

Navigating Commercial Loan Transactions: Collateral and Insurance Coverage

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In [our first blog post](#), we discussed the importance of access to capital for business growth and the complexities involved in securing a loan. We highlighted the crucial role of due diligence in the lending process, focusing on corporate structure and governance. Now, in our second blog post, we delve into another vital aspect of lending transactions: collateral and insurance coverage.

Collateral plays a pivotal role in lending transactions, providing security for lenders in case of default by the borrower. Understanding the significance of collateral and its various forms is essential for both borrowers and lenders. This blog post will discuss the importance of collateral in securing loans, the importance of insurance coverage for such collateral, and the due diligence approach taken by lenders when evaluating both. Additionally, this post will discuss strategies for maximizing the value of collateral and mitigating risks for both parties involved in the transaction.

Collateral Overview

Collateral is an asset or group of assets that a borrower pledges to a lender as security for a loan. In the context of lending transactions, collateral serves as a form of protection for the lender, ensuring that they have a way to recover the outstanding loan if the borrower defaults. This practice reduces the lender's risk and can enable a borrower to access larger loan amounts or more favorable terms than they might otherwise qualify for in the absence of collateral.

The types of assets commonly used as collateral are:

- *All Business Assets.* Wide range of a business's assets, including but not limited to, accounts receivable, inventory, equipment, intellectual property, cash, and business contracts.
- *Real Estate.* Improved or unimproved real property that is owned. The two types of real estate collateral are commercial real property and residential real property.
- *Inventory.* Goods held for sale by the borrowing company can be used as collateral. This is common in the retail and manufacturing sectors.
- *Equipment.* Heavy machinery, production equipment, and other industrial tools can be pledged, particularly in manufacturing and construction industries.
- *Receivables.* Money owed to the borrower by customers for goods or services delivered but not yet been paid for. This type of collateral is common in industries with significant credit sales.
- *Intellectual Property.* Patents, trademarks, and copyrights that hold significant market value.
- *Investment Accounts.* Stocks, bonds, and treasury securities owned by the borrower.

Key Considerations:

- *Asset Evaluation.* Collateral such as real estate, inventory, and equipment must be appraised, and the borrower or other grantor must hold a clear and marketable title.
- *Ownership.* Ensuring clear and undisputed ownership of collateral is vital for securing a loan, as it confirms the borrower's legal right to pledge the asset and prevents potential legal disputes that could affect loan approval and terms or make it difficult for the lender to enforce remedies against such asset.

- *Loan-to-Value Ratio*. Calculated by dividing the loan amount by the appraised value of the collateral, is a crucial metric lenders typically use for assessing loan risk
- *Insurance*. Maintenance of insurance with respect to these assets is critical to preserve their value, which is discussed further below.

Insurance Coverage Overview

Insurance plays a crucial role in protecting both the borrower and the lender. Adequate insurance coverage is often a condition for loan approval, and lenders typically require borrowers to have adequate insurance to mitigate risks and ensure the collateral retains its value throughout the loan term.

Types of Insurance Coverage:

1. *Property Insurance*. Protects against damage to buildings and other structures used as collateral. The most common evidence of property insurance certificate requested by lenders is the Acord 28 for commercial property insurance. This certificate does not confer any rights to the Lender, it is simply provided to assure the Lender that the Borrower has insurance coverage. The typical rights to insurance and insurance proceeds that a Lender requires must be effectuated by an endorsement to the insurance policy issued by the underwriter that underwrites the insurance policy, typically in the form of ISO Form CP 10 30 for commercial property insurance.
2. *Liability Insurance*. Protects against claims of bodily injury, property damage, and other liabilities. The most common liability insurance certificate requested by lenders is the Acord 25. This certificate does not confer any rights to the Lender, it is simply provided to assure the Lender that the Borrower has insurance coverage. The typical rights to insurance and insurance proceeds that a Lender requires must be effectuated by an endorsement to the insurance policy issued by the underwriter that underwrites the insurance policy, typically in the form of ISO Form CG 00 01 for general liability insurance.
3. *Flood Insurance*. When an asset is used as collateral for a loan and is located in areas prone to flooding, lenders often require flood insurance as a condition of the loan.
4. *Title Insurance*. Protects against potential title disputes or claims against real property used as collateral, and ensures that the lender's claim to the real property is not subject to any third-party claims at the time of closing the loan.
5. *Business Interruption Insurance*. Compensates a borrower for lost income and operating expenses if a business is forced to shut down temporarily due to a covered event like a fire or natural disaster.

Best Practices:

- *Choose Appropriate Collateral*. Assess and document all available collateral, including business assets, and complete the lender's standard perfection certificate to accurately detail certain lender-required information with respect to all business assets, ensuring transparency and compliance with lender requirements. Lenders typically require a perfection certificate from any loan party entity that is granting collateral.
- *Evaluate Collateral*. Choose collateral that you can afford to risk without compromising your financial stability, and ensure the nature and value of the collateral meets the lender's requirements.
- *Secure Adequate Insurance*. If not already obtained, the necessary insurance must be obtained to protect the collateral and ensure the insurance coverage aligns with the lender's requirements.

Takeaway:

Navigating the complexities of collateral and insurance coverage is vital for borrowers engaging in secured financing. By understanding the types of collateral that can be used, the associated risks, and the importance of adequate insurance coverage, borrowers can make informed decisions that safeguard their financial interests and foster successful loan transactions.

If your business is considering entering into a commercial loan transaction, the Wilentz, Goldman & Spitzer, P.A. [Banking and Finance](#) practice group is well-equipped to assist and provide such expertise and guidance to your business. Please note that the foregoing is not intended, and should not be construed, as legal advice.

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