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Insurance Exclusion Clauses: Excluding War Risks and Terror Risks from Insurance Contracts

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Summary

An insurance policy is only as good as the losses it covers. Most insurance and reinsurance policies exclude classes of risks, perils, and exposures from coverage. Common exclusions include war risks, nuclear risks, political risks, and risks on property exceeding a certain value. After September 11, "it may be that terrorism risk is no longer insurable," according to Dean R. O'Hare, Chairman and CEO of Chubb, Inc., a major insurer.

"The Terrorism Protection Act," H.R. 3210, placed on the Senate Legislative Calendar on December 3, 2001, and "The Terrorism Risk Insurance Act," S. 2600, laid before the Senate by unanimous consent on June 13, 2002, respond to the widespread exclusion of terrorism risks from insurance contracts.

This report provides background on exclusion clauses generally. In particular, it discusses how "terrorism" risk clauses may be interpreted by the courts, and examines how "war risk" exclusion clauses have been interpreted by New York (and other) courts. This report also touches on issues unique to the interpretation of reinsurance contracts. The review concludes with a discussion of potential constitutional barriers to retroactive federal and state regulation impairing the private enforcement of exclusion clauses.

Though constitutional barriers exist, Congress enjoys Article I power to regulate the business of insurance under the commerce clause. However, the regulation of insurance is generally left to the states. While Congress has constitutional power to act, legislation impairing insurance contracts covering losses arising out of the destruction of the World Trade Center would involve, to some degree, the federalization of insurance law.

Commercial law is made in the private markets, not the courts. Under the law of contracts, state courts are likely to reflect business reality, so long as the exclusion clause language unambiguously excludes the relevant loss from coverage. As such, a business judgment to exclude "terrorism risk" from the conventional basket of insurable risks will force the hand of market forces or legislators to put it back, not state courts.

After the events of September 11, it has been noted that "the line between war and terrorism is increasingly ambiguous." The complication surrounding the popular understanding of "war" will likely render future negotiations over the scope of "war risk" exclusions more contentious. Moreover, the background culture's ambiguous understanding of "war" also raises the issue as to whether the events of September 11 were "acts of war" for the purposes of exclusion clauses.

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Insurance Exclusion Clauses: Excluding War Risks and Terror Risks from Insurance Contracts

I. Overview

The events of September 11, 2001 raise issues relevant to private interests in property and life under the law of contracts, in general, and insurance law, in particular. Insurance is only as good as the losses it covers. Insurance contracts, even “all-risk” insurance contracts, generally exclude certain classes of risk from coverage. Common exclusions include losses due to political risks, war risks, and nuclear risks. On September 26, a panel of industry professionals before the House Financial Services Committee suggested that “terrorism risk” may join the list.¹

“The Terrorism Protection Act,” H.R. 3210, placed on the Senate Legislative Calendar on December 3, 2001, and “The Terrorism Risk Insurance Act,” S. 2600, laid before the Senate by unanimous consent on June 13, 2002, respond to the widespread exclusion of terrorism risks from insurance contracts.

This report examines the judicial interpretation and private enforcement of exclusion clauses. It pays attention to how courts may interpret potential “terrorism risk” exclusion clauses, and reviews case law interpreting “war risk” exclusion clauses. The report highlights issues relevant to the reinsurance industry. It concludes by discussing constitutional issues regarding possible federal and state legislation.

Congress enjoys Article I authority to regulate the business of insurance under the commerce clause.² However, pursuant to the McCarran-Ferguson Act, Congress generally leaves such regulation up to the states, declaring “that the continued regulation and taxation by the several States of the business of insurance is in the

¹ See, e.g. statement of Dean R. O’Hare, Chairman and CEO of Chubb, Inc., before the House Financial Services Committee, “America’s Insurance Industry: Keeping the Promise,” September 26, 2001. [<http://www.house.gov/financialservices/092601oh.pdf>], visited October 9, 2001. See also, Ronald E. Ferguson, “The Impact of the September 11, 2001 Terrorist Attack on America’s Insurance and Reinsurance Industry,” [<http://www.house.gov/financialservices/092601fe.pdf>], visited October 9, 2001.

²U.S. Const., Art. I, § 8, cl. 3 (giving Congress the power “to regulate Commerce . . . among the several states.”) See also, *United States v. South-Eastern Underwriters Assoc.*, 322 U.S. 533 (1944)(holding that “insurance” is “commerce” for the purposes of the commerce clause.)

public interest.”³ While Congress has constitutional power to act, legislation impairing insurance contracts covering losses arising out of the destruction of the World Trade Center would involve, to some degree, the federalization of insurance law. Inasmuch as insurance regulation is primarily a matter of state regulation and state contract law, this report predominately covers state law themes.

The examination proceeds on four related levels:

First, insight into how courts interpret exclusion clauses heightens the significance of “terrorism risk” exclusions becoming common fixtures in private insurance policies. An enduring truth of Anglo-American contract law is that commercial law is made in private markets, not courtrooms.⁴ Norms of contract construction compel the courts to vindicate the parties’ mutual understanding at the time of contract, not to intervene and decide how the parties “ought to have agreed.” When a clause is ambiguous, the courts entertain extrinsic evidence to ascertain meaning, where market norms and mores carry heightened weight. Thus, once industry excludes “terrorism risk” from the conventional basket of insurable risks, it can only be put back or mitigated by market forces or democratic institutions.⁵ However, in the case of an ambiguous exclusion clause, norms of interpretation and procedure tend to favor the insured.⁶

Second, when public officials, such as Members of Congress, characterized the events of September 11 as an “act of war,” many feared that insurance companies might invoke “war risk” exclusion clauses in seeking to deny coverage.

Widespread invocation of war risk exclusion clauses appears to be unlikely, however:

- As a matter of business judgment, industry leaders pledged to honor claims for losses arising out of the events of September 11.⁷
- The understanding of the parties at the time of contract, not the public’s understanding, constitutes the benchmark of meaning for categorizing a risk as a “war risk.”
- Characterizations by public officials, even an official declaration of war by Congress, will not have a dispositive effect upon the interpretation of

³15 U.S.C. § 1011. See also, 15 U.S.C. § 1012(b)(“No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance.”)

⁴ See, *Insurance Co. of the State of Pennsylvania. v. Grand Union Ins. Co.*, (1990) 1 Lloyd’s Rep 208 (HK CA 1989), cited in Graydon S. Staring, LAW OF REINSURANCE § 13:1 (1993).

⁵ See e.g. “Bush Details Plan to Help Insurers on Future Terror Claims,” NY TIMES A-1 (October 16, 2001).

⁶See section III, *infra*.

⁷ See section IV(A), *infra*.

war risk exclusion clauses, though it could inform the judicial viewpoint and legal arguments by the insurance industry.⁸

- The leading New York case in this area, *Pan American World Airways, Incorporated v. Aetna Casualty and Surety Company*,⁹ suggests that the losses to life and property on September 11 could not aptly be attributed to a “military or usurped power” for the purposes of triggering a “war risk” exclusion clause.¹⁰
- New York statutory law appears, in some instances, to favor the insured. Statutory law defines “war” or “acts of war” for the purposes of life insurance, disability insurance, worker’s compensation, and health insurance for state and retired state employees. These definitions, on their face, appear favorable to the policyholder, but have important differences. There is an authoritative interpretation of the life insurance policy; however, the other provisions do not appear to have one.¹¹

Third, this report highlights some important similarities and differences among legal issues affecting reinsurance policies and consumer policies.¹²

The examination concludes with a discussion of constitutional constraints that may impede federal and state legislation designed to suspend the enforcement of these clauses.¹³

II. Choice of Law

In general, state statutory and common law governs the interpretation and application of insurance contracts. This Report attempts to balance the weight of authority pertaining to the interpretation of exclusion clauses, in general, and war risk exclusion clauses, in particular. It does not provide an exhaustive survey of the issue. To convey a sense of the common law’s trajectory in light of the events of September 11, this Report focuses on New York law, primarily, and examines basic contract principles as addressed by various common law systems, including that of England.¹⁴

Emphasis on New York law is based on two grounds: (1) in the area of evaluating the application of “war risk” exclusion clauses in cases involving a non-sovereign entity, New York has the most developed jurisprudence, and (2) heightened Congressional attention to losses stemming from the destruction of the

⁸See section IV(B), *infra*.

⁹ 505 F.2d 989 (2nd Cir. 1974)(applying New York law).

¹⁰ See section IV(C), *infra*.

¹¹See section IV(D), *infra*.

¹² See section V, *infra*.

¹³See section VI, *infra*.

¹⁴ In the insurance context, citation to English authority appears to be common practice. Two reasons explain this reliance. England and the United States share a common law system, and English law displays an extensive and well developed insurance law jurisprudence.

World Trade Center appear to be most efficiently addressed through New York law.

A focus on New York law is self limiting, not only in light of possible claims arising in Virginia and Pennsylvania, but also in light of claims in other jurisdictions that may arise due to choice of law provisions in insurance policies, or that may arise due to future acts of terrorism in other states.

III. Some Procedural and Interpretive Norms Governing the Invocation, Application, and Construction of Exclusion Clauses.

Insurance policies are private agreements controlled primarily by state contract law, not federal law. When enforcing an agreement, the task of the court is to determine what the contract language means from the contracting parties' point of view. When interpreting contracts, courts strive to give words their ordinary meaning, advance reasonable interpretations, avoid absurdities, "take the contract by its four corners, consider all its terms, and examine meanings in light of the entire transaction."¹⁵

Generally, when the court interprets an integrated, final agreement, it will not go outside the four corners of the document, unless there is an ambiguity.¹⁶ In the United States Court of Appeals for the Second Circuit, an ambiguous clause is one that gives rise to multiple meanings when viewed "objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement and who is cognizant of the customs, practices, usages and terminology as generally understood in the particular trade or business."¹⁷ The court generally opts for a meaning most consistent with the underlying purpose and intent of the contract,¹⁸ but if ambiguity persists, then the ambiguous clause will be strictly construed against the party who wrote it.¹⁹

Regarding the judicial construction of "terrorism risk" exclusion clauses, the relative lack of "industry standards" to define an "act of terrorism" will complicate judicial inquiry. Moreover, the events of September 11 may likely inform contracting parties as they bargain over the scope and meaning of common exclusion clauses, such as "war risk" exclusion clauses or, less common "terrorism" exclusion clauses. As the line between war and terrorism blurs, crafting language to categorize

¹⁵ Graydon S. Staring, *LAW OF REINSURANCE*, § 13:1.

¹⁶ Moreover, while the parol evidence rule requires the exclusion of evidence of conversations, negotiations and agreements made prior to or contemporaneous with the execution of a written contract which may tend to vary or contradict its terms such proof is generally admissible to explain ambiguities therein. See e.g. *Wall Street Co. v. Franklin National Bank*, 333 N.E.2d 184, 186-87 (N.Y. 1975).

¹⁷*U.S. Fire Ins. Co. v. General Reinsurance Corp.*, 949 F.2d 569 (2nd Cir. 1991)(applying New York law).

¹⁸ See, *Youell v. Bland Welch and Co*, 2 Lloyd's Rep 431, 440 (1990).

¹⁹ See *Pan Am*, 505 F.2d at 1000.

potential risks as “acts of war” or “acts of terrorism” may prove to be a complicated and subtle task even for the most sophisticated parties.

If ambiguity prevents a court from reaching the substance of the underlying agreement, procedural issues like burdens of proof, interpretive canons, and presumptions may resolve cases and controversies arising under the enforcement of exclusion clauses. Towards these narrow issues, a brief survey of New York law may be instructive.

Under New York law, various procedural and interpretive norms favor the policy holder in the event an insurer denies coverage under an ambiguous exclusion clause:

- The insured establishes a prima facie case for recovery “merely by showing the existence of the policy and a loss with respect to covered property.”²⁰
- The burden of proof then shifts to the insurer to show that the event giving rise to the claim falls within an exclusion clause under the policy.²¹
- The court interprets exclusion clauses in a manner “which is most beneficial to the insured.”²²
- Most importantly, under the rule of *contra proferentem*, an insurer does not meet its burden when it merely offers “a reasonable interpretation under which the loss is excluded,” but only when its interpretation “is the only reasonable reading of [a relevant term] of exclusion.”²³ Under this rule, the insurer, as the party generally responsible for the ambiguity, usually has the uncertainty enforced against it.

The bottom line in New York is that exclusion clauses “are not to be extended by interpretation or implication, but are to be accorded a strict and narrow construction.”²⁴

²⁰ *Insurance Co. of North America v. Historic Cohoes II*, 879 F.Supp. 222, 224-25 (N.D.N.Y. 1995), citing *Pan Am*, 505 F.2d at 999.

²¹ See, *Allianz Ins. Co. v. RJR Nabisco Holdings Corp.*, 96 F.Supp.2d 253, 255 (S.D.N.Y. 2000). See also, *Marino v. New York Telephone Co.*, 944 F.2d 109 (2nd Cir. 1991); *Seaboard Surety Co. v. Gillette Co.*, 476 N.E.2d 272, 285 (N.Y. Ct. App.1984); and *Pan Am* 505 F.2d at 999.

²² *Pan Am*, 505 F.2d at 999. Accord, *Westchester Resco Co. v. New England Reinsurance Corp.*, 818 F.2d 2, 3 (2nd Cir. 1987) (per curiam)(holding that under New York law, the “general rule” is that “ambiguities in an insurance policy are to be construed strictly against the insurer”).

²³ *Pan Am*, 505 F.2d at 1000 (emphasis added). See also, *Holiday Inns Inc. v. Aetna Insurance Co.*, 571 F. Supp. 1460, 1464 (S.D.N.Y. 1984). If a case presents facts demonstrating that the insured is responsible for the ambiguity, then it is unlikely that the court would invoke the rule against the insurer.

²⁴ *Id.* See also, *Island Lathing and Plastering, Inc. v. Travelers Indem. Co.* 2001 WL 1006114 (S.D.N.Y. 2001); *Seaboard Sur. Co. v. Gillette Co.*, 476 N.E.2d 272 (N.Y. 1984)(“whenever [the] insurer wishes to exclude certain coverage from its policy obligations, it must do so in clear and unmistakable language”), *id.* at 275 (“any exclusions or exceptions from insurance policy coverage must be specific and clear in order to be enforced; they are not to be extended by interpretation or implication, but are to be accorded (continued...)

These norms distribute the relative burdens of litigation heavily on the insurer's side, which will inform industry when deciding whether to deny a claim under an exclusion clause. As applied to potential claims arising out of September 11, a sketch of the litigation process follows.

In the event that an insurer denies a policy holder coverage for a loss caused by the events of September 11 based on a "war risk" or similar exclusion, the policy holder appears to have some advantages, if the case proceeds to litigation. The policy holder would merely have to assert a loss and the existence of a policy covering that loss to sustain a cause of action through a preliminary motion to dismiss by the insurer. The insurer, on the other hand, would bear the burden of proving that the events of September 11 are "acts of war" or are "acts of terrorism" or fall under some other pocket of risks excluded under the relevant policy. If the exclusion clause is ambiguous the insurer would have to demonstrate that its interpretation of the exclusion clause is the *only* reasonable interpretation. The relative burdens between the insured and the insurer may deter the insurance industry from denying coverage under, for example, a "war risk" exclusion clause,²⁵ but not necessarily another exclusion clause, like a terrorism exclusion clause.

Other than inferring from early statements by industry, it is difficult to predict the scope and depth of litigation stemming from claim denials under exclusion clauses.²⁶

IV. War Risk Exclusion Clauses

Almost always,²⁷ insurance policies contain terms that exclude from coverage "war risks"²⁸ – losses of property or life due to acts of war.²⁹ When public officials

²⁴(...continued)

strict and narrow construction."). Moreover, "a court may infer from an insurer's reliance on a large number of exclusions that the insurer 'recognize[s] that each of the exclusions is ambiguous or has only uncertain application to the facts.'" *Historic Cohoes II*, 879 F.Supp. at 224-25, quoting *Pan American*, 505 F.2d at 1005.

²⁵ For a more detailed discussion of "war risks," see section III, *supra*.

²⁶ For instance, the reinsurance market, consisting primarily of foreign corporations (primarily England), could place pressure on the primary insurance market to assert exclusions under war exclusion clauses, inter alia. Indeed, the most contentious conflicts may be between the reinsurance market and the primary insurance market, and not between the insurance market and the policy holders. See section IV, *supra*.

²⁷ Aviation insurance contracts generally extend coverage for "war risks." See Jason Bibby, *War Risk Aviation Exclusion*, 60 J. AIR L. AND COM. 609 (1995).

²⁸ For example, basic commercial property policies generally exclude losses for "(1) war, including undeclared war or civil war; and (2) warlike action by a military force, including action in hindering or defending against an actual or expected attack, by any government, sovereign, or *other authority* using military personnel or *other agents*." Jeffrey W. Stempel, LAW OF INSURANCE CONTRACT DISPUTES § 1.02[a] (2001)(emphasis added).

²⁹ The purpose of excluding "war risks" from insurance policies is to prevent the insurer from being bankrupted by shouldering countrywide losses from war, as these risks are of a large (continued...)

characterize the events of September 11 as “acts of war,” an issue arises as to the potential effect of such a characterization on the judicial interpretation of these clauses. However, “even [a] broadly drafted war exclusion [clause] that seek[s] to preclude coverage for anything that looks like armed conflict is not ironclad for the insurer.”³⁰

This section addresses the interpretation of these clauses under New York contract and insurance law.³¹

A. Reports from the Industry.

It appears, as a matter of business judgment, that most insurance companies will not invoke war risk clauses, at least initially. On September 25, a panel of American insurance and reinsurance professionals testified before the House Financial Services Committee and indicated that industry has the capacity and will to pay claims arising out of the events of September 11.³² Conclusions concerning the industry’s overall inclination to contest, arbitrate, or litigate may be premature, however, as international reinsurance providers revise (and increase) their loss estimates.³³ On September 17, a Wall Street Journal article reported that “insurers intend to pay claims stemming from [the attacks] on the World Trade Center, despite certain ‘act of war’ policy exclusions.”³⁴ The public statements by industry are not uniform, as reports on September 19 suggest that certain segments of the industry have not ruled out denying claims under a theory of war risk exclusion (or other exclusions).³⁵

Even in the case of litigation, a survey of New York case law suggests that the events of September 11 may not be sufficient to be categorized as acts of war under insurance contracts. While the law is not categorical, the weight of authority appears

²⁹(...continued)

scale (e.g. the 1991 Gulf War, World War II) and may go on for years (e.g. insurgency against the former Soviet Union’s occupation of Afghanistan). Jefferey W. Stempel, LAW OF INSURANCE CONTRACT DISPUTES § 1.02[a] (2001).

³⁰ Id. at § 15.02

³¹This section focuses on New York law for the sake of brevity, clarity, and probability. There are, no doubt, “choice of law” issues which may preclude the application of New York law to particular insurance policies. However, even in these circumstances, New York jurisprudence is influential in the area of policy exclusions under “war risk” clauses. It is likely that the Second Circuit’s decision in *Pan Am*, 505 F.2d 989, will serve as a template in other jurisdictions addressing these issues. See III(C), *infra*.

³²See, “Hearing on America’s Insurance Industry: Keeping the Promise,” September 25, 2001; <http://www.house.gov/financialservices/092601tc.htm> <visited October 1, 2001>

³³See, “Insurers Revise Terrorist Attack Estimates” at <http://www.lloyds.com/un/en/article/0,1252,101020000|101119,00.html> <visited September 21, 2001>

³⁴ Christopher Oster, *Insurers Pledge Act of War Won’t Block Claims*, THE WALL STREET JOURNAL, A-3 (Sept. 17, 2001).

³⁵ See Christopher Oster, *Insurers Weigh Invoking Act-of-War Clauses to Invalidate Policies*, THE WALL STREET JOURNAL, A-4 (Sept. 19, 2001).

to favor the insured on this issue. However, the insurance industry enjoys recourse to a battery of arguments in its favor.

B. The Public’s Interpretation Versus the Court’s Interpretation of “Act of War.”

Though procedural and interpretive norms tend to favor the insured,³⁶ the pervasive characterization of the events of September 11 as an “act of war” by public officials, sovereigns, international organizations, and the media could affect how the courts interpret a war exclusion clause. However, even a declaration of war by Congress will not have a dispositive effect on the construction of material terms contained in private contracts. The intent of the parties, not the description of Congress, controls whether the events of September 11 are “acts of war” within the meaning of private contracts.³⁷ The material issue, here, is whether the events of September 11 were “proximately caused by an agency fairly described, for *insurance purposes*, by an exclusion clause” in the relevant policy.³⁸ Or, in similar terms, the court will construe the “exclusions as the parties would reasonably have expected them to be construed.”³⁹ This is essentially a question of fact.⁴⁰

To stress again, as the court is dealing with a question of fact, how the background culture characterizes the events of September 11 may inform a court when it categorizes what “warlike” action means under a policy’s exclusion clause, if the court admits extrinsic evidence in giving the words their ordinary meaning. Still, precedent suggests that characterizations of an event by public officials is not dispositive of the issue.⁴¹

As these cases turn on the application of New York norms of construction in individual cases, comprehensive analysis and prediction is not possible – such is the

³⁶ See section II, *supra*.

³⁷ Under New York law, insurance policies are to be interpreted in accordance with their terms. See *Continental Insurance Company v. Arkwright Mutual Insurance Company*, 102 F.3d 30 (2nd Cir. 1996).

³⁸ See, *Holiday Inns Inc. v. Aetna Insurance Company*, 571 F. Supp. 1460, 1464 (S.D.N.Y. 1983) (holding that interpretation of insurance policies does not turn on how political leaders describe the events giving rise to a loss, but on how the policy describes the event), quoting *Spinney’s Ltd v. Royal Insurance Co., Ltd*, 1 Lloyd’s L. Rep 406 (Q.B.). *Holiday Inns* involved a claim for damage to a hotel shelled during a battle in Beirut, Lebanon. The issue involved whether the three entities in conflict were “at war” for purposes of the insurance contract. The insurer argued that three factions fighting in Lebanon had sovereign attributes. The court focused only on the faction that did the damage and held that the faction was not a sovereign entity, and even if it were, it was not fighting another sovereign when the damage was done. As such, the “war” exclusion clause was not applied.

³⁹ *Pan Am*, 505 F.2d. at 1003.

⁴⁰ See *id.*

⁴¹ *Id.* See also 571 F. Supp at 1464.

nature of contract law. However, the leading case in this area, *Pan American World Airways, Incorporated v. Aetna Casualty and Surety Company*,⁴² may be instructive.

C. The Pan American Case.

In *Pan Am*, a jet was hijacked and destroyed by political dissidents in the Middle East. “Notwithstanding the obvious political overtones of the event,” the court ruled that “the hijacking was too contained to come under the war or insurrection exclusion.”⁴³ A rule of causation and a rule of identity informed this conclusion.

According to the *Pan Am* decision, when the court interprets an insurance policy excluding from coverage any injuries “caused by” a certain class of conditions, “the causation inquiry stops at the efficient physical cause of the loss; it does not trace events back to their metaphysical beginnings.”⁴⁴ With respect to claims arising out of the September 11 incident, a court following this rule may examine the naked act of a plane crashing into a building, stripping the event of its political motivations and significance. The court will then likely ask whether this naked act is the sort of instrumentality properly categorized as an “act of war” for the purposes of the relevant war exclusion clause. This narrow inquiry into the cause underpinning the events of September 11 cuts against an argument attributing losses to property and life from these events to an act of war.⁴⁵

In the *Pan Am* case, the court examined contract language excluding from coverage losses caused by a “military or usurped power.” Under *Pan Am*, an act causing such a loss “must be at least that of a de facto government.”⁴⁶ On the facts of *Pan Am*, where the “military or usurped power” language was part of the insurance policy, the court found that the terrorist organization that highjacked the

⁴² 505 F.2d 989

⁴³Id. at 1009. Jefferey W. Stempel, LAW OF INSURANCE CONTRACT DISPUTES § 1.02[a] (2001)

⁴⁴*Pan Am*, 505 F.2d at 1006. See also *Kimmins Indus. Service Corp. v. Reliance Ins. Co.*, 19 F.3d 78, 81 (2nd Cir. 1994), *Album Realty Co. v. American Home Assurance Co.*, 176 A.D.2d 513, 514 (N.Y. Ct. Ap. 1991)(reversed on other grounds), quoting *Home Insurance Co. v. American Insurance Co.*, 147 A.D.2d 353, 354 (1989).

⁴⁵ See also, *Queen Insurance Company v. Globe and Rutgers Insurance Co.*, 263 U.S. 487 (1924)(applying a similarly narrow causation rule, holding that a collision of two merchant ships traveling the Atlantic ocean in World War I was not caused by a “war risk.”) In *Queen Insurance*, the ships were traveling at night, without lights, and one ship changed its course into the direction of the other because of a submarine attack. The Supreme Court held that the damage was due to a “collision” as such, which could have occurred at any time; therefore, it was not the result of “war.” But see, *TTR/FTC Communications, Inc. v. Insurance Company of the State of Pennsylvania*, 847 F. Supp 28 (D. Del. 1993)(finding that looting of merchandise and equipment during the Panama conflict was sufficient to trigger a war risk exclusion clause since the act was “enabled by the military hostilities occurring between Panama and the United States.”) In dicta, the *TTR/FTC* court suggested that the conclusion would follow, even if the looters were not an arm of the Panama government’s forces.

⁴⁶*Pan Am*, 505 F.2d at 1006.

Pan Am airplane “was not a de facto government in the sky over London when the 747 was taken.”⁴⁷

D. New York Statutory Law.

State law governs the application of “war risk” exclusion clauses. While New York’s common law controls the interpretation of many categories of insurance contracts, statutory law controls the interpretation of war risk clauses in life and disability insurance contracts, in health insurance contracts for state and retired state employees, and in workers’ compensation programs. When parties agree to contract terms, these statutes set the outer limits by which insurers may exclude coverage for losses stemming from “acts of war.” New York statutory law only provides for narrow exclusions in life insurance⁴⁸ and disability insurance⁴⁹ contracts. On the other hand, broad exclusion language controls the interpretation of health insurance contracts for state employees,⁵⁰ as well as in worker’s compensation programs.⁵¹

The New York courts remain, for the most part, silent on the extension of these statutory provisions.⁵²

However, *Shneiderman v. Metropolitan Casualty* offers insight into how New York courts interpret “war risk” exclusions in life insurance contracts.⁵³ *Shneiderman* involved a photo-journalist who died in the Suez Canal vicinity during a “cease fire” in the Arab-Israeli conflict of the 1950’s.⁵⁴ The issue there was whether a death during an official cease fire was “caused by war or any act of war”

⁴⁷Id.

⁴⁸See, NY INS. § 3203(c)(1)(A) - (C)(2001)(defining “war” and “act of war” in narrow terms for the purpose of general life insurance contracts); NY CIV SERV § 4510(b)(1)(A),(C) and (b)(2)(A)-(C)(McKinney 2001)(defining “war” and “act of war” in narrow terms for the purposes of life insurance contracts provided by fraternal benefit societies); and, 11 NYCRR 45.1 (May 15, 2001)(administrative regulation requiring that when life insurance contract contain “act of war” exclusions, the insured must have separate, written notice of the inclusion of such clauses in the contract. It is not clear whether the insured has to acknowledge the separate notice.)

⁴⁹See, NY INS. § 3215(b)(1)(C)(McKinney 2001)(defining “an act of war” in broad terms, but contemplates that such acts occur while “the insured is outside the geographical limits” specified by the policy).

⁵⁰See, NY CIV. SERV. § 161(2)(McKinney 2000)(severe limits on benefits, excluding payment for “services received for injury or sickness due to war or any act of war, whether declared or undeclared, which war or act of war . . .”).

⁵¹ See, NY WORK. COMP. § 205 (McKinney 2001)(a very broad exclusion clause for “any disability due to any act of war, declared or undeclared . . .”).

⁵² Note that *Pan Am* and *Holiday Inns* dealt with insurance contracts covering property insurance.

⁵³ 14 A.D.2d 284 (N.Y. 1961)

⁵⁴See id. at 285.

under a life insurance policy.⁵⁵ The court answered no.⁵⁶ The court’s interpretive approach, not its holding under the facts, is relevant here.

The *Shneiderman* court read terms like “war” in a way consistent with “everyday,” rather than “specialized,” language.⁵⁷ Finding for the insured, the court took “cognizance of the fact that an insurance policy is generally a contract with the average man who presumably is unfamiliar with the existence of a state of war from the strictly political, military and/or legal standpoint.”⁵⁸ Common use of “war or act of war” in “every day expression” controlled the court’s interpretation, rather than the use that controls “international relations or military affairs.”⁵⁹

V. Interpretation and Construction of Reinsurance Contracts

Reinsurance is insurance for the insurance industry. Generally, there are two forms of reinsurance: facultative reinsurance and treaty reinsurance.⁶⁰ Exclusion clauses are found in both (though more commonly in facultative contracts.)

“There is no reason for reinsurance contracts not to be interpreted and construed according to the rules for contracts generally.”⁶¹ However, as the business reality of the reinsurance market is guided by a different set of market norms and mores than the primary insurance market, the application of the court’s rules of construction may differ. In this respect, it is possible that a claim may not fall under an exclusion clause in a primary insurance policy, but may fall under one in a reinsurance policy. So, it is possible that a primary insurer of the events of September 11 will have to pay its policy holder, but not enjoy coverage under its reinsurance contract.

Understanding how reinsurance market norms and mores inform the judicial construction of exclusion clauses is easier said than done, since reinsurance “is a field in which differences have often been settled by handshakes and umpires, and pertinent precedents . . . are few in number.”⁶² However, this in itself suggests that any conflict between the insured and reinsurer will likely be handled, at least initially, in arbitration. Though uncertainties abound, a few generalizations about exclusion clauses in general may be made. Moreover, there are some relevant similarities and distinctions between reinsurance and primary insurance.

⁵⁵See *id.*

⁵⁶See *id.* at 290.

⁵⁷*Id.* at 287.

⁵⁸*Id.*

⁵⁹*Id.*

⁶⁰ Facultative reinsurance is policy specific – it underwrites particular risks, in whole or part, on a single policy. Treaty reinsurance exhausts the remaining universe of reinsurance – it is generally used to aggregate and thus simplify reinsurance transactions, as they cover multiple contracts under one reinsurance policy. Facultative reinsurance, which requires individual attention, is used less often, but is nonetheless important.

⁶¹ Graydon S. Staring, *LAW OF REINSURANCE* §13:1 (1993).

⁶² *Sumitomo Marine and Fire Ins. Co. v. Cologne Reinsurance Co.*, 552 NE2d 139 (1990).

For this report’s purposes, three points of similarity and difference are noteworthy:

- The burdens of proof are similar. The reinsured carries the burden of proving the fact of a loss and a relevant policy covering that loss.⁶³ The reinsurer carries the burden of proving an exception to the policy.⁶⁴
- The reinsurance contract is distinct from the underlying policy.⁶⁵ While parties generally aim to make a reinsurance policy coextensive with an underlying policy, reinsurance is not, as a matter of law, coextensive with the underlying policy.⁶⁶ Moreover, an exclusion clause in a reinsurance contract may be enforced against the reinsured, even though the reinsured paid out on the underlying policy without invoking a similar exclusion clause.
- While the canon of contra proferentem generally favors the policy holder in the primary insurance market,⁶⁷ the reinsured does not necessarily enjoy the favorable rule as against its reinsurer. The courts are split on the extent to which an insurance company may invoke the canon against its reinsurer.⁶⁸ Due to this splintered precedent, a commentator on reinsurance law suggests that the “party who would avoid the rigor of the canon or who wants to avoid it will have to prepare a good factual case on negotiation, economic duress, drafting, and who proffered the contested wording.”⁶⁹

⁶³See, 19 COUCH ON INSURANCE 2d, §§79.345, 79:368 (Rev. ed. 1983), *cited in* LAW OF REINSURANCE §12:2.

⁶⁴ See *id.*

⁶⁵ See, *Imperial F. Ins. Co. v. Home Ins. Co.*, 68 F 698 (1895).

⁶⁶ For example, extrinsic evidence could suggest that parties *intend* the reinsurance to cover risks coextensive with the underlying policy, but under the court’s policy of limiting interpretation to the four corners of the contract, a reinsurance policy that is unambiguous may be interpreted to exclude, contrary to the party’s intent, losses from coverage. See e.g. *Youell v. Bland Welch and Co.*, 2 Lloyd’s Rep 423 (Q.B. 1990).

⁶⁷ See footnote 23, *supra*, and accompanying text.

⁶⁸ In New York, when the reinsured is responsible for the ambiguity, the rule of contra proferentem is applied *against* the reinsured. See, *London Assur. Corp. v. Thompson*, 62 N.E. 1066 (N.Y. 1902)(holding that “the responsibility for the ambiguity should be borne by the party who caused it,” even though in the normal run of cases, the insurer is responsible.) The Second Circuit, applying Massachusetts law, has held contra proferentem a nullity “when both [parties] are large insurance companies long engaged in far-flung activities in that field.” *Great American Insurance Co. v. Fireman’s Fund Ins.*, 481 F.2d 948, 954 (2d Cir. 1973)(remanding to the lower court to apply parol evidence rules to the contested contract language), *quoting Boston Insurance Company v. Fawcett*, 258 N.E.2d 771 (1970). Still others apply the rule categorically against the reinsurer. See, e.g., *Royal Ins. Co. v. Vanderbilt Ins. Co.*, 52 SW 168 (Tenn. 1899).

⁶⁹ Graydon Staring, LAW OF REINSURANCE §13:2.

VI. Constitutional Impediments to State and Federal Legislation

Various constitutional impediments may obstruct federal and state legislation designed to retroactively frustrate the private enforcement of exclusion clauses.

A. Federal Legislation.

In the event that Congress considers legislation to suspend or obstruct the enforcement of “war risk” or “terror risk” clauses, various constitutional issues may arise. Though Congress has the power under the commerce clause to regulate the insurance industry, the Fifth Amendment’s due process and takings clauses may frustrate certain legislative responses to the invocation of exclusion clauses.

Congress enjoys Article I authority to regulate the business of insurance under the commerce clause.⁷⁰ However, pursuant to the McCarran-Ferguson Act, Congress generally leaves such regulation up to the states, declaring “that the continued regulation and taxation by the several States of the business of insurance is in the public interest.”⁷¹ While Congress has constitutional power to act, legislation impairing insurance contracts covering the World Trade Center could involve, to a certain extent, the federalization of insurance law.

If Congress retroactively affects the insurance industry’s private interests in contract, constitutional proscriptions may frustrate the legislation. Federal legislation that interdicts or interferes with private contracts triggers a person’s due process rights.⁷² As a general rule, the courts will treat such legislation under the lenient, rational basis test accorded to economic regulation (whether the legislation operates retroactively or not).⁷³ Regulation subjected to this test is generally upheld.

However, in the light of *Eastern Enterprises v. Apfel*,⁷⁴ a majority of the Supreme Court may subject such legislation to a higher standard of scrutiny. *Eastern*

⁷⁰U.S. Const., Art. I, § 8, cl. 3 (giving Congress the power “to regulate Commerce . . . among the several states.”) See also, *United States v. South-Eastern Underwriters Assoc.*, 322 U.S. 533 (1944)(holding that “insurance” is “commerce” for the purposes of the commerce clause.)

⁷¹15 U.S.C. § 1011. See also, 15 U.S.C. § 1012(b)(“No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance.”)

⁷²U.S. Const. amend. V. (“No person shall . . . be deprived of life, liberty, or property, without due process of law.”)

⁷³See *Pension Ben. Guar. Corp. V. R.A. Gray and Co.*, 467 U.S. 717, 731 (1984)(finding that “the enactment of retroactive statutes confined to short and limited periods required by the practicalities of producing national legislation . . . is a customary congressional practice. We are loathe to reject such a common practice when conducting the limited judicial review accorded economic legislation under the Fifth Amendment’s Due Process Clause.”) Accord, *United States v. Sperry Corp.*, 493 U.S. 52, 65 (1989).

⁷⁴ 523 U.S. 498 (1998)(plurality).

involved the constitutionality of a Federal statute requiring coal mining companies to fund lifetime health benefits of miners they employed decades earlier, even when some of the companies never promised under their employment contract to provide such benefits.⁷⁵ A company, Eastern Enterprises, which had not made such a promise, challenged the statute when a former employee sued Eastern for benefits under the statute.⁷⁶ In a 4-1-4 plurality, the Court found the statute unconstitutional *as applied* to Eastern.

Five justices held that the Fifth Amendment's due process clause controls the evaluation of regulation retroactively impairing a party's contract rights. Four justices held that the takings clause of the Fifth Amendment is the relevant clause. Four dissenting justices voted to uphold the statute under due process. One justice voted to strike it down under due process. The remaining four justices voted to strike it down under the takings clause. The reason for the 4-1-4 split follows.

Under the due process clause, four members of the current Supreme Court – Stevens, Souter, Breyer, and Ginsburg – appear willing to strike down retroactive economic regulation only if it is “fundamentally unfair.”⁷⁷ These justices apply the traditional rational basis test accorded to economic regulation. For Breyer, who wrote for the dissenters, Eastern Enterprises needed to “show a sufficiently reasonable expectation that it would remain free of future health care cost liability for the workers whom it employed.”⁷⁸ Otherwise, it fails to “show that the law unfairly upset its legitimately settled expectations.”⁷⁹ From the dissent's point of view, the company failed to meet this burden. Thus, four members of the court would have upheld the statute as applied to Eastern.

Relative to the dissent, Justice Kennedy takes a similar, but more rigorous approach. Similar to the four dissenting justices, Justice Kennedy invoked due process principles to settle the matter before the Court.⁸⁰ However, he subjected the regulation to a higher standard of scrutiny.⁸¹ For Kennedy, “if retroactive laws change the legal consequences of transactions long closed, the change can destroy the reasonable certainty and security which are the very objects of property ownership.”⁸² “As a consequence,” Kennedy concludes, “due process protection for property must be understood to incorporate our settled tradition against retroactive laws of great severity.”⁸³ In other words, Kennedy would apparently subject regulations of “severe retroactivity” to “severe scrutiny,” but not necessarily “strict

⁷⁵ Id. at 500.

⁷⁶ Id.

⁷⁷ See id. at 559 (Breyer, J., dissenting)(Justices Stevens, Souter and Ginsburg joined.)

⁷⁸ Id. at 567.

⁷⁹ Id. at 568.

⁸⁰ Id. at 547 (Kennedy, J., concurring in the judgment, dissenting in part).

⁸¹ Id. at 549.

⁸² Id. at 548.

⁸³ Id. at 549.

scrutiny.”⁸⁴ As such, Kennedy appears more likely than Justices Breyer, Stevens, Ginsburg, and Souter to strike down, under due process, retroactive economic regulation of private contracts.

The remaining four justices, Rehnquist, O’Connor, Scalia, and Thomas, take a different approach.⁸⁵ In *Eastern*, these justices applied the Court’s “regulatory taking” jurisprudence under the Fifth Amendment.⁸⁶ As a general rule, contract impairment does not constitute a taking for the purposes of the Fifth Amendment.⁸⁷ However, the weighing of three general factors cut the plurality’s analysis in the other direction: (1) the economic impact of the regulation, (2) the extent to which the regulation interferes with investment-backed expectations, and (3) the character of the governmental action.⁸⁸ The plurality found a taking in *Eastern* on two grounds: (1) the statute imposed *severe* retroactive liability on a limited class of parties who could not have anticipated the liability, *and* (2) the extent of liability was substantially disproportionate to the company’s experience in the relevant market.⁸⁹

Moreover, it should be noted that the plurality and the four dissenters appear to operate under a different conception of “retroactive impairment,” the Breyer dissenters being more likely to view such legislation as imposing a “future liability” on the rational grounds of a preexisting relationship.⁹⁰

The absence of a case or controversy under an existing legislative scheme limits constitutional analysis and prediction. However, it appears is that a majority of the Supreme Court may be willing to subject economic regulation that retroactively impairs private interests in contract to a higher standard of scrutiny than rational basis.

B. State Legislation.

Under the Fourteenth Amendment’s due process clause and the Fifth Amendment’s takings clause (as incorporated by the Fourteenth Amendment), the

⁸⁴ When the court applies the “strict scrutiny” standard, the regulation, in order to pass constitutional muster, must be narrowly tailored to serve a compelling state interest. In *Eastern*, Kennedy appears to apply a less strenuous standard of review than strict scrutiny, but more severe than rational basis. Thus, “severe scrutiny” is an apt descriptor as it reflects the tone of his opinion.

⁸⁵Id. at 529 (O’Connor, J., plurality)(“we reach [our] conclusion by applying [regulatory takings analysis,] although Justice Kennedy and Justice Breyer would pursue a different course . . .”).

⁸⁶U.S. Const. amend. V. (the amendment provides “. . . nor shall private property be taken for public use, without just compensation.”)

⁸⁷See, e.g., *Connolly v. Pension Benefit Guar. Corp.*, 475 U.S. 211 (1986).

⁸⁸See, *Eastern Enterprises*, 523 U.S. at 524 (O’Connor, J., plurality),

⁸⁹ See id. at 529 - 537.

⁹⁰ Compare id. at 555 with id. at 532.

court will subject state regulation to a similar standard as federal regulation.⁹¹ As such, the Court’s ambiguous jurisprudence, discussed above, will likewise cloud the analysis of state regulation designed to retroactively impair the enforcement of exclusion clauses. However, an additional constitutional hurdle faces the states – the contracts clause.

Article I, § 10, cl. 1 forbids the States from passing laws impairing the obligation of contracts.⁹² However, under *Home Building and Loan Assn. v. Blaisdell*,⁹³ the stricture is not daunting, unless the states are attempting to avoid their own contractual obligations.⁹⁴ Under *Home Building*, “obligations of a contract are impaired by law which renders them invalid, or releases or extinguishes them.”⁹⁵ However, a state’s economic interests may justify exercise of its protective power, “notwithstanding interference with contracts.”⁹⁶ Moreover, “where protective power of the state is exercised in a manner otherwise appropriate in regulation of business, it is no objection that performance of existing contracts may be frustrated by prohibition of injurious practices.”⁹⁷

In light of the events of September 11 and its rippling effect on New York’s local economy (apart from the national and world economies), state legislation designed to serve the state’s economic interests by retroactively impairing the enforcement of private insurance contracts are not likely to be struck down under the contracts clause. However, without a specific legislative scheme at hand, prediction and analysis is limited.

VII Conclusion

State common and statutory law controls the interpretation and enforcement of exclusion clauses. This Report offers a few generalities concerning the extension and application of these provisions. It does not provide an exhaustive survey.

Reports from industry suggest that “war risk” exclusion clauses will not likely be invoked against losses arising out of the events of September 11, in general, and the destruction of the World Trade Center, in particular.

In the event insurers invoke war risk clauses, interpretive canons and norms of procedure suggest that success is unlikely, if the exclusion clause is ambiguous and the insurer is the party responsible for the uncertain language. However, when an exclusion clause is unambiguous, norms of interpretation generally do not cut against

⁹¹ See, *Chicago B. & Q.R.R. v. Chicago*, 166 U.S. 226 (1897)(Harlan, J.)(applying the fifth amendment’s takings clause against the states through the fourteenth amendment.)

⁹² “No State shall . . . make any . . . Law impairing the Obligation of Contracts . . .”

⁹³ See, 290 U.S. 398 (1934).

⁹⁴ See, *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977).

⁹⁵ 290 U.S. at 431.

⁹⁶ *Id.* at 437.

⁹⁷ *Id.* at 438.

the insurer's interests, and, therefore, courts are more likely to apply exclusion clauses against the insured.

The intent of the parties, the commercial context in which they bargain, and the type of insurance at issue play significant roles in anticipating how a court will interpret and apply an exclusion clause. As such, precise analysis and prediction is difficult. However, generalities about bedrock common law doctrine can be offered. These generalities convey a flavor for how courts traditionally interpret exclusion clauses, and thus provide background for appropriate regulation.

Direct regulation of the insurance industry by Congress will involve, to a certain extent, the federalization of insurance law, a deviation from the policy underlying the McCarran-Ferguson Act. Under the Commerce Clause, Congress enjoys plenary authority to regulate the insurance industry, but remains limited by other provisions of the Constitution, like the Due Process Clause and the Takings Clause.