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(RE-)DRAWING THE LINE

Professional Liability Is Out; D&O Is In Under Revised Federal Terrorism Program

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Professional liability underwriters have had to adjust to some changes in the federal terrorism reinsurance program in recent months.

Professional liability insurance was originally one of the lines of commercial insurance eligible for coverage under the federal Terrorism Risk Insurance Program (TRIP), first created in 2002. (See "Explanation of Terms.")

No more. Under an extension of TRIP enacted in December 2005, professional liability insurance was eliminated from coverage under the program.

At the same time, Congress expressly extended the program to cover directors and officers liability insurance. Previously, it not entirely clear whether D&O was covered under TRIP.

Rules issued in mid-May by the U.S. Department of the Treasury, which administers TRIP, state that, for purposes of the revised program, "directors and officers liability insurance is not included in the definition of professional liability insurance."

These clarifications, of course, directly affect the type and amount of exposure held by professional liability and D&O carriers.

In this regard, it is important to clarify that federal terrorism "reinsurance" merely provides liquidity to the property/casualty industry in the event that certain acts of terrorism cause losses in excess of certain thresholds. Every federal dollar spent on paying claims will be recouped through assessments on P&C carriers.

By doing that, however, the program has the effect of spreading the impact of some terrorism losses from carriers that incur the losses to the entire industry.

Since being eliminated from the program, professional liability writers and their reinsurers are on their own to meet claims that can arise from terrorist attacks. It is estimated that $4 billion of the approximately $32 billion in losses sustained in the World Trade Center disaster are liability losses, an undetermined share of them professional liability claims.

On the other hand, D&O carriers will have federal reinsurance for losses they sustain from acts of terrorism that meet certain criteria—provided those carriers make sure their policyholders know that federal terrorism coverage is available.

DUTIES

While clarifying which lines of insurance are eligible for federal terrorism reinsurance, the latest revisions to TRIP also affect the duties of professional liability agents, brokers, and underwriters to their insureds.

When professional liability insurance was reinsured under the federal program in its original form, professional liability carriers and intermediaries were *required* to offer their policyholders coverage for "certified" terrorist acts (see "Explanation of Terms"), and to disclose the amount of premium devoted to the coverage. Insureds could accept or decline the coverage.

That's changed.

Today, professional liability carriers and intermediaries *should not* suggest that there is federal terrorism reinsurance in place for professional liability losses from certified acts, even if the losses arise from professional liability coverage included in policies (such as umbrellas) that are otherwise covered under the federal program.

Of course, insurers can still offer private coverage for professional liability losses arising from terrorist acts. Given that, if a carrier inadvertently attaches an outdated TRIP endorsement to a professional liability policy, that carrier may be exposed to losses covered under the endorsement.

By now, professional liability agents, brokers, and underwriters should have verified that they are not using outdated TRIP coverage endorsements. Given the number of terrorism endorsements in circulation, however, it's not hard to imagine that some outdated ones are still being used.

PREMIUM

Professional liability writers have another new challenge arising from changes to the program.

Given that certain types of commercial losses will not be covered under TRIP, the new Treasury rules state that insurers should subtract premium for lines not reinsured under TRIP (including professional liability) from other commercial premium when reporting direct earned premium to the Treasury Department.

In other words, when reporting to Treasury, carriers should subtract premium for professional liability policies from the total they report on Line 17, Other Liability, of their annual statements.

That reporting is done to determine the assessments on insurers that would reimburse the federal government following an attack. If carriers don't subtract professional liability premium, carriers could be paying a higher assessment than necessary following a loss covered under TRIP.

That task may be relatively straightforward for professional liability coverage provided through monoline policies, but it becomes more complicated when the coverage is packaged and the premium is reported along with other coverages that are still reinsured under TRIP, including D&O.

That is often the case when umbrella policies are written over a range of underlying coverages, some of them reinsured under TRIP, some not.

HYBRIDS

Regarding umbrella and other "hybrid" policies, the new Treasury rules state the following (wording is abridged):

> "An excess or umbrella liability might cover both an underlying professional liability policy (generally excluded from the program) as well as an underlying general liability policy (generally included in the program). Where the included segment of an excess or umbrella liability policy is merely incidental to the remaining excluded coverage, an insurer may treat the entire policy as not providing property and casualty insurance. In such circumstances, the 'make available' and disclosure requirements will not apply and no losses will be paid by Treasury." (For the complete text, see *Federal Register*, p. 27568, May 11, 2006.)

The Treasury Department defines "incidental" as any coverage that accounts for less than 25% of the premium for a policy.

Therefore, under the Treasury rules, if the share of a policy's premium for general liability coverage, which is reinsured under TRIP, is less than 25% of the premium for an umbrella, and all the other underlying coverages are not reinsured under the program, there would be no federally terrorism reinsurance for losses under that policy.

However, if a TRIP-reinsured coverage exceeds 25% of the premium for an umbrella policy, the logic of the Treasury rules suggests that insureds must be offered federal reinsured coverage for certified acts.

EXPLANATION OF TERMS

The federal Terrorism Risk Insurance Program (TRIP) was established by the Terrorism Risk Insurance Act (TRIA) in 2002. Sometimes "TRIP" and "TRIA" are used interchangeably.

The program was extended and modified by the Terrorism Risk Insurance Extension Act (TRIEA) of 2005.

TRIP is administered by the U.S. Department of the Treasury, and the program provides federal reinsurance for losses arising from "certified" acts of terrorism.

"Certified" acts of terrorism are acts carried out or directed by foreigners that cause losses in excess of certain dollar amounts. To trigger coverage under the program, the Secretary of the Treasury, with the concurrence of the U.S. Attorney General and Secretary of State, must certify that an attack or series of attacks meets those criteria.

"Non-certified" act of terrorism are, therefore, all terrorist attacks not certified as such by federal officials. Non-certified acts would include acts of domestic terrorism and acts whose resulting damages did not meet statutory dollar thresholds.

It will be challenging for umbrella underwriters to determine whether federal terrorism reinsurance would be in effect on umbrella policies, as the underlying exposures and rates change over time.

To calculate direct earned premium, carriers are allowed (but not required) to segregate umbrella premium for TRIP-reinsured coverages from umbrella premium for coverages not reinsured under the program.

D&O

Things are simpler for D&O writers. If they have not been offering federally reinsured coverage for certified acts before, they must do so now.

It's not yet clear what will happen to companies that fail to do that. D&O agents, brokers, and underwriters have to consider at least two possibilities, however:

- A D&O carrier that fails to offer coverage for certified acts could be required to cover losses from them anyway, but without the benefit of federal reinsurance.
- An agent or broker that fails to offer coverage for certified acts on a D&O policy could be subject to an errors or omissions claim.

A more remote possibility is that a D&O carrier that fails to offer coverage for certified acts could be subject to state market conduct penalties. Given that insurance regulation has been expressly delegated to the states for more than 60 years, there is little precedent for state enforcement of federal requirements in insurance.

The requirement that D&O carriers offer federally-reinsured coverage for certified acts of terrorism can create additional mandatory exposure for those carriers. If an insured agrees to purchase federally reinsured coverage for certified acts, the carrier will be responsible for a 10% deductible on losses covered under the program in 2006 and 15% in 2007.

Then, on Dec. 31, 2007, the program is scheduled to expire. If that happens, D&O underwriters—along with all underwriters of lines covered under TRIP—will have to change how they go about addressing terrorism losses.

There is rationale behind the complexities of the federal terrorism reinsurance program.

The distinction between "certified" and "non-certified" acts, increases in the amount of damages needed to trigger TRIP coverage, progressive increases in insurer retentions, and the elimination of certain lines from the program all derive from a desire to limit the role of federal terrorism reinsurance.

From the outset, the program was designed to be a temporary mechanism to assist in the financing of losses from large-scale, warlike attacks originating overseas.

There is pressure from some quarters to expand the application of the program and make it permanent, but until that happens, all commercial underwriters should monitor developments in the program carefully to ensure that they understand their exposure and their duties to insureds.

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