REAL ESTATE COUNSELORS

Lending Focus: Insurance Proceeds & Casualty Events

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REBUILDING AFTER A CASUALTY. Recent events such as Hurricane Sandy confirm that commercial properties can incur substantial damage and that insurance claims will follow. When the property is encumbered by a mortgage, disbursement of insurance proceeds is governed by the mortgage or loan agreement. Such documents typically give the lender the right to apply all insurance proceeds to reduce the loan debt.

Borrowers, however, typically want the right to use the insurance proceeds to restore the property, especially in those cases where a borrower is obligated to restore the property under one or more leases.

During the loan negotiations, the borrower and lender have the opportunity to set out how the insurance proceeds will be distributed and how the rebuilding process will work. Each party should negotiate certain key issues. The lender will want to set out conditions and limitations to protect its interests. The borrower will want to make clear that the insurance proceeds will be used to rebuild subject to tolerable limitations. In considering whether the borrower should be entitled to receive insurance proceeds, a lender should consider several factors:

Lender's Issues:

- **Default** – The lender may wish to withhold distribution of insurance proceeds for restoration if there is an occurrence of default by the borrower under the loan documents, or a history of prior monetary or material non-monetary defaults.
- **Amount of Damage** – The lender may want to set thresholds for the percentage of the gross area of the building damaged and the amount of the loss.

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- **Leases** – The lender may require confirmation that one or more major tenants cannot terminate the lease due to the casualty and/or that the property will (after restoration) meet a required occupancy threshold.

- **Restoration** – The lender may require assurance that restoration can be timely performed for the amount of the insurance proceeds (or such additional capital as borrower is willing to provide), and that the restoration can be completed within a reasonable time prior to the loan's maturity date.

Borrower's Issues:

- **Minor Casualty** – The borrower may want the right to obtain proceeds to restore minor damage without the more rigorous tests that would apply to a major restoration.

- **Default** – The borrower will seek to limit default tests to the time of the casualty and not count prior events it has cured.

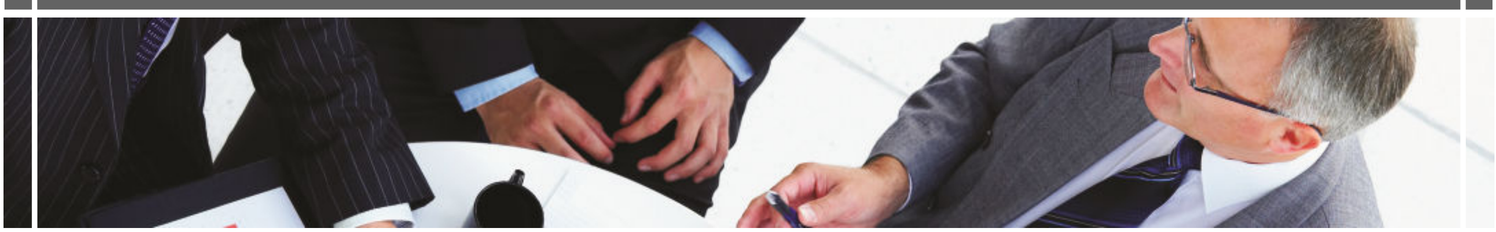
- **Leases** – The borrower will want some flexibility on required major tenants and vacancy thresholds.

When the Test is Met: When the borrower meets the test to use insurance proceeds to restore, new issues arise for both parties to consider:

Borrower's Issues:

- **Guaranty** – The borrower should try to avoid any obligation to provide bonding or a personal guaranty as a condition to restoring the building.

- **Direct Payment** – Disbursement procedures under the loan documents can be complex and cumbersome. Consequently, it is in the borrower's interest that the proceeds be paid directly to the borrower if the loss is below a certain threshold.



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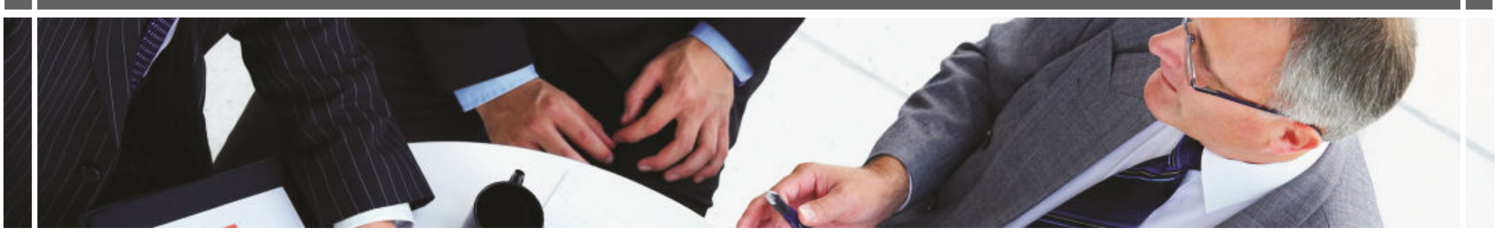
- **Control** – The borrower will want to control the insurance adjustment process as much as possible by having the lender agree to confer with the borrower on issues of rebuilding.
- **Leases** – The project's existing lease may provide tenants with termination rights or obligate the landlord to restore the project under certain circumstances (e.g., repairs that can be done in 90 days). The borrower should make sure that the language in the loan documents and existing (and future) leases are consistent in order to avoid a conflict between the two documents.
- **Remaining Proceeds** – Once restoration is fully complete, the borrower would like to receive any insurance proceeds that remain after restoration free of any lender claims.

Lender's Issues:

- **Budget** – The lender will want the work to be performed at a set price and in accordance with plans and specifications and a budget that is satisfactory to the lender.
- **Schedule** – The lender will want the borrower perform the restoration work in accordance with an agreed-upon restoration schedule and in any event complete the work prior within a reasonable time prior to loan maturity.
- **Restoration Costs** – If the restoration costs exceed the proceeds available, the insurance proceeds may not be advanced until the borrower deposits the full amount of the deficiency with the lender.
- **Lender Costs** – The lender wants the borrower to pay the lender's costs and expenses incurred in disbursing the insurance proceeds, and any third-parties lender may use to review the restoration plans and specifications.

CONCLUSION. The lender and the borrower both have significant concerns when addressing the criteria by which the borrower can, or is obligated to, restore the property following a casualty.



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