CHAPTER 191

INSURANCE FOR ACTS OF TERRORISM

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SCOPE OF CHAPTER

This chapter discusses insurance case law arising from acts of terrorism, including those arising from the September 11 attacks. It analyzes the Terrorism Risk Insurance Act of 2002 (TRIA), as amended by the Terrorism Risk Insurance Act of 2005 and the Terrorism Risk Insurance Program Reauthorization Act of 2007, as well as the administrative program created by the legislation. Examples are provided and NAIC Policyholder Disclosure Notice forms are included. Policy considerations surrounding TRIA are also discussed including insurance industry strategies, the difficulties of assessing terrorism risks, the effect of TRIA subsidized insurance on the market, and the benefits and problems such subsidized insurance engender.

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§ 191.01 Terrorism Risk

[A] Insurance Paradigm Before September 11, 2001

Before the terrorist attacks of September 11, 2001, the insurance industry did not consider terrorism as a special risk in the nature of natural catastrophes such as earthquakes and hurricanes, or potentially large scale events like a nuclear disaster. For these exceptional risks, insurers typically charge a separate premium or exclude the risk altogether, because the risk is either considered too great to underwrite or too correlative to effectively spread it. The conventional wisdom in the insurance industry was that terrorism posed a discrete risk of low intensity, high visibility violence, the type of risk that insurers could easily assume. Terrorism was unique, perhaps from the standpoint of a media event and public shock, but not so much different from other ordinary fortuitous events from the standpoint of insurance underwriting.

Before September 11, the paradigm cases of terrorism were the killing of Israeli athletes during the 1972 Munich Olympics and the 1988 bombing of Pan Am 103 over Lockerbie, Scotland. Consistent with this assumption, the actuarial and pricing models did not consider terrorism as an extraordinary risk in the same category of nuclear contamination, war loss, or earthquake loss for which either the risk is excluded or additional premiums are collected.[1] Insurers implicitly covered terrorism risk in most "all risk" policies because they did not specifically exclude it.[2] Nor did reinsurers specially carve out the risk in their treaties. Insurers considered the risk to be so small that it was covered for "free."[3]

These actuarial assumptions continued as terrorism was slowly brewing into a major problem over the course of several decades. The 1990s ushered in

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[1] *See, e.g.*, **Cal.**— Int'l Dairy Eng'g Co. of Asia v. Am. Home Assurance Co., 352 F. Supp. 827 (N.D. Cal. 1970). Certain risks are considered so high that, without an additional premium, insurers regularly exclude them, e.g., the war risk loss and nuclear hazard exclusions. 352 F. Supp. at 828. Without an additional premium, most policies exclude risks of loss due to war and nuclear, biological or chemical contamination.

See also **N.Y.**—Zen Cont'l Co. v. Intercargo Ins. Co., 151 F. Supp. 2d 250, 253 (S.D.N.Y. 2001).

[2] **U.S.**— City of Burlington v. Indem. Ins. Co. of N. Am., 332 F.3d 38 (2d Cir. 2003). An "all risk" policy covers all contingencies except those specifically excluded. 352 F.3d at 41.

[3] U.S. Gen. Accounting Office, Terrorism Insurance: Implementation of the Terrorism Risk Insurance Act of 2002, at 5 (2004).

See, e.g., **N.Y.**—Four Times Square Assocs., LLC v. Cigna Invs., Inc., 306 A.D.2d 4, 5, 764 N.Y.S.2d 1 (2003) ("all risk" policies included acts of terrorism since terrorism was not specifically excluded).

See also Dan L. Crippen, Cong. Budget Office, A CBO Study: Federal Reinsurance For Disasters 11 (2002) ("Prior to September 11, terrorism insurance was provided only implicitly; that is, most existing policies did not explicitly include or exclude losses from terrorism."); Dan Miller, Report to the Joint Econ. Comm. of U.S. Congress, Economic Perspectives on Terrorism Insurance 3 (2002) (most policies "automatically covered" from terrorism).

the era of catastrophic terrorism, with the phenomenon first taking root in Western Europe. Arguably the first catastrophic, non-airline related terrorist act occurred when the Irish Republican Army (IRA) bombed London on April 21, 1992, causing $671 million in insurance losses.[4] Subsequently, on February 26, 1993, Islamic terrorists bombed the World Trade Center and caused losses of $725 million.[5] On April 24, 1993, IRA terrorists again bombed London and caused $907 million in losses.[6] On April 19, 1995, American terrorists bombed the Alfred P. Murrah Building in Oklahoma City and caused $145 million in losses.[7] On June 15, 1996, IRA terrorists bombed Manchester, UK, and caused $744 million in losses.[8] In hindsight, these events formed a consistent trend that would culminate in the September 11 attacks.

In a prescient assessment, Swiss Re wrote in 1993: "A single bomb attack can kill thousands of people, cause several billion dollars of damage and paralyse entire branches of industry. . . . [and] lay entire cities to waste."[9] And, in a 1999 report, the U.S. Commission on National Security chillingly warned that "Americans will likely die on American soil, possibly in large numbers."[10] Contrary to popular belief, the attacks of September 11 did not beget a new awareness of catastrophic terrorism risk. Scholars and policymakers warned of such risks before and industry leaders were aware of the potentially massive exposure to terrorism long before al Qaeda acquired its infamy.[11] In the years before September 11, the insurance industry considered many eventualities. In fact, insurers considered as "possible" an airplane crashing into a building in a high density urban center but dismissed the risk as not "probable."[12]

This account is not to suggest that September 11 should have been expected. The losses from September 11 were many folds more severe than the largest previous loss from terrorism. Without previous experience to verify or validate an extrapolation of then existing data, the insurance industry would have had to overcome the natural tendency of humans to discount to virtually zero the possibility of a remote risk.[13]

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4 Auriela Zanetti et al., Swiss Re, Sigma No. 1/2002, Natural Catastrophes and Man-Made Disasters in 2001: Man-Made Losses Take on a New Dimension, at 17 tbl. 4 (Thomas Hess ed., 2002) (indexed to 2001 value).

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.*

9 Swiss Re, Terrorism and Insurance 3 (1993).

10 U.S. Comm. On Nat'l Sec., 21st Century Nat'l Sec. Study Group, New World Coming: American Security in the 21st Century 4 (1999) (commission chaired by former U.S. Senators Warren Rudman and Gary Hart).

11 *See* Am. Acad. of Actuaries, Public Policy Monograph, Terrorism Insurance Coverage in the Aftermath of September 11th, at 7 (2002) ("extreme terrorist events have had a certain amount of theoretical attention in academia"); The U.S. Comm. on Nat'l Sec., 21st Century Nat'l Sec. Study Group, New World Coming: American Security in the 21st Century, at 4 (1999).

12 Munich Re, 11 September 2001 11 (2001).

13 *See* Richard A. Posner, Catastrophe: Risk and Response 168 (2004) (noting "the inability of many, maybe most, people, much of the time, to respond rationally to very-low-probability risks").

[B] Attacks of September 11 and Their Aftermath

The attacks of September 11 are unprecedented in insurance history. In a single series of attacks, al Qaeda terrorists killed approximately 3000 people, displaced over 1025 businesses employing more than 75,000 people, disrupted another 18,000 businesses employing 563,000 people,[14] inflicted about $36 billion in insured losses,[15] and another $50 billion more in uninsured losses.[16] These figures do not include the indirect economic costs stemming from the attacks, which struck at a time when the country was experiencing an economic slowdown after the collapse of the internet and technology market bubble. September 11 was not only the largest terrorist attack in history in terms of economic loss, but it was also the largest single event insurance loss.

Almost immediately, there were questions whether the insurance industry would invoke the war loss exclusion found in most policies.[17] The invocation of the war and sovereign act exclusions would have been plausible because there was a perception of a close connection between al Qaeda and the Taliban government of Afghanistan, which gave al Qaeda sanctuary in the country and perhaps had financial, governmental and policy dealings with al Qaeda. It is unclear how successful this argument would have been. The factual case would have been complex and difficult to make, and ultimately insurers would have faced highly skeptical jurors and judges who probably would not have been able to fully disassociate their deliberation from the national crisis at hand.

Perhaps more significantly, however plausible the legal strategy may have been, at least in terms of the isolated legal issue of contract interpretation, an industry-wide denial of claims would have been a highly risky business strategy. There would certainly have been a massive political and public backlash that ultimately would have extracted legal, political, and reputational costs far greater than the insurances losses. And, it would have been untenable to lobby for new legislation, such as the Terrorism Risk Insurance Act of 2002 ("TRIA"), that the insurance industry believed it would need to limit exposure to catastrophic terrorism.

Given these realities of practical politics, insurers made the right business decision under the circumstances and quickly announced that the industry would not invoke the war loss exclusion.[18] Indeed, the insurance industry

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14 Lloyd Dixon & Rachel Kaganoff Stern, RAND Institute for Civil Justice, Compensation for Losses from the 9/11 Attacks 15, 103 (2004).

15 Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 1 (Aug. 2007).

16 *See* U.S. Gen. Accounting Office, Catastrophic Insurance Risks: Status of Efforts to Securitize Natural Catastrophe and Terrorism Risk 1 (2003) ($80 billion).

17 Doyle McManus & James Gerstenzang, *America Attacked: The Political Response*, L.A. Times, Sept. 13, 2001, at A1.

18 *See, e.g., After the Attack: "Act of War" Exclusion Doesn't Apply to Attacks, Insurers Say*, L.A. Times, Sept. 17, 2001, at C3; Tom Hamburger & Christopher Oster, *Insurance Industry Backs U.S. Terrorism Fund*, Wall St. J., Oct. 9, 2001, at A3.

associated a certain degree of patriotism with its coverage decision.[19] However, insurers made the concession with the caveat that they could dispute ordinary coverage issues. These cases produced a volume of litigation and case law, the most important surrounding the insurance coverage of the World Trade Center,[20] which was significantly underinsured from the perspective of total loss.[21]

Historically, the industry reacts to an event shock by withdrawing from the market. The last such shocks were Hurricane Andrew in 1992 and the Northridge earthquake in 1994, which precipitated a withdrawal from the market by reinsurers. This in turn led to dramatic price increases in the short term,[22] but as the industry recapitalized the market eventually went into a soft price cycle for much of the 1990s. In the case of September 11, Secretary of Treasury Paul O'Neill summarized the economic reality of the situation: "Because insurance companies do not know the upper bound of terrorism risk exposure, they will protect themselves by charging enormous premiums, dramatically curtailing coverage or—as we have already seen with terrorism risk exclusions—simply refusing to offer the coverage."[23]

After an industry shock, the first to exit the market are reinsurers. Reinsurance provides additional capital to insurers and thus increases underwriting capacity. Because reinsurers are unregulated, they can enter and exit markets at will. In the case of 9/11, reinsurers bore the majority of the losses.[24] Unlike primary insurance policies which are renewed throughout the year, reinsurance treaties are typically renewed on a January-July insurance cycle. As much as 70% of reinsurance treaties came up for renewal during the

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19 Richard Allyn & Heather McNeff, *The Fall and Rise of Terrorism Insurance Coverage Since September 11, 2001*, 29 Wm. Mitchell L. Rev. 821, 828 n.41 (2003) (noting the testimony of Ronald E. Ferguson, Chairman, General Re, that he was "proud of the way [the insurance industry] stepped up to the losses of September 11th without complaint").

20 *See* § 191.02[B] *below* (discussing September 11 related insurance case law).

21 The World Trade Centers were insured for $3.55 billion per occurrence. *See* Dixon & Stern, note 14 *above*, at 103 (stating the replacement value estimated at $4.5 billion, and contents at $5.2 billion). *See* Mark Hamblett, *Industry Lawyers Argue WTC Was Underinsured*, N.Y.L.J., Apr. 16, 2004, at 1 (noting that lawyers for insurers argued the World Trade Center was underinsured).

22 *See* Crippen, note 3 *above*, at 3 ("[R]einsurance rates rose 75% between January 1992 and July 1994.").

23 *Terrorism Risk Insurance, Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. (2001).

24 *See* Miller, note 3 *above*, at 4 (noting that about 25% of the global reinsurance capital was wiped out in assuming a burden of 60% to 80% of the insurance losses). European and Bermuda based reinsurers took the brunt of the losses: Munich Re ($1,959 million), Swiss Re ($1,777 million), Allianz ($1,335 million), ACE ($559 million). Oxford Metrica, A Shareholder Value Analysis of the Global (Re)insurance Industry 22 (2003); R. Glenn Hubbard & Bruce Deal, Analysis Group, The Economic Effects of Federal Participation in Terrorism Risk 18 (2004) (providing similar loss figures); Howard Kunreuther & Erwann Michael-Kerjan, *Insurability of (Mega-) Terrorism Risk: Challenges and Perspectives*, *in Recent Trends in the Catastrophic Risk Insurance and Reinsurance Market*, *in* The OECD Conference on Catastrophic Risks and Insurance (Nov. 22, 2004) (noting that 9/11 losses covered by 150 insurers and reinsurers, with reinsurers being responsible for about 67% of the losses).

January 2002 reinsurance cycle, most of which were not renewed.[25] As expected, when a majority of the reinsurance treaties came up for renewal in January 2002, they were not renewed as to terrorism coverage.[26]

Without reinsurance, insurers could not limit the exposure to severe liability and had no choice but to exclude coverage. Insurers filed new exclusions with individual state regulators. Every state approved the new terrorism exclusion language, except for California, Florida, Georgia, New York, and Texas, which collectively accounted for about 35% of the commercial market.[27] The new exclusion broadly defines terrorism as the use of force that has the effect or intent to coerce a government or civilian population; and terrorism coverage is limited to losses that are $25 million or less with exclusions for losses exceeding this amount.[28] The exclusion places terrorism risk squarely on the shoulders of commercial policyholders and their financiers.

Reduced capacity to underwrite terrorism risk and high premium levels for such coverage led to difficulties in transferring and spreading risk. Unless required by financial covenants or commercial lease terms, few policyholders bought terrorism coverage. The new pricing of terrorism coverage and cost-benefit perceptions of policyholders could have led to a perception of adverse selection. Those perceived to be most at risk (e.g., policyholders and financiers of trophy properties) were the most likely to purchase terrorism coverage, if such coverage was available, while lower risk policyholders would have chosen to forego expensive coverage for a minute risk of an extreme event.

September 11 disrupted the insurance market, and specifically the ability to transfer and spread terrorism risk. There was a perception that the temporary dislocation of supply and demand of insurance contributed to a slowdown in the national economy. In addition to the direct losses caused by the attacks and the immediate consequences on the airline, hotel and tourism industries, high premiums would have had a trickle down effect on the rest of the economy. Higher financing costs would have also led to higher cost of goods and services, resulting in higher prices and reduced profits.[29] One should note,

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25 *Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities: Hearing Before the House Subcomm. On Capital Mkts., Ins. & Gov't Sponsored Enters. & the Subcomm. On Oversight & Investigations, Comm. on Fin. Servs.*, 108th Cong. 4 & n.2 (2002) [hereinafter *Rising Uninsured Exposure Hearing*].

26 *Rising Uninsured Exposure Hearing*, note 25 *above*, at 2. *See also* Miller, note 3 *above*, at 4 (stating that reinsurance treaties were not renewed in January 2002); *Congress Needs to Act Fast to Avert Insurance Crisis*, Newsday, Dec. 5, 2001, at A40 ("About 70 percent of reinsurance contracts expire at [month's end], and reinsurers are threatening not to renew them.").

27 *See* Jeffrey E. Thomas, *Exclusion of Terrorist-Related Harms from Insurance Coverage: Do the Costs Justify the Benefits?*, 36 Ind. L. Rev. 397 (2003) (discussing the new terrorism exclusion).

28 *See* Am. Acad. of Actuaries, note 11 *above*, at 14–15 (quoting the new war and terrorism risk exclusions filed by ISO on behalf of the insurance industry).

29 *Terrorism Risk Insurance, Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. (2001) [hereinafter *Hearing*] ("[I]ncreased premiums and/or

however, that since only a little more than a year passed before the enactment of TRIA, which was signed on November 26, 2002, it is difficult to gauge how much costs in increased premiums and cost of capital have actually flowed down to the economy as a direct consequence of the insurance market dislocation as opposed to the economic dislocation of the terrorist act itself.

Nevertheless, the inability to obtain terrorism risk coverage did adversely and substantially affect the real estate and financing industries. The lack of coverage and higher premiums increased the cost of capital and restricted capital flow to the real estate and construction sectors.[30] Approximately $15 billion to $17 billion worth of commercial real estate loans, "representing about 10% of the CMBS [Commercial Mortgage Backed Securities] market," were suspended or cancelled due to terrorism risk and the inability of businesses to transfer the risk.[31] Commercial mortgage backed securities saw a decline in overall credit rating and prices,[32] and borrowers faced the possibility of default and loan recalls due to covenants requiring insurance coverage.[33] Lenders refused to finance billions of dollars of construction projects without terrorism coverage, resulting in significant job losses in the construction and real estate industries in an economy that was already sliding into a recession.[34]

In short, 9/11 caused substantial short-term economic damage on a national level. The insurance market was perceived to be unstable in the short-term, causing price and capacity dislocation, adverse selection of risk, concentrated risk, economic slowdown, and significant job losses. Of particular concern was the real estate and construction industries, which

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increased risk exposure for businesses . . . will be passed on to consumers in the form of higher product prices, transportation costs, energy costs and reduced production.").

30 *See Rising Uninsured Exposure Hearing*, note 25 *above*, at 2 ("[S]ome sectors of the economy—notably real estate and commercial lending—are beginning to experience difficulties because some properties and businesses are unable to find sufficient terrorism coverage, at any price."); Miller, note 3 *above*, at 1 ("As a result, a significant barrier to economic activity has been created, as businesses are forced to bear higher costs of insurance or are unable to conduct business due to financing requirements to carry terrorism insurance.").

31 Miller, note 3 *above*, at 14 & n.70 ($17 billion); THE CATO INST., POLICY FORUM, INSURING AGAINST TERROR: IS THERE A ROLE FOR GOVERNMENT REINSURANCE? 24 (2002) (citing $15 billion in 17 states); President George W. Bush, Address on the Signing of the Terrorism Insurance Act (Nov. 26, 2002) (citing $15 billion).

32 *See* Daniel B. Rubock, CMBS World, Moody's Update on Terrorism Insurance, 48 (2003) (downgrading 11 deals); Am. Acad. of Actuaries, note 11 *above*, at 6 (lenders reluctant "to finance projects of $100 million or more" and to invest in single asset CMBS bonds).

33 *See Rising Uninsured Exposure Hearing*, note 25 *above*, at 11.

34 *See* Gary Embleton & Kelley Bernal, Gen Re Facultative Matters, Terrorism—To TRIA . . . and Beyond 2 (2004) (stating lenders held up approximately $17 billion of construction projects for lack of terrorism coverage); *see also Rising Uninsured Exposure Hearing*, note 25 *above*, at 9 ("Some examples of large projects canceling or experiencing delays have surfaced, with the lack of terrorism coverage being cited as a principal contributing factor."); Alison R. Orlans, *Terrorism Insurance and Commercial Real Estate: The New Frontier*, 7 N.C. BANKING INST. 93, 94 (2003) (noting that more than $11.7 billion of real estate projects were delayed or cancelled).

experienced slowdown and financing problems. In the midst of this perceived temporary economic turbulence, the government enacted the TRIA.[35]

[C] September 11 Victim Compensation Fund

Within days of the attacks, the government enacted the Air Transportation Safety and System Stabilization Act.[36] Among other things, this statute created the September 11th Victim Compensation Fund. The Fund has been described as a "political compromise" that balanced the desire to provide generous compensation to a large number of 9/11 victims, many of whom had no or little life insurance, for the quid pro quo of limiting the liability of the airline industry.[37] The statute required that a claimant under the Fund must "waive the right to file a civil action (or be a party to an action) in any Federal or State court for damages sustained as a result of the terrorist-related aircraft crashes of September 11, 2001."[38]

Compensation under the Fund was variable, and the main components were an award for economic loss, an award for noneconomic loss, and collateral source offsets. Economic loss was calculated based on a number of factors, including present and future income, and age. Noneconomic loss was a flat $250,000 per victim killed, plus an additional $100,000 per spouse and dependent child. Lastly, the statute provided that collateral sources, such as life insurance and governmental benefits, offset the award of compensation.

In the end, 2879 claims out of 2976 deaths (representing 97%) were filed.[39] The Fund paid out on average of $2.08 million per claim, with a total payout of approximately $5.13 billion.[40] Victims received on average $3.1 million, with 69% coming from the Fund, "23[%] from insurance, and 8[%] from charity."[41]

§ 191.02 Insurance Case Law Arising from Acts of Terrorism

The following section discusses selected American state and federal case law on coverage issues concerning acts of terrorism. With a few exceptions, most cases arising out of September 11 applied New York insurance law. The

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35 *See* President George W. Bush, Address on the Signing of the Terrorism Insurance Act (Nov. 26, 2002) ("[T]he Terrorism Risk Insurance Act will permit many construction projects to move forward and to help this economy grow.").

36 Air Transportation Safety and System Stabilization Act (ATSSA), Pub. L. No. 107-42, 115 Stat. 230 (2001). The statute was enacted on September 22, 2001.

37 *See* Dixon & Stern, note 14 *above*, at 20–21.

38 49 U.S.C. § 40101 (2003). Some have suggested that the airline industry was the primary beneficiary of the fund's provision that tort claims must be waived. Saul Levmore & Kyle D. Logue, *Insuring Against Terrorism—and Crime*, 102 MICH. L. REV. 268, 286 (2003). *See* George L. Priest, *The Problematic Structure of the September 11th Victim Compensation Fund*, 53 DePaul L. Rev. 527, 529 (2003) (criticizing the fund on the basis that "it lacks any internal rationale of definition or constraint" found in the systems of compensation provided in society).

39 Dixon & Stern, note 14 *above*, at 24–25.

40 Dixon & Stern, note 14 *above*, at 25.

41 Dixon & Stern, note 14 *above*, at xxiii.

discussion in this section does not cover international cases, and foreign or domestic resolutions in extra-judicial proceedings. Because large scale terrorism has not historically been a problem in the American modern era, there are few pre-September 11 cases discussing insurance coverage issues triggered by acts of terrorism. The few published opinions, however, are a help in understanding coverage issues in cases of terrorism.

[A] Non-September 11 Related Insurance Case Law

[1] Sovereign Act and War Exclusions

In *Pan Am. World Airways, Inc. v. Aetna Cas. & Sur. Co.*, the Second Circuit analyzed the coverage issue associated with the destruction of a commercial airline on September 6, 1970, by the Popular Front for the Liberation of Palestine (PFLP).[42] The insured, Pan American, had policies from a consortium of insurers covering "all physical loss of or damage to the aircraft," except for any loss resulting from certain specified exclusions. The three exclusions were:

> 1. "damage to or destruction thereof by any Government or governmental authority or agent (whether secret or otherwise) or by any military, naval or usurped power, whether any of the foregoing be done by way of requisition or otherwise and whether in time of peace or war and whether lawful or unlawful";
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> 2. war, invasion, civil war, revolution, rebellion, insurrection or warlike operations, whether there be a declaration of war or not; and
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> 3. strikes, riots, civil commotion[43]

Upon a bench trial, the federal district court found that none of these exclusions applied to the destruction of the airplane, and thus it held that the insurers failed to meet their burden of showing that the loss fell within the specified exclusions.[44]

The insurers first argued that, under exclusion (1), the airplane was destroyed by a "military . . . or usurped power," which they argued means "an organized force defying the general enforcement of the laws by force of arms."[45] The court found that the PFLP "occupied" ground in Jordan at the sufferance of the Jordanian government, and that such occupation was insufficient to constitute a military or usurped power.[46] The Second Circuit Court of Appeals upheld the findings of fact. It reasoned that "to constitute a military or usurped power the power must be at least that of a de facto government."[47] The PFLP was not a de facto government in the sky when it

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[42] 505 F.2d 989 (2d Cir. 1974).

[43] 505 F.2d at 994.

[44] Pan Am. World Airlines, Inc. v. Aetna Cas. & Sur. Co., 368 F. Supp. 1098 (S.D.N.Y. 1973).

[45] 505 F.2d at 1009.

[46] 368 F. Supp. at 1129-30.

[47] 505 F.2d at 1009.

hijacked the airplane. Thus, the exclusion for "military . . . or usurped power" did not apply.

The insurers next argued that the "war" exclusion should apply. The Court of Appeals noted "war" in insurance terminology "refers to and includes only hostilities carried on by entities that constitute governments at least de facto in character."[48] The court reasoned that a terrorist group "must have at least some incidents of sovereignty before its activity can properly be styled 'war.'"[49] The evidence showed that the PFLP was not a sovereign or quasi-sovereign state, or accorded such status by sovereign states in the Middle East. Thus, the court did not find a sufficient nexus between the PFLP and a sovereign state or entity.[50]

Lastly, the insurers argued that the terrorist act fell within the exclusion for riots and civil commotion. Riots and civil commotions are purely domestic disturbances.[51] A civil commotion refers to disorders "such as occur among fellow citizens or within the limits of one community."[52] A riot, on the other hand, "occurs when some multitude of individuals gathers and creates a tumult."[53] The Court of Appeals held that a terrorist act, committed by foreign terrorists such as the PFLP, is neither a civil commotion nor a riot.

The *Pan Am* case is relevant to a situation where loss from terrorism can be characterized as a sovereign act and an act of war. In fact, the insurance industry could have argued that the September 11 attacks should have been excluded under the "war" exclusion of all risk policies, though terrorism risk was otherwise covered in all risk policies. Unlike many terrorist groups, which are stateless and have little, if any, official recognition by other states, al Qaeda was headquartered at the time in Afghanistan and, by many accounts, had a close relationship with the Taliban government. A case could have been made that al Qaeda was a quasi-sovereign entity or de facto branch, perhaps a paramilitary arm, of the Afghani government. Obviously, this argument would have required extensive findings of facts on the nature of the relationship between al Qaeda and the Taliban, and there would have been no guarantee that the argument would have succeeded.

If the issue was submitted to a jury as a question of fact, as it most certainly would have been, insurers would have had a difficult challenge of persuading a jury to deny coverage in a time of national crisis. Rather than pursue a legal strategy that would have alienated the insurance industry,

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48 505 F.2d at 1012. The court noted that a war can exist between quasi-sovereign entities, and that undeclared de facto wars may exist between sovereign states. 505 F.2d at 1013 (citing Hamdi & Ibrahim Mango Co. Reliance Insurance Co., 291 F.2d 437 (2d Cir. 1961); N.Y. Life Ins. Co. v. Bennion, 158 F.2d 260 (10th Cir. 1946)).

49 505 F.2d at 1012.

50 505 F.2d at 1015. "The loss of the Pan American 747 was not caused by any act that is recognized as a warlike act. The hijackers did not wear insignia. They did not openly carry arms. Their acts had criminal rather than military overtones. They were the agents of a radical political group, rather than a sovereign government." *Id.*

51 505 F.2d at 1019 (citing Rogers v. Whittaker, 1 K.B. 942 (1917)).

52 *Id.* (internal quotation marks omitted).

53 505 F.2d at 1021.

insurers quickly announced that they would not invoke the war exclusion.[54] There were many factors that led to that decision. Certainly, patriotism was a factor.[55] Beyond the visceral emotional aspect of the decision, the insurance industry surely considered the devastation to goodwill and public reputation if it systematically had tried to avoid liability. The exercise of the litigation option would have also undermined a broader legal-political strategy that culminated in the enactment of the Terrorism Risk Insurance Act of 2002 and its subsequent amendments.

That insurers chose not to invoke the war and sovereign act exclusions in the case of September 11 does not mean that the war and sovereign act exclusions are irrelevant in future cases of terrorism. The United States government continues to refer to the problem of terrorism as a "global war against terrorism." This "war" has been characterized in military terms as one of amorphousness and asymmetry. From a legal perspective, this characterization is also apt. The "war" is unlike the traditional sovereign-to-sovereign warfare seen throughout much of history. Yet, it is not an extensive criminal law enforcement effort either. There is a heavy military aspect to fighting terrorism. While this "war" is not the traditional kind, insurers can still make the case that the conflict to quell global terrorism such as violent Islamic movements resembles more war than criminality for the purpose of insurance coverage and exclusion.

In this regard, there is a connection between the risk and the exclusion. As seen in the case of September 11, a great national tragedy may put significant public and political pressure on the insurance industry that is outside of the consideration of the legal issues. The legal risk is only one factor in the overall business risk. On the other hand, small scale events, which are more typical of acts of terrorism, are less susceptible to the forces of public and political opinions. In these matters, a lawyer advising a client must have a sense of the politics of terrorism and the situation since terrorism insurance is unique in this sense. Unlike most coverage issues in insurance, the coverage of terrorism goes beyond the four corners of the contract. Any terrorist act on the homeland again will strike a raw nerve on the public and political conscience. As a matter of practical politics, there may be significant media and political coverage of a small scale event, but such coverage may not extend to the technical details of insurance coverage and exclusion. In this sense, the legal issues associated with smaller events are less susceptible to being "distorted" by politics and public perception. As the losses get bigger, and the harm to the American psych becomes greater as well, the insurance industry may find it again difficult to rely on the war and sovereign act exclusion. The same problem of practical politics and industry goodwill will come to bear.

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[54] *After the Attack: "Act of War" Exclusion Doesn't Apply to Attacks, Insurers Say*, L.A. Times, Sept. 17, 2001, at C3; Tom Hamburger & Christopher Oster, *Insurance Industry Backs U.S. Terrorism Fund*, Wall St. J., Oct. 9, 2001, at A3.

[55] *See* Christian Brauner & Gedrges Galey, Swiss Re, Terrorism Risks in Property Insurance and Their Insurability After 11 September 2001 15 (2003) (stating that excluding coverage "could be interpreted as terrorists' victory over society and hence of the free democratic system").

Additionally, there will be a few other complications as well. Obviously, the industry set a prior precedent of not invoking the exclusion in the case of September 11. And, if the exclusion is invoked, any hope of renewing the Program or making it permanent would disappear. For these reasons, one would expect that the coverage and exclusion decision would reach the CEO and Board levels of most insurers.

Moreover, the relative risks must be considered. In the context of terrorism risk in general, there is a low risk of an attack from a terrorist group that is clearly associated with a foreign government.[56] A sovereign deemed to be responsible for or complicit in such an attack would risk open armed conflict with the United States. This is a highly unlikely situation as it may be tantamount to a sovereign's declaration of war against the United States. Like most attacks in the past, a terrorist would likely come from a stateless organization with loose ties to states. Therefore, while the sovereign act and war exclusions are not entirely irrelevant to coverage of terrorist related losses, an insurer seeking to invoke these exclusions faces steep factual, legal and political hurdles.

[2] Physical Loss and Proximate Cause

In *New Market Invest. Corp. v. Fireman's Fund Ins. Co.*, the issue was whether the policy covered only physical loss directly caused by a terrorist attack.[57] In early March 1989, the United States Embassy in Chile received several anonymous phone calls, threatening that shipments of Chilean grapes were deliberately tainted with cyanide. The caller said that the fruit was poisoned in order to protest the plight of the Chilean poor and to bring economic injustice in Chile to the attention of the United States and the world. Subsequently, one of the policyholder's shipments of grapes was discovered to have been contaminated with cyanide. The FDA issued a press release and implemented prophylactic procedures, including the destruction of grapes that entered the United States, and enhanced inspection of grapes at ports. These developments ultimately resulted in substantial losses for the policyholder. Much of the fruit spoiled, was destroyed by the FDA, was damaged by inspection, or made unsalable due to the public crisis; and the policyholder also gave credits to some of its customers who were unable to sell fruit that had already been delivered to them.[58]

At issue was the insurance cover, which provided: "*destruction of, or damage to*, the property insured directly caused by vandalism, sabotage, or malicious act . . . carried out for political, terroristic or ideological purposes."[59] The policyholder argued that it suffered losses as a proximate result of

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56 For example, the United States has designated the Iranian Revolutionary Guard a terrorist organization under Executive Order 13224. *See* Robin Wright, *Iranian Unit to Be Labeled "Terrorist": U.S. Moving Against Revolutionary Guard,* Washington Post, at A1 (Aug. 15, 2007).

57 774 F. Supp. 909 (E.D. Pa. 1991).

58 774 F. Supp. at 912.

59 *Id.* (emphasis added).

terrorism, and the insurer argued that only the shipment of actually tainted grapes by terrorists were covered as a physical loss. At trial, the jury found that all of the policyholder's loss was proximately caused by terrorism.[60] The district court upheld the jury's verdict upon the insurer's motion for judgment notwithstanding the verdict and new trial.[61] It reasoned that "physical damage" (i.e., damage from cyanide) was not a prerequisite. It noted that other provisions of the policy, not relevant to the loss here, referred to "physical loss or damage."[62] The court found that "the parties knew how to limit coverage to *physical* damage or *physical* loss where that was their intent."[63] Thus, the most reasonable interpretation of the provision at issue was that physical damage was not a prerequisite to coverage.

The insurer also argued that terrorism was not the proximate or efficient cause of the policyholder's loss. In instructing the jury, the court explained:

> The defendant claims that the acts of terrorism were not the proximate cause of the plaintiff's loss.
>
> Defendant takes the position that losses were proximately caused by the orders and the press release of the Food and Drug Administration and it also claims that the losses being claimed by the plaintiff in this case are excluded under the terms of that endorsement, that section that excludes delay and loss of market.
>
> * * *
>
> Now, I'm going to tell you how the law defines proximate cause; particularly proximate cause in connection with insurance.
>
> It means the predominant and determining cause. It's also been defined as the real efficient cause. Those words are interchangeable and also I want to tell you that the cases say the proximate cause is not necessarily that cause which is nearest in time to the damage, but rather proximate cause is the one cause which is the predominant or efficient cause.[64]

Based on this instruction, the jury found proximate cause in favor of the policyholder, and upon motion the court found no error in its instruction and upheld the finding of fact.[65]

The *New Market* case shows that losses from terrorism need not be physical losses "directly" (in the sense of immediate proximity between act and loss) connected to a violent act. The terrorist tactic targeted economic harm rather than physical harm. Economic terrorism is a foreseeable evolution of terrorist tactics. Violence is not the end of terrorists, but only a means towards coercion. As security measures are hardened around borders and soft target assets, economic terrorism may become a new weapon of coercion. For example, it is within the realm of the foreseeable that on the day after

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[60] 774 F. Supp. at 913-14.

[61] The policyholder also moved for a new trial on damages only, and the district court denied the motion. 774 F. Supp. at 918.

[62] 774 F. Supp. at 914.

[63] *Id.*

[64] 774 F. Supp. at 915.

[65] *Id.*

Thanksgiving, traditionally the busiest shopping day of the year, terrorists would coordinate a series of bombings in under-secured shopping malls, thus devastating the retail shopping season for many companies and damaging the national economy.[66]

Interestingly, as discussed later in this chapter, the Terrorism Risk Insurance Act of 2002 can be construed to address only losses arising from acts of violence or destruction. The attacks of September 11, while unprecedented, were simply an extension of the terrorists' tactics previously in use. Rather than small artillery rockets or a car bomb, terrorists hijacked commercial airlines, a common tactic, and deployed them as larger scale explosives against a civilian population. The act still fits within the existing paradigm of violence. The next paradigm shift in terrorism may entail economic terrorism and chaos, though how such attacks may be executed is anyone's guess at this point in time.

[3] Uninsured Motorist Coverage

In *Nichols v. Nationwide Mut. Ins. Co.*, the federal district court addressed on summary judgment the issue of whether uninsured motorist policy covered the policyholder from loss incurred in the April 19, 1995, Oklahoma City bombing of the Alfred P. Murrah Federal Building.[67] The policyholders claimed that the axel of the truck containing the bomb landed on their car and caused damage. Following Oklahoma law, the district court set forth a four-part test: (1) whether the injury arises out of the use of a motor vehicle, (2) whether there is a causal connection between the use of the vehicle and the injury, which requires findings that the use of the vehicle was connected to the injury and that the use related to the transportation nature of the vehicle, (3) whether an intervening force severed the causal connection, and (4) whether the uninsured was an owner or operator of the vehicle during the commission of the wrongful act.[68] The court held that while the bombing could be broadly construed as the use of a motor vehicle, the plaintiff could not as a matter of law establish that the use was related to the transportation nature of the vehicle.[69] Moreover, the court also found that the connection between the transportation use of the vehicle and the injury, if any, was severed by the

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66 "The impact of any act of terrorism on the economy cannot be underestimated. For instance, a terrorist attack in the Mall of America or a Walmart superstore would probably have a relatively small impact on the insurance losses, but it would have a significant short-term effect on retailers throughout the nation." Robert J. Rhee, *Terrorism Risk in a Post-9/11 Economy: The Convergence of Capital Markets, Insurance and Government Action*, 37 Ariz. St. L.J. 435, 437 n.4 (2005). *See also* John Kimelman, *Wall Street Assesses Terrorism: Is the Overall Risk Reflected in Market?*, Int'l Herald Trib., Aug. 4, 2003, at 10 ("'Imagine a person going into a shopping mall or movie theater with a bomb. That could paralyze the economy.'") (quoting Kari Bayer Pinkernell of Merrill Lynch).

67 948 F. Supp. 988 (W.D. Okla. 1996).

68 948 F. Supp. at 990-91 (citing Safeco Ins. Co. of Am. v. Sanders, 803 P.2d 688 (Okla. 1990)).

69 948 F. Supp. at 991.

criminal act of the terrorist.[70] Thus, the policyholders could not recover under uninsured motorist coverage.[71]

[4] Subrogation and Foreign Sovereign Immunity Act

In *Hartford Fire Ins. Co. v. Socialist People's Libyan Arab Jamahiriya*, the Federal District Court determined whether a foreign sovereign, the state of Libya, could be held liable under the Foreign Sovereign Immunity Act ("FSIA") for acts of terrorism to the insurer as subrogee.[72] In a previous case, a jury found Pan Am and the security firm responsible for handling luggage liable for the 270 deaths in the bombing of Pam Am Flight 103 over Lockerbie, Scotland.[73] In a separate criminal proceeding, a Libyan intelligence agent was convicted for his role in the bombing.[74] Subsequently, the insurer of the airline and the security firm sued Libya to recover approximately $500 million in compensation to victims and defense costs. Ordinarily, FSIA provides foreign sovereigns immunity from lawsuit in the United States unless the action falls within specified exceptions.[75] The statute provides an exception for acts of terrorism.[76] This exception applies if (1) the foreign state was a designated state sponsor of terrorism when the act occurred, (2) the plaintiff afforded the foreign state a reasonable opportunity to arbitrate the dispute if the act occurred within the foreign state's territory, and (3) either the claimant or the victim was a United States national when the act occurred.[77] The federal district court held that FSIA provides subject matter jurisdiction for an action

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70 948 F. Supp. at 992.

71 In *Mayer v. State Farm Mut. Auto. Ins. Co.*, the Supreme Court of Oklahoma addressed the same issue and decided similarly that the requisite connection between the loss and the use of the truck as a transportation vehicle was missing. 944 P.2d 288 (Okla. 1997). The Oklahoma City bombing also resulted in tort litigation against the manufacturer of ammonium nitrate that was sold as fertilizer and was used as the major explosive component of the bomb. *See* Gaines-Tabb v. ICI Explosives, USA, Inc., 160 F.3d 613 (10th Cir. 1998), *aff'g* 995 F. Supp. 1304 (W.D. Okla. 1996).

72 2007 U.S. Dist. LEXIS 46657 (D.D.C. 2007).

73 The Second Circuit affirmed the jury verdict. *See In re* Air Disaster at Lockerbie, Scotland, 37 F.3d 804, 830 (2d Cir. 1994), *abrogated in part on other grounds by* Zicherman v. Korean Airlines, 516 U.S. 217 (1996).

74 A special panel comprised of three Lords Commissioners of Scotland's supreme criminal court, the High Court of Justiciary, tried two Libyan intelligence officers at Camp Zeist, Netherlands. The court unanimously convicted one officer and acquitted the other. *See* Her Majesty's Advocate v. Megrahi, No. 1475/99, 2001 G.W.D. 5-177. An appeal by the defendant was affirmed by the five judges of the High Court. *See* Megrahi v. Her Majesty's Advocate, No. C104/01, 2002 J.C. 99.

75 28 U.S.C. § 1604.

76 28 U.S.C. § 1605(a)(7). This section provides: "A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case . . . in which money damages are sought against a foreign state for personal injury or death that was caused by an act of torture, extrajudicial killing, aircraft sabotage, hostage taking, or the provision of material support or resources . . . if such act or provision of material support is engaged in by an official, employee, or agent of such foreign state while acting within the scope of his or her office, employment, or agency . . . ."

77 28 U.S.C. § 1605(a)(7).

against a foreign sponsor of terrorism for acts of terrorism in an action brought by the insurer subrogee, and that an insurer subrogee could assert state statutory and common law claims against a foreign sovereign.[78]

[B] September 11 Insurance Case Law

[1] World Trade Center

Although the insurance industry chose not to invoke the war exclusion to avoid wholesale coverage, insurers raised ordinary coverage issues in connection with the attacks of September 11. The attacks against the World Trade Center in particular led to a series of complex insurance litigation in federal court resulting in published opinions. The plaintiffs were various entities controlled by real estate developer Larry Silverstein, who earlier in 2001 signed 99-year leases for the World Trade Center Complex from the Port Authority of New York and New Jersey. Over 20 individual insurance companies had signed binders that obligated them to provide property coverage. The litigation produced several published judicial opinions. The crucial question in the litigation was whether the attacks against both twin towers were a single occurrence or two separate occurrences.[79] The resolution of the legal question determined whether the policyholder was entitled to an approximately $3.5 billion payout, or a payout up to $7 billion.[80]

The plaintiff's filed a motion for summary judgment against Travelers Indemnity before the federal district court.[81] Unlike the three insurers, Travelers bound coverage under its binder, and not the form provided by the insurer broker Willis of New York ("WilProp"). The plaintiffs argued that, because Travelers did not define the term "occurrence" in its binder, it agreed to be bound by the meaning given to that term in New York case law, and that such law defines occurrence as the "immediate, efficient, physical, proximate cause of the loss, not some indirect or more remote cause of causes."[82] The district court denied the plaintiffs' motion for summary judgment, holding that "none of the relevant cases compels a finding that the term 'occurrence' has such an unambiguous meaning that, in its search for the truth, justice should blind itself to the wealth of extrinsic evidence concerning the parties' intentions that is available in this case."[83] Thus, the court concluded that there were genuine issues of material facts and denied summary judgment.

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78 2007 U.S. Dist. LEXIS 46657, at *8-15.

79 Other issues involved the obligation of insurers to pay for defense costs. *See In re* September 11th Liability Insurance Coverage Cases, 458 F. Supp. 2d 104 (S.D.N.Y. 2006).

80 It was undisputed that the attacks caused losses greater than $3.5 billion. The World Trade Center was underinsured at the time of the attacks. *See* Steven Brill, After: How America Confronted the September 12 Era 156, 389 (2003) (replacement value estimated at $5 to $6 billion); Dixon & Stern, note 14 *above*, at 103 (stating the replacement value estimated at $4.5 billion, and contents at $5.2 billion).

81 SR Int'l Bus. Ins. Co., Ltd v. World Trade Center Prop., LLC, 2002 U.S. Dist. LEXIS 9966 (S.D.N.Y. 2002).

82 2002 U.S. Dist. LEXIS 9966, at *7.

83 2002 U.S. Dist. LEXIS 9966, at *16.

The federal district court separately ruled on motions for partial summary judgment filed by three insurers, Hartford Fire Insurance, Royal Indemnity, and St. Paul Fire & Marine Insurance.[84] These insurers argued that they signed the WilProp binders,[85] and that the WilProp form contained a definition of "occurrence" under which the attacks against the World Trade Center was a single occurrence. There was no genuine dispute of material facts that each insurance company bound itself to the WilProp form only.[86] Only one of the many insurers that bound coverage had issued a final policy at the time of the attacks.[87]

The WilProp form contained the following definition of occurrence: "'Occurrence' shall mean all losses or damages that are attributable directly or indirectly to one cause or to one series of similar causes. All such losses will be added together and the total amount of such losses will be treated as one occurrence irrespective of the period of time or area over which such losses occur."[88] In interpreting this language, the court cited the principle that insurance policies should be construed according to the ordinary meaning of the language.[89] It held that as to the WilProp form the "ordinary businessman would have no doubt that when two hijacked planes hit the Twin Towers in a sixteen minute period, the total destruction of the World Trade Center resulted from 'one series of similar causes.'"[90]

The Second Circuit affirmed the grant of partial summary judgment to the insurers.[91] The court agreed that, under the summary judgment standard, the plaintiff and the three insurers (Hartford, Royal and St. Paul) intended the binders to incorporate the terms of the WilProp form.[92] It also agreed that no reasonable person could find that the attacks against the World Trade Center were two separate occurrences rather than a single, coordinated plan of attack constituting a "series of similar causes" under the term of the WilProp form.[93]

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84 SR Int'l Bus. Ins. Co., Ltd v. World Trade Center Prop., LLC, 222 F. Supp. 2d 385 (S.D.N.Y. 2002).

85 A binder is "a short method of issuing a temporary policy for the convenience of all parties, to continue until the execution of the formal one." 222 F. Supp. 2d at 388 (quoting Lipman v. Niagara Fire Ins. Co., 24 N.E. 699 (N.Y. 1890)).

See **N.Y.—**Employers Commercial Union Ins. Co. v. Fireman's Fund Ins. Co., 384 N.E.2d 668, 670 (N.Y. 1978) (binders serve as a "quick and informal device to record the giving of protection pending the execution and delivery of a more conventionally detailed policy of insurance").

86 222 F. Supp. 2d at 390-98.

87 345 F.3d 154, 158 (2d Cir. 2003).

88 222 F. Supp. 2d at 398.

89 222 F. Supp. 2d at 398 (citing National Screen Serv. Corp. v. U.S. Fidelity & Guaranty Co., 364 F.2d 275, 278 (2d Cir. 1966)).

90 222 F. Supp. 2d at 399.

91 World Trade Center Prop., LLC v. Hartford Fire Ins. Co., 345 F.3d 154 (2d Cir. 2003).

92 345 F.3d at 170.

93 345 F.3d at 180. With respect to the Travelers case, the Second Circuit affirmed the District Court's ruling that the meaning of "occurrence" in the Traveler binder was sufficiently ambiguous under New York law to preclude summary judgment. 345 F.3d at 190. *See* note 90 *above*.

For most insurers, summary judgment was not possible because two major issues remained unresolved: (1) whether the parties actually bound to the WilProp form, (2) whether they intended to bind coverage based on a definition of occurrence that contemplated a one- or two-occurrence treatment of the attacks of September 11. The district court held a two-phase jury trial. In Phase I, 12 insurers and 20 Lloyd's of London syndicates participated, while six other insurers chose not to participate because they conceded that their coverage was not governed by the WilProp form. A jury determined that all but three of the insurers who participated in Phase I bound coverage to the WilProp form that contemplated a single occurrence treatment of the attacks. In Phase II, the jury determined that the three remaining insurers and the six insurers who did not participate in Phase I bound coverage to contracts that contemplated a two-occurrence treatment. The district court entered judgment according to the jury's findings.

On appeal, the Second Circuit Court of Appeals affirmed the entry of judgment.[94] As to the appeals from both Phase I and II of the trial, the court upheld the jury's findings of facts, the trial court's evidentiary rulings and its jury instructions.

[2] Subrogation

In *Industrial Risk Ins. v. Port Auth. of N.Y. & N.J.*, the Second Circuit considered whether the property insurer, as subrogee of a World Trade Center building lessee, has a cognizable claim against the owner and sublessee for gross negligence in maintaining a large stock of diesel fuel in 7 World Trade Center.[95] The federal district court dismissed the action pursuant to Rule 12(b)(6) on the ground, among others, that the lease between the lessee and the sublessee mutually released each other from liability, and each party agreed to obtain insurance that accepted the mutual releases and waived subrogation rights.[96] Subrogation waivers reflect the intention of the parties to seek recovery of losses from their insurers, and such contracts between sophisticated parties are typically upheld.[97] The Second Circuit upheld the judgment of the lower court on the issue of waiver of subrogation.[98]

[3] Business Interruption

In *Zurich Am. Ins. Co. v. ABM Indust., Inc.*, the Second Circuit addressed the issue of whether an insured contractor that provided janitorial and HVAC service in the common and tenanted areas of the World Trade Center, and occupied office space there, was covered for business interruption under its

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94 **U.S.**—SR Int'l Bus. Ins. Co., Ltd v. World Trade Ctr. Prop., LLC, 467 F.3d 107 (2d Cir. 2006).

95 **U.S.**—493 F.3d 283 (2d Cir. 2007).

96 **N.Y.**—387 F. Supp. 2d 299, 310 (S.D.N.Y. 2005).

97 387 F. Supp. 2d at 312-13.

98 493 F.3d at 287.

policy.[99] The policy covered loss or damage to "*real* and personal *property*, including but not limited to property owned, controlled, *used*, leased, or intended for use by the Insured."[100] The business interruption coverage term (the "BI" coverage) provided coverage for "loss resulting directly from the necessary interruption of business caused by direct physical loss or damage, not otherwise excluded, to *insured property at an insured location*."[101] The policy also had a contingent business interruption term (the "CBI" coverage) that extended coverage to actual losses sustained "due to the necessary interruption of business as the result of direct physical loss or damage of the type insured against to properties *not operated by the Insured* which wholly or partially prevents any direct receiver of goods and/or services from the Insured from accepting the Insured's goods and/or services."[102] The CBI coverage had a sublimit of $10 million per occurrence, whereas the BI coverage had no limit.

The insurer argued that only the CBI coverage applied and sought a declaration that liability for business interruption was limited to $10 million. It argued that the policyholder did not have an ownership or tenancy interest in the WTC complex to trigger the BI coverage. The court rejected this argument. It noted that the "real property" was defined not only by property "owned" or "leased," as indicated by the qualifying phrase "but not limited to," but the definition also included property "used" or "controlled" or "intended for use" by the policyholder.[103] The Second Circuit reasoned that the policyholder "used" and "controlled" the common areas and the premises that it cleaned as a part of its contracting service: "These areas and premises were the means by which [the policyholder] derived its income and were as essential to that function as [its] cleaning tools."[104] Because the policyholder "used" and "controlled" the WTC complex, it was entitled to BI coverage.[105]

The court next addressed the argument that the activities of "used" and "controlled" over the World Trade Center did not create a legally cognizable insurable interest in the property. The New York insurance statute provides that an insurable interest can be "any lawful and substantial economic interest in the safety or preservation of property from loss, destruction or pecuniary damage."[106] The insurable interest in this circumstance was not simply the real property interest, but also included the economic value of the future income stream that would be threatened by damage or loss to the real property. This was implicit in the insurance contract that defined real property in a way that extended beyond ownership and leasehold. The court ruled that the

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99 **U.S.**—397 F.3d 158 (2d Cir. 2005), *rev'g* Zurich Am. Ins. Co. v. ABM Indus., Inc., 265 F. Supp. 2d 302 (S.D.N.Y. 2003).

100 397 F.3d at 162 (emphasis added).

101 *Id.* (emphasis added).

102 *Id.* (emphasis added).

103 397 F.3d at 165.

104 397 F.3d at 165-66.

105 The court also held that the CBI coverage does not operate. CBI coverage is triggered when there is "direct physical loss or damage of the type insured against to properties *not operated by the Insured*." The court held that through its activity of maintenance and upkeep the policyholder operated the WTC complex. 397 F.3d at 168-70.

106 N.Y. Ins. L. § 3401.

policyholder's income stream is dependent upon the common areas and leased premises in the WTC complex, and thus met New York's requirement of an insurable interest.[107]

In *Duane Reade, Inc. v. St. Paul Fire & Marine Ins. Co.,* the Second Circuit addressed whether business interruption coverage extended to the time a policyholder could resume a functionally equivalent operation to that of the store that was destroyed during the September 11 attacks.[108] Under New York law, business interruption coverage is triggered when there is a total interruption or cessation of operations.[109] The policyholder was a chain of drug stores whose most profitable store was located in the main concourse of the World Trade Center. The policy provided that the Restoration Period for business interruption coverage "shall not exceed such length of time as would be required with the exercise of due diligence and dispatch to rebuild, repair, or replace such property that has been destroyed or damaged."[110] The policy also had an Extended Recovery Period clause, which provided additional coverage for the event that the policyholder continues to suffer losses due to its business interruption after it reopens the damaged or destroyed store. This clause guaranteed the policyholder its pre-September 11 profits until the earlier of when the policyholder can restore business at the WTC store to the condition it would have been in had the attacks not occurred or 12 months after the Restoration Period ends.[111] Based on these terms, the insurer paid 21 months of lost profit: 9 months to relocate the store, and another 12 months of extended recovery coverage. The policyholder argued that coverage should be extended to the actual time period required to restore a store at the WTC site and that the restoration period "is coterminous with the time necessary to rebuild the complex which will replace the World Trade Center."[112] After a bench trial, the federal district court issued a declaratory judgment holding that the business interruption coverage must continue for the hypothesized time to rebuild the store and "resume functionally equivalent operations in the location where its WTC store once stood."[113]

The Second Circuit held that the lower court erred in construing the policy to provide coverage until the business can be resumed at the same location. The use of "functionally equivalent operations" language would enhance the business interruption coverage in such a way that the enhancement

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[107] 397 F.3d at 167-68. The Second Circuit also reversed the District Court's ruling that the civil authority provision, which provides coverage when "access to real or personal property is impaired by order or action of civil or military authority," did not apply. The Second Circuit noted that although the WTC was destroyed in the attacks, the policyholder operated other non-WTC sites that could have been subject to the civil authority provision. 397 F.3d at 171.

[108] 411 F.3d 384 (2005).

[109] **N.Y**.—Broad St., LLC v. Gulf Ins. Co., 37 A.D.3d 126, 132, N.Y.S.2d 1, 5 (1st Dep't 2006).

[110] 411 F.3d at 387.

[111] 411 F.3d at 393.

[112] *Id.*

[113] **N.Y**.—Duane Reade, Inc. v. St. Paul Fire & Marine Ins. Co., 279 F. Supp. 2d 235, 239 (S.D.N.Y. 2003).

would make superfluous the Extended Recovery Period coverage. Functional equivalence would simultaneously terminate both the Restoration and Extended Recovery Periods, and thus the declaratory judgment failed to harmonize the Restoration and Extended Recovery Periods. Moreover, the lower court's interpretation would extend coverage beyond the time limit of the Extended Recovery Period if the policyholder cannot achieve functional equivalence, a consequence that the parties did not intend based on the language of the policy.[114] The court held that "coverage extends only for the hypothetical time it would reasonably take Duane Reade to 'repair, rebuild, or replace' its WTC store at a suitable location."[115] The court modified the district court's declaration to read (modifications in italics):

> On their face, the Restoration Period clauses envision a hypothetical or constructive (as opposed to actual) time frame for rebuilding, *repairing, or replacing*, as evidenced, for example, by their use of the subjunctive "would." Moreover, what is to be hypothesized is the time it would take to rebuild, repair, or replace the *functional equivalent of the store Duane Reade lost*, not the *WTC* complex that once surrounded it. Once Duane Reade could resume operations in a *permanent location reasonably equivalent to the site of its former store at the WTC*, the Restoration Period would be at an end. Any losses continuing beyond that point would be addressed by the "Extended Recovery Period" provision in the Policy, not by the Restoration Period clause.[116]

In *United Air Lines, Inc. v. Ins. Co. of Pa.*, the Second Circuit addressed whether a commercial airliner can recover for its lost earnings caused by the national disruption of flight service and the government's temporary shutdown of an airport.[117] The policyholder claimed business interruption losses from its facilities at Ronald Reagan Washington National Airport when the airport was shutdown for several weeks in the immediate aftermath of September 11. Only the Pentagon was attacked on that day in Washington, and the airline's facilities there did not incur any physical damage. The policy provided: "[insurer] will indemnify [policyholder] for property damage, loss of gross earnings, and extra expense in excess of the Deductible . . . resulting from [terrorism], and any ensuing fire damage, damage from looting, or other damage caused by an act of a lawfully constituted authority for the purpose of suppressing or minimizing the consequences of [an act of terrorism]."[118] In affirming the lower court's grant of summary judgment to the insurer, the

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114 411 F.3d at 394.

115 411 F.3d at 398.

116 411 F.3d at 399.

See **N.Y.—**Children's Place Retail Stores, Inc. v. Federal Ins. Co., 37 A.D.3d 243, 829 N.Y.S.2d 500 (2007) (holding that business interruption loss was limited to the period it would have taken a reasonable retailer to resume operations in a different location).

117 **U.S.—**439 F.3d 128 (2d Cir. 2006), *aff'g* United Airlines, Inc. v. Ins. Co. of Pa., 385 F. Supp. 2d 343 (S.D.N.Y. 2005).

118 439 F.3d at 129. A subsequent section provides that the policy "insures against loss resulting directly from the necessary interruption of business caused by damage to or destruction of Insured Locations resulting from Terrorism." *Id.*

Second Circuit held that business interruption coverage does not apply unless there was physical damage to the airport facilities.[119]

The policy also provided coverage "when access to the Insured Locations is prohibited by order of civil authority as a direct result of damage to adjacent premises."[120] The court held that, although the Pentagon and the airport were in close geographical proximity (on the order of several miles), the attacks against the Pentagon did not constitute physical damage to an "adjacent premise" and that the airport was not shut down "as a direct result of damage to" the Pentagon.[121] Thus, the airline could not recover on the mere basis that an order of a civil authority caused the loss.

In *Philadelphia Parking Auth. v. Federal Ins. Co.*, the federal district court considered under Pennsylvania law whether purely economic losses were recoverable under the business interruption provision of the policy at issue.[122] The plaintiff, who operated parking garages at the Philadelphia International Airport, incurred economic losses arising from the temporary flight restrictions imposed after September 11. The insurer denied the claim on the basis that the plaintiff suffered no direct physical loss. The policy provided: "We will pay for loss of Business Income and Extra Expense which you incur due to the actual interruption of your operations during the period of indemnity. This actual interruption of your operations must be caused by direct physical loss or damage caused by a covered cause of loss." The court held that this provision does not support a claim for economic loss that is not supported by some physical problem with the covered property.[123]

[4] Obligation to Obtain Terrorism Insurance

In *Omni Berkshire Corp. v. Wells Fargo Bank*, the plaintiff borrowed $250 million, which was secured by five hotels.[124] The credit agreement required the plaintiff to obtain "comprehensive all risk insurance" on the collateral, but did not define this term. Before September 11, "all risk" policies included terrorism risk at no additional premium. After the attacks, however, terrorism risk became a separate coverage, and premiums were expensive. The

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119 439 F.3d at 131. The court noted that dust and ash from the attacks against the Pentagon did not constitute physical damage to the airport.

See **N.Y.**—Abner, Herrman & Brock, Inc. v. Great N. Ins. Co., 308 F. Supp. 2d 351, 336 (S.D.N.Y. 2004) (holding that civil authority provision providing coverage "when a civil authority prohibits access to your premises" does not extend to the circumstance where vehicular traffic was restricted in Lower Manhattan but access was still available).

N.Y.—N.Y. Career Inst. v. Hanover Ins. Co., 6 Misc. 3d 734, 791 N.Y.S.2d 338 (2005) (holding that coinsurance provision of business interruption policy applies to loss caused by action of "civil authority").

120 439 F.3d at 129.

121 439 F.3d at 134-35.

122 **N.Y.**—385 F. Supp. 2d 280 (S.D.N.Y. 2005). The plaintiff also argued that it was entitled to coverage under the civil authority provision of the policy. But the court held that no civil authority prohibited access to the plaintiff's garages and that the government's order pertained only to all aircraft operators. 385 F. Supp. 2d at 289.

123 385 F. Supp. 2d at 288.

124 **N.Y.**—307 F. Supp. 2d 534 (S.D.N.Y. 2004).

plaintiff had difficulty obtaining separate terrorism risk coverage. It received a reasonable quote of $316,000 for a $60 million cover of the five hotels, but this premium was approximately 63% of the cost of the plaintiff's all risk policy.[125] The plaintiff filed suit, seeking a determination that it was not required under the credit agreement to purchase terrorism insurance. After a bench trial, the federal district court found that the parties did not intend to freeze the meaning of "all risk" to the time when the credit agreement was signed, i.e., 1998 when "all risk" implicitly included terrorism risk.[126] Instead, the parties intended "all risk" to mean "what the industry generally accepted—knowing that the generally accepted all risk policy might evolve over time."[127] However, the court also found that the creditor could require the debtor to obtain insurance under the "other reasonable insurance" term of the agreement.[128] It found that "in the post-9/11 world when so much more is at risk, it was reasonable for Wells Fargo to request, on behalf of its certificate holders, that Omni provide an additional $60 million in insurance coverage to account for the loss of terrorism coverage created when the insurance industry decided to exclude terrorism from all risk policies."[129]

The court's reasoning in *Omni Berkshire* is problematic from contract and insurance perspectives. Presumably, the parties understood "all risk" in 1998 meant the inclusion of terrorism risk, which was the industry standard at the time.[130] Therefore, it is reasonable to assume that the agreed price in the credit agreement incorporated the mitigation of this risk through insurance. Even if the parties had not specifically bargained or thought to bargain over this point, the price achieved would have been the same had they negotiated over the specific point because terrorism risk was included in all risk policies at the time.[131] The court's ruling in effect changes the terms of the credit transaction because the parties at the time of contracting could not have predicted the industry standard governing all risk policies. The result is that credit transactions are subject to a degree of uncertainty that cannot be resolved at the time of contracting because the industry standard governing "all risk" would change, but such changes are not predictable. Courts have noted in other contexts concerning contract interpretation in credit transactions that uncertainty should be avoided if possible for it increases the cost of capital.[132]

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[125] 307 F. Supp. 2d at 539.

[126] 307 F. Supp. 2d at 539-41.

[127] 307 F. Supp. 2d at 541. The court noted that there was little case law on this point. 307 F. Supp. 2d at 539 (citing a preliminary determination of the issue in Four Times Square Assocs., LLC v. Cigna Invs., Inc., 306 A.D.2d 4, 764 N.Y.S.2d 1 (2003)).

[128] 307 F. Supp. 2d at 541-42.

[129] 307 F. Supp. 2d at 542.

[130] 307 F. Supp. 2d at 536.

[131] See **N.Y.**—Kenford Co. v. County of Erie, 537 N.E.2d 176, 179 (N.Y. 1989) ("the commonsense rule to apply is to consider what the parties would have concluded had they considered the subject").

[132] *See* **U.S.**—Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982) ("Such uncertainties [in contract interpretation] would vastly increase the risks and, therefore, the costs of borrowing with no offsetting benefits either in the capital market or in the administration of justice.").

In *BFP 245 Park Co., LLC v. GMAC Commercial Mortgage Corp.*, the court held that the credit agreement at issue required terrorism coverage.[133] The agreement provided that the property be insured against "any peril now or hereafter included within the classification All Risk or Special Perils, in each case . . . in an amount equal to 100% of the Full Replacement Cost." The court distinguished *Omni Berkshire* on the ground that the agreement there did not contain the clause "now and hereafter," which suggests that terrorism risk should be covered.

Credit arrangements are not the only transactions that may require the parties to procure terrorism risk coverage. The issue also arises in the context of commercial landlord-tenant relationships.[134]

[5] Consequential Damages

In *Hold Brothers, Inc. v. Hartford Cas. Ins. Co.*, the federal district court considered, upon the insurer's motion to dismiss pursuant to Rule 12(b)(6), whether a policyholder can recover for consequential damages from an insurer's breach of contract.[135] Guided by a New York case on consequential damages in breach of contract actions,[136] the court ruled that to recover consequential damages for an insurer's breach of the policy, the policyholder must show that such damages "were within the contemplation of the parties as the probable result of a breach at the time of or prior to contract."[137] In this regard, the insurer argued that the policy specifically excluded consequential damages. The policy stated that the insurer "will not pay for loss or damage caused by or resulting from . . . Consequential Losses: Delay, loss of use or loss of market."[138] Elsewhere, the policy provided that the insurer will not pay for "Any other consequential loss."[139]

N.Y.—Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1520 (S.D.N.Y. 1989) ("The sort of unbounded and one-sided elasticity [in interpreting the implied covenant of good faith and fair dealing in credit transactions] . . . would interfere with and destabilize the market.").

See also **N.Y.**—Morgan Stanley & Co., Inc. v. Archer Daniels Midland Co., 570 F. Supp. 1529, 1536 (S.D.N.Y. 1983) (noting that the subjective expectations of bondholders in a contract term providing redemption limitation "would likely cause greater uncertainty among bondholders").

133 **N.Y.**—BFP 245 Park Co., LLC v. GMAC Commercial Mortgage Corp., 12 A.D.3d 330, 786 N.Y.S.2d 425 (2004).

See **N.Y.**—Four Times Square Assoc., LLC v. Cigna Investments, Inc., 306 A.D.2d 4, 764 N.Y.S.2d 1 (2003) (granting landlord preliminary injunction against the servicer of a loan from holding the loan in default for failing to obtain terrorism coverage).

134 *See, e.g.,* **N.Y.**—TAG 380, LLC v. GMAC Commercial Mort. Corp., 40 A.D.3d 1, 830 N.Y.S.2d 87 (2007) (holding that the lease did not require the procurement of terrorism coverage by the tenant).

135 **N.Y.**—357 F. Supp. 2d 651 (S.D.N.Y. 2005).

136 *See* **N.Y.**—Kenford Co. County of Erie, 537 N.E.2d 176 (N.Y. 1989).

137 357 F. Supp. 2d at 658 (internal quotation marks omitted) (quoting *Kenford*, 537 N.E.2d at 178).

138 357 F. Supp. 2d at 658.

139 357 F. Supp. 2d at 659.

The court made a distinction between contractual agreement on exclusion, which goes to the terms of the policy, and the legal remedy that can be had for a breach of the contract. It found the exclusions in the policy to be coverage exclusions, but these terms did not address whether consequential damages would be allowed for a breach of the contract. "Thus, while the cited policy language may ultimately have a direct bearing on what damages for breach were within the contemplation of the parties at the time of contracting, a question of fact exists as to whether these provisions exclude the recovery of consequential damages."[140]

In *Lava Trading Inc. v. Hartford Fire Ins. Co.*, the federal district court, again construing New York law, applied similar reasoning:

> However, a policy exclusion speaks only to what constitutes a covered loss under a policy of insurance, and not to what remedies are available for breach of a policy. The scope of a policy's coverage and the damages that are recoverable if the insurer breaches the policy are, of course, distinct concepts. Payment to an insured for a covered and non-excluded loss is performance under the contract of insurance. Breach of the contract of insurance is an entirely different matter governed by the present day successors to *Hadley v. Baxendale*, 9 Exch. 341, 156 E.R. 145 (1854) such as the *Kenford* case discussed above.[141]

Because there was still a factual question of the parties' intent as to consequential damages in the event of a breach of contract, it precluded the grant of summary judgment.[142]

[6] Subject Matter Jurisdiction

In *Port Authority of N.Y. & N.J. v. Allianz Ins. Co.*, the Federal District Court determined, upon a motion for remand to the state court, whether the Air Transportation Safety and System Stabilization Act of 2001 (the "Act")[143] provided subject matter jurisdiction to the federal court in an insurance dispute.[144] The plaintiff insureds, including the Port Authority of New York and New Jersey and the World Trade Center lessee, sought a declaration from the defendant insurers that the "Conceptual Framework" agreed upon to redevelop the WTC site will not violate any anti-assignment provisions of the policies. Financing for the rebuilding plan depended on the insurance proceeds. Failing to reach a satisfactory agreement on the point, the plaintiffs filed suit in

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140 357 F. Supp. 2d at 659.
Accord **N.Y.—** 326 F. Supp. 2d 434 (S.D.N.Y. 2004).

141 326 F. Supp. 2d at 442.

142 326 F. Supp. 2d at 443.

143 Pub. L. No. 107-42, 115 Stat. 230, 241 (codified as amended at 49 U.S.C. § 40101 note). Among other things, Section 403 of the Act created the September 11th Victim Compensation Fund.

144 443 F. Supp. 2d 548 (S.D.N.Y. 2006).

New York state court, and the defendants removed the action to the District Court. The parties agreed that the sole basis for jurisdiction was Section 408(b)(3) of the Act, which provides:

> The United States District Court for the Southern District of New York shall have original and exclusive jurisdiction over all actions brought for any claim (including any claim for loss of property, personal injury, or death) resulting from or relating to the terrorist-related aircraft crashes of September 11, 2001.

At issue was whether the Act provides subject matter jurisdiction for an insurance dispute concerning the economics of the rebuilding effort at the WTC. Citing Second Circuit precedent, the court rejected a reading of Section 408(b)(3) that would provide the federal court exclusive jurisdiction for every action involving economic losses having a causal connection to September 11.[145] It reasoned that the dispute is "a matter of pure contract interpretation that does not require the court to revisit what happened on 9/11."[146] While the suit has a connection to September 11, the essential dispute lacks a direct proximity to the attacks of September 11 in the way that "claim[s] for loss of property, personal injury, or death" resulting from the attacks do. Thus, the court remanded the action back to the New York state court.

§ 191.03 Terrorism Risk Insurance Act of 2002

[A] Time Frame and Program Expiration

On November 26, 2002, the Terrorism Risk Insurance Act of 2002 ("TRIA") was signed into law.[147] TRIA established a Federal "backstop" for

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145 443 F. Supp. 2d at 553.

See **U.S.—**Canada Life Assurance Co. v. Converium Ruckversicherung (Deutschland) AG, 335 F.3d 52, 58-59 (2d Cir. 2003)). The Second Circuit in *Canada Life* held that Section 408(b)(3) did not create jurisdiction over a contract dispute between a reinsurer and its retrocessionaire for liability arising out of claims by victims of September 11. 335 F.3d at 54, 57.

146 443 F. Supp. 2d at 554.

147 Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, 116 Stat. 2322 (2002), 15 U.S.C. § 6701 note.

Title I of the statute sets forth the federal insurance program. Additionally, Title II sets forth laws concerning the treatment of terrorist assets, and Title III provisions amend Section 11 of the Federal Reserve Act, 12 U.S.C. § 248. TRIA §§ 201, 301. Section 201(a) of Title II provides that in the case in which a person has obtained a judgment against a terrorist party, "the blocked assets of that terrorist party . . . shall be subject to execution or attachment in aid of execution in order to satisfy such judgment." Blocked asset means any asset seized or frozen by the United States under section 5(b) of the Trading with the Enemy Act (50 U.S.C. § App. 5(b)) or under sections 202 and 203 of the International Emergency Economic Powers Act (50 U.S.C. §§ 1701-1702). TRIA § 201(d)(2). The statute does not affect the immunities provided in the Foreign Sovereign Immunity Act. TRIA § 201(a) (judgment against blocked assets applies only if the terrorist party is not immune under 28 U.S.C. § 1605(a)(7)). *See* note 76 *above* and accompanying text. Title II also sets forth special rules in cases against Iran. TRIA § 201(c)-(d).

Also, TRIA does not affect the jurisdiction or regulatory authority of state insurance commissioners to otherwise regulate the insurance market. TRIA § 106(a).

large losses from terrorism. It is public-private cost sharing program with the private insurance industry (hereinafter referred to as the “Program”). Unlike a private reinsurance arrangement with insurers, the government funds losses, determined by a statutory formula,[148] but it does not collect premiums or develop a reserve prior to the occurrence of an event. Federal payout is subject to an ex post mandatory recoupment, as determined by a statutory formula, and discretionary recoupment.[149] Because the Program does not require the recoupment of all federal payouts, the cost sharing arrangement is a form of subsidized reinsurance that provides a layer of capital protection in the event of a large catastrophic terrorist attack.

The Program is administered by the Secretary of Treasury (the “Secretary”),[150] and it requires the property and casualty insurance companies to make available terrorism coverage to policyholders under terms and premium pricing not materially different from other risks in exchange for federal compensation under the Program’s terms and conditions, and in turn the Program provides for a scheme under which the federal government bears a substantial portion of losses upon the losses exceeding a defined trigger.

Because TRIA was envisioned as a temporary price stabilization measure, it had a sunset date of December 31, 2005.[151] Shortly before the sunset of TRIA, and in response to considerable lobbying from the insurance and business interests, the government extended the Program by enacting the Terrorism Risk Insurance Extension Act of 2005 (the “Extension Act of 2005”).[152] The Extension Act of 2005 extended TRIA for another two years and modified some key terms of TRIA, including establishing higher deductible levels.[153] Shortly before sunset of the Extension Act of 2005, the Program was modified and extended for another seven years under the Terrorism Risk Insurance Program Reauthorization Act of 2007 (the “Reauthorization Act of 2007”).[154] As amended, the Program now has a sunset date of December 31, 2014.

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[148] *See* § 191[E] *below*.

[149] *See* § 191[E] & [F] *below*.

[150] *See* § 191[J] *below*.

[151] TRIA § 108(a). Section 103(c)(2) provides that not later than September 1, 2004, the Secretary shall determine whether the Program should be extended to 2005. On June 18, 2004, the Secretary announced his decision to extend the “make available” requirements through 2005. *Terrorism Risk Insurance Program; Technical Amendments to “Make Available” Provisions and “Insurer Deductible” Definition*, 70 Fed. Reg. 7403, 7404 (Feb. 14, 2005) (to be codified in 31 C.F.R. Part 50).

[152] Terrorism Risk Insurance Extension Act of 2005, Pub. L. No. 109-144, 119 Stat. 2660, 15 U.S.C. § 6701 note. The statute was signed into law on December 22, 2005.

[153] *See* note 230 *below*.

[154] Terrorism Risk Insurance Program Reauthorization Act of 2007, Pub. L. No. 110-160, 121 Stat. 1839 (2007), 15 U.S.C. § 6701 note. The statute was signed into law on December 26, 2007. In addition to extending the Program through 2014, the Reauthorization Act of 2007 made the following significant changes to TRIA as amended by the Extension Act of 2005: (1) applied a 133% surcharge multiplier to the mandatory recoupment, *see* § 191.03[F][1] *below*; (2) directed that the 3% surcharge applies to discretionary recoupment only, *see* § 191.03[F][2] *below*; (3) applied a fixed timetable for the recovery of mandatory recoupment, *see* § 191.03[F][3] *below*.

Given that Congress has extended TRIA twice for a total of nine additional years beyond the original three-year program, it is clear that a short-term price stabilization measure has turned into a long-term, public-private cost sharing program. As a matter of policy and politics, it is an open question whether the Program will be made permanent through a series of extensions, or whether the private sector will eventually be willing to assume the risk of extreme terrorism. There is no way to forecast the likely outcome of the Program, other than to suggest that the insurance industry and the business community will continue to lobby for a government co-share program. It is clear that any contribution that subsidizes the risk of terrorism, i.e., the mechanism in which the costs of terrorism are not fully internalized to the activity, is a benefit that inures to the bearers of that risk. The broader policy question is whether the subsidization and externalization of the cost to the American public are justified by other considerations, perhaps for example that they help to spread the risk more broadly. The Program's fate beyond 2014 will depend on a number of factors, including the political environment, the history of terrorism loss and claims, and the state of the insurance and financial markets.

The focus of this chapter is on the Program, as amended by the Extension Act of 2005 and the Reauthorization Act of 2007. Where appropriate, this chapter identifies and analyzes the changes made to TRIA and subsequent developments of the Program.[155]

[B] Congressional Findings and Purpose

In enacting TRIA, Congress found that the market could not support "reasonable and predictable prices" because September 11 hindered the normal risk spreading function, which in turn adversely affected economic growth and development.[156] The insurance and financial markets, vital to the national economy and its smooth operation, faced "widespread financial market uncertainties" including significant actuarial data and methods to properly allocate risk and loss.[157] The withdrawal of insurance from the market and substantial premium increases could seriously undermine or otherwise suppress economic activity.[158] Thus, Congress found that the federal government should provide a temporary financial cost sharing scheme, thereby contributing to the stabilization of the national economy, while insurance industry and capital markets develop products and programs necessary to create a market for private terrorism risk insurance.[159]

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155 TRIA and its amendments set forth for different years different trigger amounts, deductibles, industry aggregate retention levels, and surcharge multiplier. Since September 11, there has been no terrorist act in the United States or its carriers that has triggered the Program. Since only the present and future are relevant for the determination of losses and payouts, this chapter sets forth the relevant figures for 2008 and forward. The footnotes annotate the different figures for past years.

156 TRIA § 101(a)(1).

157 TRIA §§ 101(a)(2)-(4).

158 TRIA §§ 101(a)(5).

159 TRIA § 101(a)(6).

Based on these findings, Congress enacted the Program to (1) assure "widespread availability and affordability of property and casualty insurance for terrorism risk," and (2) "allow for a transitional period for the private markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses."[160]

[C] Mandatory Participation and Availability

[1] "Insurer" and "Affiliate"

The Program is mandatory. It requires that an "insurer," as defined by the statute, "shall participate in the program."[161]

An "insurer" is an entity that is (1) licensed or admitted to engage in the business of providing primary or excess insurance in any state,[162] (2) federally approved to offer property and casualty insurance in connection with maritime, energy or aviation activity,[163] (3) a state residual market insurance entity or state workers' compensation fund,[164] or (4) a captive or self-insurance arrangement to the extent provided for in the rules of the Secretary.[165]

Moreover, to meet the definition of an insurer, an entity must receive "direct earned premium"[166] for providing any type of commercial "property and casualty insurance" coverage.[167] Direct earned premium is interpreted to

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160 TRIA § 101(b).

161 TRIA § 103(a)(3).

162 TRIA § 102(a)(6)(A)(i). *See* 31 C.F.R. § 50.5(f). If the entity is not licensed or admitted, it is still an insurer if it is an eligible surplus line carrier listed on the Quarterly Listed of Alien Insurers of the National Association of Insurance Commissioners. TRIA § 102(a)(6)(A)(ii).

163 TRIA § 102(a)(6)(A)(iii).

164 TRIA § 102(a)(6)(A)(iv). The Secretary must issue rules pertaining to state residual market insurance entities and state workers' compensation funds. TRIA § 103(d)(1). A state residual market insurance entity that does not share its profits and losses with private sector insurers is a separate insurer. TRIA § 103(d)(2). One that shares its profits and losses is not treated as a separate entity, and must report to each private sector insurance participant its share of insured losses of the entity, which must then be included in each private sector insurer's insured losses. *Id.* Moreover, any private insurer that shares profits and losses with a state residual market insurance entity must include in its calculations of premiums any premiums provided by the state residual market insurance entity. TRIA § 103(d)(3). The Secretary's rules on state residual markets are found in 31 C.F.R. Subpart D, §§ 50.30, 50.33, 50.35, 50.36.

165 TRIA § 102(a)(6)(A)(v). Captive insurers or other self-insurance arrangements are eligible for the Program, but only if the Secretary, prior to the occurrence of an act of terrorism, decides in consultation with state and regulatory bodies to apply the Program. TRIA § 103(f).

166 "Direct earned premium" means a direct earned premium for property and casualty insurance issued by any insurer for insurance against losses occurring at the locations covered by the Program. TRIA § 102(4). *See* TRIA § 102(15) (providing locations that the Program covers).

167 TRIA § 102(a)(6)(B). This requirement does not apply to a state residual market insurance entity, state workers' compensation fund, captive insurer, or other self-insurance arrangements described in TRIA §§ 103(d), (f). *See* notes 164 & 165 *above*. Also, the

mean "all commercial property and casualty insurance (as that term is used in the Act and Treasury's regulations) issues by an insurer for insurance against losses at the specified locations" covered by the Program.[168] If an insurer covers both commercial and noncommercial risk exposures, it may allocate the premiums in accordance with the proportion of risk between the two components to ascertain direct earned premium.[169] The same rule applies for coverages for loss in locations that are and are not covered by the Program.[170]

The definition of "property and casualty insurance" includes excess insurance and workers' compensation insurance.[171] It excludes the following types of insurance, and therefore these product lines and their underwriters are not covered by the Program:[172]

- federal crop insurance and reinsurance under the Federal Crop Insurance Act, or any other type of crop or livestock insurance that is privately issued or reinsured;
- private mortgage insurance or title insurance;
- financial guaranty insurance issued by monoline financial guaranty insurance corporations;
- medical malpractice insurance;
- health and life insurance, including group life insurance;
- flood insurance under the National Flood Insurance Act of 1968;
- reinsurance or retrocessional reinsurance;
- commercial automobile insurance;
- burglary and theft insurance;
- surety insurance (which TRIA had originally included);
- professional liability insurance;
- farm owners multiple peril insurance.

The definition of an "insurer" includes "any affiliate."[173] An "affiliate" means "any entity that controls, is controlled by, or is under common control

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Secretary may prescribe other requirements or restrictions to the definition of insurer. TRIA § 102(a)(6)(C).

168 *Terrorism Risk Insurance Program*, 68 Fed. Reg. 48280, 48281 (Aug. 13, 2003) (to be codified in 31 C.F.R. Part 50).

169 31 C.F.R. § 50.5(d)(iv) (2007).

170 *Id.*

171 TRIA §102(12)(A). The Extension Act of 2005 eliminated surety insurance and included directors and officers liability insurance. Extension Act of 2005 § 3(b)(2). Property and casualty umbrella insurance is considered "excess insurance" and is therefore included in the Program. *Terrorism Risk Insurance Program; Disclosures and Mandatory Availability Requirements*, 68 Fed. Reg. 59720, 59725 (Oct. 17, 2003) (to be codified in 31 C.F.R. Part 50).

172 TRIA § 102(12)(B)(i)-(vii), *as amended by* Extension Act of 2005 § 3(b). *See* Federal Crop Insurance Act, 7 U.S.C. § 1501 *et seq*. (providing federal crop insurance program); Homeowners Protection Act of 1998, 12 U.S.C. § 4901 (providing definition of private mortgage insurance); National Flood Insurance Act of 1968, 42 U.S.C. § 4001 *et seq.* (providing federal flood insurance program).

173 TRIA § 102(6).

with the insurer."[174] An entity is conclusively deemed to "control" another entity if (1) it directly or indirectly owns, controls or has power to vote 25% or more of any class of voting securities of the other entity, (2) it controls in any manner the election of a majority of the directors or trustees, or (3) the Secretary otherwise determines that the entity directly or indirectly exercises a controlling influence.[175]

If an insurer does not come within the above conclusive control provisions, the Secretary will apply a rebuttable presumption of controlling influence if at least two of the following factors exist:

- The insurer is one of the two largest shareholders of any class of voting stock;
- The insurer holds more than 35 percent of the combined debt securities and equity of the other insurer;
- The insurer is party to an agreement pursuant to which the insurer possesses a material economic stake in another insurer resulting from a profit-sharing arrangement, use of common names, facilities or personnel, or the provision of essential services to another insurer
- The insurer is party to an agreement that enables the insurer to influence a material aspect of the management or policies of another insurer
- The insurer would have the ability, other than through holding of revocable proxies, to direct the votes of more than 25 percent of the other insurer's voting stock in the future upon the occurrence of an event
- The insurer has the power to direct the disposition of more than 25 percent of a class of voting stock in a manner other than a widely dispersed or public offering
- The insurer and/or the insurer's representative or nominee constitute more than one member of the other insurer's board of directors
- The insurer or its nominee or an officer of the insurer serves as the chairman of the board, chairman of the executive committee, chief executive officer, chief operating officer, chief financial officer or in any position with similar policymaking authority in another insurer.[176]

In addition to at least one of the above factors, if any one of the following factors exists, there is a rebuttable presumption of control:

- A state has determined that an insurer controls another insurer;
- An insurer provides 25 percent or more of capital or policyholder surplus; or

[174] TRIA § 102(2).

[175] TRIA § 102(2); 31 C.F.R. §§ 50.5(c)(2)-(3).

[176] *Terrorism Risk Insurance Program*, 68 Fed. Reg. 41250, at 41252 (July 11, 2003) (to be codified in 31 C.F.R. Part 50); 31 C.F.R. § 50.5(c)(4)(iv).

- An insurer supplies 25 percent or more of the underwriting capacity for that year to an insurer that is a syndicate consisting of a group of underwriters.[177]

The Secretary interprets the statute to mean that "affiliated entities are treated as a consolidated entity for the purpose of calculating direct earned premium."[178] Non-insurers are not included in the definition of affiliate, and thus only insurers can be considered affiliated for the purpose of the Program.[179]

[2] "Make Available"

The Program requires that insurers "(A) shall make available, in all of its property and casualty insurance policies, coverage for insured losses; and (B) shall make available property and casualty insurance coverage for insured losses that does not differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism."[180] The Program requires that insurers may not exclude from its property and casualty insurance policies certified acts of terrorism. This provision is the essential legislative quid pro quo: in exchange for federal cost sharing, insurers must provide terrorism coverage at premium levels that are not materially different from coverage of other property and casualty risks.[181] The "make available" mandate reverses the terrorism exclusions filed and issued in the immediate wake of September 11.

All property and casualty insurers, as defined, must participate in the Program, and must "make available" terrorism risk coverage "that does not differ materially" from other types of risks. Note that this does not mean that terrorism risk is not subject to ordinary exclusions applicable to other covered risks, such as exclusions for losses associated with war and sovereign acts, and nuclear, biological and chemical events.[182]

Although the Program is mandatory for property and casualty insurers, it is voluntary for policyholders.[183]

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177 *Terrorism Risk Insurance Program*, 68 Fed. Reg. 41250, at 41255 (July 11, 2003) (to be codified in 31 C.F.R. Part 50); 31 C.F.R. §§ 50.5(c)(4)(i)-(iii).

178 *Terrorism Risk Insurance Program*, 68 Fed. Reg. 41250, 41254 to 41255 (July 11, 2003) (to be codified in 31 C.F.R. Part 50).

179 *Terrorism Risk Insurance Program*, 68 Fed. Reg. 41250, 41253 (July 11, 2003) (to be codified in 31 C.F.R. Part 50).

180 TRIA § 103(c).

181 TRIA voided any terrorism exclusion in force to the extent that it excludes losses that would otherwise be insured losses. TRIA § 105(a). It also voided any state approval of such exclusions. *Id.* § 105(b).

182 *See* note 277 & accompanying text *below*. At some point in time, the government may consider covering these losses. See Extension Act of 2005 § 8.

183 *See* Robert J. Rhee, *Terrorism Risk in a Post-9/11 Economy: The Convergence of Capital Markets, Insurance and Government Action*, 37 Ariz. St. L.J. 435 (2005) (discussing the economic effects of this mandatory-voluntary aspect of the Program).

[3] Disclosure of Premium

In providing terrorism coverage, the insurer must provide a "clear and conspicuous disclosure to the policyholder of the premium charged for insured losses covered by the Program and the Federal share of compensation for insured losses under the Program."[184]

[D] Certification of "Act of Terrorism"

To qualify for compensation under the Program, the Secretary must certify an event as an "act of terrorism."[185] The certification of an "act of terrorism" must be in concurrence with the Secretary of State and the Attorney General.[186] The Secretary may not delegate the determination of whether an act of terrorism occurred.[187] Given the inherent uncertainties of how future acts of terrorism will develop and the impossibility of predicting the circumstances in which the insurers, policyholders and the government will find themselves, there is no specified time frame for certification after the occurrence of an attack.[188] The Secretary's certification decision is final and not subject to judicial review.[189]

The Secretary cannot certify an act if the insurance losses comprise less than $5 million.[190] Final rules make clear that this figure is not a limitation as to any single insurer loss, but is an aggregate loss figure.[191]

The Secretary also cannot certify an act if "the act is committed as a part of . . . a war declared by the Congress."[192] In other words, losses from war are not compensable under the Program. Final rules issued by the Secretary interpret this clause to mean that the war exclusion to certification "applies only to acts of terrorism committed in connection with a formal, congressionally declared war."[193] Congressional authorization to the President to engage in military action does not come within the war exclusion to certification. For example, the "Authorization for Use of Military Force Against Iraq Resolution of 2002"[194] gave the President authority to conduct

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184 TRIA § 103(b)(2). *See* 31 C.F.R. § 50.12 (2007). The National Association of Insurance Commissioners has drafted model disclosure forms, reproductions of which are found in § 191.05 of this chapter. *See* note 307 & accompanying text and forms *below*.

185 TRIA § 102(1)(A).

186 TRIA § 102(1)(A).

187 TRIA § 102(1)(D).

188 *Terrorism Risk Insurance Program*, 68 Fed. Reg. 4125, 41252 (July 11, 2003) (to be codified in 31 C.F.R. Part 50).

189 TRIA § 102(1)(C).

190 TRIA § 102(1)(B)(ii).

191 *Terrorism Risk Insurance Program*, 68 Fed. Reg. 41250, 41252 (July 11, 2003) (to be codified in 31 C.F.R. Part 50).

192 TRIA § 102(1)(B)(i). This provision is not applicable to workers' compensation. *Id.*

193 *Terrorism Risk Insurance Program*, 68 Fed. Reg. 41250, 41252 (July 11, 2003) (to be codified in 31 C.F.R. Part 50).

194 Pub. L. No. 107-243, 116 Stat. 1498 (2002).

military operations, and indeed a full scale war between the military forces of the United States and Iraq ensued, but it is not a formal declaration of war for the purposes of the Program.[195]

That the Secretary can certify acts of terrorism absent congressional declaration of war does not mean that the war exclusion is irrelevant. Many policies contain exclusions for losses from war and sovereign acts.[196] Under the application of state law, an exclusion for war loss or sovereign acts may apply to preclude compensation to the policyholder even though the act of terrorism could have been certified. The Program mandates that terrorism risk coverage must not be materially different from other coverages. The Secretary's rules make clear that "[i]f an insurer does not cover all types of risks, then it is not required to cover the excluded risks in satisfying the requirement to make available coverage for losses resulting from an act of terrorism that does not differ materially from the terms, amounts, and other coverage limitations applicable to acts of terrorism."[197] The Program allows ordinary exclusions allowable under state law, such as nuclear, biological and chemical events.[198] War and sovereign act exclusions are also ordinary exclusions founds in many policies.

In the above example of the Iraq War, the Secretary can certify an act of terrorism in connection with the war because Congress did not declare war against Iraq. Suppose as a hypothetical the Iraqi military forces, clearly identify as so, had executed an attack against the American homeland. Under state law, this scenario would pose a likelihood of exclusion. Thus, the act of terrorism could have been certified by the Secretary, but would most likely be excluded under the terms of the policy.

The war exclusion is still relevant in a narrow area. The above Iraq example might provide good legal, political and moral bases to invoke a contract exclusion. As long as the war or sovereign act is manifestly clear, unlike the case in September 11 where the argument was only colorable, the industry can invoke the exclusion and do so in a way that does not do substantial or lasting damage to goodwill and political capital.

[E] Definition of "Act of Terrorism"

As amended, TRIA sets forth two essential elements of an act of terrorism:

> (1) "a violent act or an act that is dangerous to human life; property; or belowstructure; to have resulted in damage within the United States, or outside the United States in the case of an air carrier or vessel . . . or the premises of a United States mission"

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195 *Terrorism Risk Insurance Program*, 68 Fed. Reg. 41250, 41252 (July 11, 2003) (to be codified in 31 C.F.R. Part 50).

196 *See* § 191.02[A][1] *above* (discussing cases).

197 31 C.F.R. § 50.23(b) (2007).

198 31 C.F.R. § 50.23(b) (2007).

> (2) "to have been committed . . . as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion."[199]

This statutory definition is the exclusive definition for the Program, and it preempts any inconsistent state law.[200]

The definition of terrorism is rooted in past experience of violent acts typically in the form of random bombings, hijackings, killings and other acts of destruction. The definition envisions the damage or destruction to life or property from a physical force, which is typically how terroristic acts have occurred and how they are perceived. But there are ambiguities in the statutory scheme, and the Program may leave essential gaps in coverage.

[1] "Damage" and Economic Loss

A loss of "human life," "property" or "infrastructure" is required. The statute does not define property or infrastructure. Obviously, physical assets such as buildings, bridges and airplanes fit within the definitions of property and infrastructure. But an ambiguity arises in the case of economic terrorism.

Not only was the terrorist attack of September 11 a large scale, military-like strike against a major urban center, but it also targeted the national economy. It is reasonable to presume that in attacking the Pentagon and the World Trade Centers, the terrorists intended to harm the symbols of American government and economy. Indeed, the September 11 attack was the second attack against the World Trade Center by radical Islamic terrorists.

As made clear in the definition of terrorism, the ultimate goal of terrorism is to "coerce" populations and governments. Acts of destruction are simply the means of coercion. While terrorism in the past has relied on the application of destructive force, the evolution of terrorism in the future may lead to nonviolent attacks against the national and international economies and infrastructures. The roots of terrorism have many dimensions, and it is beyond the scope of this treatise chapter to explore the nuances of the causes of terrorism, but one obvious dimension is a resistance to Western political, cultural and economic influence. In the future, there is the distinct possibility of economic terrorism to undermine Western populations and governments, which place a high priority in national and international economic stability and growth. In the past, violence has typically been the means of terrorism, perhaps because this was the available means to coerce policy, but coercion and influence can be brought about by nonviolent means as the techniques of coercion evolve and become more sophisticated.

One need not stretch the imagination to see the potential economic harm from minimum levels of sabotage. For example, according to Swiss Re estimates, the 2001 power failures in California caused a productivity loss of

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[199] TRIA § 102(1)(A), *as amended* 2007 Act § 2 (internal section designations omitted). A covered air carrier is defined in 49 U.S.C. § 40102, and a covered vessel is a United States flag vessel. TRIA § 102(5)(B). The United States includes "the territorial sea and the continental shelf of the United States." TRIA § 102(15).

[200] TRIA § 106(a)(2)(A).

$21.8 billion, private party income loss of $4.5 billion, and 135,000 jobs; and, the power failure that blacked out the northeast United States on August 14, 2003, caused losses of $75–$100 million from food spoilage alone.[201]

One plausible scenario of economic terrorism is the interference with or disablement of vital information technology property and belowstructure through nonviolent or nonphysical means. Cyber-terrorism can diminish the economic value tied to functionality without damaging or destroying the physical asset.[202] One can easily imagine how a computer program virus can "damage" or destroy "property" or "belowstructure" within the ordinary meaning of these terms, and such acts may trigger private insurance coverage, depending upon how the contractual language is drafted. American common law recognizes a property interest based on the interference of the functionality of information technology systems, and thus a tort action is possible for an act that diminishes the function of a computer system.[203] A policyholder may obtain coverage for business interruption or consequential loss, which may include the loss of information technology systems. Thus, there is a question of whether the Program covers cases of economic and cyber-terrorism.

[2] "Violent" and "Dangerous" Acts

Related to the issue of economic terrorism is the question of whether diminishment of capacity absent physical alteration of the asset suffices for the Secretary to deem it "damage." This term is sufficiently broad to cover loss of function and resulting economic loss as would be provided in business interruption coverage.[204] The definition of terrorism, however, suggests that the compensation provided by the Program is limited to destructive acts brought about by a physical force or agent.

The statute provides that "damage" is the resulting outcome. Damage or loss must arise from a "violent" or "dangerous" act. One must presume that these two terms are not redundant. Clearly, violence refers to the application of physical force.[205] The definition connotes that a positive force of some kind suddenly impacts the victim or protected object, such as a bomb or a shooting.

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201 Christian Brauner, Swiss Re, The Risk Landscape of the Future 15 (2004).

202 *See* Tara Mythri Raghavan, *In Fear of Cyberterrorism: An Analysis of the Congressional Response*, 2003 U. Ill. J.L. Tech. & Pol'y 297 (discussing federal legislation addressing cyber-terrorism in the wake of September 11).

203 *See, e.g.*, CompuServe, Inc. v. Cyber Promotions, Inc., 962 F. Supp. 1015, 1021 (S.D. Ohio 1997) ("Electronic signals generated and sent by computer have been held to be sufficiently physically tangible to support a trespass cause of action."); Intel Corp. v. Hamidi, 30 Cal. 4th 1342, 1347, 1 Cal. Rptr. 3d 32, 36 (Cal. 2003) ("under California law the tort does not encompass, and should not be extended to encompass, an electronic communication that neither damages the recipient computer system nor impairs its functioning").

204 *See* Black's Law Dictionary 393 (7th ed. 1999) ("Loss or injury to person or property."); Webster's Ninth New Collegiate Dictionary 323 (1983) ("loss or harm resulting from injury to person, property, or reputation").

205 *See* Black's Law Dictionary 1564 (7th ed. 1999) ("Unjust or unwarranted use of force, usu. Accompanied by fury, vehemence, or outrage; physical force unlawfully exercised with the intent to harm."); Webster's Ninth New Collegiate Dictionary 1316 (1983) ("exertion of physical force so as to injure or abuse").

If a nonviolent act that causes a loss falls within the definition of terrorism, the Secretary must determine it to be a "dangerous" act. This term provides more leeway for unconventional acts of terrorism that do not involve the application of violent force. An act could be determined to be perilous, hazardous or unsafe even though it may not be characterized as violent.[206] In the context of terrorism, the natural interpretative difference between "violent" and "dangerous" is that the latter need not connote the positive application of some physical force impacting upon the victim. An act can be considered nonviolent but yet exceedingly dangerous: e.g., exposure to pathogens or chemicals. Between these two terms, Congress covered virtually all scenarios of the conventional view of terrorism.

Although a nonviolent or nonphysical act may plausibly be considered a "dangerous" act, there is still the question of whether the Program does or should cover losses from such acts. Of course, Congress envisioned an act of terrorism as the application of a harmful physical force or agent against a person or property. This risk is extraordinary, one that is not likely to occur and, if it does occur, likely to inflict severe consequences. On the other hand, the risk of the failure of information technology infrastructure is one that businesses already face, irrespective of terrorism. Terrorism is not the only reason why such systems may be sabotaged; competitors and no-cause saboteurs such as computer hackers may do the same. Because this risk is real and substantial, irrespective of terrorism, the private sector invests heavily in system security, redundancy, and recovery. One can argue that this is a risk that private parties, policyholders and insurers, allocate themselves, and that there is no need for governmental assistance under these circumstances. Thus, the statutory language and the rationale of the Program do not support extension of the Program to economic terrorism and cyber-terrrorism that are not accompanied by an act that falls within the meaning of "violent" or "dangerous."

The above interpretation of "violent" and "dangerous" is supported by the preemption provisions of the statute. The Program preempts all state law causes of action "for property damage, personal injury, or death."[207]

Consider cases like *New Market Inv. Corp. v. Fireman's Fund Ins. Co.*[208] There, a conventional act of terrorism (introduction of poison to food products) directly and proximately caused physical losses to the policyholder's property. Cases like *New Market* present a stronger claim for coverage under the Program than cases where there was no violent or dangerous act in the plain meaning of those terms in the context of assessing an act of terrorism.

Ultimately, in the case of an unconventional act that inflicts damage to property or infrastructure, resulting in great consequential economic harm for which there may be insurance coverage, the Secretary must exercise discretion and determine the policy question of whether such economic losses should be covered under the Program. Absent a statutory clarification or the issuance of a

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206 *See* Black's Law Dictionary 399 (7th ed. 1999); Webster's Ninth New Collegiate Dictionary 324 (1983).

207 TRIA § 107(a)(2).

208 *See* note 57 & accompanying text *above*.

rule by the Secretary, one can reasonably foresee that the Secretary's decision would depend on the circumstances of the loss, the extent of the loss, the impact on the national economy, the financial conditions of the affected policyholders and insurers, and the degree to which the risk was capable of being borne solely by the private sector.

[3] Domestic Terrorism

An act of terrorism also requires that the act be done with the purpose of coercing the public or influencing the policies of the American government. In the original version of TRIA, a terrorist was defined as "an individual or individuals acting on behalf of foreign person or foreign interest."[209] In the Reauthorization Act of 2007, this definitional component was deleted.[210] The Program as amended now can encompass acts of domestic terrorism conducted by domestic terrorists, including American natives, citizens, or residents. Nationality or immigration status is unimportant. Since the original language required that a person be "acting on behalf of foreign person or foreign interest," the Program covers any terroristic act by any person, foreign or domestic, even if that person is not acting "on behalf" of a foreign person or interest.

The purpose of the amendment in the Reauthorization Act of 2007 appears to be two-fold. First, it may be extremely difficult to show a causal connection among a terrorist, who may have died during the attack as was the case in September 11, the purpose of the act, and a foreign interest. The statutory requirement in the original TRIA intended to address the greatest threat to domestic security, that of radical Islamic terrorism. But the statute may have imposed an unintended, burdensome evidentiary hurdle in order to trigger the Program. Second, even if Congress was primarily concerned with radical Islamic terrorism, the July 7, 2005, bombing in London showed that domestic nationals and residents can execute terrorist attacks independent of any foreign person or interest,[211] though the inspiration or motive for such attacks may have some connection to a movement or cause vis-à-vis a "foreign person or foreign interest."

These problems prompted Congress to eliminate the requirement of showing that an act is on behalf of a foreign person or interest. However, this elimination also opened the Program to domestic terrorism. The Program now includes domestic acts of terrorism such as the April, 19, 1995, bombing of the Alfred P. Murrah Federal Building in Oklahoma City, or violence connected to

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[209] TRIA § 102(1)(A)(iv). Final rules interpreting TRIA provided that "acts of domestic civil disturbance would not be covered by the Act's definition of 'act of terrorism' or by the Program." *Terrorism Risk Insurance Program*, 68 Fed. Reg. 41250, 41252 (July 11, 2003) (to be codified in 31 C.F.R. Part 50).

[210] 2007 Act § 2.

[211] For example, the July 7, 2005, London suicide bombings of the train and bus systems were executed by four British nationals, but the purpose behind the bombings were clearly tied to the global radical Islamic terrorism movement. *See* Don Van Natta, Jr. & Stephen Grey, *Bombings in London: The Inquiry*, N.Y. Times at A8 (July 18, 2005).

purely domestic policies and agendas carried out by various social, religious or political groups. More troubling is the possibility that the Program can be triggered by mass domestic riots or civil disorders that can be construed as acts of coercion. These acts may also be excluded by the insurance policy as an ordinary exclusion in property and casualty policies,[212] but to the extent that there is no exclusion in the policy they can trigger the Program for they can meet the definition of a terrorist act. Again, these kinds of losses are probably not the type that Congress contemplated in enacting TRIA.

The deletion of the term "acting on behalf of foreign person or foreign interest" does not resolve the question of the purpose for which terrorists act. It simply allows that terrorists can be American citizens or residents with little or no connection to a foreign person or interest other than a commonly shared political or religious agenda. For example, the London bombers may have been British citizens or residents, but one can reasonably guess that they were inspired by a virulent form of radical Islamic religious and political movement. A plain reading of the statute, however, suggests that the Program does not limit an act of terrorism to a specific motivation; a terrorist act seeks only "to coerce the civilian population or to influence or coerce the policy and conduct of the government." The motivation can be purely domestic policies and matters, such as abortion protests, to ill-defined political movements, such as the protests of anarchists and isolationists, to highly defined movements such as the global jihad of radical Islamic terrorist groups. For example, one can easily imagine losses from violent marches or demonstrations on behalf of various political agendas, the type of activity that, while violent, would typically not have been classified as acts of terrorism.[213]

Since the Program cannot be triggered unless the Secretary certifies an act of terrorism, such determination being discretionary, final and unreviewable,[214] the Secretary can and should issue rules that limit the application of the Program to riots and civil disturbances.[215] This risk has traditionally been satisfactorily allocated in the private sector, and there is no reason why the Program should extend coverage. In other words, the Program extends to domestic acts of terrorism, but this does not mean that the Program subsumes within the Secretary's discretion coverage for all domestic acts of criminal destruction.

The scope of the definition of domestic terrorism affects the insurer's "make available" obligation. Without clarification, the definitional uncertainty

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212 *See, e.g.,* **Cal.**—North Bay Schools Ins. Auth. v. Industrial Indem. Co., 6 Cal. App. 4th 1741, 10 Cal. Rptr. 2d 88 (1992) (interpreting riot exclusion).

Idaho—Foremost Ins. Co. v. Putzier, 606 P.2d 987 (Idaho 1980) (same).

213 Under the current definition of terrorism, for example, it is unclear whether the 1999 demonstrations and riots in Seattle during the meeting of the World Trade Organization would be considered an act of terrorism. *See* Sam Howe Verhovek & Steven Greenhouse, *National Guard Is Called to Quell Trade-Talk Protests; Seattle Is Under Curfew After Disruptions*, N.Y. Times at A1 (Dec. 1, 1999).

214 TRIA §§ 102(1)(A), 102(1)(C).

215 The Secretary has the "powers and authorities necessary to carry out the Program." TRIA § 104(a). This power includes the authority to "prescribe regulations and procedures to effectively administer and implement the Program." TRIA § 104(a)(2).

may call into question whether insurers can continue to exclude coverage for riots and civil disorders. The rules suggest that they can continue to exclude these items because an insurer "is not required to cover the excluded risks in satisfying the requirement to make available coverage for losses resulting from an act of terrorism."[216] To the extent that further rules are necessary to clarify permissible exclusion and mandatory coverage, there are a number of factors that the Secretary should consider in the certification decision: the reason or motivation for the riot or civil disorder, the relationship between the reason and the policies of the government and the people of the United States, the spontaneous or planned nature of the destruction, the existence of an organized group that led or initiated the destruction, the stated or implied mission of such group, and the past activities of such group.

[E] Cost Allocation and Payment Structure

[1] Insured Loss

Insured loss is subject to compensation under the Program. "Insured loss" means any loss resulting from a certified act of terrorism (including an act of war, in the case of workers' compensation)[217] that is covered by primary or excess property and casualty insurance issued by an insurer.[218]

The definition of insured loss excludes any punitive damage awarded in litigation.[219] Also, rules clarify that insured loss does not include extra-contractual damages. In addition to punitive damages, the Program will not pay insurers for damages to policyholders and third parties arising from breach of contract, negligence or bad faith.[220] Also, insured loss excludes losses in excess of policy limits.[221]

Insured loss includes expenses that are allocated and identified by the claim file, but excluding staff salaries, overhead and other expenses that would have been incurred notwithstanding the loss.[222]

[2] Loss Trigger

The Program has a loss trigger, which was introduced in the Extension Act of 2005. No compensation will be paid by the Secretary unless the

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[216] 31 C.F.R. § 50.23(b) (2007).

[217] *See* note 192 & accompanying text *above*. The Secretary can certify as an act of terrorism losses from an act of war in the case of workers' compensation. *Id.*

[218] TRIA § 102(5).

[219] TRIA §107(a)(5).

[220] *Terrorism Risk Insurance Program; Claims Procedures*, 69 Fed. Reg. 39296, 39298 (June 29, 2004) (to be codified in 31 C.F.R. Part 50).

[221] *Terrorism Risk Insurance Program; Claims Procedures*, 69 Fed. Reg. 39296, 39298 (June 29, 2004) (to be codified in 31 C.F.R. Part 50).

[222] *Terrorism Risk Insurance Program; Claims Procedures*, 69 Fed. Reg. 39296, 39298 (June 29, 2004) (to be codified in 31 C.F.R. Part 50).

aggregate industry insured loss from a certified act of terrorism exceeds $100 million.[223]

Under this trigger, an act of terrorism can be certified by the Secretary if it exceeds $5 million, so that losses from these acts cannot be excluded under the "make available" provision of the Program, but losses from an act of terrorism may not reach the $100 million trigger required to obtain payment under the Program. In such case, the private market must bear the entire loss. This loss trigger is sufficiently large to exclude from the Program most low intensity violent acts, such as suicide bombings or random car bombings.

In the context of an attack against a commercial target, which is the main purpose of the Program, the $100 million loss trigger is still relatively low as the value of single commercial building or asset can easily exceed the trigger amount. September 11 was the first billion dollar attack, but not the first catastrophic terrorist attack. In the recent history of terrorism, there have been a number of events that have exceeded $100 million.[224] Clearly, the bombing of a major commercial airliner would probably exceed $100 million in losses.

[3] Insurer's Deductible

The "insurer deductible" means "the value of an insurer's direct earned premiums over the calendar year immediately preceding [the] Program Year."[225]

The reference in the statute to the preceding calendar year is a bit ambiguous. In most cases, we would expect that an act of terrorism and the Secretary's certification would occur in the same calendar year. For example, if a terrorist act occurred on June 30, 2005, meeting the loss trigger, and the Secretary soon thereafter certifies the act, the insurer deducible would be calculated based on calendar year 2004. But suppose that an act of terrorism occurred in December 2005, and the Secretary soon thereafter certifies that act

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[223] This loss trigger applies for the calendar years 2008 to 2014. Extension Act of 2005 § 6(2), *as amended by* Reauthorization Act of 2007 § 3(c)(3). In the calendar year 2006, the loss trigger was $50 million. Extension Act of 2005 § 6(2).

[224] *See* Robert J. Rhee, *Terrorism Risk in a Post-9/11 Economy: The Convergence of Capital Markets, Insurance and Government Action*, 37 Ariz. St. L.J. 435, 531 tbl. 1 (2005). Aside from September 11, the following events resulted in catastrophic losses: bombing of NatWest tower on April 24, 1993; bombing in Manchester on June 15, 1996; the first World Trade Center bombing on February 26, 1993; bombing in London on April 10, 1992; bombing of Colombo Airport in Sri Lanka on July 24, 2001; bombing of London's Docklands on February 9, 1996; bombing in Oklahoma City on April 19, 1995; bombing of Pan Am 103 over Lockerbie, Scotland on December 21, 1988; and bombings of three airplanes in Jordan on September 17, 1970. *Id.* This list does not include terrorist acts after September 11 including the September 3, 2004 attack in Belan, Russia, which killed 350 people; the October 12, 2002, bombing in Bali, Indonesia, which killed 202 people; the March 11, 2004, bombing of the Madrid train system, which killed 192 people; the July 7, 2005, bombing of the London transportation system, which killed 52 people. Also, the USS Cole was bombed on October 12, 2000, killing 17 sailors and causing substantial damage to the warship.

[225] TRIA § 102(7). *See* note 166 *above* (defining direct earned premium). When an insurer has not had a full year of operations during the calendar year immediately preceding the loss event, the Secretary determines the appropriate earned premium. TRIA § 102(7)(E).

in January 2006. Depending on the reference point from which "the calendar year immediately preceding [the] Program Year" is applied, the deductible could be calculated from the direct earned premiums of 2004 or 2005.

The Secretary's rule clarifies that "an insurer's affiliates for any Program Year shall be determined by the circumstances existing on the date of occurrence of the act of terrorism that is the first act of terrorism in a Program Year to be certified by the Secretary for that Program Year."[226] The use of the occurrence of the act date is most appropriate to determine the deductible for several reasons. The certification is simply an administrative function, a precondition to the application of the Program, but the actuarial relationship is between the direct earned premium and the loss occurrence. Moreover, there is the potential for insurers to game the deductible by changing the affiliates if there is sufficient time between occurrence and certification.

The above rule also resolves the situation where there is more than one occurrence. It clarifies that an insurer's affiliations are determined by the circumstances on the date of occurrence of the first certified act. For example, assume that a possible terrorist occurs in March (e.g., radiological exposure whose origin and causality are unknown), and there is a continuing investigation to determine whether the event is an act of terrorism. As a result, the Secretary cannot yet certify the act. In September, there is a terrorist attack that is immediately apparent (detonation of bombs in an urban area), and the Secretary certifies this second event as an act of terrorism. In November, the Secretary certifies the first March event as an act of terrorism. In this case of two terrorist acts certified at different times, the affiliations for the purpose of calculating deductibles would be fixed for the entire Program Year as of the occurrence date of the act of terrorism in September, which is the second act of terrorism but the first that is certified.[227]

If an insurer has not had a full year of operations during the calendar year immediately preceding the Program Year, the Secretary determines the appropriate portion of the direct earned premiums of the insurer to calculate the deductible.[228] In such case, the Secretary's rules provide that the direct earned premiums for the current Program Year will be annualized.[229]

The Program sets forth different deductible amounts for different Program Years. Under the Reauthorization Act of 2007, which extended the Program for the years 2008 to 2014, the insurer's deductible is 20 percent of the value of an insurer's direct earned premiums over the calendar year immediately preceding the Program Year.[230]

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[226] 31 C.F.R. § 50.55 (2007).

[227] *Terrorism Risk Insurance Program; Additional Claims Issues; Insurer Affiliates*, 70 Fed. Reg. 34348, 34350 (June 14, 2005) (to be codified in 31 C.F.R. Part 50).

[228] TRIA § 102(7)(E).

[229] *Terrorism Risk Insurance Program; Technical Amendments to "Make Available" Provision and "Insurer" Deductible" Definition*, 70 Fed. Reg. 7403, 7404 (Feb. 14, 2005) (to be codified in 31 C.F.R. Part 50).

[230] Extension Act of 2005 § 3(c)(3); Reauthorization Act of 2007 § 2(c)(1). The following are the deductibles for previous years of the Program:

Transition Year (2002): 1 percent

[4] Federal and Insurer Cost Co-Share Levels

The federal share of compensation paid under the Program is 85 percent of "that portion of the amount of such insured losses that exceeds the applicable insurer deductible required to be paid" during the specific Program Year.[231] The insurer is responsible for the remaining 15 percent of that portion of losses that exceeds the deductible up to the loss cap of $100 billion of insured losses.

[5] Loss Cap

Federal compensation under the Program and the insurer's liability for terrorism losses are capped at the aggregate insured losses level of $100 billion.[232] The Secretary cannot make any payment for the portion of losses exceeding this cap.[233] Moreover, the Program provides that "no insurer that has met [its] insurer deductible shall be liable for payment of any portion of the amount of such losses that exceeds [$100 billion]."[234]

[6] Determination of Pro Rata Share

The Secretary determines the pro rata share of insured losses to be paid by each insurer that incurs insured losses, except that "no insurer may be required to make any payment for insured losses in excess of its deductible under [TRIA] section 102(7) combined with its share of insured losses [i.e., 15 percent co-pay set forth in TRIA § 103(e)(1)(A)]."[235] The Reauthorization Act of 2007 added this last clause, and it makes clear that, once the Program is triggered, the insurer's exposure is limited to its deductible plus co-pay.

Program Year 1 (2003):	7 percent
Program Year 2 (2004):	10 percent
Program Year 3 (2005):	15 percent
Program Year 4 (2006):	17.5 percent
Program Year 5 (2007):	20 percent

TRIA § 102(7); Extension Act of 2005 § 3(c).

See Jeffrey E. Thomas, *Terrorism Insurance: Issues of Policy, Regulation and Coverage*, New Appleman on Insurance: Current Critical Issues in Insurance Law 53 (April 2008) ("… the way insurer deductibles are set may prevent TRIA from meeting its objective of maintaining insurer solvency in the event of a major terrorism loss.").

231 Extension Act of 2005 § 4. Under TRIA, the Federal share was 90 percent. TRIA § 103(e)(1)(A). The 85 percent co-share took into effect in Program Year 5 (2007). The Federal co-share is reduced by the amount of compensation provided by any other Federal program. TRIA § 103(e)(1)(B).

232 TRIA § 103(e)(2)(i). The Secretary must notify Congress if estimated or actual aggregate insured losses exceed $100 billion during the Program. *Id.* § 103(e)(3), *as amended by* Reauthorization Act of 2007 § 3(c)(5).

233 TRIA § 103(e)(2)(ii).

234 TRIA § 103(e)(2)(ii), *as amended* Reauthorization Act of 2007 § 4(a)(1)(B).

235 TRIA § 103(e)(2)(B), *as amended* Reauthorization Act of 2007 § 4(a)(2).

The Reauthorization Act of 2007 also mandates that no later than 240 days after its enactment, the Secretary must issue final regulations for determining the pro rata share of insured losses under the Program when insured losses exceed the $100 billion cap.[236] Presumably, the final regulations would address issues such as whether insured losses exceeding the cap should be a factor in the calculation of the pro rata share, the method to allocate such losses in the calculation of the insurer's pro rata payment from the Program, and other factors that the Secretary may weigh, for example, considerations of an insurer's solvency, market conditions, fairness and other policy concerns.

The Secretary's determination of payments and the methods and calculations used in making that determination are final and not subject to judicial review.[237]

[F] Recoupment

[1] Mandatory Recoupment

Once the federal government provides compensation, the Program requires a mandatory recoupment amount. The mandatory recoupment amount is the difference between the insurance marketplace aggregate retention amount ("aggregate retention") and the aggregate amount, for all insurers, of insured losses that the federal government does not compensate because such losses are within the insurer deductible, or the portion of losses of the insurer's co-pay amount ("insurer payment").[238] If the insurer payment exceeds the aggregate retention, then the mandatory recoupment amount is nil.[239]

The insurer payment is the sum of the insurers' deductible and 15 percent co-share. Under the Reauthorization Act of 2007, which applies to Program Years 2008 to 2014, the aggregate retention is the lesser of $27.5 billion and the aggregate amount, for all insurers, of insured losses.[240]

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236 Reauthorization Act of 2007 § 4(c)(2). Final rules must be issued on or about August 22, 2008. The Reauthorization Act of 2007 also requires the Secretary to report to designated committees of Congress within 120 days of the statute's enactment, or on or about April 24, 2008, the process to be used to determine the allocation of pro rata payments for insured losses under the Program when such losses exceed $100 billion. *Id.*

237 TRIA § 103(e)(5).

238 TRIA § 103(e)(7)(A).

239 TRIA § 103(e)(7)(B).

240 Extension Act of 2005 § 5(a)(3), *as amended by* Reauthorization Act of 2007 § 3(c)(6). The insurance marketplace aggregate retention amounts for previous years of the Program are the lesser of the aggregate amount, for all insurers, of insured losses and the following amounts.

Transition Year (2002):	$10 billion
Program Year 1 (2003):	$10 billion
Program Year 2 (2004):	$12.5 billion
Program Year 3 (2005):	$15 billion
Program Year 4 (2006):	$25 billion
Program Year 5 (2007):	$27.5 billion

TRIA § 103(7); Extension Act of 2005 § 5(a).

The Secretary must collect repayment of the mandatory recoupment through "terrorism loss risk-spreading premiums in an amount equal to 133 percent of any mandatory recoupment amount for such period."[241] The 133 percent multiplier is intended to neutralize the lost tax revenue when policyholders deduct the surcharges on their corporate taxes. The following is a summary of the mandatory recoupment calculation.

Scenario #1: Aggregate Retention > Insurer Payment

Recoupment = 133% x (Aggregate Retention – Insurer Payment)

Scenario #2: Aggregate Retention < Insurer Payment

Recoupment = 0

Not later than 90 days after the date of an act of terrorism, the Secretary must publish an estimate of aggregate insured losses, which will be used as the basis for determining whether mandatory recoupment will be required, and such estimate will be subject to updating as appropriate.[242]

[2] Discretionary Recoupment

If the Federal government's payment exceeds any mandatory recoupment amount, the Secretary may recoup, through terrorism loss risk-spreading premiums, additional amounts based on the following factors: (1) the ultimate cost of the Program to taxpayers, (2) the economic conditions in the commercial marketplace, including factors indicating the financial health of the insurance industry, (3) the affordability of commercial insurance for small and medium sized businesses, and (4) other factors that the Secretary may deem relevant.[243]

[3] Recoupment Through Policy Surcharge

The Secretary is responsible for the collection of recoupment. In determining the method and manner of imposing the surcharge, the Secretary must take into consideration the economic impact on commercial centers of urban areas, including commercial rents and insurance premium prices, the risk factors related to rural areas and smaller commercial centers, including the potential exposure to loss and the likely magnitude of such loss, potential for cross-subsidization between urban and rural areas, and various exposures to terrorism risk for different product lines of insurance.[244]

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241 TRIA § 103(e)(7)(C), *as amended by* Reauthorization Act of 2007 § 4(e)(1)(A).

242 Reauthorization Act of 2007 §4(e)(1).

243 TRIA § 103(e)(7)(D).

244 TRIA § 103(e)(8)(D). The Secretary has discretion to adjust the timing of recoupment collection to provide for equivalent application of the provisions to policies that are not based on a calendar year, or to apply such provisions on a daily, monthly, or quarterly

Any recoupment amount is collected as a terrorism loss risk-spreading premium.[245] This surcharge premium is imposed on property and casualty insurance policies in force after the date the surcharge is established, and is based on the percentage of premium amount charged under the policy for the property and casualty coverage.[246]

For an act of terrorism that occurs in or before calendar year 2010, the Secretary must collect all mandatory recoupment by September 30, 2012.[247] For any act of terrorism that occurs in calendar year 2011, the Secretary must collect 35 percent of any mandatory recoupment by September 30, 2012, and the remainder by September 30, 2017.[248] For any act of terrorism that occurs in calendar year 2012 to 2014, the Secretary must collect all mandatory recoupment by September 30, 2017.[249]

These timetables for collection of mandatory recoupment do not apply to any determination of discretionary recoupment. A terrorism loss risk-premium collected on a discretionary basis may not exceed, on an annual basis, 3 percent of the premium charged under the policy.[250]

[4] Examples of Payments and Recoupments

Example 1

In 2010, a terrorist attack causes $80 million of insured losses. There are 20 insurers impacted, and their direct earned premium is $2 billion.

Trigger:	Not Satisfied (< $100 million loss)
Deductible:	NA
Insurer Co-Pay:	NA
Federal Co-Pay:	NA
Total Insurer Loss:	$80 million

Although the Secretary can certify the terrorist attack, the loss does not trigger the Program. Losses must be allocated among policyholders and insurers per the insurance policies.

Example 2

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basis. TRIA § 103(e)(8)(E). This discretion is limited by the repayment schedules found in the Reauthorization Act of 2007. Reauthorization Act of 2007 § 4(e)(2)(B). *See* notes 247-249 *below*.

245 TRIA § 103(e)(8).

246 TRIA § 103(e)(8)(A). Insurers must collect the surcharge amount from policyholders and remit to the Secretary. TRIA § 103(e)(8)(C).

247 Reauthorization Act of 2007 § 4(e)(1)(B).

248 Reauthorization Act of 2007 § 4(e)(1)(B).

249 Reauthorization Act of 2007 § 4(e)(1)(B). The Secretary must issue rules pertaining to the procedure to be used for collecting mandatory recoupment by on or about April 24, 2008.

250 TRIA § 103(e)(8)(C), *as amended by* Reauthorization Act of 2007 § 4(e)(2)(A).

In 2010, a terrorist attack causes $150 million of insured losses. There are 20 insurers impacted, and their direct earned premium is $2 billion.

Trigger:	Satisfied (> $100 million loss)
Deductible:	$400 million (20% of direct earned premium)
Insurer Co-Pay:	$0
Federal Co-Pay:	$0
Total Insurer Loss:	$150 million

Since the deductible is greater than the insured loss, the insurers and their policyholders will bear the full cost of the losses.

<u>Example 3</u>

In 2010, a terrorist attack causes $2.5 billion of insured losses. There are 50 insurers impacted, and their direct earned premium is $10 billion.

Trigger:	Satisfied (> $100 million loss)
Deductible:	$2,000 million (20% of direct earned premium)
Insurer Co-Pay:	$75 million (15% of losses in excess of deductible)
Federal Co-Pay:	$425 million (85% of losses in excess of deductible)
Total Insurer Loss:	$2,075 million

The aggregate retention is the lesser of the aggregate amount, for all insurers, of insured losses and the statutory amount of $27.5 billion. In this case, the aggregate retention is $2.5 billion. The mandatory recoupment is the positive difference between the aggregate retention, $2.5 billion, and the aggregate uncompensated insurer loss, $2.075 billion. The government recoups its payment of $425 million plus 33 percent. Based on the schedule in the Program, the mandatory recoupment must be collected by September 30, 2012.

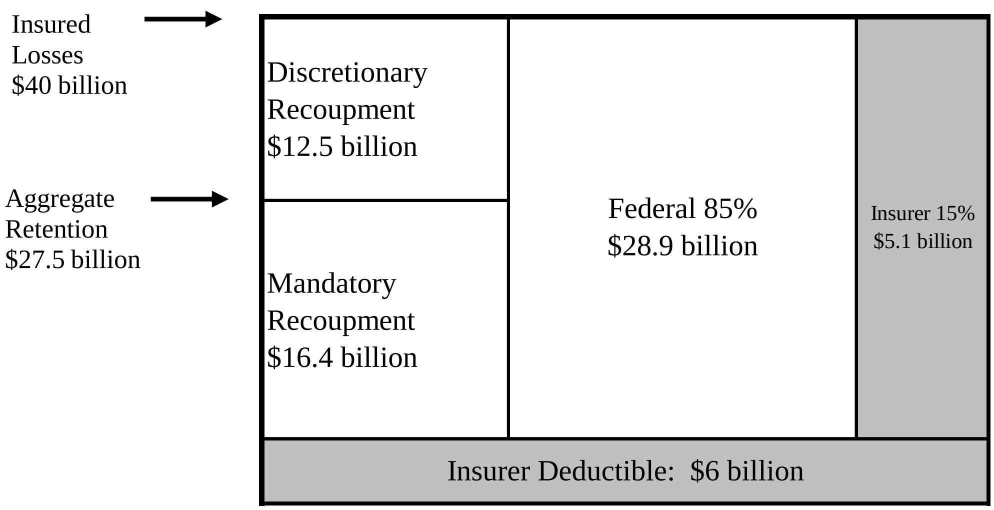
<u>Example 4</u>

This example shows how the Program works in the case of a large, mega-catastrophic event. In 2010, a terrorist attack causes $40 billion of insured losses. There are 100 insurers impacted, and their direct earned premium is $30 billion.

Trigger:	Satisfied (> $100 million loss)
Deductible:	$6 billion (20% of direct earned premium)
Insurer Co-Pay:	$5.1 million (15% of losses in excess of deductible)
Federal Co-Pay:	$28.9 billion (85% of losses in excess of deductible)
Total Insurer Loss:	$11.1 billion

The aggregate retention is $27.5 billion. The mandatory recoupment is $16.4 billion, and the remainder of the government payment of $12.5 billion is subject to discretionary recoupment. The following chart shows the breakdown of payments and recoupments.

CHART 1



[H] Reinsurance and Excess Recovery

The Program does not limit or prevent insurers from obtaining reinsurance coverage for insurer deductibles or insured losses retained by insurers (the insurer's co-share).[251] Reinsurance coverage for these losses does not affect the calculation of deductibles and retentions.[252] Federal payment is not reduced by reinsurance payment to an insurer, except that such reinsurance payment and the federal payment may not exceed the aggregate amount of the insurer's insured loss for such a period.[253] Any such excess amount, to the extent not covered in the reinsurance agreement as a recoupment by the reinsurer, must be returned to the Secretary.

More generally, the sum of federal payment and the insurer's recoveries for insured losses from other sources cannot be greater than the insurer's aggregate losses for acts of terrorism in the Program Year.[254] In other words, the insurer cannot make a windfall from an act of terrorism. Compensation provided by other federal programs can be considered duplicative payment and thus subject to offset. These programs include: (1) disaster relief and emergency assistance by the Federal Emergency Management Agency, (2) block grant assistance by the Department of Housing and Urban Development, (3) and federal programs specially established to compensate victims for losses resulting from certified act of terrorism (similar to the September 11th Victim

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[251] TRIA § 103(g)(1).

[252] TRIA § 103(g)(1).

[253] TRIA § 103(g)(2).

[254] *Terrorism Risk Insurance Program; Claims Procedures*, 69 Fed. Reg. 39296, 39300 (June 29, 2004) (to be codified in 31 C.F.R. Part 50).

Compensation Fund).[255] But there is no offset for Social Security disability payments and other similar benefits, which are entitlements to individuals as a result of service performed and are paid irrespective of whether the loss occurs as a result of an act of terrorism.[256]

[I] Insurer's Disclosure

The insurer must provide "clear and conspicuous disclosure" to policyholders of the premium charged for terrorism coverage and the federal share of compensation for insured losses under the Program.[257] For any policy issued after the enactment of the Reauthorization Act of 2007, the insurer must provide a "clear and conspicuous disclosure to the policyholder of the existence of the [$100 billion] cap . . . at the time of offer, purchase, and renewal of the policy."[258] The last section of this chapter reproduces forms drafted by the National Association of Insurance Commissioners that provide model disclosure.[259]

The disclosure requirement is only for the benefit of policyholders. There is no requirement that insurers provide disclosures to other parties, including mortgage finance providers.[260]

[J] Administration

Payment under the Program requires that a policyholder suffers an insured loss and files a claim with the insurer.[261] The insurer must process the claim in accordance with ordinary business practices and any rules of the Secretary.[262] To make a claim under the Program, the insurer must submit to the Secretary a claim for payment, written certification of the underlying claim and all payment made for insured losses, and certification of its compliance with the Secretary's rules.[263]

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255 *Terrorism Risk Insurance Program; Claims Procedures*, 69 Fed. Reg. 39296, 39301 (June 29, 2004) (to be codified in 31 C.F.R. Part 50).

256 *Terrorism Risk Insurance Program; Claims Procedures*, 69 Fed. Reg. 39296, 39301 (June 29, 2004) (to be codified in 31 C.F.R. Part 50).

257 TRIA § 103(b)(2).

258 Reauthorization Act of 2007 § 4(d)(2).

259 *See* § 191.05 *below*.

260 *Terrorism Risk Insurance Program; Disclosures and Mandatory Availability Requirements*, 68 Fed. Reg. 59720, 59722 (Oct. 17, 2003) (to be codified in 31 C.F.R. Part 50).

261 TRIA § 103(b)(1).

262 TRIA § 103(b)(3).

263 TRIA § 103(b)(4). Advanced payments are possible, but the insurer must certify that the payments will be distributed to policyholders within five business days of receipt of funds, and that any interest earned on such funds will be remitted to the Treasury. *Terrorism Risk Insurance Program; Claims Procedures*, 69 Fed. Reg. 39296, 39298 (June 29, 2004) (to be codified in 31 C.F.R. Part 50).

The Secretary administers the Program, and is vested with the power to issue interim and final rules and procedures for such administration.[264] The Secretary also has the power to assess a civil monetary penalty against any insurer that the Secretary determines has failed to charge, collect or remit terrorism loss risk-spreading premiums, has intentionally provided the Secretary false information regarding premium or loss amount, has submitted a fraudulent claim under the Program, or has otherwise failed to comply with rules and regulations.[265] Such monetary penalty is the greater of $1 million or, in the case of any failure to pay, charge, collect, or remit amounts in accordance with the Program, such amount in dispute.[266] Also, the Secretary has the power to subsequently adjust compensations, or require repayment of any compensation previously awarded.[267]

[K] Litigation Management

Upon the determination of an act of terrorism by the Secretary, the Program creates an exclusive federal cause of action for "property damage, personal injury, or death arising out of or resulting from such act of terrorism."[268] The Program preempts all state law causes of action "for property damage, personal injury, or death."[269] The substantive law, however, is derived from the law, including choice of law principles, of the state in which such act of terrorism occurred.[270] The procedures and rules issued by the Secretary under 31 C.F.R. § 50.82, as in effect on the date of issuance in final form, shall apply to any cause of action brought under the Program.[271]

By 90 days after a certified act of terrorism, the Judicial Panel on Multidistrict Litigation must designate one or more U.S. District Court that "shall have original and exclusive jurisdiction over all actions for any claim (including any claim for loss of property, personal injury, or death) relating to or arising out of an act of terrorism."[272] This assignment should be based on the convenience of the parties and the just and efficient conduct of proceedings. For the purpose of personal jurisdiction, the assigned district court is deemed to sit in all judicial districts of the United States.[273]

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[264] TRIA §§ 103(a)(2), 104; 31 C.F.R. § 50.2 (2007).
[265] TRIA §104(e)(1).
[266] TRIA §104(e)(2).
[267] *Terrorism Risk Insurance Program; Claims Procedures*, 69 Fed. Reg. 39296, 39298 (June 29, 2004) (to be codified in 31 C.F.R. Part 50).

[268] TRIA § 107(a)(1). The litigation management provisions apply only to actions that arise out of or result from acts of terrorism that occurred during the effective period of the Program. TRIA § 107(e).
[269] TRIA § 107(a)(2).
[270] TRIA § 107(a)(3).
[271] Extension Act of 2005 § 7.
[272] TRIA § 107(a)(4).
[273] TRIA § 107(a)(4).

Lastly, the United States has the right of subrogation with respect to any payment made under the Program.[274]

[L] Study and Reporting Requirements

TRIA mandated that the Secretary study and report to Congress whether adequate and affordable catastrophic reinsurance for acts of terrorism is available to life insurers that issue group life insurance, and whether terrorism risk affects the availability of life insurance and other insurance products, including personal lines.[275] The Extension Act of 2005 did not add any other lines of products to the Program, but instead excluded commercial automobile insurance, burglary and theft insurance, surety insurance, professional liability insurance, and farm owners multiple peril insurance.[276] Nor did the Reauthorization Act of 2007 include additional lines or products to the Program coverage.

However, the Extension Act of 2005 mandated that the President's Working Group on Financial Markets perform an analysis of the long-term availability and affordability of insurance for terrorism risk, including group life and coverage for nuclear, biological, chemical, and radiological events ("NBC" risk).[277] The President's Working Group submitted this report in September 2006, and it concluded, among other things, that there has been little if any disruption of the group life market since September 11 and that there has been little development in the market for NBC risk.[278] Thus, the TRIA Program does not now include group life insurance and it does not provide coverage for nuclear, biological, chemical and radiological events. The report also concluded that since September 11, the insurance market substantially improved in the financial health of the insurance industry and the delivery of terrorism coverage to the market. But the report expressed uncertainty on the potential long-term development of the terrorism risk insurance market.

The Reauthorization Act of 2007 mandates that the President's Working Group on Financial Markets continue to analyze the long-term availability and affordability of the market for terrorism risk.[279] The Group must submit reports in September 2010 and 2013, the year before sunset of the Program.

The Reauthorization Act of 2007 also mandates that the Comptroller General of the United States must examine the availability and affordability of insurance coverage for losses caused by terrorist attacks involving NBC risks, and the capacity of the private market to manage these risks.[280]

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274 TRIA § 107(c).

275 TRIA § 103(h)-(i).

276 Extension Act of 2005 § 3(b)(1)(C).

277 Extension Act of 2005 § 8.

278 Terrorism Risk Insurance: Report of the President's Working Group on Financial Markets at 80 (Sept. 2006), *available at* www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/report.pdf (last visited on Mar. 24, 2008).

279 Reauthorization Act of 2007 § 5(c).

280 Reauthorization Act of 2007 § 5(a). This report is due no later than one year after the enactment of the statute. The Comptroller is also required to submit a study to determine

Collectively, these study and reporting requirements will continue to inform Congress of the evolving nature of terrorism risk and its effects on the insurance market and economy. Moreover, they will play a significant role in the government's decision to terminate, continue or modify the Program in the future.

[M] Summary of TRIA and Amendment Changes

The following table presents some of the major changes as the Program evolved from TRIA to its two amendments, the Extension Act of 2005 and the Reauthorization Act of 2007.

§ 191.04 TRIA and Beyond: Policy Considerations

[A] Insurance Industry Strategy

Since the enactment of TRIA, the strategy of the insurance industry has been clear. A federal co-share agreement provides subsidized insurance at the

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whether there are specific markets in the United States where there are "unique capacity constraints on the amount of terrorism risk insurance available." Reauthorization Act of 2007 § 5(b). This report was due on or about April 24, 2008.

extreme end of terrorism risk. The Program has evolved since 2002. Under the Extension Act of 2005 and the Reauthorization Act of 2007, the Program has shifted a greater share of the burden to the insurance industry: a loss trigger was introduced; deductibles, co-pay percentage, and aggregate retention amounts have increased. These mechanisms ensure that most ordinary acts of terrorism are covered mostly, if not all, by the private sectors among policyholders and their insurers. This makes sense because the insurance industry can underwrite these types of losses in the same way as other insurable fortuitous risks. The loss from a car bomb should be just as insurable, without extraordinary governmental assistance, as the loss from an engineering failure in a structure. That the private sector would assume most ordinary acts of terrorism was the assumption of the "make available" requirement of the Program. However, when there are extreme events such as September 11, the Program assumes a great portion of the losses up to the cap. Some payments are ultimately paid back in the form of a mandatory recoupment, but the remaining payment need not be recouped.

Since some payments may not be recouped, and since the Program does not charge an ex ante premium for participation, the Program provides subsidized reinsurance. In effect, the government provides free capital.

From the insurer's perspective, there is no reason to discontinue the Program since the provision of free capital is always a good thing. Lobbying efforts by both the insurance industry and the business community resulted in extensions of the Program in 2005 and again in 2007. There is no reason to believe that the same incentives will not come to bear in 2014 when the Reauthorization Act of 2007 is set to expire. Although TRIA was enacted "to allow for a transition period for the private markets to stabilize," the Program has gone from a temporary program (originally envisioned for three years) to a long-term, public-private partnership (12 years). There is nothing to suggest that the insurance industry, now or in the future, will shun free reinsurance coverage for extreme risk.

[B] Difficulties of Assessing Terrorism Risk

The argument for a federal reinsurance program essentially stems from the difficulty in assessing terrorism. If acts of terrorism were predictable in the same vein as auto accidents or home fires, there would be no argument for government intervention. The risk can be efficiently allocated between insurer and policyholder, and these parties should internalize the cost of terrorism. The problem is the great uncertainty associated with terrorism risk.

September 11th presented an information shock on two levels. First, the insurance industry learned that diversification of business lines does not necessarily reduce the risk. The attacks affected 23 different product lines, including property and casualty, life and health, liability, aviation, business interruption, and workers compensation. Second, and more profoundly, the severity of the loss exceeded any expectations or linear extrapolations from previous data, and losses from catastrophic terrorism could exceed those of extreme natural catastrophes. Without a mechanism to assess the risks and reserve against anticipated losses, terrorism risk could become a black hole of liability. These considerations pose the question of whether the risk is quantified in an actuarial sense and so can be priced. Because the keystone concept in insurance is the law of large numbers, insurance works best when frequency is high and severity is relatively low, e.g., auto and home insurance. When frequency is low and severity is high, as is the case in both man-made and natural catastrophes, assessibility of risk is problematic and insurability is tested at the extremities.

Two primary arguments have been made to suggest that terrorism risk is unique, and therefore should be a subject to a government compensation program. First, the risk can be extreme. Second, it is unpredictable in the sense that the risk is not capable of assessment.

September 11 was a paradigm shifting event because it showed that acts of terrorism can cause extreme losses, equaling or exceeding the worst natural catastrophes. But this fact alone is not so compelling to justify government subsidized reinsurance. Terrorism is similar to natural catastrophes in that it is random and involves low frequency, potentially high severity. Only a few spectacular acts will cause widespread losses. In this regard, terrorism is very much like natural catastrophes. In the context of the twentieth century, September 11 was a 1/100 year event. In recent history, only Hurricane Andrew, the Northridge earthquake, and Hurricane Katrina were comparable to September 11 in terms of scale of insurance losses.[281] Indeed, large natural catastrophes are more likely to occur than similar scale terrorist acts, and over the course of many years the aggregate loss from large scale natural catastrophes will most probably inflict greater losses. Yet no one has suggested that the insurance industry should not cover natural catastrophes or that losses from these events are uninsurable.

While the losses from September 11 were extreme, it is important to note that the event did not truly test the solvency of the industry. Whereas Hurricane Andrew resulted in the bankruptcies of 12 small insurers,[282] September 11 did not have the same effect on the industry. Few, if any, insurers became troubled as a result of the losses. Reinsurers absorbed a bulk of the losses, and since September 11, the insurance industry has recapitalized and the financial health of sector is now stronger than it was then.

The probabilities are that a natural catastrophe is more likely to threaten the solvency of the industry. Consider, for example, the tsunami that struck South Asia on December 26, 2004, killing approximately 280,000 people. The afflicted regions were underdeveloped, and there was shallow penetration of insurance, which is indicative of less developed economies.[283] These types of natural catastrophes are not limited to poor countries. There is a tangible possibility that such a similar scale event will occur in California or the Pacific Northwest. With only a substantial fraction of the lives lost as compared to the

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[281] *See* Crippen, note 3 *above*, at 9.

[282] Christopher M. Lewis & Peter O. Davis, *Capital Market Instruments for Financing Catastrophe Risk: New Directions?*, 17 J. Ins. Reg. 110, 113 (1998).

[283] *See* Christian Brauner, Swiss Re, Tsunami in South Asia: Building Financial Protection 7 (2005) ("However, due to the very low insurance density, the insured losses will be relatively low compared to the overall scale of the losses suffered.").

South Asia tsunami, many property and casualty and life insurers may become troubled as a result of the massive losses that would ensue. Thus, the greatest risk of exogenous shock to the industry is from a natural mega-catastrophe.[284]

Terrorism risk can be extreme, but no more so than the risk of many different kinds of natural catastrophes that can strike a major urban or commercial area where there is a concentration of insured interests. The argument that terrorism risk is so fundamentally different and thus uninsurable is in truth self-serving, and reflects more lobbying strategy than actuarial reality. "Terrorism coverage may be quantitatively different, but it is not qualitatively different."[285]

With respect to assessibility, it has been suggested that the "biggest—perhaps virtually insurmountable—problem with terrorism risk is that very limited historical data are available on terrorist attacks, and because terrorism threat is dynamic, even the available historical data are less relevant in predicting future incidents in the case of terrorism than natural catastrophes."[286] The pricing of premium presupposes the sufficient quantification of risk. The informational challenge is great. The industry needs to collect, analyze and schematize data into a working model of frequency and severity, methods of terrorism, weaknesses in the national security system, geographic location, political risk, and international developments as well as individual risks and vulnerability of policyholders.

But here again the problem is not insurmountable. Most types of natural catastrophes, like hurricanes and earthquakes, are limited to particular geographic areas. And, most types of catastrophic terrorism are limited to areas of large concentration of value. This means major cities and commercial centers. Patterns of terrorism already are evident in the data. Terrorism risk is claimed to be different from natural catastrophes because it can strike anywhere as opposed to the geographic limitation of some natural catastrophes.[287] But even the most cursory review of the unrefined data shows that 8 of the top 10 costliest catastrophes struck London, New York, and the airline industry. Below is a table showing the top 10 most costly terrorist attacks.[288]

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284 Harry Shuford, *Understanding Cycles and Shocks in the Property and Casualty Insurance Industry*, 39 BUS. ECON. 38, 39 (2004). Indeed, sophisticated insurers recognize the potential exposure to mega-catastrophes hitting large population centers and the opportunities for the insurance industry to both profit from these risks and provide a service to society. *See* Munich Re, Megacities—Megarisks: Trends and Challenges for Insurance and Risk Management 4–5 (2004).

285 The Cato Inst., note 31 *above*, at 34 (comment of Scott Harrington, Wharton School of the University of Pennsylvania).

286 Hubbard & Deal, note 24 *above*, at 56.

287 *See, e.g.*, The Cato Inst., note 31 *above*, at 21 ("[T]errorism is not an accidental risk, it is not a quantifiable risk . . . it is not predictable.") (comment of Debra Ballen, American Insurance Association).

288 Auriela Zanetti et al., Swiss Re, sigma No. 1/2002, Natural Catastrophes and Man-Made Disasters in 2001: Man-Made Losses Take on a New Dimension 17 tbls. 4–5 (Thomas Hess ed., 2002). The loss listed for September 11 in this table understates the actual loss, which was in excess of $30 billion.

TABLE 2

Losses (US$ M)	**Victims**	**Date**	**Event**	**Country**
19,000	3000	9/11/01	WTC and Pentagon attacks	US
907	1	4/24/93	Bombing of NatWest tower	UK
744	--	6/15/96	Bombing in Manchester	UK
725	6	2/26/93	WTC garage bombing	US
671	3	4/10/92	Bombing in London	UK
398	20	7/24/01	Bombing of Colombo Airport	Sri Lanka
259	2	2/9/96	Bombing of London's Docklands	UK
145	166	4/19/95	Bombing in Oklahoma City	US
138	270	12/21/88	PanAm bombing over Lockerbie	UK
127	--	9/17/70	Three planes hijacked, bombed	Jordan

Costly acts of terrorism, of the kind that is violent or dangerous to person or property, presupposes concentration of high value, insured interests, which are found in large cities and commercial centers. In the past, commercial airlines have been targeted because security was soft, commercial jets are expensive assets, and the aircraft provides a natural hostage setting. That London and New York have been historical targets is not surprising since they are major population and commercial centers, as well as symbols of Western political and economic power. The attack against the Pentagon during September 11 and the Oklahoma City bombing are connected in that both attacks targeted the United States government. Collectively, these simple observations explain the historical data.

This is not to suggest that acts of terrorism will follow historical trends. As discussed earlier, it is foreseeable that terrorism will evolve to inflict new types of risks and losses, including economic and electronic terrorism. However, the important point is that, for the purposes of the insurance industry, catastrophic terrorism presupposes a concentration of high value, insurable interests. Viewed in this way, assessment is not an insurmountable task. Just like natural catastrophes, which are limited to large swaths of geographic areas like Florida and California, high value economic targets tend to be concentrated in geographic areas, whether they be cities, industrial zones, certain industries, or specific assets. The tragedy of September 11 has many dimensions, but one striking aspect is that high value economic targets such as New York and the World Trade Center were considered "soft" targets. With the realization that terrorists have targeted high value economic assets, security around those assets has increased significantly. Many of these properties are no longer "soft" targets. Major cities, ports of entry, and economic assets like factories, dams, and skyscrapers have increased their security. These assets are less risky now.

Since September 11, there has not been another terrorist attack, big or small, in the geographic United States. During this time, the insurance industry has recovered much of its losses through the premiums charged to cover terrorism risk. No one knows when the next terrorist strike will occur, perhaps this year or perhaps ten years from now, but when it occurs there certainly would have been many years of premium collection and the building up of reserves. Whether that reserve is sufficient to pay the loss is unknown, but this is also a part of the business of insurance—no one ever promised the insurance industry a guaranteed profit under the guise of the law of large numbers. The fundamental business of insurance is to assume risk.

There will never be a day in which terrorism risk can be calculated to an actuarial certainty like auto or life insurance. Significant uncertainty will always surround terrorism risk. But it is a mistake to believe that uncertainty equates to inassessibility.

[C] Effect of Subsidized Insurance on the Market

In the opinion of this author, the involvement of the government presents significant questions of fairness and efficiency.[289] The advantages of government involvement are apparent. After the initial price dislocations in the immediate aftermath of September 11, the "take up" rate of terrorism coverage has gone up to 64 percent in the first half of 2007.[290] Premium rates have also declined. In 2006, terrorism coverage constituted 4.2 percent of the premium for the overall property and casualty premium.[291] This constitutes approximately $47 per $1 million of total insured value.

However, there is a significant caveat to these positive pricing trends. Although the amendments to TRIA imposed greater share of financial responsibility on insurers and policyholders, the pricing continued to decline. This indicates that "competition has held down premium increases."[292] Competition in the industry increases as the industry has more capital. Insurance is a cyclical business, with price levels ebbing and flowing with the supply of capital. Since September 11, capital has flowed into the insurance industry. With a greater supply of capital, insurers will feel a need to provide terrorism risk coverage, whether there is or is not a Federal reinsurance. Moreover, the Congressional Budget Office concludes: "In the absence of a federal mandate, insurers have a strong incentive to offer terrorism coverage to their commercial customers because to do otherwise risks their losing business on other property and casualty line."[293] Presumably, they would lose business because in a competitive market, such as the insurance market, there would be a competitor who would provide terrorism coverage to gain another insurer's

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[289] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 1 (Aug. 2007).

[290] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 15 (Aug. 2007).

[291] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 15 (Aug. 2007).

[292] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 15 (Aug. 2007).

[293] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 6 (Aug. 2007).

customer. Thus, there might be a sufficient availability of terrorism coverage even without the Program.[294]

Because extreme risk is mitigated dramatically, insurers can underwrite terrorism with the knowledge that an act of terrorism will most likely not cause insolvency or otherwise threaten the existence of the firm. Given the rarity of terrorism on the American homeland, and the more remote possibility given the added security measures in a post-September 11 world, the provision of terrorism coverage, which mortgage financiers require in the provision of credit, is a highly profitable venture. In years 2002 to 2004, estimates of terrorism risk premiums were $700 million, $2.3 billion, and $2.7 billion, respectively.[295] Obviously, these premiums do not make up for the $36 billion loss of September 11, but over the course of several more years, without further claims, the loss would be made up.

Moreover, the financial health of the insurance industry currently is good. At the end of 2006, the property and casualty insurers' net worth was $487 billion, which is greater than their pre-September 11 levels. This surplus level was achieved despite large losses associated with Hurricanes Charley, Frances, Ivan, Jeanne and Katrina in 2004 and 2005. In 2006, the industry benefited from an underwriting gain of $31 billion, and had net profits of $64 billion.[296]

In sum, since September 11, premiums for terrorism coverage have declined, and the take up rate of terrorism coverage has increased. Certainly, the Program had a significant effect. The Program mandates that insurers "make available" terrorism coverage, and the existence of the federal reinsurance program assures that premiums are no different from that of other coverages. Given this structure, the insurance industry has benefitted substantially. Terrorism risk coverage has provided substantial underwriting profit, which would also result in substantial investment profits.

[D] Problems of Subsidized Risk

In the opinion of this author, it is fairly clear that government subsidized insurance has a net negative effect in terms of fairness and efficiency. As the Congressional Budget Office (CBO) concludes, "TRIA does not lower the total costs of terrorism risk but rather shifts more of the burden from commercial property owners and their tenants to taxpayers."[297] The Program does not have a cost reducing effect, which would result in a net benefit for society, but is instead a wealth transferring apparatus that shifts some of the cost of the

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[294] "Even if risk cannot be priced with great precision, insurance markets may function reasonably well as long as those insurers bearing risks are compensated for the uncertainty that surrounds estimates fo the probabilities of their incurring losses." *Id.* at 5.

[295] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 17 (Aug. 2007).

[296] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 17, 19 (Aug. 2007).

[297] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 10 (Aug. 2007).

activities of well funded, profitable industries such as insurance, commercial real estate, and finance to the American taxpayer.

There is no question that the insurance industry and the business community can bear the full cost of terrorism. September 11 was a paradigm shifting, cataclysmic event in the annals of insurance and terrorism histories. Yet, the insurance industry readily absorbed the loss.[298] Currently, the net worth of insurers writing commercial lines covered by the Program is about $187 billion, and thus this amount is still sufficient to cover a $100 billion total exposure under the Program.[299] Certainly, a $100 billion hit to capital from a terrorist attack several multiples greater than September 11 would be devastating, but such an event would not result in a systemic failure of the insurance industry,[300] which should be the benchmark for determining whether governmental intervention is warranted or not.

If the private sector of insurers and commercial policyholders can absorb a multi-billion dollar loss, then the only justification for government intervention is to shift the cost from businesses and insurers to American taxpayers. This raises problems of fairness and efficiency.

As to fairness, the issue is evident. There is no reason why American taxpayers should partially fund the cost of business activity when there is no net social gain from such subsidization. In other words, since subsidization does not reduce the overall level of losses expected from terrorist acts—i.e., terrorists would not be deterred because there is a cost shifting mechanism in place—the cost of terrorism must be born by the insurer, policyholder, or American taxpayer. Given this reality, one must ask why the American taxpayer should subsidize the cost of business activity when the insurers and policyholders are capable of assuming the costs, though the cost could be unpleasant under some scenarios.

As far as efficiency, there is substantial evidence to suggest that the enactment of the Program is not cost neutral, i.e., the Program does not affect the total amount of the anticipated cost of terrorism. Rather, the Program is inefficient in that it may increase the cost of terrorism. If an activity does not fully internalize its cost, the externalization of some of the cost results in inefficient behavior. A tangible example can be given. Assume that a commercial developer has a choice of two architectural designs: Design A is a state of the art glass office tower structure, which is highly susceptible to an

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[298] In fact, the insurance industry has also absorbed the large losses from Hurricane Katrina without systemic failure as well.

[299] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 19 (Aug. 2007).

[300] *Insurance and Terrorism: Hearing Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Activities* (Oct. 24, 2001), *available at* 2001 WL 26187518 (statement of J. David Cummins, Harry J. Loman Professor of Insurance and Risk Management, The Wharton School, University of Pennsylvania: "A study I recently conducted indicates that the insurance industry could survive an event of that magnitude [$100 billion loss] but that markets would be disrupted by numerous insurer insolvencies as well as market price and availability problems."). Since the time of September 11, when Professor Cummins' assessment was made, the insurance industry has gained a stronger balance sheet. Thus, the $100 billon loss scenario is one that the industry can absorb without systemic failure.

attack from a truck bomb; Design B is a more generic structure made of concrete and reinforced steel. Or, consider a choice of location: Location A is a highly desirable urban location that is dense with high value properties; Location B is a suburban location that is low risk for a terrorism strike. If the cost of procuring terrorism coverage is risk based and fully incorporates the choice of design, the commercial developer must consider the added cost of insurance associated with Design A and Location A. On the other hand, if some of the insurance cost is subsidized by a third party, then the reduction in cost adversely factors into the developer's choice of architectural design and location. In these everyday choices, businesses can opt to avoid or mitigate risks, though such avoidance or mitigation may result in costs such as loss of aesthetics, convenience, or financial costs. The more risky choice increases the cost of terrorism, and yet a subsidized insurance program may actually incentivize risky behavior, thus increasing overall cost.

These examples illustrate a fundamental problem of government insurance subsidies.[301] More importantly, it is not an abstract hypothetical. There is evidence that the effect described above is taking hold in the market. Again, the CBO notes that "[a]n abundance of evidence suggests that commercial policyholders as a group are not taking significant steps to avoid or mitigate terrorism risks associated with their existing properties."[302] In addition to a failure to avoid or mitigate risk, there is evidence of undesirable risk-taking. The CBO also notes that "TRIA's subsidies also appear to dampen the inclination of firms to relocate their operations away from high-risk areas," thus reducing the risk of exposure.[303] Compounding this problem is the fact that as a result of subsidized insurance "[p]olicyholders generally do not receive explicit discounts on their terrorism insurance premiums for taking specific mitigation steps."[304] Thus, there is substantial reason to believe, based on policy analysis and empirical observation, that the Program ultimately increases the cost of terrorism.[305]

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[301] This problem is well documented in the National Flood Insurance Program. *See* Robert J. Rhee, *Catastrophic Risks and Governance after Hurricane Katrina: A Postscript to Terrorism Risk in a Post-9/11 Economy*, 38 Ariz. St. L.J. 581 (2006) (discussing the problem of flood insurance).

[302] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 20 (Aug. 2007).

[303] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 2 (Aug. 2007). "Moreover, by keeping premiums for terrorism insurance artificially low, TRIA may encourage construction in areas at greatest risk of being targeted and thus could increase losses from a terrorist attack." *Id.* at 2.

[304] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 20 (Aug. 2007).

[305] Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 20 (Aug. 2007). *See* Robert J. Rhee, *Terrorism Insurance: Subsidy is Corporate Welfare*, Nat'l L.J. (Dec. 3, 2007) ("If the federal subsidy to the insurance industry is extended again or made permanent, Congress and President Bush should explain why American taxpayers should fund a corporate subsidy that ultimately causes greater loss of property and life, undermines national security and advances the agenda of terrorists.").

The evidence suggests that even without the Program, terrorism risk coverage would be available in the market. Such insurance may and probably would be more expensive without a federal reinsurance program, but the cost is a matter that would be allocated between the two principal private market actors, the insurer and the policyholder. As between them, the cost is zero sum: the policyholder would pay more premiums, but eventually the insurer may end up having paid a greater cost. The cost is fully borne by the activity, and if the cost is deemed too high such that the activity is foregone, it is reasonable to conclude that the activity, on the whole, should not be initiated, which would be the result under a fully internalized cost structure. As seen, however, the Program provides government subsidy of extreme risk. When an activity does not fully internalize its cost and some cost is externalized, there is an adverse effect. Inefficiency may result, meaning a greater total cost, though much of this is dispersed to a greater number of cost bearers (i.e., American taxpayers) in a way that the original risk bearers (i.e., insurers and policyholders) profit from the subsidization. This scheme would then raise substantial issues of fairness.

In 2014, when the Program is once again set to expire, the government will once again have the opportunity to weigh these considerations. One option would be to eliminate the Program altogether. Another option could be to incorporate an ex ante premium. The Congressional Budget Office has calculated that premiums for the reinsurance program, if charged, would have had a value of approximately $850 million in 2006 and 2007, respectively.[306] It is odd that the government has chosen not to charge these premiums, or at least hold these premiums as a potential offset to recoupment under the Program. Another option could be to dramatically raise the trigger amount to the level of loss that would in fact cause a systemic failure of the insurance market. Presumably, this trigger would be far greater than the current trigger of $100 million, perhaps by 2014 a trigger amount in the order of $50 billion or even greater.

One must bear in mind that the public's (and therefore the government's) concern is not the preservation of the insurance industry's or policyholder's profits, but is instead a systemic failure of the economic system. In other words, the effects, whether positive or negative, of a private contractual arrangement between two sophisticated parties should not concern the American public or politicians. If there is a loss or higher cost among them, they should assume that effect as part of doing their business. It is only when their activity affects third-parties, who are not parties to the contract and have not or cannot negotiate for the disposition of such effects, as would be the case in a systemic failure of the insurance industry, does the matter rise to one of public concern, for such failure would adversely affect everyone. In this regard, the trigger amount should reflect the level of loss that would endanger an entire industry as opposed to inflict losses on the industry or endanger a few insurers or policyholders who ex post may have made bad choices. From this perspective,

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306 Peter R. Orszag, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, Congressional Budget Office Paper, 20 (Aug. 2007).

a $100 million trigger is a tiny amount. The history of natural catastrophes, particularly in the 1990s and the twenty-first century, shows that multi-billion dollar losses are now quite routine.

§ 191.05 Disclosure Forms

On December 19, 2007, the Property and Casualty Insurance Committee and the Terrorism Insurance Implementation Working Group of the National Association of Insurance Commissioners adopted the Model Disclosure Forms.[307] The Treasury Department worked with the Committee and the NAIC Working Group to assure that the disclosures satisfy the revised disclosure requirements in the Act.[308] Following are versions of Form 1 and Form 2 that were current as of this writing in early 2008.

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[307] These forms are found on: www.naic.org/documents/topics_tria_disclose1.pdf (last visited on Feb. 18, 2008), and www.naic.org/documents/topics_tria_disclose2.pdf (last visited on Feb. 18, 2008).

[308] *See* 31 C.F.R. § 50.17 (2007) (providing that disclosure is satisfied by using the NAIC model forms).

[A] NAIC Form 1 ─ Policyholder Disclosure Notice of Terrorism Insurance Coverage

POLICYHOLDER DISCLOSURE
NOTICE OF TERRORISM INSURANCE COVERAGE

You are hereby notified that under the Terrorism Risk Insurance Act, as amended, that you have a right to purchase insurance coverage for losses resulting from acts of terrorism, *as defined in Section 102(1) of the Act*: The term "act of terrorism" means any act that is certified by the Secretary of the Treasury—in concurrence with the Secretary of State, and the Attorney General of the United States—to be an act of terrorism; to be a violent act or an act that is dangerous to human life, property, or belowstructure; to have resulted in damage within the United States, or outside the United States in the case of certain air carriers or vessels or the premises of a United States mission; and to have been committed by an individual or individuals as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion.

YOU SHOULD KNOW THAT WHERE COVERAGE IS PROVIDED BY THIS POLICY FOR LOSSES RESULTING FROM CERTIFIED ACTS OF TERRORISM, SUCH LOSSES MAY BE PARTIALLY REIMBURSED BY THE UNITED STATES GOVERNMENT UNDER A FORMULA ESTABLISHED BY FEDERAL LAW. HOWEVER, YOUR POLICY MAY CONTAIN OTHER EXCLUSIONS WHICH MIGHT AFFECT YOUR COVERAGE, SUCH AS AN EXCLUSION FOR NUCLEAR EVENTS. UNDER THE FORMULA, THE UNITED STATES GOVERNMENT GENERALLY REIMBURSES 85% OF COVERED TERRORISM LOSSES EXCEEDING THE STATUTORILY ESTABLISHED DEDUCTIBLE PAID BY THE INSURANCE COMPANY PROVIDING THE COVERAGE. THE PREMIUM CHARGED FOR THIS COVERAGE IS PROVIDED BELOW AND DOES NOT INCLUDE ANY CHARGES FOR THE PORTION OF LOSS THAT MAY BE COVERED BY THE FEDERAL GOVERNMENT UNDER THE ACT.

YOU SHOULD ALSO KNOW THAT THE TERRORISM RISK INSURANCE ACT, AS AMENDED, CONTAINS A $100 BILLION CAP THAT LIMITS U.S. GOVERNMENT REIMBURSEMENT AS WELL AS INSURERS' LIABILITY FOR LOSSES RESULTING FROM CERTIFIED ACTS OF TERRORISM WHEN THE AMOUNT OF SUCH LOSSES IN ANY ONE CALENDAR YEAR EXCEEDS $100 BILLION. IF THE AGGREGATE INSURED LOSSES FOR ALL INSURERS EXCEED $100 BILLION, YOUR COVERAGE MAY BE REDUCED.

Acceptance or Rejection of Terrorism Insurance Coverage

☐ I hereby elect to purchase terrorism coverage for a prospective premium of $_____________.

☐ I hereby decline to purchase terrorism coverage for certified acts of terrorism. I understand that I will have no coverage for losses resulting from certified acts of terrorism.

____________________________	____________________________
Policyholder/Applicant's Signature	Insurance Company
____________________________	____________________________
Print Name	Policy Number
____________________________	
Date	

[B] NAIC Form 2 ─ Policyholder Disclosure Notice of Terrorism Insurance Coverage (Includes Notice of Premium Attributable to Terrorism Coverage)

POLICYHOLDER DISCLOSURE
NOTICE OF TERRORISM INSURANCE COVERAGE

Coverage for acts of terrorism is included in your policy. You are hereby notified that under the Terrorism Risk Insurance Act, as amended in 2007, the definition of act of terrorism has changed. As defined in Section 102(1) of the Act: The term “act of terrorism” means any act that is certified by the Secretary of the Treasury—in concurrence with the Secretary of State, and the Attorney General of the United States—to be an act of terrorism; to be a violent act or an act that is dangerous to human life, property, or belowstructure; to have resulted in damage within the United States, or outside the United States in the case of certain air carriers or vessels or the premises of a United States mission; and to have been committed by an individual or individuals as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion. Under your coverage, any losses resulting from certified acts of terrorism may be partially reimbursed by the United States Government under a formula established by the Terrorism Risk Insurance Act, as amended. However, your policy may contain other exclusions which might affect your coverage, such as an exclusion for nuclear events. Under the formula, the United States Government generally reimburses 85% of covered terrorism losses exceeding the statutorily established deductible paid by the insurance company providing the coverage. The Terrorism Risk Insurance Act, as amended, contains a $100 billion cap that limits U.S. Government reimbursement as well as insurers’ liability for losses resulting from certified acts of terrorism when the amount of such losses exceeds $100 billion in any one calendar year. If the aggregate insured losses for all insurers exceed $100 billion, your coverage may be reduced.

The portion of your annual premium that is attributable to coverage for acts of terrorism is __________, and does not include any charges for the portion of losses covered by the United States government under the Act.

I ACKNOWLEDGE THAT I HAVE BEEN NOTIFIED THAT UNDER THE TERRORISM RISK INSURANCE ACT, AS AMENDED, ANY LOSSES RESULTING FROM CERTIFIED ACTS OF TERRORISM UNDER MY POLICY COVERAGE MAY BE PARTIALLY REIMBURSED BY THE UNITED STATES GOVERNMENT, MAY BE SUBJECT TO A $100 BILLION CAP THAT MAY REDUCE MY COVERAGE AND I HAVE BEEN NOTIFIED OF THE PORTION OF MY PREMIUM ATTRIBUTABLE TO SUCH COVERAGE.

_____________________________ _____________________________
Policyholder/Applicant’s Signature Date

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Print Name

Name of Insurer: _____________________

Policy Number: ______________________