny the policyholder's claim for indemnification based on the acts of the policyholder or because the policy holder failed to comply with the terms of the insurance coverage, the mortgage holder will still have the right to receive loss payment if the mortgage holder: 1) pays the premium due; 2) submits a signed, sworn statement of loss within 60 days

after receiving notice from the insurer of the Insured's failure to file a proof of loss notifies the insurer of a change in ownership or occupancy or change in risk provided this was known to the mortgage holder. All terms of this coverage would then be applied directly to the mortgage holder.

If the insurer pays the mortgage holder for loss or damage and can deny payment to the borrower because of their acts or because they have failed to comply with the terms of the coverage part:

1. The mortgage holder's rights under the mortgage will be transferred to the insurer to the extent of any amount the insurers pay the mortgage holder.
2. The mortgage holder's right to recover the full amount of the mortgage holder's claim will not be impaired. The insurer may pay the whole principal on a mortgage plus any accrued interest. In this event, the mortgage and note will be transferred to the insurer and the borrower will pay the remaining mortgage debt to the insurer.
3. If the policy is canceled, the insurer is required to give written notice to the mortgage holder at least 10 days before cancellation if the reason is non-payment of premiums, or 30 days before cancellation for any other reason.
4. If the insurer elects not to renew this policy, the insurer must give written notice to the mortgage holder at least 30 days before the expiration of the policy.

IMPORTANT NOTE - As noted above the mortgage holder can be paid for a loss, even if the insurer can deny payment to the borrower, because the borrower has failed to comply with the terms of coverage. One reason for denying coverage is when the borrower is aware of an increase in hazard to their operations. If the borrower does not advise the insurance company of this increase in hazard, then the insurer can deny payment to the borrower in the event of a loss. Under the NY Standard Mortgagee Clause, as long as the mortgage holder was unaware of the increase in hazard then the mortgage holder is still eligible for payment under the policy.

A recent ruling by the Tennessee court has now defined a foreclosure action as an increase in hazard. In this circumstance if the mortgage holder does not inform the insurer that they have begun foreclosure proceedings against the borrower, and there is a loss, the insurance company would be allowed to deny payment to the mortgage holder.

It is important to keep in mind that while this ruling applies to the State of Tennessee only, and is under appeal, we do suggest that the insurance company be advised by the mortgage holder that a foreclosure has begun, so the mortgage holder's rights under the policy are protected. Before any notice is given, however, the mortgage holder should confer with their attorneys on this point, and only proceed with the consent of their legal counsel.

Mortgagee clauses differ. If the actual policy has not been reviewed and the Mortgagee Clause checked, a Standard Mortgagee Clause should be attached to the Certificate of Insurance.

Similar to the Standard Mortgagee Clause is a form called the Lenders Loss Payable Clause. These two forms contain virtually the same language protecting the lender's interest in the real property.

A word of caution: The Loss Payable Endorsement is another form commonly used. However, it does not provide adequate protection to the Mortgagee in a real property transaction. It is used to communicate a lien holder's interest in such personal property as office equipment or automobiles.

Rental Income insurance and/or Business Interruption should be made payable to the lender either under the Mortgagee Clause or Lender's Loss Payable Clause. This is done to help ensure ongoing debt service payments are paid to the lender.

Liability Insurance

The Commercial General Liability and Umbrella Liability policies should name the lender as Additional Insured in their respective policies.

This can be accomplished three ways:

1. Language that automatically names any party required to be covered in a written contract as an Additional Insured.
2. An endorsement naming specific Additional Insured is added to the Commercial General Liability policy (CG 2018 Lender as Additional Insured).
3. Issue a binder of insurance evidencing the lender's status as additional insured.

Evidence of Insurance Coverage for Loan Closings:

Many commercial lenders fail to conduct an actual review of the borrower's insurance policies in order to determine if adequate protective clauses, such as a Standard Mortgagee Clause, Lender's Loss Payable Clause, and Additional Insured endorsements are actually provided. In addition, many lenders only require that the borrower present Certificates of Insurance at the time of loan closing. This practice is dangerous for several reasons:

1. Certificates of Insurance are supposed to reflect the coverage contained in insurance policies, but this is often not the case.
2. Insurers have been known to disavow coverage extended to additional interests due to the number of disclaimers on the certificate. This is particularly true on liability certificates. For example, the Acord 25, the most widely used liability certificate, contains the following disclaimers: "This certificate is issued as a matter of information only and confers no rights upon the certificate holder. This certificate does not amend, extend or alter the coverage afforded by the policies below".

As if that were not enough, the authors of the certificate form added the following: "This is to certify that the policies of insurance listed below have been issued to the named insured above for the policy indicated. Notwithstanding any requirement, term or condition of any contract or other document with respect to which this certificate may be issued or may pertain. The insurance afforded by the policies described herein is subject to all the terms, exclusions and conditions of such policies. Limit shown may have been reduced by paid claims." The cancellation provision on the certificate, which reads as follows; 'Should any of the above described policies be canceled before the expiration date thereof, the issuing company will endeavor to mail 30 days written notice to the certificate holder named to the left, but failure to mail such notice shall impose no obligation or liability of any kind upon the company, its agents or representatives.'

CAUTION: Similar language disclaiming the insurers or brokers responsibilities to the lender or other certificate holder are also contained on two popular property certificates, the MM#3 form used by Marsh and the new Acord 27 & 28 forms, and should not be accepted without the actual policy endorsement or Binder of Insurance clearly naming the lenders interests.

Use of the Acord 25 form to communicate a Mortgagee's interest in real property is unacceptable. Acord 25 forms should be limited to general information about the Borrower's liability insurance program. If Additional Insured status is to be communicated to the lender with this form, an Additional Insured Endorsement (CG 2018) should be attached to the certificate of insurance.

The Mortgagee's interest should be stated on a Certificate of Property Insurance. The most common form used for this is the Acord 27 (3/93) or the new Acord 28 2003/10 edition (see caution note above). Both forms offer several positive statements regarding coverage as follows: "This is evidence that insurance as identified below has been issued, is in force, and conveys all the rights and privileges afforded under the policy." The cancellation clause contained on this form is as follows: "The policy is subject to the premiums, forms, and rules in effect for each policy period. Should the policy be terminated, the company will give the additional interest identified below 30 days written notice, and will send notification of any changes to the policy that will affect that interest according to the policy provisions or as required by law." In addition, the Mortgagee's interests can be specifically indicated on this certificate. Only this or a similar form should be accepted to reflect a Mortgagee's interest in real property.

Insurer Rating:

There are several agencies that monitor the financial health of insurance companies. The most commonly referred to are A.M. Best's and Standard and Poor's.

AM Bests is the rating agency most closely related to the insurance industry. AM Best provides ratings in the following manner:

AM Best Rating

AM Best Quality

A++ and A+

Superior

A and A-

Excellent

B++ and B+

Good

AM Bests considers all of the above ratings “Secure”. Omega Risk Management LLC does not recommend insurers with ratings lower than A:X except in circumstances where capacity is needed for special risks (see more information below).

AM Best also places the companies it rates into financial size categories, from I to XV. This is determined by the company’s policy holder surplus (that is the amount insurers have to pay losses). The largest size, XV, has a surplus of \$2,000,000,000 or more.

It is important to note that many insurance companies are rated on a “pooled” basis. This means that all the individual insurance companies under a corporate umbrella are given the same rating, based on the overall health of that organization.

As a general rule we recommend that the minimum best rating be A, with a size of X, (\$500,000,000 in policy holder surplus or higher). As of the 2007 AM Best Rating Manual; of the 2182 property and casualty insurance companies AM Bests rated, 43% met this minimum requirement of A:X or greater.

In addition to AM Best, the Standard and Poor’s ratings are also commonly used as a benchmark for an individual insurance company’s acceptability. This has been historically driven by the CMBS marketplace. S&P rates insurers’ with the following:

AAA; AA; A; BBB: These ratings are considered “Good” to Extremely Strong”

BB; B; CCC; CC: These are considered vulnerable ratings.

R: This means that the insurance company has had regulatory action taken regarding its solvency

S&P will also add a “+” or “-“ after the letter grade to indicate a relative standing within a certain class.

Both A.M. Bests and S&P will also assign a trend or outlook to each rating, to provide additional guidance as to how they view the company’s future performance.

Omega Risk Management LLC will generally follow the standard that an A is the minimum rating required for insurers providing coverage for our clients. Insurers rated A- with stable or positive trend may be used to build capacity in high hazard areas, such as California

(Earthquake) and Gulf Coast (Windstorm). Insurers rated A- with negative trend should not be used. Insurers with ratings less than A should not be exposed to an amount of insurance greater than 5% of their policy holder surplus. For A rated insurers in the size category IX or lower they should not be exposed to insurance amounts greater than 10% of their policy holder surplus.

It is always important to check an insurer's rating prior to selecting an insurer or during the lenders due diligence process. It is also important to periodically monitor insurer's ratings as new developments arise. The current credit crunch has already affected the AM Bests and S&P ratings of well known insurance companies most notably AIG. In September of 2008, AIG saw its ratings lowered when the holding company was bailed out by an \$80 Billion + credit facility from the US Government. In October of 2008 Harford was placed under review with negative implications, AM Bests. We would like to note that both rating organizations have been criticized for being slow to downgrade insurers.

Section II: Case Studies; Applying the Principles of Part I

This section contains case studies drawn from our experience conducting due diligence for commercial lenders. Details have been changed to prevent identification of borrowers or lenders.

Case 1: High-Rise Building with a Historical Twist

The mortgage financing transaction involved a recently constructed 35-floor high-rise office building atop a restored historical theater on the ground floor. One tenant occupied more than 50 percent of the building. The amount of the insured value was 25 percent below the loan amount.

On the surface the mortgage loan appeared to be straightforward. However, after analysis of the appraisal report and interview of the loan officer, several factors emerged that necessitated special risk management considerations. If a loss occurred, the historical theater would have to be preserved and restored to its original grandeur. Sculptured plaster ceilings, ornate architectural millwork and frescoes would have to be insured for their reconstruction cost. In addition, the building's extraordinary location resulted in an economic appraisal disproportionately high, far exceeding the insurable replacement cost value of the structure. Further, the fact that one major tenant occupied a substantial portion of the leaseable office space in the building created concern over a possible lease cancellation and escape clauses that could lead to premature termination of the lease.

The borrower's insurance policy provided that following a loss the insurer would pay the least of several options to rebuild the premises. Although this is not uncommon in insurance policies, the restoration that would have been required by the historic nature of the theater created concerns. Since the building and restorations were recent, the actual budgets were easily accessible. This information was presented to the insurance company, and the coverage shortcomings were discussed with the borrower and the lender. Successful negotiations secured special replacement cost valuation clauses that integrated the high restoration costs of the theater's unique architectural details.

The tenant's lease permitted the tenant to vacate the entire premises if more than 50 percent of their leased area was damaged by fire. The risk management evaluation of the property, located in a major city with professional fire fighters, a complete automatic sprinkler and fire alarm system coupled with fire resistant construction concluded that lease termination due to a fire or other insured peril was unlikely. To the rental income insurance on this loan, an extended period of indemnity endorsement was added to help address potential loss of a major tenant. Although not a major concern in this transaction, some lease provisions allow tenants to escape their lease obligations not only for the damaged portion of the premises affected, but also for their entire lease area.

The last issue was the lender's concern about the adequacy of the insurable value. The loan amount of this transaction was more than \$100 million and the insurable value was slightly

over \$80 million. The lender was concerned that in the case of a major loss there would be inadequate insurance proceeds to pay the outstanding loan amount.

The correct amount of insurance should be sufficient to rebuild the premises (i.e. the bricks and mortar reconstruction cost of the building). Additional insurance proceeds can be obtained from rental income loss insurance. In this case the total insurance payment from all sources was more than 25% below the loan amount. Initially the lender wanted to increase the insurance to the loan amount. This approach was unnecessary due to the fact that the insurance payments and the value of the land on which the building was erected together exceeded the principal amount of the loan. The most that an insurance company would pay for a major loss is the replacement cost value of the building and the rental income loss paid had the premises been rebuilt with due diligence and dispatch.

Case 2: Building on Top of a Building

A borrower proposed to build a 22-story residential building on top of a four-story commercial building to be occupied by retail establishments. The borrower had signed a *plane lease* (versus a ground lease).

Although each building had separate owners, both were to be built by the same construction management firm and designed by the same architectural and engineering firms. The concern was that each owner would provide a different level of insurance coverage during the construction phase, and after completion of the project. Since the borrower's building sat on top of another owner's building that acted as the foundation for the structure, damage to the lower building could leave the borrower with inadequate insurance. In addition, damage of the lower building would impair access to the premises and to electrical power and heat. Another consideration was the insurance requirements of a ground lease for the land upon which the buildings were being constructed.

There were numerous risk management issues. The construction project's insurance requirements, each of the owners, their lenders' and attorneys' reactions had to be taken into consideration. The property insurance had to accommodate the interdependence of the two structures, their operations, and the reaction of each of its insurers in case of loss. A long-term agreement would have to be struck between the parties to govern the modalities and level of insurance coverage provided.

The Reciprocal Easement Agreement (REA) was the "control" document between the parties, defining insurance purchase and reconstruction following loss. The REA noted the lower building owner's obligations to the ground lessor. It outlined liability insurance for the ground owner, and the building owner's obligations to reconstruct the premises.

Since all parties wanted to guarantee the project's overall success, it was necessary to assure that the insurance would respond without gaps to reconstruct any potential damage. Therefore one common property insurance policy was clearly the best vehicle not only during construction but also after completion of the improvements.

Two basic policy forms would affect reconstruction after loss. These were the "All Risk" Property and the Comprehensive Boiler & Machinery coverage. The "All Risk" Property insurance included Rental Income and Business Interruption insurance for each of the owners. The Comprehensive Boiler & Machinery insurance coverage was included in one master property insurance policy for the project. This served to eliminate disputes over payment of loss if electrical equipment, elevators, heating and air-conditioning systems which were interconnected; therefore a loss of equipment for one owner would affect the others.

Insurance policy terms and conditions, especially "other insurance" clauses, were reviewed with the lender, and later, the borrower and its legal counsel. The REA (Reciprocal Easement Agreement) adopted as reference. Negotiations among the numerous parties attained an adequate level of insurance coverage in the REA to secure the lender's interests and to assure that funds for the reconstruction of the project would be available. In addition, it included provisions to pay the owners and their respective lenders. The parties, however, were responsible for buying their own public liability insurance, and naming the other parties as Additional Insureds.

The REA modifications also dealt with escalation clauses. The REA lease, created to run for 100 years, incorporated modifications to increase the amounts of coverage and accommodate changes in insurance industry forms.

Case 3: Is Your Borrower the Insured?

A review of a borrower's insurance policy found that the borrower was not insured on its own policy. The borrower's insurance broker insisted that it had issued a certificate of insurance naming the borrower as an "Insured".

The insurance policy not only did not name the borrower, which was a single purpose entity, it also failed to provide wording that would have extended coverage by association to include the borrower as an entity controlled by the named insured.

The insurance certificate issued by the insurance broker, (Acord 25), contained numerous disclaimers including: "This certificate does not amend, extend or alter coverage afforded by the policies below." The policy also lacked an Additional Insured Endorsement that would have extended the liability insurance to cover the lender.

Note: Since the insurance policy did not contain a specific Additional Insured Endorsement or Broad Additional Insured language, a specific endorsement was necessary. Lacking this, a Binder of Coverage signed by the insurance underwriter would be necessary to extend coverage to protect the lender in the event of a liability suit in which the lender was named.

The above issues were resolved using insurance binders extending the policy before loan closing. After the closing a review was conducted of actual policy forms and endorsements.

Case 4: Are your buildings insured?

A recent evaluation of the insurance for a strip shopping mall disclosed that although the lease called for the anchor store to insure their net leased building and continue to pay rent even if the premises were unusable. The local management yielding to the tenant's wishes granted a post lease commencement date concession and decided to assume the responsibility to insure the building. The only problem is they failed to tell the corporate insurance department who carried no coverage on the anchor store.

During the course of our due diligence we asked for the evidence of the tenants insurance on the building as this structure was part of the loan collateral. The omission was discovered and coverage was added to the borrower's policy.

Case 5: A Flood in the Desert!

During the loan review for the construction of several garden-style apartment buildings in a desert area of Arizona, we made a startling discovery: on the architectural plan showing the buildings' proximity to each other we noticed a street called River Road. This prompted us to ask the loan officer if the property was located in a flood zone. That query was passed on to the land surveyor who prepared the plan.

Although the property was located in a desert area, it was in a "V" Flood Zone, subject to flash floods during rainstorms. Velocity Floods or V-Type Floods have a tendency to wash away land and building foundations, often resulting in collapse of the structure. The insurance policy providing coverage for this apartment complex contained a restriction imposing a Flood deductible, equal to the maximum amount of Flood insurance available in the federal program, for any property in a federally designated flood zone. In this case, the deductible equaled the replacement cost of the particular building exposed to the flood. The National Flood Insurance Program issued a special flood insurance policy, for \$250,000 per residential building located within the boundaries of the flood zone.

For more on the National Flood Insurance Program, please visit: <http://www.fema.gov/nfip>. The regular insurance program for the location provided higher coverage. The lender was named as Mortgagee on the owners' real property insurance policy, as well as on the National Flood Insurance policy.

Case 6: More Water!

I should have known from past experience that names of places usually have roots. The apartment complex in California named River Gulch, turned out to be in Flood Zone A, or so it appeared. We worked with our flood hazard service people to determine if the site was in or outside the flood zone.

The property policy of the borrower contained a Flood Zone A exclusion. Review of the Flood Zone Certificate showed A/E zone. It required the use of aerial photographs and an on site engineering consultant to determine that the building structure was out side the Flood Zone by

3 feet. Thus no exclusion was applicable. When the site was developed they re-graded the site eliminating the exposure and the need to purchase Federal Flood Insurance.

Case 7: Earthquake at a College Dormitory in California

A review transaction involving a 17-story, concrete and steel, college dormitory in California revealed that the borrower, a single purpose entity, purchased their insurance as part of a group policy that also insured several real estate ventures. An Earthquake PML study was conducted.

The seismic engineering survey disclosed deficiencies and estimated that a PML 90 Earthquake could cause more than 40% structural damage to the property. This was high, indicating that overall structural failure was a real possibility. The survey also indicated that modifying the building structure would reduce the PML estimates to tolerable levels.

After the lender reviewed the PML study results with the borrower, they agreed that structural modifications to the premises were necessary if the loan was to go forward. An in-depth engineering study was conducted, and after structural modifications to minimize the risk profiles for this building were completed, the loan could be made.

Another issue was the amount of earthquake limits and annual aggregate insurance available in the master insurance program. The plan administrators were keeping an ongoing portfolio PML study. For each new building the PML characteristics were entered into a data bank and a new PML damage estimate was periodically calculated. With the new estimate for this building included in the portfolio, the overall damage estimate for buildings in this region of California totaled 70% of the available Earthquake Limits. Adequate rental income insurance (in this case loss of tuition and profits) to cover an estimated one and one-half years lost income expected in a PML Earthquake was provided.

Note: "Loss of tuition and profits" is a special form used for educational institutions to cover exposure to loss for an entire semester due to a partial loss of facilities for only a portion of the semester. Rental income insurance covers the period starting with the loss or destruction insured in the policy and ending with the completion of repairs. If a loss occurs at the college dormitory on August 1 and repairs are completed on September 30, loss in a standard rental income form ends. But since the premises were not ready for occupancy at the beginning of September, students found other housing for the whole semester. "Loss of tuition and profits" special form would have extended the loss of income through the rest of the semester.

The single purpose entity owner of the dormitory must also contend with contingent exposure created by loss to the college facilities. (Remember: for business income insurance there must be damage to the property insured.) If fire or other insured peril renders the college classrooms unusable, and no students are occupying the dormitory, the business Interruption or loss of tuition and profits would not pay the rental income loss at the dormitory. For this, it is necessary to add a Contingent Business Interruption endorsement, which extends the property insured to include loss of rental income caused by damage to property of others. These "other" properties would then be listed in the insurance policy for the dormitory.

Case 8: Insurance Coverage: Not Really Coverage!

A review for a loan transaction involving an old-style reinforced concrete high-rise structure indicated that the appropriate types and amounts of Boiler & Machinery insurance were provided. Examination of the insurance policies, however, disclosed another story.

The 37-story building, located in the heart of a major U.S. city, was originally constructed in the 1920s. The building, and its mechanical and electrical systems, had deteriorated to the point that losses occurred with considerable frequency. Insurance companies were well familiar with it, either through direct payment, or by payment of reinsurance losses at the building.

The borrower purchased the building two years before this loan transaction? During that time, the new owner upgraded the building and its mechanical and electrical systems. Now the loan would be used not only for permanent financing, but to complete restoration to its original Class A status.

The existing blanket Comprehensive Boiler & Machinery insurance policy had a serious coverage restriction applicable to this location. It limited the insurer's liability for losses to machinery and equipment to \$25,000 per occurrence. A typical Boiler & Machinery loss, involving air-conditioning systems, boilers, or electrical switch gear and distribution systems, could cost many hundreds of thousands of dollars to repair. After discussions we learned that the borrower was unaware of the insurance restriction in its policy. The insurer was unwilling to provide the coverage and was thus replaced after equipment improvements were made.

Case 9: Construction Project Liability Insurance (Non CIP)

How much insurance coverage is enough? What amount of liability insurance should be specified for a construction project? The amount of insurance should be commensurate with the risks presented by the contractor or project exposures.

The owner's contract with a construction management firm to build an office building in Chicago, specified that the General Contractor/Construction Manager provide \$30 million in public liability insurance. The owner carried \$20 million in liability insurance. The project, a 40-story office tower, needed much higher liability limits. It was recommended that the construction manager increase the limits of liability to a minimum \$100 million per occurrence and in the annual aggregate and that the owner should increase the limit to a minimum of \$50 million per occurrence and in the annual aggregate. Another coverage suggestion was to add a "per project" or "per location" aggregate endorsement. Without this endorsement, the aggregate limits of liability for each of these parties would affect their other construction projects or locations.

The coverage provided by sub-trade contractors is another issue. In this situation insurance should be commensurate with the risks of loss presented by the contractors' operations: for instance, not less than \$20 million and preferably higher for crane operators, steel erectors,

electrical, concrete, footings and foundation contractors, and any others engaged in high-hazard operations.

Case 10: Construction Insurance; Professional Liability (Architects & Engineers)

For a project to design and build a high-rise office building in San Francisco, the lead architect carried insurance coverage of \$1 million per claim and \$2 million for all claims combined during the annual policy. With construction costs more than \$300 million the architect's \$1 million was inadequate.

The borrower's insurance broker informed us that the developer was also planning to build two more major projects in other parts of the United States during the coming two years. So, rather than the design professionals increasing their insurance for the project to an acceptable level (a costly proposition), the owner should buy an owner's protective policy.

Added to this developer's risk was its plan to construct additional large projects. This situation lent itself to a multiple location, or rolling owner's protective professional liability policy, which offers savings if insurance for multiple locations is purchased in one policy. Another way of controlling costs associated with this policy is by deductibles (these apply only if the architect's regular insurance is depleted). The result was that the owner/developer purchased an owner's protective architects and engineer's professional liability policy for \$20 million per claim in the aggregate for all claims, for the three projects. This type of policy assures its owner that limits of liability are dedicated to his projects, and not shared among the architects, or engineers' other projects.

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James Branigan is president & CEO of Omega Risk Management LLC, which provides insurance consulting services to corporations and conducts due diligence reviews for financial institutions originating large commercial and construction loans throughout the United States and Canada.

Mr. Branigan has written several papers on insurance in real estate finance for the Practicing Law Institute (PLI) and co-authored a chapter on insurance in the Commercial Leasing book published by the New York State Bar Association in 2004. He co-authored a Model Loan Document for Commercial Real Estate Transactions that has been widely published in trade and legal publications nationally. He has served on the PLI Faculty for eight years, has been a speaker at the New York Bar Committee on Leasing and was a panelist on insurance in commercial leasing for the New York City Dirt Lawyers. He has made presentations on terrorist insurance before the New York State Bar Association-Real Property Section annual meeting (January 2002) and the Texas Bar Advance CLE Seminar (July 2002). Mr. Branigan has delivered numerous insurance training sessions for commercial lenders, the Real Estate Lenders Association and law firms throughout the U.S.

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Mr. Bischoff joined Omega Risk Management LLC in January 2007, and since then has conducted insurance due diligence reviews on over \$2 billion of real estate loan transactions. He has spoken as a member of the PLI faculty, delivering the insurance and risk management portion of the 2007 real estate finance course. He has delivered several insurance training sessions for both commercial lenders and real estate law firms.

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A special thanks to **Alan E. Doller**, CPCU, ARM, AIC, Director Technical Services for Omega Risk Management LLC who contributed valuable technical input to this paper.