

# There is Something New Every Day: Hot Topics in Securitized Mortgage Loans

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## I. Recent Evolution of Loan Document Provisions: Natural Evolution or Sign of a Turn in the Cycle?

One of my mentors said, you can reduce real estate loan documentation to a one or two page note and a four page mortgage. Those numbers wouldn't cover transmittal letters in today's transactions. So with what are we filling all the additional space? The undisputed fact is that loan documents today look materially different in both content and size than they did ten or so years ago. I would suggest that most of these differences are the result of prudent evolution which has its origin in the expansion of available credit from the capital markets, which in turn has been driven by loan securitizations.

Many of us are familiar with the document changes that have evolved over time. They include such items as (a) the addition of defeasance (see Annex A) allowing for orderly property transfers notwithstanding the prior securitization of the mortgage securing the property, (b) provisions for replacement reserves (see Annex B) which provide funds to maintain mortgaged properties, as well as deferred maintenance reserves which compel borrowers to address current repair needs by establishing immediate repair funds and (c) establishment of cash management systems (see Annex C) which direct cash flow to property needs and loan repayment. All of these changes and significant others (such as the addition of SPE borrower provisions and the bankruptcy remote borrower structuring attendant thereto; recourse carve-outs, tenant improvement and retenancing reserves) seem to have least common denominators of strengthening loan security, promoting loan origination and furthering the likelihood of refinancing.

So, what about more recent changes (be they tweaks or modifications of more substance) to these provisions and to so-called loan document boiler plate. Are they part of the aforementioned natural evolution and betterment of our loan documents or are they possibly evidence of an adverse turn in the commercial mortgage lending cycle.

To learn more, look at some common recent changes to mortgage loan documentation and related issues:

### A. *Defeasance*

1. Different substitute collateral. The provisions for alternative (i.e., non-treasuries) collateral has facilitated refinancings and property sales.
2. Prepayment window at end of term tied to end of defeasance period.
3. Who is the owner of excess payments?
4. Shortened notice periods.
5. Maturity of securities.

### B. *Reserves*

1. What is being waived today? Prudent or not so prudent? Depends on who's side you are on.
2. Use of caps.
3. Allocated obligations to tenants.
4. Evidence of work. The requirements imposed upon borrowers and enforced by loan services are often viewed as burdensome by property owners.

### C. *Cash Management*

Hard v. Soft Structures. If appropriately drafted and negotiated, such structures can augment credit availability while imposing only reasonable controls on cash flow.

D. *SPE Provisions.*

Very efficient and relatively clean structures are now commonplace and reflect current thinking as to how best to insulate borrowers from factors unrelated to the loan and the mortgaged property. (See Annex D)

1. New thresholds for SPE. Is the upper tier envelope being pushed?
2. Second Tier.
3. Non-Delaware Single-Member Borrowers.
4. Independent Managers.
5. Non-Consolidation Opinions.
6. TIC Requirements.
7. Piercing the corporate veil. You will recall from law school the lesson that is almost unheard of to pierce the corporate veil. What about piercing the LLC veil? As with a corporation, one often established an LLC to shield its members from the entity's contractual and tort liability. One recently circulated case (*Stone v. Frederick Hobby Associates II, LLC*, Conn. Superior Court July 2001.) did pierce. The court found that one would need to apply the "instrumentality rule" and the "identity rule".

The instrumentality rule requires (1) domination and control of an entity's policies and business, (2) use of such control to commit a wrong and (3) proximate cause of (1) and (2) leading to the harm.

The identity rule basically involves the failure to observe legal formalities of an entity.

The wrong in this case was the company seemed to have been set up for the purpose of shielding the individual members from known liability.

Let's put this theory under the same heading of you cannot shield yourself from fraud by a document which says you are shielded from claims of fraud. If you do something sufficiently egregious, a court may well find a reason to nail you.

Now, helping the court here was the identity theory. The LLC member and beneficial owner lines were not particularly distinct in the cited case. This is interesting from a capital markets perspective. We

set up SPE's with requirements of separate books, stationery and the like. We do this to avoid substantive consolidation. We shall also do it to avoid a successful piercing argument. Lenders may be less willing to limit the carve-out liability for failing to abide by loan and formation documents' SPE provisions.

E. *Recourse Carve Outs (Annex E)*

We've seen a refinement across the industry for what's excepted. There is also some pressure on what constitutes a "warm-body" guarantor.

F. *Prepayment Provisions.*

(I note with appreciation that the following is based on a summary prepared by my Chicago partner, Al Kruse.)

Many industry players ran to look at the way their yield maintenance prepayment provisions read following the ruling last fall in *River East Plaza, L.L.C. v. The Variable Annuity Life Company* by the United States District Court for the Northern District of Illinois, Eastern Division that the prepayment provision in that case was unenforceable.

The provision provided, in essence, for a fee equal to the greater of 1% of the principal loan balance or the difference between (1) the present value of unpaid debt service payments calculated from the prepayment date to the maturity date, discounted at a specified reinvestment rate equal to the yield to maturity on a United States Treasury bond or note maturing on or about the loan maturity date and (2) the principal loan balance at prepayment.

This provision hinges on the reinvestment in U.S. treasuries without the addition thereto of a spread.

The borrower's argument focused upon the reduced risk accepted by a lender reinvesting in a Treasury-flat obligation, rather than accepting a level of risk comparable to that of the loan, i.e., by adding on thereto an appropriate spread. The court found that the provision was not reasonable when entered into and did not bear a relation to the damages which might be sustained.

The court also noted that the parties did not agree to the note provision (evidenced by a carve out in the legal opinion provided by borrower's counsel).

The court said that even if the provision is not enforceable, the lender could show actual damages; however, the court barred any evidence of the lender's actual damages because the lender refused to produce such evidence during discovery.

The lender had sought \$4,713,601.27. The court found that the lender was entitled to only the 1% or \$123,012.15.

The case is on appeal before the 7th Circuit (Oral argument April 11, 2007). The Commercial Mortgage Securities Association filed an amicus brief noting that the lower court decision if left to stand would undermine fundamental principles of contract law and would result in significant disruption of the commercial mortgage backed securities (CMBS) market. (Brief of Amicus Curiae. The Commercial Mortgage Securities Association in support of Appellant).

G. *Borrower Comments.*

It's worth looking at some additional borrower loan document comments coming with increased frequency. To address the not-insignificant fear that some borrowers have expressed at being turned over to servicers who will decide their fate on such matters as leasing, property transfers and management changes, borrower's counsel seek to negotiate significant leeway into the original loan documentation.

1. Leasing: Specified areas of approval in shorter time frames (with deemed approvals) on increasingly fewer leases. The concept of what constitutes a "material lease" has been eroded somewhat.
2. Transfers: providing for a greater array of pre-approved transfers, especially of ownership interests.
3. Casualty: Greater role assumed by borrower in agreeing upon proceeds determination and increased rights to rebuild and to repay loan without penalty in absence of being granted proceeds use.

## II. Insurance.

### A. *Terrorism.*

1. Background. Most of us know about TRIA, the Terrorism Risk Insurance Act of 2002. (See Annex F).

Insurance providers must "make available" terrorism insurance on 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". To ease this burden, the federal government would pay a portion of terrorism losses in excess of certain thresholds. The latest TRIA extension expires at year end. The good news for those in favor of further extension of TRIA is that the new Congress has vocal and powerful supporters for an extension, including committee chairman Rep. Barney Frank (D-MA) and Sen. Christopher Dodd (D-CT). A.M. Best Co. (an international insurance rating and information agency) increased the outlook for overall commercial insurance lines from "negative" to "stable" ("MBA Newslink" Vol. 6. Issue 46. 3-8-07.). Mayor Michael Bloomberg (NY) said that without an extension of TRIA, New York's \$46 Billion commercial real estate pipeline would cease ("MBA Commercial Multifamily Newslink" Vol. 5. Issue 11. 3-8-07.) Issues under Congressional review, in addition to the basic extension of the Act, include providing market certainty and avoiding interruption in the availability or perceived availability of federal protection, making coverage affordable, making the federal protection permanent, removing the \$100 Billion program cap (to signal to insurers that they are not liable for a huge catastrophe) and covering additional risks including domestic terrorism and so called "NBCR" (nuclear, biological, chemical and radiological) risk.

2. Documents. Borrowers have addressed the risk of non-renewal of TRIA by arguing for or that:

- a. Terrorism coverage does not just apply to certain properties.
- b. Caps on premiums.
- c. Self insurance.

*B. Windstorm.*

1. Background. In 2006, reinsurance companies raised reinsurance rates based in part on hurricane-loss models showing increased expected windstorm losses. When added to the pressure on primary insurers stemming from their 2005 losses, this resulted in significantly higher premiums for properties in Tier 1 windstorm areas (most hurricane damage prone areas). Moody's reports premium cost increases from 40% to 400% or more and deductibles ranging from 5% of total insured value to 10% (See Daniel B. Rubock's article in Winter 2007 *CMBS World* entitled, "Is PML the Answer to the Hurricane Insurance Crunch?"). Although some renewing borrowers and, given augmented building codes, certain newer property owners, are finding it somewhat easier to obtain insurance, many find significant challenges to obtaining desired or required coverage.

Of the top 30 costliest hurricanes during the period 1851-2004, about half (14) have occurred since 1995 (NOAA - Tropical Prediction Center, cited in MBA-February 2007 "Gone With the Wind" Presentation (Kenneth A. Travers, "Hurricane Risk - A Technical Perspective -- Can the Past Predict the Future?")), in not-insignificant part due to increased coastal population and property. We are in a warm multi-decadal oscillation period for 25-40 years, having started in 1995, i.e. in a period with increased likelihood of serious windstorms. Premiums are increasing by significant multiples in some cases, caps on coverage are appearing, coverage is increasingly being excluded and there is no immediate remedy in sight by way of federal legislation.

2. Documents Today.

- a. Requiring coverage equal to the lesser of 100% of replacement value or loan value.
- b. Easing up on insurance rating requirements.
- c. Greater allowance of self-insurance.
- d. Increase in deductibles and providing per-building deductibles rather than per occurrence.
- e. Covering insurance gap with net deductible increase, letters of credit, guaranties, reserves, reduced proceeds, obable maximum loss (PML) analyses (as with earthquake coverage) and cross collateralizations. Some transactions have looked to multiple insurers with each willing to insure a portion of the value. PML analyses involve consideration of property construction, specific property locations, historical exposure to hazards and surroundings. Although accepted by the insurance industry, other market players and the rating agencies have not yet become fully comfortable.
- f. Blanket coverage facilitates obtaining coverage due to spreading of the risk, depending on property concentration in hurricane-prone areas.

*C. Lender Coverage Warning.*

Be sure lender is named on mortgagee clauses as loss payee for rents and business income and check language of mortgagee clauses and ACORD form language.

*D. ACORD Forms. (See Annex G).*

Changes were made in July 2006 to the ACORD 28 Insurance Form (Evidence of Commercial Property Insurance). ACORD (the Association for Cooperative Operations Research and Development) is a

nonprofit industry organization that provides standard forms used by most insurance carriers, agents, and brokers. Blanks are provided in ACORD 28 for amount and type of coverage (including terrorism and business interruption). The most important aspect of the certificate is to serve as proof of coverage in the absence of the policy being available. The form can be e-mailed, faxed or pdf'd to add efficiency and speed to the review and closing processes. Prior to the form changes, the form (adopted in 2003) provided a brief description of the coverage and coverage limits then in effect.

1. The form was revised last July to provide that it is issued "as a matter of information only and confers no rights upon the additional interest named below."
2. The revision now states that the insurer will only "endeavor" to notify the additional interest party in the event of the policy's cancellation prior to its expiration date.
3. The new Form 28 provides that the indicated coverage limits "may have been reduced by paid claims."
  - a. Freddie Mac took a look at the changes and amended its servicing guide to state that new form 28 was not acceptable. The insurance industry says it needs to accurately describe the policy and the policy often is not ready at closing.
  - b. Servicers fill the void with certificates, binders and declaration pages.
  - c. Loan document impact is not to lessen the requirement of delivering policies well before expiration.
  - d. Some insurers have developed their own evidence of coverage forms, similar to old Form 27.

4. Prudential Asset Resources has made a formal ACORD maintenance request to return to the 2003 version.
5. ACORD is establishing a working group to find a solution to the "FYI" language and cancellation notification clause.

### III. Lender Liability

With the workout possibly nearing the point where commercial properties may begin to lose value, we turn once again to loan default scenarios.

In Blue Hills Office Park v. J.P. Morgan Chase Bank, a recent Massachusetts U.S. District Court case (2007 WL755202 (D. Mass.)), the court would not find a breach of the good faith and fair dealing covenant, choosing instead to look to the four corners of the loan documents. Having said that, however, the facts of this case did not present the strongest lender liability argument.

Address the three "c's":

1. course of conduct
2. consistency
3. conversations.

## **ANNEXED DOCUMENTS**

ANNEX A	Defeasance
ANNEX B	Replacement Reserve Tests
ANNEX C	Cash Management
ANNEX D	SPE Provisions
ANNEX E	Recourse Carve-Outs
ANNEX F	TRIA
ANNEX G	ACORD

Note: The annexed documents are merely examples of portions of applicable provisions and documents and should not be used in actual transactions.

## **ANNEX A**

### **Defeasance**

either (x) direct, non-callable obligations of the United States of America or (y) non-callable obligations, other than U.S. Treasury Obligations, that are “government securities” within the meaning of Section 1.860G-2(a)(8) of the Treasury Regulations, as amended, that are acceptable to each applicable rating agency, in each case, and that provide for payments prior, but as close as possible, to all successive Payment Dates occurring after the Release Date through and including the Maturity Date, with each such payment being equal to or greater than the amount of the corresponding installment of principal and interest required to be paid under the Note.

## **ANNEX B**

### **Replacement Reserve Tests**

- Written request to disburse and certification
- Invoices
- Lien waivers/mandatory threshold
- Architect's certification/monetary threshold
- C of O/ monetary threshold

# ANNEX C

## Cash Management

- (i) First, to the Taxes and Insurance Reserve Account;
- (ii) Second, to the Monthly Payment Amount;
- (iii) Third, to the Replacement Reserve;
- (iv) Fourth, if applicable, to other reserves;
- (v) Fifth, to other amounts due and payable under the Loan Documents;
- (vi) Sixth, to monthly Cash Expenses, less management fees payable to affiliates of Borrower, pursuant to the terms and conditions of the related Approved Annual Budget;
- (vii) Seventh, to the payment of Extraordinary Expenses approved by Lender, if any;
- (viii) [Eighth, from and after the Maturity Date, to Lender, to be applied to the reduction of the outstanding principal balance of the Note];
- (ix) Ninth, from and after the Maturity Date, to Lender, to be applied to Accrued Interest] and
- (x) Lastly, and provided no Event of Default has occurred, any excess amounts, if any, shall be disbursed to Borrower.

## **Annex D**

### **SPE Provisions**

- No other business
- No other property
- No consolidation
- Organizational formalities
- No loans to others
- No subs
- No commingling
- No debt beyond limited trade debt/financing leases
- Arms length related party agreements
- No guarantees
- Own tax returns
- Adequate capital/remain solvent

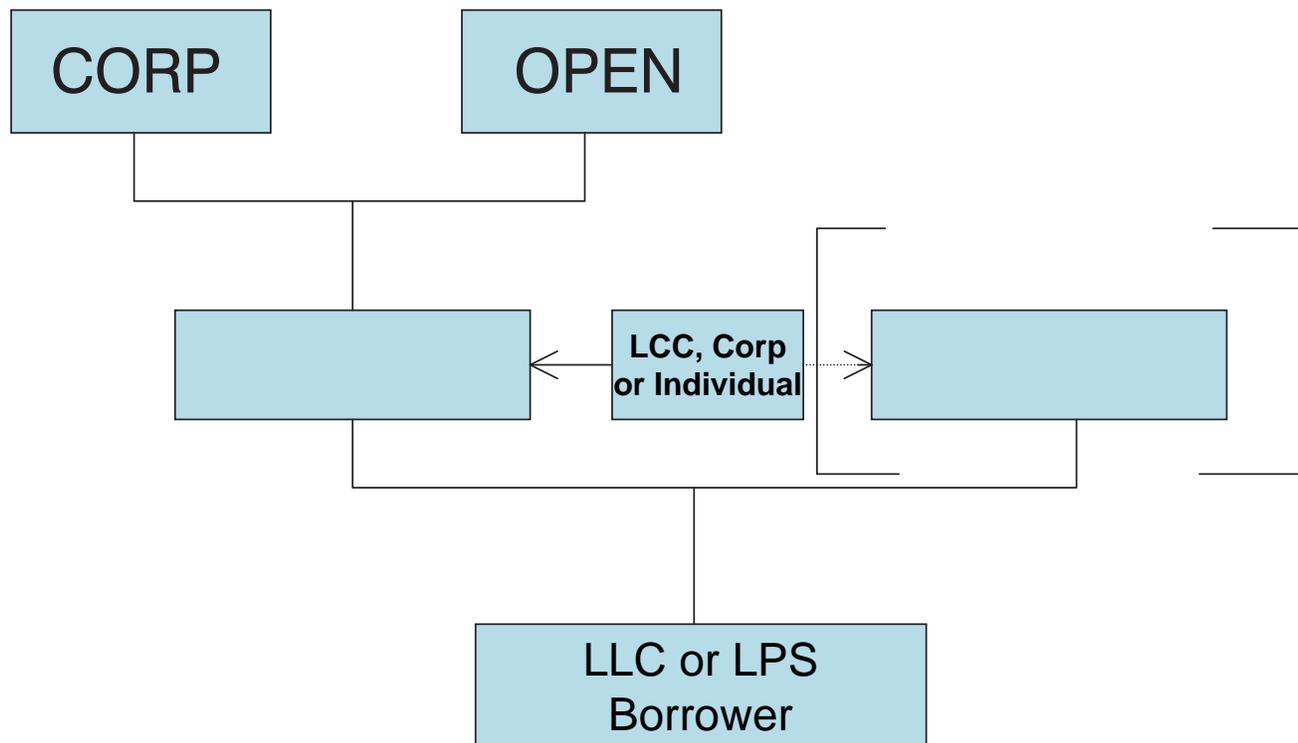
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unanimity to file bankruptcy

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structures

## SPE Provisions (Continued)



## **ANNEX E**

### **Recourse Carve-Outs**

Unpaid balance of the Loan in the event of:

- any fraud, willful misconduct or material misrepresentation by Borrower or any Guarantor
- failure to make the first full monthly payment of principal and interest due under the Note
- a breach of the terms of the SPE Provisions
- the voluntary filing by Borrower, or the filing against Borrower by any Guarantor or any affiliate of any Guarantor, or an involuntary bankruptcy filing against Borrower in which Borrower or Guarantor acts in collusion

Loss, liability, damage, cost, expense:

- waste
- misapplication, misappropriation or conversion of: rents or security deposits
- insurance proceeds
- awards or amounts received in connection with the condemnation
- Environmental Matters

# ANNEX F TRIA

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## Extending TRIA

*Likelihood of continuation improves with Democrats in control of Congress.*

BY PETER J. KORDA  
AND DANIEL J. EVANS

THE REAL ESTATE finance and insurance worlds are well acquainted with the Terrorism Risk Insurance Act of 2002 (as amended, TRIA) and its impact on the real estate and lending communities. Much was written in 2005 about the prior two-year extension of TRIA to the end of 2007, and there was significant debate as to whether TRIA should be further extended, expanded or even exist at all. Now, the Democratic takeover of Congress in 2007 gives supporters of another extension of TRIA much to be excited about in the new year.

By way of brief explanation, TRIA was enacted in 2002 in response to the 9-11 terrorist attacks in which insurers suffered estimated insured losses of some \$32.5 billion, as reported by the Insurance Information Institute. Such extensive losses caused many insurers to significantly reduce the availability and/or amounts of insurance coverage or to cease providing terrorism insurance outright. Insurance companies that continued to offer terrorism insurance substantially raised prices on policies as a reflection of additional risk and the additional costs of capital.

These increased costs were passed on to consumers. Individual businesses in the United States saw risk management costs rise a reported 85 percent from 2000 through 2002. The ripple effect spread to the capital markets as property owners were unable to maintain insurance in amounts required by lenders. Similarly, owners were reluctant to sign loan documents requiring ongoing terrorism insurance coverage at whatever cost when they could not predict how high premiums could rise. The uncertainty seriously affected lenders, many of whose loan programs required having insurance in place to cover all casualty risks. The viability to continue making non-recourse loans on properties was at risk when the collateral for a loan could disappear in a moment without lenders having an assurance that adequate terrorism insurance was in place.

With such financial uncertainty spreading through the real estate related financial markets, the federal government sought to return a measure of stability with the enactment of TRIA in late 2002. TRIA required property and casualty insurers to "make available" terrorism insurance on terms that do not "differ materially from the terms, amounts and other coverage limitations applicable to losses arising from events other than acts

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With Senator Dodd poised to take over the chairmanship of the Senate committee responsible for sending any new TRIA legislation to the Senate floor for a vote, chances for expanded TRIA coverage look more promising than in prior years.



Senator Chris Dodd



'We are going to extend [TRIA]. We will succeed. [We're] going to get the votes because when it comes to a vote we have a winner.'



Representative Barney Frank



of terrorism.<sup>2</sup> In return for forcing insurance companies to insure terrorism risks, TRIA required that the federal government pay a portion of terrorism losses in excess of certain statutory thresholds. The "make available" provisions and federal government "backstop" provided by TRIA have served to settle the marketplace since TRIA's passage by allowing for more affordable premiums and the availability of coverage, especially for properties in higher risk markets (e.g., larger cities).

With the uncertainty and potential for market disruption relatively fresh in their minds, the real estate and insurance communities have paid close attention to the future of TRIA. TRIA initially was passed as a temporary means of restoring confidence in the markets and allowing the insurance industry to recover from the 9-11 attacks. The program contained sunset provisions and, as passed in 2002, was to last only until Dec. 31, 2005. As the sunset date approached, many members of Congress and the real estate, financial and insurance industries were concerned that the stability gained by TRIA would be lost overnight once the government backstop was removed. Speculation as to the availability of terrorism insurance in a post-TRIA world varied with some believing the insurance industry had recovered sufficiently to provide terrorism insurance on its own and others believing that the market would return to the pre-TRIA days of exceedingly high costs, unavailability of coverage and uncertainty in the broader markets. In the end, Congress passed an 11th hour extension of TRIA, extending the program, and the debate, for an additional two years.

### Looking Ahead

Although TRIA is currently set to expire on Dec. 31 of this year, powerful incoming committee heads in Congress who have been among the most vocal supporters of TRIA in the past have publicly stated that they intend to make continued, and pos-

sibly expanded, terrorism and disaster insurance a "very high" priority this year.<sup>3</sup> In addition to past voting trends which seem to indicate that a TRIA extension is likely, the change in control of Congress following the recent midterm elections will likely result in an ideological shift more favorable to governmental intervention in and support of the insurance and financial markets.

In reviewing the political landscape after the midterm elections, Dottie Cunningham, chief executive officer of the Commercial Mortgage Securities Association (CMSA), a trade organization representing commercial real estate capital market interests, said that "the changes [in Congress] are good for this [TRIA] debate because it changes the debate from 'are we going to have a program' to 'what will the program look like.'<sup>4</sup>

Two key congressional voices in undoubtedly determining what TRIA will ultimately look like have provided early indications that they would like to see TRIA extended and potentially expanded. Representative Barney Frank (D-Mass.), the incoming chair of the House Financial Services Committee, has indicated that he would like to see a long-term extension of TRIA.<sup>5</sup> Senator Chris Dodd (D-Conn.), the incoming chair of the U.S. Senate Committee on Banking, Housing and Urban Affairs, has expressed his intention that TRIA be made permanent, having been quoted as stating that "I will not do another extension. It's either going to be a permanent bill or not, in my view."<sup>6</sup>

Although Mr. Frank and Mr. Dodd may appear at first glance to be at odds in the scope of their approaches to enacting ongoing TRIA protections, with Mr. Frank seeking an extension and Mr. Dodd seeking a permanent fix, Mr. Frank confirmed in a telephone interview that there is "no disagreement between Senator Dodd and myself" and stated that although he would be excited to see TRIA made permanent, his foremost pursuit is getting a workable law in place.<sup>7</sup> Mr. Frank is confident that such a workable law will be enacted before

TRIA expires at the end of the year, stating that "we are going to extend it. We will succeed. [We're] going to get the votes because when it comes to a vote we have a winner."<sup>8</sup>

Additionally, Mr. Frank has previously expressed an interest in seeing an expansion of coverage to include insurance over nuclear, biological, chemical and radiological (NBCR) risks and to cover individuals through group life insurance. With respect to group life in particular, upon the passage of a prior TRIA bill that did not survive the Senate, Mr. Frank pointedly commented in a floor statement on Dec. 17, 2005, that "[g]roup life is gone. This is kind of like, remember the old neutron bomb? It killed people and left the buildings standing. We have neutron terrorism insurance. It protects the buildings, but it ignores the people." The debate over expanded TRIA coverage in 2007 will likely focus on these issues, regardless of the final outcome of the legislative debate. If the indications hold, though, the end result will most likely be viewed as good news by property owners, developers and financial industry leaders who are looking to the federal government to backstop the cost and insure the continued availability of terrorism insurance.

### Past Trends and Debates

Two years ago, the prospects for a TRIA extension did not look nearly as good as they do today. It is instructive, though, to look to past trends and debates from 2002 and 2005 in order to help determine how the TRIA debate of today will likely turn out. TRIA was set to expire on Dec. 31, 2005, and the increasing distance from 9-11 and various political changes created doubts as to its continued existence. When TRIA was originally passed in 2002, the largely party-line House vote was 227-193 with 207 Republicans voting for TRIA and 183 Democrats voting against its passage. The 2002 vote in the Senate garnered more Democratic support with all 51 Democratic senators voting for passage and 32 of 46 Republicans doing so.

With the Republicans controlling the Senate in 2005, however, Republican support for an extension seemed crucial. Disappointingly for proponents of a continuation of TRIA, in the months leading up to the TRIA twilight date in 2005, passage of a TRIA extension was anything but a certainty as Republican support for a continued TRIA program seemed to be eroding.

The original TRIA legislation required the Treasury Department to study the effects of TRIA and to report its findings prior to the sunset date. In his transmittal letter accompanying the report's delivery to Congress on June 30, 2005,

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# TRIA (Continued)

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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 9-11 and expressed the view that a continuation of the program as it then currently existed would likely hinder the development of a private insurance market. Mr. Snow reported that "the [Bush] 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 then current floor of \$5 million per attack to a new floor of up to \$500 million per attack, an increase in private co-pays and deductibles and the elimination of certain lines of insurance coverage from the federal program.

The July 2005 terrorist attacks in London altered the public discourse, and the administration began to demonstrate an increased flexibility in its approach to TRIA. Mr. 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. Due to changing world events and to the bipartisan leadership efforts of Representative Frank and the then Chairman of the House Financial Services Committee Representative Michael Oxley (R-Ohio), who sponsored the initial TRIA legislation in the House of Representatives in 2001, and the efforts of Mr. Dodd, who sponsored TRIA legislation in the Senate in 2002 and

## Terrorism Risk Insurance Act

2005, TRIA was extended at the 11th hour and then only through great compromise, through 2007.

The newly enacted program contained a number of structural changes which passed a portion of risk back to the insurance industry and reflected the then current congressional desire that TRIA only be a temporary measure to give the insurance industry time to recover from the 9-11 terror attacks and that TRIA not act as a permanent "backstop" to the insurance industry with respect to all future terrorist attacks. However, in seeking the compromise legislation, Congress took a more liberal position than that suggested by the Bush administration. While Mr. Snow had suggested that the federal government raise the threshold for triggering the government insurance backstop to a terrorist attack causing at least \$500 million of damage in the aggregate, the TRIA extension, as passed by Congress, reset this trigger for government involvement to \$50 million in the aggregate for terrorist acts occurring in 2006 and to \$100 million in the aggregate for terrorist acts occurring in 2007.

Of the TRIA extension legislation introduced in both houses of Congress in 2005, the House legislation by far offered the most expansive governmental backstop for insurance losses. The House bill passed with overwhelming Democratic approval and provided for not only a TRIA extension, but also for an expansion of coverage to include NCBR and group life. However, in order to reach agreement with the Senate, the House had to give up those expanded areas of coverage. Arguably, with a Democratically controlled House in

the upcoming congressional sessions and Mr. Frank continuing the work he began with Mr. Oxley as chair of the House Financial Services Committee, it would not be surprising to see a similar House stance at the very least emerge in 2007.

### Voting and Sponsorship Trends

In further gauging the level of House interest in extending TRIA in 2007, it is worth noting certain voting and sponsorship trends from past years. As indicated above, House Democrats largely voted against TRIA in 2002 with 183 "no" votes registered on the Democratic side of the aisle. However, 2005 Democratic votes in support of the TRIA extension tallied 192 for and three against (with seven not voting). The Democratic voting trend in the House certainly appears to be headed in the right direction for further TRIA extension.

With House approval of a TRIA extension likely, the focus turns to the Senate. In 2005, the Senate vote was taken by unanimous consent and therefore it is difficult to gauge the vote of individual senators. However, one can look to the passing of the Senate leadership baton to the Democrats, and with Senator Dodd poised to take over the chairmanship of the U.S. Senate Committee on Banking, Housing and Urban Affairs, the Senate committee responsible for sending any new TRIA legislation to the Senate floor for a vote, chances for expanded TRIA coverage look more promising than in prior years.

One can also look to the increase of senators willing to act as co-sponsors to Mr. Dodd's bills, however, to gain a rough measure of the number of senators will-

ing to see their names attached to some form of TRIA legislation. Mr. Dodd's 2002 TRIA bill had a total of six co-sponsors, while his 2005 TRIA bill had a total of 33 co-sponsors and included members from both parties. As the 2005 co-sponsors included a number of incoming Democratic senatorial leaders, including incoming majority leader Senator Harry Reid (D-Nev.), it appears as though Mr. Dodd will find an ideologically sympathetic Senate hierarchy when the 2007 TRIA legislation comes out of his committee.

When taken together, control of key congressional committees by some of TRIA's most ardent supporters, assurances from congressional leaders that legislation providing for a continuation of TRIA protections will be passed this year and general voting patterns showing growing congressional interest in continuing TRIA, property owners, developers and real estate, insurance and financial industry leaders may have reason to see the new year bring them continued (and possibly expanded) TRIA relief.

1. Insurance Information Institute, "Terrorism, Insurance and the United States Government," 2 (2004) (quoting Risk & Insurance Management Society, 2004 Cost of Risk Survey).  
2. Terrorism Risk Insurance Act of 2002, §1.03(c), 15 U.S.C. 6701 (2002).  
3. Kevin Drawbaugh, "Disaster Insurance High on U.S. House's Frank's List," Reuters, Nov. 30, 2006, at 3:16 pm ET at [http://today.reuters.com/news/articlebusiness.aspx?type=BRK&storyid=2006-11-30T20:647Z\\_01\\_N0187121\\_RTRDST\\_01\\_INSRANCE-FRANK-UPDATE1.XML&from=business](http://today.reuters.com/news/articlebusiness.aspx?type=BRK&storyid=2006-11-30T20:647Z_01_N0187121_RTRDST_01_INSRANCE-FRANK-UPDATE1.XML&from=business).  
4. Telephone interview (Dec. 29, 2006).  
5. Kevin Drawbaugh, "U.S. Sen. Dodd Urges Lasting Terror Insurance Fix," Reuters, Dec. 7, 2006, 6:25 p.m. ET at [http://today.reuters.com/news/articlebusiness.aspx?type=BRK&storyid=2006-12-07T23:25:42Z\\_01\\_N07317743\\_RTRDST\\_01\\_INSRANCE-TERROR.XML](http://today.reuters.com/news/articlebusiness.aspx?type=BRK&storyid=2006-12-07T23:25:42Z_01_N07317743_RTRDST_01_INSRANCE-TERROR.XML).  
6. Id.  
7. Telephone interview with Representative Barney Frank (Dec. 28, 2006).  
8. Telephone interview with Representative Barney Frank (Dec. 28, 2006).

Continued from page S11

Restrictions or Waiver and providing other required documentation,<sup>2</sup> the merger can be effectuated.

Forms of those required documents, including the Declaration of Restrictions, Certificate of Parties in Interest pursuant to Subdivision 12-10(d) of the definition of Zoning Lot, the Waiver, and the Zoning Lot Description and Ownership Statement were drafted by the New York City Department of Buildings (DOB) and are contained in a DOB Memorandum dated May 18, 1978. With some minor additions, they remain the standard today.

In addition to the documents required by the Zoning Resolution, in the form recommended in the 1978 DOB Memorandum, two other documents are highly recommended to be executed and recorded. Since the Declaration of Restrictions does not state which of the owners of the merged lots has a right to use the development rights an agreement must be entered into between the parties setting forth these rights. Accordingly, it is standard practice for the owners of the lots to be merged to enter into a zoning lot development agreement (ZLDA) which establishes the various rights and obligations of the parties to the merger. The ZLDA also gets recorded against the executed lots.

The Declaration of Restrictions also does not address how construction on

## Development Rights Deals

one of the adjacent properties can affect the other. Thus, the parties usually agree to enter into an Easement for Light and Air which prevents the property owner who is going to add to his building from denying the adjacent property access to light and air.

*The 1961 Zoning Resolution expressly provided for the shifting of development rights and, in effect the permitted Floor Area, from one lot to another by means of a zoning lot merger.*

Yet, there is another, perhaps more significant, reason to execute an Easement for Light and Air. Notwithstanding the fact that the title company executed the Certification of Parties in Interest and recorded all of the necessary documents it will still not issue title insurance for the transaction. The reason for this is simple. The parties to the zoning lot merger may have acquired valuable assets but they did not acquire real property. Instead, all that they have acquired are development rights, a creation of the Zoning Resolution, and although those rights may be valuable they are not real property and cannot be insured by a title insurance company against a future claim.

This obviously puts the parties making the merger in a difficult situation. Hundreds of thousands or even millions of dollars may have been spent acquiring the development rights and a purchaser of those rights will want to insure their investment. The solution to this problem

is found in the Easement for Light and Air.

Since an easement is an interest in real property it can be assigned a dollar value and it can be insured for that amount by a title company. Therefore, although not required for a zoning lot merger, an Easement for Light and Air is an essential part of the transaction as it gives the owner of the merged lots an opportunity to insure, and financially protect, the merger.

Although a title company will not insure the development rights by themselves since they are not real property, most companies will make a development rights endorsement a part of a title policy for property they are otherwise endorsing.

This endorsement insures that (a) all of the parties in interest as defined in §12-10 (d) either executed the Certificate of Parties in Interest or waived their right to do so, (b) any recorded ZLDA is a valid agreement in accordance with §12-10, and (c) any Easement for Light and Air referred to in the ZLDA was properly recorded. This endorsement provides a measure of assurance to a developer who is insuring title to a property that includes a zoning lot merger.

### Conclusion

Development rights deals have become far more common in New York City as creative developers continue to look for new ways to develop the land in the city and even the air above it. Accordingly, an attorney should understand both the legal context and mechanics required to effectuate such a deal. Indeed, it is an invaluable skill to acquire, as the land that the city sits on certainly won't expand, but developers' desire to build upon it undoubtedly will.

1. "Floor Area" is defined in the Zoning Resolution as "the sum of the gross areas of the several floors of a building or buildings, measured from the exterior faces of exterior walls or from the center lines of walls separating two buildings..." minus specified exclusions.  
2. In addition, the applicant must execute and record a zoning lot description and ownership statement accurately describing the lots to be merged.

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# ANNEX G

## ACORD

<b>ACORD EVIDENCE OF COMMERCIAL PROPERTY INSURANCE</b>		DATE (MM/DD/YYYY)
<b>THIS IS EVIDENCE THAT INSURANCE AS IDENTIFIED BELOW HAS BEEN ISSUED, IS IN FORCE, AND CONVEYS ALL THE RIGHTS AND PRIVILEGES AFFORDED UNDER THE POLICY.</b>		
<b>PRODUCER NAME, CONTROL PERSON AND ADDRESS</b> <small>(A/C No. Ext):</small> <small>FA#</small> <small>(A/C No):</small> <small>E-MAIL</small> <small>Address:</small>	<b>COMPANY NAME AND ADDRESS</b>   <small>IF MULTIPLE COMPANIES COMPLETE SEPARATE FORM FOR EACH</small>	<small>NAIC NO:</small>   
<small>CODE:</small> <small>AGENCY CUSTOMER ID #:</small>	<small>SUB CODE:</small> <small>NAMED INSURED AND ADDRESS</small>	<small>LOAN NUMBER</small> <small>POLICY NUMBER</small> <small>EFFECTIVE DATE</small> <small>EXPIRATION DATE</small> <input type="checkbox"/> <small>CONTINUED UNTIL TERMINATED IF CHECKED</small>
<small>ADDITIONAL NAMED INSURED(S)</small>		<small>THIS REPLACES PRIOR EVIDENCE DATED:</small>
<b>PROPERTY INFORMATION (Use additional sheets if more space is required)</b>		
LOCATION/DESCRIPTION		
<b>COVERAGE INFORMATION</b>		
<small>CAUSE OF LOSS FORM</small>	<input type="checkbox"/> <small>BASIC</small>	<input type="checkbox"/> <small>BROAD</small>
<input type="checkbox"/> <small>SPECIAL</small>	<input type="checkbox"/> <small>OTHER</small>	
COMMERCIAL PROPERTY COVERAGE AMOUNT OF INSURANCE: \$		DED:
<input type="checkbox"/> <small>YES</small>	<input type="checkbox"/> <small>NO</small>	
<b>BUSINESS INCOME / RENTAL VALUE</b>		<small>IF YES, LIMIT: Actual Loss Sustained # of months:</small>
<b>BLANKET COVERAGE</b>		<small>IF YES, indicate amount of insurance on properties identified above: \$</small>
<b>TERRORISM COVERAGE</b>		<small>Attach signed Disclosure Notice / DEC</small>
<small>IS COVERAGE PROVIDED FOR "CERTIFIED ACTS" ONLY?</small>		<small>IF YES, SUB LIMIT: DED:</small>
<small>IS COVERAGE A STAND ALONE POLICY?</small>		<small>IF YES, LIMIT: DED:</small>
<small>DOES COVERAGE INCLUDE DOMESTIC TERRORISM?</small>		<small>IF YES, SUB LIMIT: DED:</small>
<b>COVERAGE FOR MOLD</b>		<small>IF YES, LIMIT: DED:</small>
<small>MOLD EXCLUSION (If "YES", specify organization's form used)</small>		
<b>REPLACEMENT COST</b>		
<b>AGREED AMOUNT</b>		
<b>COINSURANCE</b>		
		<small>IF YES, %</small>
<b>EQUIPMENT BREAKDOWN (If Applicable)</b>		
		<small>IF YES, LIMIT: DED:</small>
<b>LAW AND ORDINANCE - Coverage for loss to undamaged portion of building</b>		
		<small>IF YES, LIMIT: DED:</small>
<small>- Demolition Costs</small>		
		<small>IF YES, LIMIT: DED:</small>
<small>- Incr. Cost of Construction</small>		
		<small>IF YES, LIMIT: DED:</small>
<b>EARTHQUAKE (If Applicable)</b>		
		<small>IF YES, LIMIT: DED:</small>
<b>FLOOD (If Applicable)</b>		
		<small>IF YES, LIMIT: DED:</small>
<b>WIND / HAIL (If Separate Policy)</b>		
		<small>IF YES, LIMIT: DED:</small>
<b>PERMISSION TO WAIVE SUBROGATION PRIOR TO LOSS</b>		
		<small>IF YES, LIMIT: DED:</small>
<b>REMARKS - Including Special Conditions (Use additional sheets if more space is required)</b>		
<b>CANCELLATION</b>		
<b>THE POLICY IS SUBJECT TO THE PREMIUMS, FORMS, AND RULES IN EFFECT FOR EACH POLICY PERIOD. SHOULD THE POLICY BE TERMINATED, THE COMPANY WILL GIVE THE ADDITIONAL INTEREST IDENTIFIED BELOW _____ DAYS WRITTEN NOTICE, AND WILL SEND NOTIFICATION OF ANY CHANGES TO THE POLICY THAT WOULD AFFECT THAT INTEREST, IN ACCORDANCE WITH THE POLICY PROVISIONS OR AS REQUIRED BY LAW.</b>		
<b>ADDITIONAL INTEREST</b>		
<small>NAME AND ADDRESS</small>   	<small>LENDER SERVICING AGENT NAME AND ADDRESS</small>   	
<input type="checkbox"/> <small>MORTGAGEE</small> <input type="checkbox"/> <small>LOSS PAYEE</small>	<small>AUTHORIZED REPRESENTATIVE</small>	
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