

STATE CORPORATION COMMISSION

AT RICHMOND, JUNE 13, 2005

COMMONWEALTH OF VIRGINIA

At the relation of the

STATE CORPORATION COMMISSION,
Applicant,

v.

CASE NO. INS-1994-00218

HOW INSURANCE COMPANY,
A RISK RETENTION GROUP,
HOME WARRANTY CORPORATION,
and
HOME OWNERS WARRANTY CORPORATION,
Respondents.

ORDER APPROVING PLANS OF LIQUIDATION

On October 14, 1994, the Circuit Court for the City of Richmond entered its Final Order Appointing Receiver for Rehabilitation or Liquidation (the "Receivership Order"), which appointed the State Corporation Commission (the "Commission") as Receiver, Steven T. Foster, the Commissioner of Insurance, as Deputy Receiver, and Patrick H. Cantilo as Special Deputy Receiver, and authorized and directed them to administer the business and affairs of HOW Insurance Company, a Risk Retention Group ("HOWIC"), Home Owners Warranty Corporation ("HOW"), and Home Warranty Corporation ("HWC") (collectively, the "HOW Companies"), and to do all acts necessary or appropriate for the rehabilitation or liquidation of the HOW Companies. On May 1, 1996, by Order of this Commission, Alfred W. Gross succeeded Steven T. Foster as Commissioner of Insurance and Deputy Receiver of the HOW Companies. As a result of the receivership, the affairs and business of HWC are administered by the Receiver, the Deputy Receiver, and the special Deputy Receiver, who are vested with all the powers and authority expressed or implied under the provisions of Title 38.2, Chapter 15 of the Code of Virginia.

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On November 30, 2004, Alfred W. Gross, as Deputy Receiver of the HOW Companies, filed with the Clerk of the Commission his Application for Orders Setting Hearing on Plans of Liquidation of HOW Insurance Company, a Risk Retention Group, Home Owners Warranty Corporation, and Home Warranty Corporation, Establishing Response Date, Approving Plans of Liquidation, Approving Claims Bar Date, and Related Matters (the "Application"), seeking a hearing for the Commission's review and approval of plans of liquidation for the HOW Companies (the "Plans of Liquidation") and matters related thereto.

In the Application, the Deputy Receiver discusses the financial condition of the HOW Companies and the Plans of Liquidation, including the current and anticipated liabilities, the disposition of remaining assets including the costs of administration, the return of capital contributions, and the distribution of residual assets. The Deputy Receiver also requests an order declaring that the rights, interests, and contingent claims of all builders, policyholders, certificate holders, and creditors of the HOW Companies be fixed as of the date of the entry of the liquidation order, declaring that the only former members of HWC who are entitled to any refund of capital contributions are those described in the Application, and declaring that those persons entitled to any residual assets are builders with active insurance policies as of the date of the Receivership Order. He further requests authority to establish a deadline for filing all claims ("Bar Date") and approval of the proposed notice procedures related to the claims Bar Date. Finally, he requests approval to terminate the receivership proceedings without the necessity for further order of the Commission upon completion of the liquidation and dissolution of the HOW Companies pursuant to the Plans of Liquidation.

On December 27, 2004, the Commission entered an Order Setting Hearing on Plans of Liquidation for HOW Insurance Company, a Risk Retention Group, Home Owners Warranty Corporation, and Home Warranty Corporation, Establishing Response Date, Approving Plans of

Liquidation, Approving Claims Bar Date, and Related Matters ("Order Setting Hearing"). The Order Setting Hearing scheduled a hearing for May 17, 2005, to determine whether further efforts to rehabilitate the HOW Companies would be useless such that the Plans of Liquidation should be approved. The Order Setting Hearing also required the Deputy Receiver to send notice and a copy of the Order Setting Hearing to all builders who at one time were members of HWC, to the owners of all homes that are currently enrolled in the HOW Program, and to known creditors of the HOW Companies. The Notice was also to be published in the Richmond Times-Dispatch, the Wall Street Journal, and USA Today. We also directed the Deputy Receiver to file with the Commission prepared testimony and exhibits of each witness expecting to present direct testimony in support of the Application. The Order Setting Hearing also directed the filing of Notices of Participation by Respondents and Respondent Testimony, and provided an opportunity for rebuttal testimony by the Deputy Receiver.

On February 25, 2005, the Deputy Receiver prefiled the testimony and exhibits of Alfred W. Gross, Mike R. Parker and Theodore J. Zubulake. On March 15, 2005, the Deputy Receiver filed his First Supplement to his prefiled direct testimony in which he withdrew certain exhibits previously filed and submitted supplemental exhibits in support of the application.

By March 25, 2005, the Commission had received Notices of Participation from Paul Hollinger, Stephan Levine and M.D.C. Holdings, Inc. ("MDC"). Mr. Hollinger and Mr. Levine indicated that they did not plan to appear at the hearing but both seek relief from the HOW Companies for roofing problems with their homes. Mitchell and Lori Langsner also filed a letter in the case noting that they have an outstanding claim and seek a settlement.¹

¹ The Commission addressed this claim in an Order in Case No. INS-1995-00218 issued on April 27, 2005, which found that the Langsners had been fully compensated as to their direct and indirect claims. The Order further noted that any payment of interest compensation deemed owed to the Langsners may be considered by the Commission in a subsequent case or addressed in this proceeding. The Deputy Receiver's Plans of Liquidation do address payment of interest.

In MDC's Notice of Participation, it urges the Commission to eliminate the "fixed component" proposed by the Deputy Receiver for allocation and distribution of 50% of the residual assets of HWC, as described in Exhibit A.1 to the Plans of Liquidation. In the Application, the Deputy Receiver proposes to distribute 50% of any residual assets among all *Builder Distributees*² on a per capita basis (the "fixed component"). The remaining 50% of any residual assets would be distributed among the Builder Distributees in accordance with their relative contributions to the presumed profitability of the HOW Companies (the "variable component"). MDC requests that all of the residual assets be allocated and distributed among the Builder Distributees in accordance with the "profitability contribution" formula, or variable component.

On April 21, 2005, MDC filed a letter with the Clerk stating that it did not intend to present witness testimony or exhibits at the hearing, but reserved the right to cross-examine the testimony and exhibits of the Commission staff and other parties and present oral argument at the hearing.

On April 29, 2005, Centex Homes ("Centex") filed a Motion for Late Filing of Notice of Participation ("Motion") and Notice of Participation as Respondent. We granted Centex's Motion by Order dated May 6, 2005, and accepted the late Notice of Participation. Like MDC, Centex objects to the "fixed component" of the residual asset allocation and requests that all residual assets be allocated according to a variable component. Centex is represented by the same counsel as MDC, and stated that it did not intend to present testimony at the hearing, but reserved the right to cross-examine testimony and present oral argument.

² The Deputy Receiver believes that the builders with active insurance policies as of the date of this Order are considered HWC's owners, and the builders with active insurance policies as of the date of the Receivership Order should be deemed owners of HWC. These builders are referred to in the Application as "Builder Distributees."

The hearing convened as scheduled on May 17, 2005. Patrick H. Cantilo, Esquire, and Howard W. Dobbins, Esquire, appeared on behalf of the Deputy Receiver, Peter B. Smith, Esquire, appeared on behalf of the Bureau of Insurance, and Patricia E. Bruce, Esquire, and Scott D. Albertson, Esquire, appeared on behalf of MDC and Centex. At the hearing, the Commission received evidence in support of the Plans of Liquidation from the Deputy Receiver through its three witnesses. Counsel for MDC and Centex cross-examined the Deputy Receiver's witnesses regarding the proposed allocation methodology for residual assets. At the conclusion of the hearing, counsel for the Deputy Receiver and Centex and MDC presented closing arguments in lieu of briefs.

NOW THE COMMISSION, having considered the record and the evidence presented at the hearing in this case, finds that further efforts to rehabilitate the HOW Companies would be useless, and that the HOW Companies should be liquidated pursuant to the Plans of Liquidation, subject to a modification of the percentage allocation of residual assets to Builder Distributees as discussed herein. We will also authorize the Deputy Receiver, in his reasonable discretion, to establish by directive a period for filing proofs of claims against the HOW Companies, such filing period to end on the Bar Date. Finally, we will direct the Deputy Receiver, upon completion of the liquidation and dissolution of HOW, HOWIC, and HWC pursuant to the Plans of Liquidation, to file a request with the Commission for approval to terminate and close this receivership proceeding.

Regarding the distribution of residual assets to Builder Distributees, we believe that a more reasonable allocation of residual assets is 25% on a per capita basis, or fixed component, and 75% based on the profitability contribution, or variable component. At the hearing, the Deputy Receiver testified that since he could not find a prescribed method of allocation for the residual assets in a risk retention group, he analogized these transactions to the demutualization

of mutual insurance companies in which there is generally both a fixed and variable component.³ He stated that he had no reason to weigh one component more than the other, so he proposed a 50/50 split of the assets between the two components.⁴ The Deputy Receiver explained that the purpose of the fixed component is to provide some compensation for voting rights and other rights of membership.⁵

Theodore J. Zubulake, a consulting actuary for the HOW receivership, testified as to the fairness of the proposed methodology for distributing the residual assets to the builder distributees. Mr. Zubulake believes that the 50/50 allocation is fair because at the time the HOW Companies were put into receivership, there was no value attributable to the companies.⁶ It was only through the efforts of the Deputy Receiver, he stated, that the HOW Companies ended up with a positive surplus in 2004.⁷ However, on cross examination, Mr. Zubulake stated that in his experience with mutual company demutualizations, the fixed component for distribution has ranged from 15 to 26 percent.⁸ He admitted that he was not familiar with any demutualizations where the fixed component was higher than 26 percent.⁹

Although we do not regard this liquidation proceeding as perfectly analogous to the demutualization context, we find that an acceptable allocation falls within the range to which the Deputy Receiver's expert testified. According to Mr. Zubulake, in demutualizations in which he has been involved, a fixed component generally ranges from 15 to 26 percent.¹⁰ We are also

³ Transcript at 37 (Tr.).

⁴ Id.

⁵ Tr. at 38.

⁶ Tr. at 132.

⁷ Id.

⁸ Tr. at 129.

⁹ Id.

¹⁰ Id.

persuaded by the "fairness argument" raised by MDC and Centex—namely, that those builders who caused the HOW Companies to suffer losses should not be able to share equally in the distribution of residual assets via the fixed component. We therefore find that a reasonable and fair allocation of assets to Builder Distributees is 25% on a per capita basis, or fixed component, and 75% based on the profitability contribution, or variable component.

Accordingly, IT IS ORDERED THAT:

(1) Further efforts to rehabilitate the HOW Companies would be useless, and the HOW Companies should be liquidated pursuant to the Plans of Liquidation, as modified herein and discussed in Ordering Paragraph (2) below.

(2) With regard to the Distribution of Residual Assets to Builder Distributees, the Deputy Receiver shall modify the Plans of Liquidation to allocate 25% of the assets on a per capita basis, or fixed component, and 75% of the assets based on the profitability contribution, or variable component.

(3) We hereby authorize the Deputy Receiver to adopt a directive implementing the HOWIC Plan of Liquidation, described in Exhibit A to the application as modified herein, if and when he files a written report with the Commission advising that he has received an actuarial projection that HOWIC has sufficient assets to satisfy its liabilities and to declare a dividend to HWC sufficient for HWC to satisfy its liabilities, including the refund of all vested capital contributions.

(4) If the Deputy Receiver does not issue a directive adopting the HOWIC Plan of Liquidation within three years of this Order, he shall return to the Commission for further instruction.

(5) Once the Deputy Receiver adopts the HOWIC Plan of Liquidation and completes the actual liquidating distributions from HOWIC to HWC pursuant thereto, he shall issue a second

directive adopting the HOW/HWC Plan of Liquidation, described in Exhibit A to the application, as modified herein.

(6) The rights, interests, and contingent claims of all builders, policyholders, certificate holders, and creditors of the HOW Companies are fixed as of the date of the entry of this Order.

(7) The only former members of HWC who are entitled to any refund of capital contributions pursuant to the Builder Agreements are those whose capital contributions vested pursuant to the terms of the Builder Agreements and who either: (i) after the inception of the receivership, had their Builder Agreements automatically terminated during 1994 and 1995 upon expiration of their Builder Agreements' one-year terms; (ii) voluntarily terminated their Builder Agreements either before inception of the receivership or prior to the date that such Builder Agreements would have terminated automatically during 1994 or 1995 upon expiration of their one-year terms, and who at the time of termination had been members in good standing for at least five consecutive years (collectively, "Eligible Builders"); (iii) were Member Builders in good standing as of October 14, 1994, but who had not been members in good standing for at least five consecutive years as of the date their Builder Agreements were terminated automatically for non-renewal because of the receivership; or (iv) were Member Builders who were terminated only for filing bankruptcy prior to the receivership, since their terminations were pursuant to so-called *ipso facto* clauses which federal bankruptcy courts have held are void as a matter of law.

(8) The HOW Companies' owners, who are entitled to any Residual Assets upon dissolution, are those persons who were HOWIC insureds as of the date of the Receivership Order (regardless of whether those persons are also Eligible Builders). Each such Builder Distributee shall receive a share of any Residual Assets pursuant to the Plans of Liquidation as modified herein by Ordering Paragraph (2).

(9) The Deputy Receiver, in his reasonable discretion, shall establish by directive a period for filing proofs of claims against the HOW Companies, such filing period to end on the Bar Date (such Bar Date to be no less than 180 days, nor more than 365 days, following the date of the Deputy Receiver's issuance of the directive). All claims (including contingent claims, claims of Eligible Builders for refunds of capital contributions, and claims for increased percentage payments on previously approved claims) against the HOW Companies would be required to be filed before the Bar Date except that the following claims would not be subject to the Bar Date: (i) claims of any kind that have already been submitted properly to the Deputy Receiver, whether general creditor claims, claims for repairs of Major Structural Defects, claims for payment of builder defense costs, claims for breach of warranty, or any other claims, except that, to the extent that a claimant has not submitted the affidavit required to perfect a claim for an increased percentage payment of an approved claim pursuant to a Distribution Notification, such claim for an increased percentage payment of a previously approved claim shall be subject to the Bar Date, (ii) proper administrative expense claims (i.e., claims for payment of services rendered, or goods supplied, to the HOW Companies at the request of the Deputy Receiver after October 14, 1994), (iii) claims covered by HOW Companies' policies and certificates for the repair of covered Major Structural Defects that have not yet manifested themselves as of the Bar Date, (iv) claims by builders for refund of Loss Reserve Deposits, or release of letters of credit, and (v) claims by Builder Distributees to a share of the Residual Assets. Claims submitted after the Bar Date, if approved, would be subordinated in payment to all timely filed claims, with the exception of the claims described in categories (i) through (v) above, which would not be subject to the Bar Date. All claims of whatsoever nature would be permanently barred from sharing in the assets of the HOW Companies if such claims were not submitted to the Deputy Receiver

before closure of the receivership, with the exception of claims described in category (v) above, which would be governed by the unclaimed property laws.

(10) Disputes concerning any claims against the assets of the HOW Companies shall be resolved in accordance with the Receivership Appeal Procedure adopted by the Circuit Court in the Receivership Order.

(11) The Deputy Receiver may, in his reasonable discretion as part of the Plans of Liquidation, extend the initial Bar Date by directive to a date no more than 365 days following the date of the directive establishing the initial Bar Date, if the initial Bar Date results in a filing period of less than 365 days.

(12) We hereby approve the Deputy Receiver's proposal to provide written notice of the Bar Date (and any extension thereof) and proof of claim instructions, by first-class United States mail to all known claimants, creditors, and former Member-Builders at their last known address disclosed in the books and records of the HOW Companies, in a form reasonably calculated to provide interested persons with notice of the proposed Bar Date (and any extension thereof), and the consequences of failing to timely file claims against the HOW Companies, except that the Deputy Receiver is not required to mail a notice if he reasonably believes that the last known address is no longer valid.

(13) We hereby approve the Deputy Receiver's proposal to publish notice of the Bar Date (and any extension thereof) and proof of claim instructions for one day each week for two consecutive weeks in the Richmond Times-Dispatch, The Wall Street Journal, and USA Today. The public notice should be of a form reasonably calculated to provide sufficient notice to any claimant, creditor, or former Member-Builder who does not receive direct notice by first-class United States mail of the Bar Date (and any extension thereof) and proof of claim instructions.

(14) Upon completion of the liquidation and dissolution of HOW, HOWIC, and HWC pursuant to the Plans of Liquidation, the Deputy Receiver shall file a request with the Commission for approval to terminate and close this receivership proceeding.

(15) This matter is continued generally.

AN ATTESTED COPY hereof shall be sent by the Clerk of the Commission to:
Patrick H. Cantilo, Special Deputy Receiver, HOW Insurance Company, In Receivership, P.O. Box 184, Austin, Texas 78767-0184; Ronald H. Garber, Esquire, Boxley Bolton & Barger, LLP, 227 West Main Street, P.O. Drawer 1429, Raleigh, North Carolina 27602; Paul Hollinger, 55 Raisin Tree Circle, Baltimore, Maryland 21208; William A. Broschious, Esquire, Kepley Broschious, 7201 Glen Forest Drive, Suite 102, Richmond, Virginia 23226; Stephan J. Levine, 57 Raisin Tree Circle, Baltimore, Maryland 21208; Mitchell and Lori Langsner, 3 Becket Court, Princeton Junction, New Jersey 08550; Patricia E. Bruce, Esquire, Capsalis Bruce & Reaser, PLC, 2200 Wilson Boulevard, Suite 800, Arlington, Virginia 22201; and the Commission's Office of General Counsel and Bureau of Insurance.