P & P CAPTIVE NEWSLETTER

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SPECIAL EDITION

We are publishing this Special Edition of our Captive Newsletter to provide information to our captive clients about the recently enacted federal Terrorism Risk Insurance Act of 2002. The specific provisions of the Act – including the shared compensation mechanism, mandatory recoupment, and whether the Act applies to captive insurers – have been the subject of vigorous discussion over the past couple of weeks. We hope our discussion clarifies some of these issues.

We believe that Vermont captives, including risk retention groups, are not mandatory participants. The best outcome would afford each captive the opportunity to opt-in on an individual basis, and we are working with the VCIA to accomplish that result. We have not included a copy of the Act, but you may find the full text on the U.S. Department of Treasury website, www.ustreas.gov.

Please follow-up with us on any continuing questions or concerns you may have as you consider whether to seek participation in the program.

TERRORISM RISK INSURANCE ACT OF 2002

Overview

The Terrorism Risk Insurance Act of 2002 (the “Act”) was signed into law by President Bush on November 26, 2002, and became effective immediately. The Act requires commercial property and casualty insurers to offer terrorism coverage to their policyholders at deductibles and limits that do not differ materially from the coverage provided for other perils. The Act creates a temporary Federal program, the Terrorism Insurance Program (the “Program”), that establishes a shared compensation mechanism to allocate covered commercial property and casualty losses between the insurance industry and the Federal

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Government. The Terrorism Insurance Program requires commercial property and casualty insurers to offer terrorism coverage commencing on the date of enactment through December 31, 2004; thereafter, the Secretary must determine whether to extend the requirements of the Program through December 31, 2005.

This article outlines the requirements of the Act for all participants and also analyzes whether Vermont-domiciled captives are subject to its provisions.

Purpose of Act

The stated purpose of the Act is to establish a temporary Federal program that provides for a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism. The Act is intended to ensure the availability and affordability of terrorism coverage in the wake of commercial market disruptions following the terrorist acts of September 11, 2001. Congress also seeks to create a transition period during which the private markets could stabilize, resume pricing of terrorism coverage and build capacity for future losses.

Mandatory Participants

The following entities, including any affiliate thereof, that receive direct earned premiums for any type of commercial property and casualty insurance coverage must participate in the Program:

(1) entities licensed or admitted to engage in the business of providing primary or excess insurance in any State;

(2) eligible surplus line carriers listed on the Quarterly Listing of Alien Insurers of the NAIC;

(3) entities approved for the purpose of offering property and casualty insurance by a Federal agency in connection with maritime, energy, or aviation activity;

(4) State residual market insurance entities or State workers' compensation fund; or

(5) any other entity described in Section 103(f), to the extent provided in the rules of the Secretary.

H.R. 3210 §102(6) and 103(a)(3).

Property and casualty insurance includes most commercial lines of property and casualty insurance, including excess insurance, workers' compensation insurance and surety insurance. H.R. 3210 §102(12)(A). Excluded from the definition are federal crop insurance issued or reinsured under the Federal Crop Insurance Act or any other type of crop or livestock insurance that is privately issued or reinsured; private mortgage or title insurance; financial guaranty insurance issued by monoline financial guaranty insurance corporations; insurance for medical malpractice; health or life insurance, including group life insurance; flood insurance provided under the National Flood Insurance Act of 1968; and reinsurance or retrocessional insurance. H.R. 3210 §102(12)(B).

Status of Captive Insurers and Risk Retention Groups

The definition of insurers contained in subparagraph (1) above arguably includes

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captive insurers and risk retention groups, because they are licensed to provide primary or excess insurance in at least one state. However, the broad definition expressly excludes entities described in Section 103(f) unless included in the rules or regulations to be promulgated by the Secretary. Subsection (f) of Section 103 of the Act states, in part, that "the Secretary may . . . apply the provisions of this title, as appropriate, to other classes or types of captive insurers . . ." Inclusion of subsection (f) would therefore appear to remove captives from the category of mandatory participants.[1]

The Act does not define "captive insurer". Any application of the Program to captive insurers and other self-insurance arrangements must be determined before the occurrence of an act of terrorism to be valid and must apply the provisions of the Act comparably to such entities. H.R. 3210 §103(f). The Treasury Department stated that it will release guidelines or regulations in the near future stating how Treasury intends to apply the provisions of the Program to captive insurers and other self-insurance arrangements. It is important to note that any captive insurer solely writing lines of insurance excluded under §102(12)(B) is excluded from the Program under any scenario. The same is true for reinsurance captives, although their fronting companies will be mandatory participants. Consequently, many reinsurance captives will be indirectly affected.

Our interpretation that captives are removed from the mandatory participation category applies as well to Vermont-domiciled risk retention groups. Some states regulate risk retention groups as traditional insurance companies, others treat them as captive insurers. Because of the Act's definition of "insurer", risk retention groups domiciled in certain states would not be "captives" and would, therefore, be mandatory participants under the Act. However, in other jurisdictions, including Vermont, risk retention groups are captive insurance companies for all purposes of the Act. Therefore, risk retention groups would not be mandatory participants. This approach is supported by Section 106 of the Terrorism Risk Insurance Act, Vermont statute and the legislative history underlying the Liability Risk Retention Act of 1986 ("LRRA"). Section 106 of the Act expressly defers to the regulatory authority of state insurance commissioners except in three specific areas, and does not address the issue of whether risk retention groups are captives. Vermont law defines a risk retention group as a form of captive. 8 V.S.A. §6052(a). The approach taken by Vermont, of regulating risk retention groups as captive insurers, was expressly endorsed by the

[1] The word "other" in Section 103(f) raises a possible ambiguity over mandatory participation of domestic captive insurers in the Program. The inclusion of the word "other" appears to have been a drafting error. In Conference Report 107-779, the Joint Explanatory Statement of the Committee of Conference omitted the word "other" in explaining that Section 103(f) gives the Secretary the discretion to apply the Act to "various" classes of captives. While this possible ambiguity exists, the intent of Congress was to exempt domestic captive insurers from mandatory participation, as discussed below. Therefore, the better interpretation of the Act is that domestic captive insurers are not mandatory participants in the Program and may choose to opt-in once such mechanism is established by rule or regulation by the Secretary.

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House Energy and Commerce Committee while considering the LRRA. H.R. Rep. No. 97-190 97th Cong., 1st Sess., p.4, reprinted in 1981 U.S. Code Cong. & Admin. News 1442, 1434. Therefore, where risk retention groups are treated as captive insurers by state insurance regulators, such risk retention groups should not be mandatory participants under the Program.

Although it is not clear how Treasury will apply the Act to captive insurance companies, the only meaningful approach is to seek a flexible opt-in mechanism that will permit each captive insurance company, including risk retention groups, to make an individual decision whether to participate in the Program. We believe that this is the most effective way to allow captive insurers to realize the advantages of the Program where individual risks and premium make participation a cost-effective choice. In introducing the language of Section 103(f) into the Act, Vermont Senators Leahy and Jeffords intended to exclude captives from the mandatory participant category and allow the Secretary to provide for a viable opt-in mechanism, as appropriate, in consultation with the NAIC and State insurance commissioners.

The Vermont Captive Insurance Association ("VCIA") has retained a Washington D.C. law firm to advance the foregoing interpretation of the Act before the Treasury Department. Assuming that the regulatory process results in a viable opt-in mechanism for captive insurers, those captive insurance companies and risk retention groups that wish to participate in the Program should carefully consider the section below regarding mandatory disclosures. Finally, we encourage all risk retention groups to carefully evaluate all of the Act's requirements, particularly the disclosure requirements discussed below, in the event that the Secretary determines that all risk retention groups are mandatory participants.

What Does the Act Require Participating Insurers to Do?

Make Available Terrorism Coverage to P&C Policyholders

The Act voids any terrorism exclusion in force on the date of enactment and preempts any State approval of any terrorism exclusion from a contract for property and casualty insurance that is in force on the date of enactment. H.R. 3210 §105(b). An insurer covered under the Act must "make available", in all of its property and casualty insurance policies, coverage for insured losses. H.R. 3210 §103(c)(1)(A). The Treasury Department has interpreted this requirement to mean that an insurer must make a formal offer of coverage to a policyholder for acts of terrorism (as defined in the Act) at deductibles and limits that do not differ materially from the coverage provided for other perils, except for price. See Interim Guidance II(B). Insurers must offer this coverage commencing November 26, 2002 through December 31, 2004. H.R. 3210 §103(c)(1). Prior to September 1, 2004, the Secretary of the Treasury must determine whether the Program will be extended through December 31, 2005. H.R. 3210 §103(c)(2).

Disclosure of Premium and Federal Share

As a condition for receiving Federal payments under the Program and to avoid

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possible civil penalties, insurers must make clear and conspicuous (not yet defined) disclosures to policyholders of the premium charged for insured losses covered by the Program and the Federal share of compensation for insured losses under the Program. H.R. 3210 §103(b)(2). For existing (in-force) policies issued before November 26, 2002, insurers must make the required disclosures no later than February 24, 2003. H.R. 3210 §103(b)(2)(A). For policies issued between November 26, 2002 and February 24, 2003, disclosure must be made at the time of offer, purchase and renewal of the policy. H.R. 3210 §103(b)(2)(B). Finally, for policies issued after February 24, 2003, disclosure is required in the form of a separate line item in the policy at the time of offer, purchase and renewal of the policy. H.R. 3210 §103(b)(2)(C). The Treasury Department stated in its Interim Guidelines that insurers using either of two NAIC Model Disclosure Forms which may be modified as appropriate for the particular policy, will be in compliance with the disclosure requirements under the Act for policies issued within 90 days of enactment. The Treasury Department also stated that use of the NAIC Model Forms are not the exclusive means of compliance with the disclosure requirements of the Act. These forms are available on the NAIC's website, www.naic.org.

As indicated above, Section 103(b)(2) requires disclosure of, in part, the "premium charged for insured losses covered by the Program . . ." This language raises the question of whether disclosure is required if there is no change in the premium charged for covered losses under the Program. The Interim Guidelines state that insurers with in-force policies on the date of enactment must comply with the disclosure requirements of Section 103(b)(2)(A) even if there are no changes in the premium charged for covered losses. Insurers using NAIC Model Form 2 in this instance will be in compliance with the requirements of Section 103(b)(2)(A).

Disclosures Required for Reinstatement of Terrorism Exclusions

An insurer is entitled to reinstate a preexisting exclusion for an act of terrorism in a contract for property and casualty insurance that is in force on the date of enactment only if: 1) the insurer receives a written statement from the insured that affirmatively authorizes such reinstatement or 2) if (a) the insured fails to pay any increased premium charged by the insurer for the terrorism coverage and, (b) the insurer provided notice at least 30 days before any reinstatement of (i) the increased premium and, (ii) the rights of the insured with respect to such coverage, including the date upon which the exclusion would be reinstated if no payment is received. H.R. 3210 §105(c). The Treasury Department stated in its Interim Guidelines that it will deem disclosure by an insurer to an existing policyholder using NAIC Model Disclosure Form 1 to comply with the reinstatement disclosure provisions of the Act.

What Risks are Covered Under the Program?

The Program covers any "insured loss", which is a loss resulting from an "act of terrorism" that is covered by primary or excess property and casualty insurance issued by an insurer if the loss occurs within the United States, to an air carrier or

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United States flag vessel, or at the premises of any United States mission. H.R. 3210 §102(5). An "act of terrorism "must be certified as such by the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General. H.R. 3210 §102(1)(A). To qualify for certification as an act of terrorism, an act must be a violent act or an act that is dangerous to human life, property or infrastructure, resulting in damage in the United States, or outside of the United States if an air carrier or a United States flag vessel, or the premises of a United States mission. Furthermore, the act must 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. H.R. 3210 §102(1)(A). The Program excludes any act committed as part of the course of a war declared by Congress, except with respect to coverage for workers' compensation, or any act where property and casualty insurance losses resulting from the act do not exceed $5,000,000 in the aggregate. H.R. 3210 §102(1)(B). Finally, by implication the Act excludes acts of domestic terrorism.

Mechanics of Making a Claim for the Federal Share

The Program essentially reinsures covered losses. In order to qualify for the Federal share of compensation, several conditions must be satisfied. H.R. 3210 §103(b). First, a person who suffers an insured loss must file a claim with an insurer. Second, the insurer must have provided the disclosures required under Section 103(b)(2). Third, the insurer must process the claim for the insured loss in accordance with appropriate business practices (undefined) and reasonable procedures that the Secretary may prescribe. Fourth, the insurer must submit a claim for payment of the Federal share of compensation for insured losses under the Program to the Secretary of the Treasury. Fifth, the insurer must submit written certification to the Secretary of the underlying claim and all payments made for insured losses. Finally, the insurer must certify that it has complied with the provisions of subsection (b) of Section 103.

Loss Allocation between Insurers and the Federal Government

When a covered loss occurs, an insurer will pay an initial amount up to its "insurer deductible"; thereafter, the Federal Government will cover 90% of the remaining losses (the "Federal Share") up to a combined aggregate limit of $100 billion during each year of the Program. H.R. 3210 §103(e). The 10% balance of covered losses will be paid by insurers that incur covered losses, in addition to the insurer deductible, as a quota share in amounts determined by the Secretary. H.R. 3210 §103(e)(2)(B). The Act is unclear as to how such losses will be allocated among insurers with covered losses.

The initial "insurer deductible" shall be an amount equal to each participating insurer's prior year's direct earned premiums multiplied by a fixed percentage determined by the Program Year as follows:

1. Transition Period (11/26/02 - 12/31/02) = 1% of direct earned premium over the

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calendar year immediately preceding 11/26/02.

2. Program Year 1 (1/1/03 - 12/31/03) = 7% of direct earned premiums over the calendar year immediately preceding Program Year 1.

3. Program Year 2 (1/1/04 - 12/31/04) = 10% of direct earned premiums over the calendar year immediately preceding Program Year 2.

4. Program Year 3 (1/1/05 - 12/31/05) = 15% of direct earned premiums over the calendar year immediately preceding Program Year 3.

The Treasury Department has interpreted direct earned premium in its Initial Guidelines as meaning the direct premiums earned as reported to the NAIC in the Annual Statement in column 2 of the Exhibit of Premiums and Losses (commonly known as Statutory Page 14). Treasury will be releasing additional guidelines for entities covered under the Program that do not report to the NAIC.

Insurers may reinsure their insurer deductibles and their quota share exposures. H.R. 3210 §103(g). The Federal Share will not be reduced by any reinsurance of insurer deductibles or quota share; however, any amounts recovered under the Federal Share and reinsurance may not exceed the amount of the insurer's covered losses for such period. H.R. 3210 §103(g). Finally, no insurer that has met its insurer deductible shall be liable for the payment of covered losses in excess of the $100 billion cap. H.R. 3210 §103(e)(2)(A)(ii).

Recoupment of Federal Share

The Act mandates recoupment of the amount of Federal assistance provided for covered losses within the marketplace aggregate retention that exceeds total industry costs (aggregate insurer deductibles plus 10% quota share). H.R. 3210 §103(e)(7)(A). The insurance marketplace aggregate retention amount is determined as follows:

1. Program Year 1 - the lesser of $10 billion and the aggregate amount, for all insurers, of insured losses during such period;

2. Program Year 2 - the lesser of $12.5 billion and the aggregate amount, for all insurers, of insured losses during such period;

3. Program Year 3 - the lesser of $15 billion and the aggregate amount, for all insurers, of insured losses during such period.

H.R. 3210 §103(e)(6).

To illustrate the recoupment mechanism, assume that aggregate covered losses in Program Year 2 total $30 billion, and aggregate insurer deductibles total $5 billion. The Federal Share of covered losses would total $22.5 billion (90% of the aggregate covered losses less aggregate insurer deductibles) and the quota share allocable among insurers involved in the covered losses would total $2.5 billion. Thus, total industry costs would equal $7.5 billion. The aggregate market retention for Program Year 2 would be $12.5 billion (the lesser of $12.5 billion and $30 billion aggregate covered losses). The Secretary

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would be required to recoup $5 billion in this example ($12.5 billion insurance marketplace aggregate retention less $7.5 billion in industry costs).

In the event that recoupment is mandated, the Secretary must collect risk-spreading premiums equal to the mandatory recoupment amount for the period. H.R. 3210 §103(e)(7)(C). The risk-spreading premium would be collected by all participating insurers through policyholder surcharges on property and casualty policies in force after the Secretary's determination. H.R. 3210 §103(e)(8). The risk-spreading premium would be based on a percentage of the premium amount charged for property and casualty insurance coverage under the premium. H.R. 3210 §103(e)(8)(A)(iii). The surcharges may not exceed 3% of the premium charged for coverage under the policy on an annual basis. H.R. 3210 §103(e)(7)(C). The Secretary must take into account various considerations for urban and smaller commercial and rural areas and different lines of insurance in determining the method, manner and amount of risk-spreading premiums. H.R. 3210 §103(e)(8)(D).

Finally, if the amount of Federal financial assistance exceeds any mandatory recoupment amount, the Secretary may recoup, through additional risk-spreading premiums, such additional amounts the Secretary believes can be recouped based on a number of factors. H.R. 3210 §103(e)(7)(D).

Rulemaking

The Secretary is authorized to carry out the Program and prescribe regulations and procedures to implement the Program, and to ensure that all insurers and self-insured entities that participate in the Program are treated comparably under the Program. We hope that the Department of Treasury promulgates rules and regulations that provide a viable opt-in mechanism for captive insurers instead of determining participation by class. We also believe that the best method of determining participation of a risk retention group is on the basis of how the company's domicile regulates it: either as a captive insurer or a traditional insurer.

Conclusion

The Secretary of the Treasury will ultimately determine, by rules and regulations, whether captive insurers and risk retention groups are excluded from the Program and whether a viable opt-in mechanism will be established for such insurers. In the interim, the following list sets forth key considerations for all property and casualty insurers that either are or may become subject to the provisions of the Act:

- Disclosures: Insurers covered under the Program must make disclosure of the premium charged for losses covered by the Program and of the Federal Share in order to be eligible to participate in the Federal Share and to avoid possible civil penalties. For policies in force on November 26, 2002, the disclosure must be made within 90 days of November 26, 2002. For policies issued within 90 days of November 26, 2002, disclosure must be made at the time of offer, purchase and renewal. For policies issued more than 90 days after November 26, 2002, disclosure must be made as a separate line item in the policy at the time of offer, purchase and renewal. Disclosure

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is required even if there is no change in the premium charged for covered losses. As a practical matter, if it is not clear whether an insurer will be included in the mandatory participant category, it may be prudent to make the appropriate disclosures and explicitly state that, due to uncertainty under the Act, the disclosure is being made as a precaution.

• Make Coverage Available: Commencing on November 26, 2002, insurers covered by the Act must make formal offers of coverage to policyholders for acts of terrorism (as defined in the Act) at deductibles and limits that do not differ materially from the coverage provided for other perils, except for price.

• Conditions for Reinstatement of Terrorism Exclusions: Insurers may reinstate preexisting terrorism exclusions in force on November 26, 2002, only if: 1) the insurer obtains a written statement from the insured affirmatively authorizing reinstatement or, 2) the insured fails to pay any increased premium charged for terrorism coverage and the insurer provided notice at least 30 days before any reinstatement of (a) the increased premium and, (b) the rights of the insured with respect to such coverage, including the date upon which the exclusion would be reinstated if payment is not received.

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