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Aligning Function and Process: CMBS Insurance Solutions
By Peter K. McKee

Insurance issues are among the most challenging in commercial real estate transactions today. Policy premiums can swing wildly over the life of a loan, creating underwriting and loan structure challenges for originators, loan sizing and contingent liability issues for borrowers, and risk allocation and pricing issues for investors. As loans incorporate customized insurance solutions, loan servicers are left to monitor, interpret and enforce loan documents that all too often inadequately anticipate secondary market standards and servicing processes.

How to get it done right?

Processing Insurance Information. The insurance requirements for any loan are expressed in (i) loan documents, (ii) insurance certificates, and (iii) internal insurance approval. Too frequently the loan documents, certificate and loan approval do not match.

Coordination across functional lines of responsibility is often to blame: loan underwriters and closers evaluate the asset against program-standard requirements, but may not be aware of property-specific issues or product deficiencies unless advised; lender's counsel has property due diligence (title, survey, zoning and, sometimes, lease reviews, each of which has the potential of affecting insurance requirements) and drafting responsibility for the loan documents, but typically not for the insurance certificate or insurance approval tie-out; insurance consultants look at the overall insurance package in light of market or industry standards, but may not be apprised of insurance-related matters that arise out of property diligence, and may not necessarily review loan document requirements. This legal/insurance/business balkanization puts a premium on the sharing of information.

Secondary Market Expectations.
Insurance representations are among the most detailed and demanding that loan originators/sellers provide. Typical representations include the following elements:

- the loan documents require certain core coverages (typically casualty, business interruption and liability, and terrorism insurance in varying degrees);
- the loan documents require certain conditional coverages (such as earthquake, flood, windstorm, and building law and ordinance insurance) if triggered by recognized property attributes; and
- if required by the loan documents, the coverages are actually in place within prescribed parameters.

Taking exceptions to these representations obliges the loan seller to detail mitigating circumstances, or else risk pricing discounts or kickouts from investors.

Specific Action Strategies.
Lenders can take specific actions to identify and resolve insurance-related problems that impact secondary market loan sales:

- *Coordinate Property Diligence Information.*
  Title, survey, zoning and leasing information can affect the parameters of a loan's insurance package. For example, recorded covenants or leases may impose more stringent insurance requirements than the lender's program. Surveys may show improvements in special flood hazard areas, reveal monitoring wells that prompt environmental evaluation, or indicate improvements that do not conform to current zoning. Zoning reports may also reflect past conditions apparent from prior approvals that suggest an insurance response. A variety of factors can prompt changes in loan requirements. By systematizing insurance reports at defined points in the loan closing process, communication across functions should improve, and outcomes should be more consistent and predictable.
- *Assign Overall Tie-Out Responsibility.*
  Responsibility should follow control. While definitive approval for insurance may be retained internally or outsourced, it is essential that the related insurance documents all fit together. Information should be pushed to the parties that need it.
- *Watch for Self-Insurance Variations.*
  Self-insurance means that conventional third party insurance is not being provided, and that the related risk is being borne by some other transaction party. Because this feature is almost always an exception to loan seller representations, it must be tracked for securitization purposes. Two self-insurance traps to avoid are: (i) structuring the loan as having waived insurance requirements rather than conditionally suspending them (thereby making allowance for changes that could revive the borrower's obligation to provide required third party insurance), and (ii) pegging loan requirements to whatever the lease requires. Single tenant leases rarely oblige the tenant to maintain business interruption or terrorism insurance, for example.
- *Mitigate Adverse Impacts.*
  In response to competitive pressures, loan originators may consider concessions where the related risk is deemed diminished or otherwise adequately mitigated. Springing recourse, non-recourse carve-outs, or springing escrows are among the more typical mitigants, but their efficacy depends upon the sponsor's strength. Sponsor-based mitigants should include financial covenants with a remedy if such covenants are breached (such as the resumption of third party of insurance or funding of an escrow). Also, sponsor financial information should be included with other periodic financial reporting required by the loan documents. In considering how to ameliorate the underwriting impacts of premium increases, increasing policy deductibles may be preferable to limiting the scope of required coverage or capping premiums.
- *Make Insurance Requirements Servicer-Friendly.*
  After the loan is closed, the servicer has to interpret, monitor and enforce insurance requirements. Loan originators care about servicing because their customer relationships may hang in the balance. Loan documents should consider how the servicer will know of any enforcement issues, and how it will interpret the related requirement. Loan documents should exercise particular care concerning conditional requirements: Is the trigger for such action clearly defined based on information readily available to the servicer? If not, how can that information be pushed to the servicer most readily? Look to augment financial reporting requirements with whatever the servicer reasonably need to monitor compliance.

Prepayment Premiums Questioned
By Patrick C. Sargent

Prepayment protection is a critical feature of commercial loan documents. Typical CMBS prepayment premium or yield maintenance formulas require a payment to the lender to compensate for the lost interest payment stream after prepayment since the original interest rate was based on the full term of the loan.

A federal court applying Illinois law recently determined that a prepayment premium was an unenforceable penalty. The case, *River East Plaza, L.L.C. v. The Variable Annuity Life Company,* 2006 U.S. Dist. Lexis 73317, is under appeal to the Seventh Circuit, and several industry groups and lenders have filed *amicus curiae* briefs in support of the appellant. The court held that prepayment premium calculation, based on the present value of all remaining interest payments discounted at the yield to maturity of a U.S. Treasury note having a maturity date closest to the maturity of the loan, was not reasonable and did not bear some relation to possible damages. Consequently, it enforced the floor prepayment charge of 1% as an alternative, finding no evidence of actual damages suffered by the lender and that the parties did not intend to agree in advance to the settlement of damages that might arise from a breach (not surprising, since the negotiated provision was for a permissible prepayment, not a liquidated damages clause in anticipation of a breach).

The court's decision runs counter to a long line of cases holding that prepayment of premiums represent bargained-for consideration for the contractual right to prepay prior to the stated maturity of the loan; that sophisticated parties in commercial transactions have the right to freedom of contract as they choose; that a liquidated damages analysis is not appropriate for evaluating voluntary prepayment options; and that commercial borrowers do not have a common law right to prepay loans.

The decision, if it stands in Illinois or is applied in other states, puts commercial lenders in a quandary. Should they use a reinvestment rate with a pread over Treasuries in establishing prepayment premiums? What spread is sufficient? And will th eprepayment premium clause otherwise be subject to scrutiny as liquidated damages for a breach that did not occur? Pending the Circuit Court's decision, there will be uncertainty. Lenders should monitor the situation and evaluate their current prepayment provisions accordingly.