



MBA's COMMERCIAL REAL ESTATE FINANCE/MULTIFAMILY
HOUSING CONVENTION & EXPO
Walt Disney World Swan And Dolphin, Orlando, Fla.

Sleeplessness in Seattle – Are Uninsured Perils Giving You Heartburn?

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Fire and Property Coverage – What You're Not Thinking About Can Hurt You!

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- Standard fire and property coverages don't seem very sexy in a world full of newer insurance products and issues.
- After all, fire insurance has been around for many, many years – in fact, in this country, Benjamin Franklin started the Philadelphia Contributorship for Insurance of Houses From Loss by Fire in 1752.
- The Contributorship is still in business today, and so are numerous other companies providing fire insurance on residential and commercial property.
- The problem is – so are fires, floods, tornadoes and many other perils insured under these coverages.



- My goal in the next few minutes is to help refresh your recollection – to help remind you of some of the issues that can arise even in “ordinary” fire and property losses and to give you some basic insights on how to avoid bad news if there is a loss.
- Given our time constraints, we necessarily must look at these issues from a “30,000 foot” perspective, which leads to the



IMPORTANT DISCLAIMER!

Remember, every insurance policy is different. Terms, coverages, conditions, and exclusions vary.

READ THE POLICY.

Failure to read the policy may result in loss of collateral or cash flow, headache, heartache, nausea, fear of default, criticism and/or other side effects. If any of these occur, discontinue use and consult counsel immediately!



Seriously folks

Read the policy.

Many common questions about coverage can be resolved simply by reading and understanding the policy's terms and provisions. Do this in advance as a part of the underwriting process.



So . . . Read the policy.

The whole thing.



With that said, let us move on to a small sampler of some of the more important topics in fire and property insurance you should be aware of –

- ▶ COINSURANCE
- ▶ LOSS PAYEE STATUS
- ▶ FLOOD COVERAGE



1. Coinsurance

COINSURANCE -- 1

- Coinsurance is a penalty imposed for underinsuring property.
- It usually is expressed as a percentage – e.g., an 80% coinsurance percentage means the policy limits must be at least 80% of the property's full value.
- If the amount of insurance on the property is less than the coinsurance percentage, the insured recovers less than 100% of any loss.

COINSURANCE -- 2

Why is coinsurance important to lenders?

Look at the numbers (yes – we’re going to do some math now):

$$\text{Amount paid} = (\text{Amt. of loss}) \times \frac{(\text{Policy limits})}{(\text{coins. \%})(\text{actual value})}$$

In other words, as the actual value goes up, the denominator (in red) also goes up, and the amount paid by the insurer goes down.

As long as the fraction in color exceeds 1, there is no reduction in the amount paid. Keeping it there – i.e., requiring the borrower to keep adequate policy limits on the collateral – ensures that there will not be an inadequate recovery for a fire or other covered loss.



COINSURANCE – 3

Moral of story:

Adequate limits on the day a loan closes may soon become inadequate as property values rise.

Make sure your loan documents require the borrower to “insure to value” or increase coverage to keep even with or ahead of increases in property value over the entire life of the loan.

2. Loss Payee Status



LOSS PAYEE STATUS -- 1

Just because your borrower has insurance, it does ***not*** mean you, a lender, will receive any of the proceeds if the insurer pays a claim. Your rights depend upon your status under the policy.

Consider the possibilities --



LOSS PAYEE STATUS – 2

If the lender is listed as a “certificate holder” – i.e., has a certificate of insurance – which sadly is too often the situation –

- The lender is entitled *only* to notice that the policy has been cancelled.
- The lender has no rights against the insurer, may not participate in the adjustment process and has no rights to any payment.
- In short, being a certificate holder only gives a lender no protection at all.



LOSS PAYEE STATUS – 3

If the lender is listed as a “loss payee” –

- The insurer adjusts the claim with the borrower/insured (not the lender).
- Any payment is made jointly to the borrower/insured and the lender and anyone else with equal status.
- The lender is subject to any defenses the insurer has against the borrower/insured – i.e., if the loss is not covered because of the insured/borrower’s conduct, there is no coverage for the lender either.



LOSS PAYEE STATUS -- 4

If the lender is listed as a “lender loss payee” –

- The lender now has an independent interest in the policy.
- The lender may still receive payment even if the borrower/insured is barred from recovery, but the lender may be obligated to pay overdue premiums, submit independent loss information to obtain payment, or comply with other policy conditions.



LOSS PAYEE STATUS – 5

Moral of story:

These terms are among the most misused and misunderstood in all of insurance, even among insurance professionals, many of whom think “loss payee” status gives full protection.

They are wrong. Omission of a single word in your loan documents (“lender”) can result in huge problems. Check your status carefully.

This also is a situation where language on standard ACORD forms may NOT match up with what the policy provides. Check again!

3. What is a flood?



FLOOD INSURANCE -- 1

The hurricanes of 2005 – Katrina and Rita – exposed a number of very significant issues affecting insurance on commercial property ranging from what is covered to how to value the loss.

Today, let's focus briefly on an issue that burned many, many residential and commercial insureds – what is a flood?



FLOOD INSURANCE – 2

Standard property insurance generally does not cover floods.

Flood insurance is available through the National Flood Insurance Program – a part of FEMA that actually works.

Private insurers may provide flood coverage but are not obligated to do so, and often include elaborate restrictions on flood coverage in their policies.



FLOOD COVERAGE -- 3

Just about all of the various flood exclusions in commercial insurance policies got tested in the wake of Hurricane Katrina in litigation in New Orleans.

Reduced to its essence, the dispute was whether the failure of the levees in New Orleans, which allegedly came about because of bad design and construction, counted as a flood under the private coverages. If not, there would be large additional amounts of coverage available.



FLOOD COVERAGE – 3

In August 2007, the United States Court of Appeals went straight down the line with the insurance companies, holding that it didn't matter whether the water got out because it went over the tops of the levees or the levee broke due to faulty construction. *Any* escape of water from the channels was a flood, and floods were not covered.

In re Katrina Canal Breaches Litigation, 495 F.3d 191 (5th Cir., August 2, 2007).



FLOOD COVERAGE – 4

Moral of story:

We have been very lucky for two years, with no major hurricanes like those of 2005 to wreak havoc.

Do not be fooled into thinking the problem has gone away. In target areas, comprehensive flood coverage (property coverage, broad form business interruption coverage, etc.) remains *mandatory*.

There aren't any clever workarounds here. Lenders need to ensure that borrowers need to get the real thing, in amounts large enough to protect the collateral!



IN CONCLUSION . . .

Virtually of all of what you will hear about today can be fixed, solved, minimized or avoided by careful drafting of loan documents and by paying attention during the loan underwriting/origination process.

As with so much else in life, paying attention early can prevent huge problems later.

In short



Wear sunscreen.

Check your oil.

And read the policy.