

## MEMORANDUM

**TO:** Clients and Friends

**FROM:** Morris, Manning & Martin Terrorism Risk Insurance Group

**DATE:** July 10, 2003

**SUBJECT:** Final Rule Implementing the Terrorism Risk Insurance Act of 2002

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### I. Introduction

On July 8, 2003, the U.S. Department of the Treasury (“Treasury”) issued the first in what will be a series of final rules implementing the Terrorism Risk Insurance Program (“the Program”) established by the Terrorism Risk Insurance Act of 2002 (“the Act”). A copy of the final rule is available on Morris, Manning & Martin’s website at [www.mmmlaw.com/terrorism](http://www.mmmlaw.com/terrorism). The final rule will be published in the Federal Register shortly and will take effect on the date of publication.

Many aspects of the final rule are identical to the “interim final rule” on which it is based, which Treasury issued with a request for public comment in February.<sup>1</sup> The final rule, however, contains some important changes and clarifications.

### II. Overview

Highlights of the final rule include the following:

- Treasury rejects arguments made by commenters that state licensed and admitted captive insurers should be permitted to opt in to the Program. Instead, Treasury reiterates its position that state licensed and admitted captives must participate.
- Treasury establishes a formal procedure by which interested parties may request an interpretation of the Act or regulations implementing the Act.

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<sup>1</sup> 68 Fed. Reg. 9804 (February 28, 2003).

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- Treasury substantially modifies the rebuttable presumptions for establishing “control” among insurers that were contained in the interim final rule. The presumptions are important to the calculation of an insurer’s deductible under the Program. The existence of a control relationship under State law no longer is sufficient, by itself, to establish rebuttable presumption of control for purposes of the Program.
- Treasury establishes new criteria for determining whether joint underwriting associations, pooling arrangements and other similar entities that are not clearly “State licensed or admitted” are required to participate in the Program.
- Treasury considers but rejects arguments made by commenters to change its approach to the participation of federally approved insurers in the Program. The final rule makes no changes to the treatment of federally approved insurers established in the interim final rule.
- The Act gives Treasury discretion to establish additional criteria for participation in the Program beyond the express statutory requirements. Treasury had earlier asked for comment on whether it should establish such criteria to deal with special situations. Criteria under consideration included standards to prevent “gaming” of the deductible by newly formed insurers and financial integrity standards for federally approved insurers. Treasury states that it is not proposing any such criteria at this time, but will continue to monitor the market.
- Treasury takes the position that fidelity insurance is not covered by the Act.
- Treasury clarifies that the Act’s exclusion for acts of terrorism committed as part of a course of war declared by Congress applies only to acts of terrorism committed in connection with a formal, Congressionally declared war.

### **III. Discussion**

The following discussion examines in greater detail some of the major actions taken by Treasury in the final rule.

#### **A. Captives**

The final rule reiterates Treasury’s position that state licensed or admitted captive insurers are required to participate in the Program. In the preamble to the rule, Treasury considers, but rejects, a number of arguments made by commenters that such captives should be permitted to opt in to the Program. Treasury also confirms that if a captive is not state licensed or admitted, it is not in the Program. Treasury expressly leaves open the possibility that non-state licensed or admitted captives may be permitted to participate in the Program under rules to be issued at a later date but provides no indication of whether it is inclined to issue such rules. Finally, Treasury clarifies that premiums received by a fronting insurer are included in the fronting insurer’s direct earned premiums for purposes of calculating its deductible under the Program.

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## **B. Formal Process For Requesting Interpretations**

The final rule establishes a formal process by which persons may request an interpretation of the Act or regulations implementing the Act from Treasury. Persons seeking an interpretation must submit a written request to the Terrorism Risk Insurance Program Office giving a detailed explanation of the facts and circumstances and the reason why an interpretation is needed. Treasury in its discretion will provide written responses to such requests, although it reserves the right to decline to provide a response in any case. Except in the case of any confidential business or trade secret information, Treasury will make written requests for interpretations and responses publicly available after the response has been provided.

## **C. Control Relationships Among Insurers**

### **1. Rebuttable Presumptions of Control**

Treasury has retooled the rebuttable presumptions that appeared in the interim final rule regarding when “control” exists between two or more insurers. The presumptions are important to the calculation of the deductible for federal reimbursement of terrorism losses under the Terrorism Risk Insurance Program. The deductible is calculated as a percentage of annual direct earned premiums, and two or more insurers in a control relationship must aggregate their premiums for purposes of determining their deductible.

Consistent with the Act, the interim final rule established two tests under which control was deemed to exist among insurers. The final rule also contains these tests and clarifies that they are conclusive and not subject to rebuttal.

In addition, the interim final rule established certain tests under which control was presumed to exist, but could be rebutted by the insurer. Among these was a presumption of control if “a State has determined that an insurer controls another insurer”. This raised concern that ownership of a little as 10 percent of the voting securities of an insurer would give rise to a presumption of control under the standards of some state insurance company holding acts.

The final rule modifies the rebuttable presumptions so that a State determination of control, by itself, is not sufficient to give rise to a presumption of control. Under the final rule, a rebuttable presumption of control arises if an insurer controls another insurer under any State law and one or more of the factors listed below apply. Absent control under State law, control is presumed to exist if two or more of the factors apply. The factors are as follows:

- The insurer is one of the two largest shareholders of any class of voting stock;
- The insurer holds more than 35 percent of the combined debt securities and equity of the other insurer;

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- The insurer is party to an agreement pursuant to which the insurer possesses a material economic stake in the other insurer resulting from a profit-sharing arrangement, use of common names, facilities or personnel, or the provision of essential services to the other insurer;
- The insurer is party to an agreement that enables the insurer to influence a material aspect of the management or policies of the other insurer;
- The insurer would have the ability, other than through the holding of revocable proxies, to direct the votes of more than 25 percent of the other insurer's voting stock in the future upon the occurrence of an event;
- The insurer has the power to direct the disposition of more than 25 percent of a class of voting stock of the other insurer in a manner other than a widely dispersed or public offering;
- The insurer and/or the insurer's representative or nominee constitute more than one member of the other insurer's board of directors; or
- The insurer or its nominee or an officer of the insurer serves as the chairman of the board, chairman of the executive committee, chief executive officer, chief operating officer, chief financial officer or in any position with similar policymaking authority in the other insurer.

Control also is presumed if one or more of the factors applies and if an insurer provides 25 percent or more of another insurer's capital, policyholder surplus, or corporate capital. In addition, control is presumed if one or more of the factors apply and an insurer, at any time during a Program Year, supplies 25 percent or more of the underwriting capacity for that year to an insurer that is a syndicate consisting of a group including incorporated and individual unincorporated underwriters.

## **2. Official Determinations Regarding Control**

Like the interim final rule, the final rule permits an insurer to request a hearing with Treasury to rebut a presumption of controlling influence. Rebuttal is available through written submissions and, at Treasury's discretion, an informal oral hearing. In addition, the final rule permits any insurer that is uncertain of whether a controlling influence exists to request such a hearing, even if a rebuttable presumption of control is not present.

## **3. Pro Rata Allocation of Premium Among Multiple Owners**

Separately from the interim final rule, Treasury solicited comment on a pro rata method for allocating direct earned premium in situations in which multiple insurers each owns 25 percent or more of an insurer. Treasury states in the preamble it is still considering this approach and may adopt it at a later date.

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#### **D. Joint Underwriting Associations and Other Pooling Arrangements**

In the preamble to the final rule Treasury states that joint underwriting associations that are State licensed or admitted must participate in the Program. Treasury acknowledges, however, that certain joint underwriting associations, pooling arrangements and other similar entities may not fit neatly into the “State licensed or admitted” category. The final rule provides that such an entity must participate in the Program if it:

- Has gone through a process of being licensed or admitted to engage in the business of providing primary or excess insurance that is administered by the State’s insurance regulator, which process generally applies to insurance companies or is similar in scope and content to the process applicable to insurance companies;
- Is generally subject to State insurance regulation, including financial reporting requirements, applicable to insurance companies within the State; and
- Is managed independently from other insurers participating in the Program.

#### **E. Other Actions**

Other significant actions taken by Treasury include:

- The final rule provides that an insurer offering a hybrid commercial property and casualty policy that covers risk exposures for losses that are covered under the Program and losses that are not covered under the Program—for example, a contract for hospital general liability coverage combined with medical malpractice coverage—may exclude premiums for the coverage that is not subject to the Program from its direct earned premiums. If the coverage subject to the Program comprises less than 25 percent of the direct earned premiums for the hybrid coverage, it is considered “incidental”. In this case, the premiums for the hybrid coverage as a whole may be excluded from the insurer’s direct earned premiums. The same rules apply to hybrid policies containing both commercial and personal property and casualty coverage. Personal coverage is not subject to the Program.
- The final rule clarifies that premiums for coverage for one-to-four family rental units owned for the business purpose of generating income for the property owner should be excluded from the calculation of an insurer’s direct earned premiums.
- Treasury reiterates its position that an insured loss covered by the Program includes losses to a United States air carrier or vessel that occur outside the United States, but not losses outside the United States incurred by other parties that are covered by third party insurance contracts that are separate from the insurance coverage provided to the air carrier or vessel. If, however, such third party losses occur within the United States, they would be covered.