

The Terrorism Risk Insurance Act of 2002 Summary Based on November 11, 2002 Draft

There has been a concerted effort on many fronts to encourage the Congressional Conference Committee to adopt the *Terrorism Risk Insurance Act of 2002*. Those efforts offer renewed hope that the conference committee will adopt, and the President will sign, the bill shortly. At the time this was drafted, the bill was passed by the House of Representatives on Thursday, November 14, 2002 and is pending action in the Senate. This document provides a summary of the proposal in an effort to keep insurers informed about progress on the Act and to help them prepare to meet the very tight timeframes for insurer action that are outlined in the Act. Insurers need to take certain steps now to prepare for implementations of certain provisions of the bill. The specific steps will be identified later in this document.

Overview of the Bill

The bill provides a federal backstop for certain acts of terrorism through a temporary federal program where the federal government would share the risk of loss from future terrorist attacks with the insurance industry. The bill spells out the deductible and coinsurance features under which insurers will share losses with the federal government. The Act provides for the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General, to certify that a particular action is an act of terrorism that might result payments under the federal Terrorism Insurance Program, provided other applicable conditions are met. The bill defines what constitutes an act of terrorism and, during the first two years, requires that all commercial lines insurers offer insurance coverage for acts of terrorism. The Secretary of the Treasury has discretionary authority to extend this requirement to the third year of the program. Participating insurers must disclose to existing policyholders, new business and renewal business the premiums that they charge for coverage for acts of terrorism and inform them of the existence of a federal backstop. The Act provides for general nullification of in-force contractual provisions excluding coverage for acts of terrorism that were in force on the date the act is signed into law. The Act also provides for preemption of state policy language approvals related to current exclusions for acts of terrorism. Once an insurer makes an offer to provide coverage and quotes a price for that coverage, a business can decide to either accept the offer and pay the applicable premium for the terrorism coverage or allow the insurer to exclude coverage for acts of terrorism.

Section-by-Section Analysis

TITLE I—TERRORISM INSURANCE PROGRAM

Section 1

This section provides that the Act may be cited as the *Terrorism Risk Insurance Act of 2002*.

Section 101

This section details Congressional Findings and states the purpose of the Act. It recognizes the important role that insurers play in the national economy and the importance to American businesses of having reasonable and predictable insurance prices. It observes that the tragic events of September 11th have

affected the economy and insurers appetite for risk, particularly with regard to acts of terrorism. It concludes that the United States Government should provide temporary financial assistance to stabilize the national economy. The purpose of the Act is to create a temporary federal program where the federal government would share the risk of loss from future terrorist attacks with the insurance industry. The program would address market disruptions, ensure the widespread availability and affordability of property and casualty insurance for acts of terrorism and allow for a transition period for the private insurance markets to stabilize and build capacity.

Section 102

Section 102 provides definitions of act of terrorism, affiliate, control, direct earned premium, insured loss, insurer, insurer deductible, NAIC, person, program, program years, property and casualty insurance, secretary, state, and United States. It also contains a rule of construction for dates. The details regarding various defined terms will be included later in this document as they are needed to explain what is provided by the Act.

Section 103

This section provides many of the program details. It establishes a program in the Department of Treasury and grants administrative authority to the Secretary of the Treasury. It provides details about the conditions under which federal payment may be sought and made. It generally requires that to receive compensation, a person must have suffered an insured loss, the insurer must have provided a conspicuous disclosure to the policyholder of the premium charges for coverage and the existence of a federal program to provide financial assistance to insurers, and the insurer must have processed the claim consistent with its usual business practices and any reasonable procedures established by the Secretary of the Treasury. It discusses the documentation that insurers must provide to make a claim for compensation under the loss sharing provisions of the Act. It discusses the mandatory nature of participation in the program. It authorizes state residual market pools and workers' compensation funds to participate in the program. The section sets out the details of the federal shared loss compensation, prohibits duplicative compensation and establishes an annual \$100 billion cap on insured losses. It provides for policyholder surcharges to recoup federal funds expended for the program, up to 3% of premium. It allows the Secretary of the Treasury to, after consultation with the NAIC, include captive insurers and self-insurers if appropriate considerations can be worked out. It allows the purchase of reinsurance, however, it prohibits an insurer from unjust enrichment by combining reinsurance recoverables and the payments under the program in amounts in excess of insured losses. It requires a study of the impact of terrorism on group life insurance and a study and report on the federal program.

Section 104

Section 104 gives the Secretary of the Treasury the necessary authority to administer the program and to investigate and audit claims by insurers for compensation under the program. The Secretary is authorized to issue rules related to insurer filing and certification of claims, the manner in which the federal portion of the loss sharing arrangement will be undertaken and the steps that will be taken to reconcile ultimate incurred losses. The section provides for consultation with the NAIC and allows the Secretary to employ persons or contract for services necessary to implement the program. It provides for civil penalties for various failures to comply with the Act. The section requires the Secretary to compile information on the rates insurers charge for terrorism risk insurance. The section provides funding for loss payments and administrative expenses.

Section 105

This is an important section for insurers as it provides nullification of any provision in an existing insurance contract that excludes coverage for losses resulting from acts of terrorism. Further it preempts state approvals of policy language that authorizes an insurer to sell a policy containing an exclusion of coverage for acts of terrorism. It also provides for reinstatement of terrorism exclusions under certain conditions. It allows reinstatement of exclusions if the insurer has received a written statement from the insured that affirmatively authorizes the reinstatement of the exclusion or if the insured fails to pay the increased premium charged by the insurer for providing terrorism coverage, following proper notice. The notice must give the insured 30 days to consider the offer and price and explain the rights of the insured with respect to coverage, including the date that the exclusion will be reinstated if no payment is received.

Section 106

Section 106 discusses the effect that the Act will have on state laws. It provides that the Act shall not affect any jurisdiction or regulatory authority over insurers except as specifically provided for in the Act or for three specified areas. The first is that the definition of “acts of terrorism” contained in Section 102 shall be the exclusive definition of that term for purposes of compensation under the Act. The second provision provides a limited preemption of state rate and policy form filing requirements. It preempts the prior approval provisions and the waiting periods allowed in some file and use laws, however, it allows states to perform subsequent review of rates, disclosure forms and contract language and apply statutory rating and contract language standards. Finally, the section allows the Secretary of the Treasury to have access to the books and records of insurers to the extent that they are needed to administer the program. The section also clarifies that existing reinsurance agreements are unaffected by the provisions of the Act.

Section 107

Section 107 provides for litigation management of insured losses under the program. It establishes an exclusive federal cause of action for claims resulting from an act of terrorism. In the process, it preempts state causes of action for claims resulting from an act of terrorism; however, it preserves the state law as the substantive law that will be applied to a particular case. The section authorizes the Judicial Panel on Multidistrict Litigation to designate one or more U.S. District Courts as having original and exclusive jurisdiction over a claim. While it does not prohibit the court from awarding punitive damages to an aggrieved party, it prohibits the compensation for punitive damages from the federal program funds. It does not limit the liability of any government, organization or person who knowingly participates in, conspires or commits an act of terrorism. The section provides that the United States will have subrogation rights with respect to any payment or claim paid under the Act. The section limits the application of the section to the effective period of the program.

Section 108

Section 108 provides that the program will terminate on December 31, 2005. It provides the Secretary of the Treasury with authority to continue to collect or distribute funds after the program sunset to balance the books. It requires a report to Congress to assess the effectiveness of the program and evaluate the insurance industry’s capacity to offer insurance coverage for acts of terrorism after the program has expired.

TITLE II—TREATMENT OF TERRORIT ASSETS

Section 201

Section 201 is designed to address the enforcement of judgments granted to victims of acts of terrorism by enabling them to attach the blocked assets of terrorists. It contains a special rule related to Iran. There is a formula that provides for proportional payments when multiple claimants seek access to the same set of assets. The section contains a more liberal definition of acts of terrorism than the insurance program definition.

TITLE III—FEDERAL RESERVE BOARD PROVISIONS

Section 301

Section 301 addresses certain changes to Section 11 of the Federal Reserve Act that do not relate directly to insurance.

Key Provisions of the Bill for Insurers and Insurance Regulators

Definition of Insured Loss

Section 102(5) provides a definition of *insured loss*. It states, “the term “insured loss” means any loss resulting from an act of terrorism (including an act of war, in the case of workers’ compensation) that is covered by primary or excess property and casualty insurance issued by an insurer if such loss—(A) occurs within the United States; or (B) occurs to an air carrier (as defined in section 40102 of title 49, United States Code), to a United States flag vessel (or a vessel based principally in the United States, on which United States income tax is paid and whose insurance coverage is subject to regulation in the United States), regardless of where the loss occurs, or at the premises of any United States mission.”

Definition of Act of Terrorism

Section 102(1) defines an *act of terrorism* for purposes of the Act. Section 102(1)(A) states, “The term “act of terrorism” means any act that is certified by the Secretary, in concurrence with the secretary of State, and the Attorney General of the United States—(i) to be an act of terrorism; (ii) to be a violent act or an act that is dangerous to—(I) human life; (II) property; or (III) infrastructure; (iii) to have resulted in damage within the United States, or outside the United States in the case of—(I) an air carrier or vessel described in paragraph (5)(B); or (II) the premises of a United States mission; and (iv) to have been committed by an individual or individuals acting on behalf of any foreign person pr foreign interest, as part of an effort to coerce the civilian populations of the United States or to influence the policy or affect the conduct of the United States Government by coercion.” Section 102(1)(B) states, “No act shall be certified by the Secretary as an act of terrorism if—(i) the act is committed as part of the course of a war declared by the Congress, except that this clause shall not apply with respect to any coverage for workers’ compensation; or (ii) property and casualty insurance losses resulting from the act, in the aggregate, do not exceed \$5,000,000.” Section 102(1)(C) and (D) specify that the determinations are final and not subject to judicial review and that the Secretary of the Treasury cannot delegate the determination to anyone.

Definition of Insurer

Section 102(6) defines the entities considered “insurers” for purposes of the Act. Included are all insurers that are licensed or admitted in any state; eligible surplus lines insurers listed on the NAIC Quarterly Listing of Alien Insurers; insurers approved for the purpose of offering property and casualty insurance by a federal agency in connection with maritime, energy or aviation activity; state residual market mechanisms and state workers’ compensation funds; and other entities authorized by the Secretary of the Treasury. Municipalities or other entities participating in self-insurance arrangements, such as self-insurance pools or risk-retention groups, may participate in the program if the Secretary makes the determination to allow such participation prior to any act of terrorism in which the entity suffers insured losses.

Covered Lines of Business

The program is designed to provide for commercial lines of property and casualty insurance, including excess insurance, workers’ compensation insurance and surety. Section 102(12) itemizes the commercial lines of business that are covered and lists several lines that are not included in the program. Excluded from participation are: crop and livestock insurance products that are issued or reinsured under the Federal Crop Insurance Act and those that are privately issued or reinsured; private mortgage insurance; financial guaranty insurance; medical malpractice; life or health insurance regardless of whether they are issued on a individual or group basis; federal flood insurance; and reinsurance, including retrocessional reinsurance.

Insurer Obligations Regarding Rates and Policy Forms

Section 106(a)(2)(B) states that “during the period beginning on the date of enactment of this Act and ending on December 31, 2003, rates and forms for terrorism risk insurance coverage covered by this title and filed with any State shall not be subject to prior approval or a waiting period under any law of a State that would otherwise be applicable...” The subsection further notes that rates remain subject to subsequent regulatory review based on the applicable rating standards in the State. Similarly, policy forms are subject to subsequent review based on all applicable laws and regulations not specifically preempted by the Act. Thus, a use and file system is created where insurers can immediately implement rate changes for coverage of *insured losses* related to *acts of terrorism* as defined in the Act. Policy language granting coverage or excluding coverage for *insured losses* is only exempt from prior approval or waiting periods to the extent that the policy language relates to *insured losses* as defined in the Act. Other policy language changes remain subject to current applicable state law.

Insurer Obligations Regarding Disclosures

In-force business receives special consideration under the Act. Section 105 (a) voids any terrorism exclusion on existing policies to the extent that it excludes losses that would otherwise be *insured losses* as defined in the Act. It details a process for insurers to provide written notice to existing policyholders notifying them that they have benefited from a voidance of existing contract language related to exclusions of losses that would otherwise be *insured losses*. Insurers must give policyholders at least 30 days before exclusions can be reinstated. The notices must disclose the price for providing terrorism coverage and include the date that any terrorism exclusion would be reinstated if the policyholder fails to pay the required premium. An insurer can only reinstate an exclusion if one of two conditions is met. First a policyholder can provide the insurer with written authorization that affirmatively authorizes the reinstatement. Alternatively, the insurer can provide notice of the price that it intends to charge for

providing coverage for *insured losses* and the policyholder can decline to pay for the coverage. These disclosures must also comply with standards set forth in Section 103(b)(2).

There are also disclosures required for new business and renewals business. Although avoidance of contract language is not an issue, insurers must make certain disclosures to policyholders to remain in compliance with the Act. Section 103(b)(2) requires insurers to provide a clear and conspicuous disclosure to the policyholder of the premium charged for covered *insured losses* and advise that a federal program exists where the federal government will share significant portions of major *insured losses* with insurers.

Federal Cost Sharing Program

Each participating insurance company is responsible for paying out a specific amount in claims for *insured losses*—an insurer deductible—before federal assistance becomes available. This deductible is based on a percentage of direct earned premiums from the previous calendar year that varies in each year of the program. It starts at 7% during the first year, changes to 10% in the second year and rises to 15% in the final year. The cost sharing formula provides that for *insured losses* above an insurer's deductible, the federal government will cover 90%, while the insurer is responsible for the remaining 10%. *Insured losses* covered by the program are capped at \$100 billion—above this amount, Congress is to determine the procedures for and the source of any further payments. Insurers are not liable to provide policyholders with coverage for any portion of amounts that exceed the \$100 billion, provided the insurer has met its obligations under its deductible amount and coinsurance provisions.

If the federal government reimburses insurers for *insured losses* during the course of a year, the Secretary of the Treasury is required to recoup the difference between total industry costs (individual insurers' losses up to their deductibles, plus the industry's 10% cost share above the deductibles) and the following fixed dollar amounts per year: \$10 billion for the first year, plus the last few months of 2002; \$12.5 billion for the second year; and \$15 billion for the final year. The recoupment is accomplished through a surcharge on all policyholders that is collected by insurers and remitted to the Treasury. The Secretary of the Treasury has discretion on the timing of the surcharge, but the surcharge cannot be more than 3% of the premium paid for a policy in a given year. The Secretary has discretion to recoup additional amounts beyond the mandatory recoupment. The Secretary of the Treasury may assess civil penalties on participating insurance companies for submission of false or misleading information or failure to repay the Treasury for any amount required to be repaid.

Reports Prepared by the Treasury Department

On an expedited basis, the Secretary of the Treasury must report to Congress on the availability of group life insurance in accordance with Section 103(h). Based on the results of this report, the Secretary of the Treasury has discretionary authority to allow group life insurers to participate in the program. Another study of life insurance and personal lines coverages is required within nine months of enactment.

The Secretary of the Treasury will also prepare a significant study that analyzes the many facets of the affected insurance markets. This study will be completed in the middle of 2005 and will help guide future Congresses and Administrations as to the state of these markets and the capacity of participating insurers to handle the risk of loss from future acts of terrorism.