



MEMORANDUM

TO: Captive Insurance Clients and Friends of Paul, Frank & Collins

FROM: William D. Riley, Alan D. Port and Stephanie J. Mapes

RE: Update on Terrorism Risk Insurance Act of 2002

DATE: December 31, 2002

On December 18, 2002, the United States Department of the Treasury (“Treasury”) issued interim guidance concerning the application of the Terrorism Risk Insurance Act of 2002 (“TRIA”) to captive insurance companies. **As will be explained below, it is our belief that the December 18, 2002 interim guidance requires that most Vermont domiciled captive insurance companies writing commercial property and casualty insurance participate in the federal “Terrorism Insurance Program” created under TRIA.** In light of this development, it is important that owners and managers of captive insurance companies understand the consequences of participation under TRIA and comply with various procedures mandated by the statute.

A. TRIA’s Terrorism Insurance Program

Congress recently passed TRIA in response to insurance market uncertainties regarding the risk of losses arising from possible future terrorist attacks in the wake of the September 11 tragedy. TRIA is designed to temporarily protect and subsidize the commercial property and casualty insurance business through the creation of a federal terrorism reinsurance program. President Bush signed TRIA into law on November 26, 2002, and it is effective from that date until December 31, 2004. The Secretary of the Treasury has the discretion to extend the program through December 31, 2005. (The full text of TRIA is available at <http://thomas.loc.gov/cgi-bin/query/z?c107:H.R.3210.ENR:>). Only specifically defined

- insurers, writing
- covered lines of insurance are covered for
- certified acts of terrorism.

1. Insurer Participation

TRIA applies to “insurers” that provide “property and casualty insurance.” The term “insurer,” as used in TRIA, means any entity that: (1) is licensed in any state to engage in the business of providing primary or excess insurance; (2) is an eligible surplus lines insurer listed

on the “Quarterly Listing of Alien Insurers of the NAIC;” (3) is approved by a Federal agency for the purpose of offering property and casualty insurance in connection with maritime, energy or aviation activity; or (4) is a state residual market insurance entity or state workers’ compensation fund; and which receives “direct earned premiums for any type of commercial and casualty coverage.” TRIA § 102(6). Note that only “direct” insurers, and not reinsurers, are included under TRIA.

2. Covered Lines of Insurance

As to the types of insurance that are covered by TRIA, the term “property and casualty insurance” is defined to mean “commercial lines of property and casualty insurance, including excess insurance, workers’ compensation insurance and surety insurance.” TRIA § 102(12)(A).¹ TRIA does not apply to personal lines insurance, federal crop insurance, private mortgage insurance, financial guaranty insurance issued by monoline financial guaranty insurance companies, health or life insurance (including group life), medical malpractice insurance, flood insurance, reinsurance or retrocessional insurance. TRIA § 102(12)(B).

3. Certified Acts of Terrorism

The federal insurance backstop created under TRIA is triggered upon the happening of an “act of terrorism” as certified by the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General. In order to be certified as an “act of terrorism,” the triggering event must: (1) be a violent act or an act that is dangerous to human life, property or infrastructure; (2) have resulted in damage within the United States (or outside the United States to an United States air carrier, flag vessel, or on the premises of any United States mission); (3) have been committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion; and (4) cause losses of at least \$5,000,000. The Secretary of the Treasury is prohibited from certifying an event as an act of terrorism if the act is committed as part of the course of a war declared by Congress, except with respect to workers’ compensation coverage. TRIA §102(1). It is important to note that TRIA’s definition of an act of terrorism is narrower than that contained in many existing terrorism exclusions. For example, an act directed by and carried out on behalf of a domestic terrorist organization is not certifiable as an “act of terrorism” under TRIA.

¹ An Interim Guidance issued by Treasury on December 3, 2002 states that “Treasury deems the following lines of insurance from the NAIC’s Exhibit of Premiums and Losses (commonly known as Statutory Page 14) to be included in the [TRIA] Program: Line 1—Fire; Line 2.1—Allied Lines; Line 3—Farmowners Multiple Peril; Line 5.1—Commercial Multiple Peril (non-liability portion); Line 5.2—Commercial Multiple Peril (liability portion); Line 8—Ocean Marine; Line 9—Inland Marine; Line 16—Workers’ Compensation; Line 17—Other Liability; Line 18—Products Liability; Line 19.3—Commercial Auto No-Fault (personal injury protection); Line 19.4—Other Commercial Auto Liability; Line 21.2—Commercial Auto Physical Damage; Line 22—Aircraft (all perils); Line 24—Surety; Line 26—Burglary and Theft; and Line 27—Boiler and Machinery.”

4. The Federal Reinsurance Backstop

Upon the Secretary of the Treasury's certification that a qualifying act of terrorism has occurred, TRIA's cost sharing program becomes operational. Under the cost sharing system, each participating insurer is required to pay insured losses up to a deductible amount based on a percentage of the insurer's direct earned premium on covered commercial lines during the previous calendar year. For the period November 26, 2002 through December 31, 2002, the deductible is equal to 1% of the direct earned premium in 2001. The applicable percentage for calculating the deductible increases to 7% for 2003, 10% for 2004 and 15% for 2005. The federal government then covers 90% of the insured loss above the deductible, with the insurer coinsuring the remaining 10%. The aggregate amount of government assistance provided pursuant to TRIA, however, may not exceed \$100 billion dollars annually. No insurer that has met its deductible is liable for the payment of any portion of covered losses that exceed the \$100 billion dollar program cap.

As described above, all "insurers," as defined by TRIA, must participate in the program. TRIA § 103(a)(3). Such insurers must "make available" in all policies of "commercial property and casualty insurance" coverage for insured losses resulting from certified "acts of terrorism" as defined by TRIA. The terms and conditions of coverage for losses caused by terrorism may not differ materially from the terms and conditions applicable to non-terrorism risks. TRIA § 103(c). With respect to terrorism exclusions existing in policies issued before the enactment of TRIA, such exclusions are deemed null and void to the extent that they exclude coverage mandated by TRIA. TRIA § 105(a). Nevertheless, such pre-existing terrorism exclusions may be reinstated upon the happening of either of two events: (1) the insurer has received a written statement from the insured that authorizes such reinstatement; or (2) the insured fails to pay any increased premium charged by the insurer for providing such terrorism coverage after receiving at least 30 days written notice of the additional premium from the insurer. TRIA § 105(c).

TRIA permits an insurer to purchase reinsurance to cover its deductible and 10% quota share, and the existence of such reinsurance coverage does not affect the calculation of the deductible or retention. The amount of financial assistance provided under TRIA is not reduced by reinsurance paid or payable to an insurer from other sources, except that the total of reinsurance recoveries and the amount of financial assistance provided under TRIA during a program year cannot exceed the aggregate amount of the insurer's losses for the period. If there is such an excess "and there is no agreement between the insurer and the reinsurer to the contrary," the excess sum must be returned to the Treasury. TRIA § 103(g). That is, unless otherwise agreed between the insurer and reinsurer, TRIA protection will not provide coverage in addition to existing reinsurance for the same risk.

TRIA provides for the mandatory recoupment of a portion of the funds paid out by the federal government as part of the backstop program. Specifically, the Secretary of the Treasury is required to recoup the difference between total insurance industry costs (i.e., the deductible amounts paid by insurers, plus the industry's 10% quota share above the deductible amounts) and the following fixed amounts per year: \$10 billion for 2003, \$12.5 billion for 2004 and \$15 billion for 2005. The recoupment will be funded through a policyholder premium surcharge on all commercial property and casualty policies in force after the date that the Secretary of the

Treasury determines that a triggering event has occurred. The surcharge cannot exceed 3% of the premium paid on each applicable policy in a given year. TRIA § 103(e)(7). To the extent that the amount of Federal financial assistance exceeds any mandatory recoupment amount, the Secretary of the Treasury has discretion to recoup, through a policyholder premium surcharge, such additional amounts that Secretary believes can be recouped after considering a number of designated factors. TRIA § 103(e)(7)(D). Insureds are potentially subject to these mandatory and discretionary premium surcharges regardless of whether they elect to purchase the terrorism coverage that must be made available under TRIA.

TRIA also establishes procedures for making a claim for federal reinsurance payments. First, the person that suffers the insured loss, or a person acting on behalf of that person, must file a claim with the insurer. Second, the insurer must have provided to the policyholder “clear and conspicuous” disclosure of the premium charged for insured losses covered by the Program and the Federal share of compensation for insured losses under the program. Third, the insurer must process the claim in accordance with “appropriate business practices,” and any reasonable procedures that the Secretary of the Treasury may prescribe. Fourth, the insurer must submit to the Secretary of the Treasury a claim for payment of the Federal share of compensation for insured losses under the Program. Fifth, the insurer must submit to the Secretary of the Treasury written certification of the underlying claim and all payments made for insured losses. Finally, the insurer must provide certification of the insurer’s compliance with TRIA’s claim procedures. TRIA § 103(b).

B. December 18, 2002 Interim Guidance

Since TRIA’s enactment into law on November 26, 2002, Treasury has stated its intent to issue guidelines concerning whether captive insurance companies, including risk retention groups, could be deemed mandatory participants in TRIA’s terrorism insurance program. Treasury’s December 18, 2002 Interim Guidance answers that question in the affirmative. Specifically, the interim guidance concludes that any “entity” that falls within TRIA’s definition of “insurer,” and which reports direct earned premiums to the NAIC in the Annual Statement in column 2 of the Exhibit of Premiums and Losses (commonly known as Statutory Page 14) “or reports comparable information to its licensing or admitting State,” will be considered by Treasury as an “insurer” under TRIA, “even if the entity is also in a self-insured or captive arrangement.” Interim Guidance, December 18, 2002, at 7 (emphasis added) (available at <http://www.treasury.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/po37041.pdf>). Association and risk retention group captives are required to use Statutory Page 14 to report premiums. Although the information reported by other Vermont captive insurance companies in their annual reports to the Vermont Department of Banking, Insurance, Securities and Health Care Administration is less comprehensive than that required by the NAIC’s Statutory Page 14 form, we believe that it is sufficiently “comparable” such that otherwise qualifying Vermont captives will likely be deemed mandatory participants by Treasury. Accordingly, we recommend that all Vermont domiciled captive insurance companies that receive “direct earned premiums for any type of commercial and casualty coverage,” take all necessary actions to comply with the mandates of TRIA.

C. Compliance Issues

There are several compliance issues that must be addressed relatively quickly by insurers that are covered by TRIA:

1. Coverage Disclosure--Property and casualty insurance coverage for insured losses caused by acts of terrorism, as defined by TRIA, must be offered to policyholders. As part of this offer of coverage, insurers must provide to policyholders clear and conspicuous disclosure of the premium charged for insured losses covered by the Terrorism Risk Insurance Program and information concerning the Federal share of compensation for insured losses under the Program. Such disclosure must be made by February 24, 2003 for existing (in-force) policies issued before November 26, 2002. For policies issued between November 26, 2002 and February 24, 2003, the disclosure must be made at the time of offer, purchase and renewal of the policy. For policies issued after February 24, 2003, the disclosure must be made "on a separate line item in the policy" at the time of offer, purchase and renewal of the policy.
2. Reinstatement of Terrorism Exclusions--As noted above, terrorism exclusions existing in policies issued before the enactment of TRIA were nullified as of November 26, 2002 to the extent that they exclude coverage mandated by TRIA. In order to reinstate such exclusions, TRIA requires the happening of either of two events: (1) the insurer has received a written statement from the insured that authorizes such reinstatement; or (2) the insured fails to pay any increased premium charged by the insurer for providing such terrorism coverage after receiving at least 30 days written notice of the additional premium from the insurer. It is important to recognize that the insured remains subject to potential premium surcharges that could be ordered by Treasury as part of TRIA's recoupment provisions, even if the insured declines the terrorism coverage.

The NAIC has issued two model disclosure forms designed to achieve compliance with TRIA's disclosure and notice requirements for policies issued prior to November 26, 2002 and until February 24, 2003. Model Form No. 1 (available at http://www.naic.org/pressroom/releases/disclose_one_final.pdf) may be used to disclose premium and federal reinsurance information, as well as to provide the insured with the choice to purchase the offered terrorism coverage or to reinstate a previously issued terrorism exclusion. Model Form No. 2 (available at http://www.naic.org/pressroom/releases/disclose_two_final.pdf) may be used to disclose premium and federal reinsurance information with respect to a policy that already provides terrorism coverage. In its December 3, 2002 Interim Guidance (available at <http://www.treasury.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/interimguide.pdf>), Treasury approved the use of either form (or an appropriate modification thereof) until it issues final regulations or further guidance on the subject.

It should be noted that TRIA authorizes the imposition of civil monetary penalties of up to \$1,000,000 with respect to various acts of insurer misconduct and/or failure to comply with TRIA's provisions.

D. Advice for Captives and Additional Issues for Consideration

TRIA raises many issues with respect to the operation of captive insurance companies subject to its provisions. Among these issues are:

1. Captive insurance companies that are subject to TRIA should fulfill each of the compliance obligations discussed above. Such insurers must bear the burdens imposed by TRIA, and cannot partake in the substantial benefits of the program without achieving full compliance.
2. The maximum premium surcharge that potentially could be assessed under TRIA's mandatory recoupment provisions should be calculated for each insured. Knowing this exposure beforehand should prove useful in analyzing the potential impact of TRIA for general business planning purposes for the captive and its insureds.
3. For policies issued between November 26, 2002 and February 24, 2003, the disclosures mandated by TRIA must be made at the time of offer, purchase and renewal of the policy. If a captive insurance company has issued a policy since November 26, 2002 without the required disclosures, we recommend that the disclosures be issued to the insured as soon as possible.
4. Captive insurance companies that have in-force direct policies containing terrorism exclusions, and which are reinsured by policies that exclude coverage for terrorism, now have some terrorism exposure that is not reinsured (i.e., the insurer retention comprised of the deductible and 10% quota share provided for under TRIA). Unless and until its insured elects to reinstate the terrorism exclusion, the captive must recognize and address this additional risk.
5. In light of the limited nature of the existing market for terrorism insurance coverage, we expect that calculating an appropriate premium for terrorism coverage may prove to be a difficult task for many captive insurance companies. Early information indicates that many traditional carriers are using a surcharge approach in which the terrorism coverage premium is calculated as a percentage of the overall policy premium. We anticipate that Vermont regulators will begin to study and adopt standards for reviewing terrorism coverage premiums over the next several months. It should also be noted that TRIA requires the Secretary of the Treasury to annually compile information on the terrorism risk insurance premium rates for the preceding year. TRIA § 104(f).
6. Captive insurers that purchased reinsurance for direct terrorism coverage prior to the enactment of TRIA have now paid for private reinsurance that may be

duplicative of the coverage they are getting under the TRIA program. It is now beneficial for captive insurance companies to purchase reinsurance (or have their existing coverage endorsed, if possible) as excess to the government coverage provided under TRIA.

7. The December 18, 2002 Interim Guidance issued by Treasury does not constitute final word on the subject of TRIA's application to captive insurance companies. It is possible that Treasury's regulations on the subject may include an opt-in/opt-out feature, which would allow captives the choice of whether to participate. The Vermont Captive Insurance Association is currently mounting a vigorous lobbying campaign in support of the opt-in/opt-out alternative. As a result, all actions taken by captive insurance companies in response to the December 18, 2002 Interim Guidance should be completed with the understanding that participation in the program may become optional in the near future. We would be happy to discuss the possibility of including language in a captive's TRIA disclosure statements that will allow for future modifications should an opt-in/opt-out feature be implemented by Treasury.

We will continue to monitor the implementation of TRIA, especially with respect to developments concerning its application to captive insurance companies.

If you have any questions regarding TRIA or this memorandum, please feel free to contact William D. Riley at (802) 658-2311 or wriley@pfclaw.com. While William Riley is our principal contact on this matter, please also feel free to contact Alan D. Port or Stephanie J. Mapes at (802) 658-2311 or aport@pfclaw.com and smapes@pfclaw.com, respectively.

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