THE COMMONWEALTH COURT OF PENNSYLVANIA

M. DIANE KOKEN, Insurance Commissioner of the Commonwealth of Pennsylvania, Plaintiff, v. RELIANCE INSURANCE COMPANY, Defendant.	:	Honorable James Gardiner Colins, President Judge No. 269 M.D. 2001 Before Referee Byron R. LaVan

IN RE: Objections of Phoenix Assurance PLC, Commercial Union Assurance Company, the British Aviation Insurance Company Ltd., Marine Insurance Company Ltd., And the Yorkshire Insurance Ltd. ("BAIG Companies") to the Liquidator's Denial of A Direct Payment Request

ORDER

And NOW this ____________ day of _______________, 2006, upon the consideration of the Statement of Undisputed Facts and Motion for Summary Judgment of Phoenix Assurance PLC, Commercial Union Assurance Company, the British Aviation Insurance Company Ltd., Marine Insurance Company Ltd., and the Yorkshire Insurance Ltd. ("BAIG Companies"), and the Liquidator's Response and accompanying Memorandum of Law thereto, it is HEREBY ORDERED AND DECREED that the BAIG Companies' Motion for Summary Judgment of is DENIED.

It is further ORDERED that the Liquidator's Denial of the BAIG Companies' direct payment request is AFFIRMED AND APPROVED as a matter of law.

____

REFEREE BYRON R. LAVAN

THE COMMONWEALTH COURT OF PENNSYLVANIA

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IN RE: Objections of Phoenix Assurance PLC, Commercial Union Assurance Company, the British Aviation Insurance Company Ltd., Marine Insurance Company Ltd., and the Yorkshire Insurance Ltd. ("BAIG Companies") to the Liquidator's Denial of A Direct Payment Request

LIQUIDATOR'S RESPONSE TO THE BAIG COMPANIES' MOTION FOR SUMMARY JUDGMENT

M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania, in her official capacity as Statutory Liquidator ("Liquidator") of Reliance Insurance Company ("Reliance") (In Liquidation), through her undersigned counsel, hereby submits this Response in Opposition to the Summary Judgment Motion of Phoenix Assurance PLC, Commercial Union Assurance Company, the British Aviation Insurance Company LTD., Marine Insurance Company LTD., and the Yorkshire Insurance LTD (collectively referred to as "BAIG Companies"). In support thereof, the Liquidator hereby incorporates by reference the accompanying Memorandum of Law and Affidavit of Eric Rothschild in Support of Memorandum of Law.

In response to the Statement of Undisputed Facts of the BAIG Companies, the Liquidator avers as follows:

1. Denied as stated. It is admitted that the British Aviation Insurance Group ("BAIG") (f/k/a British Aviation Insurance Company) has been an underwriter for the ABC for over 50 years, although the individual insurers that comprised the BAIG has changed over the years, including the years relevant to the dispute. It is also admitted that members of the ABC have been securing aviation liability insurance through the ABC for over 50 years. The remaining characterizations are denied as misleading because they suggest the insureds subject to the instant cut-through proceeding ("affected assureds") have been subscribing through the BAIG Companies for over 50 years. As discussed more fully in the accompanying Memorandum of Law, the affected assureds did not have any role in creating the ABC Program, and have not received insurance from BAIG or other insurers of the ABC Program for the past 50 years. In addition, during the relevant years, multiple insurers participated in the ABC by accepting a portion of the risk. The BAIG Companies never insured 100% of the members of the ABC.

2. Denied as stated. The Liquidator is without knowledge or information regarding whether the affected assureds met with the Lead Underwriters at the annual conference during the relevant years. It is only admitted that there is a Board of Trustees, Leading Underwriters, an American Brokers Committee and a London Brokers Committee that each have different roles in the ABC Program.

3. Denied as stated. The Liquidator incorporates by reference its response to paragraph 1.

4. Denied as stated. It is only admitted that a base wording is established each year. It is also admitted that aviation manufacturers seeking insurance through the ABC Program may use the master policy as a base wording for its individual coverage.

5. Denied. The master ABC wordings are documents in writing, which speak for themselves. By way of further response, as set forth more fully in the accompanying Memorandum of Law, the Liquidator objects to the characterization of the "Master Line Slips" cited in this Paragraph as the best evidence of the ABC base wordings. The slips identified in Paragraph 5 were not the same as the final slips sent to Reliance reflecting its participation.

6. Denied as stated. Each Master ABC Wording is a document in writing, which speaks for itself.

7. Denied as stated. It is admitted that the BAIG companies committed to subscribe to 17.5% of 100% of each risk placed under the ABC Program in the relevant periods in the states that it was licensed to write direct insurance, and that it assumed 17.5% of 100% of each risk from Reliance in states that it was not licensed to write direct insurance. The Liquidator is without information or knowledge on the dealings between the Lead Underwriters. It is admitted that the insurance broker that administers the ABC Program obtained the remaining security from various insurers. The Liquidator is without information or knowledge as to the remaining allegations. Furthermore, the case cited by the BAIG Companies is a document in writing, which speaks for itself.

8. Denied as stated. As set forth more fully in the accompanying Memorandum of Law for the 1995 Program year, Reliance subscribed to 3% in 46 states and 20.5% in the remaining four states subject to a reinsurance arrangement with the BAIG

Companies for 17.5% of the 20.5%. The documents cited in this paragraph speak for themselves.

9. Admitted.

10. Denied as stated. The cover note is a document in writing, which speaks for itself. Moreover, as set forth more fully in the accompanying Memorandum of Law, the BAIG Companies did not reinsure 100% of Reliance's risk. Nor did the BAIG companies insure 100% of the affected assureds' risk.

11. Denied as stated. The cover notes are documents in writing, which speak for themselves.

12. Denied as stated. The cover notes are documents in writing, which speak for themselves.

13. Denied as stated. The October 12, 1995 letter is a document in writing, which speaks for itself.

14. Denied as stated. Reliance did not act as a 100% front for the BAIG Companies in respect of the policies it issued in favor of assureds in Connecticut, Massachusetts, Michigan and New Jersey. The documents referred to in this paragraph speak for themselves.

15. Denied. The final ABC wording for 1995-1996 is a document in writing, which speaks for itself. By way of further answer, as set forth more fully in the Liquidator's Memorandum of Law, the "Master ABC wordings" that Reliance received from Crawley Warren reflecting Reliance's participation did not contain the endorsement described in this paragraph.

16. Denied. The master policy wordings are documents in writing, which speak for themselves. The Liquidator incorporates by reference her response to Paragraph No. 15. Moreover, the remaining 1996, 1997 and 1998 master policy wordings relied upon by the

BAIG Companies do not contain the endorsement described in this paragraph. The Liquidator is without knowledge of information regarding whether the Master policy wordings given to brokers of the affected assureds contained the endorsement described in this paragraph as there are no documents in the record evidencing what the affected assureds received.

17. Denied as stated. The Liquidator is without knowledge and information on what "basis" the insureds sought quotations. It is admitted only that the brokers sought coverage through the ABC.

18. Denied as stated. The Liquidator is without knowledge and information as to the negotiations between potential assureds and the Lead Underwriters. No evidence has been presented in this matter from any assured of the ABC Program.

19. Denied as stated. It is admitted that the Lead Underwriters, as "agent" on behalf of the entire facility, had authority to settle claims. The Master ABC wording is a document in writing, which speaks for itself. Moreover, it is unclear which Master ABC wording the BAIG Companies refer to.

20. Denied as stated. It is only admitted that the BAIG was one of the Lead Underwriters. The characterizations in this paragraph are denied as misleading to the extent they suggest that the BAIG had a special role with respect to the policies issued in these four states based upon the reinsurance arrangement.

21. Denied. The documents and cases cited in this paragraph speak for themselves.

22. Denied as stated. The averments in this paragraph relate to documents in writing, which speak for themselves.

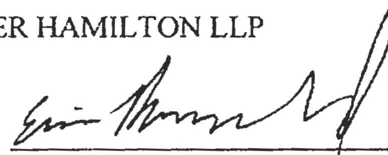
23. Denied as stated. The averments in this paragraph relate to documents in writing, which speak for themselves.

24. Denied as stated. The averments in this paragraph relate to documents in writing, which speak for themselves.

25. Denied. The Liquidator has no knowledge about the existence or extent of any affected assureds' shortfall as no evidence regarding their claims or recoveries has been made part of the record in this proceeding. By way of further answer, assureds may seek recovery through the proof of claim process provided for under Pennsylvania law, and the Court's Orders governing the Liquidation of Reliance.

WHEREFORE, in consideration of the Liquidator' Response to the BAIG Companies' Motion for Summary Judgment and accompanying Memorandum of Law, the Liquidator respectfully requests that said Motion for Summary Judgment be denied. The Liquidator further requests that this Court deny the BAIG Companies' objections and approve and affirm the Liquidator's denial of the BAIG Companies' cut-through request as a matter of law since the reinsurance contracts do not permit direct access. In the alternative, the Liquidator requests that this Court order the parties to appear for a hearing to determine if the BAIG Companies' facts permit a cut-through under a third-party beneficiary analysis as out lined in relevant Pennsylvania case law.

PEPPER HAMILTON LLP

By: 

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Dated: March 7, 2006

THE COMMONWEALTH COURT OF PENNSYLVANIA

M. DIANE KOKEN, Insurance Commissioner of the Commonwealth of Pennsylvania, Plaintiff, v. RELIANCE INSURANCE COMPANY, Defendant.	:	Honorable James Gardiner Colins, President Judge No. 269 M.D. 2001 Before Referee Byron R. LaVan

IN RE: Objections of Phoenix Assurance PLC, Commercial Union Assurance Company, The British Aviation Insurance Company Ltd., Marine Insurance Company Ltd., And The Yorkshire Insurance Ltd. ("BAIG Companies") to the Statutory Liquidator's Denial of A Direct Payment Request

LIQUIDATOR'S MEMORANDUM OF LAW IN SUPPORT OF HER RESPONSE TO THE BAIG COMPANIES' MOTION FOR SUMMARY JUDGMENT

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I. INTRODUCTION

M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania, in her official capacity as Statutory Liquidator ("Liquidator") of Reliance Insurance Company (In Liquidation) ("Reliance"), hereby submits this response to the summary judgment motion of the "BAIG Companies," comprised of Phoenix Assurance PLC, Commercial Union Assurance Company, the British Aviation Insurance Company LTD., Marine Insurance Company LTD., and the Yorkshire Insurance LTD. For the reasons set forth below, BAIG Companies' motion for summary relief (without a "*Legion*"-hearing, as undertaken in *Koken v. Legion Insurance Company,* 831 A.2d 1196 (Pa. Commw. Ct. 2003) ("*Legion*"), *aff'd per curiam*, 878 A.2d 51, 583 Pa. 400 (2005)), must be denied.

Reduced to its essence, the BAIG Companies seek to divert Reliance's reinsurance away from the Reliance Estate into the hands of a small subset of policyholders (hereinafter referred to as the "affected assureds"), thereby advantaging them both in timing and amount over all of the other policyholders of Reliance who must await an equitable distribution of assets pursuant to 40 P.S. § 221.44 of the Pennsylvania insolvency statute. BAIG Companies justify this result based upon two general contract law "arguments"—first, that the insurance and reinsurance agreements should be construed as a single document (BAIG Memorandum of Law at 2) and second, that the affected assureds should be deemed to be third-party beneficiaries of the reinsurance agreement. (BAIG Memorandum of Law at 2).

Remarkably, in advancing these two arguments, the BAIG Companies ignore that the common law is superseded by legal standards established specifically for determining when "direct access" to the reinsurance of a liquidated insurance company should be allowed. That is, while passing reference is made to the pertinent caselaw, nowhere do the moving papers of the BAIG Companies advance any arguments as to its entitlement for direct access based upon:

- the insurance insolvency statutes and regulations of the Commonwealth of Pennsylvania, (specifically, 40 P.S. § 221.34 ("Section 221.34");

- the orders issued by the Court charged with oversight of the Reliance Estate; *see* Oct. 3, 2001 Order of Liquidation, (Exhibit A) and August 26, 2002 Order and Guidelines for the Enforcement of 40 P.S. § 221.34 (Exhibit B); and/or

- the decisions of the Pennsylvania Supreme Court identifying the limited circumstances under which "direct access" to reinsurance may be granted following the liquidation of a Pennsylvania domestic insurance company. *See Legion* and *Koken v. Reliance: In Re: Baptist Health South,* 846 A.2d 167 (Pa. Commw. Ct. 2004), *vacated and remanded,* 2005 Pa. Lexis 2550 (Nov. 23, 2005) (Revised Order February 8, 2006) (Justice Newman Concurring) ("*In Re: Baptist*").

The reason the BAIG Companies give short shrift to the applicable law is evident. When the correct legal standards are applied, BAIG Companies have no evidence (much less undisputed evidence) that they meet any of the recognized limited exceptions to Section 221.34, permitting diversion of Reliance assets to some of Reliance's creditors. As set forth more fully below, the BAIG Companies do not have the specific contractual language required by Section 221.34 or the Guidelines; they have not submitted the necessary documentation to support their application, as required by the Guidelines; the reinsurers are neither 100% "fronted" by Reliance for the policies issued to the affected assureds,[1] nor did the affected assureds put together the insurance relationship directly with the reinsurers and then add Reliance, as required by *Legion*; nor are the BAIG Companies handling claims in their capacity as reinsurers (as was the case in *Legion*), but rather has undertaken its claims handling activity in its capacity as "agent" on behalf

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[1] "A fronting contract is one in which the reinsurers underwrite 100 percent of the risk on a policy issued by the direct insurer, or 'fronting company', which retains a small percentage of the premium for its services." (*See Koken v. Reliance: In R: Lexington Insurance Company's Exceptions to the Decision of Referee Finkelstein Affirming Liquidator's Denial of Direct Payment Request*, Memorandum Opinion and Order at 2, fn. 3 (Pa. Commw. Ct. Oct. 5, 2005) (J. Colins) ("*In Re: Lexington*"), *quoting* Law of Reinsurance, § 2.8.

of the entire pool, which is *not* 100% fronted; finally, the BAIG Companies cannot, and do not, seek to establish that a "novation," or legal substitution of all of the commercial entities by the BAIG Companies for Reliance (as was referenced in *In Re Baptist*).[2] In short, applying the clear and unmistakable legal standards, the BAIG Companies' motion for summary judgment must fail.

Equally fatal to the BAIG Companies' application for summary relief is the fact that its application relies on facts which cannot be sustained on the present record. These misstatements are material to the BAIG Companies' motion, and addressed more fully below. However, as a threshold matter, it must be pointed out that the presence of challenged facts in and of itself justifies the defeat of summary judgment.[3]

II. COUNTER-STATEMENT OF FACTS

A. Factual Background

1. Aircraft Builders Council, Inc. ("ABC")

The Aircraft Builders Council Program is one of many commercial products liability insurance programs available in the insurance market to aerospace manufacturers. (*See* Deposition Transcript of Louis Nunez at 16) (Exhibit C) (ABC program or facility was "essentially a consortium of insurers, insureds, and brokers working on a scheme to provide liability protection for product liability in particular."). Essentially, the ABC is a "scheme" to

[2]This Court has recognized that direct access may be granted if the parties can show that the relationship between the parties have effected a novation. *In Re: Lexington; and In Re: Baptist Health South*. Here, not only do the BAIG Companies fail to raise the issue of novation, if they did, they would not be able to establish the elements of a novation. (*See* discussion below in Section IV-C).

[3] Even if these facts were established, they would not, as described herein, support direct access under Section 221.34, or the controlling case law. As such, a dismissal of the BAIG Companies' Objections and approval of the Liquidator's denial of direct access is supported by the present record.

provide insurance to multiple aviation manufacturing companies covering the substantial risk associated with the aviation industry. The manufacturer's risk is covered by multiple insurers that sign on to provide a certain percentage of each manufacturer's risk. The ABC Program is serviced by a coordinating London broker, the brokers who represent the individual manufacturers, and the lead underwriters, who essentially act as agents on behalf of the other insurers by underwriting risk and settling claims on behalf of all of the insurers who agree to participate.

The ABC Program was established in the early 1950's by a group of aviation manufacturers, brokers and insurers to provide limits up to $5 million (now over $1 billion) to manufacturers of aviation products. *See* Deposition Transcript of Martin Cox Deposition at 36-7 and 14; (Exhibit D);[4] and *The ABC & Aerospace – A 50 Year Partnership* (DVD), attached as Exhibit 1 to Affidavit of Ann C. Taylor In Support of Statement of Facts And Memorandum of Law Submitted By The BAIG Companies In Support of Their Motion For Summary Judgment ("Taylor Affidavit"). None of the assureds now seeking direct payments had anything to do with setting up the ABC Program. *See e.g.* Aircraft Builders Counsel, Inc. Declarations 1955, attached as Exhibit E).

The ABC Program operates as a commercial product available to the aerospace industry. The coverage is provided by a group of commercial insurers, which changes from year to year, including during the years 1995-99 that are at issue in this dispute (the "relevant years"). They individually agree to assume a portion of the overall limits for each insured. *See e.g.*

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[4] Martin Cox is an underwriter at Global Aerospace Underwriters Managers, formally the British Aviation Insurance Group ("BAIG"), who personally participated in the underwriting of the ABC Program during the relevant years.

Declaration Placement Slip for Wall Colmonoy, attached as Exhibit F (the following insurers agreed to directly share 100% of Wall Colmonoy's risk as follows: Various Lloyd's Underwriters – (56.500%), Indemnity Insurance Company of North America – (10.000%), Reliance – (20.500%), Arkwright Mutual and New York Mutual – (4.000%), and Ace – (9.00%) (REL 004508-9). At no time during the relevant years was any one company a 100% insurer for any specific policyholder.

One or more of the insurers serves as the lead underwriter, which means that the other insurers (the "following insurers") allow those insurers to negotiate policies and resolve claims on their behalf. (*See* Deposition Transcript of Martin Cox at 57-58) (Exhibit D). During the relevant period, the co-Lead Underwriters of the ABC Program were the BAIG Companies, (now the Global Aerospace Underwriters Managers) and Lloyds Syndicate Ariel (now ACE Global Markets).[5] (Deposition Transcript of Louis Nunez at 19) (Exhibit C). The BAIG is, itself, a pool of insurance companies, the composition of which has changed over the years, including during the relevant years. (Deposition Transcript of Martin Cox at 10-11) (Exhibit D); (Deposition Transcript of David Hardy at 32) (Exhibit G). That pool, operating under the names BAIC or BAIG, has been one of the lead underwriters since the ABC Program's inception. At no point, did the BAIG Companies, individually or collectively, provide 100% of the coverage to any ABC Program insured in any state.

During the relevant years, the coordinating London broker that administered the ABC Program was Crawley Warren Co., Ltd. The employee at Crawley Warren who personally administered the ABC Program was David Hardy. Part of the responsibilities of the coordinating

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[5] Although Ariel was a co-Lead Underwriter of the ABC Program, they are not a part of this action.

London broker was to administer the program, work with the co-Lead Underwriters to draft a master policy (base wording) for the ABC Program and coordinate participation of the insurers. (Deposition Transcript of Martin Cox at 19-20 (Exhibit D); and Deposition Transcript of David Hardy at 13) (Exhibit G).

In addition, the ABC is comprised by a Board of Trustees; a coordinating legal counsel; an American Brokers Committee and a London Brokers Committee. (*See generally* Deposition Transcript of Martin Cox at 44-48 (Exhibit D)). The coordinating legal counsel for the ABC Program throughout its existence has been the law firm of Mendes & Mount.

2. Reliance's Participation in the ABC Program

Reliance's recent participation in the ABC Program began in 1995[6] when the coordinating London broker Crawley Warren requested Reliance become a direct (subscribing) insurer of the ABC Program. (*See* Deposition Transcript of Louis Nunez at 18-19 (Exhibit C); *see also* Letter dated 12 October 1995 from D. Hardy to L. Nunez, attached as Exhibit I)). Reliance agreed to subscribe for 3% of the entire limits offered by the ABC Program in every state. In the 1995, 1996, and 1997 program years, Reliance participated in ABC Program as a direct subscriber (insurer) for 3% of the entire limits offered by the ABC Program in every state. In 1998, Reliance reduced its direct participation to 2%.

During this same period, the BAIG Companies participated as direct subscribers (insurers) for 17.5% in 46 states; however, for regulatory reasons, the BAIG Companies could not directly insure the affected assureds in four states—Connecticut, New Jersey, Massachusetts and Michigan. Those states became the subject of the reinsurance arrangement between

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[6] Upon information and belief, Reliance participated during earlier years of the ABC Program, which are not at issue in this proceeding. (*See e.g.,* Addendum to Schedule A of Master Agreement for 1955, attached as Exhibit H).

Reliance and the BAIG Companies. Reliance subscribed for 20.5% (or 19.5%) of the ABC Program in the four states and 3% (2%) in every other state, with the BAIG Companies reinsuring 100% of 17.5% of Reliance's 20.5% (or 19.5%) participation in the four states during the relevant years. The BAIG Companies never reinsured the remaining 3% (or 2%) in the four states, or Reliance's 3% (or 2%) in the 46 other states. (*See* Deposition Transcript of David Hardy at 33-7 (Exhibit G); Deposition Transcript of Martin Cox at 96 (Exhibit D); *and* Deposition Transcript of Louis Nunez at 59-60 (Exhibit C)). The remaining 79.5% - 80.5% of limits in every other state were covered by other insurers having no involvement in this dispute, including the other leading underwriter, Ariel.

3. The Documents Relating to the Coverage

The insurance and reinsurance arrangements involving Reliance's participation in the ABC Program are reflected in certain documents. First, there is the Master Policy Slip (base wording) for the relevant years. The program year for the ABC Program begins on December 1 of each year and runs for 12 months or until November 30th of the following year. Reliance's participation in the program as an insurer was reflected by the copy of the base wording that the coordinating London Broker, Crawley Warren, sent Reliance on a yearly basis. In the relevant years, Reliance's participation is reflected by following Master Policy Slips sent to Reliance:

> On 18 December 1995, Crawley Warren sent Reliance the slip reflecting Reliance's participation for the 1995 Program Year (December 1, 1995 – November 30, 1996). *See* attached Letter and Slip, attached as Exhibit J.
>
> On 29 November 1996, Crawley Warren sent Reliance the slip reflecting Reliance's participation for the 1996 Program Year (December 1, 1996 – November 30, 1997). *See* attached Letter and Slip, attached as Exhibit K.
>
> On 5 December 1997, Crawley Warren sent Reliance the *two* slips reflecting (separately aircraft grounding liability insurance and products legal liability grounding liability and incidental liabilities)

Reliance's participation for the 1997 Program Year (December 1, 1997 – November 30, 1998). *See* attached Letter and Slips, attached as Exhibit L.

On 30 November 1998, Crawley Warren sent Reliance the slip reflecting Reliance's participation for the 1998 Program Year (December 1, 1998 – November 30, 1999). *See* attached Letter and Slip, attached as Exhibit M.[7]

Each of these slips reflect that Reliance agreed to accept 3% (or 2%) in all states but 20.5% (or 19.5%) in the four states:[8]

HEREON: 3.000%

But, 20.500% in respect of business domiciled in Connecticut, Massachusetts, Michigan, New Jersey, and any other state of America that the [BAIG Companies are] not licensed to write business in as may be agreed.

(See e.g. 1995 Master Policy Slip at p. 4) (Exhibit J). The master policy wording is also reflective of the base wordings that are used to negotiate the terms of an insureds' coverage through the ABC Program. (Deposition Transcript of Martin Cox at 75, 77) (Exhibit D).

In their Memorandum of Law, the BAIG Companies represent that the Master Policy Slips (base wordings) in effect each year contained an addendum that set forth the BAIG Companies' and Reliance's reinsurance arrangement—a fact that the BAIG Companies consider "particularly significant" to its legal argument. (Memorandum of Law of BAIG at 15). But that addendum appears on only one version of the Master Line Slip, for one year (*see* Exhibit 6 of Taylor Affidavit), and does not appear on the finalized slips sent to Reliance each year to

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[7] Exhibit M was produced by Crawley Warren, without bates stamps, prior to the deposition of David Hardy.

[8] The 1996 Master Policy Slip reflects that Reliance participated for 4% (21.5% in the four states), however, this is incorrect because Reliance's participation in that year was in fact only 3.% (20.5% in the four states).

memorialize Reliance's participation. (Exhibits J, K, L, M). Nor is there any documentary evidence in the record that the version of the Master Line Slip with the addendum was sent to the affected insureds.

The reinsurance arrangement between Reliance and the BAIG Companies was memorialized by cover notes[9] provided to Reliance in the same manner Reliance received the Master Policy Slips reflecting its participation:

> On 21 December 1995, Crawley Warren sent Reliance Reinsurance Cover Note No. AJ950006 reflecting the reinsurance for Declarations attaching during 12 months from 1 December 1995, attached as Exhibit N (REL 000031-33, 28).
>
> On 13 January 1997, Crawley Warren sent Reliance Reinsurance Cover Note No. AJ960006 reflecting reinsurance for Declarations attaching during 12 months from 1 December 1996, attached as Exhibit O (Reliance 000024-25, 27, 29).
>
> On 19 December 1998, Crawley Warren sent Reliance Reinsurance Cover Note Nos. AK970006 and AK970010 reflecting reinsurance for Declarations attaching during 12 months from 1 December 1997, attached as Exhibit P (REL 000016-22).
>
> On 17 February 1999, Crawley Warren sent Reliance Reinsurance Cover Note No. AJ980006 reflecting reinsurance for Declarations attaching during 12 months from 1 December 1998, attached as Exhibit Q (REL 000010-14).

Those reinsurance cover notes provide:

> *HERETO*: 100.000% of 17.500% part of 20.500% of whole.

(*See e.g.* 1995 Reinsurance Cover Note AJ950006 at p. 2) (Exhibit N); *see also* Deposition Transcript of Louis Nunez at 47, 54-5) (Exhibit C). Reliance did not cede to the BAIG

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[9] A cover note is "[a] written statement issued by an intermediary, broker, or direct writer, indicating that coverage has been affected." THE REINSURANCE CONTRACT, REINSURANCE CONTRACT WORDING (Robert W. Strain, Ed.) 745 (1992). There is no dispute that the reinsurance cover notes reflect the final agreement between Reliance and the BAIG Companies with respect to the reinsurance arrangement.

Companies its 3% participation in the four states or the 3% Reliance retained in the other 46 states. The reinsurance cover notes do not contain an insolvency clause, a cut-through or direct payment clause, or any language relating to the reinsurers' obligations or policyholders' rights in the event of Reliance's insolvency. This was expressly admitted by BAIG's witnesses. (Deposition Transcript of David Hardy at p. 69) (Exhibit G); (Deposition Transcript of Martin Cox at pp. 108-09) (Exhibit D).

4. Declarations To The ABC Program During The Years Reliance Participated

Manufacturers seeking coverage for airline products and grounding liability could secure that coverage from a number of providers in the market, including those participating in the ABC program.

> Q. So, can you walk through the process for an insured to join the ABC?
>
> A. Yes. Firstly, the insured, a US insured, US manufacturer, would approach his local broker, let us assume for an example this happened to be Marsh in the US. Marsh would under their terms have to seek quotations from a number of markets whilst, for example, the Aircraft Builders Council is one market where the broker Marsh could obtain a premium, but we also have competitors. There are a number of US companies AIG is an example that I could think of, a United States aviation insurance group -- AIG is another example and there are a number of underwriters in the London Market that do not participate in this program that would also provide competitive quotations.

(Deposition Transcript of Martin Cox at 49) (Exhibit D).

The reinsurance arrangement between the BAIG Companies and Reliance was in place before the affected assureds subscribed to the ABC each year. By way of example, during the 1995 ABC Program year, Blade Acquisition Corporation, a Connecticut insured, placed its business with the ABC Program through its US broker, C.T. Bowring. As described above, on

18 December 1995, Crawley Warren provided Reliance with the Master Wording reflecting its participation in the 1995 ABC Program year reflecting participation beginning December 1, 1995. (1995 Letter and Master Policy Slip) (Exhibit J). And on 21 December 1995, Crawley Warren provided Reliance with a reinsurance cover note reflecting the 17.5% reinsurance arrangement with the BAIG Companies in the 1995 ABC Program year, where Blade's insurance coverage attached. (*See* 1995 Reinsurance Cover Note AJ950006) (Exhibit N). For the 1995 ABC Program year, Blade's coverage attached as of July 1, 1996 and continued for 12 months. (*See e.g.* 1995 Slip for Blade Acquisition Corporation from BAIG's Records, attached as Exhibit R). Accordingly, the Master Policy and the reinsurance agreement were in place well before the Blade Acquisition was declared to the ABC Program for that year.

Once insureds had subscribed to the ABC Program, their brokers prepared slips reflecting the coverage. A slip was sent to Reliance reflecting its share of the coverage. (*See e.g.* Slip for Wall Colmonoy) (Exhibit F). In addition, at the same time, in the four states that the BAIG Companies were reinsuring Reliance for 17.5%, the brokers sent a placement slip to BAIG reflecting the reinsurance arrangement between Reliance and the BAIG Companies with respect to the specific insureds risk (*See* Slip for Blade) (Exhibit R).[10] As these documents clearly reflect, at the time these insureds were declared to the ABC Program, their brokers were aware of the reinsurance arrangement between Reliance and the BAIG Companies, which was in place before the declaration was prepared.

[10] For other placement slips reflecting knowledge of the reinsurance arrangement see Exhibit 13 of Taylor's Affidavit. The BAIG Companies have presented no evidence that these placement slips were provided to Reliance, and none appear in Reliance's records.

B. Background of the Direct Payment Request

1. Reliance's Liquidation and the Order and Guidelines

On October 3, 2001, this Court entered an Order of Liquidation declaring Reliance insolvent and appointing the Insurance Commissioner as Liquidator. Pursuant to Article V of the Insurance Department Act, this Court ordered the Liquidator "immediately to take possession of Reliance's property, business and affairs," "to liquidate Reliance" and "to take such action as the interest of the policy holders, creditors or the public may require." *See* Order of Liquidation, ¶ 3 (Oct. 3, 2001), attached hereto as Exhibit A). On August 26, 2002, this Court issued an Order and Guidelines for the Enforcement of 40 P.S. § 221.34 establishing an orderly process involving both the Liquidator and this Court, by which a reinsurer and/or an insured could apply for approval of a direct payment. *See* April 26, 2002 Order and Guidelines, attached as (Exhibit B).[11] The Court ruled that only when the Order and Guidelines are satisfied can a policyholder of the insolvent Reliance have its claim paid directly by a reinsurer, rather than as part of the overall distribution of the assets of the Estate by the Statutory Liquidator. *See* Order and Guidelines.

2. Request for Cut-Through

On March 4, 2002, David Hardy, of Benfield Greig Ltd., the successor to Crawley Warren & Co., the coordinating London broker and administrator of the ABC Program, inquired whether the Liquidator would consider a cut-through arrangement ("direct payment request") permitting the BAIG Companies to pay claims to certain assureds of Reliance[12] directly:

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[11] The BAIG Companies did not file any objections to the Petition seeking the Order and Guidelines.

[12] The Reliance assureds are: Blade Acquisition Corporation, Cabot Corporation, E.G. & G. Inc., Ensign-Bickford Industries, Inc., Hanson Industries, Inc., IMO Industries, Inc., Ingersoll Rand Company, Millenium Chemicals, Inc., Loos & Co., Inc., Transtechnology Corporation, Wall Colmonoy Corporation, Kollmorgen (continued...)

> ...both BAIG and the brokers would be interested to learn whether or not the Liquidator would be prepared to accept a cut through arrangement which would enable the brokers to collect the proportionate share of the claims from BAIG for direct settlement to their clients.

(*See* March 4, 2002 letter to L. Nunez from D. Hardy, attached as Exhibit U); (Deposition Transcript of David Hardy at 61-62) (Exhibit G).

There was no suggestion by Mr. Hardy that the BAIG Companies' reinsurance contracts with Reliance contained language providing for a cut-through, or that any other facts about their relationship required that a cut-through be allowed. *Mr. Hardy was asking for something that the parties had not provided for when they entered their contracts.* Mr. Hardy and the BAIG Companies knew perfectly well what the contract would look like if the parties had intended for direct payments to be made during insolvency:

> Q: What is your understanding of a cut-through clause?
>
> A: That it would allow the reinsurers to pay directly to the insured in certain circumstances.
>
> * * *
>
> Q: Did any of the reinsurance contracts at issue here contain a cut-through clause?
>
> A: Not that is reflected in the cover notes, no.

(Deposition Transcript of David Hardy at p. 69) (Exhibit G);

> Q: Can you tell me what a cut through clause is?

(continued...)

Corporation, and Perkin Elmer (collectively referred to as the "affected assureds"). The affected assureds, their state, their broker and their years of participation are described in the attached list of declarations provided by the coordinating London Broker to Reliance, attached as Exhibits S and T. None of the affected assureds have participated in these proceedings.

A: I can tell you in general terms what a cut through clause is. A cut-through clause is used in certain reinsurance agreements to allow direct payments.

A: Did any of the reinsurance agreements between Reliance and BAIG contain a cut through clause?

A: To the best of my knowledge, no they did not.

(Deposition Transcript of Martin Cox at pp. 108-9) (Exhibit D).

The Liquidator reviewed the direct payment request and denied the request for the following reasons:

> The reinsurance contract between Reliance and the reinsurer fails to create a direct coverage obligation between the reinsurer and the insured;
>
> The reinsurer has not obtained the named insured's informed consent to the reinsurer's substitution for Reliance in the direct coverage relationship; and
>
> The reinsurer has not submitted documentary proof of its unequivocal assumption of Reliance's coverage obligations to the insured.

See December 17, 2002 letter from Mark Fisher, attached as Exhibit V. The BAIG Companies have never contested any of these findings.

Pursuant to the process established by the Order and Guidelines, on January 17, 2003, the BAIG Companies filed Objections with this Court requesting that the Court permit the BAIG Companies to pay claims directly to the affected assureds. On February 13, 2003, the Liquidator filed a response to the Objections of the BAIG Companies. On April 11, 2003, this Court assigned Referee Byron R. LaVan, Esquire, to hear the Objections of the BAIG Companies and to make a recommendation to the Court. On May 13, 2004, Referee LaVan provided a Scheduling Order for the proceeding, which required the parties to conduct

depositions, including those of fact witnesses located in London, England, various expert witnesses, briefings, and a hearing.

With the Referee's permission, the parties requested an adjournment of these proceedings pending disposition of the two pending Pennsylvania Supreme Court appeals, addressing the precise issue here: the application of Section 221.34 to the distribution of reinsurance proceeds during the insolvency of a ceding insurer.[13]

By Order dated, July 9, 2004, the Court granted the parties joint motion to stay these proceedings. (See Order attached as Exhibit W). On July 19, 2005, the Supreme Court of Pennsylvania handed down its decision in the Legion Appeal, and on November 23, 2005, the Supreme Court of Pennsylvania handed down its decision in the Reliance Appeal. Both decisions established that direct payment requests must be considered on a case-by-case basis, confirmed the general rule that reinsurance proceeds must go to the estate of the insolvent insured, and identified the specific circumstances where direct payments should be allowed.

After the Legion Appeal was decided, the parties resumed discovery in the matter, including the depositions of Mr. Hardy and Mr. Cox. In addition to discovery, the schedule allows for the BAIG Companies' summary judgment motion and the instant response. A hearing is scheduled for April 20-21, 2006.

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[13] The two appeals were: (1) *Koken v. Reliance Insurance Company: In Re: Baptist Health South Florida Inc. objection to the Liquidator's denial of a direct payment request; Palm Springs General Hospital objection to the Liquidator's denial of a direct payment request; the Exceptions to the Report of Referee James Schwartzman* (Docket Nos. 60 MAP 2004 and 63 MAP 2004) ("Reliance Appeal"); and (2) *Koken v. Legion Insurance Company*, (Docket No. 205 MAP 2003) ("Legion Appeal").

III. LEGAL STANDARD AND SCOPE OF REVIEW

In this matter, the BAIG Companies have the burden of proving that the reinsurance arrangement with Reliance provides for direct payment during an insolvency. In a motion for summary judgment, the moving party bears the burden of proving that no genuine issue of material fact exists; summary judgment should not be entered unless the case is clear and free from doubt. *Accu-Weather v. Prospect Communications*, 435 Pa. Super. 93, 97-98, 644 A.2d 1251, 1254 (1994). "[S]ummary judgment is proper only when the uncontroverted allegations in the pleadings, depositions, answers to interrogatories, admissions of record, and submitted affidavits demonstrate that no genuine issue of material fact exists, and that the moving party is entitled to judgment as a matter of law." *Rauch v. Mike-Mayer*, 783 A.2d 815, 821 (Pa. Super. 2001) (quoting citation omitted). The record is viewed in the light most favorable to the non-moving party and all doubts as to the existence of a genuine issue of material fact are resolved against the moving party. *Mallesky v. Stevens*, 427 Pa. 352, 235 A.2d 154 (1967). "In sum, only when the facts are so clear that reasonable minds cannot differ, may a trial court properly enter summary judgment." *Rauch*, 783 A.2d 815, 821 (citation omitted).

"[W]here the moving party is the plaintiff, or the party bearing the burden of proof at trial, the standard is more stringent." *RCN Telecom Services v. Deluca Enterprises, Inc.*, No. Civ. A. 04-264, 2005 WL 1660161, *3 (E.D. Pa. July 12, 2005). (citation omitted). "The moving party must support its motion with credible evidence that would entitle it to a directed verdict if not controverted at trial." *Id.* at *3 (citation omitted). "In other words, when the moving party has the burden of proof at trial, that party must establish, on all of the essential elements of its case, that no reasonable jury could find for the nonmoving party." *Id.* at *3 (citation omitted); *see also*, *National State Bank v. Federal Reserve Bank of New York*, 979 F.2d 1579, 1582 (3d Cir. 1992) ("where the movant bears the burden of proof at trial and the motion

does not establish the absence of a genuine factual issue, the district court should deny summary judgment even if no opposing evidentiary matter is presented.") (citation omitted).

The right to make direct payments that the BAIG Companies seek, in the absence of any clear contractual language providing for such treatment, depends on very specific facts that are not easily resolved on summary judgment. In *Legion*, the Court explained that in a Pennsylvania liquidation proceeding, "direct access to reinsurance is a right established on a case by case basis," *Legion,* 831 A.2d at 1234, and in accordance with *Legion,* courts must examine the circumstances of the reinsurance relationship to determine if an exception to the general rule that reinsurance proceeds must become assets of the estate of an insolvent insurer applies:

> [t]his Court is obligated to examine the reinsurance arrangements in their entirety to discern the parties' rights and obligations.

Legion, 831 A.2d at 1236. *See also Koken v. Reliance: In Re: Baptist Health South*, 846 A.2d 167 (Pa. Commw. Ct. 2004) *vacated* 2005 Pa. Lexis 2550 (Nov. 23, 2005) (Justice Newman Concurring) (Revised Order, February 8, 2006) (Supreme Court of Pennsylvania remanded proceedings to the this Court for discovery on whether the insured was entitled to direct access). In reaching the conclusion that the four policyholder intervenors in *Legion* were entitled to direct access to reinsurance proceeds, the Commonwealth Court took testimony during several days of evidentiary hearings, where the policyholder intervenors presented facts establishing the inception and operation of the reinsurance relationship between the parties. *Legion,* 831 A.2d at 1208-1211 (discussion interest of Policyholder Intervenor- Pulte Homes); *id,* at 1211-1215 (discussing Policyholder-Intervenor Psychiatrists' Purchasing Group, Inc.); *id.* at 1215-1217 (discussing interest of Policyholder-Intervenor Rural/Metro Corporation.); and *id.* at 1217-1223 (discussing interest of Policyholder-Intervenor American Airlines, Inc.). The Referee should

resist resolving this matter in the BAIG Companies' favor in summary judgment, in the absence of clear evidence paralleling the *Legion* facts.

Moreover, the Supreme Court of Pennsylvania has held that "our courts will not disturb [the Insurance Commissioner's] administrative discretion in interpreting legislation within [the Insurance Department's] own sphere of expertise absent fraud, bad faith, abuse of discretion or clearly arbitrary action." *Winslow-Quattlebaum v. Maryland Ins. Group*, 561 Pa. 629, 752 A.2d 878, 881 (2000); *see also Foster v. Mutual Fire, Marine and Inland Insurance* Company, 614 A.2d 1086, 1092, 531 Pa. 598, 609-610 (1992); *Alpha Auto Sales, Inc. v. Dept. of State, Bureau of Professional and Occupational Affairs*, 537 Pa. 353, 357, 644 A.2d 153, 155 (1994) (stating that "[w]e have long held that the contemporaneous construction of a statute by those charged with its execution and application...is entitled to great weight...."); *In re Insurance Stacking Litigation*, 754 A.2d 702, 706 (Pa. Super. 2000) (stating that "[c]ourts traditionally accord an interpretation of a statutory provision by an administrative agency charged with administering that statute... deference") (citations omitted). Accordingly, any disposition of this dispute, whether on this motion, or after a hearing, should be made with due deference to the Liquidator's expertise in the implementation of laws relating to insolvent insurers.

IV. ARGUMENT

A. The Right To Direct Access Must Be Decided Based On The Pennsylvania Insolvency Laws and Cases Interpreting Their Application

This case arises out of the insolvency of Reliance, and must be resolved according to the laws relating to insolvency, and the court decisions that address the rights of insolvent insurers and their policyholders during a liquidation. Amazingly, in their 25 page Memorandum

of Law, the BAIG Companies never mention the Pennsylvania insolvency statute, or this Court's Guidelines for applying the statute. That is where the analysis of this dispute must start.

Section 221.34 of the Pennsylvania insolvency statute mandates that the amount recoverable by an insolvent insurer from a reinsurer should not be diminished due to the insolvency of the ceding insurer absent language in the reinsurance contract establishing a direct payment obligation:

> The amount recoverable by the liquidator from reinsurers shall not be reduced as a result of delinquency proceedings, regardless of any provision in the reinsurance contract or other agreement. Payment made directly to an insured or other creditor shall not diminish the reinsurer's obligation to the insurer's estate except when the *reinsurance contract provided for direct coverage of an individual named insured* and the payment was made in discharge of that obligation.

Section 221.34; *see also Eastern Engineering & Elevator Co., Inc. v. American Re-Insurance Company*, 309 Pa. Super. 578, 583, 455 A.2d 1235, 1237 (1983) ("the liability of the reinsurer is intended to run to the estate of the insolvent insurer for the eventual benefit of the insureds, and not directly to the policyholders of the insurer"). This general rule is recognized by Pennsylvania courts including the *Legion* Court. *See Legion*, 831 A.2d at 1234 ("The general rule in liquidations is to deny policyholder claimants direct access to reinsurance."). It is also reflected in the Guidelines adopted by the Court.[14] The reason for this rule is to ensure that particular insureds do not get preferential treatment over other insureds in the distribution of the Estate's assets. This is plainly consistent with the statutory goal of "equitable apportionment of any unavoidable loss." 40 P.S. § 221.1 (c); *see also Commonwealth v. Consolidated Indemnity*

[14] The Guidelines also require documentary proof of the reinsurers' unequivocal assumption of Reliance's coverage obligations to the insureds and the named insureds' informed consent to the reinsurers' substitution for Reliance in the direct coverage relationship. None of this documentation has been produced. On this basis alone, the Referee must deny Summary Judgment.

and Insurance Co., 362 Pa. 561, 571, 67 A.2d 434, 438 (1949) ("The ordinary rule of distribution of the assets of an insolvent is equality amongst creditors of the same class. . .").

Section 221.34 makes it rather simple for sophisticated insurance companies to provide for direct access to policyholders in the event of insolvency of the ceding insurer: write a provision in the contract. *See Eastern Engineering,* 309 Pa. Super. at 583, 455 A.2d at 1237 ("*unless the reinsurance contract provides for payments to the individual named insured*, the liability of the reinsurer is intended to run to the estate of the insolvent insurer for the eventual benefit of the insured and not directly to the policyholders of the insurer (emphasis added)"); *see also Legion*, 831 A.2d at 1221 (language in LIC's[15] reinsurance agreement with Syndicate 271 covering insured American Airlines "was included in the contract to provide the airlines direct access to the reinsurers in the event of [LIC]'s insolvency."). The witnesses for the BAIG Companies, David Hardy and Martin Cox, both integral participants in the formation of the reinsurance arrangement between the BAIG Companies and Reliance, knew exactly what kind of language is required to "allow reinsurers to pay directly to the insured" but they did not put such language in the reinsurance contracts with Reliance. (Deposition Transcript of David Hardy at p. 69 (Exhibit G); (Deposition Transcript of Martin Cox at pp. 108-9). (Exhibit D). The absence of language permitting a direct payment, when the party now seeking to make direct payments knew that it was required, is substantial evidence that this party did not have the requisite intent when they entered into the contract.[16]

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[15] In *Legion* the Court analyzed the estates of Legion Insurance Company and Villanova Insurance Company collectively, hereinafter the two Estates will be referred to as "LIC".

[16] The absence of an insolvency clause does not, as the BAIG Companies argue, advance its case for a cut-through. It is not the absence of an insolvency clause which determines whether a direct payment will be granted, it is the absence of a cut-through or direct payment clause that governs whether the BAIG Companies are permitted to make direct payments to Reliance insureds in the event of insolvency. *See Eastern Elevator, supra,* at 1237 *and*

(continued...)

B. **The Facts of the BAIG Companies' Reinsurance Relationship with Reliance Do Not Warrant Permission to Make Direct Payments Under *Legion***

In the *Legion* case, the Commonwealth and Supreme Courts found that in addition to satisfying Section 221.34 by explicit contract language (as it found American Airlines had), there are particular reinsurance arrangements where direct payments should be allowed to fulfill the policyholders' expectations. Specifically, after closely examining the facts presented by the four policyholder intervenors,[17] the *Legion* court found that the LIC insurance/reinsurance agreements fell outside the general rule for an insurer/reinsurer relationship because:

(continued...)

Legion, supra, at 1221. In fact, the BAIG Companies' acknowledgement that the reinsurance agreement lacked an insolvency clause actually supports the Liquidator's position because it is in the "typical insolvency clause" where one would find the language creating a direct payment obligation in the event of insolvency. (*See* Liquidator's Petition to Approve Guidelines Regarding the Direct Payment of Reinsurance Proceeds Pursuant to 40 P.S. § 221.34, ¶ 30 (a) - (c), attached as Exhibit X); *see also Legion,* at 1221 (reinsurance contract between LIC and Syndicate 271 respecting the interest of American Airlines contains virtually identical language as the examples provided in the Liquidator's Petition).

[17] As discussed more fully in *Legion,* the following characteristics of the reinsurance arrangements regarding the four policyholder intervenors were pertinent (emphasis added):

> Pulte Homes is a single family residential construction company issued LIC insurance policies from 1997 through 2001. Pulte Homes' *general liability coverage was negotiated between Pulte Homes and their reinsurers.* LIC only acted as a fronting company to satisfy financial responsibility laws of various states. LIC received $100,000 per year as a fronting fee *but did not retain any risks.* Additionally, Pulte Homes hired a third-party administrator, who handled all of its claims. (*See Legion,* 831 A.2d at 1208-1211).
>
> The Psychiatrists Purchasing Group ("PPG") was established by the American Psychiatric Association ("APA") to cover professional liability insurance for its members. In 1988, LIC became the principal fronting company for policies issued to the PPG. LIC's policies were reinsured initially by Psychiatrists Mutual Insurance Company ("PMIC") and then by Transatlantic Reinsurance Company ("TRC"). The reinsurance contracts did not contain cut-through clauses; however, the members of the PPG were the intended beneficiaries of these contracts. LIC *did not actively participate in securing reinsurance coverage. Although LIC retained some risks, LIC's retention was funded by the members of the APA.* LIC did not play a role in administering the program or handling claims; these functions were handled directly by the reinsurers and PPG's third-party administrators. (*See Legion,* 831 A.2d at 1211-1215).

(continued...)

The reinsurer, not LIC, bears 100% of the underwriting risk, and the *reinsurer was chosen by the policyholder. This was the case with all the Policyholder Intervenors. The Policyholder Intervenors, through their consultants and agents, chose their reinsurers as the intended source of their coverage. The fronting company was the last party to the transaction; its identity was not even known until after the reinsurance was placed* and all material terms decided by the Policyholder Intervenors and their reinsurers.

Legion, 831 A.2d at 1241 (emphasis added).

The BAIG Companies do not attempt to argue that their direct payment request is similarly situated to those granted to intervenors in *Legion*, nor could they. The BAIG Companies did not bear 100% of the underwriting risk, for the program generally or for Reliance specifically.[18] The BAIG Companies have assumed only 17.5% of the overall risk for the ABC

(continued...)

Rural/Metro is an emergency and medical transportation company, which negotiated and executed reinsurance agreements with TRC to cover its automobile, professional and general liability. After Rural/Metro secured its reinsurance, it selected LIC to issue fronting policies to cover its insurance for the policy periods of June 5, 2000 to June 5, 2001 and June 5, 2001 to June 5. 2002. Rural/Metro selected LIC because LIC maintained licenses in every state where Rural/Metro operated. The *policies issued by LIC were derived from, and consistent with, the terms set in facultative reinsurance certificates issued by TRC*. Rural/Metro also hired a third-party administrator to adjust its claims. LIC played no role in adjusting claims or setting reserves for Rural/Metro's program. (*See Legion*, 831 A.2d at 1215-1217).

American Airlines, the world's largest commercial air carrier, has multiple insurance carriers covering portions of its liability insurance. *Largely through a reinsurance intermediary, American Airlines secured aviation insurance from foreign insurers and reinsurers.* LIC was American Airlines' fronting insurer for part of the risk already assumed by American Airlines' quota share program. LIC was not required to use its own funds to make claims payments. The reinsurers either paid money into a fund that paid claims or paid claims made to LIC directly. *The reinsurance contracts with LIC contained insolvency clauses, which purported to provide American Airlines with direct access to the reinsurers in the event of LIC's insolvency. (See Legion*, 831 A.2d at 1217- 1223).

[18] The Liquidator is aware that the reinsurer required to make direct payments to American Airlines in place of LIC did not reinsure 100% of LIC's risk in all years. But that situation is distinguishable because the Court found that the relevant contracts had explicit cut-through language satisfying Section 221.34.

Program in the relevant years, whether in the forty-six states that they wrote business directly, or the four states where they reinsured Reliance. The remaining underwriting risk was shared among numerous carriers. The BAIG Companies did not assume Reliance's 3% (or 2%) participation in any state, and indeed have not offered to assume that participation during insolvency.

The BAIG Companies attach great import to the fact that BAIG, not Reliance, negotiated terms with insureds and had authority over claims. (BAIG Memorandum of Law at 18-19). These responsibilities, however, derive from its role as a *co-lead underwriter* of the entire ABC facility, not its reinsurance arrangement with Reliance. BAIG had this same relative status vis-a-vis all of the carriers participating in the ABC Program not just Reliance, even though it had no reinsurance relationship with the other carriers. This was not a case like *Legion* where BAIG had authority over underwriting and claims resolution as a result of the coverage arrangements between itself, Reliance, and the affected assureds. The authority derived from other arrangements relating to the ABC Program, having nothing specifically to do with the BAIG-Reliance reinsurance relationship.

Nor was this a case where "[t]he [affected assureds] chose [BAIG] as the intended source of their coverage" and Reliance "was the last party to the transaction; its identity ... not even known until after the reinsurance was placed and all material terms decided by the [affected assureds' and BAIG]." *See Legion*, 831 A.2d at 1241. Instead, by subscribing to the ABC Program, assureds accepted multiple insurers as the source of their coverage. The precise composition of insurers providing coverage, and the percentage that each insurer committed to changed every year, and was in place before any individual policyholder subscribed for coverage.

Similarly, the policyholders had no role in setting up the BAIG-Reliance reinsurance relationship; it was in place when they subscribed to the program. Indeed, in its brief, BAIG expressly admits that "[t]he affected ABC assureds were *advised* of the reinsurance arrangement between Reliance and the BAIG Companies at the outset, before coverage attached." (BAIG Memorandum of Law at 17). This admission, by itself, dramatically distinguishes the BAIG Companies' direct payment request from the *Legion* facts.

The timing and circumstances of the coverage arrangements in *Legion* provide a basis for allowing direct payments that does not exist in this case—the fulfillment of the policyholders' expectations. *Legion,* 831 A.2d at 1246. The *Legion* Court made clear that an essential aspect of its approval of direct payment requests was that "the reinsurance was placed by the policyholder, not [LIC], *for the policyholder's benefit.*" *Id.* at 1247 (emphasis added). By contrast, in this case, the reinsurance was arranged between the BAIG Companies and Reliance *for the BAIG Companies' benefit*, so that they could assume business that they could not write directly. The internal business arrangements among the various carriers insuring the ABC Program – including the allocation of risk between the BAIG Companies and Reliance – was their affair, not the policyholders. The policyholders simply shopped the airline liability market for the best terms and selected the ABC Program, as it was constituted, for their coverage. (Deposition Transcript of Martin Cox at 49-50). (Exhibit D). There is simply nothing about this business arrangement between the BAIG Companies and Reliance—established for BAIG Companies' business needs, not the policyholders'—that warrants an exception to the general rule regarding reinsurance proceeds.

C. The Parties Did Not Novate the Reinsurance Agreements

Although never raised by the BAIG Companies, the Court has recognized that direct access may be granted if the parties can show that the relationship between the parties

have effected a novation. *See In Re: Baptist Health South*, 846 A.2d 167 and *In Re: Lexington, supra*. The Liquidator recognizes that in some specific instances, this Court has recognized that the parties' pre-liquidation conduct may effect a novation. However, even in those instances, the novation must fulfill certain requirements of both case law and statutory regulations governing the issuance of insurance in the states.

Here, not only do the BAIG Companies fail to raise the issue of novation, they fail to satisfy the requirements of a novation. The legal elements of a novation are: 1) the displacement and extinction of a valid contract; 2) the substitution for it of a valid new contract; 3) sufficient legal consideration for the new contract; and 4) the consent of the parties. *Levey v. Sklar*, 63 Pa. D. & C. 4th 543, 550, 2003 WL 21499891, *3 (Pa. Com. Pl. 2003) (citations omitted). No evidence has been presented on these elements and now that discovery has ended, the BAIG Companies should be precluded from trying to establish such facts. The elements for novation are not met here. Moreover, if a novation was affected here, the BAIG Companies would become direct insurers of the affected assureds in the four states; something they are not permitted to do, which is why they entered into the 17.5% reinsurance relationship with Reliance in the first place. (*See* discussion above in Section II-A-2).

D. The BAIG Companies "Single Contract Theory" Must Fail

Since the BAIG Companies cannot make the case – indeed do not try to make the case—that their direct payment request is similarly situated to the requests in *Legion* or *Baptist Health*, they argue instead that various documents that relate to the ABC Program must be construed together as a "single contract of insurance for each affect ABC assured," (BAIG Memorandum of Law at 16), which continues in effect during Reliance's insolvency. This rationale ignores the clear instructions in Section 221.34 about how a contract should provide for direct payments. Nor is this rationale for a direct payment justified by *Legion*, which

emphasized the sequence of how the coverage was arranged and the policyholder's role in arranging it, not simply purported connections between insurance and reinsurance documents. Moreover, the BAIG Companies baldly misrepresent the coverage extended to insureds under the ABC Program. Each insured received coverage from multiple carriers in every state, including from Reliance. Under no interpretation of the documents can they be construed as a single insurance contract solely between the BAIG Companies and individual policyholders.

In addition, if the BAIG Companies' interpretation were credited, it would mean that the BAIG Companies have been violating state insurance laws by issuing direct insurance in states where they are not licensed to do so. *See e.g.,* 40 P.S. § 46 ("[n]o insurance company, association, or exchange of another state or foreign government shall do an insurance business within this Commonwealth without first having obtained a certificate of authority from the Insurance Commissioner authorizing such company, association, or exchange to do such business."); *see also United Healthcare Benefits Trust v. Insurance Commissioner of Pennsylvania*, 620 A.2d 81 (Pa. Commw. Ct. 1993) (court upholds fines levied against certain parties conducting the business of insurance without a license).[19] This of course would defeat the purpose that the BAIG Companies entered into the reinsurance arrangement with Reliance in the first place, which was to comply with regulatory requirements. (BAIG Memorandum of Law at 6, 15). Clearly this argument does not reflect the BAIG Companies' actual intent at the time the contracts were entered into, but rather a post-hoc rationalization designed to accomplish what

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[19] This issue cuts across all states in which Reliance wrote business that was ceded to the BAIG Companies, not just Pennsylvania. *See* Conn. Gen. Stat. Ann. §38a-41 (2000); Mass. Gen. Law Ann. Ch. 175 §162I (2005); Mich. Comp. Laws Ann. §500.402 (2002); N.J. Stat. Ann. §17:22A-29 (2005); and N.J. Stat. Ann. §17:17-12 (2005).

was not done when the contracts were entered into -- provide for direct payments during insolvency.

Indeed, none of the BAIG Companies' generalized arguments about construing contracts together support an interpretation that the documents they rely upon can be construed to provide for direct payments during insolvency. None of the documents they rely upon refer in any way to any intention to make direct payments if Reliance becomes insolvent. The principle that multiple documents can be construed together has never been extended to construe documents to mean things that they do not say.

The BAIG Companies attempt to bolster their argument by the fact that BAIG, not Reliance, negotiated terms and resolved claims directly with insureds. As described above, these responsibilities, however, derive primarily from its role as a *co-lead underwriter* of the entire ABC facility, not its reinsurance arrangement with Reliance. Moreover, the right to settle claims directly during solvency, does not, by itself, support direct payments. *Cf. USX Corporation. v. Adriatic Ins. Co.*, 64 F. Supp. 2d. 469, 477 (W.D. Pa. 1998) (reinsurer's contractual rights to control original insured's "registers, books, reports, and other papers in any way relating to the policies" and to "assume the care and expense of the adjustment of all losses which may occur under the policies" under insurance contract covering all of original insurer's outstanding risks did not give rise to basis for a direct suit by policyholders where reinsurance policy did not expressly (1) provide for the assumption of all underlying policies and (2) obligate the reinsurer to pay the policyholders directly), *citing, Appeal of Goodrich*, 2 A. 209, 213 (PA. 1885); *and Allendale Mutual Ins. Co. v. Crist*, 731 F. Supp. 928, 933 (W.D. Mo. 1989) ("distinguishing cases which expressly assigned proceeds of reinsurance to underlying policyholders and opining that "standing alone, what a reinsurer does about paying claims has no

bearing on whether the reinsurer is directly liable to the original insured."); *In Re: The Bennett Funding Group, Inc. v. Ades Investor Group*, 60 Fed. Appx. 863, 865-6, 2003 U.S. App. LEXIS 4611, *6-7 (2d Cir. Mar. 13, 2003) (the fact that an insurer is operating in a fronting capacity does not mean that the reinsurance contract becomes an insurance contract or that the separate policies collapse into one).

Finally, there are evidentiary questions about the particular documents that the BAIG Companies rely upon for its "single contract" argument that cannot be surmounted on the present record.

The document that the BAIG Companies primarily rely upon is the Master Line Slip (or what it calls the "Master ABC Wording"). They represent that the document is "particularly significant" because it contains an addendum that incorporated the terms and conditions of the reinsurance arrangement between Reliance and the BAIG Companies in respect of the 17.5% subscription that the BAIG Companies could not directly undertake in Connecticut, Massachusetts, Michigan and New Jersey. (BAIG Memorandum of Law at 16). But BAIG fails to disclose that the document that it relies upon for that assertion is not the final version of the Master ABC Wording that was sent to Reliance. The only document in the record that contains the purportedly "significant" addendum is REL 270-277 (Exhibit 6 to Taylor Affidavit), a version of the Master Slip for policies attaching during the 12 months from 1 December 1995. But the final version of the Master Slip for that time period that was sent to Reliance does not contain the addendum. (*See* 1995 Letter and Slip) (Exhibit J). (REL 429-436). And *no other version* of the Master Line Slip for 1995 *or any of the other three years* that the BAIG Companies reinsured Reliance contains the addendum, a fact that the BAIG Companies avoid by failing to attach the wordings for subsequent years. (BAIG Memorandum of Law at 5 n.2). (*See*

Letters and Slips for 1996, 1997 and 1998). (Exhibits K, L, M). When the BAIG Companies represent to the Referee that "the final Master ABC Wording in respect of the ABC Program *in each period at issue* contained an endorsement noting the arrangement between the BAIG Companies and Reliance" that representation is not reflected in the documents in the record. There are also no documents demonstrating that the affected assureds received Master Line Slips with the addendum.

A second group of documents that the BAIG Companies claim is crucial are the declarations prepared by insureds' brokers that reflect the reinsurance relationship between Reliance and the BAIG Companies. There is no evidence that document was ever sent to Reliance. The BAIG Companies are trying to argue a tripartite agreement about what should happen in the event of Reliance's insolvency from a document that there is no evidence the insolvent company ever received.

Even if these evidentiary problems did not exist, the Liquidator would strenuously object to the argument that the multiple documents in the ABC relationship can be combined for a proposition that none of them address – direct payments during an insolvency. It certainly cannot stand on the foundation of the hodgepodge of documents that the BAIG Companies rely upon.

E. The BAIG Facts Fail to Meet the *Legion* Test for Third Party Beneficiary Status

As an alternative to its single contract theory, the BAIG Companies argue that the affected assureds should be deemed third party beneficiaries of the reinsurance contracts with Reliance. In doing so, they invoke the *Legion* decision but ignore the circumstances that warranted conferring third party beneficiary status in *Legion*. The Court made clear that third party beneficiary status must be determined "in accordance with the principles set forth in the [ ]

Opinion." *Legion*, 831 A.2d at 1248. The circumstances supporting direct payments in *Legion* included the absence of any assumption of underwriting risk by LIC or Villanova and that the reinsurance was placed by the policyholder, not LIC or Villanova, for the policyholders benefit. *Legion,* 831 A.2d at 1247. As discussed above, those factors are not present here. In particular, the record does not support a finding that the reinsurance was arranged by the policyholders without Reliance's involvement. Quite the contrary, here the reinsurance was arranged between the BAIG Companies and Reliance, without the policyholders' involvement. There is no basis for reading *Legion* to allow third party beneficiary status, or deviation from the general rule that reinsurance proceeds go to the insolvent insurer, absent these factors.

Moreover, the *Legion* court also based its third party beneficiary reasoning on language in the relevant reinsurance contracts.

> The rights of Pulte, Rural/Metro and PPG stem from facultative reinsurance agreements specific to their individual risks; they were issued facultative certificates. American claims rights under a reinsurance agreement that is not strictly facultative, i.e., a facultative obligatory treaty. On the other hand, the contract, or wording, between Legion and Syndicate 271 contains language that expresses American's right to cut-through Legion to collect reinsurance directly from Syndicate 271.

Id. at 1237. The reinsurance contracts between the BAIG Companies and Reliance do not fit these descriptions. Here, the reinsurance covernotes provide for a broad array of risk for insureds who subscribed in that particular year; the actual insureds are not identified anywhere in the reinsurance agreements. Nor is there language, such as the Court found between Legion and Syndicate 271, that expresses a right to a cut-through. In *Legion*, there was also testimonial evidence from policyholders of the parties' specific intent to allow direct payments during insolvency. *Id.* at 1218. No such evidence has been presented here.

F. The BAIG Companies' Equity Argument Is Without Merit Because The Insolvency Statute Treats Them Exactly Like Any Other Policyholder Of The Reliance Estate.

The BAIG Companies' argument that it should be granted a cut-through under the principles of equity must fail because the affected assureds are held to the same regulatory requirements as all Reliance insureds, and nothing prevents them from filing claims with the Reliance Estate. Direct insureds of Reliance, absent an approved cut-through, must submit their claims to Reliance under the proof of claims process. *Vickodil v. Commonwealth of Pennsylvania Insurance Department*, 559 A.2d 1010, 1012 n.4, 126 Pa. Cmwlth. 390, 394 n.4 (1989) (the claimant must file a claim with the liquidator of the estate of the insolvent insurer, who then acts under court direction to distribute the estate's assets in accordance with a statutorily ordered priority of claims) (citing 40 P.S. § 221.37 – 221.46).

If the Liquidator were to grant a cut-through, the affected assureds would be receiving a preference over other insured-claimants to Reliance's Estate, which is prohibited by statute. *See Commonwealth v. Consolidated Indemnity and Insurance Co.*, 362 Pa. 561, 571, 67 A.2d 434, 438 (1949) ("The ordinary rule of distribution of assets of an insolvent is equality amongst creditors of the same class. . ."). Having entered into this arrangement with Reliance to satisfy regulatory requirements, the BAIG Companies cannot now ask that the Court ignore the state's laws and regulations relating to insolvency. The Statutory Liquidator is not oblivious to the impact of the state's insolvency laws on the affected assureds. However, "the exigencies attendant to a major commercial insolvency . . . necessitate[s] the reality that 'individual interests may need to be compromised in order to avoid greater harm to a broader spectrum of policyholders and the public.'" *Foster v. Mutual Fire, Marine and Inland Insurance* Company, 614 A.2d 1086, 1094 (Pa. 1992) (citations omitted).

V. CONCLUSION

For the foregoing reasons, M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania, in her official capacity as Statutory Liquidator ("Liquidator") of Reliance Insurance Company, requests that the Court enter an Order in the form attached, denying the BAIG Companies' Motion for Summary Judgment and affirming the Statutory Liquidator's denial of the BAIG Companies' direct payment request.

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Date: March 7, 2006

CERTIFICATE OF SERVICE

I hereby certify that on March 7, 2006, true and correct copies of the Liquidator's Response to the BAIG Companies' Motion for Summary Judgment, accompanying Memorandum of Law, Affidavit of Eric Rothschild in Support of Liquidator's Memorandum of Law and Exhibits, Binder of Authorities Cited, and Proposed Order were served upon the following:

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