

EXCLUSIONS FOR WAR AND TERRORISM: WHO WILL PAY FOR MAN-MADE CATASTROPHES?

Former presidential candidate Ross Perot would have described it as a large sucking sound, the collective gasp that insurance consumer counsel all around the United States made when they watched George Bush announce on TV that the World Trade Center attacks were “an act of war.” A presidential declaration of war could have the legal import of subjecting tens of thousands of personal and commercial insurance claims that would arise from the September catastrophe to the “act-of-war exclusions” that typically dot most insurance policies.

The magnitude of the loss of lives and property was surreal: The destruction of four jetliners and the killing of all their crews and passengers, the collapse of one of the largest pieces of commercial real estate in the world and damage to the surrounding buildings, partial destruction of the Pentagon, the death of thousands of workers in and around the buildings, the loss of lives of hundreds of emergency response personnel, destruction of thousands of vehicles and loss of that great mass of office systems, equipment, furniture, files, and personal belongings that filled the hundreds of business offices that disappeared into rubble and, finally, the endless ripples of business interruption for those companies.

This is a nation whose people, businesses, and industries insure against catastrophe, and it was immediately clear that the ability to cope with the financial loss was going to involve massive insurance claims. In an eerie prediction of the future, an insurance industry analyst in 1999 had made a rough calculation of the life insurance loss if 5,500 people died from *an act of terrorism* in the downtown core of a U.S. city. Assuming a conservative \$100,000 average life insurance per worker, the cost of life insurance benefits alone in such a catastrophe would be \$550,000,000.¹ Remarkably, almost 5,000 people subsequently died in the September 11 attacks. Most of those killed were adults acting in the course and scope of employment, which **may** result in thousands of compensable workers compensation claims for surviving dependents. An unknown number of injured will file work comp claims for medical and disability benefits. The World Trade Center had just been leased to a real estate investment trust under a 3.2 billion 99-year lease agreement. The German reinsurance firm, Hanover Re, said the WTC was insured for \$4 billion in property damage and \$400 million for business interruption. Business loss for the companies in the towers and area affected by the bombing is incalculable. After the 1993 WTC bombing, New York City officials estimated company and government losses at \$692 million per week if the World Trade Center were closed.²

Initially, several insurance companies cited President Bush’s declaration that the jetliner attacks constituted “an act of war” and indicated an intention to invoke the act-of-war exclusions common in the policies. Cox Insurance in Britain, which insured part of the World Trade Center, said it might try to reject claims on policies where the acts of war were specifically excluded citing insurer based in Bahrain, noted tersely that the act-of-war exclusions issue “adds another legal dimension to the insurance aspect of this catastrophe.”

However, within days, the insurance industry was making clear its election not to assert the war risk exclusions. Metropolitan Life quickly said it would pay \$300 million in death benefits for survivors of the WTC attacks. Chubb Corporation issued a news release saying that the act-of-war exclusions would not apply. Hartford Financial Services Group, Inc. concurred and said it had already begun paying out claims. The major insurance trade organizations predicted their members would not try to use the defense. A spokesman for the American Council of Life Insurers said, “It’s not an issue.”

The insurers recognized three realities that prompted their readiness to honor claims in spite of the magnitude of the losses. First, with the exception of aviation policies, their policy exclusions were for “acts-of-war” and not for terrorism. Second, existing case law had construed the war risk clauses to mean actions between sovereign nations. Third, and perhaps most importantly, the carriers recognized that any attempt to stand behind the exclusions in the face of the intense national emotion arising out of the attacks would be a colossal public relations disaster. As the Director of Insurance with the Consumer Federation of America said, “It would be very hard for a company to do that [assert the war exclusion] even if they’re right.”

Nevertheless, one analyst speaking on National Public Radio thought it realistic that, out of the public eye, reinsurers might assert the act-of-war exclusions against the primary carriers. While the reinsurers accept premiums to guard front line carriers against financial catastrophes, they apparently were not planning on a game where the stakes were so high. Germany’s Munich reinsurance estimated its liabilities from the bombings at up to \$903 million, Swiss Re at \$730 million and Zurich Financial at \$400 million. The CEO of Carvill America, Inc., a reinsurance broker in Norwalk, Connecticut, predicted that claims of the policyholders would be honored but that the industry would then engage in wrangling over which insurers would be liable for those claims.

It is axiomatic that if the insurers are forced to pay enormous claims as a result of the bombings they themselves will become plaintiffs in subrogation claims against economically viable sources who they believe should have been able to prevent the losses. As one writer says, insurance companies have the resources to be powerful plaintiffs.³ Insurers for the defendants in the subrogation claims who are faced with providing defense or indemnity of these large claims may have more incentive and less public relations risk in asserting war risk exclusions of coverage.

According to the Insurance Information Institute, the attacks on the World Trade Center in New York on September 11, 2001 will ultimately be the most costly man-made or natural catastrophe in U.S. history. The 1993 bombing of the World Trade Center caused losses of \$510 million, the Los Angeles riots of 1992, \$775 million, and the Oklahoma City bombing \$125 million. It is also notable that the World Trade Center bombing in 1993 resulted in 174 lawsuits seeking a total of \$1.9 billion.

Natural disasters such as the Northridge Earthquake in Southern California which caused \$16 billion in insured losses, and Hurricane Andrew in 1992 at \$15.5 billion, pale in comparison to the September 11 World Trade Center attack which is expected to tally insured losses of between \$30 billion and \$70 billion. Montana's Insurance Commissioner, John Morrison, related the estimated \$30 to \$70 billion WTC losses to the world insurance industry's total supply of money of \$300 billion and concluded that the claims may amount to a fifth or sixth of that supply, a situation that will surely cause rates to increase.⁴ Insurance ratings analysts predicted that liability of the property carriers would be modest but that risk to the workers compensation and business interruption insurers was virtually unlimited in terms of number of claims. Life insurance, commercial general liability insurance, commercial property insurance, homeowners insurance, auto insurance, and workers compensation insurance will all play major parts in covering the losses of September 11.

Prevalence of the Exclusions

The Insurance Services Office, Inc. in New York, trade organization for the property/casualty insurance industry, drafts the forms for the industry. The ISO forms contain broad exclusions that the insurer will "not pay for loss or damage caused directly or indirectly by war and military action." The exclusions include undeclared civil wars and "warlike action by a military force," as well as insurrection, rebellion or revolution. Consequently, all standard property and liability policies, including homeowners and auto policies, include war risk exclusions. However, as a general rule, workers compensation coverage does not exclude injury due to war.⁵

During the Vietnamese War, many life insurance policies contained war risk exclusions.⁶ Now, however, the American Council of Life Insurers, the main life insurance trade group, asserts that the life insurers stopped using war exclusions in their policies in the 1970s. This is likely the reason why insurers like Metropolitan Life and Northwestern Mutual Life were able to announce quickly that they would pay claims knowing that few persons in the WTC work force would have been old enough to have pre-Vietnam era life insurance policies.

Because insurance had its birth in the maritime industry and because maritime shipping has throughout history been a target in wars, the war risk exclusion is most prevalent, explicit and interpreted by courts in maritime policies.⁷ In those policies, these exclusions are called "Free of Capture and Seizure" or "F.C.S." clauses.⁸ Interestingly, none of the F.C.S. exclusions covers piracy⁹, which may be viewed more as an act of theft than a warlike gesture.

The War Risk Exclusions

War risk exclusions generally bar coverage for damages resulting from "war, invasion, civil war, revolution, insurrection or warlike operations, whether there be a declaration of war or not."¹⁰ Most property insurance policies include act-of-war clauses in their exclusions. The exclusion will commonly provide as follows:

We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss.

* * *

War and Military Action

- 1 War, including undeclared or civil war;
- 2 Warlike action by a military force, including action in hindering or defending against an actual or expected attack, by any government, sovereign or other authority using military personnel or other agents; or
- 3 insurrection, rebellion, revolution, usurped power or action taken by governmental authority in hindering or defending against any of these.

Court Construction of the Act-of-War Exclusions

The inventiveness of mankind in designing violent solutions to political problems requires the courts to examine coordinated violence to determine if it constitutes an "act of war." As one author said:¹¹

Hostilities between nations and civil wars are not always conducted on a formal basis and often have no precise temporal or spatial boundaries. Despite several centuries of experience with war exclusions and the best (and sometimes less than the best) drafting efforts, questions of whether or not a loss is covered by a "war exclusion" are still being brought to the courts for settlement.

The essential question is whether attacks such as September 11 are acts of war within the meaning of the exclusions. As a general rule, the courts have been finding acts of terrorism not to be acts of war under the exclusion. For example, a case with striking similarities to events of September 11 is the 1974 case of *Pan American World Airways, Inc. v. Aetna Casualty & Surety Co.*,¹² from the Second Circuit. On September 6, 1970, the Popular Front for the Liberation of Palestine hijacked a Pan Am jetliner departing Amsterdam for New York. Over London, they diverted the plane to Beirut where they landed for fuel and took on a demolitions expert. They flew the plane to Cairo where they evacuated the passengers and totally destroyed the airplane by explosion causing a loss of over \$24 million. On the same day, the PFLP hijacked a TWA airliner departing Frankfurt and a Swissair jet leaving Zurich, while being foiled in an attempt to hijack an El Al airliner. The TWA and Swissair planes were both flown to a Jordanian airfield and destroyed by explosives while surrounded by Jordanian troops.

The insurers who carried “all risk” policies on the Pan Am plane sought to avoid coverage by reason of the act-of-war exclusion. The court, in its review, compared the burdens of the parties pointing out that the insurers needed to prove that the proximate cause of the loss fell within their exclusion, while the exclusion would be given the interpretation most beneficial to the insured. The court asserted that the insured, Pan Am, under the all risk policy, needed only to show the existence of the policies and the loss of the covered property. Also, the court noted that the exclusion was ambiguous with regard to political hijackings and that the carriers, in light of the 200 airline hijackings that had occurred in the previous ten years, (eight of which involved Pan Am planes), knew of the ambiguity but did not change it.

The court held that a “war” required the engagement of sovereign or quasi-sovereign nations and that an “insurrection” must involve an intent to overthrow a lawfully constituted regime. Consequently, it held that the policies did not exclude coverage of losses related to political hijacking; that the loss was not due to destruction by military or usurped power and was not due to war, warlike operations, insurrection, civil commotion, or riot within the exclusion clauses of the policies. The court found the hijackings and destruction of the aircraft to be for propaganda purposes and not for overthrow of the governments involved in ownership of the aircraft or their airports involved with departure or landing. Neither was the PFLP a sovereign that could engage in a “war.”

In *Holiday Inns Inc. v. Aetna Insurance Co.*,¹³ (S.D.N.Y., 1983) the insurers were trying to avoid paying for the loss of the Beirut Holiday Inn. The Hotel, which opened in 1974, became a focal point for factional fighting in the Kandari district of West Beirut in 1975 and 1976. An amazing array of political parties, front groups, commando groups, militia groups, and other organizations caused the hotel to change hands numerous times in armed fighting which apparently rendered it unfit for a Best Western designation and resulted in a claim for its loss.

The exclusion in the Holiday Inns policy provided:

2. This insurance does not cover:

a.) Loss or damage caused by any of the perils hereby insured against, if such loss or damage either in origin or extent is directly or indirectly, proximately or remotely, occasioned by or contributed to by any of the following occurrences, or either in origin or extent, directly or indirectly, proximately or remotely, arises out of or in connection with any such occurrences, namely: “War, invasion, act of foreign enemy, hostilities or warlike operations (whether war be declared or not) civil war, mutiny, insurrection, revolution, conspiracy, military or usurped power.”

The court in *Holiday Inn* adopted the definition of “insurrection” from the *Pan Am* case and held that an insurrection must be preparatory to a civil war. However, the court found that the parties were fighting for control of the district and that none was trying to overthrow the Lebanese government, not even the Palestinian and Syrian forces involved.

It is against this background that the courts today would decide whether the attacks of September 11 were “acts-of-war.” While bin Laden’s organization certainly advocates the overthrow of governments unfriendly to fundamentalist Muslim governments and even Muslim governments that are too moderate, his organization is unlikely to be found to be a “sovereign” so as to be engaged in a war. Though the events of September 11 far exceed in death and damages those of the *Pan Am* case in 1970, the WTC attacks could still be viewed as undertaken for purposes of propaganda and not the overthrow of Holiday Inn in the United States. The *Pan Am* and cases holding that war must occur between sovereigns and that insurrection must necessarily be aimed at overthrow of the government likely persuaded the WTC insurers not to stand on the acts-of-war exclusions. Admittedly, there are substantial cases in favor of the insurers on this issue. In at least seven cases, courts have enforced the war and insurrection exclusions.¹⁴ However, in each of the seven cases, the property subject to the exclusion was damaged during wars or insurrections by groups expressly attempting to overthrow existing governments.¹⁵

The insured in the case of a terrorism loss will likely not have a difficult time meeting the burden of showing that the loss falls within the coverage of the basic insuring agreement. The property/casualty policies use broad insuring agreements followed, especially in the case of commercial general liability policies, by a long list of exclusions. In terrorism cases, it becomes incumbent on the insurer to prove that the claim falls within the war risk exclusion. The insurer’s burden is made more difficult because the insurance contract is a contract of adhesion. Consequently, courts likely will construe an ambiguous

war risk exclusion against the insurer and in favor of the insured. Finally, as a matter of social policy, courts typically construe an insurance exclusion narrowly in favor of coverage.

The Specter of Terrorism Exclusions

With the exception of aviation insurance, American insurance companies have not used terrorism exclusions in their policies. It was apparently clear to the insurers that the war risk exclusions as previously interpreted in such cases as *Pan Am* and *Holiday Inn* would not protect them from the claims arising from the September 11 attacks. Nevertheless, it is equally clear that the industry will take no chance of suffering similar losses in the future. Hence, they will follow the lead of the carriers in Britain and the continent who use terrorism exclusions tailored to acts of political terrorism and hijacking that cannot be interpreted to apply only to acts of sovereigns or acts designed to overthrow government.

Such terrorism exclusions would have profound implications for commercial insureds who want to protect their property from the heightened risks posed by modern terrorism especially risks involved in transportation and energy. Inability to insure against loss by terrorism could stifle or even freeze some components of the economy. Could one operate trains, busses, or commercial aircraft without coverage for losses from terrorism? Could a group build a skyscraper, amusement park, or athletic stadium without such coverage? Would banks lend to build such projects if their mortgagees' interest were not insured against such losses? Should the regulators, the National Association of Insurance Commissioners, forbid terrorism exclusions? Would the industry refuse to insure without the exclusions?

It is easy to be critical of the industry for refusing to cover that which is such a visible and important risk. After all, isn't that the purpose of insurance? In the insurers defense, one of the principles of insurance underwriting is that the insurer should only underwrite those losses that can be calculated both in terms of frequency and magnitude of loss. State Farm actuaries can tell with reasonable certainty how many of their insureds will be in auto accidents and how much they will pay in indemnity benefits next year. They can even predict with actuarial reliability how many earthquakes they will pay out on in a given 100-year period. But no insurer can predict what will constitute next year's terrorism, either in character, frequency, magnitude, or geographic location. That is why providing war risk insurance where terrorism is likely is so expensive. Following the invasion of Kuwait, the war risk insurance premium for a single flight to the Saudi Arabian capital of Riyadh was \$162,500.¹⁶ A flight to Tel Aviv Israel was \$65,000, and a KLM stop at Oman cost an additional premium of \$57,700.¹⁷ Such premiums to cover terrorism added anywhere from \$100 to \$1,000 cost per passenger. Worse, the coverage term was per flight for aviation and on a 24-hour basis for marine hulls.¹⁸ It was the insurers way of saying we can't predict or underwrite the risk.

Insuring the Insurers Against Terrorism

A struggle with economic, political, social ramifications is in progress now over the core question of how we should best spread the losses from acts of terrorism. The industry's immediate move was to ask Congress to cover 100% of the cost of insuring terrorism. The Bush administration countered with a proposal that the taxpayers would shoulder the first 80% of the cost of terrorism leaving the rest to industry. Both proposals beg the question of why government (read taxpayers) should be the first payor. Why not let government be the ultimate reinsurer and let the insurers cover the underlying risk in layers. The British government formed "Pool Re" the "reinsurer of last resort" which provides coverage beyond the exclusions of the private insurers.¹⁹ The British system provides five layers of coverage with the government covering after the private layers are exhausted.²⁰

It is not unusual for government to act as reinsurer of wartime risks. Encouraging private marine and aviation transport in time of war requires that government take the ultimate catastrophic risks. This often leaves private insurers to "cherry pick," that is to collect premiums where the losses are capped. Hence, the old saying that war is good for insurance companies.

Covering the Consumer for Loss from Terrorism

How will the consumer ultimately be protected from risk of terrorism? It is too early to tell, and there is a staring contest going on between regulators and the industry to see who blinks first. Insurers are threatening to exclude coverage for terrorist acts, which would bring disarray to whole areas of the economy. When Florida planned to ban terrorism exclusions, the insurers made clear their intention to refuse insurance for Disney World. Congress, on the other hand, doesn't want to shoulder the entire risk of terrorism. If Congress doesn't blink and terrorism exclusions become the norm, entities in the economy whose terrorism risk demand protection will ultimately have to buy insurance in the form of waivers of the exclusion by endorsement or by separate terrorism coverage just as entities now buy war risk coverage. One can guess that coverage might be minimal, premiums expensive, and policy terms very short. On the other hand, if Congress were to agree to be the primary insurer for the first 80% of risk, terrorism exclusions may not appear in American policies. So long as the loss did not fall under the act-of-war exclusions, consumers would still be protected from loss by acts of political terrorism.

Conclusion

The coordinated attacks on the WTC and Pentagon on September 11 revealed that losses from an act of terrorism could rival those of acts of war and threaten the financial viability of the insurers that make American enterprise possible. The insurers agree that they will survive this loss but will not take the chance on another of the same or greater magnitude. The risk of loss from terrorist acts must be spread across American society somehow. The loss can be spread in the form of premiums in the pool of insureds, primarily those purchasing property, casualty, and workers' compensation insurance. If that happens, there will be steep increases in premiums in some lines as insureds are forced by terrorism exclusions to buy endorsements or policies that provide terrorism coverage. Alternatively, the loss can be spread to the pool of American taxpayers in the form of additional taxes required to allow the government to underwrite all or a major part of the risk of terrorism. There is great urgency in developing the American structure for dealing with terrorism losses through insurance, and one can expect to see the plan formed in the next few months as Congress, the insurers, and the White House negotiate.

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 6. Andrew J. Nocas, *Are You Covered When We're at War? Are You Sure?*, 20 Sum Brief 10 (1991).
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 8. Id.
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 10. Orin, note 2 above.
 11. Nocas, above, at 13-14.
 12. 505 F.2d 989.
 13. 571 F.Supp. 1460.
 14. See, Michael Foran, *Do War Risk Exclusions Really Exclude Coverage*, 11 No. 42 Andrews Ins. Coverage Litig. Rep. 935 (Sept. 21, 2001) for collection of cases and citations.
 15. Id.
 16. Nocas, above, at 41.
 17. Id.
 18. Id.
 19. Reynolds, above, at 202.
 20. Id.