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DISPATCHES FROM THE TRENCHES

The Finer Points of “All Risk” Insurance

By Kenneth P. Weinberg

This issue of Dispatches from the Trenches discusses two cases. The first case relates to "all risk" insurance provisions. The second case covers the benefits and risks associated with outlining the manner in which collateral is sold after a default.

Omni Berkshire Corp. v. Wells Fargo Bank, N.A., 2004 WL 375954 (S.D.N.Y)

Anyone concerned about the effect of insurance provisions in lease documents can benefit from a quick review of this case. Borrower took out a loan for approximately \$250 million and the loan was secured by five hotel properties. The loan documents required Borrower to keep the collateral insured by way of a "comprehensive all risk" policy and "such other reasonable insurance" as Lender may require from time to time.

The all risk policy originally covered terrorism but, after the attacks on September 11, terrorism was added to the list of exclusions and was no longer covered by Borrower's "all risk" policy. Lender informed Borrower that, in order to comply with its obligations under the loan documents, Borrower must obtain a separate policy covering terrorism. Borrower refused, citing the extremely costly nature of such coverage. As a result, the matter ended up in litigation.

The court reviewed the loan documents thoroughly to determine whether or not those documents contractually required Borrower to maintain insurance against terrorism. After much discussion, the court concluded that the requirement of an "all risk" policy did not necessarily mean that Borrower had to insure against the risk of terrorism. According to the court, the fact that the loan agreement did not define the term "all risk" resulted in ambiguity as to whether terrorism must be covered. The court then used standard rules for interpreting contracts in order to determine the intention of the parties. The court noted that the common understanding of "all risk insurance" was that it covered all risks *other than* those that are specifically excluded by the policy. Typical exclusions historically found in such policies include war, pollution, earthquakes and floods. However, exclusions vary over time and, in many respects, reflect the general consensus of society as to what type of risks are worth insuring pursuant to an all risk policy. For example, in the mid to late 1990s, the "Y2K exclusion" was introduced to exclude damages caused from the failure of computer systems to recognize the year 2000. Similarly, "mold exclusions" have been becoming mainstream given the large suits resulting from toxic torts and other problems relating to mold. The "terrorism exclusion" is just the latest part of that evolution.

The problem in this case was that terrorism coverage was part of an "all risk" policy at the time the parties entered into the loan but subsequently became a standard exclusion to many such policies. According to the court, Borrower and Lender could have specifically required terrorism coverage or, alternatively, could have noted that Borrower must maintain insurance against "all risks" covered by such policies at the time the loan documents were executed. The failure to do so evidenced an intention by Borrower and Lender to allow the insurance requirements to evolve over time. In other words, the court held that the "all risk" policy that must be maintained by Borrower must only cover risks that are generally being covered by such policies from time to time. As additional exclusions arise, Borrower need not necessarily obtain separate policies to cover them.

Luckily for Lender, the loan documents contained a "catch-all" provision that allowed Lender to require "other reasonable insurance." After analyzing the risks that terrorism imposes on hotels

(i.e. the main collateral for the loan), the court determined that it was reasonable for Lender to require terrorism insurance even if it were not covered by an "all risk" policy.

***Beardmore v. American Summit Financial Holdings, Inc.*, 2002 WL 1817983 (U.S. Dist. Ct. Minn.)**

This case serves as a strong reminder to proceed carefully when selling collateral after a default. By way of background, Article 9 of the Uniform Commercial Code states that "[a] secured party after default may sell, lease or otherwise dispose of any or all of the collateral in its then condition or following any commercially reasonable preparation or processing." After disposition, the secured creditor must provide an accounting with respect to any surplus and, unless otherwise agreed, is entitled to any deficiency. However, any disposition must be handled in a commercially reasonable manner and the failure to do so will cost a secured credit any rights to a deficiency and can cost it additional monetary damages. This obligation of reasonableness cannot be waived by agreement but the "parties may by agreement determine the standards by which performance of such obligations is to be measured if such standards are not manifestly unreasonable."

In the case at bar, Borrower defaulted and Lender decided to foreclose on certain stocks that had been pledged as collateral pursuant to the loan documents. Lender and Borrower entered into a letter agreement outlining the manner in which the sale was to occur. However, Lender breached the letter agreement during the process of selling the collateral. The court held that the breach of this letter agreement rendered the sale commercially *unreasonable* thereby costing Lender any chance at a deficiency judgment.

The lesson is clear. An agreement with the lessee that outlines what is a "commercially reasonable disposition" can be helpful to assure compliance with Article 9. Essentially, this sort of arrangement transforms the legal issue so that the key issue is not whether the sale is "commercially reasonable" but, rather, whether it is "manifestly unreasonable." Nonetheless, such an agreement can operate as double-edged sword and must be drafted carefully.

Note, as between a lessor and a lessee, the rules regarding commercial reasonableness discussed above apply to any lease that is not a true lease covered by Article 2A of the UCC. Such rules may also apply between a broker and a funder with respect to true leases whenever there is a discounting of the rent stream or other arrangement such that the funder merely obtains a security interest in the leased equipment rather than outright ownership.

Kenneth P. Weinberg is a founding partner of Marks & Weinberg, PC. He and co-founder, Barry Marks, have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. Weinberg has written *Dispatches from the Trenches* since 2002, routinely writes articles in a variety of equipment leasing and financing journals, and has participated in numerous seminars on equipment leasing issues. If you would like more cases or articles on leasing, or have any questions or comments about this column or other leasing issues, please visit www.lease lawyer.com or contact Weinberg at 205-251-8307.



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