

MEMORANDUM

TO: Clients and Friends
FROM: Morris Manning & Martin Insurance/Reinsurance Group
RE: Terrorism Risk Insurance Act of 2002
DATE: November 20, 2002

Congress has just approved the conference committee bill establishing a federal terrorism insurance backstop. The "Terrorism Risk Insurance Act of 2002" (the "Act") is intended to stabilize property and casualty markets that have been suffering from the unavailability and high prices of insurance. President Bush is expected to soon sign the Act into law. The major provisions of the Act are as follows:

What Does the Act Do?

- The Act establishes the Terrorism Insurance Program (the "Program") within the Department of the Treasury, through which the Federal government will share the risk of loss from future terrorist attacks with the insurance industry. Insurers are required to offer mandatory terrorism coverage; but the Program acts as reinsurance for any losses.
- The Act is effective upon the President's signature, and the Program is effective through December 31, 2005.
- The Act voids any terrorism exclusion in any active insurance contract. All previous state approvals of policies with terrorism exclusions are null and void.
- The Program is triggered when the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General, certifies that an event meets the definition of an "Act of Terrorism." Such a decision is not subject to judicial review.
 - An Act of Terrorism is defined as i) a violent act that is dangerous to human life, property, or infrastructure; ii) to have resulted in damage within the United States, or damage to an air carrier or U.S. flagged vessel or a United States mission; and iii) to 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 through coercion.
 - An Act of Terrorism does not include an act committed in the course of a war declared by Congress or an act resulting in losses that do not exceed \$5,000,000.

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Which Insurers are Required to Participate?

- Participation in the Program is mandatory for the first two years of the program for any insurer that is writing property and casualty insurance in the United States or its territories. The definition of insurer includes surplus lines writers and authorized alien insurers. However, Federal crop, private mortgage, financial guaranty, health or life (including group), flood, and medical malpractice insurance are all excluded from the Act's coverage. Reinsurance or retrocessional insurance is also excluded.
 - The Secretary of the Treasury (the "Secretary") has the authority to extend the Act to cover life insurance if the Secretary determines that adequate and affordable terrorism reinsurance is not available for life insurers.
- The Secretary has the authority to require insurers to participate in the programs third year also.
- Insurers are required to provide clear and conspicuous notice to policyholders of the premium charged for insured losses covered by the Program and the Federal share of compensation for the insured losses.

How Does the Program Operate?

- Once the Secretary of the Treasury certifies an act as terrorism, a cost sharing mechanism partitions the loss between the insurer and the Federal government.
 - Each participating insurer is required to pay losses up to a retention amount based on the insurer's direct earned premium the previous year. The Federal government then covers 90% of the losses for the insurer above its deductible, while the insurer would pay the remaining 10% of losses.
 - For the transition period from signature to December 31, 2002, the insurer has a deductible equal to 1% of the insurer's direct earned premiums; for year one, the deductible is equal to 7%, for year two, the deductible is equal to 10%, and for year three, the insurer's deductible rises to 15%.
- Aggregate insured losses requiring an insurer deductible and co-payment are capped at \$100 billion in any one year. Congress would have to authorize payments for any losses over \$100 billion in any one year.
- The government will recoup a portion of the payouts it makes through the program with a surcharge on commercial property and casualty premiums. The surcharge may not exceed 3% of the premium in any given year. Insurers are required to collect and remit the surcharge to the government.

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- For purposes of the calculation of any mandatory Federal recoupment, the insurance industry is required to retain \$10 billion of risk for the first year; \$12.5 billion for year two; and \$15 billion for year three. The Secretary must recoup the difference between the insurance marketplace retention and the aggregate amount of losses that insurers are required to pay themselves. The Secretary also has the discretion to recover other Federal payouts through the same surcharge described above.

Tort Reform

The Act creates an exclusive federal cause of action (preempting any state actions) for any damages from an Act of Terrorism. The litigation shall take place in U.S. District Court. Punitive damages, if awarded, will not be considered “insured losses” and therefore will not be covered by the Program.