Terrorism Insurance Coverage

By Mary McKenna, Suzanne M. Avena, and Alexandra E. Fercovich

This Client Alert summarizes the present state of facts pertaining to terrorism insurance and changes in the availability of such coverage post-September 11, 2001. It is based on a review of current articles and conversations with various industry representatives. We caution, however, that this issue is highly dynamic – new discussions of the topic appear daily in various media – and that most conclusions remain speculative. Insurers, lenders and property owners that we spoke with were reluctant to set or state definitive policies regarding this issue.

Statement of the Issue

Prior to the terrorist attacks on September 11, 2001, insurance coverage for terrorism losses was included as a standard feature of insurance contracts in the United States, primarily because experience had suggested that the risk of domestic exposure to terrorism was remote. As a result of the tragedy at the World Trade Center, the insurance industry has been forced to reexamine its existing policies for commercial property and to consider changes to insurance policies going forward. Although regulators in New York and certain other states have required primary insurers to pay terrorism claims for damages under policies currently in force, regulators and insurance companies anticipate new coverage restrictions for terrorist damage in future property and casualty policies. According to Terri Vaughn, President of the National Association of Insurance Commissioners (NAIC), “With the inaction by Congress, state regulators will begin allowing insurers to exclude terrorism losses if a terrorist act causes insured losses exceeding $25 million.”1 In the event stand-alone terrorism coverage is made available to fill this anticipated exclusion, it may be unaffordable or commercially impractical for many property owners to purchase. For example, the General Accounting Office (“GAO”), the investigative arm of Congress, recently issued a report that cited a number of examples nationwide where unidentified commercial property owners were unable to get full or partial terrorism coverage or were unwilling to pay insurers’ high premiums.2

The diminution of available coverage for terrorist acts is causing widespread concern to major players in the commercial real estate market. Insurance brokers and industry analysts have noted that without adequate insurance, difficulties may arise with respect to acquiring and operating properties, refinancing loans, and selling commercial asset-backed securities. The lack of insurance coverage provides complications in the Commercial Mortgage Backed Securities (CMBS) market, since bond covenants usually require a certain minimum level of coverage.3 In addition, commercial property owners may have limited or no access to new financing. “Either they won’t get a loan or the bank assuming the risk will add many basis points and/or fees to the lending rate,” predicts Robert Hartwig, chief economist at the New York-based Insurance Information Institute.4 The elimination of terrorism coverage from policies could have even broader implications for other industries such as construction, transportation, hospitality, and recreation, which depend on financing from the lending community.

Proposals for Federal Subsidies to Reinsurers

To cover losses of the potential magnitude of terrorist incidents, primary
insurers typically look to their treaties with reinsurers to make them whole from such a potentially significant depletion of reserves. However, reinsurers have warned that they will no longer insure against terrorist attacks on commercial properties, effective January 1, 2002. “Not having a government backup for major terrorist attacks now is like saying you don’t need an army until war has been declared,” said Maurice R. Greenberg, chief executive of AIG. “The industry has limited capacity. So while there is some coverage being offered, the reality is that it’s not very much in relation to the potential need.”

As a result, the reinsurance industry as well as primary insurers have begun lobbying the government for a federally-backed reinsurance pool for terrorism coverage. Their proposal suggests the creation of two separate insurance pools. One pool would function as a privately run and financed reinsurance pool, to be named the Homeland Security Mutual Reinsurance Co. The second pool would be state-chartered and purchase reinsurance from the U.S. government, in a manner similar to the operation of the United Kingdom’s Pool Reinsurance Co. Ltd. Primary insurers would retain 5% of the risk of terrorism under each policy, with the remaining 95% exposure to Homeland, which would in turn purchase reinsurance from the Treasury Department. Homeland would not pay taxes or start paying premiums to the federal government until its net assets had reached $10 billion; policyholders would pay surcharges to finance the coverage.

Since the various carriers have heretofore each defined acts of “terrorism” differently, the proposal calls for promulgation of a uniform definition of “terrorism” for all insurance and reinsurance policies sold in the United States. The Treasury Department would be responsible for determining whether an act of terrorism had occurred for purposes of the reinsurance program.

Although Congress did not take official action on the reinsurance proposal before the close of the 2001 legislative session, strides have been made in related areas. For example, the U.S. House of Representatives passed the Terrorism Risk Protection Act whereby the federal government would cover a large portion of damages in the event of another terrorist attack and insurers would be allowed to repay the government over time.

Under this new legislation, the trigger level for federal coverage would be $100 million in losses, with a lower threshold for small insurance companies. If an insurer suffered losses in excess of $100 million, the federal government would cover 90 percent of losses above the threshold, leaving the insurer responsible for the remaining 10 percent. This legislation is now before the Senate for consideration. There are alternative proposals before Congress as well. However, to date no official action has been taken on any of them. Industry commentators note that the challenge lies in formulating a plan responding to the terrorism insurance issue that passes minimal cost on to taxpayers, provides policyholders with continuity of coverage and reasonable premiums, and allows the market to play a role so insurers can earn a profit.

Stand-Alone Terrorism Coverage Now Available

AIG and Lloyds of London have issued stand-alone terrorism policies for U.S. companies for a cost of approximately 10% “on-line,” or $1 million per $10 million limit of liability coverage. Underwriting concerns include the location and number of properties, whether or not the property is a stand-alone silo (i.e., single tower) or is part of a portfolio of properties, whether a property is a “signature” building such as the Chrysler building, the market size or overall exposure of the carrier to terrorism losses from its client base, geographic distinctions, whether the property poses a credit or hazard risk, what type of tenants occupy the building, the loan-to-value ratio, what is affordable for the property owner, and existing security programs in the insured’s building.

However, property owners interested in purchasing stand-alone coverage either to fill an imposed sub-limit or exclusion or to augment coverage going forward are warned that they should act quickly. Both AIG and Lloyds are limiting the capacity they will issue to an insured’s single property or portfolio of properties in New York City to $25-$50 million. Insurance representatives have observed that insurers have begun tracking coverage issued to commercial properties by zip code and that there may soon be an “aggregation” limit on available new coverage. In other words, if a developer’s properties are all in the same general location or if the underwriter has already issued coverage to a number of other properties in the same area, particularly on the East Side and in Midtown, the insured may soon encounter difficulty buying stand-alone terrorism coverage. Moreover, one Marsh & McLennan representative has noted that, in the case of institutional lenders, terrorism coverage may not be excluded for each property, but insurers may apply a basket limit to the entire portfolio.

In addition to AIG Life, Lloyds of London, and a few Japanese markets, two other domestic carriers are issuing terrorism coverage. Berkshire Hathaway, through its re-insurance company General Re, is writing policies on single, very high-profile properties (i.e., Sears Tower, Empire State Building) for very high premiums. However, the longevity of the capaci-
ty of this carrier may be deliberately limited. Marsh & McLennan is also entering the scene. As of December 1, 2001, it formed a new carrier called Axis Specialty, a Bermuda-based firm with $1.6 billion capitalization. Axis will write up to $50-$75 million stand-alone terrorism coverage for an insured as either a primary, excess, or Difference in Coverage (DIC) policy. In addition, many corporations are speaking with consultants about setting up their own insurance companies.

New policies will need to be examined by competent counsel, risk managers, and other insurance experts, to ascertain exactly what damages will be covered in the event of a claim. For example, Peter Farnam, property insurance broker at Thomas E. Sears, Inc., has noted that the various terrorism exclusions recently drafted by AIG, Factory Mutual, and certain London markets include terrorism along with the traditional Acts of War exclusion. Yet the new stand-alone policies offer coverage for terrorist acts only, thereby rendering the expensive coverage useless if the particular terrorist incident suffered was perpetrated in conjunction with an Act of War, as determined by the insurer. However, Mr. Farnam predicts that, because of the disparity among carriers in their respective definitions of “terrorism” and the ambiguous wording of various exclusions as currently drafted, courts would likely be loath to enforce such overly broad and confusing exclusions against policy holders. It is advisable that each client consult its insurance broker or provider for a more detailed analysis of coverage.

Response from Lenders

The federal deadlock regarding terrorism insurance has already contributed to instability in the loan market. The new insurance environment has lenders wondering if they will become de facto insurers with the increased risk involved with originating loans on uninsured properties. “Suppose there’s an attack on a building we insure,” said one lender. “We’re first in line to take the hit.”

Insurance brokers speculate that property owners could be in breach of the insurance provisions in their existing mortgages. One broker, Aon, has reported on more than one occasion that some lenders have already sent default notices to their borrowers. However, Marsh’s Managing Director in the Real Estate Group, Andrew Loughrane, believes that defaults are not commonplace, and foreclosure is not an issue to date. As a practical matter, a mortgage event of default based on a lack of terrorism coverage may be difficult to establish under an existing policy, given the broad language found in the insurance provisions of most mortgages to date.

Recent events involving the Mall of America in Minnesota, to which the GAO’s report alluded as an example of a loan bedeviled by difficulties relating to terrorism coverage, have offered a timely illustration of how such an allegation of default might play out, as well as highlighting the difficulties that loan servicers may encounter with regard to the insurance quandary. Apparently, when the owner of the property was unable to procure terrorism coverage as part of a new policy it purchased at the end of 2001, the servicer of the securitized mortgage loan encumbering the mall objected to the policy’s terrorism exclusion and took the position that it violated the provision of the mortgage requiring “all-risk” casualty insurance. The servicer advanced funds to purchase a $100 million stand-alone terrorism policy itself, then demanded repayment of the $750,000 premium from the mortgagor. The mortgagor objected, did not pay, and went on to obtain a restraining order against the servicer, issued by the local Federal district court. The progress of these proceedings will be keenly followed by members of the real estate and financial industries and their counsel.

For now, lenders are continuing to originate small to medium-size loans, underwriting for higher insurance costs. However, borrowers are having difficulty finding lenders to write large mortgages. Potential mortgagees are screening the location and size of buildings and in some cases refusing to lend on trophy properties that are not fully insured. Others will lend on uninsured properties, but only if the providers own recourse, thus increasing the financial risk of the borrower. A Marsh representative reports that one lender has issued specific requirements for terrorism coverage in its mortgage provisions, with the caveat that the insurance be “commercially obtainable,” while, according to a recent New York Times article, others are simply requiring borrowers to make “reasonable efforts” to obtain terrorism coverage.

Another major financing source has adopted the position that it will not close on a loan greater than $25 million unless terrorism insurance coverage is in place. For loans of less than $25 million, this lender would require terrorism coverage if it is available at commercially reasonable rates. In the event terrorism coverage lapses on a property, the mortgagor would reexamine the loan documents. If it determines that the absence of terrorism coverage constitutes an event of default, it will attempt to renegotiate the terms of the loan and raise fees accordingly.

Conclusion

Without government intervention, the state of the insurance industry with respect to terrorism insurance coverage remains unpredictable. Although terrorism coverage is currently avail-
able, it is being offered for high premiums with limited overall coverage. It remains to be seen whether – and when – market forces will eventually stabilize the situation.

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4 Banham, Russ, “Terrorism Insurance: Pray As You Go,” CFO.com, p. 1 (Feb. 4, 2002), available at http://www.cfo.com. The American Bankers Association confirms the uneasiness of banks. “The issue for banks is simple: weighing the probability they will get paid back,” says James Chessen, the ABA’s chief economist in Washington D.C. “Anything that adds to the risk of not getting paid is something to consider. The existence of insurance generally is a very important consideration. And certainly terrorism insurance, or the lack thereof, is an element of that.” Id at p. 3.


6 Proponents of government intervention are eagerly awaiting federal action. Nelson Rising, chairman of the Real Estate Roundtable has stated that, while federal protection of insurers against catastrophic losses might never be used, it would give insurers confidence to offer the coverage at affordable prices. “By not taking action in advance,” Rising argues, “you run the risk of destabilizing the economy.” “Rethinking Dire Warnings,” New York Times, at p. C-10 (Feb. 27, 2002). See also The Real Estate Roundtable, “Insurance Gap Hurting Real Estate, GAO Says; Greenspan Backs Federal Action,” NEILfax (Mar. 1, 2002).


9 Hitherto, mortgage provisions regarding casualty insurance have contained fairly general language regarding the required coverage, typically mandating “all risk” insurance policies, which cover the risk of physical loss or damage from an external cause, subject to standard exclusions which now encompass terrorist acts in most states. Most commercial mortgages also include some language allowing the lender to require insurance against otherwise unspecified risks if it is “reasonable” and “customary.”


11 Id.

12 According to one insurance consultant whose clients have included many major lenders, some of them are now requiring personal or corporate terrorism indemnities. Whether the lenders should ultimately accept such indemnities is being reviewed by their respective governing bodies. Query whether this type of indemnity will become customary, since it would effectively constitute a personal guaranty of the debt in the event of major damage from a terrorist attack.


14 But see the discussion above regarding the potential difficulties faced by a lender or servicer in substantiating an event of default based on terrorism exclusions or obtaining reimbursement from the mortgagor for a protective advance to procure the coverage at substantial cost.