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## Insurance Coverage of the World Trade Center: Interpretation of “War Risk” Exclusion Clauses under New York Contract Law

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### Summary

This report addresses the interpretation of war risk exclusion clauses under New York contract and insurance law. The purpose of excluding “war risks” from insurance policies is to prevent the insurer from being bankrupted by shouldering countrywide losses from war. The widespread characterization of the events of September 11<sup>th</sup> as an “act of war” raises the possibility that insurable risks to life and property in the World Trade Center may not receive coverage due to the enforcement of these clauses. This report suggests that any such enforcement might not be successful under New York law, as the insured enjoy favorable state rules of procedure and norms of contract construction. However, as this issue essentially boils down to one of contract interpretation – where courts will construe the “exclusions as the parties would reasonably have expected them to be construed” – how public officials characterize the events of September 11<sup>th</sup> could inform a judicial determination of whether those events constitute “acts of war” for purposes of insurance law.

The events of September 11, 2001 not only trigger legal issues vital to national security, but raise issues relevant to private interests in property and life under the law of contracts, in general, and insurance law, in particular. Often, almost universally,<sup>1</sup> insurance policies contain terms that exclude from coverage “war risks”<sup>2</sup> – losses of

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<sup>1</sup> Aviation insurance contracts generally extend coverage for “war risks.” See, Jason Bibby, *War Risk Aviation Exclusion*, 60 J. AIR L. AND COM. 609 (1995).

<sup>2</sup> 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*.” Jefferey W. Stempel, *LAW OF INSURANCE CONTRACT DISPUTES* § 1.02[a] (2001)(emphasis added). In New York, the emphasized language in this clause could be narrowly construed under the contract rule of construction known as “contra proferentem. See footnote 11 and accompanying text.

property or life due to acts of war.<sup>3</sup> When public officials characterize these events as “acts of war” for purposes of international politics, an issue arises as to the prospective effect of such a characterization on the judicial interpretation of insurance law.<sup>4</sup> This report addresses the interpretation of these clauses under New York contract and insurance law.<sup>5</sup>

A survey New York case law suggests that the events of September 11, 2001 are not sufficient to be categorized as acts of war under insurance contracts. First, a commentator on insurance law suggests, “even [...]broadly drafted war exclusion [clauses] that seek to preclude coverage for anything that looks like armed conflict is not ironclad for the insurer.”<sup>6</sup> This is largely because various procedural and interpretive norms favor the policy holder under New York law. Second, characterizations by public officials, even an official declaration of war by Congress, will not have a dispositive effect upon the interpretation of war risk exclusion clauses, though it will certainly inform the judicial viewpoint and legal arguments by the insurance industry. Rather, the understanding of the parties at the time of contract constitutes the benchmark of meaning. Third, the leading New York case in this area, *Pan American World Airways, Incorporated v. Aetna Casualty and Surety Company*,<sup>7</sup> suggests that the losses to life and property on September 11<sup>th</sup> could not aptly be attributed to a “military or usurped power” for the purposes of triggering a ‘war risk’ exclusion clause.

Under New York law, various procedural and interpretive norms favor the policy holder in the event an insurer denies coverage under an exclusion clause like a “war risk” exclusion clause. First, 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.”<sup>8</sup> The

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<sup>3</sup> The purpose of excluding “war risks” from insurance policies is to prevent the insurer from being bankrupted by shouldering countrywide losses from war, an uncorrelated risk of great magnitude, one that, unlike even the large natural risks such as hurricanes and earthquakes, is seldom very localized (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)

<sup>4</sup> Indeed, this inquiry might well be academic, as reports suggest that “insurers intend to pay claims stemming from [the attacks] on the World Trade Center, despite certain ‘act of war’ policy exclusion.” Christopher Oster, *Insurers Pledge Act of War Won’t Block Claims*, THE WALL STREET JOURNAL, A-3 (Sept. 17, 2001).

<sup>5</sup> This report 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 circumstance, 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 American World Airways v. Aetna Casualty & Surety Co.*, 505 F.2d 989 (1974)(applying New York law) will serve as a template in other jurisdictions addressing these issues.

<sup>6</sup> Jefferey W. Stempel, LAW OF INSURANCE CONTRACT DISPUTES § 15.02 (2001)

<sup>7</sup> 505 F.2d 989 (2<sup>nd</sup> Cir. 1974).

<sup>8</sup> *Insurance Co. of North America v. Historic Cohoes II*, 879 F.Supp. 222, 224-25 (N.D.N.Y. 1995), citing *Pan American World Airways v. Aetna Casualty & Surety Co.*, 505 F.2d 989, 999

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,<sup>9</sup> which the court will interpret in a manner “which is most beneficial to the insured.”<sup>10</sup> Most importantly, 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.”<sup>11</sup> In the Second Circuit, this norm of interpretation is known as the rule of ‘contra proferentem.’<sup>12</sup> Under the rule, the court resolves ambiguities in an exclusion clause strictly against the insurer.<sup>13</sup> 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.”<sup>14</sup> Litigation is likely.<sup>15</sup>

Though procedural and interpretive norms tend to favor the insured, the overwhelming characterization of the events of September 11<sup>th</sup> as an “act of war” by

<sup>8</sup> (...continued)

(2d Cir .1974)(applying New York law).

<sup>9</sup> See, *Allianz Ins. Co. v. RJR Nabisco Holdings Corp.*, 96 F.Supp.2d 253, 255 (S.D.N.Y. May 16, 2000). See also, *Marino v. New York Telephone Co.*, 944 F.2d 109 (N.Y. 1991); *Seaboard Surety Co. v. Gillette Co.*, 476 N.E.2d 272, 285 (Ct. App.1984); and *Pan American* 505 F.2d at 999.

<sup>10</sup> *Pan Am*, 505 F.2d at 999. Accord, *Westchester Resco Co. v. New England Reinsurance Corp.*, 818 F.2d 2, 3 (2d 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").

<sup>11</sup> *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).

<sup>12</sup> 571 F. Supp at 1464, citing *Pan American* 505 F.2d at 1000.

<sup>13</sup> 96 F. Supp at 255, quoting 476 N.E.2d 272.

<sup>14</sup> *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 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 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.

<sup>15</sup> In the event that an insurer denies a policy holder coverage for a loss caused by the events of September 11<sup>th</sup>, 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<sup>th</sup> are “acts of war” excluded under the relevant policy, **and** 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 a war risk exclusion clause. However, the reinsurance market, constituted primarily by foreign corporations (primarily England), will certainly place pressure on the primary insurance market to assert exclusions under war exclusion clauses, inter alia. Indeed, the most contentious litigation may be between the reinsurance market and the primary insurance market, and not between the insurance market and the policy holders.

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 an authoritative effect upon the construction of material terms contained in private contracts. The intent of the parties, not the description of Congress, is relevant to understanding whether the events of September 11<sup>th</sup> are “acts of war” within the meaning of private contracts.<sup>16</sup> The material issue, here, is whether the events of September 11<sup>th</sup> were “proximately caused by an agency fairly described, for *insurance purposes*, by an exclusion clause” in the relevant policy.<sup>17</sup> Or, in similar terms, the court will construe the “exclusions as the parties would reasonably have expected them to be construed.”<sup>18</sup> This is essentially a question of fact.<sup>19</sup> To stress again, as the court is dealing with a question of fact, how the background culture characterizes the events of September 11<sup>th</sup> may inform a court when it categorizes what “warlike” action means under a policy’s exclusion clause, albeit in a passive manner. Still, precedent suggests that characterizations of an event by public officials is not dispositive of the issue.<sup>20</sup>

As these cases will turn on the application of New York norms of construction in individual cases, precise analysis and prediction is not possible – such is the nature of contract law. However, the leading case in this area, *Pan American World Airways, Incorporated v. Aetna Casualty and Surety Company*,<sup>21</sup> may be instructive.

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.”<sup>22</sup> 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.”<sup>23</sup> With respect to claims arising out of the September 11<sup>th</sup> 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.

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<sup>16</sup> 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 (1996).

<sup>17</sup> 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.).

<sup>18</sup> *Pan Am*, 505 F.2d. at 1003.

<sup>19</sup> See *id.*

<sup>20</sup> *Id.* See also, 571 F. Supp at 1464.

<sup>21</sup> 505 F.2d 989 (2nd Cir. 1974)

<sup>22</sup> *Id.* at 1009. Jefferey W. Stempel, LAW OF INSURANCE CONTRACT DISPUTES § 1.02[a] (2001)

<sup>23</sup> *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 at 514, *quoting Home Insurance Co. v. American Insurance Co.*, 147 A.D.2d 353, 354 (1989).

The court will then likely ask whether this naked act is the sort of instrumentality that is 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<sup>th</sup> cuts against an argument by the insurance industry that the losses to property and life were due to an act of war.

In the *Pan Am* case, the court examined an act of war exclusion that contemplated an act by a “military or usurped power.” Under *Pan Am*, such an act “must be at least that of a de facto government.”<sup>24</sup> 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 hijacked the Pan Am airplane “was not a de facto government in the sky over London when the 747 was taken.”<sup>25</sup>

The identity and causation rules of *Pan Am* suggest that the losses to life and property on September 11<sup>th</sup> could not aptly be attributed to a “military or usurped power” for the purposes of triggering a “war risk” exclusion clause. Moreover, the favorable norms of interpretation and procedure in New York appear to play in the insured’s favor. However, as this issue essentially boils down to one of contract interpretation, where courts will construe the “exclusions as the parties would reasonably have expected them to be construed,”<sup>26</sup> how public officials characterize the events of September 11<sup>th</sup> may certainly inform a judicial determination of whether those events constitute “acts of war” for purposes of insurance law.

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<sup>24</sup> *Pan Am*, 505 F.2d at 1006.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 1003.