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# WORLD

## CAPTIVE FORUM

## P/C Track: Captives in Difficulty - A Regulatory View



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# Captives in Difficulty – A Regulatory View

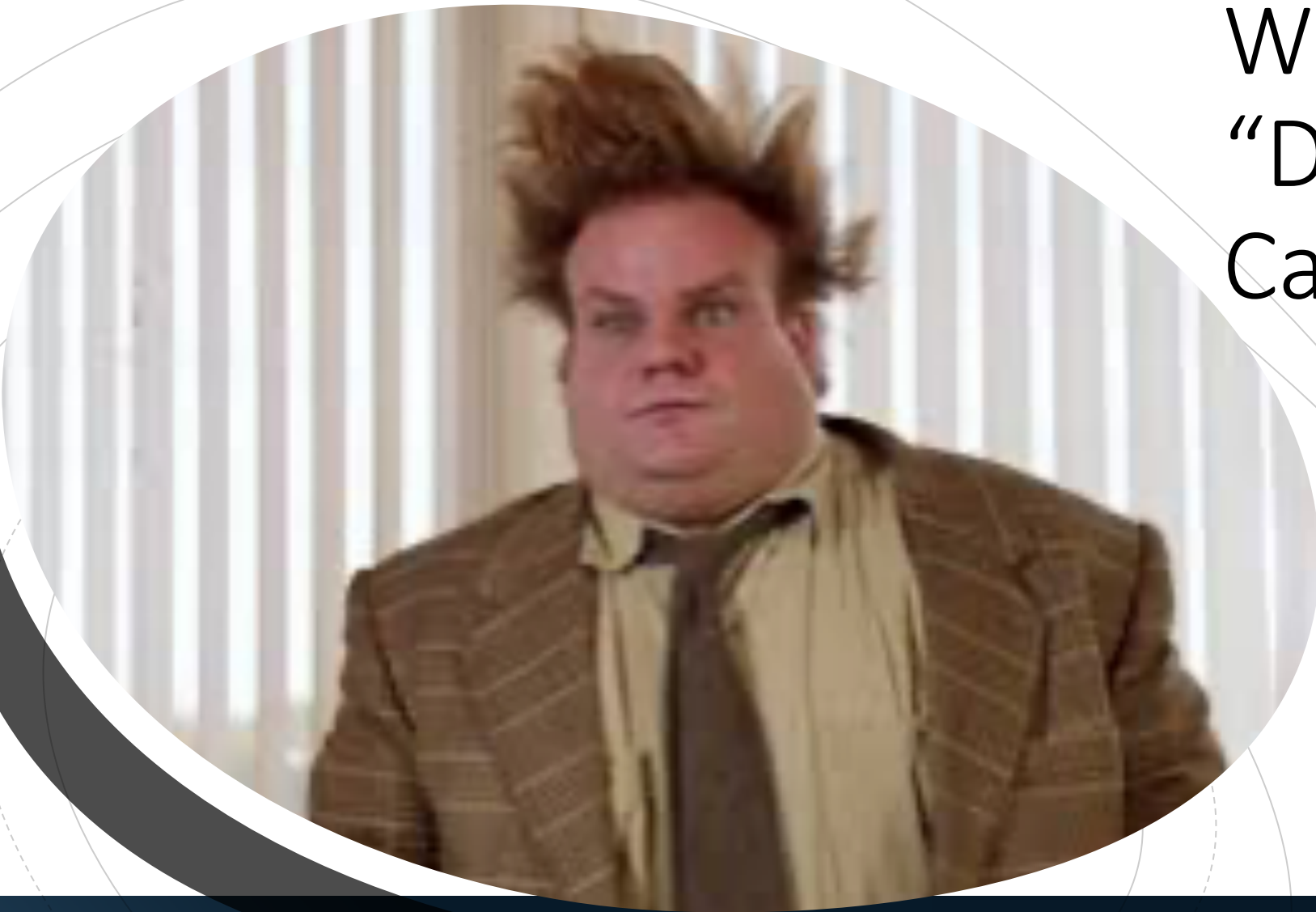
- Jay Branum, Director of Captives – South Carolina Department of Insurance
- Ruwan Jayasekera, Head of Insurance – Cayman Islands Monetary Authority
- Steve Kinion, Director - Delaware Bureau of Captive and Financial Insurance Products
- David Provost, Deputy Commissioner – Vermont Department of Financial Regulation
- Peter Kranz, Moderator, Executive Managing Director, Captive Practice Leader – Beecher Carlson Insurance Services, LLC



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What is a  
“Distressed  
Captive?”



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# How do we know what we know when we know it?



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But the Parent's doing fine, nothing to worry about!

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# Getting *OUT* of Trouble



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# JLH Insurance Company

- Based in Irvine, California, John Laing Homes, (WL Homes, LLC), was the second largest homebuilder in the U.S. in the mid-2000s.
- Recognized as America's Best Builder in 2006 by *Builder* magazine and 2004 Best Builder of the Year by *Professional Builder* magazine.
- Recognized by J.D. Power & Associates in 2005 and 2006 as the best New Home Builder Customer Satisfaction Study in Orange County, California.
- Beginning in 2002, WL Homes purchases a Home Builders Protective Insurance Policy from Zurich American Insurance Company.
- The home builders policy covers construction defect claims made by home buyers.



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# JLH Insurance Company

- WL Homes forms a captive insurer, JLH Insurance Company, in 2005 in Arizona.
- WL Homes capitalizes JLH with a \$10 million deposit at Wachovia Bank.
- JLH insured the self-insured retention on the home builders policy.
- The home builders policy was effective only after the self-insured retention was paid.
- In 2007 WL Homes enters into a line of credit with Wachovia Bank using JLH's \$10 million capital deposit as collateral. It reaffirms the line of credit in 2008.
- Neither WL Homes or JLH seek nor obtain regulatory approval for posting the deposit as collateral.



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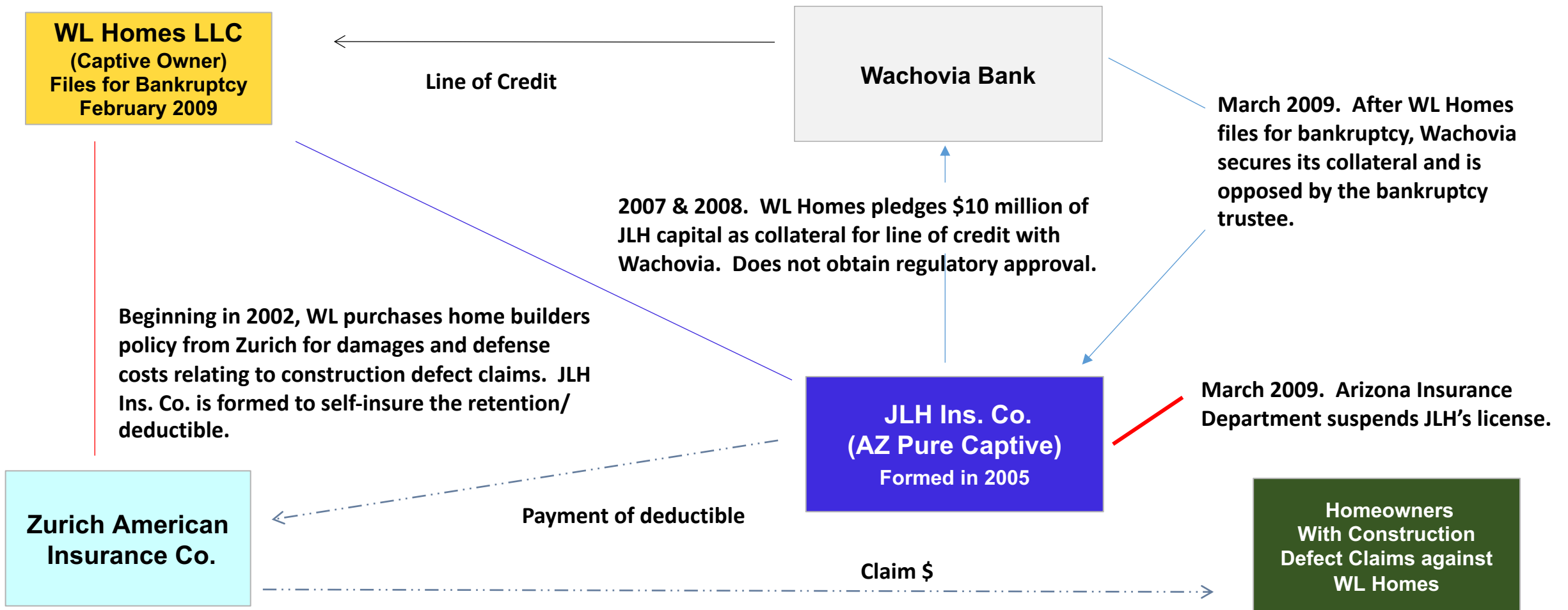
# JLH Insurance Company

- **WL Homes is a Delaware LLC and it files for bankruptcy in Delaware in February 2009.**
- **Arizona regulators suspend JLH's certificate of authority in March 2009 (in 2014 the certificate of authority was voluntarily terminated).**
- **March 2009 Wachovia Bank seeks to collect the \$10 million.**
- **The bankruptcy trustee opposes Wachovia's move using various arguments including five based on violations of the Arizona Insurance Code.**



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# JLH Insurance Company



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# JLH Insurance Company

- **First Argument.** Wachovia taking the \$10 million would drop JLH's minimum capital and surplus below the statutory minimum of \$250,000. The bankruptcy court rejected this argument because the evidence did not show the capital and surplus falling below the minimum.
- **Second Argument.** JLH did not obtain regulatory approval to pledge the \$10 million deposit and thus violated Arizona's insurance laws. The court rejected this argument on the basis that it was WL Homes that made the pledge. Thus, JLH did not violate anything.
- **Third Argument.** Pledging the \$10 million deposit threatened JLH's solvency. The court rejected this argument by considering the investment laws for pure captives. It concluded that the laws restrict investments, but do not prohibit, restrict, or penalize such investments.



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# JLH Insurance Company

- **Fourth Argument.** JLH violated the law that a pure captive may only make loans to its affiliates and the loan must have regulatory approval. The court rejected this argument because the pledge to Wachovia was not a loan. Furthermore, the court found there is no statutory provision prohibiting a pledge of assets.
- **Fifth Argument.** The pledge of the \$10 million deposit was a material change in JLH's plan of operations and material changes need regulatory approval. The court rejected this argument because while the pledge was made in 2007 and reaffirmed in 2008, in 2008 JLH continued its operations normally and made a profit that year.



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# JLH Insurance Company

- Why did the bankruptcy court allow the pledge?
- Under the Uniform Commercial Code, a debtor, i.e., WL Homes, need not have title to collateral in order to grant a security interest in the collateral. Control over the collateral rather than ownership is the key factor in determining a debtor's rights.
- WL Homes had sufficient rights in the \$10 million deposit because five of the seven signatories to the deposit certificate were WL Homes officers and the other two were officers of both WL Homes and JLH.
- The bankruptcy court did not reverse the pledge of \$10 million and the Arizona Insurance Department suspended JLH's certificate of authority.



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# JLH Insurance Company

- So what does it matter?
- It matters because the homeowners with claims for defective homes suffered.
- Because WL Homes first went into Chapter 11 then Chapter 7 bankruptcy, the court ordered a stay on all judicial proceedings.
- Homeowners who purchased homes built from May 2005 through May 2009 were eventually covered for defects. Homes built before that time were not.
- As of 2017, which is 8 years after the bankruptcy filing, some homeowners still had unresolved claims.



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# JLH Insurance Company

- Most commercial liability policies have a provision which says, “Bankruptcy or insolvency of the insured or of the insured’s estate will not relieve us of our obligations under this Coverage Part.”
- The provision means that insurers must continue to provide coverage in spite of the insured’s bankruptcy, but only for amount above the self-insured retention.
- Zurich’s Home Builders Protective Insurance Policy said,
  - ✓ Except for any “defense costs” that [Zurich is] obligated to pay [in] excess of the “self insured retention,” or that [Zurich] may elect to pay, [WL] shall pay all such “defense costs” as they are incurred until [WL] ha[s] paid “defense costs” and damages for the coverages included in the policy equal to the applicable “self insured retention” amount. *If any final judgment or settle and “defense costs” is less than the “self insured retention” amount ..., [Zurich] shall have no obligation to pay damages or “defense costs” under this policy.*

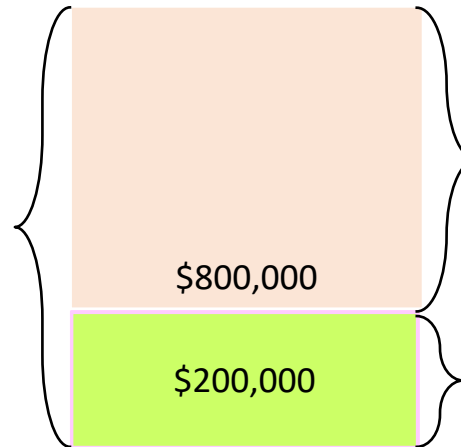


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# Bankrupt Captive Owner/Insured

- Considerations for regulators, captive managers, and captive owners:
- If a captive is issuing a deductible reimbursement policy, determine if the primary policy contains a bankruptcy clause. Some states mandate such a clause, for example Illinois at 215 ILCS 5/388, while others like Texas do not.
- What is the deductible/self-insured retention amount? If the insured/captive owner is insolvent and cannot pay the deductible, any recovery from the primary insurer - not the captive - will be reduced by the self-insured retention.

Insurance \$1 Million Limit

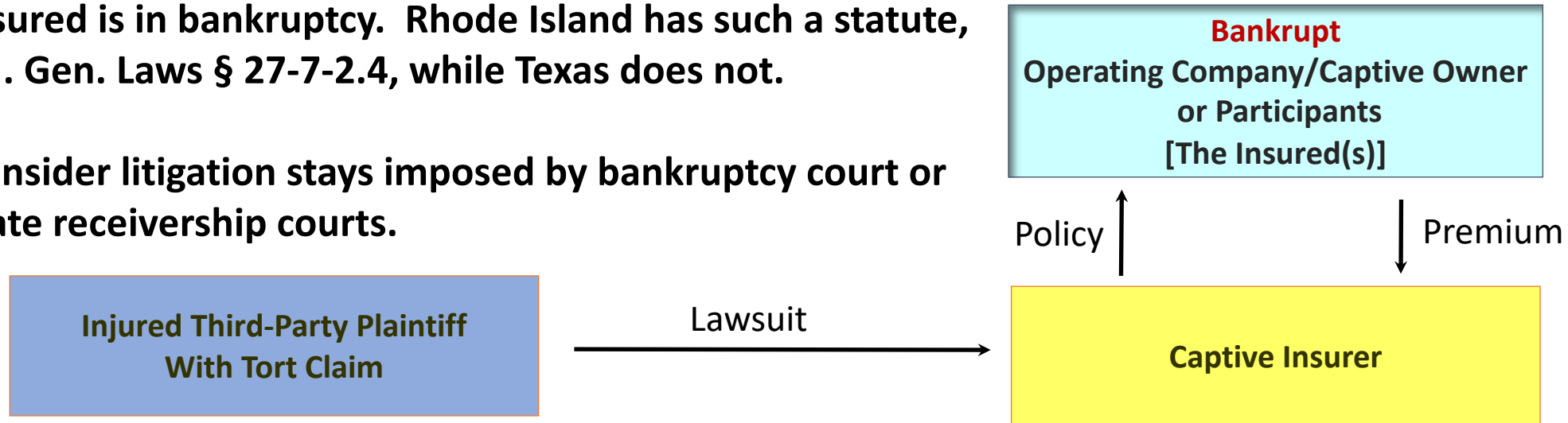


If there is a \$1 Million Insurable Event the Insurer Reduces its Payment by the \$200,000 Self-Insured Retention and only pays \$800,000

Self-Insured Retention

# Bankrupt Captive Owner/Insured

- Considerations for regulators, captive managers, and captive owners:
- Most states do not allow an injured party to directly sue an insured's insurance company until a judgment is obtained against the insured.
- Some states have direct action statutes where the injured party can directly sue the insurer if the insured is in bankruptcy. Rhode Island has such a statute, R.I. Gen. Laws § 27-7-2.4, while Texas does not.
- Consider litigation stays imposed by bankruptcy court or state receivership courts.



**Thank You**



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