needs for adequate coverage of its borrowers, transactions, and collateral. Those requirements must be communicated to the lenders. Once your bank has established guidelines, it should create a checklist to ensure compliance.

Some insurance coverage may be excluded from a property owner's commercial insurance policy in certain high-risk areas. For example, Florida is prone to hurricanes and is considered high risk for windstorm damage. Many insurers list wind coverage on the basic form, but exclude it through an endorsement somewhere else in the form. The bank's alternative is to require a separate policy for the excluded coverage—for example, a wind policy if windstorm coverage is excluded from the base hazard policy.

Builder's Risk Insurance

Builder's risk insurance is a form of hazard insurance designed specifically for construction loans. It protects a borrower against damage to buildings under construction. And it protects the financial institution's interest in materials, fixtures, and equipment employed in the construction or renovation in the event of physical loss or damage from a covered cause.

This type of insurance usually protects the insured against losses due to fire, vandalism, lightning, wind, and similar forces. Like hazard insurance, builder's risk insurance usually does not cover earthquakes, floods, acts of war, or intentional acts of the owner. Furthermore, in certain high-risk areas, such as those prone to windstorm damage, certain types of coverage may be excluded. Coverage typically applies only during the construction period and is intended to terminate when the work has been completed and the property is ready for use or occupancy.

When construction is complete, the bank must have a tickler mechanism in place to convert the builder's risk coverage to a hazard policy. Lack of the tickler may void the protection.

Hazard Insurance Requirements

To properly protect real property collateral securing commercial loan transactions, a bank must define its hazard/property insurance requirements. It's essential that various requirements for the insurance policy be vetted and communicated to all the lines of business that originate commercial real estate loans. The requirements should:

Insurance Requirements for SBA Loans

By Katie O'Brien

When extending Small Business Administration loans to borrowers, it's important that lenders require appropriate insurance coverage on all collateral securing their loan. Correctly documenting insurance coverage is vital; it protects the lender's interest in its collateral and complies with the terms of the SBA Authorization.

Hazard/Property Insurance

If the lender's collateral includes both real estate and personal property, the borrower must obtain insurance coverage on the real estate as well as on all furniture, fixtures, equipment, and inventory that are collateral for the loan.

The following details are important when hazard insurance is required:

- Coverage should be for the full amount of the replacement cost, if available, or the maximum insurable value of the property.
- If the collateral includes real estate, the lender must be named mortgagee.
- If the collateral includes personal property, the lender must be named lender's loss payee.

A lender's loss payee endorsement provides the lender with enhanced coverage and a contractual right to more or less step into the shoes of the borrower and receive payment of insurance proceeds. Moreover, the lender's interest in the collateral will still be protected despite the actions or inactions of the borrower. For example, the lender will receive insurance proceeds even if the borrower fails to make premium payments or intentionally destroys the insured property. (If the insurance policy contains only a regular loss payee endorsement, the lender may not be protected from the borrower's actions or inactions.)

The SBA requires that all casualty insurance policies provide "that any action or failure to act by the borrower or owner of the insured property will not invalidate the interest of lender or the SBA" and that the policy "must provide for a minimum of 10 days prior written notice to lender of policy cancellation." The best way to be sure this coverage is provided is to review the policy endorsements and see if they are in compliance with the SBA requirements.

Flood Insurance

The SBA also requires that borrowers obtain flood insurance under the National Flood Insurance Program (NFIP) on real estate and business personal property in the following instances:

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self-insured, the financial institution must set a limit on hazard insurance deductibles. According to Bruce Irvine of Johnson and Bryan, an Atlanta-based, full-service commercial insurance brokerage firm, “Deductibles will vary based on the value of a project and the owner’s aversion to risk. Deductibles can range from $1,000 to $100,000. In the current market, we routinely see hazard deductibles range from $1,000 to $25,000.”

- *Mortgagee/loss payee clause.* This clause/designation provides that, in the event of a claim being made under the policy, payment will be made to a third party rather than to the insured. As a result, the financial institution would control the proceeds of the claim made under the policy.
- *Notice of cancellation.* An institution should require a 30-day notice of cancellation to ensure that it has enough time to reinsure the property in which it has a security interest.
- *Rating of insurance provider.* The institution should consider a minimum rating on the insurance company used to provide the policy. Institutions should consider insurance provided by companies with an A.M. Best Guide rating of at least “A.” Also, consideration must be given to requiring an A.M. Best Financial Size category of “IX” (nine) or greater.

To ensure that it has control of the proceeds, the institution must be designated as the mortgagee/loss payee on hazard insurance policies.

Evidence of Insurance

Evidence of insurance must be procured prior to the closing date for a commercial loan secured by real estate. The following three items provide evidence of hazard/property insurance:

- *The policy.* The policy is the most accurate and useful evidence of insurance. It provides all endorsements, coverages, and exclusions and is the actual insurance commitment. In most cases, it’s difficult to get a policy before the closing date, but after the closing the institution still should obtain the actual policy and retain a copy.
- *The declaration page from the policy.* The declaration page from the policy is the second most reliable evidence of insurance. However, it also may not be available at the time of closing a transaction.
- *ACORD 28 Form.* The ACORD 28 form is preferred; however, the ACORD 27 certificate,

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- If any portion of a building that is collateral for the loan is in a flood zone.
- If any business personal property is located in a building that lies in a flood zone.

To determine if collateral is located in a flood zone, the lender should order a Standard Flood Hazard Determination, FEMA Form 81-93. The amount of flood insurance should be the lesser of the maximum amount of insurance available or the replacement cost. The NFIP limits the maximum amount of flood insurance available to $500,000 for buildings and $500,000 for contents.

Liability Insurance

While the SBA does not give clear guidelines as to which type of business liability coverage is required, lenders should use prudent lending standards. In order to properly protect its interest, the lender should be named additional insured on the borrower’s liability insurance policy. This designation extends liability coverage to the lender on the same terms that the insurer provides to the insured and increases the likelihood that the lender will receive notice of a lapse in coverage.

Life Insurance

If the viability of the borrower’s business is tied to one or more individuals, the lender must require life insurance on the key person(s) in an amount consistent with the size and term of the loan. In addition, the lender must obtain a collateral assignment of such policies. This collateral assignment should identify the lender as assignee (*not* beneficiary), and the assignment must be acknowledged by the home office of the insurer.

Additional Types of Insurance

Depending on the specific details of each loan, lenders may want to require the following types of insurance:

- Marine.
- Malpractice.
- Disability.
- Workers compensation.
- Liquor liability.
- Product liability.
- Builder’s risk.

Lenders should consult the Small Business Administration’s SOP 50 10 5(B), *Lender and Development Company Loan Programs,* and use prudent lending standards in determining which types of additional coverage are required. ❖

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***Katie O’Brien** is an associate at Starfield & Smith, PC. Contact her by e-mail at* kobrien@starfieldsmith.com *or* 215-542-7070.