REAL ESTATE & HOSPITALITY PRACTICE

Willis HRH

VIEWS

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REACHING FOR THE RESET BUTTON

One of the most frequently heard terms in the current economic downturn is *reset*. In the age of distressed assets – or, perhaps more appropriately, distressed financings – we are hearing *reset* used in connection with real estate valuations. Net operating income (NOI) is down due to declining rents and rates; capitalization (CAP) rates are returning to their historic norms. A reset of real estate valuations can't be a surprise.

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Another reset is occurring among consumers. Personal debt and the fear (and reality) of unemployment have caused consumers to reset both spending and saving rates. The pundits talk about a basic reset in values, a change in how Americans view their quality of life.

We believe the moment is ripe for a reset in risk management. A time of changing attitudes and perspectives is the perfect opportunity to rethink and redesign processes and operations in ways that can lead to greater safety and productivity as well as substantial cost savings.

Is this really a time of change? Or are these temporary phenomena, a passing phase until credit eases and we restart our engines? A clue may be found in an examination of CAP rates. According to David Sislen, a real estate professor at the Johns Hopkins Carey Business School, the historical average real estate CAP rates over the last 50 years were in the range of 8-10%. The low CAP rates from 2005-2007 were an aberration, as was the significant increase in real estate transactions over the same time period.[1] This suggests that a return to more stable times may be possible in the not-too-distant future. However, as painful as the changes of the past months may have been, making some of them permanent may not be a bad thing; it may, in fact ultimately lead to an even stronger and more stable U.S. economy.

In the area of risk management, we certainly hope that business owners and risk managers take advantage of the opportunity we see to introduce improvements, and we hope these changes are permanent. You'll be glad you did if and when the market turns, and inexpensive coverage now available in many lines is no more.

If you want to hit the risk management reset button, we suggest starting with a fresh look at loss information. Your own data can point to significant opportunities to reduce costs by making simple improvements to operations. Providing quality information to your operations team is a primary motivator in pushing your people to take cost-saving actions. Any time you are able to establish a clear standard, designate a person or position

[1] "Capitalization Rates Were Mixed in May," *The Wall Street Journal*, June 25, 2008. Using data from Real Capital Analytics and the Federal Reserve, this report showed that, since the beginning of 2001 to the end of 2007, the CAP rate for offices and apartments dropped from 10% to 5.5%, and from 8.5% to 6%, respectively.

accountable for performance, and create a metric and frequency of measurement, you can move the loss numbers. Most importantly, in most cases, you can accomplish this without expense. It's a matter of getting people to do the right things within their normal job function and then measuring performance.

As an example, let's look at shopping mall security. We have found that many in-house or contracted security services focus their patrols on the deterrence of third-party crimes. As important as that may be, the definition of *patrol* can be expanded to identify additional risks such as foreign substances (food, debris, liquid from ice, snow or drinks) on walking surfaces. Management could engage their security personnel to quickly identify these pedestrian hazards and communicate them quickly to the mall's custodial contractor for quick removal, protecting the area until the cleaning staff arrives.

With respect to CAT exposures, identifying secondary building characteristics and using both CAT and capital budgeting models could provide a significant return on investment (ROI). Taking this approach, you would identify wind or earthquake hardening recommendations and evaluate the ROI based on the cost versus the reduction in the CAT-related loss estimate, which in many cases will be within your EQ or Windstorm retention. You could act on the recommendations with the lowest cost/highest return, based upon the reduction in the Windstorm probable maximum loss (PML).

Such approaches allow risk managers to compete for capital on the same basis as other capital needs. That is a good practice in an organization, especially in hard times. As we all tighten our belts, a return to risk management basics and good management techniques can effectively control and reduce costs.

Brian Ruane & Steve Sachs
Willis HRH Real Estate Practice Co-leaders

REAL ESTATE MANAGERS PROFESSIONAL LIABILITY

Property managers provide professional management services to third-party property owners under contract for a fee. The contract may transfer most or all of the management responsibilities to the property manager. When responsibilities are at stake, so are liabilities. When liabilities arise, so do questions about insurance coverage. Generally speaking, a firm or person that claims to have special skills or expertise (intellectual capital) will be held to a higher standard of care than someone performing manual activities.

Professional liability claims can arise from allegations by the property owner that the manager, through errors or omissions, failed to adequately manage the property, which led to a financial loss. Some examples of allegations that may lead to financial loss for a property manager are:

- Loss of property value and lost rental income due to improper or negligent maintenance
- Failure to properly secure the premises against third-party criminal activities
- Wrongful eviction, malicious prosecution and defamation leading to personal injury torts
- Failure to collect or properly account for rent monies
- Failure to supervise subcontractors or vendors
- Negligence in screening prospective tenants who may have criminal backgrounds
- Discrimination (race, ethnicity, religion, disability) arising from tenant leasing activities

A property manager's Commercial General Liability (CGL) policy is intended to cover third-party bodily injury, property damage and personal and advertising injury claims arising from business operations or products. Coverage is limited for the most part to accidental events and is not meant to address errors and omissions claims that stem from the failure to perform work or provide services that meet an expected level of performance. In addition, most CGL policies specifically exclude liability arising from professional services. This points to the need for managers to consider Professional Liability coverage. Unfortunately, many property managers do not carry this coverage, as they believe these types of claims will be addressed by either their CGL or Directors & Officers (D&O) insurance policies.

D&O Liability insurance does not eliminate the need for Professional Liability coverage, as it usually does not cover employees who are not officers and directors. In the case of a publicly held corporation, the D&O policy may not cover the corporate entity for its own liability except in the case of security-related claims. Coverage for liability arising from professional services may also be excluded.

Many insureds will want to combine Professional Liability coverage with CGL coverage to protect these exposures. Care should be taken to ensure that the CGL policy does not exclude bodily injury and physical damage claims arising from professional services through a designated professional services endorsement. Few CGL policies have this endorsement, so a request should be made to have it removed if it is present. If this is not possible, the Professional Liability coverage should be modified to limit bodily injury, property damage and personal injury exclusions so that any exclusion would only apply to an intentional injury. A final option would be to place both coverages with the same insurance carrier to address any gray areas of coverage. This may not be possible, however, as not all Professional Liability insurance carriers offer CGL policies.

Real estate Professional Liability coverage is also designed to provide defense costs, which can be substantial even if allegations are unfounded.

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BEWARE THE "OTHER INSURANCE" CLAUSE

Landlord and tenant. Owner and GC. GC and subcontractor. Purchaser and vendor. In all of these relationships, the goal from an insurance perspective is to be fully indemnified by the other guy – meaning that if you are the owner and something goes wrong, you will have access to the primary and umbrella/excess liability limits of the tenant, GC, subcontractor or vendor. Even if both parties agree on such an arrangement, however, state law can complicate matters. The trouble often stems from the "other insurance" clause in the umbrella or excess policy of the hired party and the different insurance allocation rules across the country.

In a recent Illinois court case (*Kajima Construction Services v. St. Paul and Marine Insurance Company*), the court held that a general contractor had to exhaust all primary policies, including its own, before it could access a subcontractor's umbrella Liability policy. The basis of the decision was the Illinois horizontal exhaustion allocation rule. While other states also apply this allocation rule, there are many states that employ a vertical exhaustion of limits allocation rule and some that use a pro-rata system, known as the Lamb-Weston allocation rule. We offer a landlord-tenant case study below and discuss how "other insurance" clauses and the three allocation rules would impact a common contractual situation.

Landlord requires its large commercial Tenant to maintain $10 million Liability limits per occurrence, naming Landlord as an additional insured on a primary (non-contributory) basis. A large loss occurs in part from Tenant's negligence; multiple third parties are injured. Landlord is sued along with Tenant and tenders claim to Tenant's insurer since Landlord is named as an additional insured under Tenant's Liability policies.

Landlord clearly intends to allocate claims up to $10 million to Tenant to the extent the claims arise from Tenant's use or occupancy of premises. Will the strategy work? The first place to look in answering that question is in the wording of the other insurance clause in Tenant's umbrella or excess Liability policies. There are four possible combinations of other insurance clauses commonly used in primary and umbrella Liability policies:

POTENTIAL COMBINATIONS OTHER INSURANCE CLAUSES

LANDLORD	TENANT	PROBABLE RESULT [1]
Primary	Primary	Share pro-rata [1]
Primary	Excess	Landlord defends
Excess	Primary	Tenant defends
Excess	Excess	Share pro-rata [1]

[1] The pro-rata method is rooted in a 1959 court case, *Lamb-Weston v. Oregon Automobile Insurance Co.*, which prohibited other insurance clauses and provided for equitable subrogation among insurers covering the same occurrence.

The only combination that achieves the intent of the parties as described above is number 3, where Landlord's policies are excess and Tenant's policies are primary. Even here, however, things aren't always what they seem. Why not? Doesn't the industry standard Commercial General Liability insurance policy (ISO CG 0001©) automatically provide that it applies as excess over other insurance provided Landlord is named as an additional insured under Tenant's Liability policies? Yes, but keep in mind that's only the primary – typically $1 million. Even though the parties' *intent* is that Tenant's insurance be primary and non-contributory, the reality is that very few tenants endorse their umbrella Liability policies to apply as primary. The vast majority of umbrella Liability policies apply as excess only and do not attach until *all* primary insurance available to Landlord is exhausted – hence the problem.

Most jurisdictions where this issue has been decided embrace horizontal exhaustion of limits versus vertical exhaustion. In horizontal exhaustion jurisdictions (IL, PA, MD, NY, CA, KS and sometimes LA – please check with your attorney) all primary insurance available to an insured (including their own primary insurance) must be exhausted before invoking any excess insurance. Assuming both parties have other insurance wording equivalent to that found in ISO's Commercial General Liability form CG 0001©, our hypothetical $10 million claim in a horizontal allocation state would likely be settled as follows:

LOSS LAYER	HORIZONTAL EXHAUSTION WHO PAYS?	HOW MUCH?
First $1M	Tenant's primary	$1M
Second $1M	Landlord's primary	$1M
Next $8M	Tenant & Landlord	$4M ea
	Total paid by Tenant	$5M
	Total paid by Landlord	$5M

The outcome could be significantly different in vertical exhaustion jurisdictions (TX, NJ, MN, WA, CO – please check with your attorney). Under vertical exhaustion rules, all insurance from the first party must be exhausted before invoking any insurance from the second party.

LOSS LAYER	VERTICAL EXHAUSTION WHO PAYS?	HOW MUCH?
First $1M	Tenant	$1M
Second $1M	Tenant	$1M
Next $8M	Tenant	$8M
	Total paid by Tenant	$10M
	Total paid by Landlord	$0

In jurisdictions applying the Lamb-Weston rule (AL, AZ, DE, ID, IN, NV, OR, RI, and sometimes ME, MI, LA and TN – please check with your attorney), all other insurance clauses may be ignored and claims would likely be pro-rated.

LOSS LAYER	LAMB-WESTON RULE WHO PAYS?	HOW MUCH?
First $1M	Tenant's primary	$500,000 ea
Second $1M	Landlord's primary	$500,000 ea
Next $8M	Tenant & Landlord	$4M ea
	Total paid by Tenant	$5M
	Total paid by Landlord	$5M

STEPS TO TAKE

What should Landlord do in order to protect its interests? The following suggestions are presented in order of easiest to most difficult:

1. Contracts should clearly state that Tenant's insurance is primary, non-contributory and not in excess of any valid and collectible insurance carried by Landlord.

2. Amend the other insurance clause in your primary CGL. This will typically read, "This insurance is excess over any other primary insurance available to you as an additional insured." Amend it to read, "...over any other insurance whether intended to be primary, excess or contingent." In addition, many other insurance clauses require Landlord to be added to Tenant's policy "by attachment of an endorsement." In reality, that rarely happens. We suggest, therefore, you amend this requirement to read "...by specific or blanket endorsement."

3. Require that Landlord be named as an additional insured on Tenant's CGL policy through written endorsement. However, this step will not be effective unless Landlord has amended the standard other insurance language in its own Liability policies as noted above.

4. Require higher primary limits. Here is some sample language: "If Tenant is unable to amend umbrella or excess Liability insurance covering Landlord as an additional insured to apply as sole primary insurance and be non-contributable with Landlord's insurance, such insurance shall be considered non-conforming. Landlord may, at Landlord's sole discretion, allow Tenant to provide higher primary limits of Liability insurance, in no event less than $5 million (or $10 million if Landlord insists on full limits) per occurrence applying on a sole primary basis before any such non-conforming umbrella or excess Liability insurance shall attach."

5. Require Tenant to endorse umbrella or excess Liability policies to be sole primary and non-contributory with Landlord's insurance. Here is some sample language: "Primary Coverage – Tenant's commercial general and umbrella or excess Liability insurance coverage, to the extent required or necessary, shall be sole primary insurance, and any insurance or self-insurance maintained by General Contractor shall be excess of and non-contributory with Contractor's insurance. If necessary, Contractor agrees that it will amend the other insurance clauses in its insurance policies, including its umbrella or excess Liability policies, to be sole primary, and non contributory with Landlord's insurance."

If Tenant's policy is not endorsed and Landlord and Tenant's umbrella policies both apply as excess, the claim will likely be shared pro-rata. Will all umbrella liability insurers provide sole primary insurance to Landlord? Probably not. It will depend a great deal on Tenant's premium spend and leverage with insurers.

6. Request a copy of Tenant's insurance policies to check if contractual requirements have been met.

What should Tenant do to protect its interests? If you are a downstream tenant, contractor or subcontractor and your contract with an upstream landlord, owner, or general contractor requires you to provide additional insured status on a sole primary basis to the upstream party – what can you do to avoid being in breach of contract?

1. In all states other than those that follow the Lamb-Weston rule, you can require your umbrella or excess Liability insurer to apply as primary insurance for any additional insured, if your written contract with that additional insured requires the insurance to apply on a sole primary basis and be non-contributory with additional insured's other insurance (follow form with your contract).

2. Recognize that in Lamb-Weston states there may be nothing you can do since those states typically ignore other insurance clauses and require pro-rata allocation. Our suggestion in these states is to amend the policy per above, but begin with "to the fullest extent permitted by law."

Taking these steps puts the Landlord and Tenant in the best possible position, regardless of which allocation rule may come into play. Many states have yet to establish case law in this area, further complicating the issue. In crafting your own response, be sure to engage your broker and your attorney.

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2009 HURRICANE UPDATE

In recent years, the words *hurricane* and *average* have not often been used in the same sentence, but the updated forecast for the 2009 Atlantic Basin hurricane season is in fact near the historical average. In their June 2, 2009 update, Philip Klozbach, William Gray and their colleagues at Colorado State University (CSU) predicted this year's hurricane season will bring 11 named tropical storms and seven hurricanes, of which two could be major. The probability of at least one major hurricane (Category 3+) striking the U.S. has been set at 48%.

The following table compares the updated 2009 forecast to the 2008 actual activity and 50-year average.

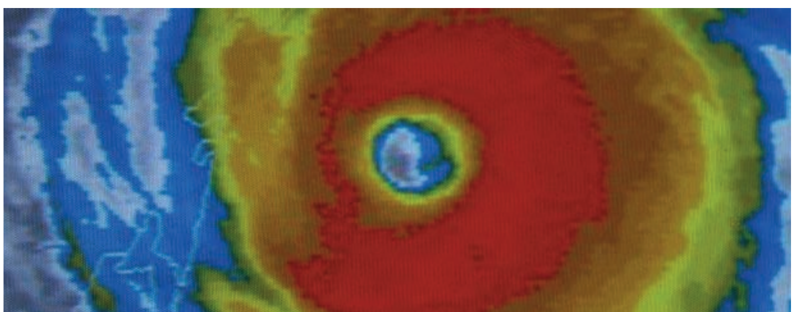
	2009 (06/02)	2008 Actual	Average
Tropical Storms	11	16	9.6
Hurricanes	5	8	5.9
Major Hurricanes	2	5	2.3

This new CSU forecast is slightly lower than its April forecast, which predicted 12 named storms, six hurricanes and two major hurricanes. The CSU team cited cooler sea surface temperatures in the Atlantic and a trend towards El Niño conditions that bring higher wind shear over the tropical Atlantic, which contributes to lower hurricane activity.

WILLIS HRH HURRICANE TRACKING AND ADVISORY SERVICE

Willis HRH offers real-time direct notification of the status and tracking of developing tropical depressions, tropical storms and hurricanes in the Atlantic Basin. Public advisories are issued at least once a day during tropical cyclone development stages. This service is available at no charge to our clients and other interested parties to help them protect their property in advance of an approaching storm.

If you are interested in this service, please contact your local Willis HRH representative or Joe Stavish, National Director, Property Risk Control Engineering, at 800 862 1441 ex. 4638, stavish_jc@willis.com; or Dave Gluckman, Senior Risk Control Consultant, at 800 862 1441, ex. 4635, david.guckman@willis.com.



INSURANCE MARKET TRENDS

The price you pay for insurance depends on a variety of micro and macro economic factors. The micro factors tend to be more under your control: your loss experience, overall risk quality, the quality of your underwriting information, your relationship with your carrier and, of course, the ability of your broker of choice to achieve the optimal price and broadest cover.

The macro forces are out of your hands. These are based on industry surplus and demand, which are largely a function of economic conditions.

The recession is cutting demand, as companies slow production, cut back on expansion and development, reduce staff and, in some cases, simply buy less insurance to save money. Surplus, or supply, is impacted by underwriting profits and losses and investment income. In 2008 the Property and Casualty industry saw a deterioration in the combined ratio to 105.1 – up from the 95.5 mark in 2007 ("U.S. P-C Industry Surplus Dropped 12%," *National Underwriter,* April 13, 2009). Investment losses exceeded underwriting profits.

When carriers reported their 2009 first-quarter results, we saw the trend toward year-over-year declines in net income continuing for many. Zurich, for example, reported that net income fell 75% when compared to the first quarter of 2008. Similar results were reported by other carriers, although Travelers just revised their forecast for 2009 by adding five cents a share to their operating earnings forecast.

Despite the poor results reported by many carriers, MarketScout recently reported that "the average rate for property and casualty insurance fell 6% in May compared to a decline of 11% a year ago." ("Insurance rates fall but year-end market turn expected," *Business Insurance,* June 5, 2009.)

Rate decreases continue for many clients. Why? Despite a drop of about 10% in surplus from 2007 to 2008 (due to investment declines), "after several years of strong surplus growth the industry can handle it," according to Andrew Colannino of A. M. Best Co. ("P&C Survives the Storm," *CFO Magazine,* April 2009). While investment losses have increased significantly for Property and Casualty insurers, the industry overall "is not in trouble by any means," Calonnino said.

Robert Hunter, a former federal insurance administrator and Texas insurance regulator who was quoted in the same article, said, "...the financial meltdown happened at a very good time for the property casualty industry with many, many companies enjoying a string of profits going back several years." Hunter went on to say, "Due to strong balance sheets and generous reserves the industry's cycle has, for the most part, yet to grind the other way."

That being said, the tale of two markets continues. For risks with limited or no catastrophe exposure, the market remains soft, with year-over-year declines, albeit moderating somewhat, for virtually all lines of coverage. For those with CAT exposures, the market can be very tough. Many are reporting that risks with catastrophe exposures can expect to see higher premiums and, in some cases, double-digit increases.

Our advice is to start the renewal process early, meet underwriters and work with your Client Advocate to tell your story. Provide the underwriters with as much engineering data as possible (especially for risks with CAT exposures) so underwriters can properly assess the Property PMLs, review reserves prior to the renewal process and request quotes well in advance of the renewal date. In other words, take control of what you can control, and keep a wary eye out for the rest.

TERRORISM, LIABILITY AND THE SAFETY ACT

Beyond the overwhelming personal, economic and political impact of terrorist acts, there is also the issue of liability that real estate owners must consider. No terrorist act has occurred in the U.S. in some time, but incidents around the world underscore the unfortunate reality that the threat remains constant. Businesses must protect themselves as best they can from the acts themselves and the potential claims that could result if people on their premises are injured. Fortunately, the U.S. government made the task much easier with passage of the SAFETY Act – a fact that many risk managers are unaware of several years after the act's passage.

The SAFETY Act (Support Anti-Terrorism by Fostering Effective Technologies Act of 2002) was created to encourage the development and deployment of anti-terrorism technologies. Qualifying technologies (both products and services are eligible) undergo a rigorous review procedure, after which the government awards the sellers of the technology landmark liability protections. Buyers of that technology also receive the same protection.

This protection is particularly relevant to real estate stakeholders following the 2008 decision by the New York Court of Appeals, *Nash v. Port Auth. of N.Y. & N.J., 2008 NY Slip Op 3991*, confirming a previous and, to some observers, surprising verdict relating to the 1993 bombing of the World Trade Center. The court determined that by not taking appropriate risk prevention action, the Port Authority of New York was more liable (68%) for the ensuing harm than the terrorists who perpetrated that act (32%). This decision demonstrated the resolve of the U.S. legal system to place blame squarely on any organization that should have known of the possibility of an attack and taken reasonable mitigation steps to prevent it.

By receiving recognition for a qualified anti-terrorism program, technology, service or product, a company will be granted, in connection with that program, technology, service or product:

- A maximum cap on liability claims as a result of a terrorist attack
- Exclusive jurisdiction in federal court for all related suits
- A prohibition on punitive damage claims, non-compensatory damages and non-economic damages (such as pain and suffering unless the plaintiff was physically harmed)
- A prohibition on joint and several liabilities for non-economic damages (i.e., only that percentage of the ultimate claim amount that is directly attributed to a defendant's negligence is recoverable)

The SAFETY Act is a striking piece of tort reform, providing very broad liability protections, caps and other incentives for qualified entities involved in the development, sale, purchase and deployment of anti-terrorism technologies. These protections apply to any claims resulting from an act of terrorism when a qualified technology was deployed.

For real estate managers, procuring SAFETY Act Designated or Certified products and services not only provides confidence in the performance of the technology, but also helps proactively manage terrorism liability. The unprecedented liability cap on products and services granted by the U.S. government serves to address the concerns of shareholders and customers alike in preventing runaway liabilities, which could have devastating consequences for the corporate balance sheet in the event of an attack.

Most corporations would only be able to withstand the potentially dire consequences of an attack by a prudent combination of risk assessment and risk management, plus the support of a private/public partnership to provide the necessary property and liability protections. Global terrorism insurance products now widely available in the private sector, working in concert with public sector support through TRIA and the SAFETY Act, can provide U.S. corporations with a more secure operating platform.

Willis HRH can assist your organization in obtaining its SAFETY Act designation or in identifying certified products and services. For more information, please contact Matt Kelly, President, Willis HRH Risk Mitigation, Inc. at 610 203 5972 or matt.kelly@willis.com.

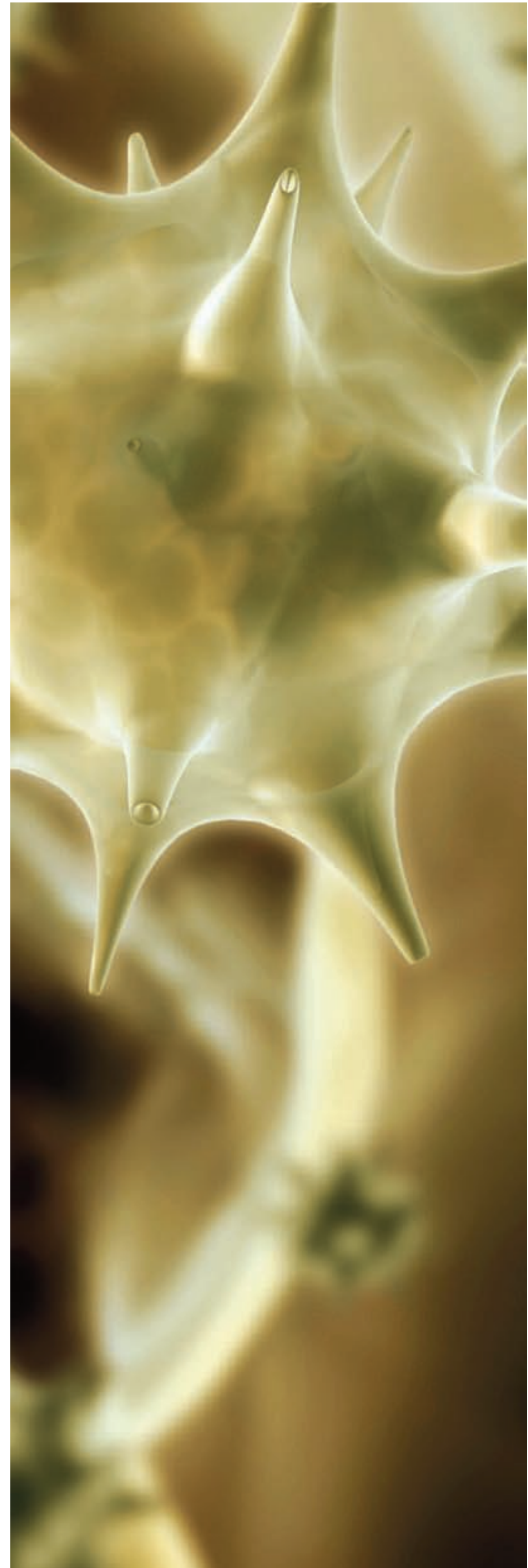
H1N1 UPDATE

The H1N1 pandemic is the first official pandemic in more than 40 years. Whatever your perspective or personal experience, you should at this point be aware that the *potential* for a serious pandemic with traumatic business and human impact is very real.

As of June 24, 2009 the World Health Organization (WHO) reported 55,867cases of influenza A (H1N1) infection in 73 countries; 238 cases resulted in death. There were 21,449cases reported in the U.S. with 87 deaths.

The Centers for Disease Control and Prevention has recommended the use of two antiviral drugs (Relenza and Tamiflu) for treatment. In addition, the U.S. government is ramping up the manufacture of an H1NI vaccine. Experts remain concerned about the possibility that H1N1 could mutate into a more virulent contagion by the fall of 2009, which could tax the supply of drugs and vaccines.

On June 11, 2009 WHO raised its pandemic alert to its highest level: Phase 6. While the level refers to the spread of illness and not the severity, we urge companies to include their response to a pandemic event in their business continuity planning if they have not already done so. This recent Willis HRH *Insights* **bulletin** offers five questions that will test your firm's response to a pandemic threat, providing an opportunity to make modifications to your business continuity plan, if required. If you are interested in help with your company planning efforts, please contact your Willis HRH Client Advocate or Jeffrey Seibert, National Technical Director Casualty and Critical Incidents, at 757 628 2304 or jeff.seibert@willis.com.



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