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# THE NEED FOR A LONG-TERM FEDERAL BACKSTOP IN THE TERRORISM INSURANCE MARKET\*

## INTRODUCTION

April 30, 2008 arrives as a clear, beautiful day across the U.S. Suddenly, Americans' lives forever change as the U.S. is confronted by its second coordinated terrorist attack.<sup>1</sup> Terrorists detonate multiple bombs on the New York City subway system, reminiscent of the Madrid and London subway bombings, and also discharge multiple bombs in Downtown and Midtown skyscrapers, all of which collapse. In San Francisco, terrorists blow up the largest buildings, including the Transamerica Tower, Bank of America and First Interstate Center. Americans and the rest of the world watch helplessly as the terrorists execute the worst terrorist attack America has ever faced.<sup>2</sup>

Unquestionably, such an attack would devastate America, not only in terms of lives lost, but also financially. Though there are no official estimates as to how much damage would result, considering the number of buildings affected, the resulting losses would dwarf those from September 11th, which amounted to an estimated \$32.4 billion in insured losses.<sup>3</sup> Assuming that insurance companies still cover terrorism in their policies, such an attack could cause insured losses in the hundreds of billions of dollars. Though insurers largely remained solvent after September 11th,<sup>4</sup> it is questionable whether insurers could remain solvent in the wake of the hypothetical attack. In 1999, it was estimated that the insurance industry

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\* As this note heads to print, the Senate has just passed the Risk Insurance Revision and Extension Act of 2007 on November 19, 2007. This proposed legislation, if enacted in its current form by the President, will not sunset until December 31, 2014. H.R. 2761, 110th Cong. (2007). TRIA and TRIEA, *see infra* notes 15 & 16, were only three and two year programs respectively. The fact that the Senate has approved such a long extension further supports the argument of this note: The market cannot currently handle terrorism risk and the federal government should provide a long-term federal backstop to the insurance industry.

1. *See* RISK MGMT. SOLUTIONS, INC., A RISK-BASED RATIONALE FOR EXTENDING THE TERRORISM RISK INSURANCE ACT 9 (2005), *available at* <http://www.rms.com/Publications/A%20Risk%20Based%20Approach%20for%20Extending%20TRIA.pdf> (arguing that terrorists are more likely to use coordinated attacks in order to maximize loss and terror, and because heightened security will make later attacks less likely in the future).

2. This hypothetical situation was taken indirectly from an AIR Worldwide Corporation study. AIR compared the estimated insured losses resulting from Anthrax, Sarin gas or car bomb attacks in New York City, Washington D.C., San Francisco and Des Moines. Jack Seaquist, *Five Years After 9/11: How Has Terrorism Risk Management Evolved?*, AIRCURRENTS, Sept. 12, 2006, [http://www.air-worldwide.com/\\_public/html/air\\_currentsitem.asp?ID=1022](http://www.air-worldwide.com/_public/html/air_currentsitem.asp?ID=1022). The study estimated that a single six-ton truck bomb would cause \$12 billion in losses in New York, \$6 billion in losses in Washington D.C., and \$9 billion in losses in San Francisco.

3. U.S. DEPT. OF THE TREASURY, ASSESSMENT: THE TERRORISM RISK INSURANCE ACT OF 2002 26 n.24 (2005).

4. Robert J. Rhee, *Terrorism Risk in a Post-9-11 Economy: The Convergence of Capital Markets, Insurance and Government Action*, 37 ARIZ. ST. L.J. 435, 463 & n.135 (2005) ("The 9/11 attacks triggered the liquidation or bankruptcy of only a few troubled insurers.").

could pay out 92.8% of a \$100 billion-dollar loss.<sup>5</sup> More recently, Standard and Poors estimated that aggregate insurance losses would have to surpass \$50 billion in order to “threaten[] the solvency of the U.S. insurance system.”<sup>6</sup> Based on these statistics, it seems that the insurance industry could not remain viable after an attack of that magnitude. Even those who suggest that the insurance industry could sustain a \$100 billion loss<sup>7</sup> do not believe that insurers could sustain multiple large-scale terrorist attacks,<sup>8</sup> as described above.

The demise of the insurance industry would in turn have halting effects on many other actors and markets. States would deplete their property and casualty guaranty funds in order to make policyholders whole.<sup>9</sup> Policyholders, who would become creditors of the insurance companies, would have to wait indefinitely for their compensation.<sup>10</sup> Because businesses would be unable to obtain appropriate insurance, credit ratings on their loans would be downgraded.<sup>11</sup> Unfortunately, these problems would not be localized to New York City and San Francisco, but rather would be felt across the nation<sup>12</sup> and the world.<sup>13</sup> Although the federal government would have no affirmative duty to mitigate the insurance disaster, having failed to exercise its power to “provide for the common

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5. See, e.g., Nicos A. Scordis, *Financing the Impact of Terrorism: Can Insurers Cope?*, 18 ST. JOHN'S J. LEGAL COMMENT. 489, 490 n.6 (2003).

6. CONG. BUDGET OFFICE, FEDERAL REINSURANCE FOR DISASTERS 11 (Sept. 2002) [hereinafter CBO].

7. Rhee, *supra* note 4, at 463 n.136.

8. *Id.* at 440.

9. 26 JOHN ALAN APPLEMAN ET AL., APPLEMAN ON INSURANCE §166.1 (2d ed. 2006) [hereinafter APPLEMAN]. States create and maintain guaranty associations in which they pool money that is put towards paying the claims of insolvent insurers. All fifty states and Puerto Rico have enacted laws which require the establishment of these associations. In order for any insurer to transact business in a state, they must become members of that association. The associations are funded by the participating solvent insurers, who give a portion of their premiums to the association. *Id.*

10. *Id.* at §163.1. “If the policyholder experienced a covered loss prior to the appointment [of a receiver, rehabilitator, or liquidator] or adjudication, the insurer remains responsible. The applicable insolvency laws will control whether, when and how the policyholder is reimbursed.” If, however, the insurer becomes insolvent before the covered loss, the insurer does not have to pay the policyholder under the terms of the insurance contract. *Id.*

11. See Joseph B. Treaster, *Ratings on Building Loans Fall on Insurance Worries*, N.Y. TIMES, Sept. 28, 2002, at C5 [hereinafter *Ratings on Building*]; see also Joseph B. Treaster, *Insurers Are Ready to Fight to Keep Federal Backing of Terrorism Coverage*, N.Y. TIMES, Sept. 29, 2006, at C1 [hereinafter *Insurers Are Ready*].

12. See, e.g., discussion *infra* p. 251. See *Protecting Americans from Catastrophic Risk; Joint Hearing Before the Subcomm. on Capital Markets, Insurance, and Gov't Sponsored Enterprises and the Subcomm. on Oversight and Investigations of the H. Comm. on H. Financial Serv.*, 109th Cong. 131 (2006) [hereinafter *Protecting Americans from Catastrophic Risk*] (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company) (arguing that people would feel the effects of terrorist attacks outside the targets, and that attacks would weaken the American economy overall).

13. See discussion *infra* p. 252.

Defence and general Welfare of the United States,”<sup>14</sup> it likely would respond with assistance. In the end, taxpayers across the U.S. would be compensating the distant New York City and San Francisco residents and businesses. Now imagine the above situation in a world where insurance policies excluded terrorism coverage. The insurance companies would remain viable, but the other constituents mentioned above would suffer even greater financial damage. Businesses would crumble, the federal government would have to provide even more financial support, and taxpayers would pay for it all.

However, with a statute similar to the Terrorism Risk Insurance Extension Act of 2005 (TRIEA)<sup>15</sup> still in place, these fears would be substantially alleviated. Assuming that the federal government extends TRIEA in its current form, insurance companies, forced to write terrorism insurance,<sup>16</sup> will only have to pay 20% of their insurer deductible.<sup>17</sup> The federal government will pay 85%<sup>18</sup> of the claim amount exceeding what insurers have already paid, and federal compensation will cease once the federal government has reached its \$100 billion limit.<sup>19</sup> Overall, the insurance companies would still have to pay significant claims, but could remain financially viable. Though the taxpayers may resent the program because they do not want to support the insurance companies, as evidenced above, taxpayers will have to pay regardless.

This note argues that the federal government should create a long-term federal backstop for terrorism risk coverage. Section I examines the insurance industry’s response to September 11th. Section II explains the framework of the Terrorism Risk Insurance Act of 2002 (TRIA)<sup>20</sup> and TRIEA. Section III examines why the federal government should create a long-term solution to this problem by showing that even with better terrorism modeling, terrorism risk is unattractive to insurers and cannot be viably insured on the open market. Since the need for terrorism insurance is so great and because terrorism coverage will continue to be unattractive to insurers, Congress should create a long-term federal backstop to take the place of TRIEA.

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14. U.S. CONST. art. I, § 8, cl. 1.

15. Terrorism Risk Insurance Extension Act of 2005, Pub. L. No. 109-144, 119 Stat. 2660 (codified at 15 U.S.C. § 6701 note) (2005) [hereinafter TRIEA].

16. Terrorism Risk Insurance Act of 2002 § 103(a)(3), Pub. L. No. 107-297, 116 Stat. 2322 (codified at 15 U.S.C. § 6701 note) (2002) [hereinafter TRIA] (saying that all entities meeting the definition “shall participate in the Program”); *id.* at §103(c)(1)(B) (insurers may not exclude terrorism risk from their policies).

17. TRIEA § 3(c)(3)(E) & (F).

18. TRIEA § 4.

19. TRIA § 103(e)(2)(A).

20. TRIA, *supra* note 16.

## I. THE EFFECT OF SEPTEMBER 11TH ON THE INSURANCE INDUSTRY

The U.S. economy suffered greatly after the attacks of September 11th. Some have projected that the U.S. economy suffered a \$639 billion loss.<sup>21</sup> Furthermore, the attacks caused an estimated \$19 billion in property loss.<sup>22</sup>

The impact on the insurance industry was equally devastating. One insurance executive estimated that insured losses relating to September 11th totaled between \$30 and \$70 billion.<sup>23</sup> A \$60 million loss would have surpassed the property and casualty insurance industry's income from 1999 to 2001.<sup>24</sup> The U.S. Department of the Treasury estimated that September 11th resulted in \$32.4 billion of insured loss.<sup>25</sup>

Although the insurance industry did not collapse as a result of September 11th, an examination of the insurance market's reaction to the attacks shows that many insurers struggled. Policyholder surplus<sup>26</sup> of all property and casualty lines dropped by almost \$50 billion from 2000 to 2001<sup>27</sup> even though the direct written premiums<sup>28</sup> in the property and casualty lines rose by about the same amount.<sup>29</sup> This means insurers were paying more in claims than they had collected in premiums.

Before September 11th, because insurance companies did not factor in the risk associated with terrorism, terrorism coverage was essentially free under commercial insurance policies.<sup>30</sup> After September 11th, however, terrorism insurance was unaffordable or unavailable<sup>31</sup> because, among other things, many insurance companies decided to exclude the coverage or leave the commercial insurance market altogether in order to avoid writing

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21. Frederic U. Dicker, *Stunning Cost of 9/11—U.S. Economy Took A 639B Hit: A NY Study*, N.Y. POST, Jan. 28, 2002, at 2.

22. Scordis, *supra* note 5, at 493.

23. CBO, *supra* note 6, at 10 n.6.

24. Lucien J. Dhooge, *A Previously Unimaginable Risk Potential: September 11 and the Insurance Industry*, 40 AM. BUS. L.J. 687, 689 n.5 (2003).

25. U.S. DEPT. OF THE TREASURY, *supra* note 3, at 26 n.24.

26. Surplus is the excess of assets over liabilities. BLACK'S LAW DICTIONARY WITH PRONUNCIATIONS 1443 (6th ed. 1990) [hereinafter BLACK'S].

27. U.S. DEPT. OF THE TREASURY, *supra* note 3, at 15.

28. *Id.* at 14 (direct written premium is "total premiums collected by insurers directly from policyholders for the upcoming period of coverage, before any adjustments for premiums ceded to reinsurers.").

29. *Id.*

30. *Id.* at 27 n.28.

31. See Michelle E. Boardman, *Known Unknowns: The Illusion of Terrorism Insurance*, 93 GEO. L.J. 783, 799 (2005) (quoting Daniel B. Rubock & Tad Philipp, *CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate*, 489 PLI/REAL EST 365, 367 (2003)); see also David Necklaus, *Insurance Industry Comes Back Strong in Weeks Since Attack*, ST. LOUIS POST-DISPATCH, Oct. 13, 2001, at 1 ("While they raise their premiums, most insurers are reducing their risk. Most new policies specifically exclude coverage of losses caused by terrorism.").

terrorism insurance.<sup>32</sup> As a result of the unavailability and/or expense of terrorism insurance, many of the New York City landmark buildings had inadequate insurance in 2002.<sup>33</sup> In turn, credit rating agencies downgraded the ratings on at least \$4.5 billion of loans on these buildings.<sup>34</sup> In addition, many construction projects had to be cancelled due to the lack of terrorism insurance.<sup>35</sup>

Though many insurers bolted from the New York City terrorism risk market after September 11th, Greater New York Mutual Insurance Company (Greater New York) was an exception to the rule and decided to stay.<sup>36</sup> According to Warren Heck, chairman and C.E.O. of Greater New York, Greater New York swam against the current and remained in the market out of a sense of moral obligation.<sup>37</sup> To remain viable, Greater New York took drastic measures, such as dropping coverage limits from \$250 million to \$50 million, decreasing the number of shopping malls covered, decreasing workers' compensation coverage, and expanding coverage outside the New York and New Jersey area.<sup>38</sup> Unfortunately, by lowering coverage limits, Greater New York lost their contracts with many office buildings that required more than \$50 million in coverage.<sup>39</sup> However, even having taken these measures to reduce exposure to terrorism, Mr. Heck explained that there was "no way for any insurance company, no matter how large, to handle the worst case scenario . . . . The government is going to have to do something."<sup>40</sup>

The September 11th attacks affected U.S. insurance markets outside New York as well.<sup>41</sup> In Milwaukee, for example, terrorism risk insurance

32. Rick Cornejo, *How Greater New York Mutual Stayed in the Terrorism Coverage Game Following Sept. 11*, BESTWIRE, Sept. 19, 2006. See Joseph B. Treaster, *Terror Attacks Often Covered By Insurance, A Report Says*, N.Y. TIMES, Oct. 3, 2006, at C6.

33. *Ratings on Building*, *supra* note 11, at C5.

34. *Id.*

35. *Terrorism Threats and the Insurance Market: Joint Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Serv. and the Subcomm. on Intelligence, Information Sharing, and Terrorism Risk Assessment of the H. Comm. on Homeland Sec.*, 109th Cong. 34 (2006) [hereinafter *Terrorism Threats and the Insurance Market*] (statement of Jeffrey DeBoer, President and C.E.O. of The Real Estate Roundtable) ("A survey The Real Estate Roundtable conducted during the 14 month post 9/11, pre TRIA time period showed that more than \$15 billion of real estate related transactions had been either stalled or completely canceled because of a lack of terrorism insurance.").

36. Cornejo, *supra* note 32.

37. *Id.* ("We have a lot of insureds that have been with the company for a very long time . . . . We owe them something. We don't feel we can leave them high and dry.").

38. *Id.*

39. *Id.*

40. *Id.*

41. *Terrorism Threats and the Insurance Market*, *supra* note 35, at 34 (statement of Jeffrey DeBoer, President and C.E.O. of The Real Estate Roundtable). DeBoer stated:

The interwoven nature of America's economy, and evidence that terrorism is a threat to national economic activity, is demonstrated by these statistics as well as by the

comprised approximately 9% of the Milwaukee Brewers baseball stadium's entire budget in 2002 due to September 11th.<sup>42</sup>

The effects of September 11th have also even been felt by insurance companies who operate outside the U.S. Some foreign insurance companies even went bankrupt due in large part to the terrorist attacks.<sup>43</sup> Other foreign insurance companies began to exclude terrorism coverage from their policies in reaction to the attacks of September 11th. QBE Insurance Group, an Australia-based insurance company, for example, sustained \$252 million in losses in 2001, and in 2002 the "majority of its policies . . . exclude[d] terrorism cover."<sup>44</sup> Norwich Union Company, which operates in England, also began to exclude terrorism coverage after September 11th.<sup>45</sup> Furthermore, Swiss Reinsurance Company cut its terrorism coverage by more than half after September 11th.<sup>46</sup>

Knowing how the insurance industry reacted to September 11th, Congress should take care to prevent a similar situation in the future. An attack even larger than September 11th, like the hypothetical coordinated attack previously mentioned, would of course have a greater effect on the insurance industry. Even with the federal backstop of TRIA in place, Greater New York completely restructured its organization to stay in the terrorism market after September 11th. Given this and other insurers' post-September 11th reactions, it is clear that Congress should create a long-term federal backstop to protect the insurance industry in case of future attacks.

## II. THE LEGISLATIVE RESPONSE

### A. THE TERRORISM RISK INSURANCE ACT OF 2002

On November 26, 2002, President George W. Bush signed TRIA into law.<sup>47</sup> In the findings section, Congress noted that the insurance industry could respond to September 11th by either excluding terrorism coverage

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anecdotal reports that although the 9/11 attacks occurred in New York and Washington, within days, busboys in Seattle and hotel employees in Houston had lost their jobs.

*Id.*

42. See Don Walker, *Terrorism Strains Stadium Budget; Officials Seek Extra \$1.4 Million*, MILWAUKEE J. SENTINEL, Oct. 23, 2003, at 1B (additional terrorism insurance took \$250,000 out of Miller Park stadium's \$2.78 million budget).

43. CBO, *supra* note 6, at 11 ("Two insurers—one in Denmark, the other in Japan—failed as a result of the attacks.")

44. *What's Hot, What's Not*, SUNDAY TEL. (Sydney, Austl.), July 21, 2002, at 101. "QBE Insurance Group is Australia's largest international general insurance & reinsurance group." QBE Insurance Home Page, [http://www.qbe.com/Version\\_2/html/group/QBE\\_group\\_entry.html](http://www.qbe.com/Version_2/html/group/QBE_group_entry.html) (last visited Oct. 23, 2007).

45. See Alfred Lee, *No Insurance Cover for British Homes: Norwich Union Won't Compensate for Damage*, STRAITS TIMES, Jan. 4, 2003, § World.

46. See Frances Williams, *The Unthinkable Was Insured—This Time*, FIN. TIMES (London), Sept. 11, 2002, at 12.

47. TRIA, *supra* note 16.

from policies or by increasing terrorism risk premiums.<sup>48</sup> Congress feared this lack of terrorism coverage would stunt property development and negatively impact the real estate market as a whole.<sup>49</sup> In reaction to these worries, the stated purposes of TRIA were to stabilize the terrorism risk insurance market<sup>50</sup> and to make terrorism insurance more available and affordable.<sup>51</sup> Unlike a regular insurance policy where the insured pays a premium in return for coverage, under TRIA, coverage by the federal government was free to insurance companies. However, under certain conditions, the insurance industry was required to repay the federal government for its contributions.<sup>52</sup>

Through TRIA, the federal government provided a backstop to the insurance industry in the form of a reinsurance<sup>53</sup> program. Every insurer that met the definition of “insurer”<sup>54</sup> under TRIA was compelled to participate in the program.<sup>55</sup> TRIA mandated that insurers were not

48. TRIA § 101(a)(5).

49. *Id.* Specifically, Congress worried this response “could seriously hamper ongoing and planned construction, property acquisition, and other business projects, generate a dramatic increase in rents, and otherwise suppress economic activity . . . .”

50. TRIA § 101(b)(2).

51. TRIA § 101(b)(1).

52. See discussion *infra* p. 255.

53. Reinsurance is “[a] contract that one insurer makes with another to protect the latter from a risk already assumed. . . . An agreement to indemnify the assured, partially or altogether, against a risk assumed by it in policy issued to third party.” BLACK’S, *supra* note 26, at 1287–88.

54. TRIA § 102(6):

Insurer—the term ‘insurer’ means any entity, including any affiliate thereof—

(A) that is—

licensed or admitted to engage in the business of providing primary or excess insurance in any State;

not licensed or admitted as described in clause (i), if it is an eligible surplus line carrier listed on the Quarterly Listing of Alien Insurers of the NAIC, or any successor thereto;

approved for the purpose of offering property and casualty insurance by a Federal agency in connection with maritime, energy or aviation activity;

a State residual market insurance entity or State workers’ compensation fund; or

any other entity described in §103(f) [Captive Insurers and Other Self-Insurance Arrangements], to the extent provided in the rules of the Secretary issued under §103(f).

(B) that receives direct earned premiums for any type of commercial property and casualty insurance coverage, other than in the case of entities described in sections 103(d) and 103(f); and

(C) that meets any other criteria that the Secretary may reasonably prescribe.

*Id.*

55. TRIA § 103(a)(3).



permitted to exclude terrorism risk<sup>56</sup> from their property and casualty policies.<sup>57</sup> Any terrorism coverage exclusions found in policies were nullified.<sup>58</sup> Nevertheless, insurers were permitted to reinstate terrorism exclusion provisions that were in place before passage of TRIA if either the insurer received written consent from the insured to exclude the coverage, or if the insured failed to pay the increased premium for terrorism coverage after receiving notice of the escalation.<sup>59</sup> Any state's approval of terrorism exclusions was preempted,<sup>60</sup> though states were not entirely precluded from regulating the terrorism insurance market; they retained the power "to invalidate a rate as excessive, inadequate, or unfairly discriminatory."<sup>61</sup>

TRIA was only triggered by an "Act of Terrorism"<sup>62</sup> that resulted in loss covered by casualty insurance and primary and excess property insurance.<sup>63</sup> Noticeably absent from the "Act of Terrorism" definition were acts of domestic terrorism. Furthermore, to fall under this definition, the attack could not be committed in the course of a war declared by Congress, and the aggregate property and casualty insurance losses must have exceeded \$5 million.<sup>64</sup> Once that level of loss had been sustained by the insurance industry as a whole, the individual insurers were required to pay

56. TRIA § 103(c)(1)(B).

57. TRIA § 103(c)(1)(A). Property and casualty insurance includes excess insurance, workers' compensation insurance and surety insurance. TRIA § 102(12)(A).

58. TRIA § 105(a).

59. TRIA § 105(c).

60. TRIA § 105(b).

61. TRIA § 106(a)(2)(B).

62. TRIA § 102(1)(A). The Secretary of the Treasury must certify the attack as an "Act of Terrorism" before coverage will take effect. An "Act of Terrorism" is defined as an act that the Secretary has certified:

to be an act of terrorism;

to be a violent act or an act that is dangerous to—

human life;

property; or

infrastructure;

to have resulted in damage within the United States, or outside the United States in the case of

an air carrier or vessel . . . or

the premises of a United States mission; and

(iv) to have been committed by an individual or individual acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion.

TRIA § 102(1)(A)(i)–(iv).

63. TRIA § 102(5).

64. TRIA § 102(1)(B).

their “insurer deductible[s]”<sup>65</sup> before federal reinsurance would become available to them. After the insurance companies paid their insurer deductibles, the federal government would pay 90% of the losses that exceeded the insurer deductible that year,<sup>66</sup> and the insurer would have to pay for the remaining 10%.

The federal government would not pay more than \$100 billion in any year under the program.<sup>67</sup> Under TRIA, once the government had paid insurance companies \$100 billion, Congress had the discretion to decide how to deal with excess losses.<sup>68</sup> Depending on how much financial assistance the federal government provided the insurance industry, TRIA included provisions providing for mandatory and discretionary recoupment for amounts paid.<sup>69</sup> By providing insurance companies with the needed support in case of a terrorist attack, TRIA stabilized the terrorism insurance market.

### B. TERRORISM RISK INSURANCE EXTENSION ACT OF 2005

Though TRIA was written to sunset on December 31, 2005,<sup>70</sup> Congress extended this sunset to December 31, 2007 under TRIEA.<sup>71</sup> Although most of the terms and provisions of TRIEA are essentially the same as those in TRIA, there are some significant differences.

First, TRIEA increases the insurer deductible.<sup>72</sup> This means insurers must pay out more claims before federal payment kicks in. Second, TRIEA reduces the proportion of federal payment in 2007. The federal government was still required to pay 90% of insured losses in excess of the insurer deductible in 2006, but that amount was reduced to 85% in 2007.<sup>73</sup> Third, TRIEA increases the recoupment amount so that the insurers are required to

65. TRIA § 102(7). To meet its “insurer deductible,” the insurer would have to pay out 1% of its direct earned premium in 2002, 7% in 2003, 10% in 2004, and 15% in 2005. TRIA § 102(7)(A)–(E). Pursuant to the Act, a “direct earned premium” means “a direct earned premium for property and casualty insurance issued by an insurer for insurance against losses occurring at the locations described in subparagraphs (A) and (B) of paragraph (5) [within the United States or to a United States flag vessel].” TRIA § 102(4). See definition of direct earned premium *supra* note 28.

66. TRIA § 103(e)(1)(A).

67. TRIA § 103(e)(2)(A).

68. TRIA § 103(e)(3) (requiring that after the \$100-billion mark had been hit, that “Congress shall determine the procedures for and the source of any payments for such excess insured loss”).

69. TRIA § 103(e)(7). See also Jeffrey Manns, *Insuring Against Terror?*, 112 YALE L.J. 2509, 2534 (2003) (citing TRIA § 103(e)(7)(A)–(C) and explaining that the recoupment “formula is that the Treasury Department must recoup the difference between \$10 billion in 2003, \$12.5 billion in 2004, or \$15 billion in 2005 and the aggregate of insurers’ uncompensated losses for each year, until the government recovers all federal compensation”). However, if aggregate uncompensated loss exceeds the “insurance marketplace retention amount,” the insurance industry does not have to repay the federal government. TRIA § 103(e)(B).

70. TRIA § 108(a).

71. TRIEA § 2(a).

72. TRIEA § 3(c)(3)(E) & (F).

73. TRIEA § 4(1)(B).

pay a higher amount back to the federal government.<sup>74</sup> Fourth, whereas the TRIA program would take effect for all Acts of Terrorism that resulted in \$5 million of insured loss, TRIEA sharply increases the program trigger to \$50 million in 2006 and \$100 million in 2007.<sup>75</sup> Overall, the TRIEA provides less federal assistance to the insurance industry than provided under TRIA.

### III. PREPARING FOR THE TRIEA SUNSET, CONGRESS SHOULD CREATE A LONG-TERM FEDERAL BACKSTOP

Faced with the pending sunset on December 31, 2007,<sup>76</sup> Congress must decide whether they want a TRIEA-esque program at all, and if so, in what form. Some believe that extension is unlikely,<sup>77</sup> while others are confident that the federal government will continue to provide a backstop in some form.<sup>78</sup> With the Democrats holding a majority in both the House and Senate, it is even more likely that Congress will extend TRIEA in some form.<sup>79</sup> Congress has many options, including allowing TRIEA to sunset and leaving the task of insuring terror to the market, extending TRIEA in its current or in a similar form for a short period as before, or creating a long-term federal backstop for terrorism risk insurance. Since only the federal government can effectively support the terrorism insurance industry and the problems associated with terrorism insurance will not change in the near future, Congress should create a long-term federal backstop.

#### A. LEAVING TERRORISM INSURANCE TO THE MARKET PROVIDES NO SOLUTION AT ALL

The consequences of leaving the terrorism risk insurance problem to the market are unavoidable. Before Congress decided to extend TRIA in 2005, concerned insurers quickly sought to raise premium prices in high-risk industries,<sup>80</sup> and there is no reason to think this will not happen again in

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74. TRIEA § 5.

75. TRIEA § 6.

76. TRIEA § 2(a).

77. Mark A. Hofmann, *Plan Seeks Federal Cover for Costliest Terror Risk*, BUS. INS., Aug. 23, 2006, § NEWS, at 1.

78. Rob Wells & Damian Paletta, *Hartford CEO: US Congress Likely To Renew Terror Insurance*, DOW JONES NEWSWIRE, Oct. 3, 2006 (quoting Ramani Ayer, head of Hartford Financial Services Group, who had “reasonable confidence that this bill, some legislation, will get enacted to respond to the risk of terrorism”).

79. Three hundred and seventy-one House members voted for the passage of TRIEA, while forty-nine voted against it, and of all those who voted, a greater proportion of Democrats voted for TRIEA’s passage. One hundred and ninety-two to three Democrats voted in favor of TRIEA, while only 178 Republicans voted for it and 46 voted against it. *Terrorism Risk Insurance Act Voting Record*, CONG. REC. S467, 612 (daily ed. Dec. 7, 2005).

80. See *Protecting Americans from Catastrophic Risk*, supra note 12, at 93 (statement of Gregory Case, President and C.E.O. of Aon Corporation). Case explained:

2007. In fact, with the 2007 sunset approaching, insurers have written “springing exclusions” into their new policies, automatically voiding terrorism coverage should Congress allow TRIEA to sunset.<sup>81</sup> The largest risk inherent in the private market solution is that insurers will decide to abandon terrorism insurance altogether, and as shown by the springing exclusions already in place, this is almost a certainty.

Congress should not leave the problem of terrorism insurance to be solved by the private market for many other reasons as well. First, insurers cannot effectively assess terrorism risk. Second, even with better risk models, terrorism insurance is unattractive to insurers, and insurers will choose to quit the market if allowed. Third, the absence of terrorism insurance would stifle certain desirable economic activities. Finally, even if states were to require insurers to provide affordable terrorism insurance, state regulation in the absence of TRIEA would create an unattractive terrorism insurance market.

### **1. Insurance Companies Cannot Effectively Price Their Policies Because the Threat of Terrorism Remains Unpredictable**

Before an insurance company determines a policy premium, it assesses the risk involved.<sup>82</sup> Using actuarial tables reflecting both the frequency of occurrence of a given risk and the cost of the resulting damage,<sup>83</sup> insurers calculate a corresponding premium price. Though accurate actuarial data is available for natural disasters and ordinary losses, the same information is not available for terrorism.<sup>84</sup> One commentator argued that due to the “short, uneven history of terrorism within the United States,”<sup>85</sup> no

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We don't have to guess what the post TRIA market will look like if the TRIA program is allowed to lapse unrenewed at the end of 2007. Renewal activity in the latter half of 2005—before TRIA was extended—as well as pre-2002 TRIA provides a clear roadmap. According to industry reports, during late 2005 . . . [for] insureds in areas with high concentrations of risk (generally urban areas), in high-risk industries, or properties perceived as “targets,” capacity was low and prices were high. This is also true of large insureds seeking large amounts of terror coverage.

*Id.*

81. *Terrorism Threats and the Insurance Market*, *supra* note 35, at 36 (statement of Jeffrey DeBoer, President and C.E.O. of The Real Estate Roundtable); Denise Trowbridge, *Future of Terrorism Insurance is at Risk: Law that Caps Losses, Helps Fund Policies Will Expire in '07*, COLUMBUS DISPATCH, Nov. 26, 2006, § BUSINESS, at 1F.

82. See KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION* 4 (4th ed. 2005).

83. Mark Boran, *To Insure or Not to Insure, That Is the Question: Congress' Attempt to Bolster the Insurance Industry After the Attacks on September 11, 2001*, 17 ST. JOHN'S J. LEGAL COMMENT. 523, 532–33 (2003).

84. Boardman, *supra* note 31, at 815 (“Scientific data is not a candidate with terrorism, nor is history a guide.”).

85. *Id.*

“meaningful [actuarial tables can] be created.”<sup>86</sup> As a result, terrorism risk cannot be insured due in large part to the lack of effective risk calculation.<sup>87</sup>

Nevertheless, AIR Worldwide<sup>88</sup> launched the world’s first terrorism-loss estimation model in September 2002.<sup>89</sup> This model estimates the “location, frequency and severity” of possible terrorist attacks.<sup>90</sup> Since there is limited historical data on terrorist attacks, AIR Worldwide assembled an experienced team of counter-terrorism experts to assist in the modeling.<sup>91</sup> Risk Management Solutions, Inc. (RMS), another risk modeling service, released a similar model of terrorism risk in 2002.<sup>92</sup> Even though insurers have these risk models at their disposal, they are not convinced that the models are effective. Years after the release of these terrorism models, the insurers who use them are still complaining that terrorism risk cannot be properly assessed.<sup>93</sup> Furthermore, academics have described the risk models as “educated guesses of individual people, or, at a minimum, the aggregation of subjective data.”<sup>94</sup> Even with the advances in risk modeling, the models seem far from accurate, making pricing of terrorism risk insurance policies impossible.

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86. *Id.*

87. *Id.* at 784 (“[I]n the absence of meaningful actuarial data on the risk of international terrorism in the United States, insurance coverage is not possible.”). Boardman also argues that this risk cannot be covered because it “may be too correlated or catastrophic for effective risk pooling.” *Id.*

88. Quantifying the Risk from Terrorist Attacks, [http://www.air-worldwide.com/\\_public/html/terrorism.asp](http://www.air-worldwide.com/_public/html/terrorism.asp) (last visited Nov. 21, 2006). According to its website, AIR Worldwide is “the world’s premium risk modeler and technology firm specializing in risks associated with natural and man-made catastrophes, weather and climate.” About AIR, [http://www.air-worldwide.com/\\_public/html/about\\_air.asp](http://www.air-worldwide.com/_public/html/about_air.asp) (last visited Nov. 21, 2006).

89. Quantifying the Risk from Terrorist Attacks, *supra* note 88.

90. *Id.*

91. *Id.*

92. *Terrorism Threats and the Insurance Market*, *supra* note 35, at 71 (statement of Peter Ulrich, Senior Vice President of Risk Management Solutions, Inc.).

93. See *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 128 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company) (arguing that there is an “inescapable fact that terrorism insurance is a classic uninsurable risk. . . . When it comes to terrorism risk insurance, we have no basis for estimating frequency. . . . They cannot tell us when or where it might occur or its likely nature. Harder still from an insurance perspective, we cannot predict its severity.”). According to Gregory Case:

Since [2002] . . . it has become clear that the private sector—insurance companies, capital markets and rating agencies—have a very limited ability to insure and rate terrorism risks that are only questionably quantifiable, totally unpredictable and, thus, essentially impossible to underwrite. . . . Because of the unique characteristics of terrorism risk—unpredictability, the political dynamic, the catastrophic nature of the losses—any workable solution must involve the federal government.

*Id.* at 90, 94 (statement of Gregory Case, President and CEO, AON Corp.). Note that this congressional hearing took place in 2006, years after the risk models were released.

94. Boardman, *supra* note 31, at 818–19.

## **2. Even With More Accurate Terrorism Risk Models, Terrorism Coverage Remains Unattractive to Insurers in the Private Market**

Despite these improvements in modeling, terrorism risk remains largely uninsurable on the open market.<sup>95</sup> Even risk modelers support the extension of TRIEA. Peter Ulrich, RMS's Senior Vice President, urged Congress to extend TRIEA, arguing that even with improved terrorism risk models, large-scale terrorist attacks will lead the "large majority of insurers to quit the terrorism market."<sup>96</sup>

It is not simply imperfection in modeling that makes terrorism unattractive to insurers; it is the sheer enormity of loss that could result from terrorist attacks that sends insurers running. As stated by Warren Heck, "damages [from large-scale terrorist attacks] could reach into the hundreds of billions, levels that only the federal government can afford to pay."<sup>97</sup> He went on to say:

Absent a terrorism insurance program, a \$778 billion terrorist event[,] the high estimate for a single terrorist event by the American Academy of Actuaries in New York City[,] would wipe out more than the total property/casualty insurance industry surplus for all lines, estimated at \$414 billion as of September 30, 2005 by the Insurance Information Institute. This would mean that the industry would be unable to meet its obligations to its other insureds for the many different coverages beyond terrorism insurance protected by that surplus.<sup>98</sup>

The insurers would either become insolvent or unable to pay claims.<sup>99</sup> Faced with the possibility of such large losses, the private market of

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95. See *supra* note 93. If terrorism insurance were on the free market, insurers would not write it. See discussion of the insurance industry post-September 11th, *supra* p. 250.

96. *Terrorism Threats and the Insurance Market*, *supra* note 35, at 79 (statement of Peter Ulrich, Senior Vice President of Risk Management Solutions, Inc.) (testifying that "[a] major benefit of having TRIA in place is it has allowed key sectors of the economy to return to 'business as usual'").

97. *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 128 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company). See *Five Years After 9/11: How Has Terrorism Risk Management Evolved?*, *supra* note 2 (estimating insured losses resulting from truck bombs, medium scale chemical, nuclear and biological attacks and large scale chemical, nuclear and biological attacks); see also Cornejo, *supra* note 32 ("There is no way for any insurance company, no matter how large, to handle the worst case scenario . . . . The government is going to have to do something.").

98. *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 129 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company). See also *Five Years After 9/11: How Has Terrorism Risk Management Evolved?*, *supra* note 2.

99. *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 129 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company) ("[T]he private market cannot cover events of such magnitude without either bankrupting insurers and reinsurers or wiping out so much insurer surplus that they could not meet their obligations on other lines of insurers . . . .").

terrorism insurance would not be able to protect itself through better modeling.<sup>100</sup>

Though TRIEA opponents believe that terrorism insurance should be left to the private insurance market,<sup>101</sup> realistically, terrorism cannot viably be insured on the open market.<sup>102</sup> Esteemed risk-analysis experts agree with this conclusion. Moody's Investor Services,<sup>103</sup> for example, does not believe "private market initiatives" could replace TRIA.<sup>104</sup> Moody's believes that TRIA provides good "solvency protection," that without TRIA, private reinsurers "are unlikely to fill the void left by" TRIA, and that primary insurers will consequently leave the insurance market.<sup>105</sup> Furthermore, although capital markets can play a role in the terrorism insurance market, RMS believes they are "unlikely to provide the bulk of the capacity needed."<sup>106</sup> Some suggest that catastrophe bonds could help fill the void should Congress allow TRIEA to expire.<sup>107</sup> When insurance companies issue catastrophe bonds, they promise to repay the investor's loans with interest, unless the specified catastrophe occurs, in which case the loan is partly or fully forgiven.<sup>108</sup> Though catastrophe bonds provide a good source of risk capacity, they cannot transfer enough risk away from insurers to replace TRIEA.<sup>109</sup>

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100. *Id.* at 129 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company); *See also Five Years After 9/11: How Has Terrorism Risk Management Evolved?*, *supra* note 2.

101. *See Manns, supra* note 69, at 2513 ("Law and Economics Scholars have repeatedly made arguments against government interventions in insurance markets, relying on solid empirical examples of the distorting of past government interventions."); *see also Boardman, supra* note 31, at 842-43 (arguing that when the government provides subsidies to the insurance industry, they, in effect, "crowd out" the "purely private insurers," in that the insureds will flock to the supported public insurance as opposed to the private insurance); H.R. REP. NO. JS-2618 (2005), *available at* <http://www.treas.gov/press/releases/js2618.html>. Then Secretary of the Treasury John W. Snow suggested the extension of TRIA will disrupt or delay the development of a solution by the insurance market by "crowding out innovation and capacity building." *Id.*

102. *Terrorism Threats and the Insurance Market, supra* note 35, at 35 (statement of Jeffrey DeBoer, President and C.E.O. of The Real Estate Roundtable) (saying that it is "highly questionable" that terrorism insurance can be handled in a private market).

103. "Moody's Investors Service is among the world's most respected, widely utilized sources for credit ratings, research and risk analysis." About Moodys, [http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=intro&redir\\_url=/cust/AboutMoodys/staticRedirect.asp](http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=intro&redir_url=/cust/AboutMoodys/staticRedirect.asp) (last visited Nov. 19, 2007).

104. *Terrorism Threats and the Insurance Market, supra* note 35, at 35 (statement of Jeffrey DeBoer, President and C.E.O. of The Real Estate Roundtable).

105. JAMES ECK, TERRORISM RISK REMAINS MATERIAL FOR INSURERS AS TRIA EXPIRATION LOOMS 5 (2005), *available at* <http://www.insureagainstterrorism.org/pdf/Terrorism%20Risk%20Remains%20Material%20for%20Insurers.pdf>.

106. RISK MGMT. SOLUTIONS, INC., *supra* note 1, at 17.

107. CONG. BUDGET OFFICE, FEDERAL TERRORISM REINSURANCE: AN UPDATE 5 (Jan. 2005).

108. *Id.* at Appendix B.

109. RISK MGMT. SOLUTIONS, INC., *supra* note 1, at 17.

### 3. The Need for Terrorism Insurance

Despite the fact that writing terrorism insurance is unattractive to insurers, terrorism coverage is necessary in today's world. Since the creation of the Homeland Security Advisory System<sup>110</sup> in 2002,<sup>111</sup> the terrorism threat level has never rated below yellow.<sup>112</sup> A threat level of yellow means that there is "significant risk of a terrorist attack."<sup>113</sup> Furthermore, the Department of Homeland Security had raised the threat level from yellow to orange nationwide on five separate occasions,<sup>114</sup> meaning that there was a "high risk of terrorist attacks."<sup>115</sup> After intercepting a serious threat that passengers would carry explosives onto a plane traveling from the United Kingdom to the U.S., the Secretary of Homeland Security raised the threat level to red,<sup>116</sup> which means "severe."<sup>117</sup> In short, the U.S. has been on constant guard since September 11th, and this will continue in the future.<sup>118</sup> President Bush has told Americans that it is not a question of *whether* America will face another terrorist attack, but rather a question of *when*.<sup>119</sup> In light of this constant threat, insurance companies and the federal government need to take

110. Homeland Security Advisory System, [http://www.dhs.gov/xinfo/share/programs/Copy\\_of\\_press\\_release\\_0046.shtm](http://www.dhs.gov/xinfo/share/programs/Copy_of_press_release_0046.shtm) (last visited Nov. 21, 2006).

111. Robert Block, *Pressure Mounts to Overhaul U.S. Terrorism-Alert System*, WALL ST. J., July 13, 2004, at A2.

112. Chronology of Changes to the Homeland Security Advisory System, [http://www.dhs.gov/about/history/editorial\\_0844.shtm](http://www.dhs.gov/about/history/editorial_0844.shtm) (last visited Nov. 11, 2007) [hereinafter Chronology]. See *Homeland Security Advisory System: Threat Codes and Public Responses*, Hearing before the Subcomm. on National Security, Emerging Threats and International Relations of the H. Comm. on Government Reform, 108th Cong. 43 (2004) [hereinafter *Homeland Security Advisory System: Threat Codes and Public Responses*] (statement of Shawn Reese, Analyst, American National Government Congressional Research Service).

113. Homeland Security Advisory System, *supra* note 110.

114. Chronology, *supra* note 112. See also *Homeland Security Advisory System: Threat Codes and Public Responses*, *supra* note 112, at 43 (statement of Shawn Reese, Analyst, American National Government Congressional Research Service); *id.* at 9 (statement of Gen. Patrick Hughes, Assistant Secretary for Information Analysis, U.S. Department of Homeland Security); *id.* at 3 (statement of Christopher Shays, U.S. Representative).

115. Homeland Security Advisory System, *supra* note 110.

116. See *Threat Level Change for Aviation Sector*, U.S. FED. NEWS, Aug. 10, 2006; Stephen Fidler & Bob Sherwood, *M15 tracked group for a year*, FIN. TIMES, Aug. 11, 2006, at 3; Chronology, *supra* note 112.

117. Homeland Security Advisory System, *supra* note 110.

118. RISK MGMT. SOLUTIONS, INC., *supra* note 1, at 1, 6–7 (suggesting terrorists are committed to complete another terrorist attack on U.S. soil and also noting that the frequency of terrorist attacks has increased since September 11th); *Terrorism Threats and the Insurance Market*, *supra* note 35, at 79 (statement of Peter Ulrich, Senior Vice President of Risk Management Solutions, Inc.) ("The U.S. continues to be the target of political violence . . . and anti-American sentiment shows no sign of abating. [Although t]he U.S. has become more secure . . . the chance of a major terrorist attack in the homeland U.S. still remains.").

119. *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 128 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company) ("President Bush and other leaders of our government tell us that there *will* be—not *may* be—another terrorist attack on our soil.").



affirmative steps to protect the economy from the effects of another attack.<sup>120</sup>

Also because of this ongoing threat, real estate and construction businesses are now often required to obtain terrorism insurance in order to receive loans from banks and other lenders.<sup>121</sup> Without terrorism coverage, ratings on commercial mortgage loans will default or be downgraded<sup>122</sup> because lenders will not want to loan money to these underinsured businesses. Terrorism coverage is therefore essential to the economy.<sup>123</sup>

Some, however, believe that TRIEA creates perverse incentives—they argue that a restriction on certain economic activities is necessary and that with the protection of terrorism insurance, people will be confronted with a “moral hazard” and take less care to minimize their own exposure to terrorist attacks.<sup>124</sup> People could reduce their risk by relocating to areas that are less likely to be a target,<sup>125</sup> and perhaps the existence of TRIEA stops people from taking such precautions. However, others argue that businesses should engage in risky behavior,<sup>126</sup> and without terrorism insurance they are

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120. *Id.* at 86 (statement of Ramani Ayer, Chairman, President and C.E.O. of The Hartford Financial Services Group). Ayer believes:

[A]s long as this terrible risk threatens our way of life, we need to have a way to fortify our economy against it. The insurance industry is willing to play an integral role to finance this risk, working together with policyholders and the government, but we cannot do it alone.

*Id.*

121. *Insurers Are Ready*, *supra* note 11, at C1.

122. *Terrorism Threats and the Insurance Market*, *supra* note 35, at 35 (statement of Jeffrey DeBoer, President and C.E.O. of The Real Estate Roundtable).

123. *See, e.g., Protecting Americans from Catastrophic Risk*, *supra* note 12, at 127 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company) (explaining that after September 11th “[t]he lack of insurance capacity had a negative impact on the New York economy resulting in the postponement of many construction projects, lack of or inadequate property coverage for many commercial office buildings, and significant increases in pricing of commercial multi-peril business”); *see also id.* at 90–91 (statement of Gregory Case, President and C.E.O. of Aon Corporation).

124. Richard R. Stedman II, *Of Hurricanes and Airplanes: The Congressional Knee-Jerk Reaction to September 11*, 49 LOY. L. REV. 997, 1017–20 (2003); Manns, *supra* note 69, at 2536–37. *But see Terrorism Threats and the Insurance Market*, *supra* note 35, at 32 (statement of Jeffrey De Boer, President and C.E.O. of The Real Estate Roundtable) (“We share the view that the threat of terrorism is not on the decline, and as a consequence the real estate industry has invested vast sums on various mitigation activities . . . nationally on terror related risks, vulnerabilities and mitigation strategies with government at all levels.”).

125. *See generally* Darius Lakdawalla & George Zanjani, *Terrorism Insurance Policy and the Public Good*, 18 ST. JOHN’S J. LEGAL COMMENT. 463, 467 (2003) (noting that “[s]elf-protection against terrorism includes more subtle behavioral changes such as making decisions about where to live, where to locate an office-building project, or where to go for entertainment on a Saturday night”).

126. *See id.* at 466; *see also Protecting Americans from Catastrophic Risk*, *supra* note 12, at 89–90 (statement of Gregory Case, President and C.E.O. of Aon Corporation) (“Because insurance provides individuals and businesses with the ability to take the risks that are essential to the functioning of our economy, constraining that ability would be economically devastating. TRIA has prevented that from happening.”).

less likely to do so. As Darius Lakdawalla and George Zanjani noted in their paper *Terrorism Insurance Policy and the Public Good*, “TRIA’s potential encouragement of risk-taking behavior was in fact a key underlying motivation, rather than a worrisome side-effect.”<sup>127</sup> That is, we want businesses to occupy the Empire State Building and other prominent Manhattan buildings even though it may be risky. Furthermore, critics who worry about the “moral hazard” seem to ignore the fact that insurers are still required to pay potentially huge losses under TRIEA,<sup>128</sup> and therefore have great incentive to make policyholders minimize their risks.<sup>129</sup> Insureds may somewhat reduce their exposure to terrorism risk by investing in better security systems and by moving to safer locations.<sup>130</sup> However, those who worry about the “moral hazard” also seem to forget that there is only so much the insured can do to limit its exposure. The federal government alone is most capable of minimizing the U.S.’s exposure to terrorist attacks.<sup>131</sup> Finally, and most importantly, these critics overlook the fact that human lives are the most significant loss in any terrorist attack. Regardless of the money, policyholders will take care to ensure their own survival.

#### 4. State Regulation Cannot Solve the Problem

Before the passage of TRIA, terrorism insurance was largely unregulated, so insurers could decide for themselves the cost of doing business.<sup>132</sup> In fact, only New York, California, Florida, Georgia and Texas regulated terrorism insurance before September 11th.<sup>133</sup> As a result of this lack of regulation, many insurers chose to exclude terrorism from their policies, deciding they did not want to be in that line of business at all.<sup>134</sup> Those that did not exclude terrorism coverage from their policies did not factor that risk into their premium calculus and essentially provided the coverage free of charge.<sup>135</sup> After September 11th and before the TRIA became effective, forty-five states allowed insurers to exclude terrorism coverage.<sup>136</sup> Some states, however, went against this trend and prohibited insurance companies from excluding terrorism coverage from their policies.<sup>137</sup> In Florida, for example, the state insurance department refused

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127. Lakdawalla & Zanjani, *supra* note 125, at 468.

128. TRIEA §§ 3(c)(3)(E)–(F), 4. *See infra* note 163.

129. Alan Wirzbicki, *Lawmakers Study Terror Insurance Renewal*, BOSTON GLOBE, Sept. 27, 2006, at A2.

130. Lakdawalla & Zanjani, *supra* note 125, at 467.

131. RISK MGMT. SOLUTIONS, INC., *supra* note 1, at 20–21.

132. CBO, *supra* note 6, at 8.

133. *Id.*

134. *Id.*

135. U.S. DEPT. OF THE TREASURY, *supra* note 3, at 27 n.28.

136. Scott Barancik, *Condos’ Premiums, Risk May Rise*, ST. PETERSBURG TIMES, Apr. 20, 2002, at 1E.

137. *Id.*

to allow terrorism exclusions after September 11th, despite the possibility that certain insurers could be priced out of the market.<sup>138</sup>

Should TRIEA lapse, one way to keep terrorism insurance affordable and available would be through state regulation. States could require insurers to provide coverage for terrorism risk, but this solution presents further difficulties.<sup>139</sup> Under their police powers, states now have the “unquestioned power” to regulate insurers,<sup>140</sup> and may do so without compensating the insurers who have no choice but to write the regulated insurance. In order to keep insurance affordable and available, which was one of the stated purposes of TRIA,<sup>141</sup> state regulators could determine the price of writing terrorism insurance.<sup>142</sup> Should insurance companies decide to raise terrorism risk insurance premiums, in most states, they would first need permission from the state regulator,<sup>143</sup> who could decline all rates that are “excessive, inadequate or unfairly discriminatory.”<sup>144</sup>

In a world without TRIEA, however, state involvement alone could not solve the problem. In fact, RMS believes that state regulation actually “hinder[s]” the terrorism insurance market, and suggests that state regulation will cause insurers to leave the terrorism market.<sup>145</sup> Under the TRIEA regime where the federal government requires insurers to provide coverage, the federal government will compensate insurers in the event of an attack as the price for making them provide terrorism coverage. States could not realistically compel insurers to provide terrorism coverage at their required prices without giving the insurers any compensation. Since the insurers would be unable to use their usual coping mechanism of increasing premiums or excluding coverage to remain profitable,<sup>146</sup> they would in turn be forced to do business at artificially low rates, and would thus lose money.<sup>147</sup> Though state regulation would protect the insured in the short run

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138. *Id.* (reinsurers threatened primary insurers that they would drop coverage unless the state regulators allowed terrorism exemptions).

139. See, e.g., *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 129 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company) (“State laws prohibit workers’ compensation policies from excluding terrorism related losses, thus leaving many regional workers’ compensation specialists in an extremely vulnerable position.”).

140. APPLEMAN, *supra* note 9, at §169.1[A].

141. TRIA § 101(b)(1).

142. CBO, *supra* note 6, at 7 (discussing how regulators keep insurance affordable).

143. See J. David Cummins & Mary A. Weiss, *Regulation and the Automobile Insurance Crisis*, REGULATION: THE CATO REVIEW OF BUSINESS & GOVERNMENT, available at <http://www.cato.org/pubs/regulation/reg15n2c.html> (discussing state regulation and rate changes in the context of automobile insurance).

144. See *id.*

145. RISK MGMT. SOLUTIONS, INC., *supra* note 1, at 20.

146. CBO, *supra* note 6, at 9.

147. Cummins & Weiss, *supra* note 143. State regulation of car insurance has caused “market failure” in at least New Jersey and Massachusetts. As discussed in the article “Regulation and the Automobile Insurance Crisis,” insurance costs are high in both New Jersey and Massachusetts due in large part to high accident rates. As a result of soaring premiums, these states commenced “strict prior approval rate regulation,” which in turn made “auto insurance unprofitable for the

by keeping insurance affordable, in the long term, the regulators could price private insurance companies out of the terrorism market<sup>148</sup> and leave the insured with no terrorism coverage at all.

### **B. THE FEDERAL GOVERNMENT ALONE CAN SOLVE THE PROBLEM**

As previously discussed, with loss estimates resulting from the hypothetical attack in the hundreds of billions of dollars, the federal government would have to support the insurance companies in the absence of TRIEA.<sup>149</sup> Without the support of the federal government, insurers would not be able to pay their claims.<sup>150</sup> Furthermore, the federal government provides enormous support to affected people after natural catastrophes and should do likewise after a terrorist attack.<sup>151</sup> Having failed to protect the country for which Congress has a duty,<sup>152</sup> Congress *should* have an affirmative duty to provide for its citizens after an attack. As Warren Heck explained at the Congressional hearing relating to the extension of TRIEA:

[T]he issue before Congress is not whether the government will be the insurer of last resort in the event of such an attack, but rather whether the government will work with the insurance industry to thoughtfully and deliberately develop a plan to maximize private sector coverage of the massive damages that will result before an attack, rather than reacting in crisis mode after an attack occurs. Better TRIA than FEMA.<sup>153</sup>

In other words, the federal government will have to support the insurance industry in some form, and it is far better to be proactive rather than reactive.

Furthermore, TRIEA's current effect on the insurance industry demonstrates its success and supports an extension of the Act. In the voluminous Report to Congress in which the Treasury Department assessed TRIA, the Treasury Department documented growth in insurer financial capacity during the TRIA years, and specifically pointed to the increase of policyholder surplus since the enactment of TRIA.<sup>154</sup> An increase in policyholder surplus means that an insurer is better able to pay its claims.<sup>155</sup>

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insurance industry." In the end, "the voluntary market for auto insurance has virtually ceased to exist" in these states. *Id.*

148. See CBO, *supra* note 6, at 8; see also Cummins & Weiss, *supra* note 143.

149. See *supra* notes 98–99 and accompanying text.

150. See *supra* note 99.

151. See, e.g., *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 130–31 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company).

152. See, e.g., U.S. CONST. art. I, § 8, cl. 1 (saying Congress has the affirmative power to "provide for the Common Defence and general Welfare of the United States").

153. *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 90 (statement of Gregory Case, President and C.E.O. of Aon Corporation).

154. U.S. DEPT. OF THE TREASURY, *supra* note 3, at 127–28.

155. *Id.*

In fact, surplus was higher in 2004 than it was immediately before September 11th.<sup>156</sup> In addition, terrorism insurance policy take-up rates increased at least 40% since TRIA's inception, and premiums have dropped.<sup>157</sup> In the Midwest and Southwest, where terrorist attacks are less likely than in locations like New York City,<sup>158</sup> take-up rates increased 35%.<sup>159</sup> It makes little sense to abandon a program that has proven to have done its job so effectively.

On the other hand, critics of TRIEA complain that the Act is a form of corporate welfare and that the insurance industry should not be given this extra support.<sup>160</sup> However, these critics overlook the fact that in 2007, TRIEA is only triggered by an act of terrorism that results in at least \$100 million in insured losses.<sup>161</sup> The federal government has not paid insurers a single dollar since the inception of the backstop.<sup>162</sup> Furthermore, the federal government only compensates insurers after insurers have already paid out a large portion of their deductibles.<sup>163</sup> In fact, RMS estimated that "in over 90% of attacks, the industry pays the majority of loss."<sup>164</sup> TRIEA is really meant for a worst case scenario.<sup>165</sup> TRIEA only provides essential support and is not a means for the insurance industry to get rich.

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156. *Id.*

157. RISK MGMT. SOLUTIONS, INC., *supra* note 1, at 24.

158. Quantifying the Risk from Terrorist Attacks, *supra* note 88 (includes a map of potential terrorist targets).

159. Trowbridge, *supra* note 81.

160. Stedman, *supra* note 124, at 1020. See Trowbridge, *supra* note 81 ("[T]he Consumer Federation of America opposed an extension [of TRIEA], saying in a letter to legislators that it could 'put taxpayers on the hook for billions of dollars in terrorism losses that the insurance industry could otherwise afford.'").

161. TRIEA § 6.

162. *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 89 (statement of Gregory Case, President and C.E.O. of Aon Corporation) ("Indeed, not only have federal funds provided by the TRIA 'backstop' never been tapped and not one taxpayer dollar spent, the program has proved to be an unqualified success in stabilizing the insurance markets . . .").

163. TRIEA § 4; *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 140 (statement of Edmund F. Kelly, Chairman, President and C.E.O. of Liberty Mutual Group). As Kelly noted:

Since company deductibles are so large, TRIEA would reimburse the industry only if a truly significant event occurred. At Liberty Mutual for example, our TRIEA deductible is approximately \$1.5 billion. A backstop that protects us from a loss exceeding \$1.5 billion is hardly a handout—especially considering we're offering coverage we would otherwise not offer, or would offer on significantly different terms.

*Id.*

164. *Terrorism Threats and the Insurance Market*, *supra* note 35, at 79 (statement of Peter Ulrich, Senior Vice President of Risk Management Solutions, Inc.).

165. *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 127 (statement of Warren Heck, Chairman and C.E.O., Greater New York Mutual Insurance Company) ("With the passage of TRIA, the fear that a worst case terrorist event could render our company insolvent was somewhat reduced, making it possible for our company to continue to do business in New York City and other urban areas.").

**C. CONGRESS SHOULD CREATE A LONG-TERM BACKSTOP  
MODELED AFTER TRIEA**

As previously discussed, there are many reasons why insurers would want to quit the market in the absence of TRIEA. Terrorism is essentially an uninsurable risk<sup>166</sup> that needs to be insured. First and foremost, terrorism is uninsurable because it is unpredictable. Unfortunately, the only real way for terrorism to become more predictable is for terrorists to launch more attacks, for you can only truly discern an accurate pattern with multiple data points.<sup>167</sup> However, even if modelers could predict the future, it does not necessarily follow that insurers will want to cover terrorism risk of their own volition. Perhaps a truly precise prediction of future terrorist attacks would make insurers even more hesitant to write the coverage. If insurers were allowed to exclude coverage, the abandonment would in turn have stifling effects on the economy, specifically on the development of the real estate market.<sup>168</sup>

It is clear that TRIEA should be extended in some form. Even former Secretary of the Treasury John W. Snow,<sup>169</sup> who opposes the extension of TRIEA believing that it hinders the development of a private market for terrorism insurance,<sup>170</sup> predicted negative consequences of allowing TRIEA to sunset. Specifically, Secretary Snow believes that after TRIEA expires, insurers will either exclude terrorism from their policies or increase premiums on terrorism coverage.<sup>171</sup> In fact, Christopher Timm, president of Century Insurance Group admits that “[t]he only reason we offer [terrorism insurance] now is because we have to under this law.”<sup>172</sup> If TRIEA expires, there is little question that insurance companies will abandon the terrorism market. The whole purpose of the Act was to make terrorism coverage affordable and available.<sup>173</sup> With Secretary Snow’s predictions, Mr. Timm’s frank statement, and in the face of a constant terrorist threat,<sup>174</sup> it seems foolish to allow the Act to sunset. Rather than allow TRIEA to do so,

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166. Boardman, *supra* note 31, at 786. *See also supra* notes 93, 95.

167. *See* Boardman, *supra* note 31, at 815.

168. *Insurers Are Ready*, *supra* note 11, at C1; *Terrorism Threats and the Insurance Market*, *supra* note 35, at 34–36 (statement of Jeffrey DeBoer, President and C.E.O. of The Real Estate Roundtable).

169. TRIA § 108(d)(1) (Congress gave Secretary Snow the responsibility to “assess the effectiveness of the Program and the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the program.”).

170. H.R. REP. NO. JS-2618, *supra* note 101.

171. U.S. DEPT. OF THE TREASURY, *supra* note 3, at 133–34.

172. Trowbridge, *supra* note 81.

173. TRIA § 101(b)(1).

174. *See supra* Part III.A.3.

Congress should create a long-term solution to the terrorism coverage problem.<sup>175</sup>

So far, Congress has had to re-visit the terrorism insurance issue every two years, arguably a great waste of its time. Terrorism will continue to threaten the U.S., and terrorism coverage will continue to be unattractive to insurers.<sup>176</sup> Ben Tucker, Vice President of national property insurance for Marsh USA, believes “[i]t will take at least [ten] more years for the insurance market to be able to handle the risk.”<sup>177</sup> Therefore, reevaluations every two years make little sense.

Not only has Congress had to re-confront the issue every two years, so have insurance companies. Since TRIA’s inception, insurers have been preparing for the sunset. Perhaps if insurance companies had spent their time with TRIA and TRIEA coverage focused solely on the development of the terrorism insurance market rather than on preparation for a looming sunset, the market would be even stronger today. A long-term federal backstop may well dispel panic and provide comfort to insurance companies and, contrary to Secretary Snow’s belief, actually help the development of a private market. If the private market grows stronger, then Congress can always amend the legislation and slowly lower federal involvement.

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175. See *Protecting Americans from Catastrophic Risk*, *supra* note 12, at 79–80 (statement of Janice Abraham, President and C.E.O. of United Educations of Reciprocal Risk Retention Group). Abraham noted:

We believe a long-term program should replace TRIA when it expires next year. We believe insurance policyholders and insurance markets generally will benefit significantly from the predictability and structure a long-term program would provide. In addition, we do not believe the Congress wants to be, or should be, asked to revisit this issue every two years.

*Id.*

176. *Terrorism Threats and the Insurance Market*, *supra* note 35, at 32–33 (statement of Jeffrey DeBoer, President and C.E.O. of The Real Estate Roundtable). DeBoer explained:

As John Adams famously once said: ‘Facts are stubborn things; and whatever may be our wishes, our inclinations, or the dictates of our passions, they cannot alter the state of facts and evidence.’ . . .

The facts which prompted Congress and President Bush in 2002 to work daily to enact the Terrorism Risk Insurance Act (TRIA) unfortunately have not changed. The threat of terrorism continues to be an unpredictable, man-made threat as opposed to natural, somewhat predicable, property and casualty risk. . . .

Consequently, in our view, insurers and reinsurers logically continue to be unable to assess and price terrorism risk insurance. Until there is clear evidence that these facts have changed, and the overall risks to our society subside, we see a continuing need for federal involvement in the failed terrorism risk reinsurance market.

*Id.*

177. Trowbridge, *supra* note 81.

The backstop should be long-term but not set in stone. As insurers' capacities grow, Congress can raise insurer deductibles and lower federal payment so that TRIEA continues to accomplish its goals of stabilizing the private market and keeping coverage affordable and available,<sup>178</sup> while not passing into the territory of government subsidy.<sup>179</sup> Having seen that a cold-turkey approach simply will not work, as evidenced by the existence of springing exclusions, Congress should adapt and rather wean the insurance companies from their essential crutch.

## CONCLUSION

If left to their own devices, insurance companies will exclude terrorism coverage from their policies. Not only have insurers admitted they are only in the terrorism market because TRIEA forces them to be, empirical evidence also shows that insurers prepared to increase premium prices as the TRIA sunset approached, and are now writing automatic exclusions into their policies as the TRIEA sunset draws near. Though some insurers, like Greater New York, feel a sense of moral obligation to stay in the terrorism insurance market, Greater New York is the exception to the rule. There will be heavy ramifications if insurers are allowed to leave the market altogether, and likewise, there will be negative consequences if insurers are forced to remain in the market without the possibility of federal compensation. The only viable option is for the government to stay its present course, forcing insurers to write terrorism coverage while providing compensation for making them do so. The terrorist threat will not go away in the foreseeable future. As long as the U.S. remains a world leader, there will be others who will want to see its demise. Therefore, the federal government should create a continuing solution to deal with the continuing problem.

*Laura M. Reiter*

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178. TRIA § 101(b)(1)–(2).

179. *Terrorism Threats and the Insurance Market*, *supra* note 35, at 79 (statement of Peter Ulrich, Senior Vice President of Risk Management Solutions, Inc.) (The federal backstop provides the “insurance industry with solvency, not subsidy”).