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Insurance, Terrorism, and 9/11

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The Post-9/11 Insurance Market

Judith F. Goodman

Much has been written about the effects of the September 11 attack—on our national psyche and on local and national finances. This issue of *TortSource* explores three areas of its impact on the insurance industry and policyholders. While the articles in this issue may raise more questions than they answer, we have tried to provide theoretical and practical starting points to address your clients' needs and, in some respects, your own professional concerns. We do caution you that the law is constantly evolving, most recently with the Terrorism Risk Insurance Act of 2002, which was signed into law by President Bush on November 26.

Our authors come from academia and from private practice, and they bring a wide spectrum of experience to our readers.

James P. Koelzer, an attorney in private practice, enlightens us as to exactly what "civil authority" business interruption insurance is, when it is triggered, and how it affects policyholders. For those of us who were kept away from our offices by the federal, city, and

state authorities in the aftermath of the World Trade Center attack, the discussion really hits home.

Robert H. Jerry, II, a distinguished law professor at the University of Missouri—Columbia School of Law, places the attacks on the continuum of natural and man-made disasters, and posits the necessity for the federal government's important, but limited, role in helping to underwrite portions of the risk posed by terrorism, while allowing the private markets to function in their traditional manner for smaller risks.

Finally, Dick Campbell, our immediate past chair, provides an overview of the Airline Transportation Safety and System Stabilization Act and the September 11 Victims' Compensation Fund of 2001. He discusses both the regulatory and definitional aspects of the Act and the constitutional challenges that have been made and are likely to be made in the future.

While we wish that there was no need for this issue of the *TortSource*, our professional lives concern "risk," and terrorism is—unfortunately—a new reality of risk. ♦

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Insurance, Terrorism, and 9/11

Robert H. Jerry, II

For most of us, the collapse of the World Trade Center towers exists at the outermost edge of human comprehension. Even after one visits Ground Zero, the events of 9/11 retain a surreal quality, invoking feelings beyond words as one tries to contemplate losses immeasurable with numbers. Indeed, the insurance losses are insignificant when compared to the human tragedies caused by the terrorist attacks—and in insurance terms, we witnessed the most costly, complex events to transpire

in a single day in the history of the planet.

Of course, the destruction of the World Trade Center was completely unexpected. Hindsight always sharpens one's vision, but we understood before 9/11 that a terrorism event of this magnitude was possible. The sarin nerve gas attack in a Tokyo subway in 1995 killed twelve and injured more than 5,500; had this attack been carried out more skillfully, more than 5,500 easily could have died.

Timothy McVeigh was an amateur using a crude device; as horrific as

continued on page 6



Illustration by Andrew O. Alcalá

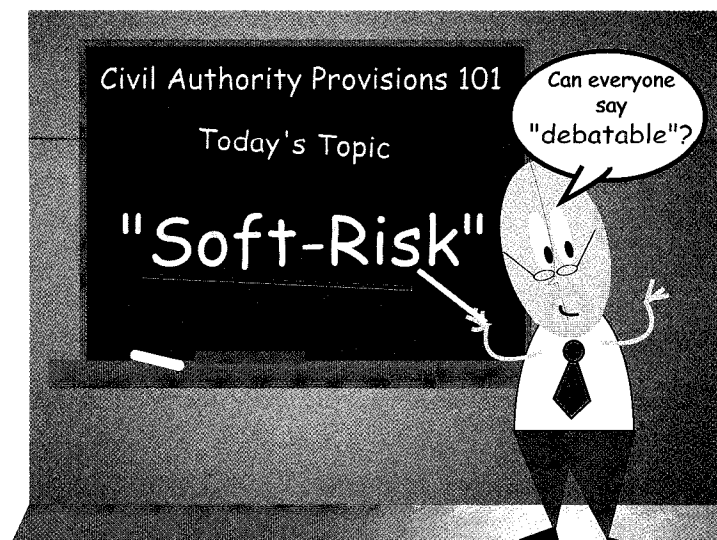


Illustration by Andrew O. Alcalá

Is Civil Authority Business Interruption Coverage a Soft Risk in the Post-9/11 World?

James P. Koelzer

The tragic events of September 11, 2001, have dramatically affected the lives of everyone who lives in the United States or does business here. The effects go far beyond the immediate losses we suffered as a direct result of the attacks. We now live with a constant awareness of a terrorist threat. We do not know if or when another attack will take place, but we no longer assume that it will not take place on our soil. We have watched as a major city ceases all regular business to clean up the rubble from fallen skyscrapers. Many people have been directly affected by biological chemical attacks that caused the closure of entire buildings—even government buildings. And many people have been evacuated from their offices while bomb threats are investigated.

It is widely accepted that the terrorist attacks and various threats of attack that took place in 2001 and 2002 will also affect the insurance industry, as it has many other areas of our lives and businesses. Almost all insurers have raised premiums on virtually all lines of com-

continued on page 4

Insurance, Terrorism, and 9/11

continued from page 1

the Oklahoma City bombing was, it could have been much worse. The Olympic Park bombing, the 1993 bombing of the World Trade Center, and the various IRA bombings in the United Kingdom are just a few reasons that on 9/10, the possibility that terrorism could wreak extraordinary damage in an urban center was not beyond our imagination. On 9/12, the world was not that much different, except with the important qualification that a major loss with wrenching consequences had occurred.

Economic losses in New York City are forecast to be at least \$83 billion and perhaps \$97 billion; most estimates predict that \$40 billion to \$50 billion of these losses will be insured. Because the magnitude of the loss that occurred on 9/11 was unprecedented, it was tempt-

ing to view both the event and the terrorism risk as *sui generis*. But catastrophic loss is not new to the insurance industry, and terrorism arguably stands as simply another kind of catastrophe, a peril neither quantitatively nor qualitatively different from various kinds of natural disasters. Hurricanes, earthquakes, volcanic eruptions, tsunamis, and even asteroid impacts all carry with them the possibility of insured losses in the tens or even hundreds of billions of dollars. During the last 20 years, the extremely rapid pace of coastal development has greatly increased the loss exposure in prime hurricane territory. Until 9/11, the largest disaster was Hurricane Andrew, which caused approximately \$16 billion in losses, a number that would have increased three to four times if the hurricane had made a direct

hit on the Miami metropolitan area. It seems obvious enough that eventually a large hurricane will hit Miami or New Orleans head-on and cause property damage greatly exceeding that which occurred in New York City on 9/11. A 1995 study estimated that if an earthquake similar to the 1906 San Francisco quake were to occur today, fatalities could reach 8,000, and total damages could reach \$225 billion, a sum nearly three times all economic loss suffered in New York City on 9/11.

When Mount St. Helens lost approximately 1,100 feet of its height and destroyed a few hundred homes in a rather remote area of Oregon in 1980, we began to pay more attention to the active volcanic range that runs along most of the west coast of the United States. Scientists now know that past eruptions in the Cascade range were far more violent than the Mount St. Helens eruption. The eruption (and destruction) of Mount Mazama about 7,700 years ago was 50 times more powerful than Mount St. Helens; what is left of this mountain is now Crater Lake in Oregon, the seventh deepest lake in the world in a crater six miles across. There are 65 active volcanoes in the United States—more than any other country except Japan and Indonesia—and many are overdue for an eruption. Washington's Mount Rainier, the tallest mountain in the Cascade range, is a particularly dangerous peak. Mudflows from Mount Rainier's past eruptions have flowed into the Puget Sound seven times in the last 6,000 years, and about 100,000 people now live in cities built on areas that have been buried in past mudflows. When Mount Rainier awakens from its temporary slumber, the consequences to the northwestern United States will be devastating. Thus, one cannot argue that the terrorism risk merits special treatment because terrorism losses are large and uninsurable. Both terrorism and natural disaster losses can be "mega-catastrophic" where private risk-spreading mechanisms are irrelevant and government institutions become the means of repairing loss and spreading the risk of future losses. The 9/11 losses are the largest in history, but they do not reach that level.

Indeed, the insurance industry has successfully absorbed the effects of 9/11. Terrorism coverage, although more expensive, has generally been available since 9/11; businesses are not always pleased with its price, but these increases were for many firms no greater than what had occurred in other insurance cycles. Although coverage disappeared for some businesses (which is what happened during the 1980s pollution coverage "crisis" and in the wake of Hurricane Andrew), the market did not collapse. Transitory capacity problems in insurance are not uncommon, and these problems are generally self-correcting.

Thus, if one agrees that 9/11 defines the upper boundary of potential terrorism losses in the United States, we might confidently conclude that the insurance world did not change appreciably on 9/11. The problem, however, is that we are not, and cannot be, certain that the upper boundary has been reached, and we are uncertain about where the mean now rests in the distribution of terrorism losses. Indeed, one lesson of 9/11 is that the mean with respect to terrorism losses is not where we previously thought it rested. Plus, there are important differences between natural catastrophes and terrorism events. The frequency of earthquakes and hurricanes can be estimated by scientists based on past experience and sophisticated predictive models. In contrast, terrorism involves human-caused losses, the timing, severity, and frequency of which are not subject to reliable prediction. Massive terrorism losses could occur, for example, in close succession temporally; a series of catastrophes, no one of which in isolation outstrips the insurance industry's capacity, could cumulatively constitute a mega-catastrophe. Past experience strongly suggests that this is highly unlikely to occur with respect to natural disasters, but intuitively such a conclusion seems

less reliable with respect to terrorism. Moreover, unlike the human actors in terrorism events, natural catastrophes do not self-select their targets or self-calibrate their destructive force.

Thus, the question whether 9/11 has changed the insurance world cannot be answered simply. In some respects, nothing is different, but it is difficult to be sanguine about this assessment. Terrorism is less predictable in terms of magnitude and frequency of loss, and this raises doubts about the capacity of the industry with respect to future events. Until the uncertainty with respect to the terrorism risk abates and markets stabilize, problems of cost and availability will persist. This, of course, has been true in other insurance sectors in the past, and temporary dislocations do not necessarily justify government intervention. If, however, terrorism is different enough to prevent the market from developing affordable, available coverage, then a government role is appropriate.

The tasks of reallocating risk and serving as the insurer of last resort are hardly foreign to the federal government. One way the government could become involved in providing terrorism coverage is by directly providing insurance and totally displacing private markets. This would be similar to the government program that protected property owners from loss from enemy attack during World War II. This approach has not received serious consideration for the present situation. An approach to be taken more seriously would have the federal government create a reinsurance company that would provide coverage for terrorism risk. Private insurers would be compelled to participate in the funding of this company, which would have the effect of pooling the industry's risk while capping industry losses through a government backstop. This approach would be sim-

ilar to that now followed in the United Kingdom. Another option would have the federal government share the risk along with private entities. For example, a large deductible would be set for insurer contributions to terrorism losses beyond which the federal government assumes all risk. This approach is potentially problematic because the government is responsible for 100 percent of all losses above a certain level, and insurers and risk managers have little incentive to constrain losses once they surpass the deductible. Thus, the challenge of crafting this approach involves designing a system that requires insurer participation in bearing an appropriate share of the risk and in compensating loss without placing disincentives on the creation of coverage. This approach is advantageous because it can be adjusted or dismantled as private markets improve their ability to underwrite terrorism coverage and manage terrorism risk. This, in general terms, is the approach likely to emerge from ongoing efforts in Congress to create a federal backstop.

Private markets have demonstrated resiliency in the aftermath of 9/11, and capacity will continue to improve, but if the industry had been required to digest a second 9/11-type event, the industry's weakened condition would have produced a much different scenario. Moreover, there looms the possibility of a mega-catastrophe—or a series of smaller events in close succession that have the cumulative impact of a mega-catastrophe—that would overwhelm the industry. All of this suggests the desirability of a limited role for the federal government: helping underwrite the portion of the terrorism risk that is beyond the industry's capacity while leaving plenty of room for private markets to function and to develop capacity for smaller losses. This kind of limited backstop would cap the industry's losses, thereby making explicit what is already the commonly assumed, unstated premise: If a mega-catastrophe were to occur, the government would provide disaster assistance *ex poste*. By making the informal understanding explicit *ex ante*, the federal government could play a useful role in facilitating a market for affordable coverage. ♦

Robert H. Jerry, II, is the Floyd R. Gibson Missouri Endowed Professor, University of Missouri-Columbia School of Law. The author's more detailed discussion of this topic will appear in a forthcoming issue of the Connecticut Insurance Law Journal.

Practice Management

continued from page 5

problem behaviors, as well as generating the desired solutions to those problems.

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