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LMA PUBLISHES INSURANCE BROKER LETTER

The Loan Market Association (LMA) has recently published a form of insurance broker letter, intended for use in real estate finance property investment transactions. This has been prepared to meet market demand given the increasing difficulties experienced across the real estate sector in negotiating insurance covenants and broker letters over the last few years. The working party responsible for this new LMA precedent consisted of banks, non-bank lenders and City law firms active in the real estate finance market with input from various insurers and insurance bodies. It is intended to represent a fair position for lenders and insurance brokers and to reinforce market standard requirements.

The result is a good starting point for negotiations where the LMA real estate finance facility agreement is used, although tailoring will be required to deal with transaction specific matters and particular concerns for individual brokers.

WHY HAVE A BROKER LETTER?

Broker letters are important in real estate finance transactions as they provide confirmation that:

- the insurance being put in place complies with the facility agreement covenants;
- all premia have been paid at the date of utilisation;
- the broker is not aware (on utilisation) of anything that would invalidate the policy; and
- the broker is placing insurance on behalf of the lender (as well as the borrower) if the policy is joint or composite insurance.

Insurance is an important part of maintaining the value of the underlying real estate asset and ensuring the lender has appropriate security.

SPECIFIC FEATURES OF THE LMA BROKER LETTER

- It includes "one-off" confirmations given on utilisation (i.e. they are not repeated during the life of the facility) - this is a standard broker requirement to avoid an ongoing liability to ensure that the insurance covenants in the facility agreement are being met.
- It includes reliance wording benefitting all finance parties and their successors - this is a standard lender requirement but is sometimes resisted by brokers. It is helpful to have this reinforced as a market standard requirement.
- There is a requirement for the insurer to give the lender notice (30 days is suggested) in the event it proposes to take action to cancel the policy (due to repudiation, avoidance or unpaid premia) and the broker needs to confirm that the policy terms comply with this requirement.
- The broker provides confirmation that the insurance policies are capable of being assigned - assignment of these policies is likely to form part of the security package.

LMA INSURANCE MARKET STANDARDS

The LMA broker letter replicates the LMA real estate facility agreement insurance covenants requiring:

- composite insurance for the lender;
- non-invalidation and non-vitiation clauses in favour of the lender;
- waiver of subrogation rights against each insured, the finance parties and any tenants; and
- a first loss payee clause in favour of the lender (although a threshold may be agreed).

Again this is helpful in reinforcing these requirements as market standard.

TAILORING FOR TRANSACTION SPECIFICS

The LMA user notes warn that it is difficult to produce one precedent to apply to all transactions when each transaction will have its specific structuring and commercial requirements. The LMA broker letter is, therefore, not being offered as a "one size fits all". This is particularly important as the individual insurance policies will be summarised by the broker for each transaction to be bespoke.

The user notes also flag the importance of dealing with insurance early on in negotiations to ensure that negotiations concerning insurance covenants and broker letters are prioritised to avoid holding up transaction timetables. This reinforces current best practice.

OTHER ISSUES RAISED BY BROKERS

- The LMA real estate facility covenants and broker letter both include an obligation for the broker to confirm "(having regard to the nature of the business and the assets of the obligors) that the insurance policies provide cover over such risks as the broker would advise and recommend to

a prudent company in the same business as the obligors to insure". Brokers are sometimes reluctant to give this confirmation as they consider there to be an element of judgement involved. Whether this can be agreed will often depend on the specifics of a transaction (e.g. it will be easier for a broker to give this confirmation for an office investment asset than for more bespoke assets such as a hotel, food and leisure assets or datacentres).

- Sometimes when brokers issue their house standard broker letter they will expressly state that no duty of care is owed to the lender. This will rarely be acceptable for a lender because where the broker letter contains any statement of fact, the lender will expect the insurer to take responsibility for giving any such statement. If the broker negligently places the borrower's insurance on inappropriate terms then it will be liable to the borrower as its client in any event and the broker will not want to have any increased liability to the lender. Where this point comes up in negotiations it can be useful to:
  - state in the broker letter that the broker's liability is subject to its terms of business agreed with the borrower as its client and the ability for the lender to rely on the broker letter will not impose any greater liability on the broker than would be owed to its client; and/or
  - consider whether a liability cap is appropriate.

CONCLUSION

The LMA broker letter will be welcomed by lenders and professionals in the real estate sector as providing a useful starting point in negotiations with insurance brokers and reinforcing market standard requirements. However, as all brokers have their own specific requirements when issuing broker letters and transaction specific insurance policy terms vary, the LMA broker letter will need to be tailored for each transaction. We do expect there to be fewer instances where a broker has to elevate negotiations to its in-house legal team as brokers should be able to develop standard responses to the LMA broker letter requirements. This should help reduce delays to negotiations but best practice will still be to ensure that insurance covenants and broker letters are negotiated up front to ensure no delay is caused to transaction timescales.

For an explanation of some of the insurance terms referred to in this note please see the following page.

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INSURANCE JARGON EXPLAINED

Composite insurance (sometimes referred to as co-insurance)

Borrower and lender are both insured parties but have **separate** insurable interests. This means if the borrower's interest in the policy is invalidated there is no impact on the lender's insurance. Each insured has their own claim limit which is applied independently so insurance proceeds relating to the lender's loss are paid to the lender direct. The lender should, however, be aware that where it is an insured party it has its own obligations to disclose all material facts about the property to the insurer to ensure that its interest in the policy is not invalidated.

Joint insurance

Borrower and lender are insured parties under a **single** insurable interest. Default by one party invalidates the entire policy. The policy terms will usually set out the apportionment of insured losses between the parties. The main disadvantage is that default by the borrower can invalidate the entire policy.

Non invalidation clauses

This can provide additional protection for a joint insurance policy. It is used to ensure that even if the borrower invalidates the policy the insurer will only implement its rights against the borrower as the defaulting party. An example of default could be failing to disclose material facts to the insurer on the policy being taken out. This type of clause is not required for a composite insurance policy as the lender's interest cannot be invalidated by the borrower's default.

First loss payee

An obligation for the insurer to pay proceeds to a nominated party (i.e. the lender). However, there can be issues enforcing the obligation where the lender is not an insured party and the Contracts (Rights of Third Parties) Act 1999 has been excluded in the policy conditions.

Noting

This is where the lender's interest in the property is noted (either specifically by adding the name of the lender or generally by the inclusion of a note of any mortgagee's interest) on the policy document. Noting does not trigger any legal protection to arise but is carried out as market practice where a lender is not an insured party. Although not required to do so, due to market practice, insurers tend to notify any lender whose interest is noted of any policy event (e.g. as a result of claim, invalidation or lapse). Insurers do not tend to exercise rights of subrogation against noted parties.

Waiver of rights of subrogation

Where insured damage is caused by a third party and an insurer has to pay out under the policy the insurer has a common law right to "step into the shoes" of the borrower and sue the third party. The LMA facility agreement requires a waiver to be obtained in relation to default caused by tenants, the borrower (and borrower group) and any finance parties. A waiver obtained in relation to tenants is standard where tenants contribute towards the buildings insurance policy premia. Waiver of subrogation of the lender is not required where there is composite or joint insurance (as insurers will not exercise rights of subrogation against an insured party).

Which do you need?

The best protection for lenders is offered by composite insurance (which is why this is the starting point required by the LMA facility agreement and broker's letter). However, the borrower is not always in control of the insurance of a property. If a borrower's landlord is responsible for insuring a property, the market standard position is that a lender cannot require greater insurance protection than the landlord is required to provide under the lease. This is because the borrower has no grounds to renegotiate the terms of the lease with the landlord. The lender will want to take security over the borrower's right to enforce the landlord's covenants to insure in the lease. Key to the success of any action taken against a landlord in default will be the covenant strength of the landlord in question. It is also worth noting that where this approach is not acceptable to a lender (e.g. for larger transactions) the borrower should be able to obtain a supplemental policy to sit beside the landlord's policy covering any additional lender requirements.

Sometimes borrowers will insure a property pursuant to a block policy which affects a number of other properties. There may then be increased pressure from the borrower not to amend the policy to provide composite or joint insurance for the lender for one property.

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