

Risks Under New Terrorism Insurance Act

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The Terrorism Risk Insurance Act of 2002, effective November 26, 2002 (the "Act")², has radically changed insurance rules. While the Act technically requires insurers to "make available" terrorism insurance, however this important new right can be lost inadvertently. As described below, owners, lenders and investors must be aware of the following new procedures in order to avoid waivers of rights. For example, hundreds of thousands of property owners should expect to receive shortly 30-day notices from insurers during this holiday season, not wishing these owners a happy new year, but instead threatening to cut off terrorism insurance unless a substantial additional premium is paid. Owners, lenders and investors should expect these notices and other disclosures, and react to protect their interests.

Watch for New Disclosures.

Section 103(b) of the Act provides that there will be no federal coverage of an insured terrorism loss unless the insurer provides "clear and conspicuous disclosure to the policyholder of the premium charged for insured losses covered by the [federal program] and the Federal share of compensation for insured losses." The December 3, 2002 Treasury interim guidance³ incorporates model disclosure forms, which are not required, but are safe harbors. Insureds may want to compare these model forms with the disclosures that the insureds actually receive, to prevent the loss of rights by waiver or estoppel. Also, while insurers will have incentives to provide the necessary disclosures, however, insureds should also make sure that the disclosures have been given. There is an implication in Section 103(b) of the Act that federal coverage may be cut off if the disclosures are not given by the insurer, even though the insured is not at fault.

Timing of Disclosures.

Pursuant to Section 103(b) of the Act, in the case of any policy issued before November 26, 2002 (the date of enactment of the Act), such disclosures must be provided to the policyholder by February 24, 2003 (90 days after the date of enactment). In the case of any policy issued during this 90 day period (i.e., from November 26, 2002 to February 24, 2003) then such disclosures must be given "at the time of offer, purchase, and renewal of the policy". Thereafter, such disclosures must be made at such time and

¹ Any person who either needs a copy of the new federal statute or the Treasury Interim Guidance discussed below, or has any comments, may send an email to BrookBoyd@aol.com with the caption "Terrorism Insurance".

² Since the GPO has not made available the text of the Act (i.e., Pub. Law 107-297), the above citations to the Act are based on the enrolled bill (available at <http://thomas.loc.gov>) passed by the House and the Senate, which should be the same as the final law.

³ "Interim Guidance Concerning New Statutory Disclosure and Mandatory Availability Requirements of the Terrorism Risk Insurance Act of 2002," (U.S. Treas. Dept. December 3, 2002, *available at* www.treas.gov/trip).

must be "a separate line item in the policy."

Respond Within 30 days.

Section 105(c) of the Act provides that an insurer may reinstate a "preexisting" terrorism exclusion in a property and casualty insurance policy in effect as of November 26, 2002 if 1) the insured expressly consents to such reinstatement or 2) the insured fails to pay any increased premium charged by the insurer for providing such terrorism coverage, and the insurer provided notice, at least 30 days before any such reinstatement, of both the increased premium for such terrorism coverage, and the rights of the insured with respect to such coverage, including the date on which the exclusion would be reinstated.

Not only insureds, but also lenders and investors, should be alert to the risk of inadvertent reinstatement of a terrorism insurance exclusion as provided above, or the risk that a borrower or managing partner may simply refuse to pay the premium and assume the risk without informing the lender or other investors. While some mortgage lenders may have a clear right to receive a copy of such 30-day notice, however the language in many standard insurance certificates does not provide a legally enforceable right to receive notice, or is limited to notice of cancellation (which may not include reinstatement of a terrorism exclusion). Loan documents, operating agreements and partnership agreements may, depending on the situation, need to be revised in order to protect the rights of lenders and investors. For example, lenders may want to provide that borrowers cannot decline terrorism insurance without the lenders' consent.

Risk of Unreasonable Premiums.

While the Act requires insurers to "make available" terrorism coverage, the Act does not set the premiums for such insurance. Therefore, it is not clear that terrorism insurance will be available at reasonable rates.

Compare Terrorism Coverage to other Coverages.

Section 103(c) of the Act provides that the terrorism insurance coverage cannot "differ materially" from the terms of other insurance coverages. Insureds will need to examine their terrorism insurance to confirm that this requirement has been met.

Insurance Not Covered; Environmental Insurance; Exclusions.

The Act applies to "property and casualty insurance" which is defined in Section 102(12) of the Act to include surety insurance, but generally not private mortgage insurance, title insurance, financial guaranty insurance, and flood insurance. Dan Rubock⁴ of Moody's (who made an excellent presentation on terrorism insurance at the December 4, 2002 New York State Bar Association Real Estate Financing committee

⁴ By the way, Dan Rubock has not had an opportunity to review this article, and my discussion of his comments is merely based on my notes.

meeting) pointed out that environmental insurance may still be available to cover terrorist acts. He also noted that domestic terrorism (e.g., the Oklahoma City bombings by Timothy McVeigh) would not be covered. Further, standard exclusions for nuclear, biological and chemical events will probably remain.

Securizations.

Dan Rubock discussed a current dispute involving a large Manhattan office building where a special servicer has taken over (because of the borrower's refusal to pay for terrorism insurance). The substantial fees of the special servicer are coming out of the debt service that would otherwise flow to the lowest tranche of debt. This has resulted in a technical default, but the borrower is asserting that it is not at fault, and the securitization documents do not clearly provide that the special servicer fees can be paid by the borrower in the absence of a default. This may impact future securitization documents.

Federal Program May Expire 12/31/04.

The Act merely provides a temporary solution. The Treasury Secretary may elect to terminate the federal terrorism insurance by December 31, 2004, and the federal program terminates anyway on December 31, 2005. Owners, lenders and investors typically have a much more long-range perspective and should therefore consider the risk that the federal program will not continue and that terrorism insurance may not be available.

Treasury Cannot be Challenged

The determination of whether there has been an "act of terrorism" is made by the Treasury Secretary. Section 102(1)(C) of the Act states that his determination is "final" and "not subject to judicial review". This raises the prospect that the Treasury Secretary might make an unreasonable determination at the expense of an isolated group of insureds.

Surcharges on Insureds.

Section 103(e)(8) of the Act provides that the Treasury Secretary has the right to impose a "terrorism loss risk-spreading premium" on policyholders not exceeding 3% of the annual property and casualty premium. It is not clear whether this can be retroactive.

Constitutional Issues.

Section 105(a) of the Act provides that any terrorism exclusion in a property or casualty insurance policy in effect as of November 26, 2002 is void. This raises constitutional issues that are beyond the scope of this article.

THE FOLLOWING BIOGRAPHICAL NOTE IS NOT INTENDED FOR PUBLICATION AND IS MERELY FOR INTERNAL USE:

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