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Terrorism Risk Insurance Act Protections Extended Through 2007

Entirely apart from the tragic deaths of some 3,000 individuals, the terrorist attack of September 11, 2001 had a number of far reaching effects. From an economic perspective, the insurance industry was particularly hard hit by estimated insured losses of $32.5 billion, as reported by the Insurance Information Institute, slightly more than half of which was paid for by global reinsurance companies. Such extreme losses severely constrained the insurance companies' claims paying capital, with U.S. reinsurers' capital position falling 20% between 2001 and 2002.[1] This capital drain further lead to a rating agency downgrade of the majority of reinsurers in the aftermath of September 11th, increasing reinsurer's costs of capital.

Not surprisingly, the insurance industry was swift to react. Reinsurers became reluctant or unwillingly to underwrite terrorism risk. As a result, insurance companies drastically reduced limits on many types of terrorism coverage, narrowed conditions in insurance contracts or excluded terrorism insurance outright and raised prices on insurance policies to reflect additional risk. These costs were passed on to individual businesses in the U.S. as risk management costs rose a reported 85% from 2000 through 2002.[2] The ripple effect continued to the individual property level and from there to capital market levels, as property owners sensitive to insurance cost increases refused to, or were unable to, maintain insurance in amounts required by lenders post-September 11th, leading to the possibility of technical defaults under numerous mortgages. Property owners entering into new loan agreements balked at entering into covenants to provide terrorism insurance for properties for which deductibles could not be reasonably foreseen. Commercial lender's were justifiably concerned with making non-recourse loans on properties without knowing if adequate terrorism insurance could be maintained when the entire collateral for the loan could be wiped out instantaneously by a terrorist attack.

Cognizant of the spread of such financial uncertainty across financial markets, the federal government returned a measure of stability to the markets with the enactment of the Terrorism Risk Insurance Act (TRIA) in late 2002. TRIA voided terrorism exclusions from property and casualty insurance (among other types) and required property and casualty insurers to "make available" terrorism insurance with terms that do not "differ materially from the terms, amounts and other coverage limitations applicable to losses arising from events other than acts of terrorism."[3] The federal government also provided a "backstop" to terrorism insurance losses by which the federal government would pay for 90% of terrorism losses in excess of a mandated deductible and insurance companies would be responsible for the remaining 10%. This backstop provided additional capacity to the market, allowing for more affordable premiums and therefore for terrorism coverage for a greater number of properties.

By all accounts, TRIA was successful in returning stability to financial markets and permitting insurance companies to recover from their losses. However, as Congress originally intended TRIA as a temporary measure, sunset provisions were provided in the enabling legislation such that TRIA is slated to expire on December 31, 2005. Currently, though, legislation to extend TRIA through the end of 2007 has been introduced in both the House of Representatives and the Senate as a result of industry advocates stressing the potentially deleterious effects of an outright termination of TRIA.[4]

So that Congress could judge the efficacy of TRIA, the original legislation required the Treasury Department to study the effects of TRIA and to report its findings prior to the sunset date. This report was delivered to Congress on June 30, 2005. In his transmittal letter accompanying the report, Treasury Secretary John W. Snow cast doubt on the likelihood of a TRIA extension by stating that TRIA "achieved its goals of supporting the industry during a transitional period and stabilizing the private insurance market." Secretary Snow went on to state that the economy has recovered since September 11th and expressed the view that a continuation of the program as it currently exists would likely hinder the development of a private insurance market. Secretary Snow then reported that "the Administration opposes extension of TRIA in its current form." However, the Secretary indicated the Administration might approve a limited extension of TRIA providing for a measured handover of responsibility for terrorism insurance from the federal sector to the private sector. The Secretary proposed increases in the event size triggering the program from the current floor of $5 million per attack to a new floor of up to $500 million per attack, an

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increase in private co-pays and deductibles and the elimination of certain lines of insurance coverage from the federal program (e.g., general liability and commercial auto).

The July terrorist attacks in London altered the public discourse and the Administration later indicated an increased flexibility in its approach to TRIA. Secretary Snow testified to the House Financial Services Committee on July 13, 2005 after the London attacks, that the Administration was not seeking to remove the backstop entirely. Public statements, press releases and questions from key members of Congress during Secretary Snow's testimony also indicate that the Congressional leadership is not interested in seeing TRIA expire in 2005. It therefore appears increasingly likely that an extension to TRIA will be passed in some form later this year.

As any extension to TRIA will likely contain a rollback of government responsibilities, it appears likely that the insurance industry and real estate capital markets will need to modify current procedures as more risk is passed back to the private sector. By way of limited conjecture, absent the "make available" provisions of TRIA, we will likely see the exit of several insurance providers from the terrorism insurance market until insurers develop appropriate models to forecast the risk and costs of future terrorist attacks. Alternately, many insurers will likely severely curtail terrorism insurance offerings. As a possible sign of things to come, the ISO website already references "conditional" and "post-TRIA" endorsements applicable only in the event that TRIA is not extended in its current form. For those insurers staying in the market for terrorism insurance, premiums charged will undoubtedly rise as the private market accepts increased risk and, as a result, the number of property owners maintaining insurance for terrorist attacks will likely drop. The negotiation of insurance provisions in loan documents will therefore likely become more intense and rating agencies will pay more attention to insurance provisions when rating loans for the capital markets. Another possible change sees those property owners required to maintain terrorism insurance incurring increased capital expenses as they seek to mitigate risk and insurance expense by "fortifying" properties against attack (e.g., installing metal detectors or car bomb barriers). Ultimately, the severity of the impact on the insurance industry and real estate capital markets will depend upon the form in which the TRIA extension is passed later this year, assuming, of course, that the extension is passed.

Health Care Mandates for Grocers and "Big Box" Retailers

The decision to offer health care benefits and the attendant costs associated with these benefits are some of the most important issues confronting employers and employees today. As the cost of providing employees with health insurance coverage rises at double-digit rates, employers have been forced to absorb the majority of these increases. Seeking to ease the pain, however, many employers have decreased premium contributions, changed the products they offer, and/or have reduced coverage. What was once considered a customary and almost obligatory part of an employee's total compensation, health care benefits are no longer "untouchable."

Labor unions and employee advocacy groups have seized on this "health care crisis" as a rallying point and are attempting to organize workers, in part, on this basis. In line with this strategy, these organizations, are lobbying local politicians to introduce legislation that would require employers in certain industries to boost spending on health care. This movement is largely driven by concern over the expansion of big-box retailers, who, some groups contend, provide fewer health care benefits than unionized retailers. States and local governments have an incentive to pass such legislation, because they are ultimately responsible for subsidizing the health care expenditures of many uninsured workers.

In 2005, lawmakers in 11 state legislatures proposed bills that would mandate employer-paid health care.[5] The majority of these bills have not made it through the legislative process. However, in New York, both New York City and Suffolk County, recently passed legislation requiring certain grocery employers to commit a minimum level of funding to health care for their employees.

The New York City Council recently overrode Mayor Michael Bloomberg's veto and passed the Health Care Security Act (HCSA or the Act). The HCSA, which is scheduled to take effect on July 15, 2006, requires certain grocers and other retailers who sell food for off-site consumption to provide health care benefits to its employees. In particular, the HCSA requires any grocery store with 50 or more employees or any retailer with 12,500 square feet or more of active retail space, such as "big box" retail stores, warehouse clubs and larger grocery stores, to make "required health care expenditures" at the prevailing rate. The HCSA specifically exempts retailers whose primary business is the sale of pharmaceuticals.

Similarly, Suffolk County, New York, recently passed the Fair Share for Health Care Act (FSHCA), scheduled to take effect on May 1, 2006. Like the New York City law, the FSHCA, requires certain grocers and other retailers of food for offsite consumption to make minimum health care expenditures totaling at least $3.00 per hour worked by an employee. Under the FSHCA, a covered employer includes any person that operates at least one retail store located in the County where groceries are sold for offsite consumption where either (1) 25,000 square feet or more of the store's selling space is used for the sale of groceries or other foods, or (2) 3% or more of the store's selling space is used for the sale of groceries and the store contains at least 100,000 square feet of selling space, or (3) had total revenues of $1 billion or more in the most recent calendar year and the sale of groceries comprise 20% or more of the company's revenue. The FSHCA, unlike the HCSA, does not exempt pharmacies.

Because Suffolk County essentially adopted the New York City law, the Acts' provisions are very similar. Both Acts define an "employee" broadly to include full time, part-time, and seasonal employees, and to exclude managerial, supervisory, and confidential employees. Both the HCSA and FSHCA also mandate an administering agency to carryout enforcement responsibilities, periodic audits, and complaint processing and investigation, and empower these agencies to determine the annual health care expenditure rate for employers covered under the Acts.

Pursuant to the HCSA and FSHCA, a covered employer must maintain: (1) an accurate log that lists the names of each employee and the hours worked and (2) accurate records of health care expenditures and proof of such expenditures for each year. This information must be filed with the administering agency on a yearly basis. Notably, a covered employer who is a signatory to one or more collective bargaining agreements that cover at least 75% of its employees are exempt from the Acts and may fully comply by filing proof of such collective bargaining agreements and their terms.

A covered employer who fails to make the required health care expenditures will be subject to civil penalties and could be subject to a revocation or suspension of certain registration certificates, permits, or licenses. Both Acts also contain anti-retaliation provisions, making it an unlawful employment practice for a covered employer to take any adverse action against a current employee or deny employment to an applicant on the basis of a person's attempts to enforce or inquire into the requirements of the Act. An individual who has been retaliated against has a private right of action and may seek damages, including attorney's fees.

While both New York City and Suffolk County have passed their respective laws, questions remain. First, several provisions are vague and ambiguous. For example, the definition of "employee" is broad and arguably includes individuals, such as temporary employees and independent contractors, who are not customarily considered employees. It is not entirely clear whether a covered employer is required to provide health care benefits for these non-traditional employees or whether a covered employer is simply required to include the hours worked by these individuals in the minimum health care expenditure calculation. The ambiguity of these laws leaves employers in a quandary and makes compliance difficult.

There is a possibility that these laws are preempted by federal law. The Employee Retirement Income Security Act (ERISA) may preempt these local laws, because their provisions arguably attempt to regulate employer-sponsored health coverage directly. ERISA contains a broad preemption provision that operates to supercede most state and local laws that relate to ERISA plans, except those that regulate insurance, banking and securities. In general, state mandates of employer-sponsored coverage are preempted except to the extent that they are incorporated in the laws governing insurance policies. Arguably, ERISA might be held to preempt the HCSA and FSHCA, as they require employers acting as plan sponsors to evaluate their plans and modify them in order to avoid or minimize the possibly onerous civil penalty assessments. Moreover, there is also an argument that these laws are preempted by the National Labor Relations Act (NLRA), because they distinguish between employers who are represented by unions and those who are not. The laws also require employers who are covered by collective bargaining agreements to file proof of their agreements with administering agencies. It is well-settled that the NLRA preempts state laws that are based on conduct that is "arguably" protected or prohibited by the NLRA. To the extent that these laws apply to employers covered under the NLRA, there is a colorable argument that they are preempted by the NLRA.

To date, we are not aware of any pending legal challenges to these laws, though we expect them to be challenged by an affected employer in the near future. We will continue monitor these new laws and provide updates as new information becomes available.

Defeasance: A Viable Option for Borrowers

Since 1996, the commercial mortgage-backed security (CMBS) or conduit market witnessed defeasance become a preferred alternative to yield maintenance and other prepayment penalties. As real estate values soar and the availability of cheap capital remains, real estate professionals must understand the opportunities of loans with the defeasance provision.

In the CMBS industry, investors holding securities backed by the securitized loans want predictable and uninterrupted cash flow. To protect investors, the underlying conduit loans contain covenants that restrict the borrower's ability to prepay. Ranging from lock-out provisions, which completely forbid the prepayment of the loan for a specified period, typically until the last 60-90 days of the loan term, to various forms of prepayment penalties, such as yield maintenance provisions, these features assure investors of a stream of uninterrupted payments. Although this "call protection" is beneficial to the CMBS investor, it severely restricts a borrower's ability to access any accumulated equity in the underlying property.

Defeasance has emerged as the preferred alternative for handling prepayment in CMBS. It has strengthened the predictability of CMBS payment streams for investors while providing borrowers with flexibility in selling or refinancing their properties. Defeasance is a means to balance the effect of the loan's lock-out provisions against the borrower's need to obtain a release of the Real Estate Mortgage Investment Conduit (REMIC) trust's lien on the related collateral. The process of defeasance substitutes real estate collateral with a portfolio of U.S. treasury securities. The securities purchased

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are designed to exactly match the cash flow of scheduled mortgage payments, including any balloon payment. The loan obligation is not cancelled when defeasance occurs, as would occur with a prepayment. Instead, the note and loan remain in full force and effect through the maturity date, with the payments under the loan being paid as the government securities are released. In essence, the note remains, but the mortgage is released allowing the borrower to sell or refinance his property.

Lenders and investors in securitized loan transactions prefer defeasance to yield-maintenance prepayment provisions because the investors receive "call protection," making pricing of the CMBS more attractive, and by providing substitute collateral. A loan's probability of default is also significantly reduced when real estate assets are replaced by U.S. treasury securities which the borrower has no right to sell or liquidate and which make the loan payments directly. This improves the credit characteristics of a significant number of CMBS transactions which contain defeased loans. Finally, defeasance provides borrowers with the ability to access accumulated equity in their real estate assets prior to loan maturity.

On the down side, defeasance of a mortgage is a relatively complex process, particularly in New York, and other states with a mortgage recording tax, where a borrower must structure the defeasance so as to not pay a second mortgage recording tax. The defeasance process in New York begins, just prior to closing the refinance of a loan, with the borrower delivering a new note to the new lender, secured by securities that the borrower pledges to the existing lender, which is typically the REMIC trust which holds the loan. At closing, the new lender transfers the new note and the pledged securities to a special-purpose entity (a trust) that issues bonds backed by the cash flow of the mortgages. Simultaneously, the trust transfers the old mortgage note and the old mortgage to the new lender, which modifies same to conform to the new loan parameters. The new borrower agrees to pay the new note and the trust releases the old borrower from liability under the new note. The trust holds the new note secured by the securities, a mirror of the old note and functionally identical, and the new lender holds the old note and the old mortgage. Neither was ever released, therefore, the borrower is not required to pay additional tax.

The attractiveness of defeasance to borrowers wishing to refinance or sell their property, and to lenders by making pricing on CMBS more favorable, has made defeasance a fixture in the present CMBS industry.

Endnotes

1 Insurance Information Institute, *Terrorism, Insurance and the United States Government*, 16 (2004),

2 *See id.*, p. 2, (quoting *Risk & Insurance Management Society, 2004 Cost of Risk Survey)*.

3 Terrorism Risk Insurance Act of 2002, § 1.03(c), 15 U.S.C. 6701 (2002).

4 The "Terrorism Insurance Backstop Extension Act of 2005" was introduced in the House of Representatives as H.R. 1153 on March 8, 2005. The "Terrorism Risk Insurance Extension Act of 2005" was introduced in the Senate as S. 467 on February 18, 2005.

5 *See* Mark Schoeff Jr., *State Healthcare Mandates Make Some Political Progress*, Work Force Management, Aug. 1, 2005, at p. 68.

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