TRIA and Captives

The Role of Captive Insurance in the Terrorism Risk Insurance Program

by William D. Riley

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Congress passed the Terrorism Risk Insurance Act of 2002 in response to widespread insurance market uncertainties that followed the terrorist attacks of September 11, 2001. TRIA was designed to temporarily protect and stabilize the commercial property and casualty insurance industry through the creation of a federal terrorism reinsurance program. The focus of TRIA, quite naturally, was directed at providing a new source of reinsurance for traditional insurance companies, which had begun excluding coverage for losses resulting from terrorism in response to their inability to access private market reinsurance on such risk. Although primarily conceived and designed as a means to assist the traditional insurance market, TRIA has had a substantial impact on segments of the alternative risk transfer industry, particularly the owners and operators of captive insurance companies.

I. Captive Insurance

A captive insurance company is generally defined as "an insurance company that is wholly owned and controlled by its insureds; its primary purpose is to insure the risks of its owners; the primary beneficiaries of its underwriting profits are its insureds." Westover, *Captives and the Management of Risk* (International Risk Management Institute 2002), at 4. There are several types of captive insurance companies, including pure captives, industrial insured group captives, risk retention groups, association captives, and sponsored captives (sometimes referred to as segregated or protected cell companies). Single parent pure captives are the most common form of captive insurance company. The primary business purpose of a pure captive is to insure the risks of its parent and affiliated companies.

Captives write primary and excess insurance on a direct basis and also operate as reinsurers. They underwrite a wide variety of first and third party risks. All-risk property, general liability, professional liability, workers' compensation, surety, employer's liability, crime, and auto liability are just a few of the many lines of commercial insurance that captives have been licensed to write.

Captives have played a steadily increasing role in the United States insurance marketplace over the last decade. In a report published in April of 2003, A.M. Best Company projected that the global alternative risk transfer market, of which captives are a major component, would capture approximately 50 percent of the total commercial market in the United States. This migration of business is further evidenced by a survey of domestic corporate risk managers conducted by the Risk and Insurance Management Society in 2003, which found that approximately 40 percent of the respondents placed business in captives or risk retention groups. Similarly, Towers Perrin Tillinghast recently estimated that more than 40 percent of major American corporations own one or more captive companies.

Much of the growth in the captive industry has occurred over the last few years. Based on a study of 159 U.S. domiciled captives that filed statutory financial statements with the rating agency, A.M. Best reported in August of 2004 that net written premiums increased by 45 percent in the five year period from 1999 to 2003. In addition, the admitted assets of those captives rose 29 percent during the same period. A.M. Best estimates that that net written premiums for U.S. captives stood at $8.9 billion for 2003, an increase of 4.6 percent from 2002.

State licensing statistics also illustrate the size and rapid growth of the captive industry. Vermont, which is the largest U.S. domicile for captives and third largest in the world, reported 530 active licensed captives at the end of 2003. Next was Hawaii, with 122, and South Carolina, with 65 active licensed captives. Many of the currently active captives licensed by these states were formed within the last three years. For example, 77 new captives were licensed in Vermont in 2003. Growth continued through 2004, albeit at a slower pace, with Vermont reporting the licensing of 43 new captives, including 29 pure captives and 8 risk retention groups.

Many states have recently recognized the commercial importance and growth potential of the captive insurance industry and are striving to become attractive domiciles. All told, 23 states and the District of Columbia now permit the formation of captive insurance companies.

II. Applicability of TRIA to Captives

The Terrorism Risk Insurance Act applies to "insurers" that provide "property and casualty insurance." The term "insurer," as used in TRIA, means any entity that is any one of the following: (1) licensed in any state to engage in the business of providing primary or excess insurance; (2) an eligible surplus lines insurer, and on the "Quarterly Listing of Alien Insurers of the NAIC;" (3) approved by a federal agency for the purpose of offering property and casualty insurance in connection with maritime, energy, or aviation activity; (4) a state residual market insurance entity or state workers' compensation fund; *or* (5) any other entity described in §103(f) of the TRIA, to the extent provided in the rules of the Secretary of the Treasury issued under §103(f); *and* which receives "direct earned premiums for any type of commercial and casualty coverage." TRIA §102(6).

"Property and casualty insurance" is generally defined under TRIA to mean "commercial lines of property and casualty insurance," with a limited set of exceptions. Of significance to captives, "reinsurance" is specifically excluded from the definition of "property and casualty insurance." TRIA §102(12).

A. Statutory Ambiguity

Upon TRIA's enactment into law on November 26, 2002, there was confusion regarding the applicability of the statute to United States-domiciled captive insurance companies. This confusion stemmed, in part, from the language of §102(6) and §103(f) of TRIA. Although it was recognized that most captives could fall within §102(6)(A)(i) as state "licensed" insurance carriers, some observers argued that §102(6)(A)(v) operated as an exclusion for captives because they are mentioned in §103(f), which authorizes Treasury, "in consultation with the NAIC or the appropriate state regulatory authority," to apply the provisions of TRIA "to other classes or types of captive insurers and other self-insurance arrangements by municipalities and other entities (such as workers' compensation self-insurance programs and state workers' compensation reinsurance pools). . . ." Because Treasury had not issued "rules" declaring captives to be "insurers," it was argued that captives were not yet subject to TRIA.

In response to the uncertainty regarding TRIA's application to captives, the Vermont Captive Insurance Association (VCIA) began lobbying efforts designed to convince Treasury that Congress did not intend captives to be mandatory participants in the terrorism risk insurance program and that Treasury should issue regulations establishing an opt-in mechanism for captives. This viewpoint, however, was not shared throughout the captive industry. For example, the South Carolina Captive Insurance Association has consistently expressed the opinion that captives established under state law should be mandatory participants in the program.

The Vermont group's opt-in argument was supported by that state's two U.S. Senators, Patrick Leahy and James Jeffords, who thought they had negotiated changes to the statutory language to exclude captives from mandatory participation in the program created by TRIA. Indeed, in his November 19, 2002 statement in support of the TRIA Conference Report, Senator Leahy remarked that he and Senator Jeffords "strongly support language in the conference report to allow those captives in property and casualty [lines] the option of participating in the program while not requiring other captives to start offering terrorism risk insurance." In making these remarks, Senator Leahy was referring to the following language in the TRIA Conference Report concerning §103(f): "This section further gives the Secretary discretion to apply the legislation to various classes of captives and self-insurance programs (such as workers' compensation self-insurance programs and State workers' compensation reinsurance pools)."

The Treasury Department attempted to address the confusion regarding TRIA's application to captives in its interim guidance issued on December 18, 2002. That document concluded 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*," would 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). In reaching this conclusion, Treasury apparently rejected the argument that TRIA §102(6)(A)(v) and §103(f) operated to exclude captives from the definition of "insurer," by concluding that §103(f) referred solely to captives "other" than those "licensed or admitted to engage in the business of providing primary or excess insurance in any State[,]" as referenced in §102(6)(A)(i).

Pursuant to the interim guidance, association and risk retention group captives were deemed to be "insurers" subject to TRIA because they are required to use "Statutory Page 14" to report premiums. Although the information reported by other types of captive insurance companies in their annual reports to their domiciliary regulators is typically less comprehensive than that required by the NAIC's Statutory Page 14 form, most observers concluded that the captive regulatory reporting requirements were sufficiently "comparable" such that otherwise qualifying captives would likely be deemed mandatory participants by Treasury.

In response to the interim guidance, most U.S.-domiciled captive insurance companies writing property and casualty insurance began taking steps to comply with TRIA's "make available" and disclosure requirements. In addition, the VCIA continued its lobbying effort to convince Treasury to implement regulations that would include an opt-in mechanism for captives.

III. Treasury's July 2003 Regulations

On July 11, 2003, the Treasury Department issued a set of final regulations that effectively extinguished any hope that it would adopt an opt-in mechanism for captives. The regulations confirmed that "State licensed captive insurance companies" and "State licensed or admitted risk retention groups" are deemed "insurers" subject to TRIA, if they "receive direct earned premiums for any type of commercial property and casualty insurance coverage." 31 C.F.R. §50.5(f).

In its commentary accompanying the 2003 regulations, Treasury summarized the three principal arguments that had been presented by those opposed to the mandatory inclusion of captives in the Terrorism Risk Insurance Program. (1) Many captive insurers were created to operate outside the traditional insurance marketplace, and thus should not be treated as other insurance companies. (2) Some types of commercial coverage provided by captive insurers may have little or no exposure to terrorism risk, thus captives insurers should not be subject to TRIA's potential recoupment provisions. (3) Mandatory participation requirements for captives, in particular TRIA's potential recoupment provisions, could negatively affect the formation of domestic captives as companies may find setting up off-shore captives to be advantageous. These three arguments were, however, summarily rejected by Treasury.

First, the Treasury Department seemingly sidestepped the "philosophical" argument that captives, as part of the alternative risk transfer market, should not be treated like traditional insurance companies. Instead, Treasury observed that requiring mandatory participation for state licensed or admitted captives was "in accord" with the plain language of §102(6)(A)(i) of TRIA, which does not distinguish between types of state licensed and admitted insurers. Furthermore, Treasury noted that such treatment of captives furthers other statutory objectives such as "ensuring that policyholders have widespread access to the terrorism risk insurance benefits of the Program, and spreading potential costs of the Program associated with any federal loss-sharing payments." Treasury also supported its position by noting that an opt-in mechanism would create the potential for adverse selection, which would likely occur as "those captive insurers that perceived themselves to have higher risk to terrorism would likely opt-in to the Program while others with lower perceived risks would likely opt-out of the Program."

Second, Treasury squarely rejected the argument that an opt-in mechanism was justified because many captives write coverage that has limited risk exposure to terrorism. Treasury noted that the same argument was equally applicable to large numbers of traditional insurance carriers and their policyholders.

Third, the Treasury Department commented that there was little or no support for the assertion that the potential recoupment provisions would adversely affect United States captive domiciles by encouraging U.S. captives to move or be formed offshore. Treasury stated that it would be difficult to quantify the net effect that TRIA would have on any particular captive jurisdiction in light of the fact that many captives would be attracted to the substantial benefits resulting from participation in the program. Indeed, Treasury's views on this issue seem to have been subsequently borne out by the fact that little empirical evidence has developed that establishes that captives are moving offshore in an effort to avoid participation in the program.

Finally, Treasury rejected arguments put forth by Senators Leahy and Jeffords, who had informed Treasury of their belief that use of the word "other" in §103(f) was a "grammatical error," and that the intent of Congress was "to create a process through which captive insurers could be integrated into the Program on an opt-in basis." Employing the rule of statutory construction that requires words in a statute to be read to have meaning unless the reading of those words produces an absurd result, Treasury concluded that the word "other" as used in the relevant provisions could easily be construed "as referring to captives other than those that are State-licensed or admitted."

IV. Practical Implications for Captive Insurance Companies

The decision of the Treasury Department to require state-licensed captive insurers to participate in the Terrorism Risk Insurance Program raises several issues of special significance to captives. These issues include the legality of captives created solely for the purpose of accessing the Program, capital adequacy, the timing of Program payments by Treasury, fronting, and the Program's treatment of cell captives.

A. Legality of TRIA-Only Captives

Following the enactment of TRIA, a substantial number of captive owners moved to take advantage of the benefits of the Program. In April of 2004, the insurance services firm Marsh reported that its captive management group had assisted over 40 clients in using captives to access TRIA coverage. Marsh, Inc., *Marketwatch: Property Terrorism Insurance 2004* (April 2004), at 33. Similarly, Aon Corporation reported in September 2003 that it was aware of at least 40 captives that have issued TRIA policies. In addition, Aon reported that several captives were formed, with the approval of state regulatory authorities, for the specific purpose of gaining access to TRIA benefits. Presentation by Gary Marchitello and Aaron Davis, "Counter Terrorism Protocol & TRIA Captive Fundamentals," at Institutional Investor Conference (September 22–23, 2003). The state of New York, in particular, has licensed two captives that were formed solely to provide TRIA coverage, and seven others that include TRIA coverage along with other traditional coverage. Congressional testimony of Gregory V. Serio, New York Superintendent of Insurance (April 28, 2004). In addition to New York, insurance regulators in Vermont, South Carolina, and Arizona have approved captive programs designed to access TRIA coverage.

In carrying out its statutory authority to "prescribe regulations and procedures to effectively administer and implement the Program," Treasury has begun examining the means by which captives have been used to access TRIA coverage. Despite its decision to mandate participation in the Program by captives, Treasury has been somewhat ambiguous about its views regarding the legality of captives formed or utilized solely to provide TRIA coverage. In response to a request from the VCIA for guidance on the subject, Treasury expressed its concern regarding "the strategic use of captives as a means of avoiding the requirements" of TRIA and its implementing regulations. With respect to such strategies, commonly referred to as "gaming the system," Treasury observed:

> The *post*-enactment formation or utilization of a captive insurer that will only provide stand-alone, single risk *TRIA-only* coverage for losses from acts of terrorism raises questions regarding the integrity of the Program. We believe that an entity considering forming a captive insurer for stand-alone, single risk terrorism insurance should be strongly cautioned and advised against undertaking such proposed action if it is doing so in order to avoid the Act's deductible requirements.

"Treasury Interpretive Letter" (March 1, 2004), at 3 (italics in original). Unfortunately, the interpretive letter does not elaborate on the types of conduct that Treasury would view as an effort to avoid the Act's deductible requirements.

The Treasury Department subsequently released two additional interpretive letters that are of importance to captive insurers. On September 24, 2004, it again addressed the issuance of a stand-alone TRIA policy by a Vermont captive. The letter appears to conclude that the issuance of such a policy, either on a primary or excess basis, is currently acceptable to Treasury. Nonetheless, Treasury reiterated its earlier concerns regarding the strategic use of captives to deal with terrorism risks: "We have concerns about the possibility that captives may be used as a tool for avoiding the requirements of the Act and implementing regulations, particularly where the Act's deductible and mandatory recoupment provisions are involved." In light of these concerns, the letter announced that Treasury will now "reconsider whether possible future rulemaking is needed to address the special circumstances and issues being raised vis-à-vis captives." Finally, the letter stated that anyone considering forming a captive insurer for stand-alone, single risk terrorism insurance "should be cautioned against undertaking such action if there is any evidence of an intent to avoid the Act's deductible or recoupment requirements."

As a whole, the September 24 interpretive letter appears to acknowledge that the statute and current regulations allow domestic captives to write stand-alone single risk TRIA policies, so long as there is no intent to avoid TRIA's deductible or recoupment requirements. More importantly, however, the letter also seems to convey some level of discomfort with the practice, particularly where the captive's only business is writing stand-alone TRIA coverage.

A third interpretive letter, dated September 21, 2004, addressed the proposed structure of a workers compensation program involving a deductible reimbursement policy issued by the insured's wholly owned captive. Under the proposed structure, the insured would "restructure its workers' compensation policy to make all insured losses under the [traditional] workers' compensation policy that are caused by a certified act of terrorism to be within the policy's deductible." The insured would then have in place a stand-alone deductible reimbursement policy issued by its captive. In essence, the structure would have the effect of transferring all of the TRIA risk under the workers compensation policy to the captive and to Treasury. After describing the proposal as an "atypical insurance program" that would have the effect of transferring risk from a traditional insurer with a high TRIA deductible to a captive with a lower TRIA deductible, Treasury cautioned against taking the proposed action "if it is being undertaken to avoid TRIA's deductible requirements."

In addition to the release of interpretive letters, Treasury officials appearing at various public speaking engagements have been asked to expand on the concept of "gaming the system" by captives. Nonetheless, these officials, to date, have not provided comprehensive descriptions of their concerns. For example, while speaking at the VCIA Annual Captive Insurance Conference in August of 2004, Program director Jeffrey Bragg analogized the issue to Justice Potter Stewart's famous observation from *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964), regarding the difficulty of defining hard-core pornography: "…I know it when I see it…."

Nevertheless, Mr. Bragg did offer two examples of what he personally considered to be "gaming the system." First, he described a scenario where a company puts a single line of coverage into its captive to secure TRIA coverage, while at the same time placing the balance of its coverage with traditional carriers. The second example involved a captive writing TRIA coverage for an unjustifiably low premium. Zolkos, "Captives Urged to Play Fair in Seeking TRIA Coverage," *Business Insurance* (August 23, 2004), at 4.

Although public statements such as those offered by Mr. Bragg provide some insight into Treasury thinking on the subject, the above mentioned interpretive letters still represent Treasury's only publications on the subject of TRIA-only captives. Nevertheless, it is important to recognize that the interpretive letters do not state a *per se* rule that all such captives are ineligible for TRIA reimbursement, but instead suggest that Treasury's concerns are focused on the purposeful avoidance of TRIA's deductible and recoupment provisions. In addition, it appears that entities operating TRIA-only captives may strengthen their position before Treasury by adding at least some non-TRIA coverage to the captive's insurance program.

Finally, it is worth noting that the language of TRIA itself does not appear to support a highly restrictive approach to captives writing TRIA-only coverage. Indeed, TRIA contains no language prohibiting the practice. It is conceivable that Treasury could justify such a prohibition by arguing that captives writing TRIA-only coverage are not operating like "real" insurance companies. Presumably, Treasury could look to legal tests, such as those commonly used in captive premium deductibility cases, as a means of testing whether a captive is writing "real" insurance. See, *e.g.*, *Humana Inc. v. Commissioner of Internal Revenue*, 881 F.2d 247 (6th Cir. 1989) (requiring proof of "risk transfer" and "risk distribution" to support the tax deductibility of premiums paid to a captive). Nevertheless, TRIA's specific acknowledgment of captive insurance and its definitions of "insurer" and "property and casualty insurance" convey no evidence of Congressional intent to limit program participation to those captives that can establish sufficient levels of risk transfer and risk distribution.

In its interpretive letter of September 24, 2004, the Treasury Department confirmed that it is "reconsidering" whether future rulemaking is needed regarding the use of captives to access TRIA benefits. In light of the widespread and ongoing use of captives to cover terrorism risk, it is vital that Treasury issue substantive guidance on the subject as soon as possible.

B. Capital Requirements

To date, the Treasury Department has not announced any rules or standards regarding minimum capitalization requirements for captives writing TRIA coverage. Based on public comments made by Treasury officials, it appears that the department will defer to state regulatory authorities on the issue. In Vermont, for example, captive regulators have publicly stated that along with adequate premium consistent with outside pricing, recommended minimum capital for the captive of a "strong parent" should be equal to ten percent of the captive's net exposure on its TRIA coverage. "VCIA Conference Notes," *Captive Insurance Company Reports* (October 2003), at 6.

For example, such a Vermont captive writing a TRIA policy with a limit of $100,000,000, would face a maximum net exposure of $10,000,000 (following federal reimbursement of ninety percent of the loss), plus the captive's deductible (calculated as a percentage of its direct earned premium). Assuming a deductible of $100,000, the minimum capital required by Vermont regulators would be $1,010,000.

The lack of published rules or standards on capitalization and the risk of Treasury using capital sufficiency as a means of gauging whether a captive has "gamed" the system, has been a source of uncertainty among captives writing TRIA coverage. Treasury's publication of an official position on the subject, whether it be an explicit statement of deference to state regulation or the adoption of federal rules or standards, would go far in assisting the management of such captives in structuring and funding their coverage of terrorism risk.

C. Timing of Government Payments

On December 1, 2003, the Treasury Department issued a proposed rule regarding claims procedures that required an insurer to certify that it had "paid all underlying claims comprising the insured losses" in its loss bordereau before it could submit its claim for payment to Treasury. This requirement raised potential cash flow difficulties for a number of captives with TRIA exposure, particularly those captives with capitalization that would be sufficient to cover only its net retained risk (*i.e.*, the captive's deductible and 10 percent quota share) or less. In order to remedy the situation, the VCIA lobbied Treasury to amend the proposed rule to include a simultaneous payment arrangement that would apply only in situations where an insurer's aggregate losses exceeded a given percentage of its surplus.

To its credit, Treasury responded to the concerns raised by the captive industry when it issued its final rule on claims procedures on June 29, 2004. The final rule contains a procedure for requesting an advance payment from Treasury and requires the insurer to certify that the advance payment will be used to pay losses within five business days after receipt.

D. Fronting

Because they are typically licensed only in their state of domicile, captives often use front companies in instances where they wish to write certain types of coverage, such as workers compensation or auto liability, that require evidence that the insurance policy has been issued by an admitted carrier. In such transactions, an admitted carrier issues the policy to the insured and then reinsures all or a substantial portion of the risk with the captive. The front company then retains a portion of the premium paid by the insured as payment for its services. With respect to such fronting arrangements, Treasury confirmed in commentary accompanying its final regulations issued on July 11, 2003 that the fronting carrier remains the "insurer" under TRIA and the premium that the fronting carrier receives must be included as part of its "direct earned premium."

Treasury's conclusions regarding fronting come in the wake of a difficult period in the captive fronting market. The number of fronting carriers available to captives has declined in recent years and the fees charged by the remaining fronting carriers have increased substantially. It is not yet clear how fronting carriers have incorporated Treasury's ruling into the pricing of fronting services and whether the ruling will cause additional complications in fronting relationships with captives.

E. Cell Captives

Cell captives, which are also known as "sponsored captives" or "rent-a-captives," maintain separate underwriting accounts for each participant. Under such programs, the policyholder is insured by the captive, but has no ownership interest in or control of the captive. In essence, the captive "rents" its capital, surplus and license to the policyholder and usually provides administrative services, reinsurance and/or a fronting carrier, if necessary. Cell captives may be structured as a "protected cell" or "segregated cell" insurer, which entails the legal segregation of the accounts of each program from the liabilities of every other program and those of the captive itself.

There has been much thought of using protected cell captives as a cost-efficient way of providing terrorism coverage to smaller business entities. However, the provisions of TRIA, and the lack of Treasury regulations on the subject, have hindered such activity. A major concern results from TRIA's definition of "insurer," which requires that the insurer be licensed by a state to engage in the business of providing primary or excess insurance. Although the cell captive itself holds a license, the individual cells within the captive do not. If Treasury is to literally apply the definition of "insurer" to cell captives, it would likely calculate TRIA deductibles and recoupment amounts by aggregating the individual cells of the captive. Such an approach would run counter to the economic framework upon which the cell structure is based. If cell captives are to play a significant role in providing TRIA coverage, guidance from Treasury on these issues is necessary.

V. Conclusion

Captive insurance and other alternative risk transfer vehicles now play an increasingly important role in the risk management strategies of American businesses. Despite their importance as a risk management tool, the application of TRIA to captives and their role in the Terrorism Risk Insurance Program has been rife with ambiguity and uncertainty. Nor is there any legislation pending in Congress that contains provisions that could further clarify the rules regarding captive insurers. Given their widespread use, and the substantial financial and human capital that has been invested in captives, it is vital that these ambiguities and uncertainties be resolved. The Treasury Department and the insurance community must carefully study and consider how best to integrate captives and other alternative risk transfer vehicles into TRIA and any successor program that may be established.

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