

A NEW DAY... OR NOT

While many of us are happy to see 2010 in our rear view mirror, progress was made in most real estate sectors. We have seen increased asset transactions in every sector and look for continued, if uneven, progress in 2011. In 2010, Willis created the Distressed Assets Practice, which aligned Willis specialists in real estate, construction, financial services, environmental, and mergers and acquisitions to bring together and coordinate the right resources to meet this growing market need.

There is continued discussion by underwriters regarding the end to the soft market; however, our market outlook has found no evidence to support such a forecast, although the anticipated RMS Version 11.0 release for modeling U.S. hurricanes may cause substantial increases in modeled losses for specific geographic areas.

In this edition of *Views*, we continue to monitor the state of the insurance market and the recovery of the hotel industry. In addition, we announce the nationwide availability of Willis' proprietary 5 STAR Apartment Insurance Program and provide articles on bedbugs, IRS reporting requirements for health care costs, the FEMA remapping project, CAT Modeling and the legislative initiatives driving sustainable, energy-efficient buildings. Finally, we provide Colorado State University's latest prediction for an above-average 2011 hurricane season.

Views continues to strive to provide our readers with articles that contain practical and actionable information. Please let us know what content you would like to see in our next edition.

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MARKET TRENDS UPDATE

Some believed that the early 2010 earthquakes in Haiti and Chile and an active winter storm season in North America and Europe would lead to a hardening of rates, or at least no further reductions. While these events were tragic, they did not alter the pricing landscape, which remained soft throughout 2010.

Some also believed that the 2010 hurricane season, which ran from June 1 to December 1, might precipitate a change in market direction. Although the season was the second most active on record, with 19 named storms, 12 hurricanes and five major ones ranked Category 3 or higher, none made landfall in the U.S., thus making the 2010 hurricane season the fifth consecutive year where the amount of insured losses related to hurricanes was well within the industry's ability to absorb them without raising rates across the board. This five-year period has contributed to a large build up in policyholder surplus.¹

A recent National Underwriter headline summarizes it nicely: "2010 now on target to be a profitable year for P&C insurers." As of September 30 the industry surplus had grown to \$545 billion up from \$491 billion year over year. Nine-month net income rose \$10.2 billion to \$26.7 billion and the nine-month combined ratio stood at a very manageable 101.2%.²

The absence of surplus-depleting catastrophe losses, the sustained increase in surplus, the reduced demand caused by the recession and a competitive reinsurance market all portend a continuation of the soft market. Willis RE reported that rates for the January 1 treaty renewals were down for both U.S. and global accounts.

There were signs throughout 2010 that the size of rate reductions had stabilized. A Moody's report stated "the magnitude of average price drops had decreased from a level of minus 5% in November 2009 to smaller declines averaging 3% in the period May to July 2010. The November 2010 barometer dipped to minus 5%."⁴

Some analysts believe the industry is overcapitalized. A Morgan Stanley report stated "P&C excess capital is at \$100 billion, an all time high."³

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Some believe that the continuing soft market will end soon. They point to the following to explain that position:

- 1)** The 10-year bond is under 2.5% and, according to William Berkley, Chairman and CEO of W.R.Berkley, "you cannot make adequate investment returns."⁵
- 2)** Reserve redundancies, which have been taken down by many carriers for three years, are now at levels that make any further take-downs less likely.
- 3)** The continuation of a low interest rate environment will impact future earnings as maturing bonds will be reinvested at lower yields. Craig Mense, the CFO of CNA Financial, stated "to the extent rates remain low for an extended period, the choice is

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either to accept a lower return on capital or seek higher profitability from premiums collected.”⁶ Travelers estimated that, if today’s low interest rate environment persists, their after-tax investment income would fall by \$49 million in 2011, \$108 million in 2012 and \$162 million in 2013.⁷

- 4) Municipal bonds account for approximately 30% of P&C Insurer’s investment assets. States may face a \$ 140 billion shortfall for 2012 according to The Center on Budget and Policy Priorities.⁸ The *Wall Street Journal* reported that “many investors take comfort in the fact that few muni issuers ever default but concerns are growing.”⁹

While P&C rates continue their softening trend, medical rates continue to climb. Depending on the size of the account, many buyers saw rate increases of 6% to 20% according to The Council of Insurance Agents & Brokers Employee Benefits Market Survey.¹⁰

Ken Crerar, the president of CIAB, stated “there is no question that the services of brokers have been in high demand since the passage of health care reform and many are concerned about the lack of flexibility among carriers. There is a lot of confusion due to the slow or prolonged implementation schedule.”¹¹

The Willis Human Capital Practice is uniquely qualified to guide our clients through both the hardening market and implementation of the Health Care Reform Act. Their objective is to “reduce costs, take work off your desk and communicate with your employees.” We can now add “help you navigate through the complex and controversial Health Care Reform Legislation.”

Willis, both our P&C and Human Capital Practice Professionals, are reading the pulse of the marketplace. We do not create the market, we manage it. Our brokers understand how to achieve the optimal results in this complex and dynamic marketplace partnering with our clients and insurers to develop programs that best respond to our clients’ needs.

HOTEL INDUSTRY UPDATE

Most signs are pointing to an improving hotel industry. For 2010, Revenue Per Available Room (RevPar), a key industry metric, for the top 25 markets rose to \$76.61, up from \$71.55. The U.S. hotel occupancy rate nationally averaged 57.9% through October 2010, up 11.7% from the same period a year earlier. In July of last year hotels sold 102 million room nights, the most room nights ever sold in one month. As the economy improves, the fortunes of the hotel industry improve with an increase in both business and leisure travel.¹²

One measure of the relative health of a real estate sector is the amount of deal flow, or transactions. According to industry data, 666 hotels were sold in 2010, up from 157 transactions in 2009. Some predict that we will see a 25% increase year over year in deal flow in 2011.¹³

REITS were the biggest buyers of hotels in 2010, accounting for 58% of all lodging acquisitions last year. One REIT, which forfeited 10 hotels in the past two years, is now looking to invest up to \$1 billion in acquisitions.¹⁴

Private equity funds are also looking for hotel acquisitions. Jim Butler Chairman of the

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Hotel Industry Update – continued from page 3

Global Hospitality Group at the law firm Jeffer, Mangels Butler & Mitchell, stated “I have never in my entire career seen so much equity on the sidelines ready to pounce.”¹⁵

Fueling the likelihood of more hotel transactions is the large amount of debt coming due in 2011 and 2012. Many expect it will be difficult to refinance this maturing debt.

Banks have been reluctant to foreclose as they need to write down the value of the asset which could cause them to raise additional capital to meet regulatory capital requirements. This practice known as extend and pretend “cannot go on indefinitely” according to Jim Butler.¹⁶

We expect 2011 to be a year the hotel industry continues to recover from the worst downturn it has ever experienced. We also expect there to be a large number of hotel transactions with REITS and private equity firms being the biggest buyers. In some cases these deals will fall into the category of distressed asset acquisitions.

The hotel industry will continue to have complex insurance needs. Emerging issues such as cyber risk and the impact of the health care reform legislation will need to be effectively managed.

The soft insurance market, for most buyers, and the improving fortunes of the hotel industry create an opportune time to conduct a comprehensive assessment of risk. The Willis Real Estate and Hotel Practice, working with our colleagues in our Distressed Assets, Human Capital, Environmental, Cyber Risk, Mergers and Acquisitions and Financial Services Practices, is uniquely capable of helping our clients identify risk and propose appropriate and cost-effective methods to manage it.

5 STAR GOES NATIONAL

We are excited to announce that the 5 STAR Apartment Insurance Program has recently been approved by Fannie Mae. In May of 2010, Fannie Mae released updated insurance requirements prohibiting the use of purchasing groups.* The new criteria require all purchasing groups to be vetted by Fannie Mae for approval. In November 2010, 5 STAR received approval.

The 5 STAR program is exclusive to Willis North America offices and offers Property, Boiler & Machinery, first dollar Liability and \$25,000,000 Umbrella coverage for qualified apartment risks.

The aspect of this program that sets it apart from others is the loss control service that is built into it. 5 STAR Loss Control® is a specific method designed for apartments that includes very practical tools for management and maintenance personnel to use in administering a proactive risk management program. Site managers are supported by loss control professionals and receive monthly emails with preventative techniques outlined.



The program is managed by Willis Associate, Andra Tipton. She has been writing and servicing multi-family risks for over 15 years. Another plus with this program is that it is offered through local Willis offices across the U.S. Clients are able to continue to work directly with the Willis Client Advocate team they have already come to trust and who know their needs.

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Eligibility for the program is very broad. Basically, we are looking for “best in class.” That doesn’t mean we only want new construction or high-end apartments. It does mean that we want to work with owners and managers that see the benefit of being proactive with loss control and preventative maintenance. A short list of ineligible risks follows:

- Aluminum wiring unless mitigated by pigtailing or installation of CO/ALR devices
- No Wind in first and second tier counties including the entire state of Florida
- No Earthquake in California
- Single-family dwellings and duplexes
- Assisted living or nursing care facilities

We do write:

- Garden-style apartments
- High-rise apartments
- Tax credit affordable housing
- Student housing (Property only)
- Senior housing
- Condominium associations (Property only)
- All construction types
- All ages

Key liability coverage highlights include:

- No deductible or Self-Insured Retention
- Blanket named insured wording to include any individual or entity with ownership interest in the subject location
- Lenders and managers as additional insured
- Blanket Waiver of Subrogation
- Per location aggregate on GL and Excess Liability
- Non-owned and Hired Auto included in GL
- \$25,000,000 Excess Liability limit

Key property coverage highlights include:

- All risk of direct physical loss, subject to form exclusions and limitations
- \$10,000 All Peril deductible except \$25,000 Wind, Hail, Flood and Quake
- Building Ordinance
- 180 Days Extended Period of Indemnity Rents (365 days available)
- TRIA included
- Equipment Breakdown (\$5,000 deductible)
- Back-up of sewers and drains
- Replacement cost valuation with no coinsurance

The application process has been simplified to a single-page questionnaire for each location and loss information to obtain a quote. For additional information, please contact your Willis representative.

*Information provided by a Fannie Mae loan servicer



BEDBUG AWARENESS

Troublesome things come in small packages. We all have noticed in recent months an increase in media coverage of bedbug infestation. Whether there is an *actual* increase in infestations or just an increase in awareness and reporting has yet to be determined. One theory is that restrictions on the use of DDT and other insecticides have led to unchecked growth in the bedbug population.

Almost every kind of occupancy has been plagued by these little critters. They are becoming incredibly well traveled and seem to enjoy air travel, the arts and shopping, since Lincoln Center in New York City and several large department stores have also reported

infestations. We have also read of numerous real estate purchases and leases that have been delayed or even cancelled until various issues regarding responsibility have been sorted out between the interested parties. Is it the landlord's or tenant's problem? Does the responsibility fall to the condo association or the individual owner?

The jury is still out on how the law and insurance will respond to these situations. Obviously, the application of the law will vary from jurisdiction to jurisdiction. New legislation to address this situation is being discussed. For example, the New York State Legislature is discussing legislation that would require insurance companies to offer their insureds coverage to address this problem, but the direction this discussion will take is still uncertain.

From the first-party property insurance perspective, there is a

serious question as to whether the presence of bedbugs is an occurrence of loss and damage under a policy. Also, most commercial policies have a vermin and insect exclusion. Insurers tend to look at these outbreaks as "maintenance" situations and not subject to coverage. From the Liability and Workers' Compensation perspectives, insurers will need to respond to the barrage of claims and suits that are sure to follow.

Louisiana State University and the CDC seem to be leading the charge in determining the most effective methods of remediation – operational effectiveness does not necessarily equate to cost effectiveness. There are two schools of thought regarding remediation. The most popular is to utilize extreme heat. Current thinking is that the affected area, which includes behind walls, needs to be subjected to between 130 and 160 degrees Fahrenheit for 12 to 24 hours. In an occupancy such as a hotel, this could be time-consuming and costly as rooms would need to be treated individually. Another method being proposed utilizes cold CO₂ and is disbursed from fire extinguisher-type equipment. The cost for an average size hotel room is approximately \$300 per room. However the room on either side of the infested space needs to be remediated also. Hepa vacuuming and other cleaning of the space following the extermination will be required also, so the cost of a large remediation project can be significant. Any calculation of cost also needs to take into consideration the loss of revenue while the property is being remediated.

Unless you operate furnaces or freezers that can generate the extreme temperatures required, you may be vulnerable. Any remediation should be done by a licensed and experienced exterminator or remediation contractor. We strongly suggest you develop a plan to deal with the remediation and removal of the insects as well as the best way to deal with employees, customers and any visitors to your premises. Numerous consultants and contractors exist to assist you in developing plans for remediation and management of the various issues associated with this problem.

Just because they're small doesn't mean they can't give you a big headache.

For more information contact your Willis representative.

The increase in bedbugs has also resulted in an increase in lawsuits against owners and managers of hotels and apartments. Hoteliers and landlords generally owe their guest or tenant a living space that is free from pest infestations. This duty is commonly referred to as the "implied warranty of habitability" and varies by state. As in most third-party liability actions, damages increase if the guest or tenant can prove that the property owner knew of the infestation but did not take reasonable steps to protect the claimant.



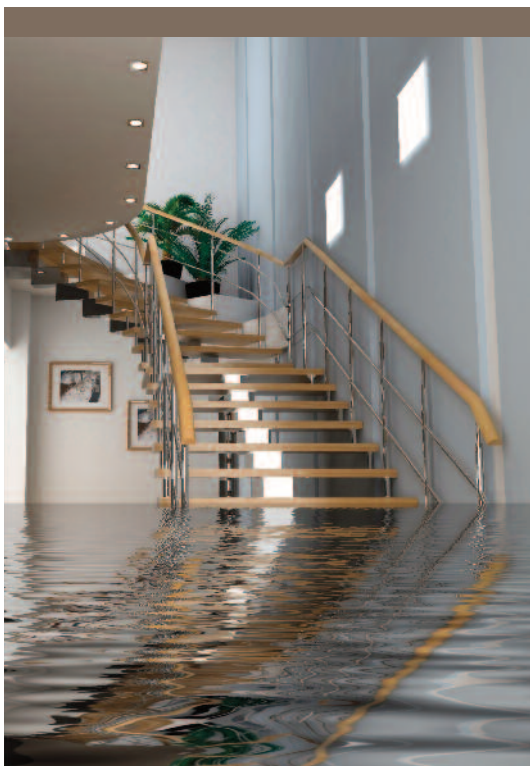
IRS: W-2 REPORTING OF HEALTH COVERAGE IS OPTIONAL FOR 2011

Internal Revenue Service (IRS) **Notice 2010-69** is short and simple: W-2s issued for 2011 do not need to include the cost of health coverage provided by the employer during the year. Reporting those amounts is optional for coverage provided in 2011, and an employer “will not be subject to any penalties...merely because it does not report the aggregate cost of employer-sponsored coverage...on Forms W-2 issued for 2011.”

The Patient Protection and Affordable Care Act (PPACA) included a requirement that employers report the value of the health coverage they provide to employees on the W-2s they issue to employees, and that requirement was set to become effective for W-2s reporting pay during 2011 (i.e., the W-2s that generally will be issued in January 2012). This requirement caused considerable confusion, however, for employers trying to program payroll systems for 2011. Identifying exactly which coverage and exactly what amounts need to be reported was difficult, and guidance on these points never materialized. The notice explains that relief from the requirement for 2011 “is appropriate to provide employers with additional time to make any necessary changes to their payroll systems or procedures in preparation for compliance with the reporting requirement.”

The IRS has been very clear that the reporting is for information purposes only “to show employees the value of their health care benefits so they can be more informed consumers.” Currently, the amounts for employer-provided medical benefits that an employer reports on an employee’s W-2 are not included in the employee’s taxable income (although it is certainly possible that the underlying tax treatment of employer-provided medical benefits could change in the future).

The Willis Human Capital Practice offers a broad array of Health Care Reform-related tools, publications and presentations. We invite you to [click here](#) to review the archive of available information. This site is updated regularly as new developments occur and new guidance published, so please check back often.



SURPRISE! YOU ARE IN A FLOOD ZONE

The Federal Emergency Management Agency (FEMA) is in the process of updating its U.S. flood maps. FEMA has stated that it expects to complete this project by 2014. This remapping project presents several challenges in terms of how a policy holder’s existing insurance program may respond after a loss:

- Which flood deductibles and limits will apply if a property’s status is changed to a Special Flood Zone Hazard Area (SFHA) during the policy term?
- Some insurance companies are allowing their adjusters to determine flood zone status after a loss by expanding the definition of a flood zone to include any exposure within 1,000 feet of the insured property.

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- Vendors of flood exposure software used by insurance brokers, insurance underwriters and lenders state in their terms of service that their product could have an error of up to 3%. This inherent error could affect 300 properties within a large portfolio comprised of 10,000 locations.

In addition, definitions as to what constitutes a high or moderate flood zone or a location can differ among insurance company policy forms. These issues point to the need to achieve better contract certainty before a loss occurs as the financial consequences can be significant. The National Property Practice in a November 2010 *Property Perspectives* article, “Ensuring Your Flood Coverage Will Respond When You Need It,” addresses these issues and is available by [clicking here](#).

For more information contact Jim Costner at 612 872 3421 or james.costner@willis.com.

SINGLE SITE VS. PORTFOLIO PML ANALYSIS

There are various ways to go about developing a PML analysis and in this article we will discuss two: a single-site engineering analysis and the portfolio-based desktop analysis. Each method has its strengths and they can be used jointly to help understand the risk.

In a single-site study an engineer will usually start with a site visit and plan review. During this phase valuable information is collected, ranging from the standard COPE information to verification of the original structural design and any upgrades or retrofits that might have taken place since the original construction date. The engineer will then look at the various faults in the surrounding area and from this list of faults will choose one and its attributes that fit a given return period. With these values in hand they will calculate a SEL/PML value.

In a portfolio-based analysis the basic COPE information is supplied and imported into the desktop model. Once the information has been imported, the model begins to run thousands of possible events against the location(s), then it takes the losses and orders them from highest to lowest to derive the exceedance of probability curve. From this curve we can look at various loss

amounts and the probability of exceeding the loss. This can be done for a single site or thousands of sites.

Each of the analysis methods above has its merits, but when trying to determine a portfolio PML it is best to use the portfolio-based models. Unlike the single-site model, which determines a loss for one site and a given event, the portfolio-based analysis looks at all sites and how multiple events might affect one or multiple sites. When looking at multiple sites the software runs multiple events against multiple sites taking into account each site’s characteristics, such as soil conditions, COPE information, distance to the event, to determine a loss for the sites affected by the event. Once again it runs thousands of possible events and then orders them from highest to lowest to determine the probability of

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exceeding the loss level. In a single-site analysis you would have no way to determine how an event would affect multiple sites. You would not want to aggregate the single-site results because each site's PML event is different and the probability of it being the same for multiple locations is highly unlikely. Therefore you would overstate your loss. For example: if you had a location in Oakland and one in San Francisco, each would have a different controlling fault that would create its

PML. The likelihood of both of these events occurring is very unlikely, but an event on one fault could cause damage to both locations, each site's loss based on its characteristic and distance from the event, not the sum of two different events. This is one example of the sum of the parts not being equal to the whole.

In conclusion, when dealing with numerous locations, a portfolio-based analysis will give a more realistic and reasonable loss estimate.

For more information contact Ben Philips, Manager, CAT Modeling, at 650 349 4010 or ben.philips@willis.com.



SUSTAINABILITY - IT'S THE LAW!

LEGISLATIVE REQUIREMENTS NOW DRIVE THE GREEN REAL ESTATE INDUSTRY

The movement toward sustainable, energy-efficient buildings has experienced tremendous growth over the last few years, though it has never been immune to doubters. Reluctance to value and adopt the practice of operating buildings efficiently, however, will soon become a moot point in the face of green legislation emerging countrywide.

While the federal government has been slow to enact policy initiatives mandating sustainable practices, state and local governments now understand that the

environmental benefits of energy-efficient buildings are matched by the economic benefits. In the commercial real estate sector, legal and regulatory mandates are driving the inclusion of energy and sustainability issues into transaction due diligence. Currently, environmental site assessment (ESA) and property condition assessment (PCA) due diligence is routinely conducted in such transactions to avoid liability. Energy and sustainability due diligence, however, is used to identify opportunities to reduce cost and increase asset value.

California and Washington, along with four major cities – New York, Austin, Seattle and Washington D.C. – have passed legislation requiring energy performance benchmarking, rating and disclosure

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for privately owned commercial buildings, which in turn has a significant impact on U.S. property markets. In New York alone, the recently passed Greener, Greater Buildings Plan affects both residential and commercial buildings over 50,000 square feet (which equates to roughly 22,000 buildings totaling nearly 2.6 billion square feet of floor space), mandating that they must benchmark their energy usage by May 1, 2011 in order to gain a publicly disclosed rating through the Energy Star Portfolio Manager program. In Seattle, almost 9,000 buildings totaling 150 million square feet and 93,800 multifamily units will be affected by new regulations. In California, a building's energy rating must be disclosed to counterparties when it is involved in a sale, lease or financing transaction beginning in 2011. Additional energy-rating policy activities are underway in over half a dozen jurisdictions, with a proliferation of rating policies likely emerging at the federal level in coming years.

As a result, the market for companies that provide sustainability and energy efficiency services for real estate has evolved into one that also helps real estate owners and managers comply with sustainability legislation. Legislative compliance has created what can be considered a mandated opportunity for buildings, real estate portfolios and REITS to take steps towards improving asset performance and value. Benchmarking policy, such as Local Law 84 in New York City, mandates that buildings create a baseline for their energy usage from which to improve, while comparing their energy performance to a database of similar buildings. For sustainability services firms, benchmarking is already the first necessary step to both understand building performance and to identify cost-effective opportunities for improvement based on ROI analysis.

Moreover, much of the legislation sweeping the country is coupled with government incentive programs to help building owners pay for sustainability initiatives. In New York City, as much as 50% of the price to perform energy audits can be rebated by the New York State Energy Research Development Authority (NYSERDA) for commercial buildings. As energy legislation rapidly spreads throughout the country with government money available, and as long as firms such as Ecological continue to provide compliance while facilitating access to those incentives, real estate owners can seize the opportunity to translate energy due diligence into realized asset value.

Property owners need to ensure that their property insurance policies provide the proper coverage to respond to this dynamic, as many carriers have forms to address the movement toward LEED, Sustainability and the Green Movement. Should you have any questions on how this type of insurance program can be implemented at your company, please contact your Willis Client Advocate®. For more information on building sustainability compliance, contact Joe Grano, Marketing Director for Ecological Group at 212 292 3125 or jgrano@ecologicalgroup.com. **Click here** for more information concerning Ecological's sustainability services.

California and Washington, along with four major cities - New York, Austin, Seattle and Washington D.C. - have passed legislation requiring energy performance benchmarking, rating and disclosure for privately owned commercial buildings, which in turn has a significant impact on U.S. property markets.

2011 HURRICANE SEASON

Philip Klotzbach, William Gray and their team at Colorado State University (CSU) issued their initial 2011 Atlantic Basin hurricane forecast on December 8, 2010. 2011 hurricane season activity is predicted to again be above the 50-year average. CSU has predicted 17 named tropical storms and nine hurricanes, of which five could be major. The probability of at least one major hurricane (Category 3+) striking the U.S. has been set at 73% compared to the last century average of 52%. A 49% probability of a major hurricane striking the U.S. east coast, including Florida, and a 48% probability for the Gulf

coast from the Florida panhandle to Brownsville, Texas has also been predicted compared to their respective long-term averages of 31% and 30%.

The following table compares the updated 2011 forecast to the 2010 actual activity and the 50-year average.

| | 2011 (12/10) | 2010 Actual | 1950-2000 Avg. |
|-------------------------|--------------|-------------|----------------|
| Tropical Storms | 17 | 19 | 9.6 |
| Hurricanes | 9 | 12 | 5.9 |
| Major Hurricanes | 5 | 5 | 2.3 |

The forecast notes that there is significant uncertainty regarding what ENSO conditions will exist next year. The CSU team acknowledges that for the past 19 years of issuing early-December forecasts, they have yet to demonstrate real-time forecast skill. They have, on the other hand, demonstrated significant real-time forecasting skill with their early June and early August predictions.

The initial 2011 forecast is available by [clicking here](#). Revised 2011 forecasts will be made on June 1 and August 3.

CONTACTS

For additional information on the topics discussed in this issue, or any others for which our Real Estate & Hotel Practice might provide assistance, please visit our [website](#) at [willis.com](#).

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¹ *National Underwriter*, Dec. 20, 2010, Ed. 27, p.25.

² *Ibid* p.6

³ *National Underwriter*, July 19, 2010, p.6.

⁴ *National Underwriter*, Dec. 20, 2010, Ed. 27, p. 6.

⁵ *National Underwriter*, Nov. 22-Nov. 29, 2010

⁶ *Wall Street Journal*, Nov. 8, 2010.

⁷ *Ibid*.

⁸ *Wall Street Journal*, November 22, 2010.

⁹ *Ibid*.

¹⁰ *National Underwriter*, Dec. 13, 2010, p. 7.

¹¹ *Ibid*.

¹² *New York Times*, Dec. 5, 2010.

¹³ *Crain's New York Business*, Jan. 14, 2011.

¹⁴ *National Real Estate Investor*, Nov. – Dec. 2010, p. 15.

¹⁵ *New York Times*, Dec. 5, 2010.

¹⁶ *Ibid*.