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Property Insurance in Real Estate Finance Transactions

November 22, 2019 | Issue No. 6

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This article examines the practical considerations that a Lender should consider in regards to insurance of the underlying collateral, as well as the legal benefits of co-insurance and properly packaged security.

Modern real estate finance transactions will often deal with a myriad of vehicles within a structure, each holding real estate in certain jurisdictions, acting as either a primary borrower or an obligor pledging security to enable a group refinancing.

For the purposes of this article we will generalise the property holder/insured party as the “Borrower” and will refer to the lending secured party (such as the security trustee for noteholders, structurally subordinated creditors or senior banks) as the “Lender.”

Please note that this article does not touch upon Warranty and Indemnities insurance and other products which are typically taken for the benefit of the buyer/borrower (which can be charged to a Lender).

The typical packages available

Assigning the proceeds of the policy to the Lender

The charging document will assign to the Lender the Borrowers’ rights to receive the proceeds of an insurance claim, providing the Lender with direct recourse to the insurance policy (and the right to even sue the Insurer directly). These monies will often be required to be paid into secured bank accounts operated by the Lender and, provided the loan is in compliance, will typically be released by the Lender back to the Borrower in order that the Borrower may utilise proceeds for their purpose. Notice of the assignment will need to be given to the Insurer to ensure the assignment is immediately legally effective (assignees rank in the order in which notice of their assignment has been given to the Insurer). Charging the policy proceeds without having the benefit of composite insurance means that there is always the possibility that any action taken by the Lender to enforce the Insurers to pay out could theoretically be met by a claim from the Insurers that the Borrower already breached the insurance contract and rendered it void.

Endorsing or ‘noting’ the Lender’s interest on the policy

Essentially, this provides some but otherwise limited practical benefit. This can provide a prompt on the face of the contract that might deal with a material issue – for instance, the Insurers being able to notify the Lenders of a failure to pay the premium. There is, however, no contract between the Lender and the Insurer here, so if the Insurer fails to notify the Lender, it is doubtful that successful legal action could be taken by the Lender if loss is suffered.

Designating the Lender as first loss payee of any payment made under the policy

Essentially, the Borrower is designating that the proceeds (typically above a certain threshold) be paid directly to the Lenders. As with endorsement, it is a statement written upon a contract that the Lender is ultimately not a party to and, as such, enforcing any rights by the Lender is not going to be straightforward.

Composite Lender insurance

This involves making the Lender a composite insured party under the policy so that it has independently enforceable rights which are not weakened by any failure by the Borrower to comply with the policy.

Important considerations

In negotiating and agreeing to the Lenders' requirements with the Borrower, various considerations need to be given at an early stage, especially where there are multiple secured properties:

- The practicalities, viabilities and legal realities must be explored as a primary matter. What can sensibly be achieved within the timelines available for the financing, and what is workable in terms of prudency and regulation? Many large property companies hold block insurance policies for the benefit of its group companies. Whilst some policies will allow Lenders' rights to be "noted on the policy," it is, of course, unlikely that the Lenders will be able to obtain an assignment of overall proceeds unless the insurance is specifically drawn and segregated into separate properties for individual claims. For the same reason, designating a Lender as first loss payee may be unworkable.
- Does the Borrower actually have a direct contractual claim with the Insurers? This may seem an odd question; however, in some parts of Europe, it is the retained obligation of the ultimate land owner (as opposed to the tenant in possession) to insure the property. Whilst the tenant may have contractual recourse through its lease against its Landlord for failure to insure, is this indirect claim sufficient for the Lender? Is the Lender essentially taking a credit assessment/risk on the performance of its Borrowers' Landlord?
- The Lenders' internal regulations. Is composite insurance going to be required and, if so, who will pay the premium?
- The Insurers themselves. Are they prepared to negotiate the standard terms or does the Borrower need to consider another Insurer?
- Governing law. It is frequently the case that a policy over property in one jurisdiction is governed under a different jurisdiction. However, where a block policy will insure properties in a number of jurisdictions, the policy cannot be subject to multiple governing laws at once. An early assessment is therefore vital to ensure that the Lenders obtain the correct securities.
- Regulation and legal guidelines. Lenders across Europe rely on industry guidelines, such as the VDP German association of Pfandebriefe Banks and the British Banking Association. Industry guidelines often dictate best practices in some jurisdictions which may be different from others, and legal/regulatory frameworks sometimes require specific matters to be complied with. Failure to address these issues could cause an issue during syndication.

The risks of 'derivative' protection

Each of the first three routes outlined above ("Assigning the proceeds of the policy to the Lender," "Endorsing or 'noting' the Lender's interest on the policy," and "Designating the lender as first lost payee of any payment made under the policy") are essentially "derivative"; they are derived out of the Borrowers' rights under the terms of the insurance with the Insurer, and, as such, the level of protection comes with risks, in particular, that the Insurer could raise defences due to non-compliance by the Borrower which affect the pay out, or indeed validity of, the insurance. The risk of issues presenting themselves is further exacerbated by the fact that the Lenders will have no direct contractual recourse to the Insurers in any event.

Whilst, for instance, properly drawn loan documentation would place prohibitions on the Borrower amending the terms of the policy, the Lenders will not have any recourse against the Insurers if the policy was changed without the Lender's knowledge. Arguments could certainly be put together to assist a Lender in certain situations – for instance, where the proceeds of the policy were assigned to the Lender ("Assigning the proceeds of the policy to the Lender") and the Insurer fails to pay out to the Lender, then it is theoretically possible in some European jurisdictions to take actions claiming third-party rights under contracts. Claims can be thwarted, though, from clauses in the contract that seek to restrict third-party rights; furthermore, practically speaking, the Insurers may also have the defence that when the Borrower breached its contract, the policy had as a result lapsed or become void.

Ultimately, with the "Composite Lender insurance" route outlined above, a Lender can seek to be made a composite insured party under the policy to give it the maximum protection available. This would provide the Lender with the ability to make its own separate claim independent of the Borrower's position alongside the Lender. Providing the policy is properly negotiated, the Lender will be protected even against breaches of the policy made by the Borrower, such as claims by the Insurer that the Borrower has vitiated the policy through non-compliance or by failing in its duty of disclosure and upmost good faith to the Insurer. The policy will need to contain a provision to the effect that the insurance shall not be invalidated against the Lender for non-payment of premium without the Insurer giving the

Lender written notice. The policy should also contain a standard mortgagee protection clause, waiver of subrogation against Lender or no disclosure obligations on the Lender.

Finally, it is worth reminding that whilst protective measures and compliance requirements will appear as standard in well-drafted European Senior Lending documentation (such as those found in Loan Market Association documentation), which typically require confirmations that composite insurance is in place with various other Lender-protective measures for the benefit of the Lender, these confirmations should be checked through due diligence and, at the least, a letter from the insurance broker to confirm that the policy meets the requirements set out in the lending documentation.