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# UPDATE: Terrorism Risk Insurance Act Set To Expire; Treasury Proposes New Rule

Since its inception in November, 2002, the Terrorism Risk Insurance Act of 2002 ("TRIA") has required that commercial property and casualty insurers "make available" to their policyholders coverage for certain acts of terrorism—in essence terrorism committed by foreign terrorists within the United States. TRIA also provides a federal reinsurance backstop for the coverage of such acts of terrorism. Under the TRIA program, the federal government would reimburse insurers for 90 percent of such insured losses in excess of a statutory deductible. This deductible is currently equal to 15 percent of an insurer's aggregate premiums on commercial property and casualty policies for the preceding year. (See the discussion of the TRIA program in our Client Alert, dated December 2002 available at http://www.lordbissell.com/newsstand_story.cfm?NSID=209.)

Unless it is extended by Congress, the entire TRIA program will expire December 31, 2005. This Client Alert discusses issues raised by the potential expiration of TRIA, industry and legislative responses to TRIA's potential expiration, and Treasury's release of a proposed rule regarding the determination of insurer affiliations for purposes of TRIA.

## PROSPECTS FOR A "HARD LANDING" ON TRIA'S EXPIRATION

Last June, the Treasury Secretary exercised his statutory authority to extend TRIA's "make available" requirement through the end of 2005. As a result, insurers are now required to make terrorism coverage available for all commercial property and casualty policies issued in 2005, including those with a term of coverage that extends into 2006. However, if TRIA expires at the end of 2005, any insured terrorism losses occurring in 2006 will not be covered by the federal reinsurance backstop. Absent an extension of TRIA by Congress or the states' approval of terrorism endorsements sharply limiting terrorism coverage in 2006, insurers are faced with the prospect of a "hard landing" for the TRIA program, i.e., a requirement that they offer the terrorism insurance contemplated by TRIA for periods not covered by any federal backstop.

The insurance industry has been lobbying Congress for an extension of TRIA that would eliminate any such "hard landing" at the end of this year. In addition, the Insurance Services Office ("ISO") has filed a set of contingent endorsements designed to address the "hard landing" issue. These filings provide insurers with a number of options, including the use of contingent endorsements that, effective upon the date of TRIA's expiration, would pare back terrorism insurance to the minimum coverage required by state insurance regulators. Most states have approved the use of new ISO endorsements for property insurance policies that would, upon TRIA's expiration, exclude coverage of any nuclear, biological and chemical terrorism and any act of terrorism resulting in insured losses exceeding $25 million in the aggregate. These states have also approved new contingent endorsements for liability policies that provide for the same exclusions as appear in the property insurance endorsements along with an additional exclusion for the coverage of any acts of terrorism resulting in death or serious injury to 50 or more people.

There are a number of factors that limit the protections afforded to insurers by these ISO filings. First, certain states, most notably Florida and New York, have not approved the use of the conditional endorsements or any other terrorism exclusions. Second, the exclusions included in these endorsements do not apply to workers' compensation insurance, since, almost without exception, all states require workers' compensation insurers to cover statutory benefits without exclusions or limitations related to the cause of an occupational injury or illness. Third, over 20 states, including California, Illinois and New York, require all property insurance policies to cover losses from fire regardless of the cause of the fire. For these reasons, insurers are not free to use ISO's conditional endorsements to reduce their post-TRIA exposure to terrorism losses in all states or for all coverages.

## LEGISLATIVE EFFORTS IN 2004

Last year, insurance trade groups began an intensive lobbying effort to persuade Congress to extend TRIA for at least another two years. During 2004, three separate bills for TRIA extension were introduced into Congress. Although these bills share many similarities, they also differ in some important respects. Each bill would have extended TRIA's "make available" requirements through December 31, 2007 and would have added group life insurance to the lines of insurance covered by TRIA. The Democrats' bill (House Bill 4634) provided for a potential "hard landing" similar to the current situation by cutting off the federal reinsurance backstop at the end of 2007. However, both the Republicans' bill (House Bill 4772) and a Senate bill introduced with bipartisan support (Senate Bill 2764) provided for a "soft landing" by making the federal backstop available for any terrorism losses in 2008 that are covered under policies issued on or before December 31, 2007. House Bill 4772 and Senate Bill 2674 would have maintained the deductible for such reinsurance protection at its current level of 15 percent of an insurer's aggregate premium from commercial property and casualty policies. House Bill 4634 would have maintained the 15 percent deductible for 2006 and increased it to 20 percent in 2007.

Proponents of TRIA extension were encouraged last Fall when House Bill 4634 picked up support from Representative Michael Oxley and was approved by the House Financial Services Committee. However, none of the bills to extend TRIA was brought to a vote in Congress last year. At the date of this Client Alert, no new legislation for the extension of TRIA has been introduced in Congress.

## CURRENT DEVELOPMENTS IN CONGRESS

The most significant development in the debate over TRIA extension to occur thus far in 2005 was the release of an analysis of TRIA by the Congressional Budget Office ("CBO"). Although this report does not recommend a course of action for Congress, its analysis is decidedly negative toward continuation of the TRIA program. The CBO notes that TRIA was designed as a temporary support for the insurance industry in order to prevent a shortage of terrorism coverage in the wake of the attacks of September 11, 2001. It argues that at present the insurance industry has a greater capacity to bear terrorism losses and thus less need for TRIA's reinsurance backstop. It also argues that the U.S. economy may actually benefit from the expiration of TRIA, since without relatively cheap, government-subsidized terrorism insurance, U.S. firms may take needed safety measures to protect themselves against terrorism (e.g., adding disaster-recovery information systems and retrofitting buildings vulnerable to attack) and thus reduce the costs of future terrorist attacks. These arguments in favor of the operation of market forces without government subsidies are likely to have a lot of appeal for a Republican-controlled Congress.

The Senate Banking Committee is expected to consider TRIA at a hearing in early March. One focus of such a hearing is likely to be the CBO's analysis of TRIA. Both witnesses from the CBO and critics of the report are expected to testify.

Treasury has been conducting a comprehensive survey of insurers and policyholders in order to collect data for its own assessment of the effectiveness of TRIA. Its report on TRIA is not due until the end of next June. Since Treasury is the agency charged with responsibility for administering TRIA, Congress is likely to give this report considerable weight and is unlikely to take any action on TRIA extension until after it has had the opportunity to review the report.

At this point, it is difficult to predict whether Congress will allow TRIA to expire at the end of the year. In the absence of any recent terrorist attacks within the United States, the atmosphere of crisis in which the original legislation passed has largely vanished. Without such an immediate crisis, Congress may hesitate to "bail out" an industry whose reputation has been tarnished as a result of the Spitzer investigations. Nonetheless, despite the conclusion of the CBO report that TRIA's expiration may actually benefit the economy, there are legitimate concerns that a sharp increase in the cost of terrorism insurance and/or a contraction in the availability of such coverage in the wake of TRIA's expiration could have severe negative consequences for the economy and especially the construction industry. These concerns may be enough to tip the balance in favor of TRIA extension.

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## PROPOSED RULE REGARDING DETERMINATION OF "AFFILIATION"

As mentioned above, TRIA's statutory deductible is calculated in terms of an insurer's commercial property and casualty premiums for the preceding year. For these purposes, the term "insurer" includes an insurance company and its corporate affiliates so that deductible calculations are to be made on the basis of the premiums of the entire corporate group. In addition, pursuant to rules finalized in June, 2004, claims for federal reinsurance are to be processed and paid for an entire corporate group rather than on a company-by-company basis. Thus, determinations of corporate affiliation are important both for calculating deductibles and for claims-handling under TRIA. The basic rules for determining affiliation were finalized in July, 2003. (We discussed these rules in our Client Alert, dated July 29, 2003 available at http://www.lordbissell.com/newsstand_story.cfm?NSID=384.) On January 18, 2005, Treasury released a notice of proposed rulemaking

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to clarify the timing of these determinations.

Pursuant to this proposed rule, affiliation is to be determined on the basis of the insurer's circumstances as of the date of the first act of terrorism certified as such by the Treasury Secretary for a particular program year. This date would be used for all determinations of affiliation for the program year, regardless of whether the insurer suffered any losses in connection with such first certified act of terrorism and regardless of whether there are changes in the insurer's circumstances after that date. The proposed rule raises a number of problems. Changes in an insurance company's circumstances could lead to seemingly anomalous results under the proposed rule. For example, an insurance company that is sold or otherwise divested by a corporate group after the first certified act of terrorism in a program year would have its deductible for any insured terrorism losses it suffers later in the same program year calculated as if it were still a part of the original corporate group, even though it has no connection with that group at the time of its losses. Such an "early" determination of affiliation could substantially increase or decrease the deductible applicable to the insured losses and thus reduce or increase any recovery of federal reinsurance.

This hypothetical case may suggest that affiliation should be determined as of the date of each certified act of terrorism in order to reflect the circumstances of the insurance company at that date. However, such an approach is not easily reconciled with statutory wording of TRIA which on its face contemplates the calculation of a single deductible per "insurer" per calendar year. TRIA §§ 102(7), 103(e)(1). Determination of affiliation as of each certified act of terrorism could result in different deductibles for the same insurer during a single program year, since the insurer may suffer insured terrorism losses on a number of dates within the year and may undergo changes in its corporate affiliations in the intervals between such losses. In its commentary on the proposed rule, Treasury finds such a result "unacceptable" on the grounds that the TRIA deductible is a single program-year deductible and not a per-event deductible.

Treasury recognizes that its proposed rule is not perfect and defends it as a "reasonable compromise approach." It points out that the proposed rule has the advantage of being relatively easy to understand and administer. Also, although not mentioned by Treasury in its commentary, determination of affiliation as of the first certified act of terrorism in a program year rather than, for instance, the last certified act within the year, has the advantage of leaving open the possibility of prompt processing and payment of reinsurance claims in the event that an insurer's terrorism losses threaten its solvency or its ability to continue writing new business.

One issue the proposed rule does not address is potential conflicts among former affiliates over both the control of claims filings for, and the eventual allocation of, any reinsurance recoveries to be paid by the U.S. government. Pursuant to the final rules regarding claims procedures, a corporate group treated as a single insurer for purposes of TRIA must designate one company within the group for providing the required loss information, receiving any reinsurance payments, and allocating those payments among the various members of the group. These rules provide very little guidance as to how such allocations are to be made, stating only that each member must be compensated for its share of the covered losses, taking into account a reasonable and fair allocation of the group's deductible. Disputes over the handling of claims and the allocation of reinsurance recoveries are much more likely to occur if some of the interested parties are no longer members of the same affiliated group. In its commentary on the final rules regarding claims procedures, Treasury indicated that it will review allocations among members of a corporate group, if necessary, in order to determine whether they are reasonable and fair given the totality of the circumstances. However, the rules do not specifically provide insurers with a right to such a review or specify how it would be conducted.

Written comments on the proposed rule regarding the timing of affiliation determinations are due February 17, 2005.

***ABOUT THE AUTHORS***

John Gurley is a partner with extensive experience in all areas of corporate insurance, including regulatory issues. Michael Trier is a partner with broad experience in the insurance industry, who has advised clients and spoken on TRIA before various industry groups.

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