

By Robert Ball

## **Background**

Recently foiled terrorist attacks targeting United States interests have rejuvenated concerns regarding the availability and viability of terrorism insurance both here and abroad. A key public policy issue for the past several years, the protection of U.S. citizens and interests from terrorism continues to be center-stage in the eyes of the government and the populace.

The Terrorism Insurance Act of 2002 (TRIA) was passed into law on November 22nd of that year to reinvigorate a terrorism insurance marketplace that had significantly receded in the wake of the unprecedented losses arising from the events of September 11, 2001. Intended as a temporary governmental stop-gap both to immediately stimulate commercial development stalled by the absence of terrorism insurance and to "buy time" for the private sector terrorism insurance market to re-emerge, TRIA had a built-in end-date of December 31, 2005.

As TRIA neared the end of its term, its success in its first objective was obvious; however, critics of the legislation argued that contrary to stimulating a robust re-emergence of the private market for U.S. domestic terrorism protection, the ability to depend on federal reinsurance removed any such impetus. The question of whether or not to renew the Act at the end of 2005 was framed by debate concerning the larger issue of the federal government's rightful role, if any, in mandating the offer of coverage from insurers and in providing reinsurance for catastrophic losses arising from that coverage.

Ultimately, Congress passed the Terrorism Risk Insurance Extension Act of 2005 (TRIEA) in December 2005, extending a modified version of the original Act through to year-end 2007. As described later in this document, most of the changes incorporated into TRIEA were aimed at further distancing the government from terrorism losses by means of increased retentions for insurers, more stringent criteria for the magnitude of losses covered, and the greater ability of the program to recoup losses after payment.

In the context of a private insurance market that is retracting in the face of potentially astronomical windstorm, flood, and earthquake damages in the event of a natural catastrophe, despite its revisions TRIEA was welcome legislation for insurers and insureds alike. In fact, some have noted that the TRIA/TRIEA model may be appropriate as a way to deal with the emerging capacity crisis concerning these other catastrophic risks whose potential magnitudes are approaching, if not beyond, the ability of the private sector market to reasonably insure alone.

Public debate on the role of the federal government in protecting commercial ventures from debilitating losses will likely continue in the time between now and the December 31, 2007 expiry of the TRIA extension. In the meantime, when the

end of TRIEA's term draws near, insureds will face concerns similar to those they faced as the original Act drew to a close regarding the post-TRIEA availability and cost of protection as well as the absence of run-off provisions for coverage expiring after 2007.

While some significant components of TRIA were amended in the extension of the Act, TRIEA retained many of the conditions and definitions that were defined the original program. Our overview of TRIEA therefore describes aspects of TRIA that were carried forward into the program extension as well as changes that were made in the Act.

### **TRIEA Definition of a Terrorist Act**

TRIEA deals exclusively with losses arising from acts of terrorism that are within the parameters of specifications defined in the Act. An act of terrorism must:

- result in more than \$5 million in loss within certain specified lines of insurance to all injured parties as a group ("aggregate industry loss")
- be perpetrated within the United States (with limited exceptions) but instigated by interests outside the United States
- meet certain other criteria
- be 'certified' as a TRIEA-covered act by the secretary of the treasury after consultation with the secretary of state and the attorney general. (Note that nothing in the law *requires* Treasury to certify an act of terror, even if it meets all other criteria.)

### **Liability Cause of Action: Treatment of Punitive Damages**

Consistent with its predecessor legislation, TRIEA extends the federal cause of action for property damage, personal injury, or death claims arising from or relating to certified acts of terrorism, which it makes the exclusive remedy (i.e., preempting state actions) for all such claims *other than* those against a person or entity knowingly participating in, conspiring to commit, aiding-and-abetting, or committing the act of terrorism. Although moving cases into the federal system probably reduces the likelihood of punitive damage awards, it is important to note that neither the federal system nor TRIEA prohibit punitive awards. Nonetheless, TRIEA's reinsurance program will not cover/reimburse punitives.

### **Program Trigger**

TRIEA continued the program defined in the original act that reinsures certain insurers for a portion of some of their TRIA losses. However, it introduced a "program trigger" feature further reducing the number of terrorism acts that can access the program. While acts of terror exceeding \$5 million in resulting aggregate industry loss can still be certified, under TRIEA the aggregate industry loss resulting from an act must be higher (must reach the new "program trigger" level) in order for the act to access the federal coverage (to be a "program trigger" act). Accordingly:

- it appears to be technically possible that an act could be certified, and so be subject to other aspects of TRIEA (i.e., Federal Cause of Action), but the resulting losses might not reach the level necessary to trigger reinsurance for the act, and
- once the aggregate loss exceeds the program trigger, *all* loss resulting from a certified act is credited to the insurer's program deductible and can access the reinsurance (i.e., *not* just the portion exceeding the program trigger).

The "program trigger" level for 2006 is \$50 million and will increase to \$100 million in 2007.

### **TRIEA Deductibles and Coinsurance and Program "Cap"**

The program's reinsurance is only available after the insurer absorbs an annual aggregate deductible in losses arising from program trigger acts. As in the original Act, the extension establishes each insurer's individual annual aggregate TRIEA deductible in any year as a stipulated percentage of its annual aggregate TRIEA "direct earned premium" in the preceding year. Also unchanged is the definition of "direct earned premium," which includes admitted and non-admitted premium from insurance covering losses occurring:

- in the United States\*
- anywhere, if at the premises of a U.S. mission
- anywhere, if to an air carrier (as defined in *Section 40102 of title 49 of the U.S. Code\*\**)
- anywhere, if to a U.S. flag vessel.
- anywhere, if to a vessel primarily based in the U.S. that pays U.S. income tax and whose insurance is subject to U.S. regulation

*\*TRIA defines "United States" to include U.S. territorial sea and the U.S. continental shelf, essentially extending to 200 miles from the various U.S. coasts.*

*\*\*in Section 40102 of title 49 of the U.S. Code, "Air Carrier" means a U.S. citizen, or an entity which is primarily a U.S. entity, either of which is undertaking by any means, directly or indirectly, to transport passengers or property as a common carrier for compensation between any of the following where any part of the transportation is by air:*

- *a State/Territory/Possession and the District of Columbia*
- *a State/Territory/Possession and another State/Territory/Possession*
- *one part of Hawaii and another, if through airspace over a place outside Hawaii*
- *one part of the District of Columbia and another*
- *one place in a Territory/Possession and another place in that same Territory/Possession*

Consistent with the original Act, the percentage of the "direct earned premium" that defines an insurer's annual aggregate deductible continues to increase each year. The TRIEA deductible for 2006 is 17.5% of the insurer's 2005 direct earned premiums and the 2007 retention will be 20% of the insurer's 2006 subject premium.

The insurer is also subject to a coinsurance responsibility as respects program trigger losses exceeding the deductible. This coinsurance remains (as defined in the initial Act) 10% for 2006, but will increase to 15% in 2007.

Finally, if \$100 billion in aggregate industry program trigger loss is incurred during a given year (*inclusive* of loss within all insurers' TRIA deductibles and quota shares, as well as losses reinsured by the program), the program will cease to reimburse further terrorism loss during that year. TRIEA also indicates that insurers that have satisfied their program deductible for that year will be able to cease paying further terrorism losses to their insureds once this \$100 billion program "cap" has been reached.

### **Types of Insurance Subject to TRIEA**

TRIEA applies to all "commercial property and casualty insurance" written for U.S. risks, with the exception of:

- Commercial Auto\*
- Surety\*
- Burglary-and-Theft\*
- Professional Liability insurance other than Directors and Officers (D&O)\*
- Farm Owners Multi-peril\*
- Federal Crop
- Private Mortgage
- Financial Guaranty, provided by a mono-line financial guaranty insurer
- Medical Malpractice
- Health or Life
- Flood, from the National Flood Program
- Reinsurance

*\* Newly excluded in TRIEA - not among coverage lines excluded from the original TRIA in 2002.*

### **Insurers (including captives) Subject to TRIEA**

TRIEA applies exclusively to any insurer that receives "direct earned premiums" on any type of "commercial property and casualty insurance" *and* is at least one of the following:

- licensed or admitted in any state\*/territory/possession
- an "eligible surplus lines carrier" on the National Association of Insurance Commissioners' (NAIC's) *Quarterly Listing of Alien Insurers*
- approved for the purpose of offering property and casualty insurance by a federal agency in connection with maritime, energy, or aviation activity
- a state residual market entity or workers compensation fund.

*\*TRIA's definition of "state" includes: the fifty states, the District of Columbia, Puerto Rico, Northern Marianas, American Samoa, Guam, U.S. Virgin Islands, any U.S. territory or possession.*

Treasury has explicitly stated that captive insurers licensed/admitted in any state/territory/possession and receiving “direct earned premiums” for any “commercial property and casualty insurance” are subject to TRIEA. Treasury has also commented in several Federal Register notices that it has authority to extend TRIEA to other captives and self-insurance arrangements (i.e., to “offshore” captives), but:

- Treasury has never as yet exercised this authority
- given the tenor of the debate surrounding TRIA’s recent extension, it would be highly controversial if Treasury were to expand its reach
- a knowledgeable Treasury official recently confirmed that such an extension is not under active consideration

**Other Significant Changes in TRIA Effective with TRIEA Extension**  
**Greater likelihood that Treasury will recoup its program payments (increased “Insurance Marketplace Aggregate Retention”)**

The “Insurance Marketplace Aggregate Retention” increases to \$25 billion for 2006 and to \$27.5 billion for 2007. Note that:

- this aggregate retention is only used to determine whether and to what extent Treasury will recoup its program payments
- it is an *annual* aggregate for *all* industry losses from *all* acts during a given year, not an insurer-by-insurer annual aggregate for all industry losses from each act
- Treasury’s mechanism for recouping program payments is by an industry surcharge (limited to 3%) on future premiums for lines of insurance affected by TRIEA

**Existing (2004) Treasury regulations stipulating prior approval of some settlements were incorporated into the law (new paragraph 7, “Litigation Management” section)**

Insurers must obtain prior approval from Treasury of settlements if the portion of the settlement attributable to personal injury (including death) exceeds \$2 million for a given claimant, or if the portion attributable to property damage (including loss of use) exceeds \$10 million for a given claimant. Treasury can, on a case-by-case basis, also require insurers to obtain its prior approval of settlements for lesser amounts. Part of the intent here is to address Treasury’s concern that certain settlements may be attributable to punitive damages, whether or not described as such, since the program does not reimburse punitive damages.

**Conclusion**

Like its predecessor legislation, TRIEA was written as a temporary solution to a very thorny problem. Whether a permanent solution can be devised before the end of 2007, when TRIEA is due to conclude its mandate, remains to be seen. While TRIEA has required the formation of specific panels, which are now at work, to aggressively explore alternative methods to deal with the issues surrounding terrorism insurance, the task they have undertaken is formidable. And if pundits are correct in their predictions that another major terrorist attack on the US is

inevitable, the ultimate test of TRIEA, or whatever other solution may be crafted, is still in the offing. The program's epilogue has yet to be written.

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