P & P CAPTIVE NEWSLETTER

LAW OFFICES OF

PRIMMER & PIPER

PROFESSIONAL CORPORATION

www.primmer.com

April 2005 **Vol. 11, Issue 1**

MONTPELIER OFFICE:
100 EAST STATE STREET
P.O. BOX 1309
MONTPELIER, VT 05601-1309

TELEPHONE 802-223-2102
FACSIMILE 802-223-2628

BURLINGTON OFFICE:
150 SOUTH CHAMPLAIN STREET, SUITE 4
P.O. BOX 1488
BURLINGTON, VT 05402-1488

TELEPHONE 802-862-2512
FACSIMILE 802-862-3286

ST. JOHNSBURY OFFICE:
421 SUMMER STREET
P.O. BOX 159
ST. JOHNSBURY, VT 05819

TELEPHONE 802-748-5061
FACSIMILE 802-748-3976

We have followed closely recent articles in Business Insurance and the Denver Post discussing Colorado's investigation into certain title reinsurance practices involving homebuilders and mortgage lenders. Consistent misunderstandings and mischaracterizations by insurance regulators cause us to offer this editorial, and to express our hope that those who scrutinize these or similar arrangements keep in mind some simple realities.

TITLE REINSURANCE INVESTIGATIONS MISS THE MARK

Recently published articles regarding the reinsurance of title policies by homebuilder and mortgage lender owned captives describe a regulatory zeal driven by the desire to protect consumers. Suggestions have been made that captive programs result in higher rates being paid for title policies. In addition, allegations have been made that title reinsurance violates both the Real Estate Settlement Procedures Act (RESPA) and analogous state prohibitions. We believe that many involved in the ongoing investigations do not understand the basic parameters of these transactions, or the context in which they occur.

First and foremost, no consumer has been harmed by title reinsurance activities by Vermont captives. Rates for title insurance are established by the primary title insurance company, and are filed with and approved by state insurance regulators. In short, none of the reinsurance arrangements results in a single consumer paying a single penny more for title coverage.

Words like "kickback" and "sham" have been used carelessly in many of the articles published. These terms suggest illegal activity and are completely inappropriate to describe the arrangements with which we are familiar. All of the reinsurance contracts in question are written on a "quota share" basis. Simply put, a quota share contract requires each party to pay its proportionate share of each and every claim in return for

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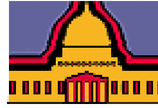
a proportionate share of the premium. There is no kickback, because the price paid is, by definition, proportionate to the risk assumed. Although possibly now under review, this position had been confirmed by the federal Department of Housing and Urban Development, which oversees RESPA.

The current investigation, which now involves states other than Colorado, is in our view misdirected. If reinsurers are not paying many claims, then title companies themselves are not paying many claims. The focus on reinsurance transactions, all of which are conducted within established regulatory guidelines, misses the point. Builders and lenders involved in reinsurance have no control over the primary rates charged by title carriers.

Finally, and most importantly, we are proud of Vermont's captive insurance industry and its well-deserved reputation for excellence in the field of alternative risk management. Because of Vermont's leadership in this industry, schools, churches, hospitals, doctors, public housing authorities, small nonprofit organizations and large corporations alike have the ability to manage their own risk. In our view, the Vermont Insurance Department, Vermont captive insurers, and the Vermont service infrastructure uniformly conduct themselves with integrity, professionalism, and a commitment to full regulatory compliance.

See the article below on title reinsurance and the recent NAIC meetings for additional information on this topic.



NEWS FROM THE VERMONT STATE HOUSE: *MODEST CAPTIVE LEGISLATION MOVING FORWARD*

The 2005-2006 Vermont General Assembly is near the mid-point of this legislative session. Legislators convened for the start of the new biennium in January and will likely adjourn in late May. The session has started off slowly as new members grow accustomed to their duties. With Democrats' newly-won control of the House comes election of a new Speaker, appointment of new committee chairs and members, and control of the agendas in committees and on the floor. This process takes time as legislative leaders begin to assert themselves despite the expected growing pains of a new Assembly.

Despite the slow start, Legislators have now turned to the art of legislating, including consideration of S.62, a bill of interest to the captive insurance industry, which contains a series of modest housekeeping amendments. The bill provides for a more streamlined process of conversion of for-profit captives to the nonprofit form; exempts captive insurance companies from certain provisions of Vermont's nonprofit corporation statutes that, in practice, do not make sense when applied to captives; provides the Commissioner discretion to waive investment restrictions for certain association captives and risk retention groups; and permits alternative forms of security required for branch captives. S.62 was introduced in the Senate and received the favorable recommendation of the Senate Finance Committee and ultimately

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the full Senate. The bill is currently pending in the House Commerce Committee, where favorable action is anticipated in the coming weeks.

Partisan politics are becoming increasingly apparent. Democrats control both the House and Senate, while Republicans remain in control of the administrative branch. The tension is illustrated by recent wrangling over S.74, a bill which proposed to create a Vermont pension investment committee. While the Governor supports the unitization of the funds for investment purposes, he has objected to the way the bill provides for election of the nine member committee, and has vetoed the bill. The House then tried unsuccessfully to override the Governor. Merits of the particular bill aside, its handling has been interesting to watch. While vetoes have been a rarity in recent sessions, there is a sense that the Democratically controlled General Assembly will face many more. Many observers believe this first veto may have been intended to test the numbers in advance of more important legislation, such as health care reform.

We believe that Vermont's longstanding bipartisan support of the captive insurance industry will be unaffected by this dynamic, and we will continue to report on the General Assembly and any other issues of potential interest to captive insurers.

TORT REFORM UPDATE: THE CLASS ACTION FAIRNESS ACT OF 2005

The Class Action Fairness Act of 2005 ("CAFA") was signed into law on February 18, 2005. CAFA both expands the jurisdiction of federal district courts over certain interstate class actions and requires heightened scrutiny of class action settlements by federal district courts. These procedural reforms are intended to reduce forum shopping and assure fairer outcomes for class members and defendants.

Federal Jurisdiction of Class Actions

Under CAFA, federal district courts now have original jurisdiction over class actions where the aggregate value of the claims exceeds $5 million, multiple states are involved, and the plaintiff class has at least one hundred members. Federal district courts may nonetheless decline jurisdiction where more than one-third (but less than two-thirds) of the class members and the primary defendants are citizens of the state in which the action was filed. The Act also precludes federal courts from exercising jurisdiction in certain limited circumstances. CAFA does not apply to class actions if the primary defendants are states, state officials or state entities, and a federal court may be foreclosed from ordering relief against those entities. Nor does the Act change the current federal jurisdictional rules for class actions solely involving claims concerning covered securities under federal securities laws and the internal affairs of a corporation under state law.

In addition to expanding the jurisdiction of federal district courts, CAFA facilitates the transfer of class actions from state to federal courts. Prior to its enactment, defendants had to show that no defendant resided in the same state as any class member. Now a defendant need only show

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that at least one member of the plaintiff class is a citizen of a state different from any defendant. Additionally, CAFA now requires aggregation of class members' claims when calculating the minimum controversy amount, further facilitating transfers from state to federal court. These reforms will increase defendants' ability to challenge forum shopping.

Judicial Scrutiny of Class Action Settlements

CAFA also requires increased judicial scrutiny of settlements of class actions originating in or removed to federal district court. The Act requires court approval of proposed settlements involving "coupons," which entitle class members to certain future services, rather than cash. The court may approve a proposed coupon settlement only after holding a hearing and making a written determination that the proposed settlement is fair, reasonable and adequate for the class members. To the extent that attorneys' fees are not based on the offered services, the fees must be based on the amount of time reasonably expended by the attorneys on the class action. And a court may approve a settlement that would result in a net loss to class members only if the court finds that the non-monetary benefits substantially outweigh the monetary loss.

Conclusions

Supporters of CAFA believe that it will decrease forum shopping and lead to the dismissal of many class actions given the more stringent federal requirements for granting class certification. They also believe that the Act may reduce the number of class actions filed in plaintiff-friendly states. Opponents argue that CAFA's reforms will have little effect because fewer states are certifying national class actions and some states have their own stringent class certification standards. Only time will tell whether CAFA will accomplish meaningful class action reform, or whether plaintiffs' counsel will find ways to circumvent its provisions.

TITLE REINSURANCE

Recent regulatory investigation and enforcement actions in several states have called attention to a small subset of Vermont's many captive insurance companies. Making claims under the Real Estate Settlement Procedures Act ("RESPA"), 12 U.S.C. § 2607, and similar state provisions, Colorado insurance regulators recently concluded that captive reinsurance of title insurance policies by lender and builder-owned captives is illegal and that the practice has artificially inflated the costs of title insurance to the detriment of consumers. Several title reinsurance captives call Vermont home.

In response to increased public and regulatory scrutiny, title insurers have cancelled all reinsurance obtained through captives leaving existing programs dormant.

In general, the Vermont captives reinsuring title risks are subsidiaries of nationally known lenders and homebuilders. When the parent companies sell or finance homes, home buyers purchase either a lender's title policy, covering risk of

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collateral loss to the lender due to deficient title, a buyer's policy, covering risk of loss to the buyer due to deficient title, or both. Captives have entered into reinsurance agreements with several major title insurers. The terms typically call for a fifty-fifty sharing of title risks (so-called "quota share") in return for fifty percent of the premium, less a flat processing fee. If a title claim is paid by a title insurer, it will recover 50% of the claim amount from the captive.

Title insurance customers receive at closing a disclosure of the captive reinsurance arrangement and a form by which consumers may "opt-out" of the arrangement. Notably, the rates charged at closing are exactly the same whether the underlying title risk is reinsured.

Insurance regulators allege captive reinsurance of title risks violates provisions of laws, like RESPA, that forbid payment of "value" for referral of business related to a real estate settlement service. They argue that paying premiums to captives controlled by lenders and homebuilders constitutes value paid in return for referrals to a title insurance company. However, RESPA exempts from its general prohibitions payment of bona fide amounts paid for services actually performed.

Vermont title reinsurance captives have paid few claims to date. This mirrors the excellent recent loss history of the title industry in general. Captive title reinsurers assume the same amount of risk as the title insurer for slightly less than the same premium. Assuming underlying title insurance rates are proper, a share of premium for an equal share of risk represents a bona fide payment. Vermont title captives have no possibility of avoiding payment of claims under reinsurance agreements and maintain reserves and capital adequate to ensure such payment. In paying their share of claims, they provide "actual service" to title companies.

Captive reinsurance of title risks has been reviewed and approved by HUD. In a letter, HUD announced that captive title reinsurance should be evaluated under the standards in the so-called "Countrywide Letter," outlining permissible practices for reinsurance of mortgage insurance risks. The Countrywide Letter required that payments made to reinsurers be (1) for reinsurance services actually furnished or for services performed and (2) in an amount that does not exceed the value of such services. HUD further explained that reinsurance would be "actually provided" if the arrangements were documented by legal contracts conforming to industry standards; involved reinsurers posting adequate capital and reserves to enable payment of claims; and represented a true sharing of risk. In regard to the third element, HUD specifically stated that quota share arrangements involved risk sharing.

While it did not dominate the recent NAIC Spring meetings, held March 12-15 in Salt Lake City, captive reinsurance of title risks was a popular topic of discussion and conjecture. The Title Insurance Working Group, co-chaired by Deputy Insurance Commissioners Erin Toll of Colorado and Woody Girion of California, which typically draws fifteen to twenty audience attendees, enjoyed a crowd of around 100, consisting

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of regulators from a handful of states, executives of all the major title companies, members of the press and a substantial number of representatives of mortgage guaranty insurance companies. Those expecting a debate on the topic, an insight into future state regulation, or an indication of whether current scrutiny would extend to MI programs left disappointed.

Ms. Toll opened discussion by outlining how she had conducted her review of title reinsurance arrangements and why she believed they violated RESPA and state analogs. To summarize some of her key points on the alleged impropriety of the arrangements:

– If title loss ratios have traditionally been 7%, fair premium for 50% quota share reinsurance would be 3.5%, not 50%;

– If the reinsurance was valuable, it would have been listed on title companies' annual statement schedules for statement credit;

– She had found no record of any reinsurance claim having been paid; and

– Title companies have reported that there is no business necessity for captive reinsurance.

At the end of the public session, two consumer advocates asked the Working Group to consider title rates directly, instead of captive arrangements.

Unfortunately, the meeting did not shed any light on what actions California and Washington, both of which have requested information from title companies, may pursue, or whether yet more states may launch their own investigations. None of the Working Group members discussed or mentioned MI captive reinsurance, though press coverage in another Colorado paper suggests the Colorado Department has begun to consider action in this area.

In sum, we believe Vermont title reinsurance captives operate in compliance with the requirements of RESPA and their activities do not constitute illegal steering of business. The rates paid by consumers for title reinsurance are approved by state insurance regulators, and the existence of title reinsurance – through captives or otherwise – does not increase the cost to the consumer. Nonetheless, the list of states examining title reinsurance arrangements continues to grow, and it appears unlikely that title reinsurance captives will resume activity anytime soon. Few expect regulators to focus on underlying rates.

VERMONT UPDATE

Vermont licensed forty-three captives in 2004, down from the record-shattering numbers of the prior two years, but still enough to post the fourth best year ever for new captives. While some attribute the more modest growth to an approaching saturation of the captive marketplace, many of last year's initiatives were undertaken by well known global businesses, such as Wal-Mart Stores, Inc., Textron, Inc., Cinergy Corp., Whirlpool Corp. and Best Buy Co. Inc. Vermont was also busy streamlining existing captives, both by merging a number of programs owned by common parents and by winding up some

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inactive programs. This produced a year-end count of active captives at 524, maintaining Vermont as by far the largest on-shore domicile, with more than double the number of active captives of any two other U.S. domiciles combined.

Vermont's robust growth was mirrored on-shore by other states, such as South Carolina, Arizona and Nevada, which all had record-breaking years. Growth in the world's largest off-shore domiciles, Bermuda and the Cayman Islands, was also strong but short of record-setting. The British Virgin Islands set records by licensing 67 new captives, though its net growth was modest as a result of redomestication and liquidation.

ANNUAL SHAREHOLDER FINANCIAL STATEMENTS

We have recently been asked by a number of group captives what information must be distributed to their shareholders on an annual basis, and when.

Vermont law requires each corporation to furnish its shareholders annual financial statements by mail within 120 days after the close of each fiscal year. If an audit is performed, it must accompany the statements (it will in most cases be impossible to meet the 120 day deadline because captive audited financial statements are generally not released within that time frame).

We recommend sending shareholders the audited financial statements as soon as available. To gain some efficiency, and whenever reasonable, we recommend including the audited statements along with other materials sent to each shareholder in advance of the annual shareholders' meeting.

If you have any questions regarding the above requirements, please do not hesitate to contact us.

E-MAIL OPTION

If you would prefer to save a tree and receive your copy of the P&P Captive Newsletter by e-mail, please contact Kurt Lutes at (802) 223-2102 or by e-mail at klutes@primmer.com.

Primmer & Piper's captive team is comprised of: Jeffrey P. Johnson, James E. Clemons, Gary H. Barnes, Russell A. Young, Randall L. Wachsmann, Cassandra C. Larae-Perez, James F. Feehan, Cara Griswold, Laura Daudelin, Kurt Lutes, Angelina Buzzi, Lisa Geer and Benjamin Begins.

John L. Primmer is now of counsel to the firm, and remains active with Primmer & Piper's captive team.

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