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THE INCALCULABLE RISK: HOW THE WORLD TRADE CENTER DISASTER ACCELERATED THE EVOLUTION OF INSURANCE TERRORISM EXCLUSIONS

“The deliberate and deadly attacks, which were carried out yesterday against our country, were more than acts of terror. They were acts of war.”

—President George W. Bush, September 12, 2001.¹

“[B]ased on our analysis it seems clear that the attacks in New York, on the Pentagon, or on the plane that crashed in Pennsylvania do not constitute ‘acts of war’ as contemplated by the language of these [insurance policy] exclusions.”

—Commissioner James C. Bernstein, Minnesota Commerce Department Insurance Division, September 24, 2001.²

I. INTRODUCTION

For all *practical* purposes—including the quintessentially utilitarian matter of insurance—the last vestiges of the distinction between war and international terrorism went up in smoke along with the twin towers of the World Trade Center on September 11, 2001. Though in many contexts these constructs remain viable and distinguishable in a theoretical legal sense, in the pragmatic mathematical realm of the actuary, both war and international terrorism now represent incalculable risks capable of rendering

1. President George W. Bush, Remarks at End of Cabinet Room Meeting with National Security Team (Sept. 12, 2001), in *Text of Bush Statement*, WASH. POST, Sept. 13, 2001, at A3.

2. Press Release, Minnesota Commerce Department, Insurance Division, Statement of Minnesota Commerce Commissioner James C. Bernstein, Insurance Policy “Act of War” Exclusion (Sept. 24, 2001), available at <http://www.commerce.state.mn.us/pages/NewsReleases/Releases2001/News010924.htm> (last visited Apr. 4, 2002).

key elements of the insurance industry insolvent.³ The line between transnational terrorism and warfare was obscured by the attacks to the point of nonexistence in the perception of Americans—irrespective of the intricacies of international law. That fact is evidenced not only by the words of President Bush, but ironically, by those of congressional leaders, who admonished the insurance industry, days after the attacks, not to lose sight of the distinction.

Fearful that insurers would attempt to invoke standard policy exclusions for losses due to “war or acts of war” in the aftermath of the disaster, members of the House Financial Services Committee and the Insurance Subcommittee directed a letter to the National Association of Insurance Commissioners (“NAIC”),⁴ downplaying the President’s war rhetoric as a mere reflection of “the passion and determination of our country, not the legal reality of Tuesday’s destruction.”⁵ Yet, in subtly revealing terminol-

3. A week after the attacks, Steven J. Dreyer, Managing Director for U.S. Insurance Industry Ratings at Standard & Poor’s, commented that the insurance industry could “withstand an enormous financial hit [T]he totals would have to exceed [fifty billion dollars] before we would begin to worry about the insurance system.” Scott Farley, *U.S. Attack ‘Will Not Cripple the Insurance Industry,’* INS. DAY (London), Sept. 18, 2001, at 3, available at LEXIS, News Library, Insdlay File. By recent estimates, the total financial impact on insurers worldwide could reach 70 billion dollars. Claire Wilkinson, *Final Cost from WTC ‘Could Exceed \$70bn,’* INS. DAY (London), Nov. 7, 2001, available at LEXIS, News Library, Insdlay File. This would far surpass the \$15.5 billion in total claims resulting from Hurricane Andrew in 1992, the most catastrophic single event on record prior to the September 11 attacks. Linda Stern, *Processing a \$25 Billion Claim: The Insurance Industry Gears Up for Massive Settlements,* NEWSWEEK, Sept. 24, 2001, at 56. It would dwarf the \$775 million outlay for claims associated with the 1992 Los Angeles riots, the most expensive man-made disaster in the past one hundred years. *At the Top of a Terrible List,* BUS. WK., Sept. 24, 2001, at 12. According to Insurance Services Office, Inc. and the National Association of Independent Insurers, for the first time ever, the property and casualty insurance industry in the United States reported a net loss for the nine months ending on September 30, 2001. Press Release, Insurance Services Office, Inc. and the National Association of Independent Insurers, *First-Ever Nine-Month Net Loss for Property/Casualty Industry in Wake of September 11 Attack and Deterioration in Investment Results* (Dec. 19, 2001), at <http://www.iso.com/docs/pres260.htm> (last visited Apr. 4, 2002). The \$3.1 billion aggregate net loss after taxes through September was attributed primarily to the September 11 attacks and sharply contrasts with a net gain of \$16.8 billion for the same period in 2000. *Id.*

4. The National Association of Insurance Commissioners (“NAIC”) is an organization comprised of the chief state insurance regulatory officials of the fifty states, the District of Columbia, and several U.S. territories. For more information about the NAIC, see NAIC’s Web site at <http://www.naic.org/1misc/aboutnaic/about/about01.htm> (last visited Apr. 4, 2002).

5. Letter from Rep. Michael G. Oxley, Chairman, House Committee on Financial Services, et al. to Kathleen Sebelius, President, National Association of Insurance Commissioners (Sept. 17, 2001), available at <http://www.naic.org/1news/releases/rel01/doc>

ogy, the congressional letter went on to condemn “[a]ny attempt to evade coverage obligations by either primary insurers or reinsurers based on such legal maneuvering” as “unsupportable and *unpatriotic*.”⁶

The congressmen need not have worried. Soon after the terrorist attacks, a number of large insurers with much at stake in the disaster issued public statements announcing their intentions not to invoke war exclusions.⁷ Had the insurers been inclined to do so—negative public relations notwithstanding⁸—they would not likely have prevailed when challenged in court.⁹

This comment examines the intended function of war exclusions in insurance policies and discusses judicial interpretations of those exclusions in cases involving terrorist acts. It recounts the events leading to the terrorism insurance crisis of 2001 and the apparent resolution of that crisis. Finally, it suggests ways in which the insurance industry may employ prior lessons learned from the history of judicial interpretation of war exclusions to avoid possible legal pitfalls that might otherwise negate the legitimate and necessary purposes of terrorism exclusions.

091801lt.pdf (last visited Apr. 4, 2002).

6. *Id.* (emphasis added).

7. See Lee Bergquist, *NML to Honor All Attack Claims; Insurer Won't Cite 'Acts of War' Exclusion*, MILWAUKEE J. SENTINEL, Sept. 15, 2001, at 1D (Northwestern Mutual Life Insurance Company); Tamara Loomis, *Crisis Management: Terrorist Actions Prompt Laudable Responses*, N.Y. LAW J., Sept. 20, 2001, at 5 (Chubb Corp., Swiss Re, and Hartford Financial Services Group); Christopher Oster, *Ace Joins Insurers That Won't Invoke Act-of-War Clause*, WALL ST. J., Sept. 20, 2001, at B2 (Ace Ltd.); David Pilla, *Life Insurers Dismiss War Exclusion*, BEST'S INS. NEWS, Sept. 18, 2001, available at 2001 WL 24724943 (MetLife Inc., Prudential Financial, and CIGNA).

8. See Scott Farley, *Fitch Initial Review Is Complete*, INS. DAY (London), Sept. 26, 2001, available at LEXIS, News Library, Insday File (commenting that “[a]ny efforts to invoke acts of war exclusions . . . could backfire. Such action might reduce losses, but would cause severe long-term damage to reputations and franchise values . . .”); Loomis, *supra* note 7, at 5 (discussing the necessity for tactfulness in public statements following the disaster).

9. The leading case pertaining to war exclusions as applied to losses incurred as the result of terrorist actions is *Pan American World Airways, Inc. v. Aetna Casualty & Surety Co.*, 505 F.2d 989 (2d Cir. 1974), in which a commercial plane was hijacked in mid-flight by terrorists, taken to Egypt, and destroyed. In a lengthy opinion, the court surveyed and summarized many of the earlier cases and held that the losses due to terrorism were not excluded under any of the several war exclusions of the all-risk insurer. See *id.* at 1012–15; see also discussion *infra* Parts III.A., IV.C.

II. INSURANCE AND THE RATIONALE FOR EXCLUDING COVERAGE FOR LOSSES DUE TO WAR

A. *What Makes Insurance Insurance*

Fundamentally, insurance represents the delicate balance between the uncertainty and the predictability of future events associated with unfavorable consequences.¹⁰ Where there is no risk, there can be no insurance, and arrangements not involving risk which masquerade as insurance are more accurately understood as entitlement programs.¹¹ Nor can an insurance proposition operate where the risk is real but inestimable.¹² To produce a mutually beneficial arrangement, the insurance bargain must relieve one party of the burden of uncertainty associated with potential losses, while allowing the other party to profit from their reasonable calculability.¹³

Insurance is of value to the purchaser only because it allows for the sharing of risk across a pool of other similarly situated but widely distributed purchasers, guaranteeing for each purchaser protection against substantial but uncertain losses in exchange for the payment of premiums both certain and manageable.¹⁴ The application of the "Law of Large Numbers"¹⁵ allows insurers to

10. See *Metro. Police Retiring Ass'n v. Tobriner*, 306 F.2d 775, 777 (D.C. Cir. 1962). See generally ROBERT RIEGEL ET AL., *INSURANCE PRINCIPLES AND PRACTICES: PROPERTY AND LIABILITY*, chs. 1-2 (6th ed. 1976) (explaining fundamental principles of risk, risk management, and the insurance mechanism).

11. See, e.g., *Jordan v. Group Health Ass'n*, 107 F.2d 239, 244-45 (D.C. Cir. 1939); *Mich. Hosp. Serv. v. Sharpe*, 63 N.W.2d 638, 639 (Mich. 1954).

12. See RIEGEL ET AL., *supra* note 10, at 17.

13. See *Epmeier v. United States*, 199 F.2d 508, 509-10 (7th Cir. 1952).

14. See *Metro. Life Ins. Co. v. State Bd. of Equalization*, 652 P.2d 426, 428 (Cal. 1982); RIEGEL ET AL., *supra* note 10, at 23.

15. The "Law of Large Numbers" is the statistical proposition that the more opportunities exist for an event to occur, the closer the actual relationship of occurrences to opportunities will be to the true probability. LEWIS C. WORKMAN, *THE MATHEMATICAL FOUNDATIONS OF LIFE INSURANCE* 121 (1982). Once the true probability is estimated by observing a large sample of events, it must then be applied to a large number of exposures before the actual occurrences will approximate the true probability. EMMETT J. VAUGHAN & THERESE M. VAUGHAN, *FUNDAMENTALS OF RISK AND INSURANCE* 25 (7th ed. 1996). Extremely catastrophic events are generally considered to be uninsurable in part because by nature they fail to conform to models based on the Law of Large Numbers. RIEGEL ET AL., *supra* note 10, at 20-21. Past experience with events of such great magnitude is usually too sparse to accurately predict how often a similar event can be expected to occur. *Id.* Further, where a particular loss is grossly disproportionate to other losses that can be an-

predict losses accurately enough to calculate premium rates, which will not be prohibitively high, but which will nonetheless produce reserves adequate to pay claims when and if the losses insured against occur.¹⁶ The cornerstone of the entire structure is the application of actuarial probability principles using complex statistical models based on data gathered from past experience.¹⁷ Discernment of a pattern that can be projected to forecast future losses is the sine qua non which, if lacking, eliminates the possibility of rational rate-setting.¹⁸

B. *The Uninsurable Nature of Losses Due to War and the Pattern of Judicial Interpretation*

War has for many years been recognized, both actuarially and legally, as an uninsurable hazard.¹⁹ The actuarial rationales for excluding coverage of losses due to war have not always been fortified, however, by judicial constructions of the policy language used by insurers to effect the desired protection of their policyholder risk pools. In both life insurance and property and casualty insurance—two of the hardest hit markets in the World Trade Center disaster—some early judicial cases interpreting the meaning of “war” were based on general prohibitions against entering into illegal contracts.²⁰ Since contracts which would “aid

anticipated to occur within the pool of policyholders, the catastrophic loss invalidates the calculation of rates and has the potential to create insolvency for the insurer. *Id.* The device of reinsurance, which will be discussed below, can mitigate some of the deleterious effects of potentially catastrophic exposures. See discussion *infra* Part III.A.

16. RIEGEL ET AL., *supra* note 10, at 18–21.

17. See Jackie Spinner, *Putting a Price on 'What Ifs': Actuaries Lack Figures to Fix Premiums for Terrorism Insurance*, WASH. POST, Oct. 24, 2001, at E1 (quoting John Purple, Chief Actuary at the Connecticut Department of Insurance, as commenting that “at its simplest, a model multiplies the probability of an event happening by the probability of how big it might be to determine the probable financial cost. The cost can then be translated into the price charged for insurance.”).

18. RIEGEL ET AL., *supra* note 10, at 17–18.

19. See generally 1 ARTHUR BIDDLE, A TREATISE ON THE LAW OF INSURANCE § 487 (1893) (discussing the history and rationale for the war exclusion).

20. *Id.* § 487, at 440–41.

With regard to war, the rule is that citizens or subjects of one country cannot trade with those of another at war with the former, without the license of the King, President, or other legal authority. . . . Therefore every insurance on alien property must be understood not to cover property lost during hostilities.

Id. (footnotes omitted).

the resources of the enemy” in time of war were forbidden,²¹ it became necessary to pinpoint when a war had commenced. Those early decisions established that the existence of a state of war was a facts-and-circumstances determination rather than an issue merely of whether or not war had been declared. One treatise citing Civil War vintage decisions, for example, noted that “[t]o create belligerent rights, it is not necessary that there should be war between separate and independent powers, but . . . they may exist between parties to a civil war, and a state of war may exist without any formal declaration of it by either side.”²²

The courts reined in this broad interpretation, however, when they found it necessary to construe specific exclusions intended by insurers to protect themselves and their policyholder pools from adverse selection by life insurance applicants and from catastrophic losses under property insurance policies.²³ Conditions resulting in non-random selection of risks (adverse selection) or in the possibility of grossly non-uniform maximum exposures (catastrophic losses) interfere with the proper working of the Law of Large Numbers in ways that can destabilize the financial condition of the insurer, and are therefore categorized as un-insurable.²⁴ While not contesting the logic of the insurers’ objectives in excluding war risks, courts have insisted upon precision in contract terms in order to prevent unfair claim denials. In deciding such cases, courts have consistently invoked the doctrine of *contra proferentem*—that ambiguities in contract language, espe-

21. *Id.* § 490, at 445.

22. *Id.* § 492, at 446 (citing *The Prize Cases*, 67 U.S. 635 (1862); *Robinson v. Int’l Life Assurance Soc’y*, 42 N.Y. 54 (1870)).

23. Adverse selection is the phenomenon by which those most likely to incur losses tend to purchase and retain insurance coverage and those least likely to incur losses tend to refrain from purchasing coverage, thus skewing the probability of losses away from normal expected values that would result given random selection by the general population. See generally VAUGHAN & VAUGHAN, *supra* note 15, at 28–29. War exclusions address the issue by recognizing the tendency of those likely to be called to military service to obtain life insurance protection with more frequency than others, and by eliminating the additional hazard created by that adverse selection while still allowing the applicants the availability of life insurance. See WILLIAM F. MEYER, *LIFE AND HEALTH INSURANCE LAW* § 7.6, at 205–06 (1972).

24. See RIEGEL ET AL., *supra* note 10, at 20; Spinner, *supra* note 17, at E5 (quoting Laureen Regan, Associate Professor of Risk Management and Insurance at Temple University, as commenting that “[w]hen you can’t rely on things happening by accident, the entire pricing process falls apart. . . . We have to be able to estimate how often this will happen.”).

cially in contracts of adhesion²⁵ such as insurance policies, must be construed strictly against the drafter and liberally in favor of the policyholder.²⁶

In *Welts v. Connecticut Mutual Life Insurance Co.*,²⁷ for example, the court interpreted insurance policy language restricting the insured person from entering into “any military or naval service whatsoever”²⁸ and excluding death “from any of the casualties or consequences of war or rebellion, or from belligerent forces in any place where he may be.”²⁹ The insured was shot and killed while employed by the government of the United States, supervising the building of railroad bridges to be used by the Union Army for military purposes during the Civil War.³⁰ Though his assailants demanded first to know whether anyone there “wore a federal uniform,” there was no evidence that they were Confederate soldiers or were acting under Confederate authority.³¹ The court, noting that “[t]he company frame[s] the policy and choose[s] the language” and that any uncertainty in the policy’s terms should therefore be resolved in favor of the insured, held that “[t]he general understanding of the term [military service] includes such persons only as are liable to do duty in the field as combatants.”³² The court further held that “[t]he language used can be considered as including only death from casualties or consequences of war or rebellion, carried on or waged by authority of some de facto government, at least.”³³

Quite possibly, as would have been consistent with the justification for the exclusion, the insurer’s intent was to exclude

25. A contract of adhesion is defined as “[a] standard-form contract prepared by one party, to be signed by the party in a weaker position, [usually] a consumer, who has little choice about the terms.” BLACK’S LAW DICTIONARY 318–19 (7th ed. 1999). For cases treating insurance policies as contracts of adhesion, see, e.g., *Healy Tibbits Constr. Co. v. Employers’ Surplus Lines Ins. Co.*, 140 Cal. Rptr. 375, 379 (Cal. Ct. App. 1977); *Princeton Ins. Co. v. Chunmuang*, 698 A.2d 9, 12 (N.J. 1997).

26. See, e.g., *Schmutz v. Employees’ Fire Ins. Co.*, 76 F.2d 119, 122 (2d Cir. 1935); *Albritton v. Fireman’s Fund Ins. Co.*, 70 So. 2d 111, 113 (La. 1953); *Raska v. Farm Bureau Mut. Ins. Co.*, 314 N.W.2d 440, 441 (Mich. 1982); *Hoffman & Place v. Aetna Fire Ins. Co.*, 32 N.Y. 405, 411 (1865); *Buckeye Union Ins. Co. v. Price*, 313 N.E.2d 844, 846 (Ohio 1974).

27. 48 N.Y. 34 (1871).

28. *Id.* at 38.

29. *Id.*

30. *Id.*

31. *Id.* at 39.

32. *Id.*

33. *Id.* at 40.

deaths resulting in any way from activity in furtherance of the war effort, which might subject the insured to significantly increased mortality risk. Yet, if that was the intent, the language failed to convey it clearly. The court found the exclusion to be ambiguously worded, and therefore construed it against the insurer, thus endowing the terms "military service" and "war," as used in insurance policies, with legal meanings that would thenceforth guide courts in construing war risk exclusions³⁴—meanings distinct from and possibly contrary to those intended by the insurers who initially used the terms.

Welts illustrates the pattern that accounts for much of the divergence in modern cases involving terrorism, between the actuarial impetus for the war exclusion and its judicially bounded operation. Where a terrorist act reproduces the conditions of uninsurability associated with traditional warfare, a determination as to whether the event was or was not "carried on or waged by authority of some *de facto* government"³⁵ (or the present-day equivalent determination of whether or not the entity possessed "at least significant attributes of sovereignty"³⁶) is a judicial exercise that bears only the most attenuated relationship to a determination of whether the event ought or ought not be deemed insurable. Nevertheless, prevailing case law wrought by the reiterative interpretations of courts applying *contra proferentem* to generations of insurance policy exclusions has refined the legal meaning of war and related terms for insurance purposes to the extent that it is now generally anticipated that war exclusions will not be held to function effectively to exclude terrorist acts.³⁷

34. The interpretations of these terms by the *Welts* court retain their vitality today. For example, the case was cited for its interpretation of "war" in *Pan American World Airways, Inc. v. Aetna Casualty & Surety Co.*, 505 F.2d 989, 1013 (2d Cir. 1974), the leading modern case interpreting terms used in typical war exclusions. The comprehensive insurance law treatise, COUCH ON INSURANCE, cites *Welts* for its interpretation of "military service" in discussing the treatment of civilians under war exclusions. 10 LEE R. RUSS, COUCH ON INSURANCE § 143:45 (3d ed. 1998).

35. *Welts*, 48 N.Y. at 40.

36. See *Pan Am*, 505 F.2d at 1012.

37. Although there is little case law directly on point as to the inefficacy of war exclusions relative to modern terrorist acts, an exception is *Pan Am*, discussed *infra* at Parts III.A, IV.C. The opinion extensively catalogs and examines the terms commonly used in war exclusions in the context of a terrorist hijacking, establishing persuasive precedent that seems likely to weigh heavily in the analysis of any court called upon to consider insurance exclusions invoked in denials of claims resulting from the events of September 11, 2001. A more recent case, *Holiday Inns, Inc. v. Aetna Insurance Co.*, 571 F. Supp. 1460

III. INADEQUATE PROTECTION AND THE POST-SEPTEMBER 11 INSURANCE CRISIS

A. Industry Unreadiness and the Role of Reinsurance

Prior to September 11, 2001, the insurance industry failed to recognize and adjust to the dual realities that exposure from terrorist actions could be so financially devastating as to undermine the entire insurance system and that the industry's standard policy exclusions utterly failed to protect it from exposures of such enormous magnitude.³⁸ A wake-up call might have come as early as 1974, when the Court of Appeals for the Second Circuit decided *Pan American World Airways, Inc., v. Aetna Casualty & Surety*

(S.D.N.Y. 1983), cites *Pan Am* heavily in its rejection of an insurer's attempt to characterize the destruction of a hotel in Lebanon due to fighting between Christian and Moslem militia groups as the result of "war."

38. John T. Sinnott, Chairman and CEO of Marsh, Inc. explained as follows:

The problem with what happened on September 11 is that it presented a risk that no one could conceive would happen. When the buildings were built, loss scenarios did contemplate the impact of one Boeing 707 (the largest commercial aircraft at the time), however the idea of two, fully fueled 767s hitting both towers was unimaginable.

Terror Insurance Availability: Hearing on Terrorism Insurance Before the Senate Comm. on Banking, Housing, and Urban Affairs, 107th Cong. (2001) [hereinafter *Senate Hearing*] (statement of John T. Sinnott, Chairman and CEO, Marsh, Inc.), 2001 WL 26187268. See also *Blackest Day as Insurers Fear for Staff*, INS. DAY (London), Sept. 12, 2001, at 1 ("The unprecedented events of yesterday are generally not even found in the 'worst case scenarios' run by some firms."), available at LEXIS, News Library, Insdlay File; Richard A. Fogel, *Sept. 11: Risk Management Lessons Learned*, N.Y. LAW J., Nov. 2, 2001, at 1, 6 ("Most commercial property insurance policies contain a standard war risk exclusion. Cases interpreting this exclusion, mostly as a result of litigation ensuing from the 1993 attack on the Twin Towers, limits its applicability."); Jon L. Gelman & Lewis L. Heller, *World Trade Center Tragedy Creates Complex Workers' Compensation Issues*, N.J. L.J., Oct. 8, 2001, at 108 ("Horrible and catastrophic events such as occurred on Sept. 11, 2001, were never contemplated in the legislative crafting of our nation's social, remedial insurance paradigm."); Christopher A. Jennings, *Where Do We Go from Here? War Risk Exclusion Clauses and "Acts of War" by Non-Sovereign Entities*, FED. LAW., Nov.-Dec. 2001, at 60, 64 ("Surprisingly, even after the 1993 bombing of the World Trade Center, insurers continued to include risks arising from acts of terrorism in the basket of insurable risks under traditional all-risk insurance policies."); Spinner, *supra* note 17, at E1 (quoting John Purple, chief actuary at the Connecticut Department of Insurance, as commenting that "[w]e model for catastrophes, but my guess is nobody ever modeled for a 767 full of fuel crashing into the World Trade Center. I doubt that anyone ever thought that was a possibility."); Walter Updegrave, *How Strong Is the Safety Net?*, MONEY, Nov. 2001, at 130, 134-35 ("Many [insurers] routinely run an RDS (realistic disaster scenario), such as two jumbo jets colliding over a large city or a major earthquake hitting Los Angeles, to determine their PML (probable maximum liability). But no one envisioned a catastrophe like the one that occurred on Sept. 11.")

Co.³⁹ The industry's failure to respond adequately to a strong admonition by the court in that case, even after the 1993 bombing of the World Trade Center provided a preview of the disaster that ultimately occurred, is at least in part attributable to the false sense of security created by the widespread use of reinsurance in providing coverage for potentially catastrophic losses.

In *Pan Am*, the court was called upon to construe a number of all-risk policy exclusions in connection with the terrorist hijacking of a United States airliner by members of the Popular Front for the Liberation of Palestine, who forced the plane's crew to fly the plane to Egypt, where the plane was destroyed with explosives.⁴⁰ In holding that the losses resulting from the terrorist action were covered under the terms of the policy, notwithstanding exclusions pertaining *inter alia* to war, warlike operations, military or usurped power, insurrection, riot, and civil commotion,⁴¹ the court forcefully emphasized that if the general rule is that ambiguous insurance policy terms are to be construed strictly against the insurer, then *a fortiori*, the doctrine of *contra proferentem* demands such interpretation when the insurer knew its exclusions were ambiguous and failed to clarify them accordingly.⁴² Citing evidence that the risk of hijacking was well known to the insurers and that, moreover, the insurers were aware that their policy exclusions were ambiguous, the court concluded that "[w]hen the all risk insurers failed to exclude 'political risks in words descriptive of today's world events,' they acted at their own peril."⁴³

Given this judicial road-map provided by the *Pan Am* court and the geometric progression in the capacity for mass destruction by terrorists in the last decade,⁴⁴ the fact that there remained, in

39. 505 F.2d 989 (2d Cir. 1974).

40. *Id.* at 993.

41. *Id.* at 994.

42. *Id.* at 999.

43. *Id.* at 999-1001 (citations omitted).

44. See *Senate Hearing, supra* note 38 (statement of Robert E. Vagley, President, American Insurance Association) (quoting Warren Buffet, CEO of Berkshire-Hathaway, one of the world's largest reinsurers, as stating that "[t]errorism today is not at all like terrorism of 25 years ago. . . . [T]he power to inflict damage has gone up a factor of—who knows what—10, 50 . . . you can't price for that."), 2001 WL 26187266; Arthur H. Garrison, *How the World Changed: A History of the Development of Terrorism*, Address at the Delaware Criminal Justice Council (Oct. 28-29, 2001) (describing the progressive evolution of terrorist activity during the 1990s toward actions aimed at mass destruction for its

2001, numerous insurance policies lacking detailed, explicit, and comprehensive terrorism exclusions would seem inexplicable but for certain industry practices that met instant obsolescence in the aftermath of September 11. One of the most significant of these was the prevalence of, and reliance on, reinsurance as a device used by insurers for spreading the risk of potentially catastrophic losses, such as those due to terrorism, that might exceed the amount which could be withstood solely on the basis of the insurers' own financial capacities.

Reinsurance is a market mechanism that allows insurers to accept more risk than would otherwise be permitted by regulators monitoring their financial solvency.⁴⁵ Through a reinsurance agreement (or "treaty"), an insurance company that directly provides coverage to policyholders (a "primary writer") transfers (or "cedes") a portion of its risk to a reinsurance company, which may in turn transfer portions, through "retrocession," to other companies.⁴⁶ Each insurer in the chain thus limits, at least in theory, the liability it retains to a specified dollar amount or percentage of the total potential loss.⁴⁷ In financial reporting, the insurer is allowed to offset its claim liabilities by amounts it expects to receive from its reinsurers, provided the reinsurers' financial condition is acceptable to regulators in the primary writer's domiciliary state.⁴⁸

Although reinsurance ordinarily functions beneficially for both insurers and policyholders by increasing the overall capacity of the market, stabilizing insurers' profits, and allowing for the acquisition of coverage on large risks without the necessity of negotiation with multiple insurers,⁴⁹ the World Trade Center disaster

own sake, fueled by hatred for the West and America and religious extremist thought, and marked by characteristics of "asymmetric warfare"), available at <http://www.state.de.us/cjc/history.ppt> (last visited Apr. 4, 2002).

45. See generally Jonathan F. Bank & Lance A. Warrick, *The Regulation of Reinsurance*, in AMERICAN BAR ASSOCIATION, *THE STATE OF INSURANCE REGULATION* 127, 137-46 (Francine L. Semaya & Vincent J. Vitkovsky eds., 1991); VAUGHAN & VAUGHAN, *supra* note 15, at 150-52.

46. RIEGEL ET AL., *supra* note 10, at 120; Updegrave, *supra* note 38, at 135.

47. See RIEGEL ET AL., *supra* note 10, at 120.

48. See Bank & Warrick, *supra* note 45, at 137-46; Alice Schroeder et al., *Reinsurance Recoverables—The Lake Wobegon Problem*, in *INSURANCE-PROPERTY-CASUALTY: WORLD TRADE CENTER SPECIAL ISSUE* (Morgan Stanley Dean Witter & Co., New York, N.Y.), Sept. 17, 2001, at 4.

49. RIEGEL ET AL., *supra* note 10, at 121-26.

has brought into sharp focus a major drawback of this arrangement that can, in certain situations known as “clash events,” result in a breakdown of the system.⁵⁰ In a clash event, an occurrence, often unanticipated or unpredictable but of catastrophic proportions, concentrates significant losses across multiple lines of insurance simultaneously.⁵¹ The World Trade Center disaster, by far the most catastrophic clash event in insurance history, is generating claims in aviation, property, liability, life, workers’ compensation, business interruption, health, disability, automobile, and other miscellaneous lines of insurance, all centralized within one concentrated area.⁵² Where the complex, overlapping reinsurance arrangements of the primary writers of these coverages resulted in reinsurers being exposed to catastrophic losses across multiple lines of insurance, companies that in ordinary circumstances would have benefited by diversifying across product lines may instead find themselves over-leveraged and insolvent.⁵³

Additionally, the retrocession arrangements behind policies providing benefits as large as those now payable due to World Trade Center losses are often multi-layered, involving extensive chains of insurers.⁵⁴ This practice creates further complex interdependencies and even more opportunities for reinsurer failures in clash events where reinsurers who are party to numerous retrocession agreements incur compound losses.⁵⁵

When the dust settles after a catastrophic clash event and the losses are finally quantified, if any reinsurers have failed—and at

50. See Tom Condon, *Insuring Insurers; Little-Known Reinsurance Companies Play Big Roles in Spreading Out Huge Risk*, HARTFORD COURANT, Oct. 9, 2001, at E1; Joseph G. Finnerty III & Eric S. Connuck, *Sept. 11: What Is the Impact on the Insurers?*, N.Y. LAW J., Nov. 26, 2001, at 1; Douglas McLeod, *Insurers Shaken But Solvent—So Far*, BUS. INS., Oct. 1, 2001, at 1; Schroeder, *supra* note 48, at 4; Updegrave, *supra* note 38, at 132.

51. See McLeod, *supra* note 50, at 1.

52. See Gary Thompson, *Insurance for Losses Resulting from the Terrorist Attacks of September 11, 2001*, 12 MEALEY’S LITIG. REP.: REINSURANCE No. 11, at 21 (Oct. 4, 2001); Updegrave, *supra* note 38, at 132–33.

53. See Finnerty & Connuck, *supra* note 50, at 6 (“A ‘clash event’ of the magnitude of Sept. 11 contradicts the actuarial assumptions relied upon by reinsurers when they diversify risks in this manner.”); Schroeder, *supra* note 48, at 4.

54. See Updegrave, *supra* note 38, at 135 (“When large policies are involved—such as many in the World Trade Center incident—it’s not uncommon to see a chain of twenty or more insurers.”).

55. See Christopher Oster, *Lloyd’s Faces Challenge Following Attack on Twin Towers*, WALL ST. J., Sept. 18, 2001, at A4; David Pilla, *Tillinghast Says WTC Disaster May Hit \$58 Billion*, BEST’S INS. NEWS, Sept. 24, 2001, available at 2001 WL 24724985.

least one industry analyst has placed the probability that some reinsurers will fail due to the World Trade Center event at close to one hundred percent⁵⁶—the primary writers, still contractually bound to pay the full policy benefits to policyholders regardless of background reinsurance arrangements, are forced to make up the difference.⁵⁷

B. *The Terrorism Insurance Crisis and Its Outcome*

As noted by insurers and financial analysts, the unprecedented magnitude and severity of the disaster that occurred on September 11, 2001, did not change the probability that another disaster of unimaginable proportions could occur at any time.⁵⁸ It was that eventuality, even more than that which had already occurred, that caused the breakdown of certain market mechanisms for providing terrorism-risk insurance and resulted in fundamental changes in insurance and reinsurance practices.⁵⁹ Industry unreadiness, disadvantageous aspects of the insurance and reinsurance regulatory scheme in the United States, and unfortunate timing each played a role in the accelerated sequence of events that culminated in the virtual elimination of terrorism coverage by insurers in the United States.

Having failed, for the most part, to implement explicit terrorism exclusions because of factors such as the competitiveness of the market, the perception of adequate protection created by complex ceding and retrocession arrangements, and the failure of actuarial worst-case maximum liability models to contemplate a

56. Schroeder, *supra* note 48, at 5.

57. Finnerty & Connuck, *supra* note 50, at 6.

58. See *Senate Hearing, supra* note 38 (statement of Walter K. Knorr, Chief Financial Officer, City of Chicago) (testifying that the City of Chicago had been presented with a "premium increase of over 5,000 percent" to renew its insurance, including substantially less terrorism coverage for O'Hare and Midway airports); Adrian Ladbury, *Life After Sept. 11: No Capacity Crisis*, INS. DAY (London), Oct. 9, 2001, at 1 (quoting Ruud Bosman, Executive Vice President of global property insurer FM Global), available at LEXIS, News Library, Insdlay File.

59. See Dawn Kopecki, *Congress Mulls Insurer Aid as Rates for Some Jump 5,000%*, CAPITAL MARKETS REP., Oct. 25, 2001 (quoting Ronald E. Ferguson, Chairman of General Re Corp., one of the four largest reinsurers in the world, while testifying before the Senate Banking Committee, as commenting, "I don't think we'll ever get back to the way we were before Sept. 11. . . . The question becomes, how many Sept. 11ths can we take? And the answer is, this one."), available at WL 10/25/01 Cap. Mkt. Rep. 15:12:00.

terrorism-generated clash event of such gigantic proportions,⁶⁰ most insurers and reinsurers had only war-risk exclusions to fall back on at the time the World Trade Center was destroyed. Assessing the negative public relations consequences and the perceived unlikelihood of withstanding legal challenges that might follow from an attempted invocation of these exclusions in connection with September 11 losses, insurers and their global reinsurers made the decision to refrain from invoking war risk exclusions and to treat the losses as covered.⁶¹ They did so irrespective of the possibility that some war exclusions might have been found applicable, even under the intense scrutiny of courts applying *contra proferentem*, given that the events of September 11 were unique and distinguishable from prior terrorist activities in a number of ways.⁶² Nevertheless, insurers agreed to provide benefits for losses under the existing policies, thereby waiving any application of war exclusions.⁶³ In so doing, however, they did not foreclose the possibility of excluding such losses in the future.⁶⁴

60. See *Senate Hearing*, *supra* note 38 (statement of Ron E. Ferguson, Chairman, General Re Corporation) (“Before September 11 the threat of terrorism within our borders seemed remote. Because of that, no insurance or reinsurance premiums were collected for terrorism coverages, and no assets or reserves were allocated to terrorism exposures.”).

61. See sources cited *supra* notes 7–8.

62. See *Senate Hearing*, *supra* note 38 (testimony of Robert E. Vagley, President, American Insurance Association) (“We have not attempted to invoke war exclusions, despite the militaristic nature of, and rhetoric surrounding, the attacks.”); Randy J. Maniloff, *The War Risk Exclusion—Looking Beyond the Events of September 11th*, 13 MEALEY’S LITIG. REP.: INS. INSOLVENCY No. 9, at 21 (Oct. 11, 2001).

[A] review of [*Pan American World Airways, Inc., v. Aetna Casualty & Surety Co.*, 505 F.2d 989 (2d Cir. 1974)] leaves no doubt that the question whether the “war risk” exclusion would apply to claims arising out of the recent attacks in New York and Washington is by no means as cut and dry as the impression one gets from reading the media reports that have simply cited [the case] and dismissed the issue out of hand.

Id.

The author identifies, inter alia, the possibility that there was sponsorship of the attacks by a state or other “sovereignty,” the declaration by bin Laden of a “jihad” or holy war against the United States, and the fact that Congress authorized the use of force in response pursuant to the War Powers Resolution as distinguishing features of the events of September 11, 2001, that might have influenced judicial construction of particular war-risk exclusions in favor of insurers. See also Alexander Nicoll, *US Advised to Concentrate on Victory*, FIN. TIMES, Oct. 19, 2001, at 2. (commenting that “[t]he US has a newly defined enemy which is . . . international terrorism and *terrorist-sponsored states*”) (emphasis added); Rod Norland et al., *War on Terror*, NEWSWEEK, Dec. 17, 2001, at 22 (discussing the terrorist “colonization” and “hijacking” of Afghanistan).

63. See sources cited *supra* note 7.

64. See, e.g., *Chubb CEO Says Industry is Strong, Warns of Unavailability of Future Terrorism Coverage*, 11 INS. COVERAGE LITIG. REP. (Andrews Publ’ns, Inc.) No. 44, at 989

On the contrary, reinsurers pointedly reserved the right to exclude terrorism-related losses explicitly, as a matter of financial survival.⁶⁵

A consensus quickly emerged among reinsurers that while the industry could survive the huge losses generated by the September 11 disaster, it could not absorb another shock of that magnitude in the near term.⁶⁶ In late September, the industry turned to Congress for intervention, proposing the creation of a federally-managed terrorism reinsurance pool modeled after the British system known as "Pool Re."⁶⁷ With seventy percent of the reinsurance agreements overlaying property insurance policies in the United States scheduled for renewal on January 1, 2002, reinsurers could not afford to delay taking action to revise their agreement terms so as to exclude terrorism coverage under renewing contracts.⁶⁸ Large reinsurers began announcing their intention to

(Oct. 5, 2001) (reporting warning of the chairman and chief executive officer of reinsurer Chubb Corp. that a series of terrorist attacks could threaten the solvency of the insurance industry), available at LEXIS, Insurance Library, Andrews File; *NAIC Backs Federal Role on Terror Re*, INS. CHRON., Oct. 29, 2001, at 1 (quoting David Mathis, Chief Executive Officer of Kemper Insurance Co., as telling the National Association of Insurance Commissioners that "[r]einsurers have already notified Kemper . . . that they intend to exclude or dramatically scale back terrorism coverage in contracts up for renewal. . . . [W]e recognize that this may be the only way to protect their solvency."), [hereinafter *NAIC Backs*] available at LEXIS, News Library, Allnews File; Douglas Quenqua, *Insurers Act to Protect Against Attacks*, PR WEEK, Nov. 2, 2001, at 6 (quoting Edward Morgan, Senior Vice President and Communications Officer of the Hartford Insurance Group as stating "Our primary message is that this industry has finite resources, and terrorism is something you can't predict, so the re-insurance markets can't protect it."), available at LEXIS, News Library, Allnews File.

65. See *NAIC Backs*, *supra* note 64.

66. See *id.*; see also *America's Insurance Industry: Keeping the Promise: Hearing on the Impact of the September 11, 2001 Terrorist Attacks on America's Insurance System Before the House Comm. on Financial Services*, 107th Cong. 25 (2001) [hereinafter *House Hearing*] (testimony of Kathleen Sebelius, President, National Association of Insurance Commissioners) ("We know the insurance industry cannot withstand multiple events of this magnitude without harm to all consumers."), available at <http://www.house.gov/financialservices/107-45.pdf> (last visited Apr. 4, 2002).

67. For testimony of the insurance industry before Congress, see generally *Senate Hearing*, *supra* note 38, and *House Hearing*, *supra* note 66. "Pool Re" is the Pool Reinsurance Company, a mutual reinsurance company established by the British government as a mechanism for providing coverage of losses due to terrorism. For an in-depth description and analysis of Pool Re, see generally William B. Bice, Comment, *British Government Reinsurance and Acts of Terrorism: The Problems of Pool Re*, 15 U. PA. J. INT'L BUS. L. 441 (1994).

68. *Senate Hearing*, *supra* note 38 (testimony of Robert E. Vagley, President, American Insurance Association) ("[M]ore than two-thirds of annual reinsurance contracts—agreements by which primary insurance companies purchase their own insurance to adequately spread the risk of large-scale losses—are renewed each January 1."); Mike

exclude all such coverage, while continuing to press for federal assistance.⁶⁹

Reinsurers were able to revise their agreement terms, despite the consternation of Congress and state insurance regulators, because of the absence of state filing and approval requirements for reinsurance contract terms.⁷⁰ Whereas state regulatory agencies exercise veto power over the specific terms of insurance policies intended for issuance to consumers by direct writers, they exercise little power over the terms of reinsurance treaties as a matter of longstanding practice.⁷¹ Although state regulators closely monitor the solvency of reinsurers,⁷² their traditional willingness to allow flexibility in the terms of reinsurance treaties reflects a recognition that such agreements memorialize complex, negotiated financial arrangements between knowledgeable, sophisticated parties. Treaties are not amenable to standard terms; instead, they are customized to meet the unique needs and circumstances of particular insurers and their specific books of business.⁷³

Since filing and approval of reinsurance contracts were not required, reinsurers were free to announce changes prior to renewing agreements with ceding primary writers for 2002, leaving the

McNamee, *Terror Insurance: How to Stop the Coming Crisis*, BUS. WK., Dec. 10, 2001, at 36; Christopher Oster & Michael Schroeder, *Carriers Plan Lower-Cost Terror-Insurance Pool*, WALL ST. J., Nov. 8, 2001, at A10.

69. See, e.g., Michael Schroeder, *Senate Panel Is Set to Offer Bill to Back Terrorism Insurance*, WALL ST. J., Oct. 26, 2001, at A4 (reporting that Zurich Financial Services' Zurich Global Energy, insurer for oil, gas, mining, and power-generating companies, had announced to clients that it would not renew terrorism coverage on property policies).

70. See 14 ERIC MILLS HOLMES & L. ANTHONY SUTIN, *HOLMES'S APPLEMAN ON INSURANCE* 2D § 103.1, at 77 (2000).

71. See *id.*

72. Bank & Warrick, *supra* note 48, at 137–46.

73. See *Terrorism Risk, The Role of the Federal Government in Assuring That Insurance for Terrorist Acts Remains Available to Consumers: Hearing Before the Senate Comm. on Commerce, Science, and Transportation*, 107th Cong. (2001) (statement of Diane Koken, Pa. Insurance Commissioner, testifying on behalf of the NAIC), available at 2001 WL 26187327.

These are considered to be the product of free market negotiations among sophisticated insurance underwriters, brokers, and professional corporate risk managers who rely upon the traditional powers of buyers and sellers to bargain for the best deal they can get. The state regulatory interest in such large transactions is mainly that they not impair the overall financial health of an insurer, since monitoring insurer solvency is a major responsibility of the regulators.

Id. See also HOLMES & SUTIN, *supra* note 70.

primary insurers without coverage for their excess risks attributable to terrorism.⁷⁴ The primary writers, however, could not in turn revise their contracts with policyholders, because they required approval by reluctant state regulators.⁷⁵ Mindful of the need for businesses to protect against losses due to terrorism, the regulators hesitated to allow direct insurers to file and obtain approval of terrorism exclusions.⁷⁶

The NAIC, representing state insurance regulators who generally favor the preservation of the traditional role of the states in regulating the business of insurance,⁷⁷ initially opposed proposals for federal intervention, fearing that a federal terrorism reinsurance pool would “supplant the private market.”⁷⁸ As reinsurers began to pull out, however, the NAIC joined the industry in supporting federal intervention to create an alternative mechanism, in recognition of the untenable position of the primary writers

74. See Diane Brady & Mike McNamee, *Give Insurers a Break—But Not a Free Ride*, BUS. WK., Oct. 29, 2001, at 38.

States, which regulate the industry, require underwriters to provide terrorism coverage, and will likely continue to do so. But the industry contends that it has no choice but to either forgo offering such coverage to businesses it considers an undue risk, or charge such exorbitant rates as to be prohibitive. The reason: reinsurance companies, which back up their policies, say they'll cut off terror insurance on Jan. 1, when trillions of dollars in policies expire. That could prompt underwriters to balk at writing policies altogether because they don't want to be left holding the bag. With no coverage, lenders won't lend, builders won't build, and business will grind to a halt.

Id.

75. *Senate Hearing*, *supra* note 38 (testimony of Robert E. Vagley, President, American Insurance Association).

Primary carriers, however, do not have the same flexibility as reinsurers with respect to our own products because we are subject to tighter regulatory controls. Any terrorism exclusions we might choose to introduce must be approved by individual state insurance departments. . . . [I]f exclusions were not approved, primary insurers would be left to shoulder 100 percent of future terrorist losses, which we simply cannot afford to do. Our only remaining option—one we would prefer not to consider—would be to simply withdraw from certain markets, and/or lines of coverage.

Id.

76. See Press Release, NAIC, NAIC Urges Final Action on Terrorism Insurance Litigation (Dec. 17, 2001), at http://www.naic.org/inews/releases/rel01/121701_terrorism.htm (last visited Apr. 4, 2002) (quoting December 14, 2001 letter from Terri Vaughan, President of the NAIC, to Senators Thomas Daschle and Trent Lott).

77. See generally EMERIC FISCHER & PETER NASH SWISHER, PRINCIPLES OF INSURANCE LAW § 7.01 (2d ed. 1994).

78. Arthur D. Postal, *Despite Terrorism 'Crisis,' P/C Reinsurance Pool Will Be Tough Sell on Capitol Hill*, INS. ACCT., Oct. 1, 2001, at 1 (quoting Kathleen Sebelius, Chairman of the NAIC), available at 2001 WL 2524499.

and the threat to their solvency presented by potential terrorism losses absent a federal "backstop."⁷⁹ On October 24, the organization adopted the following resolution:

Reinsurers are notifying their customers that they will no longer cover terrorism risk, and primary carriers are notifying state insurance regulators that they intend to seek exclusions of terrorism coverage in their contracts with policyholders. This lack of availability will have a severe adverse effect on our country's economy if, for example, lenders are unwilling to make loans without terrorism coverage.

We, the National Association of Insurance Commissioners, therefore pledge to work with the Congress and the White House and with other interested parties and take action as soon as possible to address this critical issue.⁸⁰

Rejecting the industry's proposal for a federal reinsurance pool, the Bush administration proposed a plan in which the government would assume most terrorism losses during 2002, in order to give the industry time to recover from its September 11 losses, before gradually resuming responsibility for the full risk associated with providing terrorism coverage by the expiration of the program at the end of three years.⁸¹ Both the House Financial Services Committee and the Senate Banking Committee held hearings on the subject in late October, followed by the introduction in the House on November 1, 2001, of the Terrorism Risk Protection Act,⁸² a temporary program that would have provided financial assistance to property and casualty insurers in the form of loans.⁸³ Although the House passed its bill on November 29, the

79. See *NAIC Backs*, *supra* note 64.

80. Press Release, NAIC, Members Adopt Resolution Regarding Availability of Terrorism Coverage (Oct. 24, 2001), at <http://www.naic.org/1news/releases/rel01/102401mmbrsadoptrsltnregardavlblytyerrcov.htm> (last visited Apr. 4, 2002).

81. Under the administration's proposal, the government would have initially paid eighty percent of the first \$20 billion in terrorism-related insurance claims and ninety percent thereafter, with the government's contribution gradually decreasing over the three-year period. See *Terrorism Risk Insurance: Hearing Before the House Subcomm. on Capital Markets, Ins., and Gov't Sponsored Enters.*, 107th Cong. 5 (2001) (statement of Paul H. O'Neill, Secretary of the Treasury), 2001 WL 26187520.

82. H.R. 3210, 107th Cong. (2001).

83. The House measure would have created a temporary program by which financial assistance in the form of loans up to an aggregate total of \$20 billion would be provided to property and casualty insurers affected by a triggering terrorist event, ninety percent of which would subsequently be repaid by the insurers in accordance with assessments capped at three percent of each insurer's aggregate written premium in any given year. *Id.*

Senate became embroiled in a partisan dispute over an attached tort-reform measure barring punitive damages in lawsuits arising from terrorist attacks, and failed to reach agreement before adjourning on December 20, 2001.⁸⁴

As Congress neared adjournment and it became less and less likely that federal safeguards would be in place soon enough to benefit insurers facing the year-end expiration of their reinsurance agreements, state regulators began to acknowledge that they would have no choice but to approve terrorism exclusions filed by primary insurers.⁸⁵ The NAIC took the step of adopting a definition of "act of terrorism" to be used as a guide for insurers who would file exclusions,⁸⁶ and when Congress adjourned without enacting federal legislation, the NAIC announced that "[g]iven Congress' failure to act, regulators will begin allowing insurers to exclude terrorism losses if a terrorist act causes total insured losses exceeding \$25 million."⁸⁷ As a result, barring further federal legislative developments that could convince reinsurers to re-enter the terrorism insurance market and cause regulators to

The text of H.R. 3210 is available on the Internet at the Library of Congress's federal legislative information system found at <http://thomas.loc.gov>.

84. See *Today's Debate: Terrorism Insurance, As Clock Ticks, Congress Sits on Quick Terror-Insurance Fix*, USA TODAY, Dec. 7, 2001, at A16 ("The House leadership attached the liability protection to its otherwise worthwhile terrorism insurance bill that passed last week. Meanwhile, in the Senate, Republicans say no bill will pass without it, virtually guaranteeing gridlock with Democrats who oppose it."); Jackie Spinner, *Congress Unable to Pass Terror Insurance Bill: Deadlock Ends Hope for Quick Action on Issue*, WASH. POST, Dec. 21, 2001, at E1.

85. On December 18, 2001, new NAIC President Terri Vaughan stated that "[t]here is strong consensus among NAIC members that if Congress doesn't act, state insurance regulators will be left with no choice but to begin approving some exclusions for commercial lines." Press Release, NAIC, NAIC Members Make Decision Regarding Terrorism Insurance (Dec. 18, 2001), at <http://www.naic.org/1news/releases/rel01/index.htm> (last visited Apr. 4, 2002).

86. Dennis Kelly, *Regulators Adopt Definition of Terrorist Act*, BEST'S INS. NEWS, Dec. 11, 2001, available at 2001 WL 24726087.

87. Press Release, NAIC, NAIC Members Come to Agreement Regarding Exclusions for Acts of Terrorism (Dec. 21, 2001) at <http://www.naic.org/1news/releases/rel01/index.htm> (last visited Apr. 4, 2002). According to the Insurance Services Office, Inc. ("ISO"), drafter of the NAIC-endorsed exclusion, the \$25 million threshold (commonly used in the property and casualty insurance business to identify a catastrophic loss) would not apply where terrorist acts involve the use of nuclear, chemical, or biological materials. Press Release, ISO, ISO Gratified by Insurance Regulators' Call for Approval of Terrorism Exclusions; Wording Free to Non-Customers (Dec. 21, 2001), at <http://www.iso.com/docs/pres262.htm> (last visited Apr. 4, 2002); see also *Hard Hit at the World Trade Center: At the Top of a Terrible List*, BUS. WK., Sept. 24, 2001, at 12 (listing insured losses from some man-made disasters of the last decade, including the 1993 World Trade Center bombing (\$510 million) and the Oklahoma City bombing (\$125 million)).

withdraw their approvals, explicit terrorism exclusions will now become ubiquitous across all lines of insurance that could be adversely affected by terrorist attacks like those of September 11, 2001.

IV. LESSONS LEARNED: AVOIDING THE PITFALLS OF *CONTRA PROFERENTEM*

A. *The Need for Unambiguous, Plain-English Terminology*

Now that the World Trade Center disaster and the insurance crisis it generated have demonstrated, in no uncertain terms, the uninsurability of catastrophic acts of terrorism, insurers face the challenge of drafting and implementing exclusionary policy terms that state regulators will approve, yet will withstand judicial scrutiny. Case law attests to the dangers of ambiguity, in terms of both decisions adverse to particular insurers and of judicially precedential constructions contrary to insurer intent.⁸⁸ The insurance industry must take care not to squander the words and phrases that might be strung together to produce an effective policy exclusion by allowing each, in turn, to become invested with a legal meaning that confounds the purpose of the provision. At the same time, exclusionary terms must satisfy state “readability” requirements by using words calculated to be understood according to their “plain English” meanings by the majority of potential policyholders.⁸⁹ An effective terrorism exclusion will be one that successfully marries simplicity of language with precision of purpose in identifying sources of inestimable loss capable of producing claims so catastrophic as to invalidate rate-setting models and destabilize the financial condition of the insurer.

88. See discussion *supra* Part II.B.

89. Most states have “readability” statutes or regulations requiring that policy language achieve a certain “Flesch Reading Ease score” in order to be approved for use. See, e.g., CONN. GEN. STAT. §§ 38a-295 to -300 (2001); IND. CODE ANN. §§ 27-1-26-1 to -12 (Michie 2001); KY. REV. STAT. ANN. §§ 304.14-420-.14-450 (Michie 2001); N.Y. INS. LAW § 3102 (McKinney 2000); 14 VA. ADMIN. CODE §§ 5-110-10 to -80 (West 2001). In some states, readability requirements apply only to coverage intended for consumers, rather than those intended for more sophisticated commercial policyholders. However, given the impact of the World Trade Center disaster on carriers of individual and group life insurance, which are generally subject to these rules, contract exclusions intended for application across multiple lines of insurance should be drafted so as to achieve compliance with readability requirements.

B. *Exercise: The NAIC's Proposed Definition*

Acknowledging that the NAIC, of necessity, crafted its proposal in the chaotic aftermath of September 11,⁹⁰ it is instructive, both as an illustration of the complexity of the insurers' task and as a cautionary exercise, to examine the regulators' proposed definition of "act of terrorism:"

[A]n act, intentionally dangerous or destructive to human life, health, tangible or intangible property or infrastructure, carried out by a person or group that is not an agent of a sovereign state, but is acting on behalf of an organization based in a country other than the United States, and motivated by political, religious, or social beliefs.⁹¹

As a preliminary matter, the proposed definition, standing alone, does not satisfy the readability requirements imposed by many states for various types of coverage.⁹² Although an isolated definition generally would not be evaluated separately but would be considered either as part of the policy form in its entirety or of a word sample selected in accordance with the regulation, the absence of sentence-differentiating punctuation and the number of multi-syllabic words used do not comport with the stated aims of these simplified policy language rules.⁹³ Corrective measures needed include the use of short sentences or clauses separated by semicolons or colons, the use of short, easily understood words, and the use of additional definitions, expressed in simplified language, to clarify any complex or technical terms that must be retained in order to preserve the precision and accuracy of the definition as part of a legal document.⁹⁴

90. See discussion *supra* notes 77–87 and accompanying text.

91. Kelly, *supra* note 86. According to Montana Insurance Commissioner John Morrison, the phrase "not an agent of a sovereign state" is "intended to distinguish terrorism from war, and the reference to motives is intended to distinguish acts of terrorism from acts of vandalism." *Id.*

92. For example, calculated according to the methodology prescribed by Virginia's regulation for simplified and readable accident and sickness insurance policies, 14 VA. ADMIN. CODE § 5-110-50(D)(2) (West 2001), the text achieves a Flesch Reading Ease score of just 0.56, far below the minimum required score of 40.

93. See *id.* § 5-110-50. The Virginia readability regulation, like most others that employ the Flesch Reading Ease Test, specifies that "[a] unit of words ending with a period, semicolon, or colon, but excluding headings, captions, and subcaptions, shall be counted as a sentence." *Id.* § 5-110-50(D)(4)(b).

94. Readability rules often provide that changes made to policy terms to improve their readability must not interfere with the accuracy or adequacy of the contract. For example,

As to ambiguity, the grammatical structure of the NAIC's proposed definition gives rise to at least the following interpretive issues:

(1) Whether the modifier "intentionally" pertains only to "dangerous" or to both "dangerous" and "destructive";

(2) Whether "dangerous" stands alone, or pertains, like "destructive," to "human life, health, tangible or intangible property or infrastructure";

(3) Whether "human" modifies only "life"; both "life" and "health," or "life, health, tangible or intangible property or infrastructure";

(4) Whether the phrase "tangible or intangible" pertains only to "property," or to both "property" and "infrastructure";

(5) Whether "group" alone, or both "person" and "group," are modified by the phrase "that is not an agent of a sovereign state . . ."; and

(6) Whether it is the "person or group" or the "organization based in a country other than the United States" that must be "motivated by political, religious, or social beliefs."

Moreover, the elements of intent, sponsorship, and motivation imbedded in the definition invite courts to define the terms in the light "most favorable to the insured," which may create a result radically different from the exclusionary intent of the insurers. For example, if a hijacked airplane, intended to be flown into the White House, instead nose-dives into an office building in Pennsylvania as passengers attempt to foil the hijackers' plan, could it not be argued that *contra proferentem* compels the interpretation that the losses resulted from the acts of the brave passengers and were not due to "an act intentionally dangerous or destructive . . . carried out by [terrorist(s)]?" If a terrorist "cell" comprised of foreign citizens legally residing in the United States who profess to be disciples of Osama bin Laden, but who have received no training, funding, or other sponsorship from Al Qaeda, undertake a suicide mission resulting in catastrophic loss of life and property, are the losses excluded as resulting from an "act of terrorism" as

the Virginia readability regulation states that "[r]evision of the policy to make it more readable must not lead to its devaluation as a legal document." *Id.* § 5-110-50(A).

defined, or are they covered because they are the result of domestic criminal activity? If an organization claims motivation exclusively based on religion for its violent activities, yet those activities are abhorrent to the official tenets of that religion and are publicly renounced by its leaders, are these violent events “acts of terrorism,” or do they fail the motivation prong of the definition?

Finally, the proposed terminology used by the NAIC, without further definition of key words and phrases, leaves room for misinterpretation. At a minimum, the terms “infrastructure,” “sovereign,” “acting on behalf of,” and “based” require further clarification.

C. *Where Traditional War Exclusions Failed*

It may be irrelevant now whether war exclusions might have been construed to apply to the attacks on the World Trade Center and the Pentagon, given certain salient features of those events that might have distinguished them from terrorist actions examined in earlier insurance cases.⁹⁵ In any case, after September 11, 2001, “war” and “terrorism” are now interchangeable terms when used as insurance shorthand for catastrophic acts of transnational violence constituting uninsurable risks. Given the history of war exclusion clauses, their probable ineffectiveness for eliminating terrorist acts from the universe of insured events, and the current opportunity for crafting and implementing effective terrorism exclusions, however, insurers need to differentiate between the two in order to ensure adequate protection from liability.

In crafting terrorism exclusions, insurers should be guided by the reasoning of courts that have held specific war-risk exclusions to be inadequate for purposes of excluding terrorism risks or have assigned legal meaning to specific terms that might appear within terrorism exclusions. If, conceptually, acts of war and acts of terrorism exist as distinct categories of risk, drafters should pay close attention to case law identifying the features courts view as essential for characterizing a given event as one or the other. Moreover, drafters should be guided by the overarching objective of deriving definitions appropriate *for insurance purposes*,

95. See sources cited *supra* note 62 and accompanying text.

even where legal definitions of terms for other purposes may be well established. In so doing, drafters should aim to eliminate any definitional gaps that could result in the failure of an exclusion to capture an uninsurable mega-catastrophe occurring in the gray area between “war” and “terrorism.”

There are few judicial cases addressing the distinctions between “war” and “terrorism” for insurance purposes; the most relevant case and the one generally cited by commentators after the World Trade Center disaster is *Pan American World Airways, Inc. v. The Aetna Casualty & Surety Co.*⁹⁶ The court in *Pan Am* surveyed and summarized many of the earlier cases bearing on aspects of the distinction, making the case a key source of information on how various exclusionary terms will be construed.⁹⁷ Relevant delimiters provided by the case include the following:

(1) A “war,” whether declared or undeclared, can exist only where sovereign or quasi-sovereign entities engage in hostilities.⁹⁸ Terrorism exclusions should specify that terrorist acts may, but need not, be committed on behalf of or sponsored by any sovereign or quasi-sovereign entity.

(2) An act of war cannot be committed by a terrorist group other than a de facto government or an entity acting on behalf of a government.⁹⁹ Terrorism exclusions should stipulate that a terrorist act may, but need not, be committed by or on behalf of a group that comprises a de facto government or a recognized government.

(3) The actions of a “tiny non-governmental entity” fighting the United States do not constitute “war” between the United States and that entity.¹⁰⁰ Terrorism exclusions should make it clear that the size of a terrorist organization is not relevant to the determination as to whether or not its act is excluded.

(4) Words describing violent events commonly used in war-risk exclusions are construed as having “dimensions besides the level

96. 505 F.2d 989 (2d Cir. 1974).

97. See generally *id.* (discussing the proper manner by which to interpret exclusionary terms in an insurance policy).

98. *Id.* at 1005; see also *New York Life Ins. Co. v. Bennion*, 158 F.2d 260, 264 (10th Cir. 1946); *Vanderbilt v. Travelers' Ins. Co.*, 184 N.Y.S. 54, 55 (1920).

99. *Pan Am*, 505 F.2d at 1012; see also *Welts v. Conn. Mut. Life Ins. Co.*, 48 N.Y. 34, 40 (1871).

100. *Pan Am*, 505 F.2d at 1019 n.15.

of violence," which may include requirements that multiple actors be involved.¹⁰¹ For example, according to the *Pan Am* court, for there to be a "riot" three or more actors must gather in the same place¹⁰² Similarly, "[f]or there to be a civil commotion, the agents causing the disorder must gather together and cause a disturbance"¹⁰³ Drafters should specify that excluded acts of terrorism may be committed by one or more persons or entities.

Pan Am also provides a number of cautions for insurers with respect to practices that may result in findings of ambiguity:

(1) Terms stipulating a number of specific types of excluded conduct will not be construed as describing an inclusive continuum of violent acts; rather, at least one of the specific types of conduct must fairly describe the cause of the loss.¹⁰⁴ Terrorism exclusions should be carefully drafted to avoid interpretations that limit the excluded conduct to specific listed actions.

(2) An insurer's adoption of a new exclusion to deal with the particular type of loss sustained by an insured within a short time after the loss was incurred will be deemed evidence that the insurer's previous exclusion language was ambiguous.¹⁰⁵ Care should be taken to file and implement the most comprehensive and clearest exclusionary language possible and to avoid being forced to revise and refile after unanticipated losses have been incurred.

(3) In some jurisdictions, *contra proferentem* is applied in disputes between insurers and reinsurers as well as in those between insurers and unsophisticated insurance consumers.¹⁰⁶ In these jurisdictions, ambiguities may be resolved against the drafter, even where the opposing parties are the insurer and the reinsurer of the same risk and both are sophisticated parties.¹⁰⁷

101. *Id.* at 1005.

102. *Id.*

103. *Id.* at 1020 (citing *Hartford Fire Ins. Co. v. War Eagle Coal Co.*, 295 F. 663, 665 (4th Cir. 1924)).

104. *Id.* at 1005 ("The . . . insurers' shotgun approach belies its claim that these terms have certain fixed meanings."); see also *Younis Bros. & Co. v. CIGNA Worldwide Ins. Co.*, 899 F. Supp. 1385, 1392 (E.D. Pa. 1995); *Holiday Inns Inc. v. Aetna Ins. Co.*, 571 F. Supp. 1460, 1461 (S.D.N.Y. 1983).

105. *Pan Am*, 505 F.2d at 1000 (citing *Orren v. Phoenix Ins. Co.*, 179 N.W.2d 166, 169 (Minn. 1970); *Hartol Prod. Corp. v. Prudential Ins. Co.*, 47 N.E.2d 687, 690-91 (N.Y. 1943)).

106. *Id.* at 1002.

107. See Jeffrey W. Stempel, *Reassessing the "Sophisticated" Policyholder Defense in*

Since the insurer's exclusions are subject to filing and approval by state insurance regulators, it is critical that the language filed for inclusion in the primary contract be consistent with any reinsurance agreement exclusions to avoid primary writer liability for losses that will be unrecoverable under the terms of the carrier's reinsurance agreements.

D. *Revisiting the NAIC's Draft*

Building upon the NAIC's draft definition and guided by both readability considerations and the admonitions of the *Pan Am* court, the author offers the following as a starting point from which insurers might develop terrorism exclusions appropriate for their particular products:

Losses due to acts of terrorism are not covered. For purposes of this exclusion:

"Act of terrorism" means an act that is dangerous to or destructive of:

- human life;
- human health; or
- property of any kind. This includes both tangible and intangible property. It includes real property and personal property. It includes infrastructure such as roads, bridges, and tunnels; power systems and water systems; broadcasting systems and computer systems.

The act must be planned or carried out by a person or group acting on behalf of an organization based outside of the United States.

The organization may be, but is not limited to, one that:

- claims to be motivated by political, religious, or social beliefs; or
- aims to intimidate, influence, or coerce the United States government or its citizens.

The organization may, but need not, be:

- a sovereign entity—an independent state or government;
- a quasi-sovereign entity—one that has some traits of a sovereign entity; or
- a de facto government—one that has taken over or separated from a regular government.

It need not be an organization of a particular size.

“Acting on behalf of” an organization means:

- acting as its agent or representative;
- affiliated with it; or
- being sponsored or supported by it in any way. This includes receiving assistance, funding, training, direction, or equipment from the organization.

“Based outside of the United States” means founded, located, headquartered, or maintaining a presence outside of the United States.

“Losses due to acts of terrorism” includes losses incurred in attempted acts of terrorism.¹⁰⁸

V. CONCLUSION

The risk of unpredictable multi-billion dollar losses due to acts of transnational terrorism is a risk that cannot currently be insured against without exposing the insurance industry to danger-

108. This draft exclusion is consistent with the NAIC’s intent not to categorize domestic criminal acts as terrorism for purposes of its exclusion. *See supra* note 91 and accompanying text. Although it is beyond the scope of this Comment to address this decision, the 1995 bombing of the Murrah Building in Oklahoma City calls into question whether previously held assumptions about the capacity of the law enforcement system to prevent catastrophic terrorist acts perpetrated in the United States by United States citizens can survive as the basis for a determination of insurability. If the distinctions between war and transnational terrorism have vanished in the context of insurability, distinctions between transnational and domestic acts of terrorism, which may be equally unpredictable and result in losses of similar severity, should also be reconsidered.

In addition to the NAIC draft exclusion, several other definitions were taken into consideration. *See* 18 U.S.C. § 2331 (1994); S. 1751, 107th Cong. § 3(1) (2001); H.R. 3210, 107th Cong. § 16(1) (2001); S.B. 5798, 224th Sess. (N.Y. 2001); 28 C.F.R. § 0.85(1) (2001).

ous financial destabilization and particular insurers to insolvency. Traditional war-risk exclusions are ineffective devices for eliminating these exposures, despite certain present-day similarities between war and terrorism. To protect themselves and the ability of the industry to provide coverage for insurable risks, insurers must implement effective policy exclusions in order to effect the transfer of catastrophic terrorism risks and the assumption of such losses by an alternate mechanism still to be identified by Congress. Owing to the recent crisis, state insurance regulators have generally agreed to approve terrorism exclusions, and case law suggests that the courts will uphold them if—but only if—they are written in a clear and unambiguous manner. Insurers must be informed and guided by past judicial interpretations in crafting such legally adequate and enforceable plain English exclusions for losses due to terrorism.

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