THE COMMONWEALTH COURT OF PENNSYLVANIA

M. DIANE KOKEN, Insurance Commissioner of the Commonwealth of Pennsylvania, Plaintiff, v. RELIANCE INSURANCE COMPANY, Defendant.	Docket No. 269 M.D. 2001
LEXINGTON INSURANCE COMPANY, Petitioner, v. M. DIANE KOKEN, Insurance Commissioner of the Commonwealth of Pennsylvania, Respondent.	The Honorable James Gardner Colins, President Judge Before Referee Edward Finkelstein, Esquire

LIQUIDATOR'S SUR-REPLY TO LEXINGTON INSURANCE COMPANY'S EXCEPTIONS TO THE REFEREE'S RECOMMENDATIONS

The Liquidator respectfully submits this Sur-Reply in Response to Lexington's Concise Reply filed on July 29, 2005. Since the Liquidator submitted her Response to Lexington's Exceptions, the Supreme Court of Pennsylvania handed down its decision in *Koken v. Legion Insurance Company* (Dockets Nos. 204, 205, 211, and 212 MAP 2003) (J-13-AD-2005) ("*Legion Appeal*"),[1] affirming by *per curiam* opinion the June 26, 2003 *Legion* case *(cited*

[1] Please note that the *Legion Appeal* is the same as "*Koken v. Villanova Ins. Co.,* J-13-AD-2005, decided July 19, 2005" cited at page 3 of Lexington's Concise Reply.

below) addressing "cut-throughs" or direct payment requests. However, that decision, by Lexington's own admission, does not control the resolution of this cut-through proceeding.

Lexington explicitly represented to this Court that the *Legion Appeal* has no bearing on the issues presented in the instant matter:

> [A]lthough [the *Legion Appeal and In Re Baptist*[2]] may address a question of the construction of 40 P.S. Sec. 221.34, the Supreme Court [of Pennsylvania, in the *Legion Appeal and In Re Baptist,*] is not being asked to resolve the question presented here by Lexington: whether a Liquidator can adopt, and then obtain Court approval of, procedures implementing Section 221.34 and then apply them in an arbitrary and discriminatory fashion. The clearest evidence that [the *Legion Appeal and In Re Baptist*] have no bearing on the issues here is the fact that neither Lexington nor the Liquidator has relied on either [the *Legion Appeal*] or [*In Re Baptist*] in its Objections or Responses thereto...the Supreme Court's resolution of [the *Legion Appeal and In Re Baptist*] will not help this Court rule on the issues in this case.

(*See* Lexington's Memorandum of Law in Support of Its Opposition to Liquidator's Motion to Stay Lexington's Cut-Through Proceedings at 4, attached as Exhibit 32 to the Liquidator's Response to Lexington's Exceptions). Consistent with this position, Lexington has not relied upon *In Re Baptist* in any of its pleadings to the Referee, or in the Exceptions filed with this Court. *(See id. at 6 n. 1) ("Neither Lexington nor the Liquidator has cited to Baptist Health South for any proposition in this case.")*; (*see also* May 28, 2004 letter to E. Rothschild from B. Guthrie at 1) ("[T]he resolution of the Lexington matter is not dependent upon the ultimate resolution of either [the] *Legion* [*Appeal*] or *Baptist Health South.*") (Attached as Exhibit 33).

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[2] *Koken v. Reliance; IN RE Baptist Health South Florida, Inc.'s Objection To The Liquidator's Denial Of A Direct Payment Request; Palm Springs General Hospital's Objection To The Liquidator's Denial Of A Direct Payment Request; The Exceptions Of The Report Of Referee James Schwartzman*, 846 A.2d 167 (Pa. Commw. Ct. 2004).

Moreover, Lexington's acknowledgment that the *Legion Appeal* has no bearing on the instant matter is further supported by Lexington's admission that it cannot claim third party-beneficiary status: "Lexington was not asserting a right as a third-party beneficiary, because it was seeking to enforce its own contract's terms." (*See* Lexington's Concise Reply at 4). As this Court is aware, the *Legion Appeal* affirms the decision in *M. Diane Koken v. Legion Insurance Company*, 831 A.2d 1196 (Pa. Commw. Ct. 2003) ("the *Legion* case"). That case specifically addressed whether the insureds were entitled to direct payments under a third-party beneficiary analysis. *Id.* at 1236-1239. Since Lexington concedes that it is not seeking third party beneficiary rights, the *Legion Appeal* has no bearing on the instant matter.

Furthermore, the determination in the *Legion* case that certain insureds were third-party beneficiaries was based on a substantial factual record assembled at a hearing before the Commonwealth Court, where the parties submitted factual evidence and testimony as to the circumstances leading to the inception of the reinsurance relationship itself. *Id.* at 1202- 1226. In this case, consistent with its position that the *Legion* case did not control, Lexington declined to submit such evidence, relying solely on the argument presented in its Motion for Summary Judgment that Lexington was treated differently than cut-through applicants RBH and Magellan. The Referee correctly found that Lexington's request was properly denied because the insureds were not identified in Lexington's reinsurance contract with Reliance, while the names of insureds do appear in the RBH and Magellan reinsurance contracts.

Accordingly, the *Legion Appeal* has no bearing on the instant case, and this Court should deny Lexington's Exceptions to Referee Edward S. Finkelstein's June 28, 2005 Report and Recommendation, overrule Lexington's Objections, and affirm the Liquidator's denial of Lexington's direct payment request based on the conclusions stated in the Referee's Recommendation.

Respectfully submitted,

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Date: August 2, 2005

Exhibit 33

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May 28, 2004

Via Hand Delivery

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RE: Lexington Insurance Company v. M. Diane Koken
No. 269 M.D. 2001
Lexington's Objections to the Liquidator's Denial of its Direct Payment Request

Dear Eric:

We have reviewed the Liquidator's responses to Lexington's First Set of Interrogatories, Requests for Production of Documents and Requests for Admissions. We have also discussed with our client your request of last Thursday, May 20, 2004, that Lexington agree to stay this proceeding pending the disposition of the Liquidator's appeals to the Supreme Court in the *Legion* and *Baptist Health South* cases. This letter summarizes Lexington's view of where our matter now stands given these recent developments.

As an initial matter, Lexington does not agree to stay this proceeding pending the outcome of the Liquidator's appeals in *Legion* and *Baptist Health South*. Since you are not prepared to give Lexington any assurance that, were the Supreme Court to affirm either or both of those decisions, the Liquidator would reconsider my client's Direct Payment Request, there seems no incentive for Lexington to agree to a stay. Furthermore, Lexington's long-held position is that the Liquidator must grant its direct payment request based upon the interpretation of the Guidelines adopted by the Liquidator and approved by the Commonwealth Court in the RBH and Magellan matters. Accordingly, the resolution of the Lexington matter is not dependent upon the ultimate resolution of either *Legion* or *Baptist Health South*. While we believe that the Commonwealth Court's opinions in both of those cases are helpful to Lexington's position, its' direct payment request is fundamentally about the Liquidator not providing Lexington equal protection under the law by her application of the Guidelines in an inconsistent, arbitrary and capricious manner.

Lexington is also unwilling to stay this proceeding because a stay would last for months, perhaps a year, or even longer. Lexington cannot remain still in the face of this uncertainty. As we have documented to you, Lexington is currently faced with at least one lawsuit in which a third-party is asserting a direct right of action against it. That kind of risk only increases the longer this proceeding draws out.

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Having stated the above, let me offer my view of the importance of the Liquidator's initial discovery responses to Lexington's theory of this case. First, the Liquidator's admissions in her responses to Lexington's Requests for Admissions further confirm Lexington's position that the Liquidator consulted extrinsic written evidence in the Magellan/RBH matters to satisfy the identification requirements of the Guidelines.

Four key points can be taken from the Liquidator's Responses:

1. The car dealers listed on the exhibits to the Magellan and RBH reinsurance agreements were not identified as insureds of Reliance and were not, in fact, insureds of Reliance (Request #'s 3, 4, 7, 8, 9, 10, 14, 15);

2. The Magellan and RBH reinsurance agreements identified CareGard and Warrantech as "Administrator," but CareGard or Warrantech were nowhere named, defined or referred to as "insureds" of Reliance (Request #'s 1, 2, 5, 6);

3. The declaration pages of the underlying reinsured policies did identify CareGard and Warrantech as the "Named Insured" (Request #'s 12, 13); and

4. The Magellan and RBH reinsurance contracts do not name, define, refer to, schedule, attach as exhibits or otherwise incorporate by reference the declaration pages of the underlying reinsured policies.

Only one inference is possible from these admissions. Namely, the Liquidator consulted extrinsic evidence, most likely the declaration pages of the underlying insurance policies, to confirm that CareGard and Warrantech were Reliance's insureds.

This inference is further supported by the April 24, 2002 Settlement Agreement, between the Liquidator and Magellan and RBH, (produced by the Liquidator as part of her response to Lexington's Requests for the Production of Documents). Paragraph 1(a) of that Settlement Agreement, asserts that the RBH and Magellan reinsurance contracts identify CareGard and Warrantech as insureds "for the purpose of the Guidelines" as "further reflected" in the underlying insurance policies.

At the time the Settlement Agreement was entered, the Liquidator contemplated trying to avoid interpreting the Guidelines in precisely the way she was interpreting them for RBH and Magellan. Paragraph 9 of the Settlement Agreement provides that "the execution and delivery of this Settlement Agreement . . . shall not constitute or be construed as an admission by the Parties as to the appropriate scope, meaning or validity

of the Guidelines . . . ." Unfortunately for your client, she is responsible to interpret and apply the law (including the Guidelines) in a fair, consistent and non-arbitrary manner.

Perhaps most disturbing is, Paragraph 3 of the Settlement Agreement which leads to the conclusion that the Liquidator's approval of Magellan's and RBH's direct payment requests was a *quid pro quo* for the withdrawal of Magellan's and RBH's objections to the Guidelines. Lexington is denied equal protection of the law when its direct payment request is not evaluated by the Liquidator according to the same standards applied to Magellan/RBH because, apparently, the Liquidator believed those requestors had something more valuable to offer to her than did Lexington.

Lexington believes that its Objections have been greatly strengthened by your client's discovery responses and hopes that your client will re-evaluate her position. In an effort to reach a completely agreed set of facts regarding this issue, I enclose Lexington's Second Sets of Requests for Admissions (consisting of three requests that I believe the Liquidator will admit). Also enclosed are a companion Second Set of Interrogatories. While the rules allow the Liquidator 30 days to respond to the three Requests for Admission, they are very straightforward. Therefore, we request that you consider accelerating your response to Friday, June 17th. Lexington also reserves its right to take the deposition of, among others, William Taylor, Deputy Insurance Commissioner, William G. Watson, Executive Vice President of Reliance and Mark J. Fisher, First Vice President and Deputy General Counsel of Reliance.

Despite its resolve in this matter, Lexington recognizes that it is in its best interest to conclude this matter as soon as reasonably possible. That is why Lexington has expressed on numerous occasions its willingness to enter settlement negotiations. As recently as last Friday, I expressed to you my desire for Dan Krane and I to meet with Deborah Cohen and you to discuss the effect of the Liquidator's discovery responses. Therefore, based on these recent developments, Lexington renews its request that your client meet with Lexington to consider settlement.

Sincerely

Brian T. Guthrie

Enc.
BTG

cc: Edward S. Finkelstein, Esq. (via facsimile and first class mail)
Kassem L. Lucas, Esq. (w/o attachments)
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CERTIFICATE OF SERVICE

I hereby certify that on August 2, 2005, true and correct copies of the foregoing Liquidator's Sur-Reply to Lexington Insurance Company's Exceptions to the Referee's Recommendations were served as follows:

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No. 269 M.D. 2001 (Commonwealth Court of Pennsylvania)

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