By Gregg J. Loubier and Jason B. Aro

Insuring the Risks of Terror

Questions of the cost and application of terror insurance remain open

The nation resolved soon after the terrorist attacks on September 11 to recover and rebuild. As the nation mourned, few could avoid wondering who would foot the bill. The stunning losses prompted an outpouring of governmental, corporate, and charitable relief to affected families. The federal government hastily enacted major aid and economic stimulus legislation. Property insurance companies and their reinsurers are expected to pay roughly half the total property damage losses—and currently these are estimated to be as high as $100 billion.[1] Insurance industry officials announced soon after the attacks that insurers would honor claims under existing property insurance policies and that the industry's capital reserves were adequate to pay the huge estimated losses.[2] At the same time, however, most insurers began issuing their new property insurance policies with an exclusion from coverage for losses due to acts of terrorism. The resulting uncertainty over the availability of insurance coverage for acts of terrorism has affected to some degree every insured real estate asset and mortgage loan in the United States and prompted legislation to provide federal terrorism insurance.

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Some observers have suggested that the insurance industry should have anticipated and reserved against the risks of terrorism in the United States because the risks already were apparent before September 11. Investor Warren Buffet has been widely quoted as saying that after the Oklahoma City bombing and the 1993 attack on the World Trade Center, the insurance industry failed to appreciate the risks of terrorism.[3] Another commentator has suggested, however, that no quantitative models for the evaluation of risk could have predicted the attacks because catastrophes like the one that occurred on September 11 are unpredictable.[4] Yet, the insurance industry has been forced to develop ways to predict the heretofore unpredictable in order to offer terrorism insurance again. Owners of real estate, their lenders, and their counsel have worked to understand, reduce, and insure against the risks of terror in ways that balance the interests and demands of the parties involved.

Some of the developing models for determining terrorism risk and magnitude of potential loss from a terrorist act assume that the degree of risk is proportional to the relative prominence of the real estate asset. While the logic of such an assumption is undeniable, currently the nation may be overly inclined to view acts of terrorism only as major catastrophes like the events of September 11. The experience of other nations suggests that a terrorist act is just as likely to occur in a suburban pizza parlor or crowded office plaza as it is at a national landmark. Therefore, every place is at risk to some degree and should be examined to determine whether exposure to risk should be reduced by prevention, effective emergency response, and insurance.[5]

Typical all-risk property insurance policies in existence on September 11 for real estate assets in the United States covered losses resulting from acts of terrorism, irrespective of the type, size, or value of the real estate asset insured. All-risk property insurance policies actually contain numerous exclusions and do not cover losses resulting from, for example, flood, earthquake, boiler explosion, acts of war, and nuclear damage. How-

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ever, on September 11, coverage for acts of terrorism was not excluded from most standard coverage.

After that day, the insurance industry and policyholders focused on the war risk exclusion in existing property insurance policies. Many contemplated whether insurers would invoke that exclusion to avoid paying claims arising from the attacks, particularly after President Bush declared that the terrorist acts constituted an act of war.[6] The war risk exclusion describes a "hostile or warlike action in time of peace or war…by any government or sovereign power (de jure or de facto), or by any authority maintaining or using military, naval or air forces…or…by an agent of any such government, power, authority or forces."[7] Despite the characterizations of events by governmental officials, the acts of terrorism on September 11 do not constitute acts of war for purposes of the war risk exclusion in a property insurance policy. The perpetrators were not agents of a sovereign government or a group with any incidence of sovereignty. Accordingly, insurers did not invoke the war risk exclusion.

The insurance industry acted swiftly, however, to limit or exclude coverage for acts of terrorism when writing new all-risk property insurance policies after September 11. By doing so, any insured that wants or needs to buy terrorism insurance now must obtain separate terrorism coverage if it is available. California property owners are familiar with the need to purchase separate earthquake insurance to obtain coverage for earthquake damage, which is otherwise excluded from the standard property insurance policy. And just as the availability of earthquake insurance all but evaporated after the 1994 Northridge earthquake, after September 11, terrorism insurance became largely unavailable almost overnight and, consistent with the law of supply and demand, any terrorism insurance available could be purchased only at prices uneconomic for most insureds.

Definitions and Exclusions

The insurance industry is highly regulated, and the industry's efforts to exclude terrorism coverage have occurred within its regulatory boundaries. The Insurance Services Office (ISO) is an organization that provides insurance industry advisory services and drafts standard forms of insurance policy provisions for hundreds of U.S. insurance companies. The ISO promulgated a terrorism risk exclusion that has been ratified by most state commissioners of insurance where insurers must file for approval of insurance forms.[8] Essentially, the ISO exclusion for a commercial property policy defines "terrorism" as the use or threat of force or violence when the effect is to intimidate or coerce a government or population or to disrupt any segment of the economy, or when the intent is to intimidate or coerce a government or promote political, ideological, religious, social, or economic objectives or to promote or oppose a philosophy or ideology.[9] The ISO exclusion also excludes coverage for any claim involving terrorism with nuclear materials or the dispersal or release of pathogenic or poisonous biological or chemical materials, regardless of the damage sustained. Claims caused by incidents of terrorism that exceed $25 million in total insured damage to property in the United States and Canada are also excluded.[10] A single incident includes acts of terrorism that occur within a 72-hour period and appear to be carried out in concert. The ISO exclusion for a commercial general liability policy is similar to the standard commercial property policy exclusion except that the $25 million property damage threshold is not limited geographically, and the exclusion may be triggered if there is death or serious physical injury to at least 50 people.[11]

Notably, California, New York, Texas, Georgia, and Florida have withheld approval of the ISO terrorism exclusions.[12] As an example of the concerns these states expressed, the California Department of Insurance stated:

- The $25 million countrywide damage threshold is unreasonably low.
- The 72-hour incident period may be arbitrary and/or unfair.
- The total exclusion for biological and chemical incidents may be overly broad and unreasonable.
- The 50-person death or injury requirement for liability exclusion may be unreasonably low and arbitrary.
- The exclusions as a whole may have anticompetitive effects.[13]

While California and other states debate the merits of the ISO exclusion, anecdotal evidence indicates that insurers operating from the nonratifying states are writing property insurance policies through affiliated companies that operate from other states that have approved a terrorism exclusion.[14] To further complicate the insurance landscape, 30 states (including California) are Standard Fire Policy jurisdictions.[15] SFP states require that property insurance cover direct fire damage no matter what caused the fire, even terrorism or nuclear events. Thus, terrorism exclusions in SFP states should not defeat claims for losses resulting from terrorism if the losses arise from an ensuing fire. SFP coverage may provide some comfort to property owners without terrorism coverage. Insurers writing policies in SFP states may be expected to review and possibly adjust premiums to reflect any terrorism risk judged to be embedded in the fire policy.

Impact on Financing

The limitation or exclusion of terrorism coverage in property insurance policies has broadly affected commercial real estate and mortgage finance. Most commercial real estate assets are financed, and therefore mortgage lenders determine to a certain extent how real property security for mortgage loans is insured. Virtually all mortgages existing before September 11 required that the real property security for the loan must be insured under an all-risk property insurance policy, but mortgage lenders seldom specifically required terrorism insurance. Most mortgage loan documents list in detail the specific types of insurance required and also generally obligate the borrower to provide "such other insurance as lender may reasonably require" (or a variation thereof).

Since September 11, mortgage lenders and loan servicers nationwide are reviewing these insurance provisions in existing mortgage loan documents against existing or renewal insurance policies to determine whether borrowers are providing the insurance coverage that is required by the documents and, if not, whether the lender can or should demand terrorism insurance coverage. Servicers of commercial mortgage loan portfolios have borne a heavy burden in time and expense undertaking this monumental review.[16]

In many cases, difficulties for the borrower ensue when a lender or servicer decides that the property must have terrorism insurance. Lenders and borrowers big and small have been caught in a rapidly changing environment in which few can agree upon the standard for quantifying terrorism risk. If a lender decides that terrorism insurance is necessary, the coverage may be unavailable or available only at confiscatory rates. Several noteworthy battles have erupted between lenders and borrowers after lenders demanded expensive terrorism coverage for such high-profile assets as the Mall of America in Minnesota, the Condé Nast Building in New York, and the Opryland Resort and Convention Center in Nashville.[17] These disputes are inevitable when the demand for insurance and its supply at economic rates remain out of balance. By and large, however, lenders have not pushed loans into default when confronted with absent or inadequate terrorism insurance coverage.[18] Anecdotal evidence suggests, however, that some lenders have obtained the coverage and charged the borrower for the cost.

By the end of the first quarter of 2002, a handful of large companies were offering terrorism coverage at premiums significantly lower than those quoted at the beginning of the quarter.[19] The profit motive has reportedly attracted significant new capital to the terrorism insurance market, which should make terrorism coverage more available at increasingly competitive rates.[20] Even so, available insurance amounts may be too low and deductibles too high, and policies may be canceled by the insurer on short notice. Few policies may be available where insurers act to limit geographic and concentration risk.[21] In addition, most terrorism coverage excludes protection for biological or chemical attacks.[22] Reinsurers and others continue to argue that terrorism risk is virtually impossible to quantify, making it uninsurable. As a result, insurers may remain unable to satisfy demand for terrorism insurance for the short term.[23]

For new mortgage loans, many lenders are requiring terrorism coverage that is based on a selected standard. Generally, the new language may require terrorism coverage 1) outright, 2) if commercially available regardless of cost, or 3) if available at commercially reasonable rates. There are several variations on these basic standards. Depending on the evaluation of risk and the negotiating strength of the parties, terrorism insurance may be required under one standard or another, but only if prudent or institutional owners of similar properties are obtaining such insurance or if prudent or institutional lenders are requiring such coverage for similar properties. The parties may agree to cap the borrower's annual premium expense to provide required coverage, which may be based on a multiple of the prevailing premium for such coverage at the time of loan origination. Alternatively, the amount of terrorism coverage may be limited to an amount less than the full replacement cost of the asset or higher deductibles may be permitted. To avoid gaps in coverage, counsel should make certain that the language of the terrorism coverage mirrors the terrorism exclusion in the all-risk property policy.

Evaluating the Risk

A perceived need in the mortgage capital markets has fostered the development of a model for evaluating the risk of terrorism. This model has been applied to commercial mortgage-backed securities (CMBS), through which a significant portion of the nation's commercial mortgage debt has been securitized. (In fact, the mortgage encumbering the World Trade Center was securitized less than 60 days before September 11.[24]) Investors in CMBS receive a return on their investment from the income stream generated by the mortgages backing the securities, which are usually bonds. Investors purchase CMBS in reliance on the ratings assigned to the bonds by one of the major credit rating agencies. The ratings assigned to CMBS derive in part from the availability of insurance against the risks posed by events that might interrupt payments to the bondholders.

Moody's Investors Service, one of the leading rating agencies, has developed a framework that calculates the effect on CMBS ratings of the relative likelihood that a real estate asset will be targeted by terrorists.[25] Moody's work has contributed substantially to the debate over the need for terrorism insurance on CMBS loans and has informed the review of servicers of the insurance requirements that affect existing CMBS mortgage loans. Moody's framework assumes that, given the nature of terrorism, the more prominent an asset the more likely it will be a target of an act of terrorism. The framework consists of a matrix in which the risk decreases as the number of loans in a CMBS loan pool increases (i.e., the risk is spread over a large pool of loans secured by a diverse range of real estate assets) and as the relative prominence of the real estate assets securing the loans in the pool diminishes. Conversely, the risk increases as the pool size diminishes and as the prominence of the real assets securing the loans in the pool increases. Thus, the rating of CMBS issued to investors in a so-called single-asset securitization of a mortgage loan secured by a lien on a high-profile asset such as the Sears Tower in Chicago could be affected significantly by terrorism risk considerations, while the rating of CMBS backed by a large and diverse pool of loans secured by low-profile assets would be less affected.

The risks of terror also directly affect property owners and their tenants. Counsel for owners of commercial real estate should be aware of ways to reduce the risk of attack and minimize loss of life and damage to property if an attack occurs. Since September 11, those working in and visiting downtown Los Angeles and other areas must comply with new security measures and participate in evacuation drills. One view suggests that all businesses operate under a higher standard of care after September 11, with a duty to reduce potential exposure to claims for personal injury, property damage, and other direct and indirect losses that could result from terrorist acts.[26]

A study prepared by RAND for the Building Owners and Managers Association of Greater Los Angeles evaluates the threat of terrorism to downtown Los Angeles and recommends ways to reduce and manage the risks to safeguard the health and safety of the downtown community.[27] The RAND study proposes that the likelihood that a real estate asset would become the target of terrorism depends on the relative vulnerability of the target and the potential consequences (including physical and psychological consequences) of the attack.[28] The prominence of the target affects the degree of potential vulnerability and consequences that might follow an attack. Under the RAND model, risk reduction measures are most indicated for a building that is severely vulnerable, such as one in which a certain tenant might be targeted for attack, and the consequences of an attack would be catastrophic.[29]

RAND suggests that there is little a building owner can do to prevent attacks like those of September 11. Responsibility for preventing such acts of terrorism falls largely to the federal government. Access control and perimeter security are practical first lines of defense that can discourage the more likely forms of attack that building owners can realistically expect to deter. RAND also strongly encourages building owners to focus on the primary lesson of September 11, which is that response measures—such as effective evacuation plans—save lives. Overall, the RAND study proposes that a proper balance must be struck between the need for security and the realities of the business environment in which the owners and occupants of buildings operate.[30]

Given the random nature of terrorism, prevention and response measures cannot entirely mitigate the risks of terror, and insurance will remain a critical part of terrorism risk management. Insurance costs and the costs of risk reduction measures incurred by landlords may be passed through to tenants who must pay the costs as part of common area maintenance charges under the terms of tenant leases. The landlord's ability to pass on such costs can be cold comfort because increased costs can affect the marketability of the landlord's asset. For example, the marketability of a high-profile Class A office building in a central business district may be decreased by the lender's decision to require expensive terrorism insurance when a neighboring lower-profile Class A office building escapes the expense. Tenants may bear increased expense under property insurance policies that the tenants maintain directly with respect to the leased property. If possible, the landlord should be a named insured under the tenant's terrorism insurance policy.

Proposed Legislative Solutions

The events of September 11 occurred in the midst of an economic downturn in which real estate remained a bright spot in an otherwise slow economy. Industry groups lobbied heavily for federal terrorism insurance, and proposed legislation gained momentum once the president and Congress determined that uncertainties over terrorism insurance could adversely affect jobs and economic growth.[31] Industry groups have argued that federal terrorism insurance is essential because the insurance industry may never write affordable coverage for large, expensive, and highly vulnerable real estate, or for the biological, nuclear, or chemical attacks that are a growing concern. On the other hand, many have questioned the wisdom of creating a potentially huge new federal burden through what has been characterized as a bailout of the insurance industry.

The House of Representatives and the Senate passed terrorism insurance bills that will not likely become law before the current session of Congress ends. The House bill would provide a one-year risk program whereby the federal government would make loans available to pay 90 percent of claims between $1 billion and $20 billion.[32] The Senate plan would pay 80 percent of losses resulting from a terrorist attack up to $10 billion after insurers have absorbed certain losses based on their market share. The government would pay 90 percent of losses thereafter.[33] Republicans have favored restrictions on lawsuits by victims of terrorism against both the government and businesses.[34] Democrats favor limiting suits against the government but argue that limiting suits against businesses diminishes the incentive to prevent attacks.[35]

Even as the momentum toward final federal legislation has increased, a recent Federal Reserve Board study reported that the high cost of terrorism coverage has had "little or no" effect on the demand for loans to finance high-profile projects, and many banks do not require terrorism coverage at all.[36] Such reports indicate that a consensus has yet to develop as to whether the economy will suffer any long-term adverse impact from the terrorism insurance turmoil caused by September 11 and whether the federal government should legislate a solution. ■

[1] *Terrorism Insurance Roundtable 2002,* 4 CMBS WORLD 1, 46 (Spring 2002).
[2] MOODY'S INVESTORS SERVICE, *CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate, in* STRUCTURED FINANCE: SPECIAL REPORT (Mar. 1, 2002).
[3] *Terrorism Insurance Roundtable 2002,* 4 CMBS WORLD 45 (Spring 2002). One report quoted an insurance industry analyst who believes the insurance industry's increased exposure to a catastrophe such as the September 11 attacks results from the soft insurance market over the last decade, which induced many insurers to write broad insurance coverage. MOODY'S INVESTORS SERVICE, *The Credit Impact of September 11, 2001, on the Insurance Industry, in* MOODY'S SPECIAL REPORT 3 (Oct. 2001).
[4] Mark Adelson, *How the Events of September 11 Affect Thinking about Risk,* 4 CMBS WORLD 2, 54 (Summer 2002).

[5] *Terrorism Insurance Roundtable 2002,* 4 CMBS WORLD 46 (Spring 2002).

[6] *America Attacked,* LOS ANGELES TIMES, Sept. 13, 2001.

[7] The war risk exclusion commonly reads:

> This policy excludes loss or damage caused by, or resulting from, contributed to, or aggravated by: hostile or warlike action in time of peace or war, including action in hindering, combating, or defending against an actual, impending or expected attack, (i) by any government or sovereign power (de jure or de facto), or by any authority maintaining or using military, naval or air forces; or (ii) by military, naval or air forces; or (iii) by an agent of any such government, power, authority or forces, it being understood that any discharge, explosion or use of any weapon of war employing nuclear fission or fusion shall be conclusively presumed to be such a hostile or warlike action by such a government, power, authority or forces.

[8] MOODY'S INVESTORS SERVICE, *CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate, in* STRUCTURED FINANCE: SPECIAL REPORT 6 (Mar. 1, 2002).

[9] The ISO exclusion defines "terrorism":

> Activities against persons, organizations or property of any nature:
> (1) That involve the following or preparation for the following:
> (a) Use or threat of force or violence; or
> (b) Commission or threat of a dangerous act; or
> (c) Commission or threat of an act that interferes with or disrupts an electronic, communication, information, or mechanical system; and
> (2) When one or both of the following applies:
> (a) The effect is to intimidate or coerce a government or the civilian population or any segment thereof, or to disrupt any segment of the economy; or
> (b) It appears that the intent is to intimidate or coerce a government, or to further political, ideological, religious, social or economic objectives or to express (or express opposition to) a philosophy or ideology.

See Exclusion of Terrorism (with Limited Exception) and Exclusion of War and Military Action, ISO PROPERTIES, INC., 1-2 (2001).

[10] *Id.*

[11] *Id.* at 1-3.

[12] *See* MOODY'S INVESTORS SERVICE, *CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate, in* STRUCTURED FINANCE: SPECIAL REPORT 6 (Mar. 1, 2002); *Terrorism Insurance Roundtable 2002,* 4 CMBS WORLD 42 (Spring 2002).

[13] Press Release, California Department of Insurance, California Insurance Commissioner Rejects Proposed Terrorism Insurance Exclusion Filings (Jan. 8, 2002).

[14] *Terrorism Insurance Roundtable 2002,* 4 CMBS WORLD 42 (Spring 2002); *Terrorism Coverage Remains in Doubt,* STANDARD & POOR'S 2 (Apr. 15, 2002).

[15] MOODY'S INVESTORS SERVICE, *CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate, in* STRUCTURED FINANCE: SPECIAL REPORT 5 (Mar. 1, 2002).

[16] *Terror-Insurance Reviews Taxing Servicers,* COMMERCIAL MORTGAGE ALERT 1 (June 21, 2002).

[17] *Terror Insurance: More Available,* COMMERCIAL MORTGAGE ALERT, Mar. 29, 2002, at 2; *Terror-Insurance Flap Ensnares Opryland Deal,* COMMERCIAL MORTGAGE ALERT, May 31, 2002, at 1.

[18] *Id.*

[19] *Terror Insurance: More Available,* COMMERCIAL MORTGAGE ALERT, Mar. 29, 2002, at 2.

[20] *Id.* (noting $20 billion in new capital to support issuance of new terrorism insurance coverage).

[21] *Id.*

[22] *Terror-Insurance Flap Ensnares Opryland Deal,* COMMERCIAL MORTGAGE ALERT, May 31, 2002, at 1, 7.

[23] *Terrorism Coverage Remains in Doubt,* STANDARD & POOR'S, Apr. 15, 2002, at 4.

[24] *See* news archives at CommercialRealEstateDirect.com.

[25] MOODY'S INVESTORS SERVICE, *CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate, in* STRUCTURED FINANCE: SPECIAL REPORT 1 (Mar. 1, 2002).

[26] John Gibeaut, *World of Change,* A.B.A. J., May 2002, at 44.

[27] RAND CORP., *Safety and Security in Los Angeles High-Rise Buildings after 9/11, in* DOCUMENTED BRIEFING (2002).

[28] *Id.* at 11.

[29] *Id.* at 18-19.

[30] *Id.* at 55.

[31] U.S. GENERAL ACCOUNTING OFFICE, *Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities, in* GAO02472T 7-14 (Feb. 27, 2002).

[32] *Senate Passes Aid to Insurers on Terrorism,* NEW YORK TIMES, June 19, 2002, at C1.

[33] *Id.*

[34] *Id.* at C13.

[35] *Id.*

[36] *Survey: No Big Terror-Coverage Effect,* THE AMERICAN BANKER, May 13, 2002, at 1.