

## MEMORANDUM

**TO:** Clients and Friends of Morris, Manning & Martin  
**FROM:** Morris, Manning & Martin Terrorism Insurance Group  
**DATE:** April 22, 2003  
**SUBJECT:** Terrorism Risk Insurance Act—Second Interim Final Rule

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### I. INTRODUCTION

On April 18, 2003, the U.S. Department of the Treasury (Treasury) published a second interim final rule implementing the Terrorism Risk Insurance Act of 2002 (the Act).<sup>1</sup> The most recent interim final rule follows an earlier interim final rule published in February 2003<sup>2</sup> and four interim guidance documents issued by Treasury since the Act was signed into law.<sup>3</sup> The interim final rule is effective immediately. Since the rule is an “interim” regulation, Treasury is accepting public comment on its provisions and will consider these comments in developing a final rule. Comments on the interim final rule must be submitted to Treasury by May 19, 2003.

At the same time that the interim final rule was published, Treasury issued a proposed rule that would apply the Act's provisions to state residual market entities and workers' compensation funds. The proposed rule is discussed in a separate memorandum.

### II. SUMMARY

The Act requires insurers to make certain “clear and conspicuous” disclosures to policyholders as a condition to federal compensation for losses arising from a certified act of terrorism. In addition, the Act requires insurers to “make available” coverage for losses arising from a certified act of terrorism in all of their commercial property and casualty policies. The interim rule clarifies what insurers must do to satisfy these requirements. The interim final rule generally restates earlier guidance from Treasury but offers new guidance in a few areas. The discussion below indicates where Treasury has provided new guidance.

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<sup>1</sup> 68 Fed. Reg. 19301 (April 18, 2003).

<sup>2</sup> 68 Fed. Reg. 9804 (Feb. 28, 2003).

<sup>3</sup> 67 Fed. Reg. 76206 (Dec. 11, 2002) (Interim Guidance I); 67 Fed. Reg. 78864 (Dec. 26, 2002) (Interim Guidance II); 68 Fed. Reg. 4544 (Jan. 29, 2003) (Interim Guidance III); and 68 Fed. Reg. 15039 (March 25, 2003) (Interim Guidance IV).

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Among the highlights of the interim final rule:

- Consistent with earlier guidance, the interim final rule confirms that insurers may use any reasonable notice to comply with the Act's disclosure requirements, so long as the disclosures are "clear and conspicuous". Insurers may communicate the disclosures using normal business practices. The interim final rule provides that the model disclosure forms published by the NAIC constitute a safe harbor for compliance, but not the exclusive means of complying. The disclosures must satisfy the Act's "separate line item" requirement, which is clarified in the interim final rule.
- Treasury clarifies that in the event of a terrorism loss, an insurer is only required to certify that it has provided "clear and conspicuous" disclosure for policies that it submits for federal compensation. An insurer's failure to certify disclosure for other policies will not affect its ability to obtain federal compensation for the policies it certifies.
- Treasury clarifies that the Act's "make available" requirement is not a one-time requirement. For example, if a policyholder declines terrorism coverage when it is first offered, the insurer must offer terrorism coverage again when the policy is renewed if renewal occurs while the Act's "make available" requirement is still in effect.
- Treasury notes in the preamble that it has audit and investigative authority under the Act and states that insurers should be prepared to demonstrate compliance with the Act's "make available" requirement. The interim final rule establishes no new record keeping requirements. Instead, Treasury expects that the retention of standard policy documents and adherence to normal risk management systems—for example, company policies and the use of internal audits and controls—should be sufficient to demonstrate compliance.
- Consistent with earlier guidance, the interim final rule provides that insurers may demonstrate compliance with the Act's disclosure requirements through "use of appropriate systems and normal business practices" that demonstrate compliance—for example, proof of mailing process.
- The interim final rule confirms earlier guidance that if an insurer does not cover certain risks in a policy—for example, losses arising from nuclear, biological, or chemical events—it is not required under the Act to offer terrorism coverage for such risks.

### **III. DISCUSSION**

#### **A. Disclosure Requirements**

The interim final rule clarifies the disclosure requirements that insurers must meet to be eligible for federal compensation for losses arising from a certified act of terrorism.

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### 1. “Clear and Conspicuous” Disclosure/Use of Model Forms

As a condition to federal reimbursement for losses arising from a certified act of terrorism, the Act states that insurers must provide “clear and conspicuous” disclosure to the policyholder of the premium charged for such losses and the federal share of compensation. *New guidance:* The interim final rule states that whether disclosure is “clear and conspicuous” depends on “the totality of the facts and circumstances of the disclosure”. This statement is helpful in that it indicates that Treasury will take a flexible, fact-based approach to such determinations.

The preamble states that Treasury does not intend to prescribe particular language or forms for the disclosures required by the Act. Instead, the interim final rule restates earlier guidance that insurers may use model forms the NAIC published to comply with the Act’s disclosure requirements. The model forms may be modified, as appropriate, and other forms of notice may be used so long as they conform to the Act’s notice requirements.

Consistent with earlier guidance, the interim final rule states that an insurer may disclose the premium charged for losses arising from a certified act of terrorism as a portion or percentage of annual premium, if consistent with standard business practice. *New guidance:* The interim final rule clarifies that an insurer may not characterize the premium as a “surcharge” or in any other manner that would be misleading in the context of the Terrorism Risk Insurance Program (the Program). Treasury states in the preamble that describing the premium as a surcharge would be misleading since the term “surcharge” is used by the Act to describe the additional premium that Treasury may impose on policyholders to recoup federal monies paid to cover losses arising from a certified act of terrorism.

### 2. Communicating Disclosure

The interim final rule restates earlier guidance that an insurer may provide disclosure using normal business practices, including methods of communicating similar information to policyholders. In addition, the interim final rule restates earlier guidance that if an insurer normally communicates with policyholders through a broker or other intermediary, disclosure may be provided through that channel. Responsibility for ensuring that disclosure is made, however, remains with the insurer. *New guidance:* Where there is ambiguity as to who is the “policyholder”—for example, where the insurer normally communicates with surety bond purchasers although the contract would pay other parties in the event of loss—the preamble states that the insurer should rely on normal business practices to determine which parties to provide disclosure.

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### **3. Demonstrating Compliance**

Consistent with earlier guidance, the interim final rule states that an insurer may demonstrate that it has provided clear and conspicuous disclosure, as required by the Act, “through use of appropriate systems and normal business practices that demonstrate a practice of compliance”. According to the preamble, compliance with the Act’s disclosure requirements may be evidenced in a variety of ways, including proof of mailing process and other methods consistent with normal forms of communicating with policyholders.

### **4. Certifying Disclosure**

Consistent with the Act, the interim final rule requires that in the event of a terrorism loss, an insurer must certify that it has provided clear and conspicuous disclosure to the policyholder on all policies that form the basis for any claim for federal reimbursement. *New guidance:* The preamble clarifies that certification is required only for those policies for which the insurer submits a claim for federal reimbursement. In other words, a failure to certify disclosure on other policies written by the insurer would not affect the insurer’s eligibility for federal compensation on the policies that it does certify and submit for reimbursement. The preamble further clarifies that this distinction in no way affects the calculation of the insurer’s direct earned premium or the application of the potential surcharge to all commercial property and casualty policies to recoup federal payments.

### **5. Timing of Disclosure/Good Faith Efforts**

The Act requires that insurers provide disclosure “at the time of offer, purchase, and renewal” of the policy. The interim final rule restates earlier guidance that insurers may satisfy this requirement by making disclosure no later than the time the insurer first formally offers to provide coverage, or offers to renew a policy in the case of a current policy holder, and makes a clear and conspicuous reference back to that disclosure when the transaction is completed. *New guidance:* The Act also specifies certain time limits within which insurers were required to make disclosure to policyholders in the first months of the Program. The preamble states that Treasury will be evaluating whether an insurer has materially complied with these and other requirements of the Act with respect to any claim for reimbursement. In doing so, Treasury expects to consider applicable facts and circumstances, including good faith efforts of the insurer to meet the time limits.

### **6. “Separate Line Item” Requirement**

For policies issued after February 24, 2003, the Act requires that disclosure be provided “on a separate line item in the policy”. The interim final rule restates earlier guidance that this

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requirement may be satisfied by providing disclosure: (1) on the declarations page of the policy; (2) elsewhere within the policy itself; or (3) in any rider or endorsement that is made a part of the policy.

## **B. “Make Available” Requirement**

The Act requires that insurers “make available” coverage for losses arising from a certified act of terrorism on all commercial property and casualty policies and provides that such coverage may not differ materially from the terms, amounts, and other coverage limitations applicable to other losses under the policy.

### **1. Continuing Requirement**

Consistent with earlier guidance, the interim final rule provides that insurers must “make available” coverage for losses arising from a certified act of terrorism at the time of initial offer of coverage. The “make available” requirement is effective through December 31, 2004, and may be extended by Treasury through December 31, 2005. *New guidance:* The interim final rule and the preamble clarify that the “make available” requirement is a continuing duty. For example, if the insured rejects coverage for certified acts of terrorism when it is first offered, the insurer must offer the coverage again when the policy is renewed if the renewal takes place while the Act’s “make available” requirement is still in effect.

### **2. Negotiating Other Coverage**

Consistent with earlier guidance, the interim final rule provides that once an insurer has satisfied the “make available” requirement, it may negotiate partial coverage for certified acts of terrorism with the policyholder, to the extent that this is permitted by state law. Under the Act, negotiating partial coverage for certified acts of terrorism is the insurer’s option and is not required.

### **3. Demonstrating Compliance/Audits**

*New guidance:* The interim final rule provides that in the event that an insurer makes an offer of insurance but no contract of insurance is concluded, the insurer may show compliance with the “make available” requirement “through use of appropriate systems and normal business practices that demonstrate a practice of compliance”. The preamble points out that Treasury has audit and investigative authority under the Act and states that insurers should be prepared to demonstrate compliance with the “make available” requirement. Treasury states that it is not prescribing any new record keeping requirement, but that it expects that records related to the “make available” requirement are likely to be included and retained as part of standard policy documents in the normal course of business. In the event that no contract of insurance is issued, the demonstration of compliance may rely on routine adherence to normal risk management systems—for example,

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company policies, use of internal controls and audits—and normal business practices—for example, the use of sample forms used to solicit business that incorporate the “make available” requirement.

#### **4. Same Terms, Amounts, and Other Coverage Limitations**

The Act requires that insurers “make available” coverage for certified acts of terrorism that does not differ materially from the terms, amounts, and other coverage limitations applicable to other losses under the policy. Restating earlier guidance, the interim final rule provides that if an insurer does not cover all types of risks—for example, nuclear, biological or chemical events—then the insurer is not required to “make available” coverage for such losses. Thus, it appears that, consistent with applicable state law, an insurer could offer policies that exclude coverage for nuclear perils, regardless of whether the loss arose from an accidental spill of nuclear waste or the deliberate release of radioactive materials by a terrorist—for example, by detonating a “dirty bomb”. Such policies could be offered regardless of whether the insurer historically excluded such risks, so long as the exclusion applies to both the terrorism coverage and other coverage under the policy.

In addition, consistent with earlier guidance, the interim final rule states that the price of insurance is not subject to the provision that the “terms” of coverage for certified acts of terrorism may not differ materially from the terms of other coverage offered under the policy. In other words, Treasury will not seek to regulate the price of terrorism coverage.