RISKY BUSINESS: WHY CURRENT AND DEVELOPING CHARACTERISTICS OF THE COMMERCIAL REAL ESTATE MARKET WILL NOT TOLERATE THE EXPIRATION OF FEDERAL PARTICIPATION IN TERRORISM INSURANCE*

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I. INTRODUCTION

"There are regrettable instances in which markets do not work. . ."[1]

-Federal Reserve Chairman Alan Greenspan, 2005

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1. Press Release, Coalition to Insure Against Terrorism, Fed Chairman Questions Ability of Private Market Alone to Insure Against Terrorism (Feb. 17, 2005) (*available at* http://www.insureagainstterrorism.org/release21705.pdf). Greenspan added that he has "yet to be convinced" that a private market for terrorism insurance is a workable endeavor. *Id.*

The availability and affordability of terrorism risk insurance is critical to the health of the United States economy.[2] The terrorist attacks on September 11, 2001 created uncertainties in the privative marketplace that resulted in decisions by property and casualty insurers either to terminate terrorism insurance policies or to increase premiums to cost-prohibitive levels.[3] These uncertainties reflected the lack of information available for the financial services industry to "make statistically valid estimates of the probability and cost of future terrorist events, and therefore the size, funding, and allocation of the risk of loss caused by such acts of terrorism."[4] As a result, in the absence of an intervention by the United States government, uninsurable terrorism risks would create serious obstacles to the stability of the real estate market and the U.S. economy in general.[5]

In response to this threat, on November 26, 2002, President George W. Bush signed the Terrorism Risk Insurance Act (TRIA) into law.[6] The stated purpose of this Act was to create a temporary federal reinsurance program that would "protect consumers by addressing market disruptions and ensure the continued widespread availability and affordability of property and casualty insurance for terrorism risk" and allow for private markets to stabilize and develop the systems, mechanisms, products, and programs necessary to assume such risk in the future.[7]

As of this article's completion, TRIA has yet to be extended beyond its original termination date of December 31, 2005.[8] The Bush Administration, along with the entire real estate and casualty insurance sectors, has just received the Treasury Department's long-awaited assessment of the program.[9] The analysis, which was delivered to Congress on June 30, 2005, was expected to "provide a broader and more dynamic view of the

2. *See generally* Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, 116 Stat. 2322 (2002).

3. *Id.* § 101(a)(5).

4. *Id.* § 101(a)(4).

5. *See id.* § 101(a)(5).

6. Jeffrey Manns, *Insuring Against Terror?*, 112 YALE L.J. 2509, 2509 (2003).

7. Terrorism Risk Insurance Act § 101(b).

8. *See* Terrorism Insurance Backstop Extension Act of 2004, H.R. 4634, 108th Cong. § 2(g) (2004). Advocates of TRIA consider its extension a top priority in 2005. *See* MORTGAGE BANKERS ASS'N, AVAILABILITY OF TERRORISM COVERAGE FOR COMMERCIAL REAL ESTATE 3 (2005), *available at* http://www.mortgagebankers.org/library/isp/2005_1/Availability%20of%20Terrorism%20for%20Commercial%20Real%20Estate.pdf.

9. DAVID TORREGROSA, CONG. BUDGET OFFICE, FEDERAL TERRORISM REINSURANCE: AN UPDATE 15 (2005), *available at* http://www.cbo.gov/ftpdocs/60xx/doc6049/01-05-Terrorism.pdf.

marketplace" than surveys conducted by private firms.[10] In the report, which is mandated by TRIA, the Secretary of the Treasury, "in consultation with the National Association of Insurance Commissioners, and other experts as needed", was asked to consider whether the Act has been effective in stabilizing the affected markets and whether the private insurance market has developed the capacity and mechanisms necessary to assess terrorism risk and provide adequate coverage at affordable levels.[11] Despite such high expectations for the Treasury's report, its conclusions are short-sighted and do not adequately recognize the realities of today's marketplace. There is ample evidence to show that the insurance industry has not succeeded in developing ways to provide coverage in TRIA's absence.[12] Based on these findings, this article concludes that the conditions that led to the creation of TRIA will continue to exist into the foreseeable future, making TRIA indispensable to a stable real estate market. As Real Estate Roundtable President and CEO Jeffrey D. DeBoer stated in a recent press release, "TRIA is a necessary stabilizing influence on the U.S. economy and [its] absence could lead to the same kinds of disruptions that arose before the law's enactment in 2002."[13]

II. CONDITIONS LEADING TO TRIA'S ENACTMENT

Terrorism insurance differs from other more viable forms of casualty insurance in two major respects.[14] First, private insurance markets lack the information necessary to make insurable determinations as to the probability and potential magnitude of future terrorist attacks.[15] Second, only the federal government retains the level of liquidity necessary to sustain the financial impact of another catastrophic terrorist attack.[16]

Most analogous to that of terrorism insurance calculations are those for natural disasters such as floods, hurricanes, and

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10. *Id.* at 16.
11. Terrorism Risk Insurance Act § 108(d).
12. *See* GEN. ACCOUNTING OFFICE, GAO-04-720T, TERRORISM INSURANCE: EFFECTS OF THE TERRORISM RISK INSURANCE ACT OF 2002 (2004).
13. Press Release, The Real Estate Roundtable, Extending Terror Insurance Law Will Strengthen, Protect U.S. Economy, Study Concludes (Sept. 14, 2004) (*available at* http://www.rer.org/media/newsreleases/TRIA_Extension_Study_News_Release.cfm). The Real Estate Roundtable is an organization devoted to addressing policy issues facing the real estate industry and the economy in general.
14. Manns, *supra* note 6, at 2516.
15. *Id.*
16. *Id.* at 2518.

earthquakes.[17] Both are infrequent and unpredictable yet carry significant costs when they do occur.[18] There have been so few acts of terrorism on American soil, however, that it is still much more difficult to calculate the risk of terrorism than that of natural disasters.[19]

Liquidity concerns regarding natural disasters are also similar to those of acts of terrorism.[20] Florida's 2004 hurricane season is just one reminder of the enormous losses that natural disasters pose to insurers.[21] Such catastrophic events show that both types of threats can create equally devastating losses, and that the insurance industry's ability to cover such losses may be equally unlikely.[22]

In addition, the customer base for terrorism insurance is not large enough for insurance companies to spread their expected losses effectively.[23] This issue relates back to the problem of accurately assessing terrorism risk. When there is no way for buyers to substantiate their perceived level of risk, only those who see their properties as "high risk" will purchase policies.[24] Without being able to allocate risk from high-risk policyholders among low-risk policyholders, it would be difficult for insurers to make coverage affordable.[25]

The United States is not the first country to face the difficulties in providing terrorism insurance.[26] Australia, Great Britain, France, Spain, and Germany are among those who have created government programs to assist in this task.[27]

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17. *Id.* at 2516.

18. *Id.*

19. *Id.* at 2517.

20. *Id.* at 2520.

21. *See* FLORIDA OFFICE OF INSURANCE REGULATION, DISASTER REPORTING SUMMARIES (Jan. 18, 2005) [hereinafter DISASTER REPORTING SUMMARIES], *available at* http://www.flains.org/public/011305ReportingSummaries.pdf. As of January 13, 2005, expected gross property losses from Florida's 2004 hurricane season totaled more than $21 billion. *Id.* Of the claims reported, casualty insurance consumers are expected to pay $1.6 billion in deductibles. *Id.*

22. *See id.*

23. LLOYD DIXON ET AL., ISSUES AND OPTIONS FOR GOVERNMENT INTERVENTION IN THE MARKET FOR TERRORISM INSURANCE, 6 (2004) (prepublication copy, *available at* http://www.rand.org/publications/OP/OP135/OP135.pdf.

24. *Id.*

25. *Id.* at 7. *See also* GEN. ACCOUNTING OFFICE, *supra* note 12, at 3-8 (discussing the problems created when only a small base of high-risk property owners buy terrorism insurance).

26. DIXON, *supra* note 23, at 7.

27. *Id.*

III. SHAPING THE POLITICAL CLIMATE

The case for federal intervention was brought to the forefront of Congressional and Presidential agendas, in large part, by the Coalition to Insure Against Terrorism (CIAT).[28] CIAT represents a vast array of commercial property and casualty insurance consumers, including those in public sector insurance and all sectors of the private economy.[29] CIAT and other advocates argued that the private insurance market was incapable and unwilling to provide affordable insurance against terrorism.[30] In the absence of federal intervention, they warned, the lack of affordable coverage would stymie the construction industry and subject the U.S. economy to a prolonged economic downturn.[31] By packaging the case for TRIA as an indispensable component of a healthy economy and a secure homeland in a post 9/11 America, CIAT and others were able to push the issue into the national spotlight.[32]

IV. KEY FEATURES AND GOALS OF THE TERRORISM RISK INSURANCE ACT

TRIA created a federal reinsurance program of "shared public and private compensation for insured commercial property and casualty losses resulting from acts of terrorism."[33] First, the Act voided "any terrorism exclusion in a contract for property and casualty insurance. . .to the extent that it excludes losses that would otherwise be insured."[34] During the existence of the program, insurers are required to "make available" coverage for insured losses resulting from terrorist acts at rates that do not differ materially from those applicable to other types of property and casualty losses.[35] In the event of a terrorist attack, insured

28. Manns, *supra* note 6, at 2527.

29. *Terrorism Risk Insurance: Hearing Before the Subcomm. on Banking, Housing and Urban Affairs*, 108th Cong. (2004) (statement of Christopher Nassetta on behalf of The Coalition to Insure Against Terrorism [hereinafter Nassetta Testimony]). The Mortgage Bankers Association has also been a leading advocate of TRIA's enactment and is highly involved in monitoring its implementation. *See* MORTGAGE BANKERS ASS'N, *supra* note 8.

30. Manns, *supra* note 6, at 2528 nn.86-87.

31. *Id.*

32. *Id.*

33. Press Release, Dep't of the Treasury, Remarks by the Honorable Peter R. Fisher, Implementing the Terrorism Risk Insurance Act of 2002 (Jan. 29, 2003) (*available at* http://www.ustreas.gov/press/releases/kd3810.htm).

34. Terrorism Risk Insurance Act, Pub. L. No. 107-297, § 105(a), 116 Stat. 2322 (2002).

35. *Id.* § 103(c)(1).

loss is shared between the Federal Government and the applicable insurer through an escalating deductible schedule.[36] Once an insurer has met its deductible, the federal share of compensation under the program will be 90 percent of the excess amount of the insured loss.[37] In any event, the federal share of insured loss will not exceed $100 billion for any single year of the program's existence.[38] The insurance market's aggregate share of insured loss is tied to the escalating deductible schedule set forth in the Act.[39] In the event of a payout, the Treasury Department is required to recoup some of its costs by assessing surcharges based on a percentage of the premium charged for commercial property and casualty insurance policies issued after a certified terrorist attack.[40] Due to the nature of these elements, the TRIA program is characterized as a "backstop," as opposed to the less politically palatable term "bailout."[41]

The system created by this Act is meant to "phase out" the Federal Government's role as an insurer and allow for the development of an adequate private insurance market for terrorism risk.[42] TRIA only applies to "acts of terrorism" certified as such "by the Secretary [of the Treasury], in concurrence with the Secretary of State, and the Attorney General of the United States."[43] TRIA also limits "acts of terrorism" to those committed by an individual on behalf of a foreign person or foreign interest.[44] Currently, TRIA is understood by insurers as not applicable to chemical, biological, radiological, or nuclear risks (CBRN).[45] Because CBRN losses have the potential to reach such

36. *Id.* § 103(e). *See also id.* § 102(7)(defining the term "insurer deductible").

37. *Id.* § 103(e)(1)(A).

38. *Id.* § 103(e)(2)(A).

39. *See id.* at § 103(e)(6).

40. *Id.* § 103(e)(7).

41. *See* Manns, *supra* note 6, at 2529 n.93.

42. Dep't of the Treasury, *supra* note 33 para. 5.

43. Terrorism Risk Insurance Act § 102(1)(A).

44. *Id.* § 102(1)(A)(iv). *Contra* Letter from Martin L. DePoy, Steering Committee Coordinator, Coalition to Insure Against Terrorism, to Jeffrey Bragg, Executive Director, Terrorism Risk Insurance Program, Dep't of the Treasury (Jan. 15, 2004) (*available at* http://www.insureagainstterrorism.org/pdf/11504bragg.pdf) (requesting an interpretation of TRIA confirming the "applicability of TRIA to insurance coverage for nuclear (including radiological), biological and chemical. . .contamination resulting from an act of terrorism").

45. Nassetta Testimony, *supra* note 29, at 5. *C.f.*, U.S. DEP'T OF THE TREASURY, ASSESSMENT: THE TERRORISM RISK INSURANCE ACT OF 2002 77 (2005), *available at* http://www.treas.gov/press/releases/reports/063005%20tria%20study.pdf (stating that neither TRIA's definition of insured loss nor its definition of an act of terrorism exclude chemical, biological, radiological, or nuclear risks).

high levels due to latent health defects and site cleanup costs, insurance companies exclude such coverage whenever possible.[46]

Finally, to encourage prospective policyholders to "shop around," the program requires insurance companies to disclose the amount charged for terrorism coverage and the amount for which the federal government would be responsible in the event of an insured loss.[47] Policyholders then have the option to accept or reject the coverage;[48] if the policyholder rejects coverage, insurers may then reinstate their terrorism exclusions.[49] This provision of the Act is interesting for several reasons. As discussed above, one of the problems insurers face in providing terrorism insurance is the lack of a customer base large enough to adequately spread the risk.[50] It would seem that if TRIA made terrorism insurance coverage mandatory, this problem may be reduced by creating a larger base.[51] Mandatory coverage has its disadvantages however, and buyers and insurers alike would likely reject such constraints.[52]

V. THE IMPACT OF THE TERRORISM RISK INSURANCE ACT

As stated above, TRIA was enacted with two major goals in mind.[53] The first was to ensure that economic growth was not stifled by an unavailability of coverage and to protect the United States from the economic fallout of another terrorist attack on native soil.[54] This objective has, in large part, been achieved.[55] The second objective, to allow the insurance industry time to develop mechanisms and programs to price and provide terrorism insurance, has yet to be realized.[56]

On September 14, 2004, a comprehensive report on the economic effects of TRIA was prepared by Professor Glenn Hubbard, Dean of the Graduate School of Business at Columbia University, and Bruce Deal, Managing Principal of Analysis,

46. DIXON ET AL., *supra* note 23, at 20.
47. Manns, *supra* note 6, at 2535.
48. *Id.* at 2536.
49. *Id.*
50. DIXON ET AL., *supra* note 23, at 16.
51. *See id.*
52. *See generally id.* (discussing the advantages and disadvantages of mandatory terrorism insurance coverage).
53. GEN. ACCOUNTING OFFICE, *supra* note 12, at 10.
54. *Id.*
55. *Id.*
56. *Id.*

Group, Inc.[57] Hubbard and Deal reported that "TRIA, the absence of a major terrorist event, favorable overall loss experience, and disciplined underwriting" has successfully stabilized the insurance industry in the years since 9/11, and has done so at a minimal cost.[58] They attribute this performance to several reasons. First, the industry's recovery was due in part both to the federal government's success in preventing another terrorist attack after 9/11 and limited overall catastrophic losses (at least until the 2004 hurricane season).[59] Second, TRIA has succeeded in its goals to stabilize the insurance industry and set limits on private insurer exposure.[60] Third, stricter underwriting procedures have allowed for increased premiums.[61] Finally, favorable loss experiences across various business lines for the periods since 9/11 have resulted in improved performance for insurance companies.[62] On the other hand, based on current terrorism insurance premium levels, it would take at least eight more years worth of terrorism premiums to pay for another event of the magnitude of the 9/11 attacks.[63]

Since the enactment of TRIA, terrorism insurance premiums have remained steady or declined.[64] In addition, take-up rates for terrorism insurance coverage have increased.[65] Specifically, a recent study of 2,400 U.S. businesses by Marsh, Inc., the world's largest insurance brokerage firm, reports that by the end of the fourth quarter of 2003 the percentage of businesses that purchased terrorism coverage had risen to 32.7 percent.[66] To put this into perspective it is helpful to note that in the same year only 14-17 percent of eligible California homeowners had earthquake insurance.[67] Also, in 2003 the Federal Emergency Management Agency estimated that one-half to two-thirds of property owners eligible for flood insurance coverage under the

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57. R. GLENN HUBBARD & BRUCE DEAL, ANALYSIS GROUP, THE ECONOMIC EFFECTS OF FEDERAL PARTICIPATION IN TERRORISM RISK (2004), http://www.insureagainstterrorism.org/TRIAReport.pdf.

58. *Id.* at 24. TRIA's estimated cost to the federal government was $4 million during 2003 and $5 million per year for 2004 and 2005. *Id.*

59. *Id.* at 35. *See also* DISASTER REPORTING SUMMARIES, *supra* note 21 (reporting property damage estimates from Florida's 2004 hurricane season).

60. HUBBARD & DEAL, *supra* note 57, at 35.

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.* at 44.

65. *Id.* at 49. *See also* TORREGROSA, *supra* note 9 (reporting that TRIA has led to an increase in the number of companies securing coverage, especially those located in "high risk" areas).

66. Nassetta Testimony, *supra* note 29, at 7.

67. *Id.*

National Flood Insurance Program (NFIP) do not own such policies.[68] Hubbard and Deal attribute these effects on the insurance market to TRIA.[69] Their study concludes that TRIA's framework has caused the increase in take-up of terrorism insurance by enabling insurance companies to charge lower rates while encouraging policyholders to minimize their exposure to terrorism risks.[70]

The involvement of the federal government in the terrorism insurance market has spawned the question of whether TRIA has resulted in the "crowding out" of private insurers.[71] As noted by Hubbard and Deal, TRIA was enacted to "force insurers back into the marketplace" in exchange for the federal government's assumption of some of the risk.[72] If insurance companies thought they were being crowded out, it would not make sense for them to support such government participation. Therefore, if insurers would seek to decrease their participation in terrorism coverage without TRIA, it would follow that its implementation has not crowded the private sector.[73]

In their interviews with over 30 participants in the insurance industry, Hubbard and Deal found that TRIA was not considered as having crowded out private insurers.[74] In fact, the interviews suggested that in the absence of TRIA, property owners would be met with greater restrictions and less coverage availability.[75] One might reasonably conclude therefore, that TRIA will be needed as long as lenders continue to require such policies. According to Hubbard and Deal, a majority of insurers do not believe terrorism is the type of risk that can ever be shouldered by the private market.[76] Given the choice, most would rather trade reduced premiums for terrorism exclusions.[77] It follows that TRIA has not had the effect of crowding out the private market.[78] Instead, those interviewed suggested that because TRIA defines the federal government's level of participation before a terrorist event takes place, it allows both

68. *Id.*
69. *Id.*
70. *Id.*
71. HUBBARD & DEAL, *supra* note 57, at 63.
72. *Id.*
73. *See id.*
74. *Id.*
75. *Id.* at 63.
76. *Id.*
77. *Id.*
78. *Id.*

private and public insurers to manage their risk.[79]

VI. PROJECTED EFFECTS OF ALLOWING TRIA TO EXPIRE

Supporters of TRIA fear that the insurance market will make a complete turnaround should it be allowed to expire.[80] The conditions that led to its creation, they argue, have not subsided.[81] While the insurance industry has made gains in its financial capacity, the threat of terrorism within our borders has not decreased.[82] Furthermore, the Mortgage Bankers Association correctly points out that the properties most affected by TRIA's expiration would be those viewed by the insurance industry as "high risk."[83] Such properties would include "key infrastructure components such as power plants, bridges and water treatment facilities; as well as government buildings, airports, public transportation networks, properties in the central business districts of major cities, stadiums, major sports facilities, schools, malls, and hotels."[84] As a corollary, these properties are also those on which real estate lenders would most likely insist that the owners obtain terrorism policies as a prerequisite to financing. It is worth considering those properties most likely to be affected when considering the various arguments for, and against, federal participation in terrorism insurance markets.

Insurers have yet to develop the mechanisms necessary to allow the market to continue to provide terrorism coverage in the absence of TRIA.[85] Noting this, advocates of TRIA are quick to point to the continued exclusion of biological, chemical,

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79. *Id.*

80. Parke Chapman, *Will the Shield Protecting Terrorism Insurers Be Lifted?*, NAT'L REAL ESTATE INVESTOR, May 1, 2004, *available at* http://nreionline.com/mag/real_estate_shield_protecting_terrorism/index.html .

81. Nassetta Testimony, *supra* note 29, at 3.

82. *Id. See also* HUBBARD & DEAL, *supra* note 57, at 24-27 (noting the insurance market's financial recovery since TRIA's enactment). *See also*, RISK MANAGEMENT SOLUTIONS, INC., MANAGING TERRORISM RISK IN 2004 (2003), *available at* http://www.rms.com/publications/terrorism_risk_modeling.pdf (assessing the current state of terrorism risk in the United States).

83. *A Review of TRIA and Its Effect on the Economy: Helping America Move Forward: J. Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. and H. Subcomm. on Oversight and Investigations*, 108th Cong. 144 (2004) [hereinafter *J. Hearings*] (statement of the Mortgage Bankers Ass'n), *available at* http://www.mortgagebankers.org/industry/docs/04/MBA%20TRIA%20Statement%20House%204.28.04.pdf.

84. *Id.*

85. *Id.* at 61 (statement of Richard J. Hillman, Director, Fin. Mkts. and Cmty. Investment, Gen. Accounting Office).

radiological, and nuclear risks as evidence of how the insurance markets will react should the "make available" provision expire.[86]

In their 2004 survey of the effects of federal participation in terrorism insurance, Hubbard and Deal described the likely responses to this void by the insurance industry, policyholders, and the United States economy in general.[87] Their findings suggest that, with few exceptions, insurance companies would be unwilling to continue providing coverage for terrorism without TRIA.[88] In fact, the reinstatement of terrorism exclusions or limitations has been approved in 48 of the 54 U.S. jurisdictions in case TRIA expires.[89] As further evidence of insurers' intentions, prior to TRIA's extension to its current sunset of December 2005, the Mortgage Bankers Association (MBA) reported that insurers were already preparing to withdraw terrorism coverage.[90] In what could be a sign of things to come should TRIA be allowed to expire, MBA found that several insurers were refusing to renew policies beyond the possible December 2004 expiration date.[91] A separate survey conducted by the Council of Insurance Agents and Brokers (CIAB) acknowledged that a private reinsurance market has failed to develop, further bolstering MBA's prediction that TRIA's expiration will result in a withdrawal of coverage for foreign-origin terrorist attacks.[92]

As an additional reaction to the increased financial exposure TRIA's expiration would create, insurers may refuse to renew coverage for certain types of companies in high-density, high-risk cities.[93] Insurers who continue to provide coverage would be expected to increase premiums to compensate for the loss of a federal government backstop.[94] This is a result of the continuing level of uncertainty involved in estimating terrorism risk and the high level of financial capacity necessary to absorb catastrophic terrorism losses.[95] In the long term, insurance companies may choose not to provide coverage for certain business types or in

86. Nassetta Testimony, *supra* note 29, at 5.
87. HUBBARD & DEAL, *supra* note 57, at 71.
88. *Id.* at 66.
89. *Id.*
90. *J. Hearings*, *supra* note 83, at 142 (statement of the Mortgage Bankers Ass'n).
91. *Id.*
92. *Id.* at 143.
93. HUBBARD & DEAL, *supra* note 57, at 67.
94. *Id.*
95. *Id.*

certain geographic regions.[96]

The expiration of TRIA will most likely force policyholders to choose between more expensive coverage and no coverage at all.[97] Should they choose to accept higher premiums, business and property owners will suffer decreased profitability, returns, and property values.[98] An equally likely scenario would be the postponement or cancellation of projects where lender-required terrorism insurance cannot be obtained at affordable prices.[99] In the long term, a lack of affordable terrorism coverage may result in a general unwillingness to concentrate employees in central locations or this may influence decisions to relocate to more suburban areas.[100]

In the absence of federal participation, Hubbard and Deal predict two primary macroeconomic consequences: increased operating costs (and corresponding property devaluation) and higher labor costs.[101] First, businesses will realize higher operating costs in the form of either increased coverage premiums or the assumption of the risk of a debilitating terrorist event.[102] Second, labor costs would likely increase in the form of higher worker's compensation insurance premiums and reduced levels of productivity resulting from the inefficient structure of workforce locations and densities.[103]

VII. ALTERNATIVES TO TRIA

Looking beyond TRIA, some studies have explored the viability of alternative mechanisms to absorb the risk of catastrophic terrorism loss.[104]

Additional Capital

This approach assumes that in the absence of TRIA, new insurers, re-insurers, and investors in current insurance providers would close the gap between currently available capital and the amount of capital needed to "provide surplus against which terrorism coverage could be written."[105] Even if such an assumption were plausible (see the above discussion of whether

96. *Id.* at 68.
97. *Id.* at 71.
98. *Id.*
99. *See id.*
100. *Id.* at 73.
101. *Id.* at 75.
102. *Id.*
103. *Id.* at 77.
104. *See, e.g.*, *id.* at 57.
105. *Id.* at 58.

TRIA has "crowded out" the private market), another terrorist attack would create such uncertainty over losses that it would negate any gains made from the previous infusion of additional capital.[106]

Catastrophe Bonds

A catastrophe bond is a financial instrument that spreads the risk of catastrophic loss among investors in capital markets.[107] Because of the problems associated with quantifying terrorism risk, these bonds would offer a relatively high rate of return.[108] On the other hand, the magnitude of these problems has created challenges in developing catastrophe bonds, making it difficult for these bonds to cover terrorist acts in the same way they cover natural disasters.[109]

Insurance Pooling

Insurance pooling is a mechanism by which insurance companies combine their insured risks in order to spread the aggregate risk among the whole group.[110] Insurers may contribute funds to a pool voluntarily or as part of a mandatory government-sponsored program.[111] Despite a major pooling effort, the total industry assets would likely fall short of the aggregate losses resulting from another catastrophic terrorist attack.[112] Furthermore, should the federal government sponsor such a program, its maintenance would require an organization much broader and more complex than that which currently manages TRIA.[113]

Modification of Applicable Tax Laws

There are varying reports as to the likely effect of changing tax laws governing the treatment of reserves created to cover potential terrorist attacks.[114] Currently, such reserves must be comprised of after-tax dollars.[115] Thus, in order to address the

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106. *Id.*

107. *See J. Hearings*, *supra* note 83, at 73 (statement of Richard J. Hillman, Director, Fin. Mkts. and Cmty. Investment, Gen. Accounting Office).

108. *Id.*

109. *Id.* at 74. *But c.f.* TORREGROSA, *supra* note 9, at 5, 23 (suggesting that catastrophe bonds may begin to play a larger role in mitigating terrorism risk and even submitting that if catastrophe bonds were tied to two separate events ("multi-event-risk bonds"), the security might garner a favorable credit rating from agencies such as Moody's Investors Service).

110. HUBBARD & DEAL, *supra* note 57, at 59.

111. *Id.*

112. *Id.* at 60.

113. *Id.*

114. *See, e.g.*, *id.*

115. *Id.*

insurance industry's limited capacity to absorb catastrophic terrorism losses, some suggest that additions to these reserves be tax-deductible.[116] This change, they argue, would create an incentive for insurers to expand their capacity at lower costs.[117] Furthermore, it may be argued that the increased capacity to absorb potential losses would lead to an increased willingness on the part of the insurance industry to offer terrorism coverage.[118] Critics argue that such a modification would fail to guarantee such results, and in fact, would more likely create a way for insurers to protect earnings from the tax system.[119]

VIII. HERE TO STAY

As we have seen thus far, the Terrorism Risk Insurance Act espouses the very broad goal of correcting the economic instability created by the withdrawal of terrorism insurance from the private marketplace.[120] We have also seen that the driving force behind the Act's passage was a broad coalition of participants in the commercial real estate market who sought to restore certainty to commercial property risk management.[121] Previously, this note focused on how the original conditions leading to TRIA's enactment are still present today. The remainder of the note will demonstrate how current trends in commercial real estate have entrenched TRIA in the market and expanded the consequences of its expiration.

Prior to the attacks, insurance providers had all but dismissed the risk of terrorism, to the point where they failed to recognize it as a risk distinct from other property and casualty coverage.[122] The insurance industry was rudely awakened when the 9/11 attacks left a $40 billion claim on its doorstep.[123] This awakening triggered a mass withdrawal of available new property and casualty insurance coverage for acts of terrorism.[124] This threatened the stability of the real estate market on all

116. *Id.*

117. *Id.*

118. *Id.*

119. *See J. Hearings*, *supra* note 83, at 74-75 (statement of Richard J. Hillman, Director, Fin. Mkts. and Cmty. Investment, Gen. Accounting Office).

120. Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, 116 Stat. 2322, 2323 (2002).

121. Manns, *supra* note 6, at 2526-27.

122. GEN. ACCOUNTING OFFICE, *supra* note 12, at 1.

123. *Id.*

124. *The Future of Insuring Terrorism Risks: Hearing Before the Senate Comm. on Commerce, Science, and Transportation*, 107th Cong. (2001) (statement of Philip L. Hawkins, CEO CarrAmerica Realty Corporation) [hereinafter Hawkins Statement].

levels, particularly because lenders began conditioning financing for new development and construction on the purchase of adequate terrorism insurance.[125] Absent the requisite level of coverage, it would have been virtually "impossible to develop, operate or acquire properties, refinance loans, and to sell commercial-backed securities."[126] In fact, in the first year after the 9/11 attacks, separate surveys by the MBA and the Real Estate Roundtable reported that between $8 and $15.5 billion in real estate transactions in 17 states had been "stalled or cancelled" due to the property owner's inability to secure affordable coverage for acts of terrorism.[127] At that time, the real estate and construction industries comprised more than one-quarter of the United States GDP.[128] As discussed above, insurers are no more willing to provide this coverage today.[129]

IX. LENDER UNCERTAINTY

So why would a 200-unit apartment complex in Waco, Texas, for example, care about whether they can get terrorism insurance? Surely, they do not see themselves as "high-risk" targets. In fact, most property owners would probably welcome the idea of not having to pay such premiums. In some cases, property and casualty insurance premiums have skyrocketed by 300 to 400 percent since the inclusion of terrorism coverage.[130] It would seem, therefore, that the demand for coverage is coming from another source. . .the lenders. On June 2, 2004, the MBA released the results from a survey of commercial/multi-family mortgage servicers, the goal of which was to gauge the effect of TRIA since its enactment and the likely impact of its expiration.[131] According to the MBA, "Of the $656 billion

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125. SAUL EWING, LLP, WILL THE TERRORISM RISK INSURANCE ACT OF 2002 ALLEVIATE THE INSURANCE CRISIS RESULTING FROM THE 9/11 ATTACKS?, (Feb. 2003), *available at* http://www.saul.com/common/publications/pdf_96.pdf.

126. Hawkins Statement, *supra* note 124, at 2.

127. Press Release, The Real Estate Roundtable, Extending Terror Insurance Law Will Strengthen, Protect U.S. Economy, Study Concludes (Sept. 14, 2004) (*available at* http://www.rer.org/media/newsreleases/TRIA_Extension_Study_News_Release.cfm). *See also*, Press Release, Mortgage Bankers Ass'n, More than $8 Billion in Commercial Property Deals Killed, Delayed Or Changed Due to Terrorism Insurance Losses (July 15, 2002) (*available at* http://www.mortgagebankers.org/news/2002/pr0715a.html).

128. Hawkins Statement, *supra* note 124, at 3.

129. HUBBARD & DEAL, *supra* note 57, at 19-20.

130. Parke Chapman & Matt Valley, *Terrorism Insurance: Why Owners Are Balking*, NAT'L REAL ESTATE INVESTOR, Apr. 1, 2003, *available at* http://nreionline.com/other/legislation/real_estate_terrorism_insurance_why/index.html.

131. Press Release, Mortgage Bankers Ass'n, More Than $400 Billion of Commercial/Multifamily Debt at Risk for Loss of Terrorism Risk Insurance Without Extension of TRIA 'Make-Available' Provision (June 2, 2004), *available at*

commercial/multi-family debt reviewed in the MBA study, $616 billion, or 93.9 percent, is required to have terrorism insurance by the mortgage investor and/or servicer."[132] In addition, of the commercial and multi-family lenders surveyed in the study, 96 percent said that TRIA has made terrorism coverage "widely available" and 75 percent said it has reduced the cost of coverage.[133]

Prior to 9/11, many lenders simply did not require terrorism coverage to protect the property securing the loan.[134] Since that time, however, property owners have found that more and more lenders and loan servicers are demanding coverage.[135] If the borrower refuses, as is his option under TRIA, the lender may force coverage upon them through the "all risk" wording in the loan documents.[136] In the alternative, lenders may resort to the aptly-named "force-placed" insurance.[137] In this situation, the lender takes out a policy to cover the risk of terrorism, simply passing the cost back to the borrower through a demand for reimbursement.[138] If the borrower refuses, "the lender can hold the borrower in default of their loan documents and foreclose."[139]

X. COMMERCIAL MORTGAGE-BACKED SECURITIES AND TRIA

A large reason for the new lender requirements is the increasing amount of real estate that is being financed through the commercial mortgage-backed securities market.[140] This market was created in the 1990s as a secondary market for commercial and multi-family mortgages, and has grown at such a rate that it is now a major part of real estate finance.[141] According to the Mortgage Bankers Association, "Commercial

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http://www.mortgagebankers.org/news/2004/pr0602.html.

132. *Id.*

133. *J. Hearings*, *supra* note 83 (statement of the Mortgage Bankers Ass'n).

134. Chapman & Valley, *supra* note 130.

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.* (quoting William Wheaton, managing director of loan servicing at Holliday Fenoglio Fowler's Houston, Texas office). *See generally*, Mortgage Bankers Ass'n, *supra* note 131 (releasing results from a survey of commercial/multifamily mortgage servicers which showed, among other things, that only 28 percent of those surveyed "expect to always/almost always 'force-place coverage' when there is not adequate terrorism coverage in place).

140. *See* MORTGAGE BANKERS ASS'N, SECONDARY MARKET FOR COMMERCIAL MORTGAGES (Jan. 2005), *available at* http://www.mortgagebankers.org/library/isp/2005_1/Secondary%20Market%20for%20Commercial%20Mortgages.pdf.

141. *Id.*

mortgage-backed securities (CMBS) are now the second largest source of commercial and multi-family real estate financing, second only to commercial banks, and represent approximately 17 percent of the $2 trillion total debt outstanding."[142] CMBS have changed the real estate debt market by increasing the liquidity of commercial real estate, providing access to previously "untapped" national and international sources of capital, and increasing the amount of "underwriting due diligence and discipline [given] to the flow of debt capital into real estate markets."[143]

As a preliminary note, one can see the connection between the CMBS market and the availability of terrorism insurance just by the decrease in issuances that occurred between the 9/11 attacks and the passage of TRIA.[144] In 2001, the number of global CMBS issuances hit a record $97.1 billion.[145] The following year, global issuances dropped to $95 billion.[146] According to the MBA, this small (2.1 percent) but noticeable decrease in volume "was largely attributable to continuing economic uncertainty in the United states, coupled with concerns lasting into the fourth quarter about the availability of terrorism insurance coverage for American real estate."[147]

If you separate global from U.S. CMBS issuances, the effect of the uncertainty surrounding terrorism insurance is even more apparent. In 2002, the amount of CMBS issued in the U.S. dropped 11 percent.[148] Curiously enough, in 2003, the year after TRIA's passage, global issuances reached a new high of $98.7 billion and U.S. issuances shot up 17 percent to reach a record $77.8 billion.[149] While low interest rates certainly deserve some of the credit for these results, one cannot help but notice an uncanny correlation between the growth of CMBS and the assurance of comprehensive insurance coverage for the assets behind them.

A further explanation of the inner workings of the CMBS market will help clarify the connection between its vitality and the availability of terrorism coverage.

Lenders dabbling in the CMBS market depend on their loan pools maintaining a favorable investor rating from the major

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142. *Id.*
143. *Id.*
144. *See id.*
145. *Id.*
146. *Id.*
147. *Id.*
148. *Id.*
149. *Id.*

rating agencies.[150] In 2002, property owners refusing terrorism coverage eventually caused Moody's Investors Service and Fitch Ratings to downgrade billions of dollars in commercial mortgage-backed securities.[151] They cited fears that without terrorism insurance, property owners would be unable to obtain financing for new projects, which would deal a crushing blow to the real estate market and the overall economy.[152]

In a basic CMBS transaction, mortgage debt is pooled together and transferred to a trust.[153] Each pool is comprised of single mortgage loans secured by properties of varying types, sizes, and locations.[154] The trust issues bonds of various yields, maturities, and priority from each pool.[155] These bonds are assigned credit ratings from agencies such as Moody's Investors Service and Fitch Ratings, above, based on calculated levels of investment risk.[156] Investors buy these bonds based on their desired credit risk/yield/maturity, and subsequently receive returns as interest and principal is paid back on the pooled loans each month.[157]

Loans that are securitized in this manner are serviced under the method required by the loan documents and the Pooling and Service Agreement (PSA) applicable to each trust.[158] These PSAs typically set out standardized practices and procedures that servicers must follow in order to protect those investing in the bonds.[159] Such standards usually require the servicer to act with the same level of "care, skill, and diligence as it uses to service and administer comparable mortgage loans on behalf of third parties or on behalf of itself, whichever is the higher standard."[160] In addition, any attempt to waive, consent, or modify the terms of a securitized loan (e.g., insurance coverage requirements) is subject to the standardized restrictions in the

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150. COMMERCIAL MORTGAGE SECURITIES ASS'N & MORTGAGE BANKERS ASS'N, BORROWER GUIDE TO CMBS, 7 (2004), *available at* http://www.mortgagebankers.org/industry/docs/04/CMBSBorrowersBrochureFinal2.pdf.

151. Chapman & Valley, *supra* note 130. *See also J. Hearings*, *supra* note 83, at 62 (statement of Richard J. Hillman, discussing how TRIA's "make available" provision has affected the credit ratings of commercial mortgage-backed securities).

152. Chapman & Valley, supra note 130.

153. COMMERCIAL MORTGAGE SECURITIES ASS'N & MORTGAGE BANKERS ASS'N, *supra* note 50, at 1.

154. *Id.*

155. *Id.*

156. *Id.* at 1-2; Chapman & Valley, *supra* note 130.

157. COMMERCIAL MORTGAGE SECURITIES ASS'N & MORTGAGE BANKERS ASS'N, *supra* note 150, at 2.

158. *Id.* at 3.

159. *Id.*

160. *Id.* at 4.

PSA.[161]

Equally restrictive on a servicer's ability to modify the terms of a securitized loan is its duty to maintain each bond class' credit rating.[162] Market participants assume that the credit quality of their bonds will not significantly change over their maturity.[163] As a result, many types of modifications of a loan within a securitized pool cannot be made unless the rating agency can assure that such a decision will not result in the downgrade of any class of bonds.[164]

The connection between the securitization of commercial real estate loans and the availability of terrorism insurance is a gathering force behind the demand for TRIA's renewal (or the enactment of similar legislation).[165] If the unavailability of terrorism insurance for commercial and multi-family properties will still result in the downgrade of their corresponding securities, as before TRIA, the cost and availability of financing for new projects would significantly increase.[166] This would recreate all of the ugly situations the country faced before TRIA, including economic slowdown and unemployment across many sectors of the real estate industry.[167] Additionally, the Mortgage Bankers Association reports that without terrorism insurance, many "institutional investors such as life insurance companies and pension funds" would no longer continue to finance properties they consider "high risk."[168]

In response to requests from real estate professionals, Moody's Investors Service released guidelines that illustrate its approach to rating CMBS pools both before and after TRIA's enactment.[169] Although Moody's views terrorism as an extremely unlikely risk to any one asset, the default of an Aaa rated bond is an event which they are not willing to tolerate.[170] Moody's therefore refuses to disregard such an "obvious danger" as

161. *Id.* at 5.

162. *See id.* at 7.

163. *Id.*

164. *Id. See also* Chapman & Valley, *supra* note 130.

165. *See generally* MORTGAGE BANKERS ASS'N, *supra* note 8, at 3.

166. *Id.* at 3-4.

167. *Id.* at 4.

168. *J. Hearings*, supra note 83, at 3 (statement of the Mortgage Bankers Ass'n). The MBA also stated that after 9/11, institutional investors were "prepared to reduce or discontinue commercial real estate lending activity" had terrorism insurance not been made available by TRIA. *Id.*

169. DANIEL B. RUBOCK, MOODY'S INVESTORS SERV., CMBS: MOODY'S APPROACH TO TERRORISM INSURANCE AFTER THE FEDERAL BACKSTOP (Jan. 6, 2003), *available at* http://www.mortgagebankers.org/industry/reports/03/moodys_0106.pdf.

170. *Id.* at 2.

terrorism in assessing the rating to be given a particular credit.[171] Post-9/11 but pre-TRIA, Moody's saw the insurance industry's unwillingness to issue terrorism coverage as a signal that such a risk was incompatible with their highest bond rating (Aaa).[172] The result of this conclusion, as noted above, was the ultimate downgrade of many "Aaa classes of high profile, single asset or highly concentrated transactions."[173] In their report, Moody's explains that TRIA resolved many of the issues facing the insurance industry post-9/11, but goes on to discuss how the new issues TRIA creates will or will not be reflected in their ratings analysis.[174]

First, although Moody's is aware that TRIA only covers acts done "on behalf of any foreign person or foreign interest," it characterizes the risk of an uninsured domestic terrorist event as one which can coexist with an Aaa rating.[175] Moody's bases its position on conclusions reached by its own independent analysis, and those of Congress itself, that "foreign-related" terrorism is a much larger risk.[176] Moody's takes a similar stance on the threat of biological and chemical terrorism.[177] It concludes that such an attack would create "significant though temporary and curable infrastructure problems," but that a lack of such coverage would not result in the downgrade of the securities' credit rating.[178]

Third, Moody's professes its genuine concern for the certification process created by TRIA.[179] As noted above, in order for TRIA to apply to a particular terrorist act, the Secretary of the Treasury must first certify that the event falls within its intended scope.[180] Moody's takes issue with the fact that the Treasury Department has not given any clues as to how and

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171. *Id.*

172. *Id.* at 3-4.

173. *See* Chapman & Valley, *supra* note 130.

174. RUBOCK, *supra* note 169, at 3. *See also* DECHERT, LLP, THE TERRORISM RISK INSURANCE ACT OF 2002: HOW THE MARKET IS CHANGING – AN UPDATE, 3 (Jan. 2003), *available at* http://www.dechert.com/library/Finance_&_Real_Estate_1-03-SPAL.PDF (noting the significance of Moody's determination that TRIA adds sufficient certainty of coverage to allow "single-asset securitizations to receive rated proceeds similar to that for pre-9/11 transactions").

175. *Id.* at 3-4. Terrorism Risk Insurance Act, Pub. L. No. 107-297, § 102(1)(A)(iv), 116 Stat. 2322 (2002).

176. RUBOCK, *supra* note 169, at 4.

177. *Id.*

178. *Id.*

179. *Id.* *See also* DECHERT, *supra* note 174, at 3 (noting "continuing concern" within the real estate community over the possibility that another terrorist attack, or a series of such, would overwhelm the Treasury Department's ability to make swift certifications under the Act).

180. Terrorism Risk Insurance Act, § 102(1)(A).

when such certification would be given in the aftermath of a terrorist attack.[181] Because Aaa credit ratings reflect "virtual certainty of timely payment of debt service," any undue delay or uncertainty as to whether a terrorist event will be covered by the Act would be highly troublesome.[182] In order to lessen the effects of illiquidity and volatile cash flows on the CMBS market, servicers are permitted to make advances on debt secured by real estate.[183]

Delays in certification of coverage by the Secretary, however, would cause servicers to deny advances needed to maintain an Aaa rating in the market.[184] Moody's has called for clear answers from the Treasury Department as to how fast and flexible such certification processes would be.[185] Specifically, Moody's suggests interim certification be made within 5 days of the attack and a final determination made within another 15 days.[186] Another approach would be for servicers to agree, in advance of an attack, to make advances based on "almost irrebuttable presumptions of residual land value."[187] An assumption of residual land value would allow servicers to advance for up to six or twelve months while the Secretary decides whether to grant certification under TRIA.[188] The Treasury Department's response to this issue has been unsatisfying thus far. They have basically taken the position that the complexity and extent of the certification process is both necessary and, for the most part, beyond their control.[189]

Fourth, according to Moody's, an Aaa rating reflects an assumption that the securing property will be able to qualify for the requisite insurance for the duration of the loan.[190] So what will happen to securities backed by loans whose life is beyond the term of TRIA? Moody's report seems unconcerned with the prospect of TRIA's expiration.[191] It assumes that either TRIA

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181. RUBOCK, *supra* note 169, at 4-5.

182. *Id.* at 5. *See also* Mortgage Bankers Ass'n, *supra* note 8, at 2-3 (arguing that because property owners use insurance payouts to cover debt service, restoration, and other expenses, the untimely allocation of insurance proceeds would "put property owners, tenants, lenders, investors and bondholders at greater risk").

183. RUBOCK, *supra* note 169, at 5.

184. *Id.* at 5.

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. GEN. ACCOUNTING OFFICE, GAO-04-307, TERRORISM INSURANCE, IMPLEMENTATION OF THE TERRORISM RISK INSURANCE ACT OF 2002 20 (2004).

190. RUBOCK, *supra* note 169, at 5.

191. *See id.*

will be extended or the insurance markets will have developed to such degree that TRIA is no longer necessary.[192] In Moody's own words, "So far, we are inclined to think that we are on the first leg of an irreversible, long-term solution to the terrorism insurance issue."[193] Although Moody's came to this conclusion in early 2003, this Note is based on the assertion that the relevant market factors have either remained static, or evolved in a way that has increased the need for TRIA-like legislation.

Fifth, Moody's is confident that TRIA has created an atmosphere in which lenders will be able to judicially enforce their demands for terrorism coverage as part of the borrower's compliance with the loan documents.[194] They expect, therefore, that large, single-asset loan documents will contain "absolute" terrorism insurance requirements, providing the certainty of coverage necessary to an Aaa rating.[195] In terms of the extent of coverage necessary for a favorable Aaa rating, Moody's concludes that TRIA's success in making terrorism insurance available and affordable should result in requisite coverage nearing full replacement cost.[196] Finally, based on a concern that stand-alone policies for terrorism coverage create "gaps" in coverage, Moody's believes that the market would be better served by including terrorism insurance in the regular property and casualty policy.[197]

A great example of the effect of mortgage securitization on terrorism coverage requirements is set forth in *Omni Berkshire Corp. v. Wells Fargo Bank.*[198] Prior to 9/11, Omni entered into a loan agreement for $250 million, secured by five hotels. Wells Fargo was responsible for servicing those loans.[199] At such time, the hotels were insured against losses arising from acts of terrorism under the "all risk" provision in Omni's policy.[200] Traditionally, "all risk" provisions covers all property losses not specifically excluded from coverage.[201] After the terrorist attacks on 9/11, Wells Fargo requested that Omni obtain separate

192. *Id.* at 6.

193. *Id.* at 5.

194. *Id.* at 6. The report suggests that prior to TRIA, borrowers were escaping enforcement of insurance coverage provisions (in regard to terrorism) based on "impossibility of performance" claims. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. 307 F. Supp. 2d 534, 538 (S.D.N.Y. 2004).

199. *Id.* at 535-36.

200. *Id.* at 536.

201. *Id.*

terrorism coverage for the hotels securing the loans.[202] Omni obtained quotes for such insurance and subsequently determined that the premiums were too high to justify the coverage.[203] Omni then sued Wells Fargo, arguing that the loan agreement did not require them to obtain separate terrorism coverage in the post-9/11 market.[204] Wells Fargo, on the other hand, asserted that the "other reasonable insurance" clause of the loan agreement required the opposite conclusion.[205] That clause required Omni to "obtain and maintain. . .such reasonable insurance and in such reasonable amounts as Lender from time to time may reasonably request. . ."[206]

As of 2003, well into the implementation of TRIA, Wells Fargo's policies toward terrorism insurance varied in accordance with its role in the loan transaction.[207] If Wells Fargo was the lender, it performed a case-specific analysis to determine whether terrorism insurance would be required.[208] If, on the other hand, Wells Fargo was the servicer of the loan, its policy was to require terrorism insurance "across-the-board."[209] Wells Fargo explained that when it was the lender, its sole obligation was to itself.[210] In the case with Omni, however, the loans that Wells Fargo serviced had been securitized.[211] As the servicer of securitized loans, Wells Fargo had a fiduciary duty to owners of those securities.[212] This duty resulted in strict adherence to a blanket policy requiring terrorism insurance.[213]

The court in *Wells Fargo* rendered judgment against Omni, holding that it was reasonable under the "other insurance" clause of the loan agreement for Wells Fargo to require additional terrorism coverage in the post-9/11 world.[214] In coming to its conclusion, the court made special note of the fact that one of the hotels had been damaged in the 9/11 attacks on the World Trade Center.[215] Also, despite Omni's responsive efforts to minimize security risks, the court noted that the five hotels were located in

202. *Id.* at 537.
203. *Id.* at 536.
204. *Id.* at 537.
205. *Id.* at 541.
206. *Id.* at 536.
207. *See id.* at 538-39.
208. *Id.* at 539.
209. *Id.*
210. *Id.*
211. *Id.*
212. *Id.*
213. *Id.*
214. *Id.* at 542.
215. *Id.* at 541.

New York, Chicago, or Texas, and that "surely there is some risk they could be targeted."[216] It is worth noting that while the case was pending, Omni received a quote for $60 million in terrorism coverage for the five hotels.[217] The price quoted was $316,000/year, which is the equivalent of 63 percent of the cost Omni had paid for its entire "all risk" policy.[218] The court determined this was a "reasonable" price in a post-9/11 insurance market.[219]

XI. NAYSAYERS

In January of 2005, David Torregrosa of the Congressional Budget Office (CBO) released his "impartial" analysis of TRIA and current assessment of the insurance market.[220] Although Torregrosa agreed that "the terrorism threat to the United States will continue for the foreseeable future," he maintained that such a conclusion did not support the extension of TRIA in its current form.[221] Instead, he postulated, property owners should be encouraged to mitigate their own risk by "relocating some activities, retrofitting existing structures, investing in disaster-recovery information systems, and installing security systems."[222] He claimed TRIA discouraged such tendencies by subsidizing insurance rates.[223] While Torregrosa acknowledged that without TRIA, "an especially large loss from a terrorist attack would be likely to produce another episode of scarce coverage, rising prices and uninsured assets," he remained content with the "economic efficiency" that such an absence might bring.[224]

This Note posits that Torregrosa assumed too much in making his conclusions. It also asserts that, other than TRIA-like legislation, there are only two alternatives. First, insurance companies could develop mechanisms and industry capacity that allows them to provide terrorism coverage at affordable prices.[225] Second, the calculated risk of the terrorism threat in the United States could fall to such a low level that insurance coverage is

216. *Id.* at 542.
217. *Id.* at 539.
218. *Id.*
219. *Id.*
220. TORREGROSA, *supra* note 9, at vii.
221. *Id.* at vii-viii.
222. *Id.* at viii.
223. *Id.*
224. *Id.*
225. *See* Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 101, 116 Stat. 2322 (2002).

either readily provided by insurers and re-insurers at affordable levels or is no longer required by lenders or rating agencies.[226]

Torregrosa did not suggest that either of these scenarios currently exists, or will exist, in the foreseeable future.[227] He noted that although progress has been made in modeling to predict terrorism losses, such models are "not as reliable as those for natural catastrophes, which are based on more than 100 years of data," in contrast to just the two foreign-origin terrorist attacks the U.S. experienced in the past 11 years.[228] However, a lack of accurate models to predict losses should not deter us, he said with ease, because insurers have provided coverage for natural disasters despite their unpredictability.[229] This conclusion is based on a flawed perception of the nature of terrorism. It is as though Torregrosa suggested that if we simply had more data (which we do not), as with natural disasters, the private insurance market could, and would, insure terrorism risks.[230]

The fact that "terrorism is a unique catastrophic risk characterized by an ever-changing choice of man-made attack modes and targets" makes this assumption clearly untrue.[231] Our ability to predict terrorist attacks is extremely limited because of the lack of both data and of even a small measure of predictability in terrorist actions.[232] At least with natural catastrophes there are such tools as hazard-risk maps and historical data points that allow insurers to quantify threats to a given area.[233] With terrorism, such analysis would entail extracting patterns from actors who "purposefully avoid attacking in patterns in order to minimize the possibility of capture and presumably maximize terror."[234] Furthermore, while the United States cannot prevent natural disasters, the Department of Homeland Security is actively working to *decrease* the creation of data points from which insurers can model losses.[235]

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226. *Id.*
227. *See generally* TORREGROSA, *supra* note 9.
228. *Id.* at 4.
229. *Id.*
230. *Id.*
231. Press Release, Coalition to Insure Against Terrorism, CBO Study Misses the Point (Jan. 11, 2005) (*available at* http://www.insureagainstterrorism.org/release11105.pdf). *See also* Manns, *supra* note 6, at 2516.
232. *Id.* at 2517.
233. *Id.*
234. *Id.*
235. *See* Dept. of Homeland Security, The DHS Strategic Plan – Securing Our

Torregrosa asserted that in the absence of TRIA, insurance premiums would rise in the short term, causing property owners to adopt such risk-adverse measures that would bring premiums down in the long term.[236] Such a conclusion is too quick to assume that private insurers are "jumping at the bit" to provide terrorism coverage without federal availability requirements.[237] As we have seen from the survey of insurers conducted by Hubbard and Deal, in the absence of TRIA, private insurers would simply reinstate the exclusions for acts of terrorism that were commonplace before the Act's passage.[238] Torregrosa presented no evidence to suggest that private insurers are at all willing to make coverage available if TRIA is allowed to expire.[239]

Torregrosa also acknowledged that almost all properties financed through the commercial-backed securities market (CMBS) are required to have terrorism insurance, but failed to quantify the consequences that would befall all participants in the CMBS market should such properties be unable to renew their required insurance policies.[240] The CBO report also cited the Mortgage Banker Association industry survey, noting that 94 percent of commercial/multi-family loans were required to have terrorism coverage by their investors or servicers.[241] Instead of using these figures to demonstrate the need for readily available and affordable coverage, however, Torregrosa used the survey to show that "there is a substantial private-sector supply of terrorism insurance."[242] Once again, he wrongly assumed that such supply was the result of the private insurance market's increased willingness to insure terrorism. As we have seen thus far, insurers only supply coverage because TRIA requires it.[243] For example, in a letter to U.S. Representative Michael G. Oxley, the National Association of Insurance Commissioners encouraged Congress to authorize the continuance of federal participation in terrorism insurance because in the absence of such a backstop, "some terrorism risks may be largely uninsurable."[244] They also

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Homeland (Feb. 24, 2004), *available at* http://www.dhs.gov/dhspublic/interapp/editorial/editorial_0413.xml.

236. TORREGROSA, *supra* note 9, at viii.

237. *See generally* HUBBARD & DEAL, *supra* note 57.

238. *Id.*

239. *See generally* TORREGROSA, *supra* note 9.

240. *Id.* at 10.

241. *Id.*

242. *Id.*

243. *See* HUBBARD & DEAL, *supra* note 57.

244. Letter from the Nat'l Ass'n of Insurance Commissioners to Michael G. Oxley, Chairman, H. Comm. on Financial Services (Apr. 6, 2004) (*available at* http://www.ins.state.ny.us/acrobat/sp04oxsn.pdf).

said that they expect exclusions for acts of terrorism to be put into renewed policies "on a widespread basis" based upon the continued existence of the market factors surrounding TRIA's enactment.[245] This letter seems to be as good an indicator as any of the insurance industry's intentions with regard to providing terrorism coverage in the absence of a federal reinsurance program.

The CBO report further recognized that credit rating agencies such as Moody's tend to require terrorism coverage in order to deem a commercial mortgage-backed security worthy of its coveted Aaa rating.[246] The fact that the absence of TRIA would likely cause the downgrade of billions of dollars in these securities seemed almost elusive to Torregrosa. He suggested that if terrorism insurance coverage became scarce without the Act, changes "to the capital structure of a CMBS might be required to maintain a high credit rating."[247] He arrived at this conclusion despite this clear and direct statement from Moody's Investors Service: "A current Aaa rating in our opinion should reflect confidence through the term of the loan that necessary insurance will be available. If it is likely that terrorism insurance were to casually evaporate 30-days after an attack. . .Moody's would lack confidence in the longevity of its current ratings."[248] Nowhere in its ratings guidelines does Moody's suggest that changes in capital structure would stall such a downgrade, nor does the CBO report from Torregrosa present any evidence to indicate that Moody's has changed its position on this issue.[249]

In sum, Torregrosa was willing to sacrifice too much for economic efficiency.[250] While his report is fraught with good intentions, it is out of touch with reality. Torregrosa incorrectly assumed that insurers would be willing to provide coverage, even at higher prices.[251] He was too generous in his assessment of the insurance industry's ability to insure against terrorism.[252] Finally, the report glossed over the financial havoc that would be

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245. *Id.*

246. TORREGROSA, *supra* note 9, at 10.

247. *Id.* at 13. As an example, Torregrosa suggested that an increase in owner's equity for a given property would be such a change. *Id.*

248. RUBOCK, *supra* note 169, at 5.

249. *Id. See also* TORREGROSA, *supra* note 9, at 13.

250. Torregrosa, *supra* note 9, at viii. Torregrosa stated in his report: "[T]he gains in economic efficiency from allowing TRIA to expire could require a significant trade off: without the TRIA program, an especially large loss from a terrorist attack would be likely to produce another episode of scarce coverage, rising prices, and uninsured assets." *Id.*

251. *Id.*

252. *Id.* at 3-4.

wreaked on the CMBS market should TRIA be allowed to expire.[253]

In all fairness to Torregrosa, the goal of creating incentives for property owners to manage their own risk of loss is a worthy one. The report correctly noted that federal participation in terrorism insurance is not an "all or nothing" issue; there is room for modification.[254] The CBO report pointed out that H.R. 4634, if passed, would allow TRIA to continue through 2007, increase insurers' deductibles over the next two years, increase the amount the insurance industry is required to reserve for catastrophic terrorism losses, and extend the Act to cover group life insurance providers.[255] Such modifications may achieve Torregrosa's goal of improving property owners' involvement in loss mitigation, without completely pulling the rug out from under the entire real estate sector.

XII. THE TREASURY DEPARTMENT ASSESSMENT OF TRIA

On June 30, 2005, the United States Department of the Treasury issued its assessment of the Terrorism Risk Insurance Act of 2002.[256] The Department's surveys yielded much of the same information mentioned throughout this article. As others have before them, the Department noted increases in policyholder take-up rates and the number of insurers writing policies for terrorism insurance since TRIA's enactment.[257] The assessment also made light of the low cost of such coverage and the return of insurer capacity to pre-9/11 levels.[258] While much is said about the progress made in terrorism risk modeling, the report acknowledged that the use of such models is "tempered by the large degree of uncertainty in their predictions."[259] On the other hand, while the report recognized a correlation between these events and TRIA's enactment, it declined to attribute these positive results to its mandates.[260] The Department's survey results confirmed what has been said about coverage in the absence of TRIA. The report suggested that more than one-half of insurers currently providing terrorism coverage would

253. *Id.* at 13.

254. *Id.* at 14. The CBO report listed three options for the TRIA program: expiration, renewal, or modification. *Id.*

255. *Id.*

256. U.S. DEP'T OF THE TREASURY, *supra* note 45.

257. *Id.* at 3.

258. *Id.* at 4-5.

259. *Id.* at 124.

260. *Id.* at 3.

discontinue such coverage should TRIA expire at the end of 2005.[261] However, despite the conclusion that TRIA was effective in terms of its stated goals, and the assessment that the immediate effect of the program's expiration will be less available coverage, higher prices and lower take-up rates,[262] the report determined that allowing TRIA to expire in 2005 would "encourage the development of the private reinsurance market and other risk-transfer mechanisms."[263]

Criticism of the Treasury Department's report surfaced quickly.[264] Critics have bemoaned the report as failing to present an accurate picture of the current terrorism insurance marketplace.[265] James E. Maurin, in a statement to the House Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, pointed out that if the private insurance market had the capability to bridge the gap left by the absence of TRIA, they would already be preparing to do so.[266] Instead, real estate industry participants have already begun to see "pop-up exclusions," "sunset clauses," and other restrictions imposed by the insurance industry in anticipation of the program's expiration.[267] Furthermore, while the Treasury Department recognizes the real estate industry as one of special concern,[268] it fails to adequately address one of its primary concerns: the continued health of the CMBS market.[269] Margie Custis, President of the Commercial Mortgage Securities Association

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261. *Id.* at 76. *See also, id.* at 24 ("[T]he impending expiration of TRIA prompted some 47 states. . .to approve exclusions for property terrorism risk, conditional upon either expiration of TRIA at the end of 2005, or a renewal of TRIA with deductible, co-payment, or terrorism definition different from those in the current Program.").

262. *Id.* at 7.

263. *Id.* at 5. *Cf.* TAD PHILIPP ET AL., MOODY'S INVESTORS SERVICE, U.S. CMBS 1Q 2005: ANOTHER WARNING LIGHT ON THE CREDIT DASHBOARD 2 (Apr. 28, 2005), *available at* http://www.insureagainstterrorism.org/Moodys42805.pdf (stating that Moody's Investors Service is "unaware of any viable private market initiative that would take the place of TRIA" and warning that risk models "do not adequately size the potential frequency of terrorist attacks, the key to expected loss calculations").

264. Press Release, Coalition to Insure Against Terrorism, Policyholders Reject Treasury Study as Flawed (June 30, 2005), *available at* http://www.insureagainstterrorism.org/63005release.pdf.

265. *Id.*

266. *Hearing Before the H. Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters.* 109th Cong. (2005) (statement of James E. Maurin on behalf of The Coalition to Insure Against Terrorism) [hereinafter Maurin Statement], *available at* http://www.insureagainstterrorism.org/testimony72005.pdf.

267. *Id.* at 1, 2.

268. U.S. DEP'T OF THE TREASURY, *supra* note 45, at 45.

269. Press Release, Commercial Mortgage Securities Association, CMSA Responds to Treasury's Report on the Terrorism Risk Insurance Act ("TRIA") (July 1, 2005) (*available at* http://www.cmbs.org/Press%20Releases/Treasury_Report_on_TRIA_07_01_05.pdf).

(CMSA), noted that the availability of capital for the commercial real estate market is a vital component of a healthy economy.[270] Thus, the vibrancy of the CMBS market cannot be overlooked. Dottie Cunningham, CMSA's Chief Executive Officer, estimated that 40 percent of commercial real estate is financed through commercial mortgage-backed securities.[271] Furthermore, there is $500 billion in outstanding CMBS in the United States alone.[272] In concurrence with the conclusions of this article, the leaders of CMSA have recognized that an inability to obtain adequate terrorism insurance will render a great number of commercial real estate loans "unacceptable for pooling in CMBS."[273] This unavailability, acknowledged in the Treasury's assessment, will result in the technical default of the $500 billion in outstanding CMBS.[274] Of special concern are the many pension portfolios that are heavily invested in commercial real estate, through CMBS or otherwise, representing billions of dollars that would be subject to undue liability if TRIA were to expire.[275]

XIII. CONCLUDING THOUGHTS

Of all that has been said about the Terrorism Risk Insurance Act and the effects that its expiration would have on the real estate sector, arguably one of the simplest points is often the least mentioned. In its April 28, 2004 statement to a joint hearing of two House subcommittees, the Mortgage Bankers Association noted, "TRIA represents a public/private partnership to share the cost and administrative requirements of insuring American commercial and multi-family real estate against foreign terrorist attack."[276] As this article has repeatedly attempted to illustrate, the private insurance industry is both unwilling and unable to shoulder this burden alone.[277] The MBA added, "if [TRIA] sunsets before the private market gap is breached, this burden will fall *completely* on the public sector."[278] Thus, only a seamless continuation of federal participation in terrorism insurance will protect our economy from this unique risk.[279]

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270. *Id.*
271. *Id.*
272. *Id.*
273. *Id.*
274. *Id.*
275. Maurin Statement, *supra* note 266, at 3.
276. *J. Hearings*, *supra* note 83, at 4.
277. *See* HUBBARD & DEAL, *supra* note 57.
278. *J. Hearings*, *supra* note 83, at 4.
279. *See* Maurin Statement, *supra* note 266, at 7.

Although this thought seems unimaginable, one would hope that the members of Congress take it into account when the future of federal participation in insuring against terror is debated among them. After all, our nation's effort to fight terrorism is more than just the protection of life, it is the protection of our way and quality of life, and the protection of our economy. The recent attacks on our close ally, Britain, remind us of this fact. In this respect, the Terrorism Risk Insurance Act of 2002 has become an integral part of the War on Terror.

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