2023 CBA Bankers Summit
September 15, 2023
Las Vegas, NV

A Focus on Flood Insurance Issues for Commercial Lenders

Speaker:

Joel N. Cook, Esq.

Principal & Practice Group Manager

Aldrich & Bonnefin, PLC

JCook@ABLawyers.com

Disclaimer

This presentation is intended solely for educational purposes to provide you general information about laws and regulations and not to provide legal advice. There is no attorney-client relationship intended or formed between you and the presenters or you and the authors of these materials. Consult your institution's legal counsel for advice about how this information impacts your institution.

When do the Flood Insurance Requirements Apply?

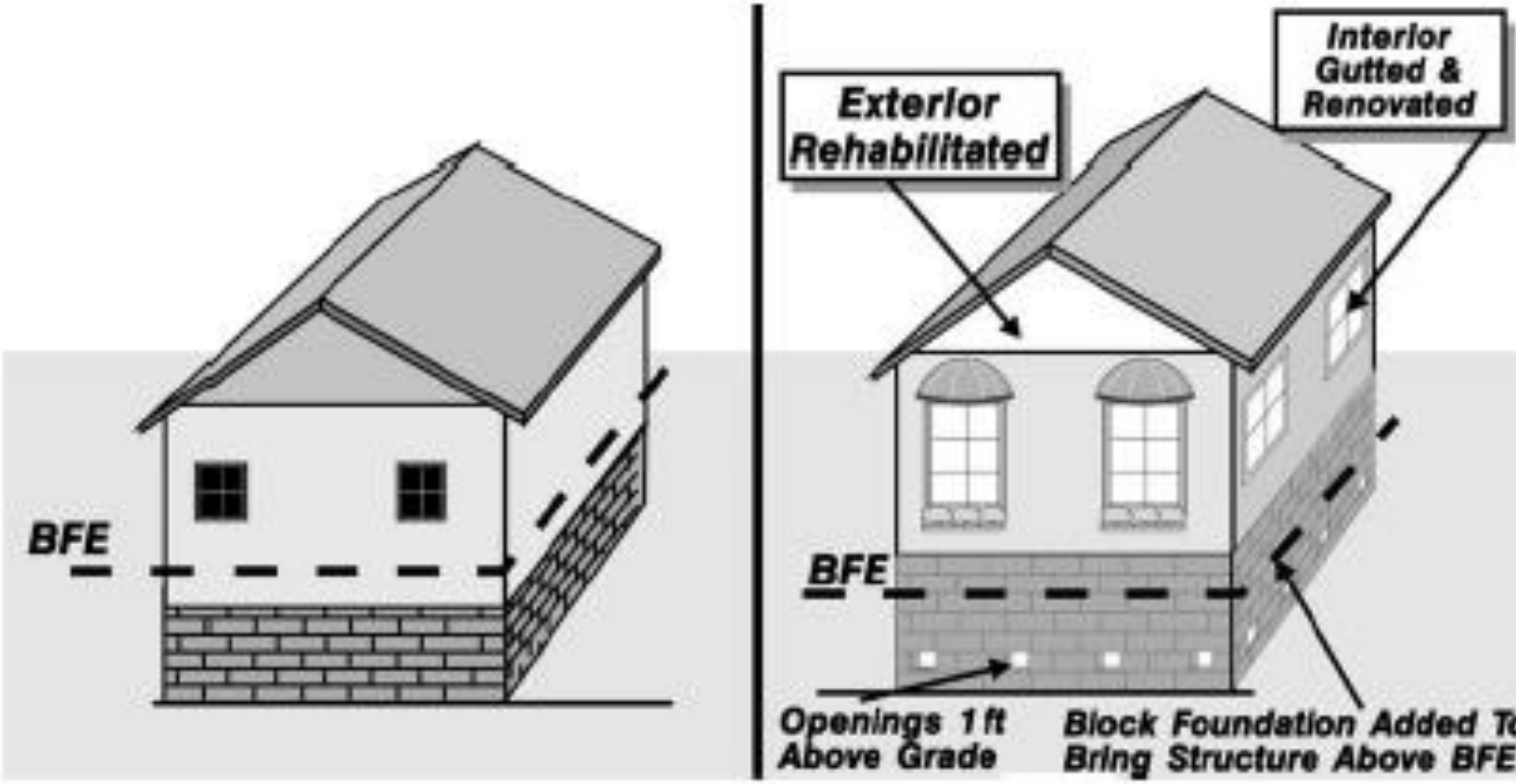
- When **m**aking, **i**ncreasing, **r**enewing or **e**xtending (MIRE) a loan, and if the loan is secured by a "building"
  - Then the flood insurance requirements may apply
- Yes, the flood insurance requirements under Flood Disaster Protection Act of 1973 (FDPA) apply to certain commercial loans

ALDRICH & BONNEFIN
Professional Law Corporation

What is a "Building"?

- Per FEMA's Flood Insurance Manual, it's a structure:
  - That has two or more outside rigid walls and a fully secured roof;
  - Is affixed to a permanent site;
  - Resists flotation, collapse and lateral movement; and
  - In general, has at least 51 percent of the Actual Cash Value of the building (including machinery and equipment that are a part of the building) above ground level

ALDRICH & BONNEFIN
Professional Law Corporation



ALDRICH & BONNEFIN
Professional Law Corporation

More About MIREing a Loan

- Is a loan purchase (or participation) a MIRE?
- How about a loan modification that does not increase the loan amount, or extend/renew the loan?
- How about a loan assumption?

ALDRICH & BONNEFIN
Professional Law Corporation

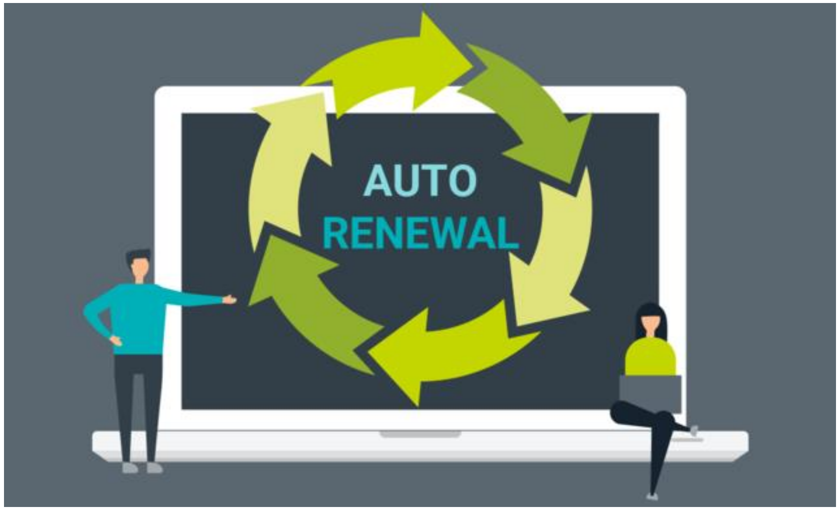
More About MIREing a Loan

- Is a loan purchase (or participation) a MIRE? NO
- How about a loan modification that does not increase the loan amount, or extend/renew the loan? NO
- How about a loan assumption? NO

Aldrich & Bonnefin Professional Law Corporation

More About MIREing a Loan

- Case Study:
  - Bank of Last Resort extended a line of credit to Notworthy LLC that auto renews each year for the first 3 years per the loan documents



  - Does that trigger the flood insurance requirements when the loan auto renews?

ALDRICH & BONNEFIN
Professional Law Corporation

More About MIREing a Loan

- Answer:

  – No, an automatic extension that was agreed upon by the lender and borrower at origination, and memorialized in the loan docs, does not constitute a triggering event

  – Q&A Applicability 11

Lender's Obligations

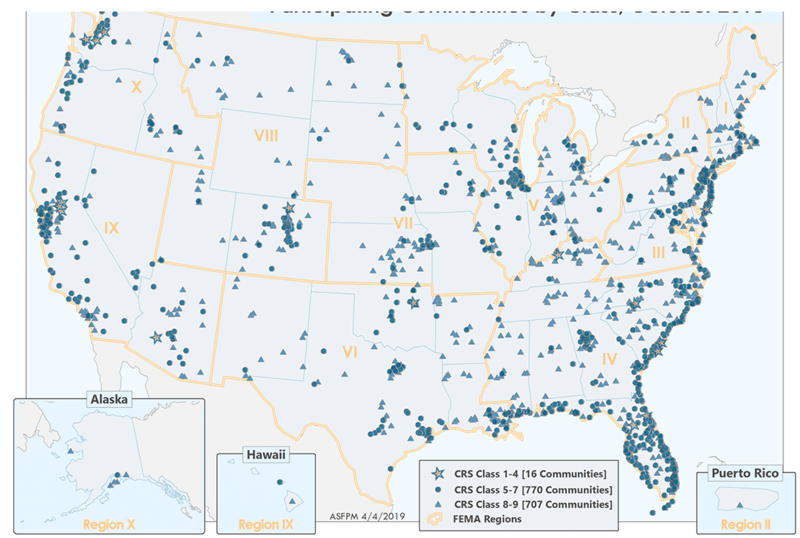
- Prior to MIREing a loan, the lender must:
  - Determine if the loan is secured by a building
  - Determine whether the building is in a special flood hazard area (SFHA)
    - If so, provide the SFHA notice to the borrower

ALDRICH & BONNEFIN
Professional Law Corporation

Lender’s Obligations

– Determine if the building is in both a SFHA and a community that participates in the National Flood Insurance Program (NFIP), *i.e.*, a “<u>participating community</u>”

- If so, then the lender may not MIRE the loan without proof of flood insurance



Lender's Obligations

- During the life of a MIREd loan with a building in a SFHA and participating community
  - If lender determines that flood insurance coverage has lapsed or the coverage is insufficient
  - Then the lender must give a 45-day notice to the borrower regarding the inadequate insurance
  - If the borrower fails to purchase the requisite flood insurance policy, then the lender must force place the required insurance

Exemptions

- State-owned property
- Small, short-term loans (original principal balance of $5,000 or less <u>and</u> a term of one year or less)
- Any nonresidential structure that is detached from a primary residential structure

ALDRICH & BONNEFIN
Professional Law Corporation

Secured Only by Inventory

- Case Study
  - Bank of Last Resort makes a loan to Notworthy LLC secured by inventory located in the ABC Office Building located in a SFHA in a participating community (PC)
  - The building itself is not pledged as a collateral
  - Is the Bank's loan subject to the flood insurance requirements?

ALDRICH & BONNEFIN
Professional Law Corporation

Secured Only by Inventory

- Answer:

  – No since the loan is not secured by a "building"

Secured by Building + Contents

- <u>Case Study – Part 1</u>
  - Bank of Last Resort makes a loan to Notworthy LLC secured by:
    - The ABC Office Building located in a SFHA in a PC
    - Contents located in a warehouse across the street also in a SFHA and PC (the warehouse does not secure the loan)
  - Must the Bank ensure flood insurance is obtained on the <u>contents</u>?

ALDRICH & BONNEFIN
Professional Law Corporation

Secured by Building + Contents

- Answer:
  - No
  - This is because the contents are located in a building that does not secure the loan

Secured by Building + Contents

- <u>Case Study – Part 2</u>
  - Bank of Last Resort makes a loan to Notworthy LLC secured by:
    - The ABC Office Building located in a SFHA in a PC
    - Contents located in the same office building
  - Must the Bank ensure flood insurance is obtained on the <u>contents</u> (in addition to the building)?

ALDRICH & BONNEFIN
Professional Law Corporation

Secured by Building + Contents

- Answer:
  - Yes!
  - This is because the contents are located in the building that secures the loan

Secured by Building + Contents

- <u>Case Study – Part 3</u>
  - Bank of Last Resort makes a loan to Notworthy LLC secured by the ABC Office Building located in a SFHA in a PC
  - Bank of Last Resort makes another loan to Unreliable Tenant LLC, a tenant of the same ABC Office Building, secured by the contents (but not the building)
  - Must the Bank ensure flood insurance is obtained on the <u>contents</u> pledged by Unreliable Tenant?

ALDRICH & BONNEFIN
Professional Law Corporation

Secured by Building + Contents

- <u>Answer</u>:
  - No!
  - This is because the contents are not located in a building that secures the loan to Unreliable Tenant LLC

Secured by Building + Contents

- <u>Case Study – Part 4</u>

  – Bank of Last Resort makes a term loan to Notworthy LLC secured by the ABC Office Building located in a SFHA in a PC

  – The Bank makes a revolving line of credit ("revolver") also to Notworthy LLC secured by certain contents of the same ABC Office Building (but not the building)

  – Must the Bank ensure flood insurance is obtained on the <u>contents</u> pledged by Notworthy LLC to secure the revolver?

ALDRICH & BONNEFIN
Professional Law Corporation

Secured by Building + Contents

- <u>Answer</u>:
  - No, but there's a "but"
  - Since the revolver is not secured by the ABC Office Building where the contents are held, the technical answer is flood insurance is <u>not</u> required with regard to the contents
  - But, if making the 2 loans was to evade the flood insurance requirements, then flood insurance covering the contents would be required

ALDRICH & BONNEFIN

Professional Law Corporation

More About Contents Coverage

- Flood insurance regulations states that a covered lender "*shall not [MIRE] any designated loan unless the <u>building</u> or mobile home and any <u>personal property</u> securing the loan is covered by flood insurance for the term of the loan*" (*e.g.*, 12 CFR Section 22.3)

- In a Standard Flood Insurance Policy (SFIP), "Coverage B – Personal Property" is "contents coverage"

- So, if a loan secured by a building that requires flood insurance is also secured by property covered by Coverage B (and not already covered by Coverage A), then Coverage B must be included in the SFIP

More About
Contents Coverage

- Coverage B covers certain fixtures, equipment and other personal property:

  - Air conditioning units, portable or window type
  - Carpets, not permanently installed, over unfinished flooring
  - Carpets over finished flooring
  - Clothes washers and dryers
  - Cook-out grills, ovens and the like
  - Food freezers, other than walk-in, and food in any freezer
  - Portable microwave ovens and portable dishwashers
  - Outdoor equipment and furniture stored inside the insured buildings
  - Other kinds of “personal property,” such as (may have special limits):
    - Art work, photographs, books, jewelry, stones, precious materials, collectibles, etc.
    - Personal property used in any business

ALDRICH & BONNEFIN
Professional Law Corporation

More About Contents Coverage

- *Must the lender perfect its security interest in the contents before contents coverage is triggered*?
  - No
  - This is issue was clarified by the regulators in FAQs
  - Merely the grant of the security interest in personal property covered by Coverage B may trigger the requirement for contents coverage
  - This is true even if the security interest in the personal property is <u>not</u> perfected

ALDRICH & BONNEFIN
Professional Law Corporation

More About Contents Coverage

- How about taking a security interest in various fixtures and personal property, but stating the collateral excludes “Coverage B items”?
- The FDIC has informed us (informally) that excluding Coverage B items from the collateral (and thus avoiding the requirement to obtain contents coverage) would make “it very clear” that contents coverage is not necessary
  - Unfortunately the regulators have not addressed this issue in the FAQs or other formal guidance

Practice Tips

- We have had several clients who have been cited in examinations for inadvertently taking security interests in Coverage B items (such as via a Deed of Trust)

- Check your Deeds of Trust to see if it inadvertently gives you a security interest in contents

- Many Deeds of Trust take a security interest in property such as the following which may be covered by Coverage B:

  - Fixtures, furniture, equipment, inventory, and appurtenances to the subject property or in any way incident to the subject property

ALDRICH & BONNEFIN
Professional Law Corporation

Practice Tips

- Could choose to not take a security interest in Coverage B items
  - Realizing that the lender is less protected from a collateral standpoint
  - How about retroactively waiving a security interest in the contents?
- Could choose to take a security interest in Coverage B items and require contents coverage

Practice Tips

- How about your SBA loans?
- The SBA's flood insurance requirements do not seem to distinguish between Coverage A and Coverage B when it comes to contents coverage
- We're not aware of the SBA opining on the issue
- SBA's SOP 10 6 states:

> "*If **<u>any</u> <u>equipment, fixtures or inventory that is collateral for the loan ("Personal Property Collateral") is in a building</u>** of which any portion is located in a special flood hazard area and that building is collateral for the loan, <u>SBA Lender must require Applicant to also obtain flood insurance for the Personal Property Collateral</u> either under the NFIP or through comparable private flood insurance ….*"

ALDRICH & BONNEFIN
Professional Law Corporation

Amount of Coverage

- **General rule** – the amount of flood insurance must be at least equal to the lesser of:
  - – The outstanding principal balance of the designated loan; or
  - – The maximum amount of insurance available under the NFIP, which is the lesser of:
    - The maximum limit available for the type of property; or
    - The insurable value of the structure

Aldrich & Bonnefin
Professional Law Corporation

Amount of Coverage

- Calculating the "outstanding principal balance of the loan"
  - Does not include interest
  - NOTE: junior lienholders must consider the outstanding balance of any senior loans as well as the amount of the junior's loan

ALDRICH & BONNEFIN

Professional Law Corporation

Amount of Coverage

- NFIP coverage limits currently in effect (from FEMA's NIP (rev. 10/22):

Building Occupancy	Building Coverage	Contents Coverage
Single-Family Dwelling		
Single-Family Home	$250,000	$100,000
Residential Manufactured/Mobile Home	$250,000	$100,000
Residential Unit[10]		
Residential Condominium Unit (in Residential Building)	$250,000	$100,000
All Other Building Descriptions	None	$100,000
Multifamily Building		
Two-to-Four Family Building	$250,000	$100,000
Other Residential Building	$500,000	$100,000
Residential Condominium Building		
Residential Condominium Building[11]	Not to exceed the lesser of: • The building's replacement cost value; or • Total number of units × $250,000.	$100,000
Non-Residential		
Non-Residential Building	$500,000	$500,000
Non-Residential Manufactured/ Mobile Building	$500,000	$500,000
Non-Residential Unit	None	$500,000

Amount of Coverage

- Calculating the “insurable value”
  - The lender must determine which SFIP form applies to the building and, under that SFIP form, determine which type of insurable value applies
  - There are two types of insurable values: (a) replacement cost value (RCV); or (b) actual cash value (ACV)
  - <u>RCV</u> is the cost to replace property with the same kind of material and construction without any deduction for depreciation
  - <u>ACV</u> is the cost to replace an insured item of property at the time of loss, minus the value of its physical depreciation
    - In other words, its RCV minus depreciation

Aldrich & Bonnefin
Professional Law Corporation

Amount of Coverage

- Lender must determine which SFIP form applies to the building and, under that SFIP form, determine which type of insurable value applies

- The FDIC has stated: "*Under no circumstances should the [lender] require more insurance on a property than FEMA will pay out in the event of a flood loss*" Directors' Training videos, Flood Insurance, Part IV

- California Civil Code Section 2955.5(a) prohibits lenders from requiring insurance coverage that exceeds the improvement's replacement value

ALDRICH & BONNEFIN
Professional Law Corporation

Amount of Coverage

- One of the interagency flood insurance FAQs (May 2022) could be read to allow a lender to use RCV for the insurable value calculation for <u>all</u> buildings, including commercial buildings

- However, based on an informal email exchange we had with the FDIC, if the NFIP pays claims based on ACV, then the lender is to use ACV as the insurable value in the insurable value calculation

- NFIP seems to pay claims on commercial real properties based on ACV

ALDRICH & BONNEFIN
Professional Law Corporation

Amount of Coverage

- The FAQ provides that in calculating the amount of insurance to require, the lender and borrower may choose from a variety of approaches, including:
  - An appraisal based on a cost-value (not market-value) approach
  - A construction-cost calculation
  - The insurable value used in a hazard insurance policy
  - The replacement cost value listed on the flood insurance policy declarations page; or
  - Any other reasonable approach

Aldrich & Bonnefin
Professional Law Corporation

Why We Care About Complying with Flood Insurance Requirements

- Protects your collateral in flood areas
- Federal banking agencies retain all of their enforcement powers under Section 8 of the FDI Act for violations of the flood insurance laws and regulations
  - Including the authority to impose civil money penalties (CMP) for flood insurance violations, or
  - Entering into a formal agreement, or a cease and desist order, to compel compliance
- CMPs for flood insurance violations
  - $2,577 per violation (as of January 15, 2023)
  - Penalties are often compounded due to issues with loan policies and practices

Aldrich & Bonnefin
Professional Law Corporation

Why We Care About Complying with Flood Insurance Requirements

- FRB issued enforcement action and fined Regions Bank approximately $2.95 million in August 2023
  - For unsafe and unsound practices in its flood insurance compliance program and for flood insurance regulatory violations
  - Noted a "pattern or practice" of violations
  - The Bank seemed to rely on third-party servicers in some cases, and did not effectively monitor loans for compliance with the flood insurance requirements
  - $58,000 was assessed under the Flood Insurance Act, and the rest was assessed under Section 8 of the FDI Act

ALDRICH & BONNEFIN
Professional Law Corporation

Why We Care About Complying with Flood Insurance Requirements

- FRB fined Deutsche Bank Trust Company Americas $105,000 in December 2022
  - Noted a “pattern or practice” of flood insurance violations
  - The whole CMP was under the Flood Insurance Act

ALDRICH & BONNEFIN
Professional Law Corporation

Questions?

We’re adjourned!

Speaker:

Joel N. Cook, Esq.
Principal & Practice Group Manager
Aldrich & Bonnefin, PLC
JCook@ABLawyers.com