

FALLACIES, FLAWS AND MYTHS WITH INSURANCE DOCUMENTATION

WHAT YOU DO NOT KNOW ABOUT YOUR BORROWER'S INSURANCE PROGRAM CAN HURT YOU!

- Fallacies of Insurance Documentation and Your Borrower's Insurance Program.
- Banker's Blanket Policy or Gap Coverage Should Not Be Your First Line of Defense.

There is often debate among lenders, borrowers, and insurance brokers over what constitutes enforceable insurance documentation. Historically, "certificates" of insurance have been passed from insurance brokers to lenders as acceptable evidence of insurance coverage, and lenders have accepted these "certificates" as proof of coverage. This is a dangerous practice and puts the lender in a vulnerable position in the event that their borrower suffers a loss to its collateralized property. There are superior alternatives that lenders should choose to protect their insurable interests in the borrower's property.

Certificates of Insurance

- Brokers prefer to issue "Certificates of Insurance", because they can issue them without approval from the insurance carrier. Don't be fooled by insurance brokers who say that a "Certificate of Insurance" is fine and is an acceptable substitute for an "Insurance Binder". The broker is not a party to the insurance contract. The borrower, other designated entities and the insurance carrier are the only parties to the policy.
- Certificates of Insurance are not enforceable evidence of coverage. Reliance on certificates has serious flaws. How can a Lender comfortably close a multimillion dollar deal while relying on a piece of paper that states? *"This Certificate is issued as a matter of information only and it confers no rights upon the Certificate Holder. This Certificate does not amend, extend or alter the coverages afforded by the policies below."* This is what is plainly printed on the industry standard *Acord 24 – Certificate of Property Insurance Form*.

Now, after reading the disclaimer on the certificate, does this document help you sleep better? It shouldn't. Why? Because, as the disclaimer is saying, if the information present in the actual insurance policy (contract) contradicts the certificate of insurance, the actual insurance policy language prevails. For example if the certificate states that the property limit for inventory is \$20,000,000, but the policy shows a limit of \$10,000,000, the actual limit available to pay claims is \$10,000,000. It does not matter what is stated on the Certificate. There is more appropriate documentation that will provide you with enforceable evidence of coverage.

- If the Certificate is not correct, the insurance broker's errors and omissions coverage will pay the damages. This is a fallacy. Do you believe that it is prudent to rely on some third party's professional liability coverage to make you whole if you borrower suffers an uninsured loss? How do you know that the insurance broker has sufficient limits? How do you know that they carry professional liability? How do you know that the insurance

will be collectible? Have you examined all of your borrower's broker's professional liability coverage?

A much better alternative would be insistence by the lender that the borrower's insurance broker provide enforceable "binders" in lieu of "certificates" of insurance.

Binders of Insurance –

- The "*Acord Form 28 – Evidence of Commercial Property Insurance*" or its equivalent is the insurance industry standard. With regard to general liability insurance, the "*Acord Form 75 – Insurance Binder*" or its equivalent is suitable.
- These binding documents were developed to provide enforceable interim evidence of coverage until the actual policy or policy endorsement is printed and issued, since it is not unusual for it to take several weeks or months for the actual policy or endorsement to be issued after coverage is bound.
- However, binders are also flawed because they are not complete copies of the policy. A binder does not allow its holder to fully understand the structure of the insurance program, because it is not the complete contract. Would you close on a multi-million dollar deal without examining the complete credit agreement?
- It is a complete myth that Binders are only issued or appropriate at the beginning of the policy period. Insurance brokers frequently make this false statement. Don't accept this urban legend! Case in point. When you first purchased your home or refinanced your mortgage did your mortgage banker require a Certificate or a Binder? I'll wager the mortgagee insisted upon a Binder, because it is enforceable evidence that coverage for the Mortgagee has been endorsed onto the insurance policy (contract). The *Acord Form 28* states "*This is evidence that insurance as identified below has been issued, is in force, and conveys all the rights and privileges afforded under the policy*". It is plainly evident that a Binder is vastly superior to the Acord Certificate.
- However, a binder of insurance does not provide enough information to have thorough knowledge of how the borrower's policy will respond in event of a loss and the subsequent claim. In order to ascertain if the policy will respond as intended, the actual property policy and at least two supporting documents must be reviewed. The binder is not a complete document. It does not provide a full description of policy terms, definitions, conditions, clauses and exclusions. It will not fully describe property coverage sublimits. In addition it will not usually provide the full scope of coverage for catastrophic perils like terrorism, toxic mold, flood, hurricane and earthquake.

The Insurance Policy and Critical Support Documents

- It is essential for a lender to review to have the full insurance policy and supporting documents in order to be assured that the policy will respond to a claim as the borrower and lender intend. The necessary supporting documents include the property policy's Statement of Values (SOV) and the Business Income (BI) worksheet as well a Summary Schedule of Policies and Schedule of Insured Locations. These documents are the analytical tools necessary to determine that the Property Policy has adequate limits and covered locations.
- The SOV document is a list of all of the borrower's locations and the respective current building and business personal property values at each site. It is signed by one of the borrower's corporate officials. The SOV is required by insurance carriers as a condition of waiving any coinsurance clauses and providing agreed value coverage. The SOV must be presented to the insurance carrier or the policy can revert to its original coinsurance clause which could lead to claims problems if the borrower (insured) does not carry "*insurance to value*".
- The BI worksheet is another form completed by one of the borrower's officials and is a method to calculate the appropriate amount or limit of Business Income coverage to carry. BI coverage is a critical coverage for a borrower to carry as it is this insurance coverage that will sustain the business survival of a borrower who sustains an insured property loss that temporarily diminishes or prevents the continued sale of the borrower's product or service.
- A proper review of insurance policy should include identifying:
 - i. Full legal correct named insured
 - ii. Full legal correct named lender (mortgagee and/or lender loss payee)
 - iii. Policy effective and expiration date
 - iv. Proper description and address of insured property
 - v. Insurance carrier's financial rating
 - vi. Proper identification of the insured location and insured property
 - vii. A full description of mortgagee and/or lender loss payee clauses
 - viii. A full understanding of the structure of the insurance program, policy terms, conditions, exclusions and definitions.
 - ix. Amount of coverage that is supported by statement of values and business income worksheets
 - x. Mortgagee and/or lender loss payee clauses that will protect the lender against a breach of policy terms and conditions by the borrower
 - xi. Coinsurance clause or an agreed amount endorsement
 - xii. Deductibles – can the borrower “afford” them?
 - xiii. How is the collateral valued if damaged or destroyed? Replacement cost, Selling Price, etc?

Mortgage Contingency and Contingent Property Provisions – Often Misunderstood

Another fallacy is that all the lender needs to do is purchase *Mortgage Contingency* coverage to protect themselves from uninsured losses suffered by their borrowers. Although most banks do procure *Mortgage Contingency* and/or *Contingent Property Provisions* under their corporate policies, such coverage is never meant to be primary. The coverage trigger for these contingent policies is a “*failure of the borrower’s insurance to respond to a loss*” Additionally, oftentimes, a condition of these contingent policies is that, upon knowledge of lapse or absence of the borrower’s insurance, the bank will be forced to place such lapsed or missing insurance. Therefore, the bank has an inherent duty to ensure that there is underlying insurance in place in order to recover under the contingent provisions of its corporate policy.

If the borrower’s coverage, presumably protecting the lenders’ insurable interest, is not properly endorsed, the lender may find their only recourse is to become involved in a very expensive lawsuit in an effort to collect the insurance proceeds to pay back their loan.

In summary, today’s business environment exposes the lending community to so many elements that you cannot control. Why not control the elements that you can. Take a closer look at your borrower’s insurance program.

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Biography

Bill McNamara joined Commercial Insurance Consultants, Inc. in 2004 and has now accumulated more than twenty years experience as a Commercial Property and Casualty Insurance Underwriter and Insurance Broker. He started his career as an underwriter for a regional wholesale insurance broker handling commercial property and liability accounts for accounts across New York State. After ten years, Bill joined a large insurance brokerage firm handling regional and international customers insurance and risk management needs. Bill obtained his Chartered Property and Casualty Underwriter (CPCU) designation in 1991. He received a Bachelor degree in Journalism from the University of Missouri – Columbia in 1981. Bill’s focus since joining Commercial Insurance Consultants, Inc. has been providing insurance due diligence to the commercial lending industry on their borrowers’ insurance programs.