



Insurance Broker Letters in Commercial Real Estate Financings: Why Do We Need Them?

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Insurance is a key and critical element to any commercial real estate financing. After all, such financings are usually limited recourse, such that the properties will be owned by a special purpose vehicle with no other equally valuable assets. In that regard, the lenders will be intent on knowing that the fundamental collateral that supports their debt is protected from destruction, damage, or any other events that could affect the value and income stream generated from such asset.

It has therefore become market standard practice for lenders to ensure that certain protections are provided with regards to insurance, one of which is a condition precedent (“CP”) that is required from the borrower: an insurance broker letter. Whilst it is not a finance document, the insurance broker letter can still in some transactions have the potential to elicit significant resources and time in order to negotiate and finalise its terms.

This article looks to explain why broker letters are needed in commercial real estate financings and what we can do to reduce the strain they can cause.

Lender protections

There are a number of key protections that lenders seek with regards to insurance. These include:

- naming the lender as composite insured or co-insured on the insurance policy in order to provide it with the same legal rights as the borrower;
- naming the lender as first loss payee to ensure that the insurer would be required to make the payment to the lenders directly, or in accordance with their authorisation and direction (though, this is often subject to a negotiated *de minimus* amount so that “nominal” payments can be excluded);
- including non-vitiation clauses to prevent the insurer from attributing non-disclosure or misrepresentation or breach of policy by the insured to the lenders;
- building in waiver of subrogation clauses to protect the lenders from the insurer “stepping into its shoes” once the claim has been settled; and
- providing obligations to notify the lender of any matters that could invalidate the policy, such as non-payment of premium.

Lender protections under the facility agreement

The Loan Market Association (“LMA”) form of real estate finance facility agreements do contain model clauses for the insurance covenants to deal with the issues addressed above, and these are now well-established clauses that are rarely negotiated at any material level, other than to conform and adapt it to the factual positions relevant to the circumstances of a particular transaction. It is through such covenants that the lenders can ensure that the borrower is contractually obliged to protect the lenders’ interests in respect of insurance.

The lenders will want to go further and seek actual evidentiary confirmation that the insurance policy currently in place (or that will be in place as at the date of utilisation of the loan) does indeed comply with the insurance covenants under the facility agreement. The lenders will conduct their own due diligence on the insurance, and in some instances, a third-party insurance auditor will be instructed at the cost of the borrower to do this (particularly for Pfandbriefe-compliant financings where such loan will form part of the collateral to Pfandbriefe-covered bonds issued by German mortgage banks).

In addition to these, the lenders will seek as a CP to drawdown of the loan a letter from the borrower's insurance broker as evidentiary confirmation that the lenders' requests for protection in respect of the insurance have been met.

Insurance broker letter

It has become a market standard CP in European real estate financings for the borrower's insurance broker to issue a letter addressed to the lenders confirming that the insurance policy complies with the terms of the insurance covenants of the facility agreement. To achieve this, the letter will usually outline the policy in place, confirm that the policy does provide the lenders with the relevant and requested protections, and that the premium has been paid.

In 2016, the LMA published a form of insurance broker letter that was intended for use in real estate finance property investment transactions. The purpose of this form of broker letter was to try to standardise the form of this deliverable across the market due to the prevailing difficulties that the real estate sector was experiencing in negotiating broker letters.

Whilst to date law firms and lenders have generally embraced the LMA form, some insurance brokers do equally have a preference toward their own "house" form of broker letter. It is for this reason that negotiations as to the exact wording and terms of the broker letter do ensue, and in practice, can take some time, and in some cases, even being the cause for holding up a transaction.

The argument that we often hear against having any meaningful negotiation on the letter is that, in principle, it is supposed to simply be a representation of fact, not opinion, so that it should be a low-risk letter that presents objective and factual positions. However, where contention often arises is:

- when the lender seeks to request positive confirmations on certain details of the policy, such as cover, limitations and exclusions, all of which would require due diligence from the broker, as well as some degree of judgment, in order to confirm;
- if the broker is insistent on using its own house form, or requires changes to the LMA form to conform it to such house form (for instance, some brokers' standard house forms will expressly state that no duty of care is owed to the lenders, whereas for the lenders they would argue that the insurer should take responsibility for giving such statement); and
- issues around liability and caps on liability, and reliance (for instance, some lenders will insist on the letter benefiting their successors, but some brokers may resist this for the reason that they believe this would extend their scope of liability too widely).

Are insurance broker letters needed?

Broker letters are a market standard CP. For now, borrowers cannot avoid this, and there are no signs of appetite from lenders of waiving this CP or allowing it to be a condition subsequent. Whilst in some cases the time and resources spent on negotiating its terms may seem disproportionate to the value it provides, the approach to negotiating and agreeing it, like most other aspects of any real estate financing transaction, will ultimately depend on risk allocation, time management and resources.

For instance, the LMA form of broker letter is undoubtedly a good starting point. However, it must be appreciated from all sides of the table the dynamics between the parties and what is being requested, such that some tailoring and negotiation of its terms will be inevitable, not least to deal with transaction-specific matters and internal positions and concerns of the individual brokers. Ultimately, the insurance broker is being asked by a third-party lender, which is not its client, to provide a letter of confirmation to be relied upon and be liable for its contents.

Needless to say, it is worth acknowledging that the confirmations given under a broker letter are a "one-off," in that they are given on the date of issuance (usually on or around the date of utilisation of the first loan) and does not get repeated during the life of the loan. As such, the benefits that a broker letter provides is ultimately limited.

Conclusion

The key point for consideration when it comes to insurance and insurance broker letters is to ensure that such work stream is actioned as early as possible in a transaction and to manage the parties appropriately in order that the right people are communicating to one another at the earliest instance. This would mean getting the insurance broker in touch with the lender, or vice versa, as soon as possible. If not, you may be unwittingly surprised by how long the process of agreeing a broker letter can take.