

EXHIBIT A.1

RESIDUAL ASSETS ALLOCATION MEMORANDUM

TABLE OF CONTENTS

I. OVERVIEW 1

II. BASIC PRINCIPLES AND METHODOLOGY 1

 A. Introduction 1

 B. General Methodology for Distribution(s) of Residual Assets 3

 C. Assumptions and Practices 6

 D. Detailed Methodology 7

RESIDUAL ASSETS ALLOCATION MEMORANDUM

I. OVERVIEW

This memorandum describes the methodology for calculating each Builder Distributee's allocated share of any Residual Assets remaining upon the liquidation of Home Warranty Corporation ("HWC"), including each Builder Distributee's share of any interim distribution of assets, pursuant to the plan of liquidation for HWC (the "HWC Plan of Liquidation").

The methodology described herein is intended to provide a fair and equitable allocation of any Residual Assets among the Builder Distributees.¹

Capitalized terms used in this Exhibit have the meanings ascribed to them in the HWC Plan of Liquidation, in the Deputy Receiver's Application for Approval of the HWC Plan of Liquidation, or in this Exhibit.

II. BASIC PRINCIPLES AND METHODOLOGY

A. Introduction

Upon liquidation of HWC, Residual Assets are expected to remain.² Those Residual Assets will be allocated among, and distributed to, the Builder Distributees, in one or more installments, as follows:

1. The Main Distribution

The Main Distribution will account for the bulk of any Residual Assets. The Main Distribution will be calculated as of December 31st of the calendar year in which the last HOWIC policy expires or a subsequent date chosen by the Deputy Receiver at his sole discretion. However, the Main Distribution shall be calculated as of a date no later than December 31st of the calendar year immediately following the year in which the last outstanding HOWIC insurance/warranty claim is finally settled or adjudicated (the "Claims Resolution Date"). If, in his sole discretion, the Deputy Receiver selects the Claims Resolution Date as the calculation date for the Main Distribution, the Main Distribution will be the ultimate distribution and no subsequent Final Distribution (see below) will be necessary. Alternatively, the Deputy Receiver may, at his sole discretion, select for the Main

¹ See In re Reorganization of Medical Inter-Ins. Exchange of New Jersey, 746 A.2d 25, 33, 36 (N.J. Super. Ct. App. Div. 2000) (affirming hearing officer's finding that insurance company's allocation plan was fair, where a company officer testified, albeit without the benefit of an actuarial opinion, that the allocation plan was a fair and reasonable compromise between a potentially unfair approach and a practically impossible approach).

² Pursuant to the HWC Plan of Liquidation, capital contributions are refunded to Eligible Builders pursuant to the terms of the Builder Agreements as a contractual matter, before the calculation and distribution of any Residual Assets.

Distribution a calculation date earlier than the Claims Resolution Date. In that event, a subsequent Final Distribution may be required after all HOW Companies' losses, expenses, and other liabilities have been paid in full and HWC may be finally liquidated. The detailed methodology for calculating the Main Distribution is described in Part II.D, *infra*.

2. Interim Distribution(s)

At his sole discretion, the Deputy Receiver may, after giving consideration to assets available, anticipated losses and expenses, and other relevant factors:

- a. direct that one or more per Interim Distribution(s) be made to all Builder Distributees prior to the Main Distribution,
- b. limit any Interim Distribution(s) to Builder Distributees who do not have open claims,
- c. decide that no Interim Distribution(s) shall be made, and/or
- d. either calculate the Interim Distribution(s) pursuant to the detailed methodology described in Part II.D, *infra*, or limit any Interim Distribution(s) to a partial advance of his best estimate of what will be the Fixed Component of the Main Distribution (in which case the Deputy Receiver shall deduct any amounts owed to the HOW Companies by Builder Distributees for loss participation or other items).

3. The Final Distribution

In the event that the Main Distribution is made before the Claims Resolution Date, a subsequent, Final Distribution may be necessary. Any such Final Distribution will be made after all HOW Companies' losses, expenses, and other liabilities have been paid in full, upon the final liquidation of HWC, in order to distribute any remaining loss reserves and any remaining portion of the \$10 million contingency reserves. The detailed methodology for calculating any Final Distribution is described in Part II.D, *infra*.

4. Deputy Receiver May Withhold Distributions Pending Receipt of Loss Participation Payments

The Deputy Receiver may withhold any and all distributions from a Builder Distributee until such time as the Builder Distributee settles any outstanding claims of the HOW Companies against the Builder Distributee for loss participation payments.

5. All Distributions Net of Costs

Prior to making any distribution of Residual Assets, the Deputy Receiver shall deduct an amount sufficient to meet the expenses of calculating and making the distribution (the “Distribution Administration Costs”). If the Distribution Administration Costs exceed the amount of assets available for distribution prior to deduction of the Distribution Administration Costs, the Deputy Receiver shall return to the Commission for further guidance. If, in the Deputy Receiver’s sole determination, the amount of assets available for distribution exceed the Distribution Administration Cost by such a small amount as to render any resulting distribution *de minimis*, the Deputy Receiver shall return to the Commission for further guidance.

B. General Methodology for Distribution(s) of Residual Assets

The first distribution of Residual Assets will be either an Interim Distribution or the Main Distribution and is referred to herein as the “First Distribution,” except that the term First Distribution shall not include any Interim Distribution which, at his sole discretion, the Deputy Receiver limits to partial advances of his best estimate of what will be the Fixed Component of the Main Distribution (see Part II.A.2, *supra*). A portion of the First Distribution will be allocated among the Builder Distributees based upon their relative estimated contributions to the Residual Assets (the “Variable Component”). The remainder of the First Distribution will be allocated among the Builder Distributees on a per capita basis (the “Fixed Component”). Fifty percent (50%) of the First Distribution will be dedicated to the Fixed Component, and the remaining fifty percent (50%) will be dedicated to the Variable Component.

The Fixed Component is intended to compensate Builder Distributees for intangible attributes of membership in HWC, including the right to vote for directors and to vote on other important matters. The Fixed Component takes into account HWC’s voting policy, pursuant to which each Builder Distributee had an equal right to vote.³ Accordingly, the Fixed Component will

³ Not every participating HOW builder was a HOWIC policyholder or a HWC member entitled to vote. Article III of HWC’s Bylaws provided, *inter alia*:

Section 1. *Authorized Membership.* The authorized membership of the Corporation shall consist of registered participants in the Home Owners Warranty program.

Section 2. *Application for Membership.* Application for membership shall be presented to the Corporation and shall be acted upon promptly. All applicants who are found acceptable shall enter into a Builder Agreement with the Corporation or Home Owners Warranty Corporation.

In the case of affiliated builders, the parent builder was the sole policyholder of the HOWIC policy, and the Builder Agreement was executed only by the parent builder. The Builder Agreement provided, *inter alia*:

be distributed equally among the Builder Distributees regardless of the number of homes enrolled by each Builder Distributee and its affiliates.

The Variable Component is intended to take into account that individual Builder Distributees made unequal “profitability contributions” (positive or negative) to the HOW Companies, depending upon the claims history on the homes enrolled by each Builder Distributee and its affiliates. Accordingly, the Variable Component is allocated on the basis of the Builder Distributees’ relative profitability contributions to the HOW Companies. The profitability contributions are calculated on an individual policy basis because policy-specific data is available in the records of the HOW Companies. The first year for calculation of the Variable Component is 1982, because that is the first year in which HOWIC became the underwriter for the Program.

Conceptually, each Builder Distributee’s annual profitability contribution is estimated from the total cash inflows to the HOW Companies, less the total cash outflows from the HOW Companies, attributable in that year to homes enrolled by the Builder Distributee and its affiliated builders: (1) On the positive side, the inflows credited in the methodology consist of enrollment premiums and administrative fees received, (2) on the negative side, the outflows debited in the methodology are losses paid, including allocated loss adjustment expenses (“LAE”), (3) for the year in which the First Distribution calculation date falls only, loss reserves as of the First Distribution calculation date less anticipated loss participation payments on such estimated losses, which will

4.01 Home Enrollment Procedures. The Builder shall submit for enrollment all homes on which it and its affiliates commence construction during the term of this Agreement and pay, with respect to each such home, the enrollment fees

Accordingly, only the parent builder was a HWC member with a right to vote. Subsidiaries or affiliates of the parent builder could participate in the HOW Program as beneficiaries of the parent builder’s policy and Builder Agreement, but were not themselves policyholders or members with a right to vote. With regard to voting, Article V of HWC’s Bylaws provided, *inter alia*:

Section 7. *Voting.* At every meeting of the members each member present, either in person or by proxy, shall have the right to cast votes. The vote of the majority of those present in person or by proxy shall decide any questions brought before such meeting, unless the question is one upon which, by express provision of statute or of the Certificate of Incorporation or of these Bylaws, a different vote is required, in which case such express provision shall govern and control.

Thus, each parent builder was entitled to one vote regardless of the number of homes enrolled by the parent builder and its affiliates. Because the fixed component of consideration has often been considered to be compensation for the loss of the policyholders’ right to vote, the Fixed Distribution is allocated among the Builder Distributees on a per capita basis, consistent with HWC’s voting system of one vote per parent builder.

provide an estimate of post-First Distribution calculation date negative drains on Residual Assets, (4) LESS gross recoveries, which include subrogation recoveries and builder loss participation payments received, minus recovery expenses, and (5) for the year in which the First Distribution calculation date falls only, any balance owed to the HOW Companies for builder loss participation.

On a year-to-year basis, interest is calculated on each Builder Distributee's running total, based upon the HOW Companies' historical gross rate of return on cash and invested assets.⁴ A Builder Distributee's profitability contribution in a particular year is treated as bearing interest over the next year at the HOW Companies' historical gross rate of return on cash and invested assets for that year. To the resulting amount is added the next year's profitability contribution.

Negative values of cumulative totals of profitability contributions for individual Builder Distributees as of the First Distribution calculation date are set to zero prior to allocating the Variable Component among the individual Builder Distributees.

After each Builder Distributee's cumulative total of profitability contributions as of the First Distribution calculation date is determined (and negative values set to zero), the allocation of the Variable Component is calculated. The Variable Component is allocated among the Builder Distributees proportionate to the relative weights of their individual cumulative totals of profitability contributions.

Each Builder Distributee's share of the Fixed Component is calculated by dividing fifty percent (50%) of the First Distribution by the number of Builder Distributees.

Next, each Builder Distributee's presumptive share (expressed as a percentage) of the First Distribution is determined by adding its Variable Component to its Fixed Component. The sum of all individual presumptive shares of the First Distribution will equal one hundred percent (100%) of the First Distribution. The same presumptive share percentages will be used for any subsequent distribution(s) of Residual Assets, except to the extent that subsequent events affect a particular Builder Distributee's cumulative total disproportionately from effects on all Builder Distributees' cumulative totals. This could occur, for example, because of losses yet to be settled or recoveries yet to be realized. For purposes of the remainder of the description of the general methodology, the term "Distribution" refers to the First Distribution or any subsequent distribution(s) of Residual Assets, as applicable.

The Builder Distributee's net presumptive share of the Distribution is determined by reducing the Builder Distributee's presumptive share of the Distribution by any amount still owed by the Builder Distributee for loss participation, etc.

⁴ The HOW Companies' historical gross rates of return on cash and invested assets are determined from the HOW Companies' annual statements, as discussed in Part II.C.3, *infra*.

Finally, each Builder Distributee's share of the Distribution is determined by re-allocating, among those Builder Distributees with positive net presumptive shares, the sum of reductions (in presumptive shares) applied to Builder Distributees which had outstanding balances owed to the HOW Companies.⁵

C. Assumptions and Practices

1. All Policies Expired as of First Distribution Calculation Date; Loss Reserves; Additional Reserves

It is assumed that all policies will have expired as of the First Distribution calculation date. Therefore, the Variable Component calculation takes into account primarily historic profitability contributions. However, in the event that the First Distribution is made before the Claims Resolution Date, some losses will continue to be paid on open claims that were filed prior to the First Distribution calculation date. The Variable Component takes such future negative profitability contributions into account through the loss reserves established for each Builder Distributee as of the First Distribution calculation date, adjusted for any anticipated loss participation by the Builder Distributee.⁶ In order to pay losses adjusted after the First Distribution calculation date, as well as costs, expenses, and other contingencies, the Deputy Receiver's HWC Plan of Liquidation seeks approval to maintain a \$10 million reserve, over and above existing loss reserves, for the payment of all losses, costs, and expenses until such time as HWC can be liquidated and a Final Distribution made of any remaining assets.

2. All Builders Treated Alike Regardless of Program

All Builder Distributees are treated equally whether they participated in the regular builder program, the remodeler program, the volume builder program, or the national accounts program. In whichever program a Builder Distributee and its affiliates participated, enrollment fees were paid for each home enrolled, and the HOW Companies became obligated to pay covered losses on those homes under the HOW Warranty and Insurance policy.

⁵ Note that the maximum of such a reduction for any Builder Distributee is the amount of its presumptive share, because presumptive shares are not reduced below zero. Thus, the amount re-distributed cannot exceed a Builder Distributee's presumptive share. Note also that the reduction in many cases will be less than the affected Builder Distributee's presumptive share. In such cases, the affected Builder Distributee will receive a partial reallocation (in the amount of its proportionate share) of the sum of all such reductions.

⁶ Any loss participation payments owed by a Builder Distributee on losses paid after the First Distribution calculation date will be deducted from the Builder Distributee's share of any subsequent distribution(s).

3. HOW Companies' Historical Gross Rates of Return on Cash Investments, Per Calendar Year

For each calendar year, the HOW Companies' historical gross rate of return on cash and invested assets is calculated by dividing gross investment income by the average of the cash and invested assets for the current year and the prior year. Those rates of return are as follows:

<u>Year</u>	<u>Rate</u>	<u>Year</u>	<u>Rate</u>	<u>Year</u>	<u>Rate</u>
1982	14.30	1991	8.14	2000	6.92
1983	8.62	1992	7.55	2001	6.47
1984	9.44	1993	6.84	2002	6.08
1985	9.51	1994	6.38	2003	4.81
1986	9.19	1995	6.61	2004	2.31
1987	8.44	1996	7.09	2005	2.31
1988	8.08	1997	7.02	2006	2.31
1989	8.74	1998	6.75	2007	2.31
1990	8.14	1999	6.87		

D. Detailed Methodology

NOTE: Calculation of the First Distribution involves Steps 1 through 9. Calculation of subsequent distribution(s), if any, will involve only Steps 7 through 9, and will begin with the value of "pd" calculated in Step 6 for purposes of the First Distribution.

1. First, for each Builder Distributee, the Deputy Receiver will compute "**s-ann**," the estimated profitability contribution or loss for each calendar year. For each Builder, **s-ann** will be calculated, on a calendar-year basis, for every year beginning with 1984 and continuing up to, but excluding, the year in which the First Distribution calculation date falls. Specifically, **s-ann** = P - L + GR

Where:

- P equals total premiums and administrative fees paid to the HOW Program during the calendar year for homes enrolled by the Builder Distributee and its affiliates,
- L equals total losses paid by the HOW Program during the calendar year on homes enrolled by the Builder Distributee and its affiliates, including LAE, and

GR equals total gross recoveries attributable to the Builder Distributee during the calendar year, including loss participation payments made to the HOW Program during the calendar year by the Builder Distributee and its affiliates, and total subrogation recoveries collected by the HOW Program during the calendar year for losses previously paid on homes enrolled by the Builder Distributee and its affiliates, minus recovery expenses.

2. Second, for the year in which the First Distribution calculation date falls, the Deputy Receiver will compute “s-cdy,” the Builder Distributee’s estimated contribution or loss to Residual Assets beginning in the year which includes the Main Distribution calculation date and ending in the year in which HWC will be liquidated and the Final Distribution of Residual Assets, if any, will be paid. Specifically, $s-cdy = GR - L - LR$

Where:

L equals total losses paid by the HOW Program during the calendar year on homes enrolled by the Builder Distributee and its affiliates, including LAE,

LR in the event that all losses have not yet been paid as of the First Distribution calculation date, equals loss reserves maintained as of the First Distribution calculation date for homes enrolled by the Builder Distributee and its affiliates, less any loss participation payments that would be due if losses were to be paid in the amount of the loss reserves, and

GR equals total gross recoveries attributable to the Builder Distributee during the calendar year, including loss participation payments made to the HOW Program during the calendar year by the Builder Distributee and its affiliates, and total subrogation recoveries collected by the HOW Program during the calendar year for losses previously paid on homes enrolled by the Builder Distributee and its affiliates, minus recovery expenses.

3. Third, the running total of each Builder Distributee’s estimated profitability contributions will be computed. By way of illustration only, assume that a particular Builder Distributee had a running total of \$0 as of the end of 1987. Assume that the historical gross rates of return on cash and invested assets were: 6% in 1989, 8% in 1990, and 7% in 1991. Assume further that the Builder Distributee’s estimated profitability contribution or loss (s-ann) for the calendar years 1988 through 1990 were as follows:

YEAR	POSITIVE INFLOWS (PREMIUMS, ETC.)	NEGATIVE OUTFLOWS (LOSSES, ETC.)	NET ANNUAL CONTRIBUTION OR LOSS ("s-ann")
1988	\$237,000	\$150,000	\$87,000
1989	\$250,000	\$350,000	-\$100,000
1990	\$270,000	\$235,000	\$35,000

The \$87,000 profitability contribution for 1988 would be added to the 1987 year-end running total of \$0, leaving a new running total at year-end 1988 of \$87,000. That amount would bear interest in 1989 at 6% and at year-end would total \$92,220. From that amount would be subtracted 1989's \$100,000 net loss, leaving a running total of -\$7,780, accruing 8% interest over 1990. At year-end, the resulting -\$8,402 would be added to 1990's \$35,000 net contribution, and the resulting \$26,598 would accrue 7% interest through 1991, becoming \$28,459 by year-end. To that amount would be added (or from it would be subtracted) the 1991 net contribution (or net loss). The resulting sum would then accrue interest at HOW's historical gross rate of return on cash and invested assets for 1992. This process is repeated for each year through the year preceding the year in which falls the First Distribution calculation date, by adding the s-ann value for that year, the balance accruing interest at HOW's historical gross rate of return on cash and invested assets for the subsequent year, with the calculation being completed as of the year in which falls the First Distribution calculation date by adding s-cdy. The resulting value constitutes that Builder Distributee's profitability contribution ("PC"), with negative values of PC set to zero.

The foregoing may be represented by the following formula:

$$PC = (((((((s\text{-ann}Y * \pi Y+1) + s\text{-ann}Y+1) * \pi Y+2) + s\text{-ann}Y+2) * \pi Y+3) \dots \dots + s\text{-ann}CDY-1) * \pi CDY) + s\text{-cdy}$$

Where:

Y equals the first year in which the Builder Distributee and/or its affiliates enrolled homes. Successive years are designated as Y+1, Y+2, etc., through CDY-1, the year preceding the year in which falls the First Distribution calculation date, and CDY, the year in which falls the First Distribution calculation date,

- s-annY equals the s-ann value for the first year in which the Builder Distributee or its affiliates enrolled homes. The s-ann values for successive years are designated s-annY+1, s-annY+2, etc., through s-annCDY-1, which is the s-ann value for the year preceding the year in which falls the First Distribution calculation date,
- π^{Y+1} equals the HOW Companies' historical gross rate of return on cash and invested assets in year Y+1. The π values for successive years are designated as π^{Y+2} , π^{Y+3} , etc., through π^{CDY} , which is the π value for the year in which falls the First Distribution calculation date,
- s-cdy equals the Builder Distributee's estimated contribution or loss to Residual Assets beginning in the year which includes the First Distribution calculation date and ending in the year in which HWC will be liquidated and the Final Distribution of Residual Assets, if any, will be paid, and
- PC equals the individual Builder Distributee's estimated profitability contribution to the HOW Companies (negative values having been set to zero).

4. Next, the Deputy Receiver will compute each Builder Distributee's share of the Variable Component "v," expressed as a percentage of the First Distribution of Residual Assets, so that $v = (PC/\sum PC) * 50$

Where:

- PC equals the individual Builder Distributee's estimated profitability contribution to the HOW Companies (negative values set to zero),
- $\sum PC$ equals the sum of PC values for all Builder Distributees,
- 50 equals the percentage of the First Distribution dedicated to the Variable Component, and
- v equals the individual Builder Distributee's share of the Variable Component, expressed as a percentage of the First Distribution of Residual Assets.

NOTE: The sum of all "v" values will equal 50, which is the percentage of the First Distribution of Residual Assets dedicated to the Variable Component.

5. The Deputy Receiver will then compute each Builder Distributee's share of the Fixed Component "f," expressed as a percentage of the First Distribution of Residual Assets, so that $f = 50/N$

Where:

50 equals the percentage of the First Distribution dedicated to the Fixed Component,

N equals the total number of Builder Distributees, and

f equals the individual Builder Distributee's share of the Fixed Component, expressed as a percentage of the First Distribution of Residual Assets.

NOTE: The sum of all f values will equal 50, which is the percentage of the First Distribution of Residual Assets dedicated to the Fixed Component.

6. Sixth, the Deputy Receiver will compute each Builder Distributee's presumptive share of the First Distribution, **pd%**, expressed as a percentage of the distribution. This will also be the Builder Distributee's presumptive share of any subsequent distribution(s) of Residual Assets. The sum of all **pd%** values will equal 100%. Specifically, $pd\% = f + v$

Where:

f equals the individual Builder Distributee's share of the Fixed Component, expressed as a percentage of the First Distribution of Residual Assets, and

v equals the individual Builder Distributee's share of the Variable Component, expressed as a percentage of the First Distribution of Residual Assets.

NOTE: Steps 7 through 10 apply both to the calculation of the First Distribution and to the calculation of any subsequent distribution(s) of Residual Assets. Therefore, the term "Distribution" in Steps 7 through 10 refers to the First Distribution or any subsequent distribution(s) of Residual Assets, as applicable.

7. Each Builder Distributee's presumptive share of the Distribution (in dollars), **pd\$**, is determined, so that $pd\$ = pd\%/100 * RAD$

Where:

pd% equals the individual Builder Distributee's presumptive share of the Distribution, expressed as a percentage of the distribution, and

RAD equals the dollar amount of Residual Assets available for the Distribution.

8. Each Builder Distributee's net presumptive share of the Distribution (in dollars), **npd\$**, is determined by reducing the Builder Distributee's presumptive share of the Distribution (in dollars) by any amount still owed by the Builder Distributee for loss participation, etc. Thus, $\text{npd\$} = \text{pd\$} - \text{o1}$ where **o1** equals, for each Builder, an offset representing all sums still owed to the HOW Companies by the Builder Distributee for loss participation payments (in dollars) but not more than **pd\$**. This cannot produce negative **npd\$** values because only that portion of amounts owed to the HOW Companies that does not exceed **pd\$** will be deducted from **pd\$**. In other words, $\text{o1} \leq \text{pd\$}$.

9. Each Builder Distributee's share of the Distribution, in dollars, **d\$**, is determined by re-allocating, among those Builder Distributees whose net presumptive share values (**npd\$**) are positive, sums not distributed to Builder Distributees whose net presumptive share values were reduced because of amounts owed by them to the HOW Companies. The amount reallocated will be $\sum \text{o1}$, the sum of **o1** for all such Builder Distributees. Thus,

$$\text{d\$} = \text{npd\$} + [(\text{RAD} - \sum \text{npd\$}) * (\text{npd\$}) / (\sum \text{npd\$})]$$

Where:

npd\$ equals the Builder Distributee's net presumptive share of the Distribution, in dollars,

RAD equals the dollar amount of Residual Assets available for the Distribution, and

$\sum \text{npd\$}$ equals the sum of all values of npd\$.

<p>NOTE: The sum of all d\$ should equal RAD and $(\text{RAD} - \sum \text{npd\\$})$ should = $\sum \text{o1}$ so that d\$ could also be expressed as $\text{npd\\$} + [\sum \text{o-1}] * (\text{npd\\$}) / (\sum \text{npd\\$})$</p>
--

10. If desired for reporting purposes, each Builder Distributee's share of the Distribution may be determined as a percentage of the Distribution, **d%**, so that **d% = d\$/RAD * 100**

Where:

d\$ equals the Builder Distributee's share of the Distribution, in dollars, and

RAD equals the dollar amount of Residual Assets available for the Distribution.

NOTE: Whereas the values of pd% for an individual Builder Distributee will be the same for all distributions, the values of d% for an individual Builder Distributee may vary from one distribution to the next. The sum of all d% values should equal 100%.