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## HUD JOINS INVESTIGATION OF MI REINSURANCE

As we reported in March, the State of Minnesota has renewed and expanded its requests for information about the reinsurance of mortgage guaranty policies by lender-owned captive insurance companies. In 2005, the Minnesota Department of Commerce sent a series of requests to all of the primary mortgage insurance ("MI") companies, who ultimately produced limited categories of information. Now the U.S. Department of Housing and Urban Development ("HUD") has become involved.

By way of background, earlier this year Minnesota regulators sent a flurry of requests to the MI companies, and at least one captive management company located in Vermont. The current requests are substantially similar to the 2005 requests and generally seek information regarding the relationship between the MI companies and captives reinsuring mortgage guaranty policies. The requests are focused on premium cession arrangements, the actuarial basis for such arrangements, and loss projections. They also seek information related to the provision of written disclosures to

borrowers regarding the relationship between lenders, MI companies and captive reinsurance companies, as mandated by the Real Estate Settlement Procedures Act of 1974 ("RESPA") (26 U.S.C. § 2601 *et seq.*).

We understand that the recipients of these requests have raised objections to their form and scope, but have nonetheless forwarded limited categories of information to Minnesota without waiving those objections. The consensus among the MI companies is that recent extensive losses in the industry conclusively demonstrate that ample risk transfer exists in the reinsurance structures at issue. Although acquiescing to some extent, the MI companies are attempting to narrow the scope of these extremely broad requests in order to lessen the burden of responding.

Minnesota regulators attended the National Association of Insurance Commissioners Spring National Meeting and were accompanied by a representative of HUD's Minnesota office. HUD representatives are reported to be actively participating in the Minnesota Department of Commerce's investigation, including meeting with representatives of

the recipients of the document requests and Minnesota regulators. In early June, HUD's Office of Inspector General issued subpoenas demanding production of documents to a special agent in the Minneapolis HUD office. The HUD subpoena largely tracks the language and substance of the Minnesota document requests. We believe the HUD subpoena was issued to avoid jurisdictional objections that had been raised by the targets of Minnesota's requests, or to address restraints on information sharing between Minnesota and HUD.

Most observers believe the Minnesota regulators and HUD representatives do not fully appreciate the differences between mortgage guaranty insurance and title insurance, with which they had some experience a few years ago. It is hoped that a broad-based educational effort may be helpful, particularly if aimed at those more senior in the Minnesota Department. Ideally, that effort would include representatives of the mortgage banking community, the MI companies, and other states' insurance regulators who may have more experience with this unique type of insurance.

To date, we are not aware of any efforts by either the Minnesota Department of Commerce or HUD to serve comparable document requests on any captive reinsurers. In that event, we have advised our clients to consider carefully how to respond. Clients should also be aware that service providers may seek to pass on to them the costs of such responses.

## **VCIA CRITICAL ISSUES FORUM**

On June 11, 2008, the VCIA held a full-day Critical Issues Forum. One purpose of this Forum was to evaluate the state of

Vermont's captive insurance industry, including its regulatory infrastructure. The program was well timed given Len Crouse's retirement and enhanced competition from other U.S. domiciles.

The Forum began with a general session focused on the economic challenges confronting New England. In Vermont, employers are faced with an aging workforce and a shortage of qualified individuals to fill vacant positions. There was a discussion of efforts that could be undertaken to attract young workers to the captive industry. Participants noted, in particular, that Champlain College and the International Center for Captive Insurance Education ("ICCIE") have provided valuable training to professionals involved in the captive insurance industry.

Break-out sessions focused on innovations aimed at enhancing Vermont's ongoing efforts to foster excellence. Suggestions included making even greater use of technology to expedite both the financial examination process and review of Business Plan changes. Forum participants noted that the Vermont Department had consistently hired and retained a sufficient number of skilled employees to regulate the industry. There was general agreement that such practices should be continued, in good economic times and bad, if Vermont is to maintain its competitive edge. There was also robust discussion of potential statutory developments and changes that could be made in order to foster additional captive growth in Vermont.

It wouldn't be a Critical Issues Forum if a question or two was not raised about a possible premium tax reduction or relaxation of the Vermont annual meeting requirements. The good news is that

Vermont's "new" captive regulation team (David Provost, Peter Raymond and Sandy Bigglestone) indicated a willingness to look at all options, while noting that the Vermont Legislature would have to approve any statutory changes.

The Forum concluded on a positive note, summarizing for the attendees the many valuable suggestions made throughout the day, and the initial steps for possible implementation were set in motion. At 4:30 p.m., participants adjourned to begin festivities related to Len Crouse's retirement after more than 17 years of extraordinary service to the captive insurance industry.

## **ENDURING LESSONS FOR A SOFT MARKET**

*If we know anything about insurance markets, it is that they are cyclical. The article below first appeared in the May 1997 edition of our Newsletter. Authored by John Primmer, one of the founding members of our firm, it offers sage advice as pertinent today as it was 11 years ago.*

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The property and casualty industry has not seen a hard market for over a decade. One of the principal reasons for this is the development of many successful group captives, whose loyalties run to their policyholder/members. Ironically, some programs are falling victim to their own success, because the reaction of the traditional market has been to compete fiercely on the basis of price in an effort to regain market share. Unlike captives, these companies are not driven by long-term considerations, but instead are required to address the short-term issue of their own bottom line.

Price pressures are amplified by other factors, most evolving from the mere passage of time. Many group captives have now reached maturity and are experiencing greater loss development. Since most are mono-line companies, they do not have the capacity, as multi-line companies do, to subsidize losses with earnings from more profitable lines. Initial policyholders usually were required to commit to a program for a fixed time, say 3 to 5 years. Most of these commitments have now expired. Personnel turnover both in the captive and in the insured has been great, so that the camaraderie developed when the program was formed may now be lost.

The response by group captives has been mixed. Some remain keenly aware of the reasons for their existence, but are slow to react to the market, wrongly assuming their policyholders will remain loyal no matter what. Others have begun to lose sight of their origins, trying to act more like the competition, on price and otherwise. Neither of these approaches will serve the long-term interests of the members.

The group captives that will survive a permanent soft market are those that are able to maintain a healthy balance sheet while providing the best available products and services to their policyholders. In most cases, this cannot be done while trying to meet price competition. Unless the policyholders understand this, and also understand how their long-term best interests are served, they are not likely to remain loyal to the program. Obvious as this may be to those of us continuously involved in group programs, it is not a given to the policyholder. The captive needs to create and sustain an environment in which these understandings are implicit.

To preserve strong loyalty the captive needs to do at least three things, easily said, but more difficult to achieve. First, the captive must in fact provide the best products and services. Second, that fact must be communicated consistently to policyholders and prospects. And third, the captive must assure that policyholders realize they share a stake in the success of the enterprise.

The first requirement, quality products and services, should be the easiest. As a member-controlled company the captive should understand better than the competition the needs of the policyholders. Traditional competitors should be left at the starting block on issues such as coverages, underwriting, claims handling, loss prevention and other member services. One area of vulnerability is the inability of RRGs to provide other than liability lines. Some have overcome this by creating an affiliated agency or joint venture to market a comprehensive product or package. The challenge is to maintain control and to make sure that other parties involved are not simply trying to get a good look at your core business. It is essential to obtain contract provisions barring the use of proprietary information.

The second requirement, consistent communication with policyholders (and prospects), is more difficult. The essential message is that the captive (i) is different from the traditional company, (ii) was formed by and for the policyholders, and (iii) will be around when things get tough again. This message must be repeatedly communicated to the policyholder's risk manager, but it is also important to find a path to other management and any other person who might have influence on an "insurance" decision. It is commonplace

for brokers to approach members of the insured's governing board to let them know how much they could save by shifting insurance companies. Communication should not be left only to the marketing department. Some captives have developed systems utilizing the best possible medium to policyholders, namely other policyholders. Management should develop materials that are instantly accessible when a marketing issue arises, or can be used by directors and other insureds to communicate with colleagues. When an insured sends a letter praising the handling of a claim, copy it to all other policyholders. One CEO of a very successful group program recommends that there be at least four contacts with each policyholder per year.

The third and final requirement is to make sure policyholders realize they have a stake in the captive. In some programs nearly every policyholder will have claims, and depending on how they are handled, that may be enough to remind them of the captive's value and to overcome price disparities. But if the line of insurance involves very low frequency, the policyholder's only contact may be payment of annual premiums. This will not strengthen loyalty.

There are several ways to create a stake in the company. Encouraging broad policyholder participation, through annual or special member meetings, service on boards or committees, etc., has proven to increase loyalty (although, as with any other democratic process, it can get messy). But the most effective way to create a stake is to make sure policyholders can see the financial results of their participation. Many group captives maintain some form of member accounting system. Some involve "equity"

or liquidation valuation. Some look to individual experience. The accounting can produce immediate recognition – through rating or other credits, policyholder dividends, or even equity dividends – or the results can instead be deferred well into the future – upon withdrawal, liquidation, or (with an individual insured) retirement. Obviously the program should not create incentives for withdrawal, and a good system will reward longevity. But the underlying fact is that if anyone “owns” the captive, it is the policyholder. Recognizing this fact before liquidation may help assure that there won’t be one.

The key to policyholder loyalty is not to fall into the trap of price competition, but to keep the policyholder convinced of the current benefits and long-term rewards of staying the course.

## **PPEC EXPANDS ITS INSURANCE PRACTICE**

Primmer Piper Eggleston & Cramer is pleased to announce the addition of two new attorneys to its insurance team. Greg Clayton and Greg Eaton, admitted to practice in New Hampshire and Vermont, have extensive experience in trial work primarily related to property, casualty and commercial lines of insurance. Both are based in our new Littleton, New Hampshire office.

Greg Clayton, a graduate of Georgetown University Law Center, completed his undergraduate degree, cum laude, from Dartmouth College. He enjoys a Martindale-Hubbell Peer Review ranking of A-V. He is also admitted to practice in Maine.

Greg Eaton earned his law degree, summa cum laude, from Vermont Law

School in 1993, after obtaining his bachelor’s degree, magna cum laude, from Boston College and earning a Master’s degree from the University of Massachusetts. He is also admitted to practice in Massachusetts.

Greg and Greg greatly enhance the PPEC insurance coverage practice. Both also have significant experience with commercial general liability coverage questions. They join Gary Barnes, Gary Karnedy and Andrew Braley in advising clients on insurance and reinsurance coverage and claims handling issues.

## **WHAT TO LOOK FOR IN CLAIMS ADMINISTRATION**

Claims administration plays a critical role in the financial success or failure of any insurer. Here are a few issues to consider in evaluating a claims administrator or claims administration firm:

*Reserve Setting (and Updating) Practices.* Perhaps the single most important function of a claims administrator is to set reserves for each claim that is reported to the insured, and to do so on a timely and consistent basis. Reserves are essential to the financial reporting function. Without realistic and consistent reserves, insurers may face substantial, swift and persistent adjustments to their financial results.

Unlike most businesses, insurers sell a product without knowing what the product costs. With actuarial assistance, insurers make educated estimates of cost, upon which they rely in setting rates. Actuaries, in turn, must necessarily rely on loss data, typically the insurer’s reserves and the adequacy of those reserves. From the insurer’s perspective, it is important that the claims administrator set reserves

early, and establish reserves within a reasonable time. Although it may be convenient to impose an arbitrary initial reserve as a “placeholder”, a realistic reserve should be set within a time frame that allows for adequate initial investigation and assessment of the likely ultimate defense and indemnity cost for each matter. “Stair-stepping” (i.e., adjusting reserves frequently in increments) should be discouraged.

Equally important is consistency in reserve setting philosophy (i.e., each claims administrator should reserve cases the same way, with the same goals). With discipline in the reserve setting process, insurers will find that their financial reporting will be more consistent and reliable, and will derive important cost information with the conclusion of each claims year. With delayed or inconsistent reserve practices, insurers will find, sometimes too late, that prior years’ profits were overstated, and premium charges were insufficient.

#### Use of Adjusters – Early Resolution.

What is the claims administrator’s responsibility for resolving claims early? Experienced claims administrators advise that claims do not age well. The sooner a claim or an incident can be resolved, the better. This follows because, with time, claimants start to think that their claims are worth more. Sometimes emotion overtakes reason, and the result is protracted litigation and unrealistic expectations. In contrast, a problem addressed early, and fairly, eliminates protracted litigation, addresses the most important money issues for the claimant, and allows for the insured to maintain better relationships with its claimants. Insurance adjusters can be useful in reaching early resolution, and helping to

resolve claims without the increased costs of over-lawyering. Does your claims administrator use adjusters?

#### Early and Continuous Settlement Evaluations.

A corollary to the use of adjusters is that the claims administrator should both early and continuously be on the lookout for settlement opportunities. Because claims seldom get cheaper to resolve as they age, effective claims administrators aggressively seek settlement opportunities. After an incident is reported, and before suit is filed, is an excellent time for a claims administrator to contact the claimant to find out what the issues are, bring in expertise to figure out efficient remedies, and discuss settlement with the claimant. Does your claims administration agreement require this?

#### Who Manages the Defense?

Not surprisingly, defense counsel, once hired by an insurer to defend an insured, may perceive a financial interest that is at odds with the insurer. The longer a case remains pending, the more legal work can be done, and the more money the defense counsel can make. Responsible defense counsel see the insurer as a source of repeat business and seek ways to get the case into a settlement posture, instead of looking for more ways to generate legal fees. Regrettably, not all defense counsel take this view, and it is the job of the claims administrator to manage the defense effort. Effective case management requires that defense counsel submit a defense plan or budget, with reasonable explanations for the timing and substance of the work to be done. With effective claims management, the defense counsel has a plan and has objectives for every activity undertaken. Ineffective claims administration has no such overall game plan, and instead

focuses on after-the-fact “bean counting” (“Why did you spend 2.3 hours on that motion, when it should have taken 2.1 hours?”). Does your claims administrator have a game plan for each case and understand his responsibility, on a strategic level, to manage the defense consistent with the game plan?

Coverage Denials and Reservations of Rights. For captives, coverage questions are less frequent than with traditional carriers, but not unknown. Does your claims administrator know your policy well enough to spot those issues? Does your claims administrator have access to underwriting files so that close questions can be examined with reference to the communications made when the application was completed and the content of the policy was considered by the underwriters? Does your claims administrator have access to competent coverage counsel, who can review proposed coverage denials before they become mega-million “bet the company” coverage denial and “bad faith” cases?

Coverage denial is serious business, as plaintiffs can use it to their advantage. Here is how it works. The Plaintiff sues the insured for mega-millions, far beyond policy limits, then offers to settle within policy limits. The insurer refuses, denying that coverage exists. The policyholder demands the insurer settle, or face a breach of contract lawsuit for wrongly denying coverage. If the insurer still declines coverage, the plaintiff settles with the policyholder for the full amount of plaintiff’s claim, agreeing to look solely to the insurer for payment, and gets from the insured an assignment of the insured’s breach of contract claim against the insurer. Then the original plaintiff hits the jackpot, for a judgment that exceeds the

amount of the coverage in question, if it convinces the court that coverage denial was a breach of the insurance contract. Your claims administrator needs to fully understand the terms of your policy, and have access to competent legal advice for coverage issues.

Even a wholly-owned captive needs to ascertain proper coverage, at peril of having its reinsurer refuse to pay reimbursement. Your claims administrator therefore needs to know when to say “No.” Not every claim or incident is covered, and someone needs to be certain that a defense is extended, and indemnity protection provided, only for covered claims. Some claims or incidents are properly the obligation of a prior insurer. Some are not covered under one policy form, but belong to the insurer who has insured under a different form. And some claims, particularly those made under a claims made policy form, are untimely. Other claims may implicate an express exclusion, or may not be within the scope of the insuring agreement, or may violate one of the policy’s conditions.

Many claims administrators defer coverage questions by using so-called “reservation of rights” letters, which purport to reserve the question of coverage until a later day. But such letters may have unintended consequences. Some states (including Vermont) disallow insurer-issued, unilateral reservation of rights letters, and hold that they are ineffective. Without an effective reservation of rights, an insurer who provides a defense is deemed to have accepted coverage and waived coverage defenses. In many states, issuance of a reservation of rights letter triggers a policyholder’s right to defend itself using its counsel of choice and making its own

strategy decisions, all at the insurer's cost. Some states modify the insured's duty to cooperate with the insurer, once the reservation of rights is issued.

Accordingly, intelligent claims administrators carefully weigh the question of coverage as each claim or incident is reported, and use coverage counsel for close calls. Reservation of rights letters should be issued with caution, and used only in jurisdictions where permitted.

*Reinsurance Reporting.* One of the best ways to lose reinsurance coverage is to ignore reporting responsibilities under reinsurance treaties. An otherwise valid claim for reinsurance reimbursement can be lost if not timely reported. If reporting to reinsurers is to be the responsibility of your claims administrator, that should be spelled out in the claims administration contract. Also, caution may dictate that you question how your claims administrator keeps track of reinsurance reporting requirements and assures compliance.

PPEC's insurance coverage lawyers advise insurers on claims administration and coverage issues, and have significant insurance coverage trial experience. We have successfully defended insurance coverage positions for insurers in federal courts (including Bankruptcy Court) on a nationwide basis.



## **NEWS FROM THE VERMONT STATE HOUSE: LEGISLATURE ADJOURNS**

The 2007-2008 Vermont General Assembly adjourned for the biennium on May 3. The Legislature moved quickly

through several dozen bills in the last days of the session and adjourned a week or two earlier than expected. Legislative leaders chose not to reconvene in the event of a gubernatorial veto, and will allow any vetoes to stand unchallenged. The Democratically-controlled Legislature may use vetoed bills as points in the November election, which is highlighted by a campaign to unseat the Republican Governor.

The dominant theme of this session was the State's declining fiscal situation. In April, forecasts showed revenue shortfalls in the State's General and Transportation funds. This confirmed the fears of many and had a direct impact on proposed legislation. Initiatives such as expanding a state-run health care program for the uninsured to small businesses and others, revising education finance to lessen the reliance on the local property tax, making improvements to the State's transportation infrastructure, and others were quickly shelved.

Declining revenues also had an impact on the overall tone of the General Assembly and its relations with the Executive branch. But for a few instances of partisan bickering, the session saw many compromises between the Legislature and the Administration in an effort to advance noncontroversial legislation, reach agreement on a balanced budget, and adjourn in a timely manner.

One non-controversial item was the approach to a series of amendments related to captive insurance. Senate Bill 284 (now Act 178) was one of several that passed the Legislature in the days prior to adjournment. The omnibus bill contains several technical amendments to the laws under the jurisdiction of, and subject to

regulation by, the Vermont Department of Banking, Insurance, Securities and Health Care Administration, including several captive insurance issues. First, the scope of financial institutions permitted to issue capital letters of credit for captive insurance companies is broadly expanded to include any bank approved by the Commissioner. Second, a provision streamlining the process for merging, consolidating or converting a captive entity is added. Specifically, the Commissioner may issue a Certificate of General Good to permit the formation of a captive insurance company that is established for the sole purpose of merging with or assuming insurance or reinsurance business from a Vermont licensed captive insurance company. The Commissioner received additional authority to waive or modify filing requirements of the newly formed captive since under this transaction that information is already known to the Commissioner. Third, authority was granted to the Commissioner to reduce by fifty percent the amount of the bond required of an attorney-in-fact of a domestic reciprocal insurer when the attorney-in-fact is not under common ownership or control with a reciprocal insurer and the Commissioner finds sufficient evidence of financial responsibility.

Clarifying amendments were also made to last year's law enabling the formation of special purpose financial captives ("SPFCs"). The amendments provide, in the case of SPFC sponsored captives, greater certainty in the segregation of the risks assumed and the securities issued on behalf of each cell in the formation and operation of the SPFC. In addition, the amendments clarify the application of insurance insolvency laws in the event an SPFC formed as a sponsored captive becomes insolvent. The amendments protect the financial interests of any solvent cell despite the insolvency of other cells in the SPFC or the captive itself. The bill was signed by the Governor in a public ceremony on May 28, and its captive provisions become effective July 1, 2008.

We will continue to report on the General Assembly and the status of captive insurance initiatives in future issues.

#### **E-MAIL OPTION**

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