



## NORTH CAROLINA BANKING INSTITUTE

Volume 7 | Issue 1

Article 9

2003

# Terrorism Insurance and Commerical Real Estate: The New Frontier

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### Recommended Citation

Alison R. Orlans, *Terrorism Insurance and Commerical Real Estate: The New Frontier*, 7 N.C. BANKING INST. 93 (2003).

Available at: <http://scholarship.law.unc.edu/ncbi/vol7/iss1/9>

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## Notes & Comments

### Terrorism Insurance and Commercial Real Estate: The New Frontier

#### I. INTRODUCTION

The new frontier for the real estate and insurance industries is the introduction of terrorism insurance. Terrorism insurance is now mandated by lenders for most commercial real estate properties to insure against losses resulting from acts of terror.<sup>1</sup> The new insurance requirements became problematic when reinsurers, and then primary insurers, excluded acts of terrorism from their coverage.<sup>2</sup> Separate insurance policies were difficult to obtain because insurers simply were not offering terrorism insurance.<sup>3</sup> The few companies that did offer terrorism insurance charged extremely high premiums.<sup>4</sup> Many borrowers and lenders, unable to secure coverage, found their investment-grade loans downgraded by rating agencies.<sup>5</sup> Responding to these

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1. See *infra* notes 47-84 and accompanying text; see, e.g., DANIEL B. RUBOCK & TAD PHILIPP, MOODY'S INVESTORS SERVICE, CMBS: MOODY'S APPROACH TO TERRORISM INSURANCE FOR U.S. COMMERCIAL REAL ESTATE (Mar. 1, 2002); Albert Warson, *Rebooting Terrorism Insurance*, MORTGAGE BANKING, Sept. 1, 2002, at 56, available at 2002 WL 11226773. Most policies do not cover loss from chemical or biological acts of terrorism. Eugene A. Pinover, Lisa M. Zana & Joseph Philip Forte, *Terrorism Insurance After September 11: Is Federal Assistance Needed?*, 22 SHOPPING CENTER LEGAL UPDATE 13, 14 (Summer 2002).

2. See *infra* notes 37-43 and accompanying text; see, e.g., Jane Kendall, Comment, *The Incalculable Risk: How the World Trade Center Disaster Accelerated the Evolution of Insurance Terrorism Exclusions*, 36 U. RICH. L. REV. 569, 583-88 (2002).

3. See *infra* notes 59-68 and accompanying text; Gregg J. Loubier & Jason B. Aro, *Insuring the Risks of Terror: Questions of the Cost and Application of Terror Insurance Remain Open*, L.A. LAWYER, Sept. 2002, at 18, 19, available at LEXIS, Nexis Library, LOSAL File.

4. See *infra* notes 59-68 and accompanying text; Loubier & Aro, *supra* note 3, at 19.

5. See *infra* notes 114-119 and accompanying text; TAD PHILIPP & PAMELA DENT, MOODY'S INVESTORS SERVICE, MOODY'S DOWNGRADES ELEVEN AND

problems, Congress enacted the Terrorism Risk Insurance Act of 2002, a federal insurance backstop.<sup>6</sup> Though it is too early to determine the industry implications of the Act, there are several remaining considerations for lenders and borrowers, and many readjustments for the real estate and insurance industries.<sup>7</sup>

Effects of the terrorism insurance “problem” are widespread.<sup>8</sup> A study of commercial real estate owners, developers, and lenders blamed lack of available terrorism insurance for the delay or cancellation of more than \$11.7 billion in real estate projects since September 11, 2001,<sup>9</sup> while President George W. Bush cited a study showing delay or cancellation of more than \$15 billion in projects.<sup>10</sup> More than \$7 billion worth of commercial mortgage-backed securities (CMBS)<sup>11</sup> were suspended or cancelled in the year following the attacks.<sup>12</sup> The week of September 22, 2002, Moody’s Investors Service cut the rating of \$4.5 billion in CMBS; eleven separate AAA-rated securities were downgraded because of insufficient terrorism insurance.<sup>13</sup> The White House also blamed terrorism insurance issues for the loss of 79,000 real estate and construction jobs in the month of April 2002

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CONFIRMS TWO SINGLE ASSET AND LARGE LOAN CMBS TRANSACTIONS CITING TERRORISM INSURANCE CONCERNS 1 (Sept. 27, 2002).

6. Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, 116 Stat. 2322 (to be codified at 15 U.S.C. § 6701 Note); *see infra* notes 141–154 and accompanying text.

7. *See infra* notes 189–244 and accompanying text for some examples.

8. *See infra* notes 9–14 and accompanying text.

9. Karen L. Werner, *Real Estate Survey Finds \$11.7 Billion in Projects Affected by Terror Coverage*, 79 BANKING REP. 363 (Sept. 9, 2002).

10. *See* Sarah Lockyer & Nicole Duran, *In Brief: Compromise on Terror Insurance?*, AM. BANKER, Oct. 4, 2002, at 19.

11. CMBS refers to the process of pooling mortgages and selling the pool to a special purpose vehicle (SPV). Alan Kronovet, Note, *An Overview of Commercial Mortgage Backed Securitization: The Devil is in the Details*, 1 N.C. BANKING INST. 288, 289 (1997). The investment risk of the pool is rated by a national rating agency (i.e. Moody’s, Standard & Poor’s). *Id.* The SPV then divides the pool into classes and sells an interest in the class to a third party investor. *Id.* Thus, loans are “converted into securities in order to gain access to the capital markets.” *Id.* at 288.

12. Warson, *supra* note 1, at 56. According to The Bond Market Association, another \$36 billion in CMBS may have been affected if federal terrorism insurance is not passed. Pinover et al., *supra* note 1, at 15.

13. *See* Norma Cohen, *The High Costs of Terrorism: Even Owners of Trophy Assets in New York Have Been Unable to Obtain Full Terrorism Insurance Cover, Triggering a Series of Investment Downgradings by Ratings Agencies*, FIN. TIMES (London), 2<sup>nd</sup> Ed., Oct. 4, 2002, at 29.

alone.<sup>14</sup> Lack of terrorism insurance is the common denominator contributing to these drastic effects on the commercial real estate and insurance industries, investors, and American workers.

This Note will examine the changing landscape of terrorism insurance for lenders, borrowers, insurance companies, and investors, and will suggest solutions to the problems that have arisen. First, it will examine the problem posed by the lack of terrorism insurance for the insurance industry and commercial real estate development.<sup>15</sup> Second, it will discuss the effect lack of terrorism insurance had on the CMBS markets and show how rating agencies are adjusting to the new CMBS landscape.<sup>16</sup> Next, it will look at the Terrorism Risk Insurance Act of 2002 and the debate surrounding this legislation to subsidize terrorism insurance.<sup>17</sup> Finally, this Note will evaluate what lenders and insureds should consider when purchasing a terrorism insurance policy.<sup>18</sup>

## II. THE PROBLEM

### A. *Insurance: Lack of Funds, Lack of Insurance*

The insurance industry was thought to have sufficient funds to cover a major catastrophic event, assuming the loss totals were not in excess of \$50 billion.<sup>19</sup> Estimates of claims on the insurance industry for losses from September 11, 2001, however, range from \$60 billion<sup>20</sup> to as high as \$100 billion.<sup>21</sup> As the total claims

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14. Warson, *supra* note 1, at 56.

15. See *infra* notes 19-84 and accompanying text.

16. See *infra* notes 85-126 and accompanying text.

17. See *infra* notes 127-188 and accompanying text.

18. See *infra* notes 189-244 and accompanying text.

19. See Kendall, *supra* note 2, at 570 n.3. "[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 (quoting Steven J. Dreyer, Managing Director for U.S. Insurance Industry Ratings at Standard & Poor's).

20. Alexandra Glickman, *Insurance and Commercial Mortgages in the New World of Risk*, in COMMERCIAL REAL ESTATE FINANCING: WHAT BORROWERS AND LENDERS NEED TO KNOW NOW, REAL ESTATE LAW AND PRACTICE COURSE HANDBOOK SERIES 537, 539 (Practising Law Institute ed., Feb. 2002).

21. Loubier & Aro, *supra* note 3, at 18.

increased from the attacks on the World Trade Center,<sup>22</sup> so did anxieties about insurance funding.<sup>23</sup> One industry representative stated, “the private insurance industry lacks the capital and resources to protect against the immense destructive power of modern warfare and . . . organized terrorism.”<sup>24</sup> Fear that the insurance industry could not survive another disaster in the near future on par with that of the World Trade Center prompted insurers to exclude acts of terrorism from their policies.<sup>25</sup>

The role of insurance is to “relieve one party of the burden of uncertainty associated with potential losses, while allowing the other party to profit from their reasonable calculability.”<sup>26</sup> Risk is generally calculated by a statistical analysis termed the “law of large numbers,” which provides some calculability to the unknown risk.<sup>27</sup> Terrorism, however, proves to be a more difficult calculation.<sup>28</sup> Some models attempt to determine risk based on the premise that the more prominent the real estate, the more likely it will be the target of a terrorist act.<sup>29</sup> This may seem a logical deduction; however, it fails to acknowledge several important variables.<sup>30</sup> History shows that terrorist acts could occur just as easily at a local bar or office building.<sup>31</sup> There is also a possibility that buildings around prominent real estate assets will be

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22. This article does not address the additional claims for life insurance, car insurance, etc. resulting from the attack on the World Trade Center. This article limits discussion to the property claims resulting from building and structural damage due to the events of September 11, 2001 and the ensuing consequences.

23. See, e.g., Lee Ann Gjertsen, *Insurers – Only 2 Fail; Diversified Risk Helps*, AM. BANKER, Sept. 6, 2002, at 10. Two insurance companies, one Japanese and one Danish, became insolvent because of claims from September 11. *Id.*

24. H. Rodgin Cohen, Address at the University of North Carolina School of Law Banking Law Institute (April 4, 2002) (transcript on file with the North Carolina Banking Institute).

25. See Kendall, *supra* note 2, at 583-87.

26. *Id.* at 572.

27. See *id.* The “law of large numbers” examines a large sample of events to determine the statistical probability of an event occurring. *Id.* at 572 n.15.

28. See *id.* This statistical process demonstrates the inherent incalculability of catastrophic terrorist attacks, because their occurrence is too rare to accurately predict the likelihood of similar events. See *id.*

29. See Loubier & Aro, *supra* note 3.

30. See *infra* notes 31-34 and accompanying text.

31. See Loubier & Aro, *supra* note 3 (stating that a suburban pizza parlor is just as likely to be hit as a national landmark).

destroyed.<sup>32</sup> One commentator suggests that no model can predict catastrophes like the events of September 11 because they are too rare and are, by definition, outliers.<sup>33</sup> In addition, models generally fail to consider political and social factors that motivate terrorists.<sup>34</sup> Some argue that the risk is so difficult to quantify, that acts of terrorism are actually uninsurable.<sup>35</sup> Although prominent buildings are generally first among anticipated targets, "every place is at risk to some degree."<sup>36</sup>

Due to the lack of funds and lack of predictability, reinsurers began excluding acts of terrorism shortly after September 11.<sup>37</sup> Reinsurers assume a portion of policy risks, allowing primary insurers to accept more risk than otherwise allowed, thereby increasing the total market capacity.<sup>38</sup> Primary insurers are still contractually obligated to pay policyholders in the event of loss, regardless of whether they are reimbursed by reinsurers.<sup>39</sup> Insurance sold to consumers is subject to approval and review by state regulatory agencies, and regulators were reluctant to allow exclusions for acts of terrorism.<sup>40</sup> Without

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32. See John Holusha, *Uncertainty In a Landscape Transformed*, N.Y. TIMES, Sept. 23, 2001, § 11. This could occur from a failed attempt to destroy the prominent building or, as with some smaller buildings around the World Trade Center, after-effects of an attack which cause damage to a nearby building not necessarily a terrorist target. See Mark Adelson, David P. Jacob, & Joshua Phillips, *Trends in Securitization: Research Perspective*, in NEW DEVELOPMENTS IN SECURITIZATION, COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES 193, 218 (Practising Law Institute ed., Dec. 2001). A New York Times article listed 30 million square feet of office space affected by the events of September 11, 2001, amounting to 36% of the total downtown space. *Id.*

33. See Mark H. Adelson, *How the Events of September 11 Affect Thinking about Risk*, CMBS WORLD, Summer 2002, at 54, 59.

34. *Id.*

35. Loubier & Aro, *supra* note 3, at 20.

36. *Id.*

37. See Kendall, *supra* note 2, at 583-84 (explaining that reinsurance companies can revise terms more easily than insurance companies because they do not need state regulator approval to do so).

38. See *id.* at 579. "Primary insurers rely on the foreign and domestic reinsurance markets to assume a portion of the risk they underwrite." James G. Rizzo, *Tragedy's Aftermath: The Impact of 9/11 on the Insurance Industry*, 46 BOSTON BAR J. 10, 10 (2002).

39. See Kendall, *supra* note 2, at 581.

40. See *id.* at 585. Kendall stated that the reluctance stemmed from concern for businesses and consumers that need to protect themselves from losses incurred from acts of terrorism. *Id.*

international reinsurers to back up their policies and absorb some of the risk, primary insurers were left with more outstanding risks than they could cover.<sup>41</sup> State regulators realized the plight of the insurance companies and approved terrorism exclusions for primary insurers.<sup>42</sup> The Terrorism Risk Insurance Act of 2002 now preempts these state-approved exclusions and requires that the exclusions be eliminated if the losses that are insured under the Act are those excluded under the current insurance contract.<sup>43</sup>

### B. *Lenders: Potential for Loan Defaults*

Mortgage terms generally require that the mortgaged property have “all risk” insurance as well as other types of insurance that may be reasonably requested by the lender.<sup>44</sup> There are certain generally recognized exclusions from “all risk” insurance, including damage resulting from earthquake, flood, and acts of war.<sup>45</sup> If a type of insurance is required by the lender, but excluded from the “all risk” policy, the borrower must purchase separate insurance.<sup>46</sup> Before September 11, 2001, “all risk” policies generally included damage and loss resulting from an act

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41. *See id.* at 585-86. The plight of primary insurers was particularly urgent because seventy percent of their reinsurance “treaties” expired on January 1, 2002. RUBOCK & PHILIPP, *supra* note 1, at 4.

42. *See* Kendall, *supra* note 2, at 587. California, Georgia, and New York did not approve the terrorism exclusion proposed by the Insurance Services Office and endorsed by the National Association of Insurance Commissioners. Pinover et al., *supra* note 1, at 14. California provided several concerns with the exclusion as proposed by the Insurance Services Office, including an arbitrary definition of a terrorist “incident” and an unreasonably low damage threshold at twenty-five million dollars country-wide. Loubier & Aro, *supra* note 3, at 19.

43. Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, §105(b), 116 Stat. 2322 (to be codified at 15 U.S.C. § 6701 Note).

44. *Force Placement of Terrorism Coverage Leads to Litigation*, NAT’L MORTGAGE NEWS, July 15, 2002, at 8, *available at* 2002 WL 8159892.

45. *See* Loubier & Aro, *supra* note 3, at 18. Insurers chose not to claim “act of war” exclusions for the events on September 11 in large part for public relations reasons, but also because they did not expect the court to find the attack an act of war. *See* Kendall, *supra* note 2, at 571. The act of war exclusion typically requires the perpetrator to be an agent of a sovereign government or power. *See* Loubier & Aro, *supra* note 3, at 19.

46. Telephone interview with Alan Kronovet, Vice President, Wachovia Securities (Sept. 24, 2002) [hereinafter Kronovet interview]; *see also* Loubier & Aro, *supra* note 3, at 19 (“[A]ny insured that wants or needs to buy terrorism insurance now must obtain separate terrorism coverage if it is available.”).

of terrorism; now they do not.<sup>47</sup> These exclusions did not affect property owners until lenders required their property to have terrorism insurance coverage.<sup>48</sup> If terrorism coverage is required and the borrower fails to obtain it, the lender may place the borrower in default for inadequate insurance under the terms of the loan.<sup>49</sup> This is, of course, dependent upon the requirement being reasonable.<sup>50</sup> Reasonableness of such a requirement is still open to interpretation.<sup>51</sup>

There are several standards by which lenders are requiring terrorism insurance.<sup>52</sup> The most stringent standard is a specific requirement that the borrower obtain coverage for terrorism; the next most stringent standard is a requirement of coverage if it is commercially available, regardless of cost; the next is a requirement of coverage if it is commercially reasonable to obtain (considering both availability and cost); and the most lenient is no express obligation to obtain coverage.<sup>53</sup> The applicable standard generally depends upon the asset's apparent risk and the negotiating strength of the borrower.<sup>54</sup> Rating agencies, and presumably investors, would ideally prefer the strictest standard.<sup>55</sup> However, requiring the borrower to obtain terrorism insurance outright has led to some lawsuits,<sup>56</sup> including lawsuits relating to the Mall of America and the Conde Nast Building at 4 Times Square.<sup>57</sup> In these cases, because the coverage was available but

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47. Glickman, *supra* note 20, at 541; Loubier & Aro, *supra* note 3, at 18-19.

48. *See* Loubier & Aro, *supra* note 3, at 19.

49. *See Force Placement of Terrorism Coverage Leads to Litigation, supra* note 44, at 8. Keith Dunsmore, a partner at Akin Gump Strauss Hauer & Feld LLP stated, "If the loan documents do permit the lender to require the insurance, then if the borrower refuses to maintain the insurance they would be in default. . . ." *Id.*

50. *See id.*; RUBOCK & PHILIPP, *supra* note 1, at 15.

51. *See* RUBOCK & PHILIPP, *supra* note 1, at 11. "It is unclear whether increases in premiums of merely 50%, or perhaps 450%, would be deemed unreasonable." *Id.*

52. *See id.* at 10.

53. *See id.*

54. Loubier & Aro, *supra* note 3, at 20.

55. *See* RUBOCK & PHILIPP, *supra* note 2, at 10-11. However, considering the current state of the insurance market, there are several problems with the most stringent requirement, including a claim of impossibility of performance. *See id.* at 10.

56. *See, e.g., Force Placement of Terrorism Coverage Leads to Litigation, supra* note 44, at 8; Pinover et al., *supra* note 2, at 15.

57. *See Force Placement of Terrorism Coverage Leads to Litigation, supra* note



very expensive, the borrower tried to prevent the lender from purchasing insurance and passing through the cost of the high premium.<sup>58</sup>

Although many lenders were requiring terrorism insurance, borrowers were discovering that it was either unavailable or extremely expensive.<sup>59</sup> After September 11, but before enactment of the Terrorism Risk Insurance Act of 2002, there were only six companies offering terrorism insurance and cost predictions estimated that owning it added \$0.20 for each \$100 of real estate value.<sup>60</sup> Coverage was most difficult to obtain in large cities.<sup>61</sup> Moody's, a national rating agency, contends that coverage is most difficult to get "for large, trophy buildings, and for office towers of over 50 stories in central business districts."<sup>62</sup> Furthermore, buildings in large cities (like New York City) are hard to insure regardless of height.<sup>63</sup> In order to ensure coverage, previous insurer rating requirements were relaxed.<sup>64</sup> Even those who have

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44, at 8; Pinover et al., *supra* note 1, at 15.

58. See *Force Placement of Terrorism Coverage Leads to Litigation*, *supra* note 44, at 8; Pinover et al., *supra* note 1, at 15. In the case of the Conde Nast Building, the servicer "tried to put the mortgage into default and seize a portion of the \$88 million in annual rents to pay for a new terrorism insurance policy." *Conde Nast Deal Downgraded*, COMMERCIAL MORTGAGE ALERT, Sept. 20, 2002, at 12.

59. See Loubier & Aro, *supra* note 3, at 19. "[A]fter September 11, terrorism insurance became largely unavailable almost overnight and, . . . any terrorism insurance available could be purchased only at prices uneconomic for most insureds." *Id.* Some real estate owners have paid as much as 500% more than last year for insurance coverage. See Warson, *supra* note 1, at 56.

60. See Warson, *supra* note 1, at 56. The six companies reportedly offering terrorism insurance were: American International Group, Inc.; Lloyd's of London; Berkshire Hathaway Group; The Chubb Corporation; Travelers Insurance Company; and Liberty Mutual Insurance Group. *Id.* The policies offered by these companies did not include losses resulting from chemical, biological, or nuclear causes. Pinover et al., *supra* note 1, at 16.

61. Moody's *Reiterates Plan to Downgrade CMBS if Terrorism Coverage Lapses*, NAT'L MORTGAGE NEWS, June 24, 2002, at 10, available at 2002 WL 8159793. One source stated, "[L]ack of terrorism insurance coverage is limited to big cities, such as New York, Chicago, and perhaps Washington, D.C." Karen L. Werner, *Terrorism Insurance Conference Resolution Has 'Sticking Points' in Informal Discussions*, 79 BANKING REP. 407, 408 (Sept. 16, 2002).

62. RUBOCK & PHILIPP, *supra* note 1, at 4.

63. *Id.* at 4 n.5.

64. See RUBOCK & PHILIPP, *supra* note 1, at 15. For example, Moody's preferred an insurer to be rated A3 before September 11, but is now willing to accept a rating of A2. *Id.*

been successful in obtaining coverage are still underinsured.<sup>65</sup> Generally, borrowers are only able to obtain between \$75 and \$100 million in terrorism insurance from one insurer.<sup>66</sup> Thus for large loans, they must layer coverage among several different insurers.<sup>67</sup> The unavailability of terrorism insurance affects both the current borrower, who may be required to obtain it, as well as real estate developers, who have shied away from new projects because of the increased costs associated with obtaining mortgage loans.<sup>68</sup>

Lenders are in a predicament.<sup>69</sup> They do not want to place normally good borrowers into default, especially when they are aware of the high cost of terrorism insurance.<sup>70</sup> However, in the absence of terrorism insurance, the lender would in effect be the insurer of the property if it was destroyed through an act of terrorism.<sup>71</sup> Lenders have generally avoided placing loans into default for insufficient terrorism insurance.<sup>72</sup> The economic downturn has given lenders an additional consideration when deciding whether to require terrorism insurance. Office space and hotels face tough times.<sup>73</sup> With less income, some borrowers are

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65. Werner, *supra* note 61, at 408. “[T]he cost is exorbitant and people are being forced to choose between being under- or uninsured.” *Id.* For example, “The New York Metropolitan Transit Authority has only \$70 million of terrorism insurance to cover its terminals, bridges and tunnels, and assets worth \$1.5 billion.” Pinover et al., *supra* note 1, at 15.

66. RUBOCK & PHILIPP, *supra* note 1, at 5.

67. *Id.*

68. See Werner, *supra* note 61, at 408; see also Warson, *supra* note 1, at 56 (discussing how all new loans are requiring separate terrorism insurance). In order to obtain a real estate loan, lenders require proof of insurance. Werner, *supra* note 61, at 408.

69. See, e.g., Warson, *supra* note 1, at 56.

70. *Id.*

71. Cohen, *supra* note 24 (stating that because of terrorism exclusions, “banks and other lenders that hold commercial mortgages have become – by default – the insurer against terrorism”).

72. Loubier & Aro, *supra* note 3, at 19. “The option of calling the mortgages for a failure to provide adequate insurance is often not a viable option.” Cohen, *supra* note 24.

73. Brian Lancaster, *Commercial Real Estate and CMBS Outlook for 2002*, CMBS WORLD, Summer 2002, at 10, 10-13. Office vacancy rates were at 13.6% in the beginning of 2002; while hotels’ revenue per available room (RevPAR) dropped 30% after September 11, 2001, maintaining a decrease of between 10% and 15% for most of 2002. *Id.* at 10-11.

having trouble paying their current mortgage.<sup>74</sup> This cash-flow problem will become amplified if borrowers must add the costs of terrorism insurance to their operating costs.

Lack of terrorism insurance can affect the value of an asset even without a terrorist attack.<sup>75</sup> “When commercial mortgage loans become due, there is often a large principal balance outstanding; that is typically repaid through a sale or refinancing.”<sup>76</sup> If the borrower lacks terrorism coverage, though, he may not be able to sell or refinance.<sup>77</sup> This could effectively stop the purchase and sale of commercial real estate.<sup>78</sup>

Another consideration is the effect of a high deductible.<sup>79</sup> If an act of terrorism destroys an asset, the borrower may be required to pay a high deductible before receiving any of the insurance funds.<sup>80</sup> The borrower will not be able to borrow more money on the destroyed asset, and because the deductible is considered a capital expense, the cost cannot be passed to tenants.<sup>81</sup> This may force the borrower to pay a high percentage of the damage from his own funds before he can receive any insurance money.<sup>82</sup> Thus, there is a risk of default even if the property has the required insurance.<sup>83</sup> Finally, if the loan is securitized and the servicer does not declare the borrower in default for lack of sufficient insurance coverage, bondholders can sue the servicer if the property is damaged from an act of terrorism.<sup>84</sup>

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74. *See id.* at 17.

75. *See infra* notes 76-78 and accompanying text.

76. Cohen, *supra* note 13, at 29.

77. *Id.*

78. *Id.* David Creamer, chairman and chief executive of GMAC Commercial Holding Corp., equates this possibility with the savings and loan crisis. *Id.*

79. *See* Glickman, *supra* note 20, at 542.

80. *Id.* For example, the deductibles on some Boston properties went from \$10,000 (pre-September 11) to \$100,000 (post-September 11) per occurrence. Warson, *supra* note 1, at 56.

81. Glickman, *supra* note 20, at 542.

82. *Id.*

83. *Id.*

84. Heidi A. Lawson, *Insurance Regulation: The Effects of September 11<sup>th</sup>*, in INSURANCE LAW: UNDERSTANDING THE ABCS, LITIGATION AND ADMINISTRATIVE PRACTICE COURSE HANDBOOK SERIES 53, 71 (Practising Law Institute ed., Apr. 2002).

## III. EFFECTS ON CMBS

One advantage to securitizing commercial mortgage loans is the distribution of investment risk among many investors, rather than solely upon an originating lender.<sup>85</sup> Thus, lenders will not bear as much of the cost if the asset is destroyed. Each pool and each class of commercial mortgage-backed securities (CMBS) contain mortgage loans of different sizes,<sup>86</sup> for different types of real estate,<sup>87</sup> and for different locations spread out across the country.<sup>88</sup> CMBS reduces risk for investors through diversification.

If one real estate asset in a conduit CMBS pool was affected by a terrorist act, each investor would lose a relatively small amount of money. This is because the loan would be owned by several investors, each investor owning only a portion, and the pool containing that loan would contain several other loans.<sup>89</sup> The investors may even be able to recover the value of the land as well as any insurance proceeds.<sup>90</sup> However, investors may be wary about investing in the CMBS markets with the outstanding risk of inadequate terrorism coverage. Most CMBS investors bought into a particular pool with the assurance that the secured assets had sufficient and appropriate insurance in the event of loss.<sup>91</sup> These investors are now faced with a novel risk of investment loss which was not apparent at the time of the investment.<sup>92</sup>

National rating agencies rate CMBS bonds according to the likelihood of repayment, or conversely, the probability of a borrower's default and the severity of loss.<sup>93</sup> Investors then rely on

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85. See Kronovet, *supra* note 11, at 288-89.

86. Kronovet interview, *supra* note 46. The average loan size for a conduit CMBS transaction is six million dollars. *Id.*

87. Lancaster, *supra* note 73, at 17. Retail loans make up 27.8% of CMBS. *Id.*

88. Kronovet interview, *supra* note 46.

89. See, e.g., Kronovet, *supra* note 11, at 289.

90. RUBOCK & PHILIPP, *supra* note 1, at 8. Land value generally varies between ten and forty percent of the total value. *Id.*

91. See Glickman, *supra* note 20, at 541.

92. See *id.*

93. See Kronovet, *supra* note 11, at 308. National Rating agencies include Moody's Investors Service, Standard & Poor's, and Fitch Investors Service. *Id.*

this rating to determine which CMBS bonds to purchase.<sup>94</sup> Insurance can be an important issue when determining a CMBS rating, because an uncovered loss may disrupt payments to the bondholders.<sup>95</sup> Thus, rating agencies must now factor terrorism insurance and its presence or absence into the CMBS rating analysis.<sup>96</sup>

Each of the three major rating agencies has developed its own framework for rating CMBS assets since September 11.<sup>97</sup> Moody's places the asset into a class based upon (1) the type of asset securing the loan and (2) the type of pool in which the mortgage is placed.<sup>98</sup> The type of asset is placed into one of three tiers.<sup>99</sup> "Asset Tier 1" includes "trophy" buildings and buildings located near the trophies, as well as the tallest buildings in a large central business district and structures that are world or regionally famous.<sup>100</sup> "Asset Tier 2" includes large buildings in a central business district, major regional shopping malls, large apartment buildings located in major cities, and large complexes housing defense or iconic-American companies.<sup>101</sup> "Asset Tier 3" encompasses all other assets.<sup>102</sup> The asset is then placed into a pooling tier.<sup>103</sup> "Pooling Tier 1" is reserved for single asset deals, "Pooling Tier 2" includes large loan/fusion deals, and "Pooling Tier 3" is made up of conduit pools.<sup>104</sup>

Using this framework, Moody's determined that assets falling into Asset Tier 1 and Pooling Tier 1 are the most likely terrorist targets; those in Asset Tier 3 and Pooling Tier 3 are the least likely targets.<sup>105</sup> Due to the nature of CMBS, single asset deals (Pooling Tier 1) are most risky because if something happens

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94. Loubier & Aro, *supra* note 3, at 20.

95. *See id.*

96. *See infra* notes 97 - 126 and accompanying text.

97. *See infra* notes 98 - 113 and accompanying text.

98. RUBOCK & PHILIPP, *supra* note 1, at 6.

99. *Id.* at 7.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

105. RUBOCK & PHILIPP, *supra* note 1, at 9. Asset Tier 1 structures rarely fall under the Pooling Tier 3 category. *Id.* at 8.

to the asset, there is nothing left in the pool.<sup>106</sup> Thus, pooling large assets is beneficial to mitigate risk.<sup>107</sup> There may be levels of risk within each tier as well.<sup>108</sup> Moody's cites several factors affecting the rating of the asset within each category.<sup>109</sup> These factors include: the terrorism coverage retained; the tenants in the building; the building's security measures; the strength of the insurance language in the loan documents; the type of building structure; the function or use of the building; and whether the asset is located in a Standard Fire Policy state.<sup>110</sup>

The other two rating agencies are not as specific in their classifications.<sup>111</sup> Standard & Poor's "does not believe it is possible to predict which buildings are at greater risk of terrorism attacks" and feels it is "difficult to quantify the risk of terrorism."<sup>112</sup> Fitch Ratings bases its classification of terrorist risk on various physical characteristics of the property "including but not limited to, proximity to a major transportation hub, height of the building, symbol of America or proximity to a symbol of America and high profile tenancy."<sup>113</sup>

Utilizing the new standards for classification of risk, rating agencies have reevaluated many CMBS ratings.<sup>114</sup> Due to the potential adverse effects of a terrorist attack on CMBS investments, several CMBS issues had their ratings downgraded.<sup>115</sup> Standard & Poor's elected not to downgrade any CMBS bonds because it does not believe that "the risk of loss is greater post-

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106. See *id.* The first single asset securitization transaction since September 11, 2001 did not occur until October 2002. See Poonkulali Thangavelu, *CMBS is Backed by NYC Unit*, NAT'L MORTGAGE NEWS, Sept. 30, 2002, at 11.

107. RUBOCK & PHILIPP, *supra* note 1, at 8.

108. *Id.* at 9.

109. *Id.*

110. *Id.* See *infra* notes 220-25 and accompanying text for more on the Standard Fire Policy.

111. See STANDARD & POOR'S, STANDARD AND POOR'S WON'T TAKE RATING ACTION ON CMBS TRANSACTION FOR TERRORISM COVERAGE ISSUES (June 10, 2002); FITCH RATINGS, TERRORISM INSURANCE REVIEW: 13 CMBS DEALS ON RATING WATCH NEGATIVE (June 3, 2002).

112. STANDARD & POOR'S, *supra* note 111.

113. FITCH RATINGS, *supra* note 111.

114. See RUBOCK & PHILIPP, *supra* note 1.

115. See PHILIPP & DENT, *supra* note 5, at 1; Julie Haviv, *Newer Type of Bond May Be Nipped in the Bud – CMBS Market is Slowed First By Attacks, and Then By Congressional Inaction*, WALL ST. J., Oct. 8, 2002, at C13.

Sept. 11 tha[n] it was before.”<sup>116</sup> Moody’s downgraded eleven (previously) AAA-rated CMBS issues in September 2002, after Congress failed to enact a federal terrorism insurance backstop.<sup>117</sup> In the previous fifteen years, Moody’s had only downgraded a total of six CMBS issues.<sup>118</sup> Fitch Ratings also downgraded three CMBS deals, totaling over \$873 million.<sup>119</sup>

After the Terrorism Risk Insurance Act of 2002 was enacted, the rating agencies did not immediately return the downgraded CMBS issues to their previous ratings.<sup>120</sup> Instead, the agencies are waiting to see the industry effects of the Act before upgrading.<sup>121</sup> The agencies remain skeptical about the effects of the Act and contend that many problems remain before the market can return to normal, if that is even possible.<sup>122</sup> Standard & Poor’s criticized the legislation, stating that it creates numerous problems for insurers.<sup>123</sup> Moody’s Investors Service believes the Act will have a slightly negative impact on the insurance industry.<sup>124</sup> Moody’s thinks that property and casualty insurance providers remain significantly exposed to terrorism risk.<sup>125</sup> Moody’s concludes that the Act has not relieved the rating problems surrounding terrorism risk, and that several things must

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116. *Moody’s Reiterates Plan to Downgrade CMBS if Terrorism Coverage Lapses*, *supra* note 61, at 10 (quoting Gale Scott, managing director at Standard & Poor’s).

117. Cohen, *supra* note 13, at 29.

118. *Id.*

119. Haviv, *supra* note 115.

120. See Michael Murray, *Bush Signs Terrorism Insurance Legislation as Implementation Procedures Begin*, MBA NEWSLINK (Nov. 27, 2002), at <http://mbaa.org/industry/news/02/1127a.html> [hereinafter Michael Murray]; Christopher Oster, *Terrorism Bill Boosts Insurers’ Risk*, WALL ST. J., Nov. 27, 2002, at C9.

121. See, e.g., Michael Murray, *supra* note 120.

122. See *US Terrorism Insurance: Problem Solved?*, REACTIONS, Jan. 2003, at 9, available at 2003 WL 11763968; TED COLLINS & JAMES ECK, MOODY’S INVESTORS SERVICE, MOODY’S COMMENTS ON TERRORISM RISK INSURANCE ACT AND ITS IMPLICATIONS FOR THE P&C INSURANCE INDUSTRY 1 (Dec. 4, 2002), available at 2002 WL 103428020.

123. See Oster, *supra* note 120. According to Standard & Poor’s, the Act “increased the risks faced by insurance companies, creating pitfalls and gray areas.” *Id.* The legislation “amounts to a command from government [for insurers] to get back into the pool of terrorism risk.” *Id.* (quoting Steven Dreyer, managing director in Standard & Poor’s insurance ratings unit).

124. See COLLINS & ECK, *supra* note 122, at 1.

125. *Id.*

happen before downgraded ratings are reexamined: insurers must comply with the Act; prices of terrorism coverage need to decrease; availability must increase; and property owners must purchase the terrorism insurance.<sup>126</sup>

#### IV. THE PROPOSED SOLUTION

Shortly after September 11, 2001, the House of Representatives introduced a bill to assist insurance companies with the costs resulting from acts of terrorism.<sup>127</sup> House Bill 3210, or the "Terrorism Risk Protection Act," was quickly passed and sent to the Senate at the end of 2001.<sup>128</sup> The Senate failed to agree upon a terrorism insurance bill until Summer 2002.<sup>129</sup> Several versions were introduced before the Senate finally passed Senate Bill 2600, termed the "Terrorism Risk Insurance Act of 2002."<sup>130</sup>

The House and Senate versions were sent to conference committee, where discussions began in order to resolve several differences between them.<sup>131</sup> After little progress, President Bush called upon the two houses to settle their differences and pass the legislation.<sup>132</sup> The main conflicts between the houses revolved around tort reform and repayment provisions.<sup>133</sup> The House bill called for a loan to insurance companies.<sup>134</sup> After assuming the first \$1 billion in losses, the government would loan 90% of the

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126. *See id.*; Michael Murray, *supra* note 120.

127. 2001 Bill Tracking H.R. 3210. H.R. 3210 was introduced on Nov. 1, 2001 and passed on Nov. 29, 2001. *Id.*

128. 2001 Bill Tracking H.R. 3210; *see* Warson, *supra* note 1, at 56.

129. Warson, *supra* note 1, at 56.

130. Terrorism Risk Insurance Act of 2002, S. 2600, 107th Cong. (2002). Other Senate Bills include S. 1743 and S. 1744. *See* Thomas A. Player, Jr., Harold D. Skipper, & Janet Lambert, A Global Definition of Terrorism (June 15, 2002) (unpublished manuscript, at [http://mmmlaw.com/articles/article\\_152.pdf](http://mmmlaw.com/articles/article_152.pdf)).

131. *See* Tad C. Philipp, *CMBS: So Far an Off Year for Credit and Volume*, ASSET SECURITIZATION REPORT, July 29, 2002, available at 2002 WL 8148393.

132. *Bush, Democrats Press Cases in Insurance Stalemate*, WALL ST. J., October 4, 2002, at A16.

133. *See* Philipp, *supra* note 131; John D. McKinnon, *Congress Will Pass Terror Insurance*, WALL ST. J., Sept. 11, 2002, at A4.

134. *See* Terrorism Risk Protection Act, H.R. 3210, 107th Cong. (2001); Christian Murray, *Weak Foundation: Lack of Insurance Against Terrorism Hinders Existing Commercial Buildings and Future Construction*, NEWSDAY, Sept. 16, 2002, at A27; Rizzo, *supra* note 38, at 13.



remaining losses to insurance companies, capping government funding at \$100 billion.<sup>135</sup> The Senate bill provided for a grant of the money with no requirement that it be paid back.<sup>136</sup> The funding would cover 90% of claims after the first \$10 billion, also with a \$100 billion cap.<sup>137</sup> The other major conflict was punitive damage awards.<sup>138</sup> The House bill prohibited punitive damage awards against building owners, while the Senate bill allowed for such damages.<sup>139</sup> Under both bills, the claim was to be filed in federal court.<sup>140</sup>

The two houses finally agreed upon the Terrorism Risk Insurance Act of 2002, signed into law by President Bush on November 26, 2002.<sup>141</sup> The final version provides for federal assistance after property and casualty insurance losses resulting from an act of terrorism exceed \$5 million.<sup>142</sup> Insurance companies must pay a deductible based upon the amount of the insurer's direct premiums earned over the immediately preceding calendar year, multiplied by 7% in 2003, 10% in 2004, and 15% in 2005.<sup>143</sup> The federal government will cover 90% of all losses above that deductible with the insurance companies paying the remaining 10%.<sup>144</sup> Federal funding is capped at \$100 billion.<sup>145</sup> The Act also contains a repayment provision.<sup>146</sup> The government will recover a portion of the payouts through a surcharge on property and casualty insurance policy holders.<sup>147</sup> The surcharge is not to

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135. See H.R. 3210; Murray, *supra* note 134; Rizzo, *supra* note 38, at 13.

136. See S. 2600; Murray, *supra* note 134; Rizzo, *supra* note 38, at 14.

137. See S. 2600; Murray, *supra* note 134; Rizzo, *supra* note 38, at 14.

138. See H.R. 3210; S. 2600; Murray, *supra* note 134; Bush, *Democrats Press Cases in Insurance Stalemate*, *supra* note 132.

139. See H.R. 3210; S. 2600; Murray, *supra* note 134; Bush, *Democrats Press Cases in Insurance Stalemate*, *supra* note 132.

140. H.R. 3210; S. 2600; Murray, *supra* note 134.

141. Press Release, Office of the Press Secretary, President Signs Terrorism Insurance Act (Nov. 26, 2002), at <http://www.whitehouse.gov/news/releases/2002/11/20021126-1.html>.

142. See Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 102(1)(B)(ii), 116 Stat. 2322 (to be codified at 15 U.S.C. § 6701 Note).

143. See *id.* § 102(7); see also COLLINS & ECK, *supra* note 122, at 1.

144. See Terrorism Risk Insurance Act of 2002 § 103(e)(1).

145. See *id.* § 103(e)(2).

146. See *id.* § 103(e).

147. See *id.* § 103(e)(7)(C).

exceed 3% of the premium, and repayment is capped at \$10 billion for the first year of the program, \$12.5 billion for the second year, and \$15 billion for the third.<sup>148</sup> Primary insurers must provide terrorism insurance, and the terms cannot materially differ from the terms and costs provided for other losses.<sup>149</sup> This is an attempt to make the costs of obtaining coverage more reasonable. This provision does not apply to reinsurers; they are not obligated to return to the terrorism insurance market.<sup>150</sup> Insurers may also get around this requirement and reinstate terrorism exclusions if authorized by the insured, or if the insured fails to pay the increased premium and the insurer provides thirty days notice of such reinstatement.<sup>151</sup> However, the Act mandates that all insurers provide the option of terrorism insurance, at least for the first two years of the program.<sup>152</sup> The Act allows punitive damages, but expressly prohibits payment of punitive awards by the federal government.<sup>153</sup> The program ends on December 31, 2005.<sup>154</sup>

Many in the industry are hopeful that the Terrorism Risk Insurance Act of 2002 will not only make coverage more available, but also that it will become less expensive to obtain.<sup>155</sup> A return of reinsurance companies would provide more relief to primary insurers and possibly expand the market capacity.<sup>156</sup> However, because the federal government will not help reinsurers recover any losses sustained from a terrorist act, reinsurers may be discouraged from accepting some of the terrorism risks.<sup>157</sup> Furthermore, upon making certain disclosures to policyholders,

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148. *See id.* § 103(e)(7).

149. *See id.* § 103(c).

150. *See* Michael Murray, *supra* note 120.

151. *See* Terrorism Risk Insurance Act of 2002 § 105(c). The Act does not specify how long the insurer must wait to receive payment before reinstating the exclusions. *See id.*

152. *See id.* § 103(c). The Secretary of the Treasury may extend these requirements for another year. *Id.*

153. *See id.* § 107(a)(5).

154. *See id.* § 108(a).

155. *See* Michael J. Kling, *Terrorism Insurance Backstop Creates New Hope for Industry*, COMMERCIAL MORTGAGE INSIGHT, Jan. 2003, at 9.

156. *See* Michael Murray, *supra* note 120; Kendall, *supra* note 2, at 579-80.

157. *See* Michael Murray, *supra* note 120; *see also supra* note 150 and accompanying text.

primary insurers may reinstate existing terrorism exclusions.<sup>158</sup> One insurance industry representative stated that the Act may cause a decrease in premiums for trophy buildings, but an increase for mainstream properties (including commercial and multifamily properties).<sup>159</sup> Moody's predicts that although availability of terrorism insurance will increase, the costs for coverage will remain high for the near future.<sup>160</sup>

Proponents of the legislation proclaim that it was necessary for the insurance industry to survive.<sup>161</sup> Many mortgage companies and special interest groups called upon their members to contact Congressional representatives in support of the legislation.<sup>162</sup> The legislation provides funds for insurance companies to recoup finances. It may also help the insurance consumer.<sup>163</sup> Federal backing may help ensure that claims are paid and premiums are lowered because the overall cost to the insurance company will be lower. However, it will also cost the consumer because federal funds come from taxpayers.<sup>164</sup> The risk of one insurance company's insolvency alone would not justify intervention by the federal government; however, the simultaneous insolvency of several insurance companies could create substantial problems for society, thereby justifying intervention.<sup>165</sup> President Bush stated, "[w]ithout coverage, the economic impact of another terrorist attack would be incredibly serious. . . . Enacting terrorism insurance will cost us nothing if we experience no further attacks."<sup>166</sup>

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158. Michael Murray, *supra* note 120; *supra* note 151 and accompanying text.

159. See Michael Murray, *supra* note 120.

160. COLLINS & ECK, *supra* note 122.

161. See, e.g., Murray, *supra* note 134. "Insurance, banking, and real estate advocacy groups say that a federal backstop is the only answer to the problem." *Id.*

162. E.g., The Coalition to Insure Against Terrorism, at <http://www.insureagainstterrorism.org> (last visited Feb. 9, 2003); H. Rodgin Cohen in his speech to members of the banking community at the University of North Carolina Banking Law Institute, *supra* note 24.

163. See *US Terrorism Insurance: Problem Solved?*, *supra* note 122 (stating that one purpose of the Act is to protect policy-holders).

164. See Werner, *supra* note 61, at 409.

165. See Player et al., *supra* note 130, at 1.

166. Bush, *Democrats Press Cases in Insurance Stalemate*, *supra* note 132.

Opponents of the legislation argue that the federal funding will create a windfall for the insurance companies.<sup>167</sup> Insurers have already charged high premiums for coverage, and nothing in the federal legislation requires repayment of those premiums.<sup>168</sup> Additionally, taxpayers will be paying between eighty and ninety percent of the claims;<sup>169</sup> yet the general public remained relatively silent on the issue.<sup>170</sup> Many argue that the insurance industry is private and the federal government should not get involved in bearing the cost of private industry.<sup>171</sup> This legislation would also impose a large burden on the federal government.<sup>172</sup> The Washington Post came out against a federal backstop, stating that “Congress is poised to shower taxpayers’ money on insurance companies for no good reason.”<sup>173</sup> Finally, as more insurance companies begin to offer terrorism insurance, there seems to be less need for federal government assistance.<sup>174</sup>

In large part, the debate surrounding the federal legislation relates to the question of who should bear the risk of another terrorist attack on real estate. Although the cost to CMBS investors may be small,<sup>175</sup> there is a strong argument that passive investors should not be asked to bear this type of risk. These investors should not be asked to assume a risk for free when the insurers are unwilling to take on the risk even in exchange for a

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167. Werner, *supra* note 61, at 409.

168. *See id.*

169. *Id.* Senator Phil Gramm opposes the Act because it overexposes taxpayers to losses. *See* David Rogers, *Terrorism- Insurance Measure Gains Approval From Senate*, WALL ST. J., Nov. 20, 2002, at A6.

170. Pinover et al., *supra* note 1, at 16 (“Tenants, business vendees, consumers, and the general public, who will ultimately foot the bill for expensive terrorism insurance coverage, have yet to raise their voice in protest.”)

171. *See* Loubier & Aro, *supra* note 3, at 21. Some have characterized the legislation as “a bailout of the insurance industry.” *Id.* at 21.

172. *See, e.g.*, Loubier & Aro, *supra* note 3, at 21.

173. *Pork for Insurers*, WASH. POST, Oct. 16, 2002, at A24. The article cites conflicting reports of the current effects on the real estate industry, including a study by the Federal Reserve finding no decrease in lending as a result of lacking terrorism insurance. *See id.*

174. Cohen, *supra* note 13; *see also* Letter from Travis B. Plunkett, Legislative Director, and J. Robert Hunter, Director of Insurance, Consumer Federation of America, to Senator Paul S. Sarbanes and Congressman Michael G. Oxley 1 (Oct. 7, 2002), at [http://www.consumerfed.org/terror\\_insurance\\_conference.pdf](http://www.consumerfed.org/terror_insurance_conference.pdf).

175. *See supra* notes 85-89 and accompanying text.

high premium.<sup>176</sup> Borrowers assume many risks in connection with their real estate,<sup>177</sup> perhaps they should be required to bear this risk as well. It is important to remember, however, that without terrorism insurance it is the lender who will be left with nothing but the dirt when the borrower cannot afford to pay.<sup>178</sup> The terrorism insurance legislation subsidizes some costs for the insurance companies.<sup>179</sup> This legislation shifts most of the risk to American taxpayers.<sup>180</sup> It may not be fair to ask that the American people bear the risk and resulting costs of an attack on a piece of real estate.

A possible compromise could have been to require a large loss before federal funding is activated. If the loss is great, there will be considerable claims on insurance companies. Since insurance companies cannot afford to pay significant sums in the near future, this could lead to more insolvencies.<sup>181</sup> Insolvencies would leave unpaid claims as well as consumers with no insurance. Thus, federal funding would be beneficial. However, requiring a large loss first removes any question about insurers receiving a windfall. The Act's threshold is \$5 million, which seems easily affordable by insurance companies.<sup>182</sup>

The insurance and banking industries are calling for a longer-term solution than that currently offered by the federal legislation.<sup>183</sup> These proponents argue that insurance companies may never be able to offer affordable coverage on valuable, vulnerable real estate assets.<sup>184</sup> On the other hand, long-term insurance protection does not seem different from some other

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176. See TAD PHILIPP, MOODY'S INVESTORS SERVICE, CMBS 3Q 2002: TERRORISM INSURANCE AND BALLOON REFINANCING RISKS OVERHANG MARKET 6 (October 23, 2002).

177. Kronovet interview, *supra* note 46.

178. *Id.*; see Cohen, *supra* note 24; *supra* note 71.

179. See Terrorism Risk Protection Act, H.R. 3210, 107th Cong. (2001); Terrorism Risk Insurance Act of 2002, S. 2600, 107th Cong. (2002).

180. See Werner, *supra* note 61, at 409.

181. See, e.g., Cohen, *supra* note 24; *US Terrorism Insurance – Problem Solved?*, *supra* note 122; *supra* notes 19-24 and accompanying text.

182. See *supra* note 19 (citing Kendall). Five million dollars seems low considering that the insurance industry could sustain losses of more than fifty billion dollars prior to September 11<sup>th</sup> before any consideration of insolvency. See *id.*

183. See, e.g., Philipp, *supra* note 131 (calling a long-term solution "optimal").

184. See Loubier & Aro, *supra* note 3, at 21.

types of insurance. The calculation of risk is more difficult because terrorism is rare, making it hard to predict.<sup>185</sup> However, insurance is available to cover other rare, destructive events.<sup>186</sup> One article states that terrorist attacks “remain unlikely, but . . . are not less probable than an earthquake or category 5 tornado.”<sup>187</sup> In addition, the risk associated with loss from a fire seems comparable to that associated with loss from terrorism. A fire resulting from terrorism would be covered by the Act but arson would not be covered, though both could potentially destroy the real estate asset. In fact, fire is generally what ends up destroying a building attacked by terrorists.<sup>188</sup>

## V. ELEMENTS OF TERRORISM INSURANCE

There are several issues that need to be addressed in both private terrorism insurance policies as well as government legislation that supports terrorism insurance. Lenders and insureds should keep these issues in mind when analyzing or purchasing terrorism insurance.

### A. *Definition of Terrorism*

Several definitions of terrorism have been offered since September 11. One article argues that a global definition of terrorism should be agreed upon to promote efficiency, remove some uncertainty related to conducting business internationally, and prevent gaps in coverage.<sup>189</sup> An industry-wide definition would also be beneficial to maintain uniform exclusions among varying policies. There are many elements to a clear, workable definition of terrorism. It is worth briefly exploring these elements

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185. For a full discussion on this topic, see *supra* notes 26-36 and accompanying text. However, there have been more than 14,000 international terrorist attacks since 1968. Rizzo, *supra* note 38, at 12.

186. See, e.g., Glickman, *supra* note 20, at 541-44 (discussing insurance for events such as floods, windstorms, and earthquakes).

187. Adelson et al., *supra* note 32, at 222. *But see* RUBOCK & PHILIPP, *supra* note 1 (distinguishing acts of terrorism from natural events such as floods and earthquakes in the risk calculation analysis).

188. Glickman, *supra* note 20, at 544.

189. See Player et al., *supra* note 130, at 1, 5.

to help alleviate some of the uncertainty associated with what constitutes an act of terrorism.

One article reviews several industry definitions of terrorism, including one used by the United Kingdom, one by the International Underwriting Association, and the definitions offered in various Congressional bills.<sup>190</sup> The authors use various definitions to extract the elements of a good definition, which include: a categorization of the perpetrators; motives for the action; method of harm utilized (i.e., whether violence is required); loss threshold required before the act is considered terrorism; and whether government certification is required and by whom.<sup>191</sup> State-sponsorship requirements are usually not included in the definitions.<sup>192</sup> These authors offer their own global definition of terrorism (the Player definition):

An act, including, but not limited to, the use of force or violence, committed by any person or persons acting on behalf of or in connection with any organization creating serious violence against a person or serious damage to property or a serious risk to the health or safety of the public undertaken to influence a government for the purpose of advancing a political, religious or ideological cause. Such act shall be certified as an “Act of Terrorism” by the senior judicial or administrative official designated by the adopting government and shall not be subject to appeal.<sup>193</sup>

A definition proposed by the National Association of Insurance Commissioners (NAIC) was critiqued in a recent law review article.<sup>194</sup> The author found several potential ambiguities

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190. *See id.* at 3, Table 1.

191. *See id.* at 4.

192. *See id.* at 4.

193. *Id.* at 5.

194. *See* Kendall, *supra* note 2, at 589-91. The NAIC definition is:

[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,

stemming from the grammatical structure of the NAIC's proposed definition.<sup>195</sup> She offered her own definition for use by insurers, incorporating elements from several other proposals (the Kendall definition):

“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

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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.

*Id.* at 589.

195. *See id.* at 589-91. Kendall stated at least six potential problems with the definition's interpretation, including “[w]hether 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.’” *Id.* at 590.



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.<sup>196</sup>

The definition adopted must be broad enough to include unforeseeable acts of terrorism, as no one could have imagined the events of September 11, 2001. However, the definition must also be narrowly tailored to exclude acts of war,<sup>197</sup> especially if the difference determines the activation and use of a federal insurance backstop. The Kendall definition specifically defines each term utilized, thereby limiting problems with interpretation.<sup>198</sup> Adding some elements of the Player definition to the Kendall definition would create the best option.

Both definitions require an act.<sup>199</sup> The final definition should include Player’s idea of not limiting the act to one of force or violence. However, Kendall’s statement that the act can be “dangerous to” human life, instead of requiring that “serious

196. *Id.* at 594-95 (taking into consideration several definitions offered by Congress and the United States Code).

197. *See id.* at 591-93; RUBOCK & PHILIPP, *supra* note 1, at 6. One widely used definition is that proposed by the Insurance Services Office (ISO) in its standard terrorism exclusion policy. *See* RUBOCK & PHILIPP, *supra* note 1, at 6. The ISO defines terrorism as

[a]ctivities against persons, organizations, or property of any nature that involves the following: 1. [u]se or threat of force or violence; or commission or threat of a dangerous act; or commission or threat of an act that interferes with or disrupts an electronic, communication, information or mechanical system; and 2. [w]hen one or both of the following applies: a. [t]he 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. [i]t 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.

*Id.* at 6. This definition has been criticized for being so broad that insurance companies could “apply this exclusion [in coverage] to any major event where the culprits have not announced themselves or been otherwise identified,” including events caused by organized crime or unexplained fires. *Id.*

198. *See* Kendall, *supra* note 2, at 594-95.

199. *See* Player et al., *supra* note 130, at 5; Kendall, *supra* note 2, at 594.

violence” must be committed against a person, is more inclusive.<sup>200</sup> Both definitions allow leeway for the type of organization carrying out the acts, but again the Kendall definition is more specific.<sup>201</sup> The Player definition does not require that the organization be based outside of the United States.<sup>202</sup> The Player definition is meant to be a global definition, allowing it to be widely adopted and cited.<sup>203</sup> No loss threshold is required in either definition.<sup>204</sup> Finally, any definition of terrorism should include Player’s certification requirement, which limits discrepancies and ensuing litigation.<sup>205</sup>

The Terrorism Risk Insurance Act of 2002 defines an “act of terrorism.”<sup>206</sup> The definition provides that the Secretary of the Treasury, Secretary of State, and Attorney General must certify the act as one of terrorism.<sup>207</sup> Their decision cannot be delegated and is not reviewable.<sup>208</sup> The definition specifies that the act must be violent, or dangerous to human life, property, or infrastructure.<sup>209</sup> The act must have resulted in damage within the United States (in limited, specified cases damage outside of the United States will qualify).<sup>210</sup> There may be any number of perpetrators acting on behalf of any foreign person or foreign interest.<sup>211</sup> The act must be part of an effort to coerce the people, policy, or government of the United States.<sup>212</sup> The definition specifically excludes acts committed as part of a declared war.<sup>213</sup>

This definition is not as thorough and the terms are not as defined as the Player or Kendall definitions. The definition does

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200. See Player et al., *supra* note 130, at 5; Kendall, *supra* note 2, at 594.

201. See Kendall, *supra* note 2, at 594-95.

202. See Player et al., *supra* note 130, at 5.

203. See *id.*

204. See *id.*; Kendall, *supra* note 2, at 594-95.

205. See Player et al., *supra* note 130, at 1, 5.

206. Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 102(1), 116 Stat. 2322 (to be codified at 15 U.S.C. § 6701 Note).

207. *Id.* § 102(1)(A).

208. *Id.* § 102(1)(C) and (D).

209. *Id.* § 102(1)(A)(ii).

210. *Id.* § 102(1)(A)(iii).

211. *Id.* § 102(1)(A)(iv).

212. Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 102(1)(A)(iv), 116 Stat. 2322 (to be codified at 15 U.S.C. § 6701 Note).

213. *Id.* § 102(1)(B)(i).

incorporate several aspects of the Player and Kendall definitions: it requires an act; its requirement of “dangerous to” human life, etc. is more inclusive than requiring only violence; it allows leeway for the type of organization behind the acts; and it excludes acts of war.<sup>214</sup> However, some ambiguous terms are not defined or qualified.<sup>215</sup> For example, property, infrastructure, and when damage outside of the United States is sufficient, are all undefined.<sup>216</sup> The certification requirement, however, eliminates any need to ponder the definition’s problems.<sup>217</sup> Three people determine whether or not an act is one of terrorism, and their decision is final.<sup>218</sup> In making their determination, hopefully they will consider the accepted industry definitions and explanations.

Even if a definition of terrorism cannot be agreed upon for global use, it is necessary for the insurance industry to agree on one definition. This would provide clarity to purchasers and lenders about what is excluded from the all-risk policy and what is included in a separate terrorism insurance policy. This may help to eliminate gaps in coverage.<sup>219</sup> It would also allow lenders and insureds to determine what is excluded from their supplemental policy that is also excluded from the all-risk policy (i.e. events that are not covered at all).

### B. *Standard Fire Policy*

Insurers also need to account for fire provisions already included in “all risk” policies. Thirty states require property insurance to cover losses resulting from direct fire damage regardless of the cause of the fire, including terrorism.<sup>220</sup> This is called the Standard Fire Policy (SFP).<sup>221</sup> The SFP provision

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214. *See id.* § 102(1).

215. *Id.* § 102(1)(A)(iii).

216. *Id.*

217. The certification requirement can be found at § 102(1)(A).

218. *See Id.* § 102(1)(C) and (D).

219. *C.f. Loubier & Aro, supra* note 3, at 20 (“[C]ounsel should make certain that the language of the terrorism coverage mirrors the terrorism exclusion in the all-risk property policy.”).

220. *See id.* at 19.

221. *See id.*

negates the lack of terrorism insurance if loss is sustained from fire.<sup>222</sup> It is likely that an asset will be destroyed or impaired by a fire resulting from a terrorist act.<sup>223</sup> Therefore, terrorism exclusions are based largely on “concurrent causation,” or the “precipitating event that causes the perils to be triggered.”<sup>224</sup> Insurers providing coverage in these states will probably adjust premiums to account for terrorist risks.<sup>225</sup>

### C. Definition of “Occurrence”

Insurance companies will also need to designate a standard definition covering multiple acts of terrorism. The Insurance Services Office standard insurance exclusion, adopted in most states, defines one “incident” of terrorism as acts that happen within 72 hours and appear to be in concert.<sup>226</sup> As seen with the World Trade Center, terrorism acts may involve more than one act, but create just one occurrence for insurance purposes.<sup>227</sup> A New York judge declared that the crash of one plane into each of the two towers of the World Trade Center was only one occurrence.<sup>228</sup> The definition stated in the World Trade Center policy was

‘Occurrence’ shall mean all losses or damages that are attributable directly or indirectly to one cause or to one series of similar causes. All such losses will be added together and the total amount of such losses will be treated as one occurrence irrespective of the period of time or area over which such losses occur.<sup>229</sup>

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222. *See id.*

223. Glickman, *supra* note 20, at 544.

224. *Id.* Glickman contends that one debate surrounding the World Trade Center attacks is whether the cause was the airplanes hitting the buildings or the terrorist plot putting them there. *Id.* at 544-45.

225. Loubier & Aro, *supra* note 3, at 19.

226. *Id.*

227. *SR Int’l Bus. Ins. Co. Ltd. v. World Trade Center Properties LLC*, 222 F. Supp. 2d 385 (S.D.N.Y. 2002).

228. *Id.*

229. *Id.* at 398.

The judge held that “when two hijacked planes hit the Twin Towers in a sixteen minute period, the total destruction of the World Trade Center resulted from ‘one series of similar causes.’”<sup>230</sup> The original House bill, H.R. 3210, specified that if federal assistance was requested, the Treasury Department should determine the number of occurrences.<sup>231</sup> There is no similar provision in the final legislation, but it is possible that the Secretary of the Treasury will specify the number of occurrences when making his certification that a terrorist act occurred.

#### *D. Cancellation*

Borrowers who are able to secure terrorism insurance may still run into problems with their coverage. Many policies allow the insurer to cancel on short notice.<sup>232</sup> Thus, lenders and borrowers remain paralyzed, knowing that the insurance company could cancel their policy any time the government comes out with a new warning that indicates an increased risk. Insureds should be sure that they understand what circumstances permit the insurer to cancel the policy.

#### *E. Ancillary damage*

One must make sure that the terrorism insurance policy will cover damage to the building even when the terrorist act was directed at a nearby building.<sup>233</sup> Some policies may only cover direct damage to a building, leaving borrowers without funds if their building was damaged because of its proximity to an act of terrorism.<sup>234</sup>

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230. *Id.* at 399.

231. H.R. 3210, Terrorism Risk Protection Act, 107th Cong. (2001).

232. Loubier & Aro, *supra* note 3, at 20.

233. *See* RUBOCK & PHILIPP, *supra* note 1, at 12.

234. *See, e.g., id.*

F. *Biological and Chemical Warfare*

Most terrorism insurance policies exclude coverage of biological and chemical warfare, including the Insurance Services Office standard exclusion, which served as the benchmark in most states.<sup>235</sup> Proposed federal legislation also excluded this coverage.<sup>236</sup> The Terrorism Risk Insurance Act of 2002 says nothing about biological or chemical warfare.<sup>237</sup> However, the Treasury Department has issued interim guidelines specifying that the “make available” requirement in § 103(c)(1) does not include all types of risk.<sup>238</sup> An insurer is not required to cover nuclear, biological, or chemical events if that insurer is outside of a state’s regulatory reach or if the state allows the exclusion.<sup>239</sup>

G. *Punitive Damages*

The Senate bill allowed claimants to sue building owners and operators for punitive damages for losses after a terrorist act.<sup>240</sup> Democrats “argue that if taxpayers help pay for losses caused by terrorist attacks through the federal backstop bill, they shouldn’t have to pay for settlements as well.”<sup>241</sup> The final legislation allows for punitive damages to be assessed against building owners; however, it specifies that the settlements will not come from federal funds.<sup>242</sup> Thus, owners must be prepared to pay any damages from their own funds. It may be prudent to sue owners for reckless security measures allowing an act of terrorism

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235. See Loubier & Aro, *supra* note 3, at 19-20.

236. See Terrorism Risk Protection Act, H.R. 3210, 107th Cong. (2001); Terrorism Risk Insurance Act of 2002, S. 2600, 107th Cong. (2002).

237. See Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, 116 Stat. 2322 (to be codified at 15 U.S.C. § 6701 Note).

238. See Interim Guidance Concerning New Statutory Disclosure and Mandatory Availability Requirements of the Terrorism Risk Insurance Act of 2002, 67 Fed. Reg. 76,206, 76,208 (Dec. 11, 2002), available at <http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/interimguide.pdf>.

239. See *id.*

240. S. 2600.

241. Warson, *supra* note 1, at 56. Much of that money would go to trial lawyers. *Id.* As of September 2002, lawsuits related to the September 11 events totaled around \$20 billion. *Id.*

242. See Terrorism Risk Insurance Act of 2002 § 107(a)(5).

to occur; however, owners cannot control acts of terrorism,<sup>243</sup> and therefore should not be liable simply because their building was destroyed by a terrorist act. Commentators have argued against punitive damages stating, “[g]iven the random nature of terrorism, prevention and response measures cannot entirely mitigate the risks of terror.”<sup>244</sup>

## VI. CONCLUSION

One industry representative called 2001 the most important year out of the past twenty-five for the banking industry, citing the events of September 11 as a main factor.<sup>245</sup> Terrorism insurance has “affected to some degree every insured real estate asset and mortgage loan in the United States.”<sup>246</sup> Substantial cost burdens have been placed on borrowers.<sup>247</sup> These costs are deterring future real estate projects, thereby decreasing the number of new loans.<sup>248</sup> Lenders will incur substantial costs if the borrower’s mortgaged asset is destroyed by an act of terrorism, with no insurance coverage to fall back on.<sup>249</sup> The lack of terrorism insurance could result in large losses for borrowers, lenders, insurance companies, and investors.

Since primary insurers can no longer shift risks to reinsurers, they are shifting risks to policyholders through lower coverage limits and higher premiums.<sup>250</sup> These premiums will then be shifted to the tenants through higher rent.<sup>251</sup> Higher rent will place landlords at a competitive disadvantage to properties that do not require terrorism insurance.<sup>252</sup>

More insurance providers are needed to fill the void. However, they may be unwilling due to the uncertain risks, the

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243. Loubier & Aro, *supra* note 3, at 20. Building owners can not prevent terrorism; that is the federal government’s responsibility. *Id.*

244. *Id.*

245. Cohen, *supra* note 24.

246. Loubier & Aro, *supra* note 3, at 18.

247. *See, e.g.*, Warson, *supra* note 1.

248. *See supra* notes 9-10, 68 and accompanying text.

249. *See supra* notes 71, 178 and accompanying text.

250. *See* Pinover et al., *supra* note 1, at 14.

251. *See* Warson, *supra* note 1.

252. *See* RUBOCK & PHILIPP, *supra* note 1, at 4 n.6.

difficulty in calculating such risks, and the high costs should an act of terrorism occur.<sup>253</sup> An increase in policy writers could be forthcoming, though, as many insurers are beginning to see large increases in business and revenue due to higher premiums.<sup>254</sup>

Terrorism insurance is the new reality of an unsure world. Until insurance companies offer terrorism coverage at reasonable prices, the dilemmas will remain for borrowers, lenders, and investors. The government has enacted a federal backstop, the Terrorism Risk Insurance Act of 2002, to assist insurance companies and help promote a more competitive terrorism insurance market.<sup>255</sup> But much debate surrounds the legislation.<sup>256</sup> Insurance companies are hopeful for relief, but are still not satisfied.<sup>257</sup> Many in the real estate industry are skeptical about the Act's effectiveness, and taxpayers are left wondering why they are poised to subsidize insurance company losses.<sup>258</sup>

There are several issues that must be examined when purchasing terrorism insurance. Insurance companies should agree on a standard definition of terrorism.<sup>259</sup> The lender and borrower need to examine the definitions and compare the all-risk policy to the separate terrorism policy to check for gaps in coverage.<sup>260</sup> They must also make sure they are covered for ancillary damage to the asset.<sup>261</sup> Finally, insurers and insureds must be aware of the Standard Fire Policy of the state.<sup>262</sup>

There are many considerations, and uncertainties, surrounding terrorism insurance. The provisions of the recently enacted Terrorism Risk Insurance Act of 2002, as well as the future of terrorism coverage, must be worked out through practice and application, and probably the court system.<sup>263</sup> September 11,

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253. See *supra* notes 19-43 and accompanying text.

254. See Murray, *supra* note 134; Gjertsen, *supra* note 23.

255. See *supra* notes 141-60 and accompanying text.

256. See *supra* notes 161-80 and accompanying text.

257. See *US Terrorism Insurance – Problem Solved?*, *supra* note 122.

258. See *supra* notes 122-26 and accompanying text; Werner, *supra* note 61.

259. See *supra* text accompanying note 219.

260. See Loubier & Aro, *supra* note 3; *supra* note 219.

261. See *supra* notes 233-34 and accompanying text.

262. See *supra* notes 221-25 and accompanying text.

263. The Department of the Treasury is charged with guiding industry compliance of the Act. Interim guidelines may be found at <http://www.treas.gov/offices/>



2001 was a day of mass destruction and horrific consequences. Many changes have taken place as a result, changes that have affected almost every United States citizen. As the country struggles to deal with the aftermath, its people are left to speculate about what tomorrow will bring.

ALISON R. ORLANS