Terrorism Insurance: U.S. Legislation to Create a Federal Backstop

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The U.S. Congress has so far failed to pass legislation to create a temporary Federal backstop for property and casualty terrorism insurance, after nearly one year of effort. The House of Representatives passed H.R. 3210 last year, but the Senate did not pass S. 2600 until June. This failure is first due to a dispute over so-called “litigation management” provisions in the House bill, particularly that bill’s far-reaching preemption of punitive damages for claims arising from a terrorism event. However, there are other differences between the bills passed by the House of Representatives and the Senate, notably including a basic philosophical difference in the House’s insistence that the insurance industry and its policy-holders repay any funds drawn from the U.S. Treasury. In this respect, the House bill is a loan program rather than a true backstop under which the Federal Government would assume responsibility to pay claims when losses stemming from terrorism exceed certain thresholds. These and other differences between the bills will have to be reconciled by the Conference Committee which has been appointed but has yet to reach agreement.
NECESSITY

In addition to tort reform and the “payback” issue, the question of necessity lurks in the background. President Bush recently urged Congress to act on the backstop legislation, citing $8 billion in construction projects that have become nonviable due to inadequate terrorism insurance – a figure generated by the Mortgage Bankers Association of America. The economists are saying that the U.S. gross domestic product has fallen between one-quarter and one-half of a percent in the past year. Still, some argue that limits on the availability of affordable terror cover have not seriously disrupted the U.S. economy. The Consumer Federation of American insists that Federal intervention should be limited to high-risk, or “trophy”, commercial properties. It is difficult to gage the impact on legislators of these varying opinions; however, no one can seriously dispute the contention voiced last month by Dr. Robert P. Hartwig, Chief Economist of the Insurance Information Institute, that more terrorism coverage would be written at lower prices with the enactment into law of federal backstop legislation. Given the slowness of the economic recovery, one would hope that Congress will produce a final bill for the President to sign, preferably before the November elections but perhaps during the expected post-election (known as a “lame duck”) session.
COST

Although the insurance industry in general has been reluctant to speak publicly in favor one bill over the other in the interest of encouraging compromise, the American Insurance Association recently commissioned Tillinghast-Towers Perrin to study and report on the budgetary impacts of the respective bills. AIA’s release of this report suggests a preference for the Senate version. The conclusion of the Tillinghast study is that the House version would cost the U.S. taxpayers more than double what the Senate version would cost. The authors said their assumptions regarding expected cost were based largely on estimates from the Congressional Budget Office. The somewhat surprising result is due to the fact that the Federal Government would step in earlier under the House bill, and, despite the loan feature of that bill, payback is likely to be deferred over an extended period, sharply reducing the present value of the recoveries to the Treasury.
The following slides highlight the more important differences between the House and Senate bills. These are the same differences which will have to be addressed by the Congressional Conference Committee which has been appointed to reconcile the competing versions.

- **TRIGGER**
- **RETENTION**
- **GOVERNMENT SHARE**
- **CAP**
- **PAYBACK**
- **DEFINITIONS**
- **STATE LAWS**
- **TORT REFORM**
TRIGGER

The House bill proves two triggers for activating the Federal program, assuming that the Secretary of the Treasury has determined that an act of terrorism has occurred:

1. Industry-wide aggregate losses of $1 billion; OR

2. Industry-wide losses of $100 million AND an individual insurer suffers losses exceeding 10% of its capital surplus AND 10% of its net commercial premium.

The Senate bill has no such triggering provision.
• RETENTION

-- The House bill requires insurance companies to absorb losses amounting to 10% of their net commercial premiums, or at least $5 million if the industry-wide loss is greater than $1 billion.

-- The Senate bill requires insurance companies to absorb the first $10 billion in losses for year one and the first $15 billion in losses for year two of the program, based on each company’s proportional share of total premiums.
• GOVERNMENT SHARE

-- The House bill calls for the Government to pay 90% of insured losses which exceed the applicable private sector retention.

-- The Senate bill calls for the Government to cover 80% of insured losses below $10 billion and 90% of insured losses above $10 billion, both calculated after the required per-company retention.
Both the House and Senate bills would cap Federal payments at $100 billion annually.

The Senate bill would relieve both the insurance companies and the Federal Government of liability for losses exceeding the $100 billion cap.

The House bill caps only the Federal payments.
• PAYBACK

Only the House bill requires insurance companies to repay the Federal Government. The bill sets up an elaborate system of assessments on companies and premium surcharges on policyholders. It grants flexibility to the Secretary of Treasury to stretch out the repayments to mitigate adverse economic impacts.
DEFINITIONS

Assuming the relevant triggers and thresholds are met, both bills cover damage to a vessel located in or outside the United States, as long as the vessel is U.S. flag or is based principally in the United States and U.S. income tax is paid on it.

-- The Senate bill is more restrictive in its definition of “participating insurance company”, covering any insurance company, including any subsidiary or affiliate thereof, that--
(i) is licensed or admitted to engage in the business of providing primary insurance in any State, and was so licensed or admitted on September 11, 2001; or
(ii) is not licensed or admitted as described in clause (i), if it is an eligible surplus line carrier listed on the Quarterly Listing of Alien Insurers of the NAIC.

-- The House bill would cover any insurer providing coverage which is "subject to regulation in the United States." This could include foreign-based P&I Clubs which provide coverage under various federal statutes but are not necessarily listed as surplus line carriers by the NAIC. The House bill provides discretion to the Secretary of Treasury to apply the law “as appropriate” to any offshore or non-admitted entities that provide commercial property and casualty insurance.
Both the House and Senate bills would preempt state regulations to the extent that they would interfere with insurers’ ability to offer terror cover. However, the pricing of terrorism insurance was an issue during consideration of both bills, and the possibility remains that an attempt will be made to add to the final legislation authority to control rate increases for terror cover through the state insurance departments or the Federal Government.
• TORT REFORM

-- The House bill creates a federal cause of action, to the exclusion of state remedies, for lawsuits arising out of acts of terrorism. It also prohibits the award of punitive damages, except in suits against terrorists, and caps attorneys’ fees at 20% in any such suits.

-- The Senate bill also creates an exclusive federal remedy for terrorism-related claims. Although it does not limit claims for punitive damages against policyholders, it does preclude use of Federal funds to pay punitive damages.

Various compromises have been discussed to reconcile the House and Senate approaches to litigation. One compromise would allow punitive damages only against businesses which have criminal liability or fail to make good faith efforts to prevent terrorism-related losses.