



Texas Construction  
Insurance Company Risk  
Retention Group, Inc.

# Member Guide

A Builder Owned Risk Retention Group Program

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**Texas Construction Insurance Company**  
**Risk Retention Group, Inc.**  
 A BUILDER OWNED RISK RETENTION GROUP PROGRAM

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This Member Guide is not complete and is not intended to be complete. No offering of shares is hereby made. Any offering will be made only after preparation and delivery of a complete Offering Memorandum, which can be obtained from Risk Services LLC. In the event of any inconsistency between this Member Guide and the Offering Memorandum, the Offering Memorandum will control and nothing in this Member Guide shall be binding on, Risk Services, LLC, Texas Construction Partners, LLC, or Texas Construction Insurance Company Risk Retention Group, Inc.

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### EXECUTIVE SUMMARY

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#### THE RISK RETENTION GROUP ALTERNATIVE FOR PROJECT BUILDERS

To address the severe liability insurance availability and affordability crisis facing members of the building industry, this proposal contemplates the formation of a risk retention group (RRG) pursuant to the Federal Product Liability Risk Retention Act of 1981 as amended by the Risk Retention Amendments of 1986 (hereinafter, "LRRRA" or the "Act").

A RRG is a group policyholder-owned insurance company (often referred to as a "captive") which, upon the basis of a single state license, can operate throughout the U.S. with the bulk of multi-state regulation by non-domiciliary insurance departments preempted by the LRRRA.

The foundation of this plan is the formation of a RRG, to be owned and capitalized by the builders and other professionals who, in turn, will be afforded liability insurance coverage by the RRG. The RRG will operate under the guidance of a Board of Directors and Committees composed chiefly of insured members of the RRG. Operational management will be provided by Risk Services, LLC serving as Program Administrator and home office and Texas Construction Partners, LLC will be the primary marketing agent for the RRG. For the foreseeable future, The RRG will outsource its operational functions to these and other service providers operating under the guidance of the Board of Directors.

#### THE SEVERITY OF THE CRISIS FOR BUILDERS' LIABILITY INSURANCE IN THE TRADITIONAL INSURANCE MARKETPLACE

An insurance crisis has hit the homebuilding and residential builders' insurance market place. Builders have or likely will at their forthcoming renewal face an exasperating and expensive process to secure insurance coverage. There will not likely be a short or medium term recovery in this sector of the insurance marketplace. Residential builders will face a significant period of turmoil, increased premiums and restrictions in insurance coverage.

Contractors will have found that traditional insurers are unresponsive to their specialized coverage and service needs, lack flexibility and are presently unable to appropriately price the risks in this sector. In short, the commercial insurance carriers have failed the insurance buyers in this sector of the market.

The following factors and influences have driven the insurance market to this point:

- Financial failure of numerous insurers in both the admitted and Excess & Surplus Lines marketplaces (e.g. Reliance, Credit General, Frontier/United Capitol, Legion).
- Withdrawals of certain carriers from this business sector due to poor underwriting results (e.g. St. Paul, CNA, CUIC, Royal, Tudor).
- Withdrawal or restriction of reinsurers providing capacity and protection to insurers.
- A decline in insurers' investment returns as stock market has tumbled.
- Insurance losses arising from the September 11<sup>th</sup> terrorist attacks.

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- Poor underwriting results due to inadequate pricing of this class in recent years.

As a result of this contraction, insurers rates are increasing from 80% up to 500%, deductibles and self-insured retentions are quadrupling, limits are being reduced, defense costs are being placed within policy limits, coverage-expanding endorsements are now largely unavailable, prior work exclusions are now a regular feature, and for many insureds the only coverage available in the commercial market is a claims made form.

Relief from these adverse insurance market conditions for those in the building industry is not likely in sight. The number of insurers serving the construction industry will potentially diminish further as these carriers face increasing restrictions in their own reinsurance programs upon which these insurers depend greatly for underwriting capacity. A number of these insurers and reinsurers are facing downgrading by financial rating services, such as A.M. Best, and increased scrutiny by regulators as to the adequacy of their loss reserves. These factors lead insurers and reinsurers to be far more risk adverse with their available underwriting capacity and to provide coverage only for what they perceive as the "safest" risks. Due to a general stigma associated with the insurability of the construction industry as a whole, the insurance community does not perceive builders' liability insurance as an attractive line of business for their diminished underwriting capacity.

### RISK RETENTION GROUPS

A risk retention group (RRG) is a federally created insurance company, typically formed in a captive friendly domicile. A captive is a specialty class of insurance company owned and capitalized by its policyholders, often in a particular industry, which insures primarily, if not exclusively, the risks of its owners. Insurance industry analysts estimate that up to 40% of annual commercial property and casualty premium (totaling in the aggregate many billions of dollars annually) are written through captives and other similar alternative insurance market mechanisms.

RRGs are entities created under the LRRRA, which was enacted into law by Congress in 1981 and expanded in 1986 to respond to the unavailability and unaffordability of commercial liability insurance. Under the Act, a risk retention group is a state chartered and licensed liability insurance company organized for the primary purpose of assuming and spreading the liability exposures of its group member owners. In order for a sponsored RRG to meet the requirements of the LRRRA:

- (a) each insured must be a stockholder of the RRG;
- (b) each stockholder must purchase insurance from the RRG; and
- (c) all insureds must, through their business or activities, be exposed to similar or related liability exposures.

As an entity formed under the LRRRA, the RRG will benefit from the Act's provisions limiting insurance regulation by states other than the RRG's state of domicile and from provisions granting exemptions from regulation under state and certain federal securities laws.

The RRG will be regulated only by its state of domicile and will have to comply only with the form and rate rules of that single state. By domiciling in a state with liberal form and rate rules the RRG, in essence, can on the basis of a single state license, insure its members throughout the U.S. utilizing any actuarially justified rate and policy form it chooses. Availing itself of this option, the RRG has secured a license in Nevada which has enacted specific captive laws and regulations and possesses the regulatory infrastructure necessary to facilitate the formation and operation of member owned

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insurance companies, including risk retention groups. Texas, although likely the home state of a significant number of the RRG's prospective member insureds, has neither the legislation nor the regulatory framework to be considered as a viable potential domicile for the RRG.

Under the LRRRA, a RRG is limited to providing commercial liability coverage to its member insureds. Thus, the RRG could not offer its members workers' compensation, property or personal lines coverage.

The Act requires all owners and insureds of the RRG to have similar or related liability exposures. Thus, participation in the RRG would be limited to those owner/insureds engaged in business in the construction industry.

The Act further requires that all RRG owners must be insureds of the RRG and all RRG insureds must be owners of the RRG. Thus, only those parties or entities insured by the RRG could own stock in the company and vice-versa.

To facilitate the raising of capital by a risk retention group, the LRRRA affords broad preemption from most state and federal securities laws that otherwise apply to a stock offering. This preemption minimizes the time, effort and often significant legal expense generally associated with the registration and sale of stock in a newly created stock company.

## BENEFITS OF A RISK RETENTION GROUP FOR IT'S MEMBERS

Unlike a traditional insurance company whose ultimate purpose is to enhance its own bottom-line profitability, the primary mission of a RRG is to provide its owners with stable, reliable and affordable insurance coverage. The RRG mechanism is designed to avoid the wide price swings common in the traditional insurance industry, and a RRG may utilize whatever actuarially justifiable premium rating structure and coverage form it chooses consistent with the approval and state filing requirements of a single domiciliary regulator. Ultimately, coverage and premium terms will be based on the actual loss experience of the RRG's members rather than on the traditional insurance industry's perception of the class of business as a whole. This flexibility to tailor coverage terms to meet the unique needs of the RRG's members, rather than to rely on "off the shelf" coverage and terms provided by traditional insurers, is a critical feature of successful association insurance programs.

A primary component of insurance industry profit is underwriting income – essentially, the difference between the premium charged and the losses paid. By reducing these losses through sound claims handling and the imposition of policyholder risk management practices, the traditional insurer benefits by improving its own bottom-line profitability, but the policyholder rarely benefits. On the other hand, enhancement of a RRG's profitability through sound underwriting practices, loss prevention and claims handling inures directly to the benefit of the RRG's policyholders, typically in the form of reduced premiums and enhanced coverage for its members.

A second component of profitability for the insurance industry is investment income – interest and gains earned by insurers on loss reserves held from premiums collected from policyholders to pay known and actuarially expected losses. Some lines of liability coverage, including those sold to policyholders in the building industry, are notoriously "long tail", meaning that the time period between when the premium is collected and when the loss is actually paid can be ten years or more. On such long tail lines, the investment income which inures to the benefit of the insurance company prior to its actual payment of claims can be quite significant. As a member-owned insurance company, this

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investment income inures to the benefit of the RRG and can be utilized by the RRG to offer lower premiums and enhanced coverage and services to its members.

Moreover, as a direct-writing insurance company, the RRG will be able to access the reinsurance marketplace which is otherwise not accessible to commercial insurance policyholders. As insurance for insurers, the reinsurance mechanism limits the exposure to large losses which the insurer assumes and expands the insurer's capacity to provide coverage to its customers. Because of economies of scale, reinsurers can offer coverage to their insurance clients on more advantageous premium terms than a traditional insurer can offer to its policyholders. Reinsurers rated A minus by AM Best will be approached to provide such reinsurance coverage to protect the assets and capital of the RRG.

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## STRUCTURE

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### TYPE OF COMPANY

The RRG will be organized as a stock company in the State of Nevada and formed as risk retention group pursuant to the LRRRA.

### ELIGIBILITY

The RRG will engage in the business of insuring Texas, Arkansas, and Oklahoma based construction companies that purchase stock in the RRG and who meet the RRG's underwriting guidelines.

### SCOPE OF BUSINESS

1. Unrelated Business

The RRG will not write any unrelated business, as it will only insure its shareholders who must be involved in the building construction industry and/or related support industries.

2. Classes of Business to be Written

The RRG will write on a direct basis the following lines of business on occurrence policy forms

- Commercial General Liability
- Excess Commercial General Liability

3. Anticipated Coverage/Limits

- a. Commercial General Liability
  - \$1,000,000 per occurrence/\$2,000,000 annual aggregate
  - \$2,000,000 products/completed operations aggregate
  - \$500,000 Fire Damage Legal Liability
  - \$1,000,000 Personal and Advertising Injury
  - \$1,000,000 Bodily Injury and Property Damage
- b. Excess Commercial General Liability
  - \$1,000,000 per occurrence/\$5,000,000 annual aggregate

4. Anticipated Deductibles and Retentions

The RRG will operate with minimum deductibles as follows:

Commercial General Liability \$5,000

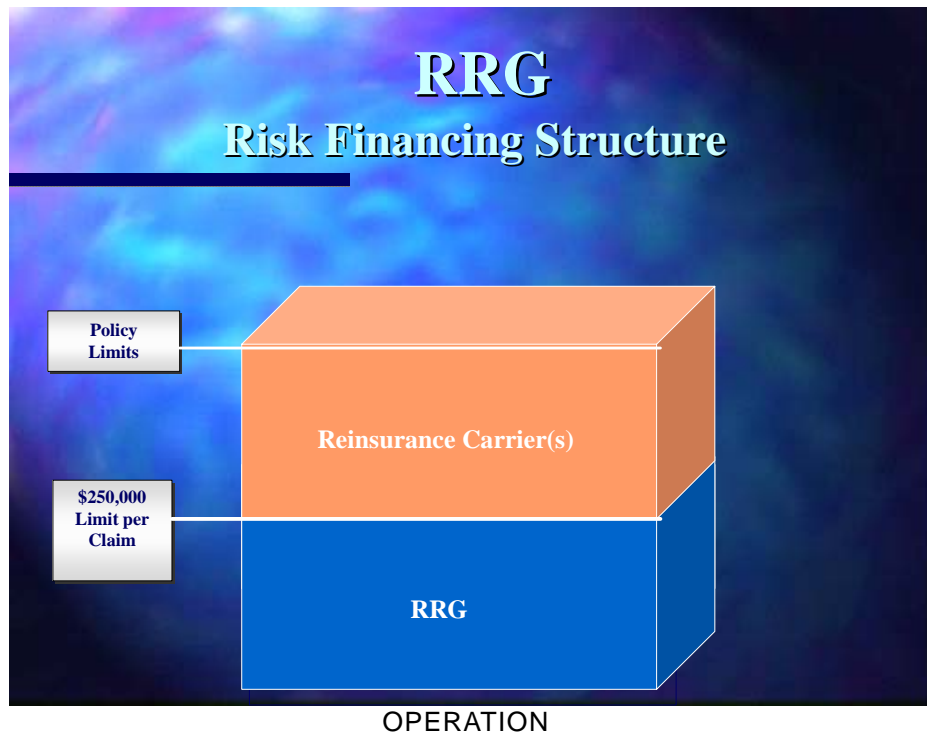
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### 5. Primary Carriers and Reinsurance

The RRG will be eligible to act as a primary carrier pursuant to the LRRRA and will issue policies directly to its shareholder insureds.

To limit its anticipated net retention, the RRG will secure reinsurance from a reinsurer approved by the RRG's domiciliary regulator. It is anticipated that the RRG will secure reinsurance to limit its exposure to any single loss to \$250,000. Aggregate reinsurance limiting exposure to a series of losses within the RRG's net retention will also be purchased, if available.



Once operational, it is anticipated that the RRG will operate efficiently without the need for salaried staff. Instead, the RRG will utilize outside service providers, coordinated by Risk Services, the Program Administrator, operating under the guidance of the RRG's Board of Directors. The Board of Directors and Committees will primarily be composed of member insureds of the RRG. Anticipated responsibilities of Risk Services, as the Program Administrator, include:

- Underwriting services
- Billing and premium collection
- Provision of policyholder services
- Issuance of policies and endorsements
- Rating and pricing applicant submissions
- Serving as the RRG's reinsurance intermediary
- Maintaining individual insured policy files

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Risk Services, LLC, will also serve as the Nevada Approved Captive Management firm acting as coordinator of activities related to the RRG's formation and operation, and shall provide home office functions for the RRG, including:

- Serving as the RRG's home office as required by domiciliary regulatory authorities
- Maintaining all accounting records as required by domiciliary authorities
- Preparing quarterly and annual financial statements and supporting schedules as required by appropriate regulatory authorities
- Preparing the NAIC quarterly and annual Statutory Convention Blank to be filed with the NAIC and appropriate states
- Coordinating the year end audit with the RRG's auditors and providing them with auditable working papers
- Coordinating the annual loss certifications with the RRG's actuarial firm
- Assisting in determining the appropriate quarterly estimated tax payments to the IRS
- Providing regulatory compliance services with the domiciliary state and all states in which the RRG conducts business, including preparation of the initial registration application with each state in which the RRG intends to operate
- Preparation of monthly, quarterly and annual premium tax returns and reports as required in each state in which the RRG is registered to conduct business

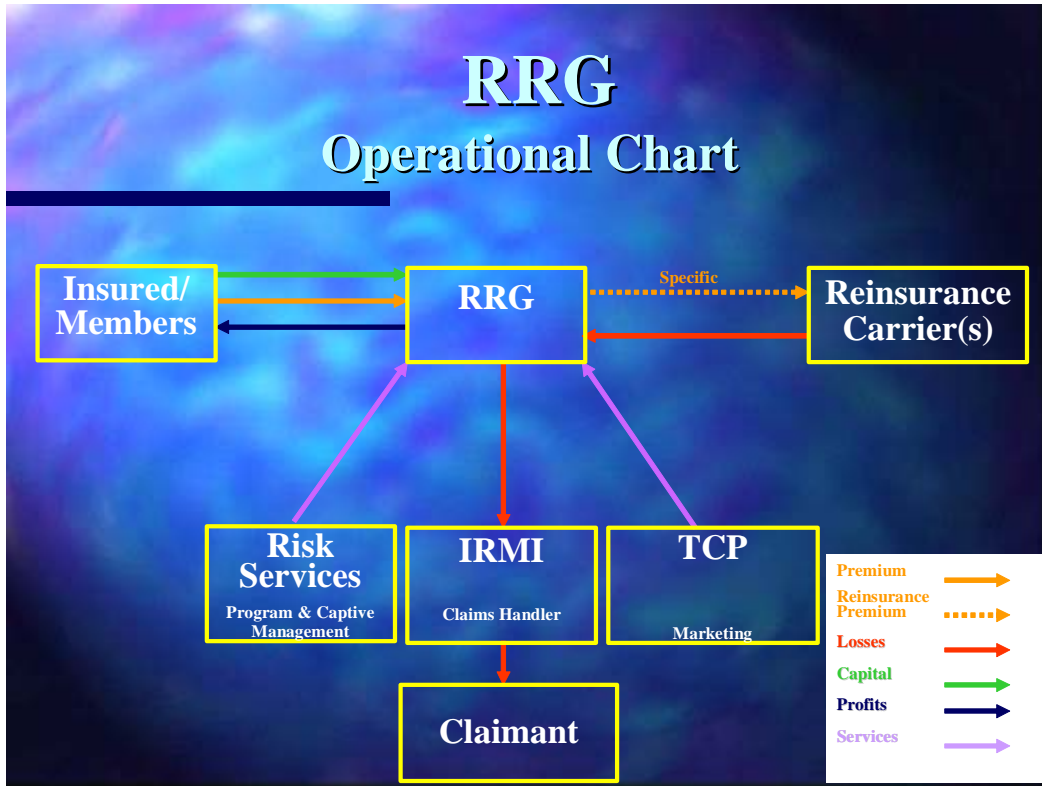
Texas Construction Partners, LLC will act as the primary marketing agent for the RRG, and its responsibilities will include:

- Coordination of claim and loss prevention service providers
- Marketing the program
- Establishing, with the assistance of the RRG's board of Directors, a Claims Committee to help set and review reserves and causes of loss
- Remitting monthly premium amounts due to the RRG.
- Issuance of Certificates of Insurance
- Sub-producer agent relations

Other outside service providers, including legal, actuarial and claims handling providers, will be appointed by the RRG upon the recommendation of its Board of Directors.

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## OFFERING OF SHARES

The RRG has been formed as a stock company, and pursuant to the requirements of the LRRRA, all insureds will be required to purchase stock in the RRG. Founding Members, defined as those members providing capital in advance of the RRG collecting \$500,000 in member provided capital, will be afforded the opportunity to purchase the RRG stock at \$1.00 per share. Non-Founding Member participants shall be sold stock in the RRG at a minimum of \$5.00 per share.

The number of shares that a potential member insured will be required to buy will be based on their annual first year's insurance premium. A member may invest amounts in excess of the required capital contribution. The price per share and the number of shares which must be purchased as a condition of membership in the RRG may be modified in the future by the RRG's Board of Directors.

Due to the requirements of RRG ownership imposed by the LRRRA, there must be significant restrictions on the transferability of RRG stock. Prospective purchasers of the RRG stock should carefully consider the potential lack of liquidity of any ownership interest in the RRG and instead view any participation as a potential long-term solution to their insurance needs.

## ORGANIZATIONAL STEPS FOR FORMING THE RRG

The expected premium volume of the RRG in its first year of operation is largely conjectural. However, given both the unavailability/unaffordability of this liability coverage in the traditional market, as well as the strong demand which Texas Construction Partners, LLC sees among its clients for this coverage, it is not unrealistic that a sufficiently capitalized RRG could write between \$2,500,000 and

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\$3,500,000 of premium in its first year of operation. The RRG will limit its exposure to any single loss to \$250,000.

The first step toward getting the RRG operational was the feasibility study which forms part of the application to the domiciliary state regulator and gives specific recommendations on the required level of funding to adequately capitalize the RRG. The study included five-year pro forma financial projections using different loss patterns assumptions. The study, in essence, is part of the filed business plan of the RRG, and any future changes in operation by the RRG which deviates from this plan must be approved by the regulator.

Milliman, an international actuarial firm was retained to complete a portion of the feasibility study. Coordinating the completion of the feasibility study and all aspects of the RRG's formation and licensing was Texas Construction Partners, LLC and Risk Services, LLC, an alternative insurance market consultant and captive management firm whose principles have formed and managed numerous risk retention groups in all major captive domiciles throughout the U.S.

In order to commence operations the RRG obtained a Certificate of Authority from the state of Nevada to transact insurance on July 18, 2006.

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#### PROJECTED FINANCIAL STATEMENTS

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The Projected Financial Statements were prepared by Risk Services, LLC and are based on assumptions as to the course of future events that are inherently impossible to accurately predict. Many of the future events that will be material to the RRG's operations cannot be controlled by RRG.

THEREFORE, IT IS LIKELY THAT THE PROJECTED FINANCIAL STATEMENTS WILL BE INACCURATE, PERHAPS MATERIALLY SO.

It is based on the following assumptions:

- 100% retention of 1st \$250,000 per occurrence on Commercial Comprehensive General Liability policies and 10% quota share of first \$1,000,000 on Commercial Umbrella and Excess Comprehensive General Liability policies.
- Initial capitalization of \$500,000.
- Members required to make a capital contribution of at least 50% of their first year premiums, payable over three years at 25%-15%-10%.
- \$1.00 Par Common Stock issued at \$1.00 cost prior to licensure and \$5.00 cost subsequent to licensure.
- Annual gross written premium of \$2,700,000 in Year 1, with anticipated growth of \$700,000 per year thereafter through Year 5.
- A 4.0% average return on invested assets over the next 5 years
- Acquisition costs of 27.9% of Net Written Premium, comprised of 10% Policyholder Services and Captive Management, 1.5% Loss Control, 2% Claims Handling, 12% Agent Commissions, and 2.4% Premium Taxes
- Estimated reinsurance costs of 23.625%.
- Organizational costs of \$25,000 expensed in Year 1.
- General & Administrative expenses increased at 4% per year.
- Net Loss Ratio established at 65%.
- Claim payout pattern equal to 100% at the end of year 10, provided by Milliman
- 50% unearned premium at the end of each year based on assumption that premiums will be written evenly over the calendar year
- No dividends declared in the 1st 5 years
- Insurance company for tax purposes, filing an 1120PC IRS return at 34% rate
- GAAP accounting