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# Insurance Implications of September 11 and Possible Responses

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THE SEPTEMBER 11 ATTACK was a “defining moment” for this generation. The graphic images of that day will forever remain seared into people’s individual and collective consciousness. Americans responded in many ways, both individually and collectively. The government, with nearly unanimous public support, immediately responded by declaring “war” on terrorism and by adopting measures to provide relief for victims of the attack.

The September 11 attack was also a defining moment for the insurance industry. It was “the largest single insured event in history.”<sup>1</sup> Insurance companies are expected to pay some \$50 billion to victims of the attack<sup>2</sup>—more than eight times what the federal government is expected to pay through the Victims Compensation Program.<sup>3</sup> This amount is also more than three times the total expected cost of the

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1. Jeff Woodward, *The ISO Terrorism Exclusions: Background and Analysis*, IRMI INSIGHTS, Feb. 2002, at <http://www.irmi.com/insights/articles/woodward006.asp>.

2. See *Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities: Testimony before the House Subcommittee on Oversight and Investigations, Committee on Financial Services*, 107th Cong. (Feb. 27, 2002) (statement of Richard J. Hillman, Director, Financial Markets and Community Investment), available at <http://www.gao.gov/new.items/d02472t.pdf> [hereinafter Hillman]. Estimates of the insured losses from the Sept. 11 attack are still uncertain and variable, and range from \$30 million to as much as \$90 billion, with consensus estimates in the range of \$36–\$54 billion. See *Need for Federal Terror Insurance Assistance: Testimony before the House Subcommittee on Oversight and Investigation*, 2002 WL 2011117 (Feb. 27, 2002) (Testimony of Mark J. Warshawsky, Deputy Assistant Secretary for Economic Policy, U.S. Treasury), available at <http://www.ustreas.gov/press/releases/po1050.htm> [hereinafter Warshawsky]; see also Press Release, Swiss Re, *Terrorist Attack in New York Causes Record Losses for Property Insurers in 2001* (Dec. 20, 2001), at [www.swissre.com](http://www.swissre.com) [hereinafter Swiss Re].

3. “The government estimates the [Victims Compensation] program will cost about \$6 billion.” Bob Van Voris, *Lawyers Take Over Ground Zero: Litigation to Follow Compensation Regulations*, NAT’L L.J., Mar. 11, 2002, available at <http://www.law.com/jsp/statearchive.jsp?type=Article&oldid=ZZZIRUCOKYC>.

airline bailout, of which the Compensation program is a part.<sup>4</sup> As one industry observer put it, “No matter how much is written about it, it is hard to overstate the significance of Sept[ember] 11 to the Insurance Industry.”<sup>5</sup>

This article will outline the insurance industry’s response to the September 11 attack and will describe its potential effect on cities. It will then suggest some possible strategies that cities might use to address the insurance industry’s response.

## I. Reaction of the Insurance Market to the September 11 Attack

### A. Scope of the Insured Losses

Before exploring the specifics of the insurance industry’s response to the September 11 attack, it is necessary to get a better sense of the scope of the losses caused by the attack. That the attack was the largest insured event in history is a good place to start, but this fact does not fully convey the significance of the losses. The losses caused by the September 11 attack were proportionately much larger than previous catastrophes. Depending on which estimate is used, the insured losses from the September 11 attack were at least *double* the next largest loss in history, and could be as much as *five times greater*.<sup>6</sup> The four next largest single-event losses were Hurricane Andrew (1992—\$15.5 billion), the Northridge Earthquake (1994—\$12.5 billion), Hurricane Hugo (1989—\$4.2 billion) and Hurricane Georges (1998—\$2.9 billion).<sup>7</sup> Assuming a loss of \$50 billion for the September 11 attack, chart 1<sup>8</sup> shows the proportional differences between the five largest single-event losses in insurance history.

Significantly, the other large single-event losses were all natural disasters. Man-made disasters generally have not contributed to the industry’s greatest losses. The two largest man-made disasters before September 11 caused damages of \$3 billion (the 1988 explosion of the

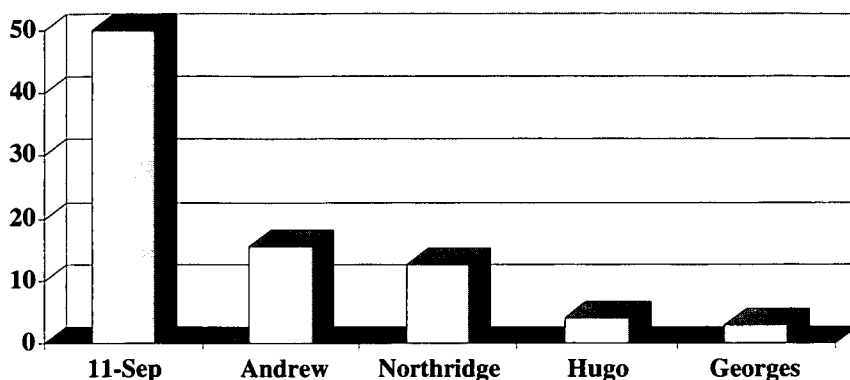
4. “The September 11 Victim Compensation Program is part of a \$15 billion airline bailout passed in September.” *Id.*

5. Am. Ass’n of Ins. Servs., *What Makes Terrorism Different?*, 26 VIEWPOINT No. 3 (Winter 2002), available at [www.aais.org/communications/viewpoint/vp.htm](http://www.aais.org/communications/viewpoint/vp.htm).

6. Hurricane Andrew caused \$15.5 billion in insured losses. See Robert P. Hartwig, *The Long Shadow of September 11: Terrorism & Its Impacts on Insurance and Reinsurance Markets*, Mar. 2002, available at <http://www.iii.org/media/hottopics/insurance/sept11/>. This is compared to between \$30 and \$90 billion in insured losses for the September 11 attack. See Warshawsky, *supra* note 2.

7. This data comes from the Chief Economist of the Insurance Information Institute. See Hartwig, *supra* note 6.

8. Data for this chart comes from the Chief Economist of the Insurance Information Institute. See Hartwig, *supra* note 6.



**Chart 1—Five Largest Single-Event Insurance Losses**  
(in billions of dollars)

Piper Alpha drilling platform) and \$2.9 billion (the 1989 explosion of a petrochemical factory in Texas).<sup>9</sup> When comparing the size of losses from man-made disasters, the September 11 damages take on even greater significance. Damages from the attack were at least *ten times greater*, to as much as *thirty times greater*, than the next largest man-made disaster.<sup>10</sup> Chart 2 illustrates the difference.

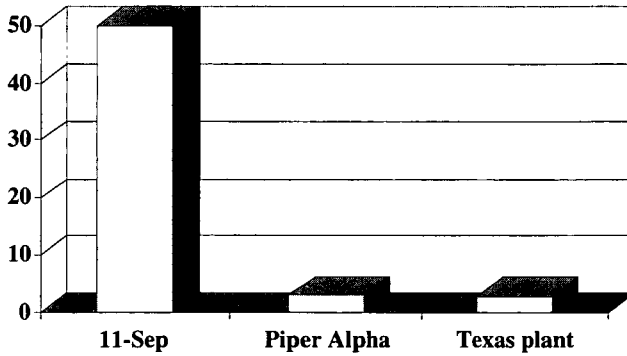
Finally, not only were the losses extraordinary in their size, they were also widely distributed throughout the insurance industry. Although the property and casualty market will bear a large proportion of the losses, substantial claims are being paid for claims under workers compensation insurance, life insurance, and liability insurance. The Insurance Information Institute estimates the following distribution of losses: property insurance for the World Trade Center, 9%; other property, 13%; aviation hull, 1%; business interruption, 26%; event cancellation, 3%; workers compensation, 10%; life insurance, 16%; aviation liability, 9%; other liability, 13%.<sup>11</sup> Chart 3 presents this data in a graphic format.

These figures begin to convey the significance of the insurance losses associated with the September 11 attack. Not only are these losses the largest in history for a single event, they are the largest by a factor of between three and five. In addition, they may be as much as thirty times

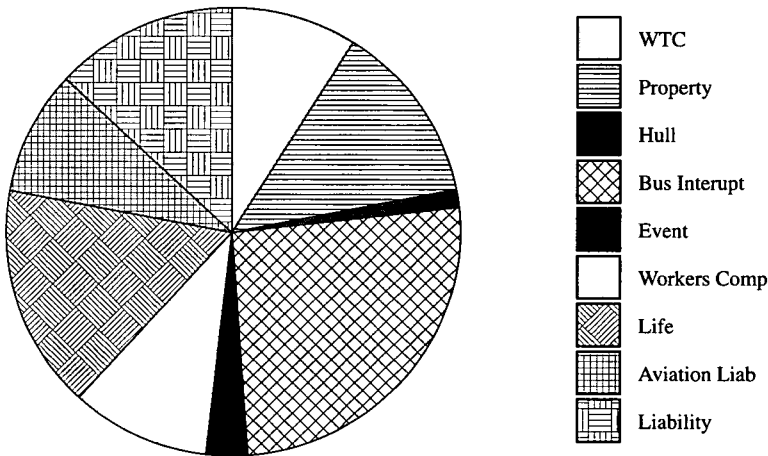
9. See Swiss Re, *supra* note 2.

10. The damages of \$3 billion, *see id.*, were compared to between \$30 and 90 billion in insured losses for the September 11 attack. See Warshawsky, *supra* note 2.

11. See Hartwig, *supra* note 6. It should be noted that these percentages are based on an estimated total loss of about \$40 billion. The distribution, of course, may turn out to be different.



**Chart 2—Three Largest Man-Made Single-Event Insurance Losses**  
(in billions of dollars)



**Chart 3—Distribution of Losses over Different Types of Insurance**

greater than the next largest man-made loss in history. These enormous losses, while concentrated to some extent among property and casualty insurers, also affected other segments of the industry, notably providers of workers compensation and life insurance.

*B. Immediate Aftermath of the Attack*

Even though the enormity of the September 11 losses created an economic incentive to delay or deny payments of claims, insurers have resisted that temptation, at least so far. As a general matter, insurers

have been quick to process and pay claims.<sup>12</sup> Within two months of the attack, nearly 20,000 claims had been received and processing begun.<sup>13</sup> By February 2002, insurers had “recorded better than \$15 billion in claims reported or paid.”<sup>14</sup> Thus, depending on the estimate used, in a matter of months some 30–50 percent of claims were well “on their way towards being settled.”<sup>15</sup>

In processing these claims, insurers also have resisted the temptation to use the “war exclusion” as a basis for delaying or denying payments.<sup>16</sup> Standard property and liability insurance policies typically exclude losses arising out of war, civil war, military action, insurrection, rebellion, revolution, or governmental action in defending against such actions.<sup>17</sup> Although an argument could be made that the September 11 attack was an act of rebellion or insurrection, or perhaps was even a military action, such arguments have not been successful with previous terrorist attacks<sup>18</sup> and have generally been dismissed by commenta-

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12. There are a few possible exceptions where insurers are raising coverage defenses, but most of these appear to be legitimate disputes not raised primarily for purposes of delay. For a summary of major insurance coverage litigation arising from the September 11 attack, see *Six Months on from September 11: Extent of Liabilities Becomes Clearer*, INS. DAY, March 12, 2002. The most high-profile coverage litigation involves the efforts of Larry Silverstein, the lessor of the World Trade Center, to maximize his insurance coverage, and one of the cases concerns whether the attack is considered to be one or two occurrences. See *id.* This second case raises a \$3.5 billion question. See Hartwig, *supra* note 6. For an analysis of the number-of-occurrences issue, see generally Neil H. Weyland & Jonathan I. Katz, *As the Dust Settles: Emerging Issues in the Wake of September 11*, ANDREWS INS. COVERAGE LITIG. REP., Feb. 22, 2002.

13. *Testimony of New York State Insurance Department Before New York State Assembly Standing Committee on Insurance*, 26–29 (Dec. 12, 2001) (statement of Gregory V. Serio, Superintendent of Insurance, New York State Insurance Department), available at <http://www.ins.state.ny.us/acrobat/gststnew.pdf> [hereinafter Serio N.Y. Testimony].

14. *Testimony of New York State Insurance Department Before Subcommittee on Oversight and Investigations, U.S. House of Representatives Committee on Financial Services*, 107th Cong. 9 (Feb. 27, 2002) (statement of Gregory V. Serio, Superintendent of Insurance, New York State Insurance Department), available at <http://www.ins.state.ny.us/acrobat/testmony.pdf> [hereinafter Serio House Testimony].

15. DRI-WEFA, *Financial Impact of the World Trade Center Attack*, Jan. 2002, at 43 (prepared for the New York State Senate Finance Committee), available at <http://www.senate.state.ny.us/SenateReports.nsf>.

16. “Major insurance companies have promised not to invoke a wartime exclusion in their policies and say they will pay billions of dollars in claims arising from last week’s terrorist attacks in New York City.” Don McAuliffe, *Major Insurance Firms to Honor Claims from Terrorist Attacks*, THE PRESS-ENTERPRISE, Sept. 21, 2001. See also Jack P. Gibson et al., *Attack on America The Insurance Coverage Issues, Part 1: War Risk Exclusions*, IRMI INSIGHTS, Sept. 2001, at <http://irmi.com/insights/articles/gibson008.asp>; Serio House Testimony, *supra* note 14 (stating that, “[t]o their credit, the industry did not resort to ‘act of war’ or other exclusions to avoid paying claims.”).

17. See Gibson et al., *supra* note 16.

18. See, e.g., *Pan Am. World Airways v. Aetna Cas. & Sur. Co.*, 505 F.2d 989 (2d

tors.<sup>19</sup> The war exclusion has been construed to apply to acts of governmental entities, and therefore to be inapplicable to acts by terrorists.<sup>20</sup>

Consumers appear to be relatively satisfied with the way insurers are responding to the claims related to the September 11 attack. Out of nearly 20,000 insurance claims that were filed as of December 2001, the New York Insurance Department received only sixty-three complaints.<sup>21</sup> This amounts to a complaint rate of only 0.31 percent, which “demonstrates that consumers are satisfied with the manner in which the industry and the Department [of Insurance] responded to the disaster.”<sup>22</sup> In February 2002, the New York Superintendent of Insurance testified:

Despite certain misleading press reports, the sense of the Insurance Department is that the industry continues to approach its claims obligations responsibly. Any difficulties arising in the claims process, we have found, is usually from limitations on coverages, the collecting and evaluating of certain business records necessary to the claims process, or to the need to keep claims files open until all losses are determined.<sup>23</sup>

### C. Market Response: The Exclusion of Terrorism Coverage

Although the insurance industry has been forthcoming in payment of compensation for losses from the September 11 attack, the industry does not want to bear the risk of future terrorist attacks.<sup>24</sup> Before September 11, terrorism-related losses were sufficiently small and infrequent that insurers did not take them into account when underwriting risks.<sup>25</sup> It is fair to say that the insurance industry did not even conceive of an attack that could generate such astronomical losses.<sup>26</sup> After the

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Cir. 1974); *Holiday Inns, Inc. v. Aetna Ins. Co.*, 571 F. Supp. 1460 (S.D.N.Y. 1983). For a good journalistic account of the legal history of the war exclusion, see Susan Massman, *War Risk Exclusion Legal History Outlined*, NAT'L UNDERWRITER—PROP. CASUALTY, Sept. 24, 2001, at 40.

19. See, e.g., Gibson et al., *supra* note 16 (stating that “[t]he research analysts of IRMI have undertaken just such a review and concluded that the standard insurance industry exclusions should not preclude coverage for most claims expected to arise from the attacks.”); Kathryn K. Jensen, *War and Military Action Exclusions: Property Insurance and the Attack on the U.S.*, CLAIMS, Nov. 1, 2001, at 43 (noting that the Property Loss Research Bureau “previously examined these standard war exclusions and concluded that they generally do not apply to acts of terrorism.”).

20. See, e.g., *Pan Am. World Airways v. Aetna Cas. & Sur. Co.*, 505 F.2d 989 (2d Cir. 1974); *Holiday Inns, Inc. v. Aetna Ins. Co.*, 571 F. Supp. 1460 (S.D.N.Y. 1983). See also Massman, *supra* note 18; Jensen *supra* note 19.

21. Serio N.Y. Testimony, *supra* note 13, at 28.

22. *Id.* at 28–29.

23. Serio House Testimony, *supra* note 14.

24. See Hillman, *supra* note 2, at 3.

25. See MUNICH RE GROUP, 11TH SEPTEMBER 2001, §§ 3.3–3.4 (2001); Warshawsky, *supra* note 2; see also Serio House Testimony, *supra* note 14, at 25–26; Hillman, *supra* note 2, at 3.

26. See MUNICH RE GROUP, *supra* note 25, § 3.4.

September 11 attack, insurers learned that terrorism-related losses can be enormous—even from a single event—and that the risk of such a loss is greater than they expected. The size of that risk cannot be measured, however, because there still is not enough information about the risks of terrorism. As a result, many insurers consider terrorism risks to be “uninsurable” from an underwriting perspective.<sup>27</sup> In other words, many insurers believe that uncertainty about the probability of a future attack and the amount of damages that it could cause make it impossible to calculate an appropriate premium for such coverage.<sup>28</sup>

Insurers responded initially by seeking governmental assistance in limiting the risk that future terrorism-related losses could pose to the industry. Several different proposals were considered,<sup>29</sup> though only the House proposal made it to a vote during 2001.<sup>30</sup> The House bill passed by a vote of 227 to 193, and would have authorized government loans for future large-scale terrorist attacks.<sup>31</sup> The loans would have been repaid by the industry, policyholders, and, with additional governmental action, taxpayers.<sup>32</sup> The Senate, however, failed to bring the measure up for a vote.<sup>33</sup>

Once it became clear that the government was not going to immediately adopt legislation to assist insurers, the industry began to exclude

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27. See Warshawsky, *supra* note 2; Serio House Testimony, *supra* note 14, at 25–26; AM. ASS'N OF INS. SERVS., *supra* note 5.

28. See Hillman, *supra* note 2, at 3; see also Rodd Zolkos, *Terrorism Uninsurable*, INS. DAY, Feb. 21, 2002, at 1.

29. See, e.g., Stephen Labaton, *A Nation Challenged: The Legislation; House Committee Approves Measure to Aid Insurance Industry in Terrorist Attacks*, N.Y. TIMES, Nov. 1, 2001, at B7; Stephen Labaton, *A Nation Challenged: The Aid Bill; White House and Key Senators Revise Proposal on Aid to Insurers*, N.Y. TIMES, Oct. 27, 2001, at B1; Stephen Labaton & Joseph B. Treaster, *Bush Details Plans to Help Insurers on Future Terror Claims*, N.Y. TIMES, Oct. 16, 2001, at C1; Stephen Labaton & Joseph B. Treaster, *A Nation Challenged: The Insurers; Government Role at Issue in Proposal to Help Industry*, N.Y. TIMES, Oct. 11, 2001, at C4.

30. See *Action on Legislation: Terrorism Insurance*, AM. BANKER, Feb. 14, 2002, available at WL 4100042.

31. See Stephen Labaton, *A Nation Challenged: The Liability; House Votes to Shield Insurers and Limits Suits by Future Terror Victims*, N.Y. TIMES, Nov. 30, 2001, at B8.

32. See *id.*

33. See *Action on Legislation: Terrorism Insurance*, *supra* note 30. Although the Senate failed to act on any legislation in 2001, the Senate passed its own legislation to provide federal backing for terrorism insurance in June 2002. See, e.g., Joseph B. Treaster, *Senate Passes Aid to Insurers on Terrorism*, N.Y. TIMES, June 18, 2002, at C1. The Senate legislation operates like federal reinsurance, so will actually pay for a portion of terrorism losses rather providing loans, as provided for by the House bill. Under the Senate bill, the government would pay for 80% of terrorism losses up to \$10 billion, and then would pay 90% of losses over \$10 billion. Insurers would bear a portion of the losses based on their share of the market. *Id.* The House and Senate versions are now in a conference committee, which may significantly change the details of the final legislation. *Id.*



terrorism-related losses from coverage.<sup>34</sup> Reinsurers were the first to adopt such exclusions, in part because they had absorbed about two-thirds of the losses from the September 11 attack.<sup>35</sup> Reinsurers are large, multinational companies who contract to insure a portion of the losses borne by insurance companies (known as “primary insurers”) who interact directly with policyholders. Because reinsurers are international in character, conduct business worldwide, and deal exclusively with sophisticated insurance companies rather than consumers, reinsurers are subject to more limited regulation and could adopt terrorism exclusions without governmental approval.<sup>36</sup> A majority of reinsurance contracts were renewed in January 2002,<sup>37</sup> and the great majority of the renewal contracts excluded coverage for terrorism-related losses.<sup>38</sup>

The reinsurers’ decision to exclude terrorism from coverage left the primary insurers bearing the risk of future terrorist attacks. Without reinsurance, a major loss from a terrorist attack could bankrupt many primary insurers.<sup>39</sup> According to the National Association of Insurance Commissioners (NAIC), a \$25 million loss for a single primary property and casualty insurer would threaten the solvency of 886 companies, or 44 percent of the companies writing commercial property and casualty insurance.<sup>40</sup> Consequently, the NAIC endorsed a terrorism exclusion for commercial property and casualty insurers.<sup>41</sup> As of February 2002, “45 states and the District of Columbia and Puerto Rico” had

34. See AM. ASS’N OF INS. SERVS., *supra* note 5.

35. See Hillman, *supra* note 2, at 8.

36. See *id.* at 3–4.

37. The majority of reinsurance policies expired in January and, by some reports, could account for as much as 70% of reinsurance. See *id.* at 4 n.2.

38. “Industry sources confirm that little reinsurance is being written today that includes coverage for terrorism.” *Id.* at 4; see also Warshawsky, *supra* note 2 (noting that “the reinsurance industry has almost entirely stopped assuming terrorism risk.”). This trend has been confirmed in surveys. The New York State Insurance Department received responses from companies that represented 89% of commercial insurance writings in New York state, and 83% of those companies reported that their reinsurers were excluding or limiting coverage for terrorism. Serio House Testimony, *supra* note 14, at 20–21. Similarly, the AAIS found that “[m]ore than 80% of the 37 personal lines companies [surveyed] indicated that ‘their current or upcoming reinsurance contracts exclude or in some way limit coverage for loss caused by terrorism.’” Am. Ass’n of Ins. Servs., *AAIS Weighs Action in Wake of NAIC Decision on Personal Lines Terrorism Exclusions*, available at <http://www.aaiss.org> (last visited June 8, 2002).

39. See INS. INFO. INST., *Terrorism Coverage is a Taxpayer—Not Insurance Company—Responsibility, Industry Forum Told*, Jan. 23, 2002, at <http://www.iii.org/media/updates/press.599962/>; *California, New York Take Big Risks on Terrorism Policies*, NAT’L UNDERWRITER—PROP. & CASUALTY/RISK & BENEFITS MGMT. EDITION, Jan. 24, 2002, at 24.

40. See Hillman, *supra* note 2, at 17.

41. See Press Release, National Association of Insurance Commissioners, NAIC Members Come to Agreement Regarding Exclusions for Acts of Terrorism (Dec. 21, 2001), at [www.naic.org](http://www.naic.org) (last visited June 8, 2002).

approved a standard terrorism exclusion drafted by the Insurance Services Organization,<sup>42</sup> which provides many standard form policies and endorsements used by the industry.

#### D. *Terms of the Terrorism Exclusion*

The initial version of the standard terrorism exclusion excluded all losses that were caused by terrorist activity, but that exclusion was rejected by state regulators as overly broad.<sup>43</sup> The National Association of Insurance Commissioners then facilitated discussions to reach a compromise between the industry and regulators. The approved version of the exclusion has three elements: (1) the event must have been caused by terrorist activity; (2) those engaged in the activity must have the requisite terrorist intent; and (3) the losses caused by the activity must either exceed a specified threshold or be of a specified type.<sup>44</sup>

#### E. *Threshold Element*

Of the three elements, the third (which I will refer to as “the threshold element”) is perhaps the most significant because it makes the applicability of the exclusion turn on the *amount* of the losses instead of the nature of the activity giving rise to the losses. To meet the threshold element, the total property damage must exceed \$25 million.<sup>45</sup> The threshold element was included to tailor the exclusion to protect against insurer insolvency, which was the primary justification for the exclusion.<sup>46</sup> A loss of \$25 million was believed to pose a significant threat to the solvency of many primary property and casualty insurers.<sup>47</sup>

Significantly, the threshold requirements can be met through aggregation of multiple losses. The \$25 million threshold is for *all* property damage—including losses from business interruption—from a terrorist event, or from related terrorist events in a seventy-two-hour period.<sup>48</sup>

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42. See Hillman, *supra* note 2, at 5. See also *States Adopt Terror Exclusion Clauses*, INS. DAY, March 5, 2002. The five states that have not approved the endorsement are California, Florida, Georgia, New York, and Texas. See Hillman, *supra* note 2, at 17. These states account for more than 35% of the total U.S. commercial insurance market. *Id.* at 5. The exclusion is still available for use in these five states under some circumstances, however, because approval of the endorsement is not necessary for “large, sophisticated buyers.” *Id.* at 5 n.7.

43. See Hillman, *supra* note 2, at 16; Woodward, *supra* note 1.

44. Examples of standard forms that have been approved by state regulators are available on the American Association of Insurance Services website. See <http://www.aaisonline.com>.

45. See Woodward, *supra* note 1; Hillman *supra* note 2, at 18.

46. See Hillman *supra* note 2, at 16–17.

47. As noted above, *supra* text accompanying note 28, a \$25 million loss for a single primary property/casualty insurer would threaten the solvency of 886 companies, or 44% of the companies writing commercial property/casualty insurance. *Id.*

48. See Woodward, *supra* note 1; Hillman *supra* note 2, at 18–19.

Related terrorist events are those carried out in concert, or where terrorists appear to be working together.<sup>49</sup> To be counted in the aggregate of terrorist activity for property insurance coverage, the property damage must take place in the United States, its territories and possessions, Canada, or Puerto Rico.<sup>50</sup>

If the threshold is met, some exclusions are “absolute,” while others allow limited coverage for fire-related losses.<sup>51</sup> Some terrorist exclusions apply to all losses or damages caused by terrorist activity once the threshold is met. The more limited exclusions have an exception for “direct loss or damage by fire.”<sup>52</sup> This exception is required in states that have adopted the standard fire policy, which means that insurers cannot offer insurance that is more restrictive in coverage than the standard fire policy.<sup>53</sup>

The terrorism exclusion developed for liability insurance has a similar threshold provision, but it differs in two respects. First, in calculating the \$25 million aggregate for property damage, the liability exclusion counts property damage occurring anywhere in the world.<sup>54</sup> Second, the exclusion for liability insurance also has an alternate threshold of fifty-or-more deaths or serious injuries.<sup>55</sup> Serious injury is defined to include injuries that involve a “substantial risk of death,” protracted and obvious disfigurement, or protracted loss or impairment of bodily function.<sup>56</sup> Both the economic threshold and the death or injury threshold are to be aggregated for a single terrorist event, or for related events in a seventy-two-hour period.<sup>57</sup>

The threshold element is satisfied for property or liability insurance if the terrorist activity involves nuclear, biological, or chemical agents.<sup>58</sup> Any losses or damages related to nuclear materials are excluded, re-

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49. Hillman *supra* note 2, at 19.

50. See Woodward, *supra* note 1; Hillman *supra* note 2, at 18–19.

51. Examples of the standard terrorism exclusions with and without the fire exception are available at <http://www.aaisonline.com/General/sr-CLwte2.htm> (last visited June 8, 2002).

52. See Woodward, *supra* note 1.

53. See *id.*, *supra* note 1. States that have adopted the standard fire policy include: Arizona, California, Connecticut, Georgia, Hawaii, Idaho, Illinois, Iowa, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, New Jersey, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, Texas, Virginia, Washington, West Virginia, and Wisconsin. *Id.*

54. See Hillman, *supra* note 2, at 19; Woodward, *supra* note 1.

55. Hillman, *supra* note 2, at 18.

56. See, e.g., AAIS General Liability War, Military Actions and Terrorism Exclusions, Form GL 0985 01 02 at 2, available at <http://www.aais.org/General/02-0075A7.htm> (last visited May 20, 2002).

57. See Hillman, *supra* note 2, at 18–19.

58. *Id.* at 19; Woodward, *supra* note 1.

ardless of the amount of the losses or the number of people injured.<sup>59</sup> For biological or chemical agents, the key issue is whether the release was intended. But if biological or chemical agents were released unintentionally, in the course of a terrorist attack using other means, the thresholds will apply.<sup>60</sup>

#### F. *Terrorist Act and Intent Elements*

If the threshold element is met, the other two elements of the exclusion must also be met to exclude the loss. The insurer also would have to show that loss resulted from a terrorist act committed with terrorist intent.<sup>61</sup>

The terrorist act element is very broad. To satisfy this element of the exclusion, the act need only constitute: “[u]se or threat of force or violence; or [c]ommission or threat of a dangerous act; or [c]ommission or threat of an act that interferes with or disrupts an electronic, communication, information or mechanical system.”<sup>62</sup> This definition is so broad that it includes violent crime, vandalism, or Internet hacking; it may include any action that has a risk of injury.

The terrorist intent element is also very broad. In fact, the element is so broad that, strictly speaking, it does not require proof of intent in the usual sense.<sup>63</sup> The intent element is satisfied if the “effect” of the act “is to intimidate or coerce a government or the civilian population or any segment thereof,” or is “to disrupt any segment of the economy.”<sup>64</sup> Alternately, if the act does not have that effect, the intent element is satisfied if it “appears that the intent [was] 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.”<sup>65</sup> Thus, terrorist intent will be found if the act causes intimidation or coercion, if that was its apparent purpose, or if

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59. See Woodward, *supra* note 1.

60. See Hillman, *supra* note 2, at 19.

61. The distinction between act and intent is somewhat artificial because those are not the labels used by the exclusions. However, I think that they are useful shorthand for basic distinctions drawn by the terms of the exclusions. The typical exclusion requires activities of a certain type (i.e., the terrorist act) and that those activities have a terrorist effect or appear to have terrorist intent (I refer to these collectively as terrorist intent for convenience and because a terrorist effect gives rise to an inference of terrorist intent).

62. Hillman, *supra* note 2, at 17.

63. I use the term “intent” because I believe that this element is meant to address intent even though in broadening the scope of the exclusion the element considers the effect of the action rather than intent in its legal sense.

64. *Id.* at 18.

65. *Id.*

the motive appears to fall into one or more of six very broad categories (political, ideological, religious, social, economic, or philosophical).

## II. Impact on Cities

### A. Unavailability of Insurance

Under the new terrorism exclusion, insurance coverage for many acts of violence would suddenly disappear.<sup>66</sup> Cities (along with other municipalities) hold billions of dollars in property, and without insurance coverage they are at risk of substantial losses if terrorists damage that property. The risk faced by cities is even greater than that faced by many private-property owners, because many government-owned properties are located in high-risk areas and are more likely to be terrorist targets.<sup>67</sup> Further, the exclusion's broad language insures that cities will face the risk of uninsured losses beyond those caused by terrorism. Under the definitions used by the exclusion discussed above, for example, any dangerous act that disrupts the economy would qualify for the exclusion even if it not undertaken by what most people would consider a terrorist organization.<sup>68</sup> Similarly, the exclusion would apply to most hate crimes<sup>69</sup> and instances of Internet hacking.<sup>70</sup>

Cities also face risk associated with third-party liability claims. Because of broad legal duties owed to citizens, cities could be liable to victims of terrorism. Potential liability of the Port Authority for the damages caused by the September 11 attack offers a good example of this risk.<sup>71</sup> Cities have greater risk of third-party liability than do most private-property owners because the scope of governmental duties tends to be broader.<sup>72</sup> As with property insurance, the exclusion for

66. See Serio House Testimony, *supra* note 14, at 4–5. Examples of properties that were unable to get sufficient terrorist insurance coverage include Safeco Field in Seattle, see Frank Vinluan & Bill Kossen, *Many High-Profile Buildings Unable to Get Terrorism Insurance*, SEATTLE TIMES, May 19, 2002, and the Golden Gate Bridge, see *Terror Aftermath Hits Golden Gate Bridge and the User Will Pay*, INS. DAY, May 9, 2002.

67. See Serio House Testimony, *supra* note 14, at 4–5.

68. See Susan Massmann, *Terrorism Exclusion Wording Unclear*, NAT'L UNDERWRITER, Feb. 11, 2002, at 21.

69. This is one reported reason that California and New York rejected the proposed terrorism exclusion.

See Russ Banham, *U.S. Terror Pool: Whose Terror Is It?*, REACTIONS, Feb. 2002, at 41.

70. Vinluan & Kossen, *supra* note 66.

71. See, e.g., David Pilla, *Sept. 11 Poses Many Claims Questions for Insurers*, BESTWIRE, Jan. 31, 2002. For a general analysis of landowner liability for terrorist acts, see Melinda L. Reynolds, Note, *Landowner Liability for Terrorist Acts*, 47 CASE W. RES. L. REV. 155 (1996).

72. Indeed, one possible consequence of required improvements in security measures is greater potential liability exposure for municipalities. See *JoC Week*, J. OF

liability insurance also seems likely to encompass some nonterrorist events. Cities that are sued because of failure to warn or protect against dangerous acts that disrupt the economy, hate crimes, or damages from Internet hacking would not be covered under liability insurance that includes the exclusion.

The use of the exclusion limit coverage for both terrorism and non-terrorist losses is mitigated to some extent by the threshold element, which requires that property damages exceed \$25 million, or that fifty or more people are seriously injured or killed if liability insurance is involved.<sup>73</sup> However, as the September 11 attack demonstrated, a terrorist attack may well exceed those thresholds. In addition, the threshold element may be met by aggregating all losses from a single event (regardless of how many different property owners were involved), or by aggregating losses from multiple, related events within a seventy-two hour period.<sup>74</sup> The release of nuclear, chemical, or biological agents is not subject to any threshold requirement.<sup>75</sup> Damage caused by anthrax would be exempted regardless of the amount of loss.

Although insurance coverage would be less available under the exclusions, coverage would not be completely unavailable. The demand for terrorism insurance has grown steadily over the past months, and many insurers have begun to offer stand-alone terrorist coverage.<sup>76</sup> Observers expect terrorism insurance to become more available and less expensive over time.<sup>77</sup> But because of the unpredictability of terrorist attacks, it is very difficult for insurers to accurately price such coverage.<sup>78</sup> As a result, terrorism coverage tends to be very expensive and limited in scope. No one can say how far the market can or will go in making affordable terrorism insurance widely available.

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COMMERCE, Nov. 12, 2001, at 6. Because of the risk of liability, proposed legislation included a provision to limit the liability of cities and municipalities (with a specific cap of \$350 million for New York City). See *US in Airport Security Shake-Up*, INS. DAY, Nov. 20, 2001.

73. See *supra* notes 45 & 54 and accompanying text.

74. See *supra* notes 48–50 & 57 and accompanying text.

75. See *supra* notes 58–60 and accompanying text.

76. See, e.g., Sarah Veysey, *Terror Coverage Market Grows*, BUS. INS., Feb. 18, 2002, at 17; *Outlook Brighter for Terrorism-Coverage Availability*, BESTWIRE, May 13, 2002.

77. See Banham, *supra* note 69, at 40. This would be consistent with a general pattern in the insurance industry, sometimes known as the insurance cycle. For a general discussion of the cyclical nature of premiums, see Anne Gron, *Capacity Constraints and Cycles in Property-Casualty Insurance Markets*, 25 RAND J. ECON. 110 (1994); see also Anne Gron & Andrew Winton, *Risk Overhang and Market Behavior*, 74 J. BUS. 591 (2001).

78. See *supra* notes 27–28.

### B. *Cost of Insurance*

Whether or not cities are someday able to obtain terrorism coverage, the cost of insurance has already risen since September 11. The September 11 attack is not solely responsible for price increases—prices were already on the rise because of other market considerations. However, claims arising from the attack substantially eroded insurers' available capital, adding significantly to price increases.<sup>79</sup> Cities have seen price increases in the 30 percent to 200 percent range,<sup>80</sup> and in some instances even more.<sup>81</sup> As a result of these price increases, some municipalities may choose to forego insurance coverage for terrorism.<sup>82</sup>

These additional insurance costs, especially when combined with reduced revenues from the economic slowdown and the additional expenditures for anti-terrorism efforts, have put many cities in a financial bind. The additional marginal cost of insurance is causing cities to reduce services<sup>83</sup> or to look for other sources of new revenue.<sup>84</sup>

### C. *Indirect Impacts*

Cities also face indirect costs from the September 11 attack. Like the rest of the United States, they are adversely affected by economic consequences of the attack. The downturn in economic activity has reduced revenues available to cities. Some of the economic consequences are due to the reaction of the insurance market.<sup>85</sup> The unavailability of

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79. See DRI-WEFA, *supra* note 15, at 45–46.

80. James Charlesworth, a broker for municipalities, said that insurance premium rates for his municipal clients have risen by 30–200%. Interview with James Charlesworth, March 11, 2002. Denver's cost of property insurance rose by 54%. See Cindy Brovsky, *Hike in Denver's Insurance Costs Adds to City's Budget Woes*, DENVER POST, May 16, 2002. The City of Seattle saw its liability insurance premium rise by 300%. See Vinluan & Kossen, *supra* note 66. Commercial property/casualty insurance has seen median rate increases of 30–50%, and median rate increases of 40–70%. See Warshawsky, *supra* note 2.

81. Vinluan & Kossen, *supra* note 66 (reporting that in some instances premium costs are ten times higher than before the September 11 attack). The cost of full coverage for the Golden Gate Bridge was described as "stratospheric," and was so high that the bridge's board of directors decided against full coverage (even though the bridge is a known terrorist target). See *Terror Aftermath Hits Golden Gate Bridge and the User Will Pay*, *supra* note 66.

82. See Warshawsky, *supra* note 2 (noting that "municipal entities and other non-profits where trustees feel a fiduciary responsibility may well forgo terrorism coverage if they see the cost is equal or greater than what they're paying for all other perils.").

83. See, e.g., Lucio Guerrero, *Cities Plan for Cost Cuts to Cope with Shortfalls*, CHI. SUN-TIMES, Nov. 5, 2001.

84. For example, Denver is considering a vending contract to put Coca-Cola products in public buildings, which would generate an additional \$1.1 million in revenue. See Brovsky, *supra* note 80.

85. See Hillman, *supra* note 2, at 2; Vinluan & Kossen, *supra* note 66 (noting that one observer attributes the decline in commercial construction to a lack of terrorism insurance).

commercial-property insurance coverage for terrorism has slowed development of new projects because banks are less willing to lend if their collateral cannot be fully insured.<sup>86</sup> The potential effect on the real estate market could be even greater.<sup>87</sup> As property insurance policies are renewed, those policies tend to exclude losses from terrorism,<sup>88</sup> which some lenders maintain puts the borrowers in default under the loan agreements.<sup>89</sup> Widespread defaults and foreclosures could further harm the economy.

Although many municipal projects do not rely on bank financing, and therefore do not run the risk of being in default because of an absence of insurance coverage, the difficulty in obtaining insurance will complicate a city's ability to take on new projects. Those involved in such projects will have difficulty in obtaining full coverage for terrorism, which will make undertaking the projects riskier. New projects will also be more expensive as a result of higher insurance and financing costs.

### III. Strategies for Cities

Cities have generally responded to the increased cost and reduced availability of insurance by making market choices. In other words, cities have responded as insurance consumers by shopping for the best possible coverage at the best price, and then deciding how much insurance they can afford. In some cases, they have been able to buy the additional coverage, albeit at a much higher cost.<sup>90</sup> In other cases, they have chosen to forego coverage.<sup>91</sup> Although these are certainly possible strate-

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86. See Hillman, *supra* note 2, at 9 (noting that “[s]ome examples of large projects canceling or experiencing delays have surfaced, with the lack of terrorism coverage being cited as a principal contributing factor.”); see also Rodd Zolkos, *Terror Risk Hits New Construction*, BUS. INS., Feb 18, 2002, at 1; Dawn Kopecki, *Terror Insurance Problems Pervasive, Drag on U.S. Economy*, DOW JONES NEWS SERV., Feb. 27, 2002.

87. See Hillman, *supra* note 2, at 2 (noting that “[s]ome sectors of the economy—notably real estate and commercial lending—are beginning to experience difficulties because some properties and businesses are unable to find sufficient terrorism coverage, at any price.”).

88. It is hard to get a full sense of the extent of this problem because many commercial property owners are reluctant to disclose difficulties in obtaining insurance. See Warshawsky, *supra* note 2.

89. See Vinluan & Kossen, *supra* note 66. For an account of a lawsuit over whether expensive terrorism insurance is required by the lending agreement, see Tom Perrotta, *New York Developer Resists Buying Terror Policy*, N.Y.L.J., May 17, 2002, available at <http://www.law.com/servlet/ContentServer?pagename=OpenMarket/Xcelerate/View&c=LawArticle&cid=1022761087961&live=true&cst=1&pc=0&pa=0>.

90. Denver is an example of this response. See Brovsky, *supra* note 80.

91. See *supra* note 81. An example of foregoing coverage is the decision to underinsure the Golden Gate Bridge. See *Terror Aftermath Hits Golden Gate Bridge and the User Will Pay*, *supra* note 66.



gies, more innovative or aggressive strategies could be employed. This section will consider possible legislative solutions, options available in the courts, and alternatives to traditional insurance coverage.

#### A. Legislative Strategies

The most obvious legislative strategy that cities might employ to address the cost and unavailability of insurance would be to urge Congress to adopt an effective federal backstop for insurance coverage for terrorist incidents. Although the House proposal was not acted upon in 2001,<sup>92</sup> the Senate adopted its own version of a federal backstop in June 2002.<sup>93</sup> The two versions are now in a conference committee. It is unclear what the final version of the legislation will look like once it comes out of the conference committee,<sup>94</sup> or how quickly the committee and Congress will act.<sup>95</sup> Moreover, depending on the final terms, the President could veto the legislation,<sup>96</sup> or insurers may be so dissatisfied that they choose not to re-enter the market for terrorism insurance. As a result, cities may want to urge Congress and the President to adopt a version of the legislation that will be effective for the insurance industry.

An effective federal backstop<sup>97</sup> would allow the federal government to bear some of the risk of future catastrophic losses from terrorism, which would encourage reinsurers to participate more fully in the market. Once reinsurers agree to provide coverage for terrorism, primary insurers will no longer have a reason to exclude terrorism.<sup>98</sup> The primary justification for the exclusion was that reinsurance was unavailable.<sup>99</sup> Most of the states approving the exclusion have made it subject

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92. See *Action on Legislation: Terrorism Insurance*, *supra* note 30.

93. See, e.g., Treaster, *supra* note 33.

94. See Steven Brostoff, *Terrorism Insurance Bill Faces Plenty of Hurdles*, NAT'L UNDERWRITER—PROP. & CASUALTY/RISK & BENEFITS MGMT. EDITION, June 24, 2002, at 5. For one industry observer's prediction of the likely terms of the bill reported out of committee, see Steven Brostoff, *Will Final Terrorism Bill Please Insurers?*, NAT'L UNDERWRITER—PROP. & CASUALTY/RISK & BENEFITS MGMT. EDITION, Aug. 5, 2002, at 33.

95. See Arthur D. Postal, *Groundwork in Place for Terror Re Bill*, INS. CHRON., Aug. 5, 2002, at 1.

96. See Tom Ramstack, *Senate-Approved Bill to Lower Cost of Terror-Attack Insurance May Face Veto*, WASH. TIMES, June 19, 2002.

97. For details of various proposals, see *supra* note 29. The House version is described in Labaton, *supra* note 30, and can be found as H.R. 3210. The Senate version is described in Treaster, *supra* note 33, and can be found as S. 2600. For a good summary of the differences and the next legislative steps, see Brostoff, *Terrorism Insurance Bill Faces Plenty of Hurdles*, *supra* note 94.

98. See *supra* notes 34–39 and accompanying text.

99. See *supra* note 41.

to a sunset provision that would revoke approval once Congress passes federal backing for reinsurance.<sup>100</sup>

A second legislative strategy would be to seek insurance through a legislative scheme. Although such a proposal has not been made to date, there are a variety of examples of federal insurance programs that might be used as a model. The federal government offers insurance for catastrophic nuclear accidents, overseas political risks, urban riots and civil disorders, and floods.<sup>101</sup> Alternately, governmental insurance for terrorism could be modeled on programs available in other countries, such as those in the United Kingdom or Israel.<sup>102</sup> Such an approach is not limited to national legislation. State terrorism insurance could be modeled on state insurance guarantee funds or state programs such as California's insurance against earthquakes.<sup>103</sup> One advantage of these legislative solutions is that they allow the risk of terrorism to be pooled in a way that is less regressive. If cities cannot obtain terrorism insurance, the risk of terrorist harm is borne by their taxpayers. As a general matter, because of the differences in tax structure, risk bearing at the local level is likely to be the most regressive.<sup>104</sup> Political circumstances, of course, may make it very difficult to obtain adoption of such proposals, which may explain why there has been little discussion of them in the press.

A third strategy is to urge that exclusions for terrorism be barred. This could be done at the state level by statute,<sup>105</sup> or at the regulatory level. Although forty-five states have approved a standard-form terrorism exclusion, five states have not.<sup>106</sup> Cities could urge regulators to reverse that position, or to deny the use of the exclusion for policies applicable to them. The problem with this approach is that it forces

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100. See AM. ASS'N OF INS. SERVS., WAR, MILITARY ACTION AND TERRORISM EXCLUSIONS COMMERCIAL LINES STATUS REPORT (May 15, 2002), available at <http://www.aaisonline.com/General/sr-CLwte2.htm>.

101. See *Terrorism Insurance, Alternative Programs for Protecting Insurance Consumers: Testimony before the Senate Committee on Banking, Housing and Urban Affairs*, 107th Cong. at 3-6 (Oct. 24, 2001) (statement of Thomas J. McCool, Managing Director, Financial Markets and Community Investment), available at <http://www.gao.gov/new.items/d02199t.pdf> [hereinafter McCool].

102. See *id.* at 8-9. For an analysis of the British system of pooling reinsurance for terrorist risks, see William B. Bice, Comment, *British Government Reinsurance And Acts Of Terrorism: The Problems of Pool Re*, 15 U. PA. J. INT'L BUS. L. 441 (1994).

103. See McCool, *supra* note 101, at 10.

104. See generally James R. Hackney, Jr., *A Proposal for State Funding of Municipal Tort Liability*, 98 YALE L.J. 389 (1988).

105. The regulation of insurance is generally a matter of state law. See 15 U.S.C. §§ 1011-1015. For a general discussion of state regulation of insurance coverage, see ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 22(e) (2d ed. 1996).

106. See *supra* note 42.

primary insurers to bear the risk of terrorist losses even though the regulators have already found that such an approach creates the risk of insurer insolvency.<sup>107</sup> If the insurers who are forced to cover terrorist losses ultimately become insolvent, cities will still ultimately bear much of the loss without insurance.<sup>108</sup>

### B. *Judicial Strategies*

If legislative strategies are unsuccessful or unavailable, cities can try to mitigate the impact of terrorism exclusions through litigation. Although the courts are unlikely to refuse to enforce the exclusions in their entirety,<sup>109</sup> municipalities can use doctrines of insurance interpretation to avoid overly broad applications of the exclusions to some events. Two doctrines might be helpful: the doctrine of *contra proferentum* (that ambiguous provisions should be construed in favor of coverage)<sup>110</sup> and the doctrine of reasonable expectations (that insurance policies should be construed consistent with policyholders' reasonable expectations).<sup>111</sup> After a conceptual discussion of these doctrines and

107. See *supra* notes 39–41 and accompanying text.

108. For example, the California Insurance Guaranty Association will pay no more than \$500,000 toward a claim against an insolvent insurer. See CAL. INS. CODE § 1063.1(c)(7). For a general discussion of solvency regulation, see JERRY, *supra* note 105, § 22(c).

109. It is possible that courts could refuse to enforce the exclusions on the grounds of public policy. Cf., e.g., *Halpin v. Am. Family Mut. Ins. Co.*, 823 S.W.2d 479, 481 (Mo. 1992) (holding that public policy of compensating victims of automobile accidents reflected by the Motor Vehicle Financial Responsibility law invalidated the household exclusion); *Slayko v. Sec. Mut. Ins. Co.*, 183 N.T.S.2d 688 (Sup. Ct. 2000) (holding an exclusion for harms reasonably expected to result for criminal acts to be overly broad and therefore unenforceable). However, because there is a competing public policy interest in ensuring the financial solvency of insurers, which the state regulators relied upon in approving the exclusion, it seems unlikely that the courts would invalidate the terrorism exclusion on public policy grounds.

110. For a general description of the doctrine of *contra proferentum*, see JERRY, *supra* note 105, § 25A[c]. For examples of the academic literature concerning this doctrine, see Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 531 (1996); Peter Nash Swisher, *Judicial Interpretations of Insurance Contract Disputes: Toward a Realistic Middle Ground Approach*, 57 OHIO ST. L.J. 543, 584–90 (1996); Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171, 173–254 (1995); James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995, 1002 (1992); David S. Miller, Note, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849 (1988). For specific applications of the doctrine to various insurance policy provisions, see JEFFREY W. STEMPER, *THE LAW OF INSURANCE CONTRACT DISPUTES* (1995).

111. For a general description of the reasonable expectations doctrine, see JERRY, *supra* note 105, § 25D. For examples of the academic literature on this doctrine, see Symposia, *The Doctrine of Reasonable Expectations After Three Decades*, 5 CONN. INS. L.J. 1 (1998) (featuring articles by Professors Kenneth Abraham, James Fischer, Roger Henderson, Robert Jerry, Mark Rahdert, Jeffrey Stempel, and Jeffrey Thomas, and by prominent insurance coverage attorneys Eugene Anderson and Susan Popik);

their application to the exclusions, this section will discuss the example of the pollution exclusion to illustrate how the doctrines might be used.

### 1. CONTRA PROFERENTUM

The key to using the doctrine of *contra proferentum* is a finding that the provision in question is ambiguous. While at first blush the terrorism exclusions would seem to satisfy this requirement, it would be more accurate to describe the exclusions as vague rather than ambiguous. Nonetheless, a provision is ambiguous if it is subject to two or more competing interpretations.<sup>112</sup> The problem posed by the terrorism exclusions is not so much that they can be interpreted in different ways, but rather that language used to define the elements of the exclusion are so broad that it is difficult to find their limits. The act element is satisfied by a threat of force or violence, by the commission of a dangerous act, or by actions that disrupt electronic communications, information, or mechanical systems.<sup>113</sup> Thus, any violent crime and most internet vandalism satisfy this element.

The intent element is even broader. It is satisfied if the effect of the act is to intimidate, coerce, or disrupt the economy, or if the act merely *appears* to be motivated by the desire to do so.<sup>114</sup> Moreover, the intent element is satisfied if the act *appears* to be for the purpose of furthering political, ideological, religious, social, or economic objectives, or to express a philosophy or ideology (or the opposition to one).<sup>115</sup> It is hard to imagine an activity that would satisfy the act element that would not also satisfy the intent element.

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Laurie Kindel Fett, Note, *The Reasonable Expectations Doctrine: An Alternative to Bending and Stretching Traditional Tools of Contract Interpretation*, 18 WM. MITCHELL L. REV. 1113 (1992); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L. J. 823 (1990); Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461 (1989); David L. Leitner, *Enforcing the Consumer's "Reasonable Expectations" in Interpreting Insurance Contracts: A Doctrine in Search of Coherent Definition*, 38 FED'N INS. & CORP. COUNS. Q. 379 (1988); Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323 (1986); William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 (1986); Scott B. Krider, Note, *The Reconstruction of Insurance Contracts Under the Doctrine of Reasonable Expectations*, 18 J. MARSHALL L. REV. 155 (1984); Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981). For specific applications of the reasonable doctrine to various insurance policy provisions, see JEFFREY W. STEMPEL, *supra* note 110.

112. See, e.g., *Dahl-Eimers v. Mut. of Omaha Life Ins. Co.*, 986 F.2d 1379, 1381 (11th Cir. 1993) (applying Florida law); *State Farm Fire & Cas. Co. v. Midgett*, 508 A.2d 469, 471 (Ark. 1995); *City of Manchester v. Gen. Reinsurance Corp.*, 508 A.2d 1063, 1065 (1986). See generally JERRY, *supra* note 105, § 25A[a].

113. See *supra* note 61.

114. See *supra* note 63.

115. See *id.*

Because of the breadth of the definitions of terrorism and terrorist intent, it is very likely that the exclusions would be found to unambiguously apply to acts such as the September 11 attack. In fact, it is likely that most people would expect events like the September 11 attack to fall within the definitions of terrorism and terrorist intent. Nevertheless, the doctrine of *contra proferentum* may be useful to limit the scope of the exclusions at the margins. For example, suppose that a vandal sets a public building on fire and that the fire causes more than \$25 million in property damage. If the fire was set as an expression of anti-government sentiment, the insurer could argue that the loss is subject to the terrorism exclusion. In this view, setting the fire was a violent act, the damages exceeded the threshold requirement, and the intent element was satisfied because it appeared that the act was the expression of an anti-government philosophy. Conversely, the municipality might argue that the term "philosophy" is ambiguous, and, therefore, the doctrine of *contra proferentum* justifies a more narrow interpretation. On one hand, "philosophy" can be defined broadly to mean a personal belief.<sup>116</sup> On the other hand, it could be defined more narrowly as a belief accepted by a defined group or school of thought.<sup>117</sup> If the more narrow interpretation is used, the municipality might be able to avoid the exclusion if the vandal was expressing an individual belief rather than that of a more formally organized group. If the broader interpretation of philosophy is used, the terrorism exclusions may well apply. This uncertainty of interpretation lends credence to the argument that the defining language of the exclusions is overly broad and, therefore, may be subject to the doctrine of *contra proferentum*.

## 2. REASONABLE EXPECTATIONS

The doctrine of reasonable expectations provides an even more potent tool for municipalities because, in its most extreme form, it permits courts to enforce reasonable expectations in spite of clear policy language to the contrary.<sup>118</sup> Unlike *contra proferentum*, however, not many jurisdictions have clearly adopted this aggressive form of the doctrine.<sup>119</sup> Moreover, even if the doctrine of reasonable expectations is

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116. See THE AMERICAN HERITAGE DESK DICTIONARY (1981); see also <http://www.dictionary.com/search?q=philosophy> [search June 5, 2002] (third entry, from WordNet 1.6 by Princeton University).

117. *Id.* Of course, as a factual matter, the insurer may try to establish that the vandal's anti-government belief was part of a group or school of thought.

118. See JERRY, *supra* note 105, § 25D, at 142-43. See also Rahdert, *supra* note 111, at 335; Robert E. Keeton, *Insurance Law Rights At Variance With Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970). For an example of a court referencing the aggressive version of the doctrine, see *Storms v. United States Fid. & Guar. Co.*, 388 A.2d 578, 580 (N.H. 1978).

119. By Professor Jerry's count, sixteen states have purported to adopt this version

available in a particular jurisdiction, courts may be unwilling to use the doctrine to invalidate the terrorism exclusions in light of the fairly widespread publicity about them. Because it is widely known that terrorism is now being excluded from commercial property and liability policies, policyholders may not be able to justify a reasonable expectation of coverage.

If the doctrine of reasonable expectations is recognized in a particular jurisdiction, it might be used to narrow the scope of the terrorism exclusions, even if it cannot be used to invalidate them. The policyholder could argue that it did not reasonably expect a particular loss to come within the scope of the exclusion. In the arson example used above, for instance, the municipality could argue that it did not reasonably expect that an isolated violent act by a single individual would be considered an act of terrorism. Most people think of terrorism in terms of more organized and public events such as “the bombing of an embassy, political hostage-taking and most hijackings.”<sup>120</sup> A solitary act such as a single individual setting fire to a government building may not come within the common conception of terrorism. Therefore, the policyholder may be able to convince a court that the single event was not within its reasonable expectations. Similarly, because internet hacking and viruses are so commonplace, policyholders may be able to argue that those acts are not within the reasonable expectations of the policyholder as well.

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of the doctrine, though “only in about ten of these states do the courts’ decisions clearly demonstrate that the court understood the doctrine” in its aggressive form. See JERRY, *supra* note 105, § 25D, at 143 (citing cases catalogued and analyzed in by Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 828–34 (1990)).

A less aggressive form of the doctrine enforces the reasonable expectations of an insured only if the provision is ambiguous. See *id.* § 25D, at 142 n.8 (citing cases). Because this version relies on ambiguity as a prerequisite to its use, it is similar to the doctrine of *contra proferentum*.

120. See *Public Report of Vice-President’s Taskforce on Combating Terrorism*, in WHAT IS TERRORISM, OPPOSING VIEWPOINTS PAMPHLETS 17 (1986). Such activities also fit an academic definition of terrorism. Starting in 1972, the Rand Corporation began a database of international terrorist incidents. Deciding which incidents to include in the database required the development of a definition. The Rand Corporation essentially defines terrorism as “violence, or the threat of violence, calculated to create an atmosphere of fear and alarm in the pursuit of political aims.” Bruce Hoffman, *Terrorism Trends and Prospects*, in COUNTERING THE NEW TERRORISM at 11 n.5 (Ian O. Lesser ed. 1999). For a more complete exposition of the definitional problems faced in developing the Rand chronology, see Brian Michael Jenkins, *The Study of Terrorism: Definitional Problems*, Dec. 1980, available at <http://www.rand.org/cgi-bin/Abstracts/e-getabbydoc.pl?P-6563>. For a more general discussion of the difficulty in defining terrorism, see BRUCE HOFFMAN, *INSIDE TERRORISM* 13–44 (1998).

## 3. POLLUTION EXCLUSION EXAMPLE

Judicial interpretations of the pollution exclusion used in commercial general liability policies provide a good illustration of the judicial limitation of a broadly worded exclusion. During the late 1980s, the wording of the pollution exclusion in most commercial general liability policies was changed in an effort to make the pollution exclusion “absolute.”<sup>121</sup> This more comprehensive exclusion excludes from coverage losses from “actual, alleged, or threatened discharge, dispersal, seepage, migration, release or escape of pollutants.” Pollutants are defined as “any solid, liquid, gaseous, or thermal irritant or contaminant, including smoke vapor, soot, fumes, acids, alkalis, chemicals and waste.”<sup>122</sup>

The literal language of this exclusion, like the terrorism exclusions, is so broad that many events are excluded even though most people would not characterize them as pollution events. For example, a toxic household cleaner such as bleach would qualify as a contaminant. If it were spilled in a grocery store causing a person to slip and fall, the exclusion, taken literally, would apply to the claim of the slip and fall victim, because the claim arose out of the release (spill) of a contaminant (bleach).<sup>123</sup> Yet this seems to go well beyond what most people would consider pollution.<sup>124</sup> As a result, the courts have refused to adopt this interpretation.<sup>125</sup> Although most courts have enforced the absolute pollution exclusion as unambiguous,<sup>126</sup> the exclusion has not been as

121. See KENNETH S. ABRAHAM, ENVIRONMENTAL LIABILITY INSURANCE LAW: AN ANALYSIS OF TOXIC TORT AND HAZARDOUS WASTE INSURANCE COVERAGE ISSUES 160–61 (1991).

122. Insurance Services Office 1993 Comprehensive General Liability Form (CG 00 01 10 93) (Dec. 1993) (on file with author). One commentator concluded that the “comprehensiveness of the absolute pollution exclusion almost defies belief.” Amanda Cohen Leiter, Note, *Environmental Insurance: Does It Defy the Rules?*, 25 HARV. ENVTL. L. REV. 259, 294 (2001).

123. For a discussion of this hypothetical, and its use at oral argument in a case before the Florida Supreme Court addressing the absolute pollution exclusion, see Jeffrey W. Stempel, *Unreason in Action: A Case Study of the Wrong Approach to Construing the Liability Insurance Pollution Exclusion*, 50 FLA. L. REV. 463, 490 (1998).

124. See *id.* at 490 n.121 (noting that even an industry representative in a proceeding before the Texas Insurance Commissioner “agreed it would be ludicrous to apply the proposed absolute pollution exclusion to bar the bleach slip claim when the ketchup slip claim was covered”). See also *Am. States Ins. Co. v. Kiger*, 662 N.E.2d 945, 948–49 (Ind. 1996) (refusing to apply the absolute pollution exclusion to gasoline in part because of a similar hypothetical when the slip-and-fall injury was caused by grease).

125. See Stempel, *supra* note 123, at 506–08 (explaining how the Florida Supreme Court’s opinion in *Deni Assoc. of Fla., Inc. v. State Farm Fire & Cas. Ins. Co.*, 711 So. 2d 1135 (Fla., 1998), avoids the bleach slip-and-fall hypothetical).

126. See Leiter, *supra* note 122, at 296. For examples, see *Technical Coating Applicators, Inc. v. United States Fid. & Guar. Co.*, 157 F.3d 843, 845–46 (11th Cir. 1998); *Certain Underwriters at Lloyd’s London v. C.A. Turner Constr. Co.*, 112 F.3d 184, 188 (5th Cir. 1997); *Am. States Ins. Co. v. Technical Surfacing, Inc.*, 50 F. Supp.

“absolute” as intended.<sup>127</sup> Courts have sometimes found the exclusion ambiguous and inapplicable to contamination that, although literally within the exclusion’s definition, is beyond what an average person would consider pollution.<sup>128</sup>

The terrorism exclusion may be similarly limited. The definition of terrorism used in the exclusion goes well beyond most people’s common perceptions of terrorism. In light of such over-breadth, courts may be inclined to limit the application of the exclusions at the margins. Thus, in the example used above of a single arsonist expressing disaffection for government, courts may choose not to enforce the exclusion even though it might literally apply. However, it seems unlikely that courts would refuse to enforce the exclusions in the event of another terrorist attack like that on September 11. As a result, judicial strategies will still leave cities bearing the risk of terrorism.

### C. *An Alternative to Traditional Insurance*

We now turn to a possible third solution, which lies outside the bounds of traditional insurance: alternative risk financing. A number of alternate risk financing mechanisms have been developed in the past fifteen to twenty years. These mechanisms were prompted by the scarcity or high cost of insurance during the mid-1980s.<sup>129</sup> Common forms of alternative risk financing include self-insurance, the use of captive insurers, and the use of risk retention groups. More recently, financial

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2d 888, 890 (D. Minn. 1999); *Northbrook Indem. Ins. Co. v. Water Dist. Mgmt. Co.*, 892 F. Supp. 170, 174 (S.D. Tex. 1995); *Heyman Assocs. No. 1 v. Ins. Co.*, 653 A.2d 122, 131 (Conn. 1995).

127. See Leiter, *supra* note 122, at 295.

128. *Id.* at 295–96. Two examples used by Leiter are the release of fumes by a contractor that harm a third party and a delivery person who was doused with diesel fuel. See *id.* (discussing *Nautilus Ins. Co. v. Jabar*, 188 F.3d 27 (1st Cir. 1999), and *Kent Farms, Inc. v. Zurich Ins. Co.*, 969 P.2d 109 (Wash. Ct. App. 1998)). Other examples include the refusal to apply the pollution exclusion to lead paint chips, *United States Liab. Ins. Co. v. Bourbeau*, 49 F.3d 786, 787–88 (1st Cir. 1995), to fecal coliform bacteria, *Keggi v. Northbrook Prop. & Cas. Ins. Co.*, 13 P.3d 785, 791 (Ariz. Ct. App. 2000), to carbon monoxide released from a furnace, *Am. States Ins. Co. v. Koloms*, 687 N.E.2d 72, 81–82 (1997), and to gasoline, *Am. States Ins. Co. v. Kiger*, 662 N.E.2d 945, 949 (Ind. 1996).

129. For examples of areas where insurance cost and unavailability have induced development of alternative risk financing include directors and officers insurance, see, for example, J. Phil Carlton & M. Guy Brooks III, *Corporate Director and Officer Indemnification: Alternative Methods for Funding*, 24 WAKE FOREST L. REV. 53 (1989), and Bennett L. Ross, *Protecting Corporate Directors and Officers: Insurance and Other Alternatives*, 40 VAND. L. REV. 775 (1987); pollution coverage insurance, see, e.g., Dean Jeffrey Telego, *Risk Financing Alternatives and the Pollution Liability Insurance Marketplace*, in PRACTICE APPROACHES TO REDUCE ENVIRONMENTAL CLEANUP COSTS, 317 PLI/Real 233 (1988); and medical malpractice insurance, see, e.g., James A. Christopherson, *The Captive Medical Malpractice Insurance Company Alternative*, 5 ANNALS HEALTH L. 121 (1996).



instruments have been developed as alternatives to insurance. One financial instrument that has been suggested for terrorism risk is the catastrophe bond. Each of these alternatives will be briefly discussed below.

### 1. SELF-INSURANCE

Self-insurance describes a variety of strategies used to prepare for risk. For some, self-insurance suggests doing without an insurance strategy of any kind. Because this approach does not seek to address the risk of sudden financial loss, it is more accurately described as “no insurance” (or, as some say, “going bare”) rather than as self-insurance.<sup>130</sup>

To constitute a real program of self-insurance, an entity must plan for and address risk. One way of planning for risk is to set aside reserves for anticipated losses.<sup>131</sup> Another form of self-insurance is to buy insurance with a large self-insured retention. For example, a city might buy a \$1 million policy with a \$500,000 or even \$1 million self-insured retention. The insurer would therefore bear much less risk. One advantage of this approach is that a policy with a large self-insured retention still operates as primary insurance, giving the policyholder the opportunity to buy excess insurance to cover catastrophic losses. Another advantage is that the insurer typically provides expertise and administrative capacity to handle claims.<sup>132</sup> Thus, the municipality may be more able to obtain insurance in the market and can avoid some administrative costs and burdens.

However, self-insurance is not a good way to address the financial risks of terrorism. Because of the threshold monetary loss requirement, the losses not insured could be catastrophic. The size of these potential losses (generally exceeding \$25 million), combined with their uncertainty, makes it very difficult for cities to set aside reserves to cover future financial loss. Indeed, these same difficulties led insurance companies to exclude losses from terrorism in the first place. The exclusion makes self-insurance through self-insured retentions a poor alternative as well. The exclusion already makes the policyholder bear the risk of terrorism, and the unavailability of reinsurance makes excess insurers unwilling to insure against terrorism risk above a self-insured retention limit. Consequently, self-insurance is ineffective.

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130. See Carlton & Brooks, *supra* note 129, at 65.

131. See *id.*

132. A good introduction to some of the issues raised by self-insurance is found in M. Paige Berry, *Self-Insurance: Is It Right for Your Clients*, N.J. LAW., Aug. 1998, at 8.

## 2. CAPTIVES

Another alternative involves a so-called “captive” insurer. A captive insurer is an insurance company that is established for the limited purpose of providing insurance to its owners.<sup>133</sup> Captive insurers come in a variety of forms. A “pure” captive is an insurer set up as a subsidiary of the insured; it insures only the parent and other related companies.<sup>134</sup> An “association” captive or “group” captive is owned by a group of companies in a related industry.<sup>135</sup> A “rent-a-captive” is a captive insurer organized and managed by a conventional insurer for the benefit of the insured.<sup>136</sup>

Captive insurers provide a potential mechanism to address terrorism risk. As a general matter, captive insurers can provide insurance when the market will not, can provide it at a lower cost, can provide more direct access to reinsurance, and sometimes even generate a profit.<sup>137</sup> But as a mechanism for addressing terrorism risk, captives have some of the same limitations as self-insurance. Insurance from a “pure” captive is essentially self-insurance that uses the structure of a traditional insurer to manage the risk, set reserves, and purchase reinsurance. Because of the unavailability of reinsurance, this approach—like self-insurance—does not address the risk of a catastrophic loss due to terrorism. Without reinsurance, a “pure” captive would not have sufficient reserves to pay for such a loss. This is less true of an “association” or “group” captive because it includes a larger pool of participants and is therefore likely to have greater reserves. However, the unavailability of reinsurance limits the ability of the association or group captive to cover very large losses, especially if more than one or two participants of the group incur such losses.

Captives are also complicated, expensive to organize, and may require a substantial capital commitment to meet reserve requirements.<sup>138</sup>

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133. See Leon I. Jacobson, *Self-Insurance Using Captives and Risk Retention Groups, and Purchasing Groups*, in *TECHNIQUES OF SELF-INSURANCE 1987: CORPORATE SURVIVAL IN A WORLD WITH INADEQUATE COMMERCIAL INSURANCE*, 439 PLI/Comm 389, 393 (1987); see also Carlton & Brooks, *supra* note 129, at 59–60.

134. See Jacobson, *supra* note 133, at 394.

135. See *id.*

136. See *id.* at 395.

137. See Carlton & Brooks, *supra* note 129, at 60. Another description of the benefits of captives can be seen in E. James Stergiou, *Self-Insurance/Captive Programs: A Layman's Description of their Benefits*, in *TECHNIQUES OF SELF INSURANCE*, 400 PLI/Comm 143 (1986).

138. See Carlton & Brooks, *supra* note 129 at 62. Another potential limitation is that the premiums paid to the captive may not be deductible as a business expense. See generally Stuart R. Singer, *When the Internal Revenue Service Abuses the System: Captive Insurance Companies and the Delusion of the Economic Family*, 10 VA. TAX. REV. 113 (1990); see also Joseph C. Safar, Comment, *When Federal Tax Law Frus-*

Because a captive is an insurance company, it must meet all applicable regulatory requirements.<sup>139</sup> Sometimes, however, the benefits will outweigh such costs.<sup>140</sup> Because captive insurers are active in providing insurance in other markets,<sup>141</sup> they could also be developed to provide coverage for terrorism risks.

### 3. RISK RETENTION GROUPS

One form of captive insurer authorized by federal law is known as a "risk retention group." The purpose of the federal statute authorizing risk retention groups is to simplify the regulatory requirements creating a captive insurer.<sup>142</sup> The law was first passed in 1981 and was known as the Property Liability Risk Retention Act.<sup>143</sup> It simplified regulatory requirements for a self-insurance pool intended to address product liability risks.<sup>144</sup> In 1986, the Risk Retention Act Amendments were passed.<sup>145</sup> These amendments broadened the Act to apply to most forms of commercial liability insurance.<sup>146</sup> The benefits of the Act are available for state and local governments, as well as their agencies and political subdivisions.<sup>147</sup>

A main difference between a risk retention group and other forms of captive insurers is that the risk retention group is regulated primarily by the state in which it is organized, whereas other forms of captive insurers are subject to regulation of every state in which they do business.<sup>148</sup> Simplified regulatory requirements make it much easier for risk

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*trates Policy: The Confused Rules Governing the Deductibility of Captive Insurance Premiums Defining Captive Insurance Companies*, 34 DUQ. L. REV. 105 (1995).

139. For a description of the regulatory issues, see Michael D. Brown, *Structuring and Operating a Captive Insurance Program: Regulatory Aspects*, in *TECHNIQUES OF SELF-INSURANCE*, 400 PLI/Comm 155 (1986). A more complete practical guide to setting up a captive insurer, see KATHRYN WESTOVER, *CAPTIVES AND THE MANAGEMENT OF RISK* (March 2002).

140. Carlton & Brooks identify a series of considerations that are helpful in evaluating whether the benefits of a captive insurer outweigh the costs. See Carlton & Brooks, *supra* note 129, at 62-63.

141. Pollution coverage is a good example. See generally Telego, *supra* note 129.

142. See Jacobson, *supra* note 133, at 393.

143. See Product Liability Risk Retention Act of 1981, Pub. L. No. 97-45, 95 Stat. 949 (codified as amended at 15 U.S.C. § 3901 (1986)) [hereinafter "the Act"].

144. See S. Stuart Soldate & Linda C. Johnson, *The Regulatory Background to the 1986 Amendments of the 1981 Risk Retention Act*, in *CURRENT PROBLEMS AND ISSUES IN LIABILITY INSURANCE*, 421 PLI/Comm 159, 162 (1987).

145. See Risk Retention Amendments of 1986, Pub. L. No. 99-563, 100 Stat. 3170 (1986).

146. Risk retention groups can offer "almost all forms of liability insurance except personal lines, workers' compensation, private passenger auto insurance and employee benefits." Jon Harkavy, *Risk Retention Amendments of 1986: An Analysis*, in *CURRENT PROBLEMS AND ISSUES IN LIABILITY INSURANCE*, 421 PLI/Comm 135, 145 (1987). See also Berry, *supra* note 132, at 8.

147. See 15 U.S.C. § 3901(a)(2)(ii) (2002). See also Berry, *supra* note 132, at 8.

148. See Jacobson, *supra* note 133, at 399. This benefit may be offset in some

retention groups to provide terrorism coverage, facilitate organization of risk retention groups, and reduce administrative costs. But, simplified regulatory requirements do not give risk retention groups any greater capacity to address terrorism risk. In other words, as with self-insurance and other captives, risk retention groups do not transfer the risk to a significantly larger pool of participants. In the case of most of the insurance provided by risk retention groups, if reinsurance were available, it would increase the capacity of the groups to bear catastrophic risks. However, because reinsurance is not currently available, the ability of risk retention groups to address terrorism risk is diminished greatly and is not much different from other forms of captive insurers.

#### 4. CATASTROPHE BONDS

In addition to the methods of alternative risk financing discussed above, several other innovations are being developed under the rubric of “securitization of risk.”<sup>149</sup> The method that seems to offer the most promise for managing terrorism risk is the catastrophe bond.<sup>150</sup> Properly drafted, a catastrophe bond would specify a contingency such as a terrorist attack on a particular location. If that contingency occurs during the life of the bond, the holder would sacrifice the principal and remaining interest. If the contingency does not occur, the principal would be returned to the holder, along with periodic interest payments.<sup>151</sup>

The primary benefit of catastrophe bonds is that such bonds directly respond to the unwillingness of reinsurers to cover terrorism risk. By selling bonds to thousands of investors, the risk can be spread through a larger pool than that available through the other alternative risk financing mechanisms. Catastrophe bonds have the additional benefit of letting investors set the amount of their exposure by controlling how many bonds they buy. While one or more reinsurers may be unwilling to take on multi-million dollar risks, there may be thousands or even millions of investors who might be willing to undertake a smaller dollar amount of risk in exchange for a reasonable rate of return.<sup>152</sup> Moreover,

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instances by the fact that risk retention groups must be set up in the United States, while captives can be set up outside the United States (“off-shore”). *See id.* at 399–401. For an analysis of differences between domestic and off-shore captives, see Leon I. Jacobson, *Domestic and Off-Shore Captives*, in *TECHNIQUES OF SELF-INSURANCE*, 400 PLI/Comm 87 (1986).

149. For a theoretical discussion of these innovations, see Neil A. Doherty, *Innovations in Managing Catastrophic Risk*, 64 *J. RISK & INS.* 713 (1997).

150. Professor Hal R. Varian, an economist at the University of California, Berkeley, suggested that catastrophe bonds could fill the gap left by the retreat of reinsurers. *See* Hal R. Varian, *Catastrophe Bonds Could Fill Gaps in Reinsurance*, *N.Y. TIMES*, Oct. 25, 2001, at C2.

151. *Id.* This method of managing risk has been used in developing various financial derivative instruments. *See id.*

152. The rate of return on these bonds would be set by the market, *see id.*, and

individual investors may be willing to invest in catastrophe bonds as a show of patriotism in support for the fight against terrorism.<sup>153</sup>

The primary disadvantage to catastrophe bonds is that they are new and untested. Because of these challenges, as well as uncertainties regarding the rate of return,<sup>154</sup> it will be hard to estimate the costs associated with managing terrorism risk in this way. On the other hand, municipalities certainly have experience with bonds and have access to a well-developed bond market. In addition, municipalities may be able to designate the bonds as tax exempt, which could provide an additional inducement for investors to buy such bonds.<sup>155</sup> If the insurance coverage for terrorist losses continues to be unavailable in the long run, catastrophe bonds could be the best way for cities to manage that risk.

#### IV. Conclusion

The risk of losses caused by terrorism will never be viewed in the same way after the September 11 attack. Insurers will be much more cautious about covering terrorism losses and will probably never again offer terrorism coverage for free. Although insurance prices have risen and terrorism insurance is not widely available, the precise long-term affect on cities is still uncertain. There are some signs that insurers are beginning to offer coverage for terrorism risks, although this time for a price. In addition, it is likely that the federal government will adopt some form of federal backstop for insurance with the objective of encouraging insurers to return to the private market for terrorism insurance. Thus, it is possible that, with time, the high prices and limited access to terrorism insurance will simply be remembered as part of an ongoing cycle of insurance.

On the other hand, the size and uncertainty of terrorism losses, if combined with an absence of a federal backstop or one that is viewed as inadequate by the insurance industry, may substantially diminish the availability of affordable forms of private insurance. As a result, mu-

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presumably would take into account the rates of return available for other investments as well as the perceived risk of terrorist losses.

153. Historically, people invested in war bonds as a show of patriotism. See, e.g., Lawrence R. Samuel, *Dreaming in Black and White: African-American Patriotism and World War II Bonds*, in *BONDS OF AFFECTION: AMERICANS DEFINE THEIR PATRIOTISM* 191 (John Bodnar ed., 1996).

154. See *id.*

155. A somewhat similar approach to financing environmental programs, known as the "Better American Bonds Program," has been authorized. For a discussion and criticism of this approach, see Robert A. Fisher, Comment, *Better America Bonds: Better is in the Eye of the Beholder*, 25 WM. & MARY ENVTL. L. & POL'Y REV. 233 (2000).

nicipalities may want to encourage the federal government to provide an effective federal backstop. If the private market for terrorism insurance does not develop affordable coverage, cities must look for alternative ways to manage terrorism risk.

Although legislative solutions might provide an effective alternative, it seems unlikely that the political environment will permit the development of additional governmental insurance programs. Judicial solutions can provide some assistance, but are not likely to be of much help beyond limiting the scope of terrorism exclusions at the margins. Alternatives to third-party insurance offer perhaps the most promising solutions, but self-insurance, captives, and risk retention groups will provide only modest protection unless reinsurance becomes available. If reinsurance becomes available, traditional insurance also is likely to be available, which would make these alternatives unnecessary.

The most promising alternative, if affordable terrorism coverage does not become generally available to municipalities, is catastrophe bonds. This is the only alternative that directly addresses the unavailability of reinsurance by providing a broader financial mechanism for the pooling of risk. In addition, bonds may be particularly appealing to cities because of their experience with bond financing, the ready market for municipal bonds, and the possibility of providing tax-based incentives for consumers to purchase such bonds.

The September 11 attack permanently changed the insurance industry's approach to terrorism risk. Cities are directly and indirectly impacted by these changes. At a minimum, insurance covering terrorism risk will become harder to find and more expensive. At the other extreme, affordable terrorism insurance may simply be unavailable to municipalities. If that happens, municipalities should look for means other than traditional insurance to manage terrorism risk, including legislation, judicial rules of interpretation, and alternative risk financing.