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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

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COMMONWEALTH COURT
OF PENNSYLVANIA
2001 NOV 22 PM 4:30

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 _____, 2001, 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, and the subsequent replies submitted by the parties, it is HEREBY ORDERED AND DECREED that the BAIG Companies' Motion for Summary Judgment 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 Statutory Liquidator's Denial of A Direct Payment Request

LIQUIDATOR'S SUR-REPLY TO THE BAIG COMPANIES' MOTION FOR SUMMARY JUDGMENT

The BAIG Companies' reply brief[1] in support of summary judgment reveals that their argument for making direct payments to policyholders of Reliance is based almost entirely on the BAIG Companies' role as a lead underwriter for the ABC Program. The BAIG Companies' status as a lead underwriter for the program, and the responsibilities that are associated with that status, have nothing to do with their reinsurance contracts with Reliance, and, therefore, should have no bearing on whether direct payments should be allowed under 40 P.S. § 221.34 ("Section 221.34"), or the case law that applies the statute. Accordingly, the Liquidator submits this surreply brief to crystallize the disputed issues between the parties, and urge the Referee to dismiss the BAIG Companies' Objections.

[1] The "Combined Statement of Facts and Reply Submitted by the BAIG Companies to the Liquidator's Response To the BAIG Companies' Motion For Summary Judgment" was submitted by the BAIG Companies on March 14, 2006.

1. During an insolvency, certain specific conditions are required by Pennsylvania courts before reinsurance proceeds can be diverted from the estate of an insolvent insurer to specific insureds.

2. First, the conventional way for policyholders and reinsurers to establish a right to make direct payments in the event of insolvency is for that intention to be explicitly provided for in the reinsurance contract, which the BAIG Companies and the ABC administrator knew, but declined to carry out.[2]

3. Second, there were certain coverage arrangements developed by policyholders that caused the court 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), ("*Legion*"), to allow direct payments from reinsurers to specific *Legion* insureds.[3] The BAIG Companies concede that its reinsurance arrangement came about quite differently than the arrangements discussed in *Legion.* The BAIG Companies admit that the Policyholders did not secure coverage with the BAIG Companies before the BAIG Companies' reinsurance arrangement with Reliance was established, or have anything to do with bringing the BAIG Companies and Reliance together. BAIG Reply at 29. Instead, the affected assureds were the last parties to the transaction when

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[2] The BAIG Companies argue that no "cut through provision" was necessary because the declarations prepared by brokers allow the BAIG Companies to settle directly with the affected assureds. But the declarations don't say anything about "direct settlement," "direct payments," or "direct collections." They provide for "simultaneous", not "direct" payments; the same as the reinsurance contracts do. And, according to the documents relied upon by the BAIG Companies, "simultaneous," but not "direct" payments is exactly what occurred pursuant to the parties' agreements. *See* ¶¶ 12-13, *infra.*

[3] The BAIG Companies do not suggest that they satisfy the novation test articulated by Judge Colins in *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*"), so that case is not further addressed herein.

they subscribed for coverage from the ABC Program each year, and the reinsurance arrangement was a *fait accompli* that they had to accept if they wanted coverage with the program.

4. Recognizing that their direct payment request cannot be justified by the same criteria that drove the *Legion* decision, the BAIG Companies claim that particular aspects about its participation in the ABC Program provides a basis for further expanding the application of Section 221.34.

5. There are three aspects of the coverage arrangements that the BAIG Companies argue as the basis for approving direct payments:

a. the affected assureds negotiated their policies with the BAIG Companies;

b. the affected assureds submitted their claims to the BAIG Companies;

c. the affected assureds collected 17.5% of each covered claim directly from the BAIG Companies.

BAIG Reply at 19.

6. The first two assertions are not disputed – and are a complete red herring. The BAIG Companies did negotiate policies with assureds, and did have authority over claims. But, unlike in *Legion*, those two functions had nothing to do with the BAIG Companies' reinsurance of Reliance, but rather from its status as one of two lead underwriters for the ABC Program. The BAIG Companies had those functions in all 50 states – the 46 states where it did not reinsure Reliance, and the four that it did. They had those functions on behalf of all following insurers – including Reliance, which they reinsured, and all the other following carriers, which they did not reinsure. *If there had been no reinsurance arrangement between the BAIG Companies and*

Reliance, the BAIG Companies would have had the exact same role in underwriting policies and resolving claims.

7. Furthermore, Lloyds Syndicate Ariel, as the other lead underwriter for the ABC Program, also negotiated policies with assureds, and had authority over claims. And, of course, its authority did not derive from, or in any way relate to, the reinsurance of Reliance, as it did not provide reinsurance to Reliance.

8. The argument that the BAIG Companies' role in negotiating policies and resolving claims requires a direct payment to the affected assureds of its reinsured Reliance, would, if taken to its logical conclusion, mean that the BAIG Companies are also required, for the same reason, to make direct payments to assureds on behalf of all the other following insurers, in all states, because the BAIG Companies, as lead underwriter, negotiated policies and claims for them. And it would, if taken to its logical conclusion, require Ariel, which, upon information and belief, did not reinsure any of the following insurers, to make direct payments to all assureds for the following carriers' share of the liability for the same reason.

9. This is, of course, an absurd result. But an absurd result is what flows when a right to cut through a reinsurance contract is based on factors that have nothing to do with the reinsurance contract. The BAIG Companies' underwriting and claims handling role did not derive from their reinsurance relationship with Reliance, and existed completely independent of it.

10. By contrast, the reinsurers' control over underwriting and claims of *Legion* insureds arose from the reinsurance arrangement set up by the intervening policyholders.[4] *Legion*, 831 A.2d at 1208 ("program of [Pulte's] own design")

11. This distinction cuts to the core of the *Legion* opinion. The reinsurers' control over aspects of the coverage normally handled by the direct insurer were significant to the court's determination that the policyholder intervenors should receive direct payments *because it arose from the* reinsurance arrangement that the policyholders brought about. If, as is the case here, the reinsurers' role in negotiating policies and claims exists for a completely different reason, having nothing to do with their reinsurance of an insolvent insurer, there is no reason for treating that role as significant to a direct payment analysis.

12. The other fact emphasized by the BAIG Companies is that the assureds collected 17.5% of each covered claim in the four states directly from the BAIG Companies. BAIG Reply at 19. This is not precisely accurate. In the four states where Reliance insured assureds for 20.5% and reinsured 17.5% of the 20.5% with the BAIG Companies, the documents relied upon by the BAIG Companies reflect that the assured's broker would debit *Reliance*, not the BAIG Companies, the entire 20.5% that was owed to insureds. *See* REL 003063 (Exh. 19 to Taylor Affidavit). There was no direct collection of the 17.5% from the BAIG Companies. The documents also reflect that the assured's broker would separately debit the BAIG Companies 17.5% pursuant to the reinsurance contract, to be credited to Reliance. *See* REL 003062 (Exh.

[4] At footnote 14 of its Reply, the BAIG Companies make assertions about how the reinsurance relating to LIC insured American Airlines worked. Those assertions are not based on anything described in the *Legion* Opinion, and should not be considered. Nor should a BAIG witness be allowed to testify about these assertions at the hearing, as they are based on facts – whether correct or not – that were not considered by the *Legion* Court.

19 To Taylor Affidavit). These transactions occurred simultaneously, just as the reinsurance contracts between the BAIG Companies and Reliance provided. *See* REL 000028, 000030-33 (Exh. 12 to Taylor Affidavit).

13. The aspect of this payment arrangement that the BAIG Companies repeatedly emphasize is that the assureds' brokers had the administrative responsibility for settling the reinsurance claims between the BAIG Companies and Reliance. This convenient procedure for carrying out an administrative function provides an incredibly slender basis for discarding the general rule that reinsurance proceeds go to the insolvent insurer that was in contractual privity with the reinsurer, not the insolvent insurer's policyholders. *Legion* does not demand this result, given all the material differences in the development of the reinsurance arrangements that are present here.

14. The *Legion* decision did not nullify the insolvency statute, or create exceptions to the general rule for every possible permutation of reinsurance. *Legion* allows direct payments only where absolutely necessary to vindicate policyholder expectations arising out of the policyholder's central role in establishing the coverage relationship. Each of the successful policyholder-intervenors discussed in *Legion* set up its coverage program with the eventual reinsurers, prior to the direct carriers becoming involved, a fact which was essential to the opinion. *See e.g., Legion,* 831 A.2d at 1241 (for each Policyholder Intervenor, "[t]he 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."); *id.* at 1247 ("the reinsurance was placed by the policyholder, not Legion or Villanova, for the policyholder's benefit"); *id.* at 1215 ("[o]nce the reinsurance was in place, Rural/Metro approached several carriers to issue a fronting insurance policy."). That fact

establishes the policyholder's unique stake in coverage from the reinsurer, which does not exist when the policyholder passively accepts a reinsurance relationship that was in place before the policyholder subscribed for coverage.

15. The BAIG Companies admit that the affected assureds did not found the ABC Program, nor establish coverage with the BAIG Companies during each policy year before adding Reliance to the relationship. The Referee should be very reluctant to override the statute where the applicant for direct payment admits it does not satisfy the limited recognized exceptions to the statute.

16. Finally, the BAIG Companies have not cured the evidentiary defects with their "single insurance contract" argument. As the Referee will recall, that argument suggests that the Master Policy, reinsurance contracts, and individual declarations prepared by assureds' brokers are linked together as one insurance contract between the BAIG Companies and the affected assureds in the four states where the BAIG Companies could not legally write insurance. The linchpin of the argument is that the Master Policy included an addendum that explicitly described the BAIG-Reliance reinsurance relationship. BAIG MSJ at 16.

17. As the Liquidator explained in its Response to the BAIG Companies' Motion for Summary Judgment, the BAIG Companies' "single insurance contract" does not satisfy Section 221.34 or *Legion* even if the facts were as the BAIG Companies have described them. Moreover, the BAIG Companies do not have competent evidence to support the argument. None of the final versions of the Master Policy sent to Reliance have the addendum. The BAIG Companies have now produced a final version of the Master Policy from Crawley Warren's files – and it also does not have the addendum. *See* Exh. 20 to BAIG Reply. Notwithstanding, the

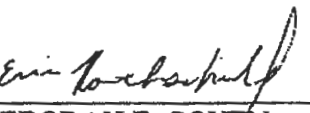
BAIG Companies continue to insist the Master Policy distributed to assureds contained the addendum. BAIG Reply at 17-18. Until that assertion is supported by competent evidence, the BAIG Companies' single contract argument should not be entertained.

CONCLUSION

In *Legion*, policyholders of LIC were able to demonstrate to the court that they had a legitimate expectation that they would receive direct payments if LIC became insolvent because they had been directly involved in arranging the reinsurance in the first place. In this case, the policyholders of Reliance have not demonstrated any involvement in constructing the BAIG-Reliance reinsurance relationship, or, in fact, provided any reason to the Referee why they should be treated preferentially to other Reliance insureds. The BAIG Companies' Objections should be dismissed.

Respectfully submitted,

PEPPER HAMILTON LLP

By: 

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Date: March 22, 2006

CERTIFICATE OF SERVICE

I hereby certify that on March 22, 2006, true and correct copies of the Liquidator's Sur-Reply to the BAIG Companies' Motion for Summary Judgment and Proposed Order were served upon the following:

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I hereby certify that on March 23, 2006, true and correct copies of the Liquidator's Sur-Reply to the BAIG Companies' Motion for Summary Judgment and Proposed Order were served upon the following:

Via Notice of Filing

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