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August 9, 2006

VIA HAND DELIVERY

Chief Clerk
Commonwealth Court Office
The Widener Building
1349 Chestnut Street, Suite 900
Philadelphia, Pennsylvania 19107

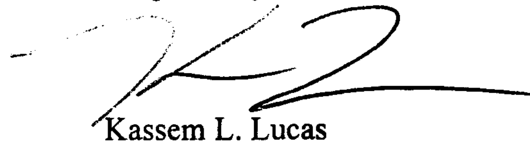
Re: *Koken v. Reliance Insurance Company*, (Docket No. 269 M.D. 2001); Objections of Phoenix Assurance PLC, Commercial Union Assurance Company, the British Aviation Insurance Company Ltd., Marine Insurance Company Ltd., and the Yorkshire Insurance Ltd. ("BAIG ") to the Liquidator's Denial of A Direct Payment Request

Dear Chief Clerk:

Enclosed is a 3 ½ inch diskette in Microsoft format, the original and four copies of the Liquidator's Exceptions to Referee's Report and Recommendation, Appendix, Proposed Order and Certificate of Service.

Please file the original and return a time-stamped copy to me in the self-addressed, stamped envelope.

Respectfully submitted,



Kassem L. Lucas

KLL:jmd
Enclosures

cc: Referee Byron K. LaVan (w/enclosures) (via electronic mail and FedEx)
Ann C. Taylor, Esquire (w/enclosures) (via electronic mail and FedEx)
Michael J. Cawley, Esquire (w/o enclosures) (via electronic mail)
Eric Rothschild, Esquire (w/o enclosures) (via electronic mail and interoffice mail)

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COPY

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") to the Liquidator's Denial of A Direct Payment Request

ORDER

And NOW this ____________ day of _______________, 2006, upon the consideration of the Liquidator's Exceptions to Referee's Report and Recommendation, and any response thereto, it is hereby ORDERED and DECREED that the Liquidator's Exceptions are GRANTED. It is further ORDERED that the Referee's Report and Recommendation is reversed and the Liquidator's Denial of the BAIG's direct payment request is AFFIRMED AND APPROVED as a matter of law.

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RECEIVED AND FILED
COMMONWEALTH COURT

____
JAMES GARDINER COLINS, President Judge

COPY

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 EXCEPTIONS TO REFEREE'S REPORT AND RECOMMENDATION

The Statutory Liquidator of Reliance Insurance Company (the "Liquidator") submits these exceptions to Referee Byron LaVan's Report and Recommendation that the Objector-Reinsurer BAIG be permitted to make direct payments to insureds of Reliance. 40 P.S. § 221.34 of the Insolvency Act, by its express terms allows direct payments (or cut-throughs) only if they are explicitly provided for in the reinsurance contract. 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), the Supreme Court permitted a narrow exception to the statutory requirement where the policyholder can establish that it set up the coverage relationship with the reinsurer, and then brought in the insurer as the last participant in the transaction. Neither of these conditions is satisfied here. There is no language in the reinsurance contract permitting direct payments, and the policyholders did not set up the reinsurance arrangement. The unrebutted evidence established that the policyholder was the last party to sign on to the

coverage relationship, after the insurer Reliance and the reinsurer BAIG had entered into their reinsurance contract. *See* April 20, 2006 N.T. 161-162 (Cox).

The Supreme Court of Pennsylvania has made it very clear, as recently as its March 20, 2006 decision in *Koken v. Reliance Insurance Co. (Appeal of Mawson & Mawson, Inc.)*, 893 A.2d 70, 82 (Pa. 2006) that lower courts should not stretch the meaning of the Insolvency Act simply to accomplish some perceived sense of equity, or avoid particular results. Because the Referee's Report and Recommendation goes beyond the plain language of the statute and the limited exception established by *Legion*, the Statutory Liquidator respectfully requests that this Court affirm the Statutory Liquidators' Denial of Direct Payments.

I. FACTS

This dispute arises out of a reinsurance arrangement entered into between Reliance Insurance Company (now in liquidation), and the British Aviation Insurance Group ("BAIG"), a pool of insurers 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 business written into the Aircraft Builders Council program. BAIG seeks approval of its request to make direct payments to certain Reliance insureds whose risks were partially ceded to BAIG pursuant to reinsurance agreements.

The Aircraft Builders Council ("ABC") is an insurance program that has been writing a variety of airline liability policies for more than fifty years. David Hardy Dep. (9/30/05) (Hardy Dep. I) at 14.[1] The ABC Program was established in the early 1950's by a

[1] David Hardy is a representative of Crawley Warren, the administrative broker for the ABC Program. The parties designated testimony from Hardy's two depositions as trial testimony in this matter.

group of aviation manufacturers (the "original insureds"), brokers and insurers to provide limits up to $5 million (now over $1 billion) to manufacturers of aviation products, and has been a source of insurance coverage to airline product manufacturers since that time. *See* April 20, 2006 N.T. 68-70 (Cox).[2] Throughout its existence, the insurance coverage for the program has come from a group of insurers that operate in either a lead or following capacity.[3] *See* April 20, 2006 N.T. 99 (Cox). The lead underwriters are the primary decision makers for the pool, setting the policy rates, and holding authority over claims, which the following insurers accept. *See* April 20, 2006 N.T. 24. BAIG has been one of the lead underwriters of the ABC Program throughout the existence of the program, including during the years relevant to this dispute.[4] *See* April 20, 2006 N.T. 68-69 (Cox).

None of the insureds for whom BAIG is seeking coverage in this action (the "later insureds") had anything to do with setting up the ABC Program in the 1950s. Hardy Dep. I at 17. The later insureds also had nothing to do with setting up the ABC Program in subsequent years, including the relevant years for this dispute. That was done by Crawley Warren (now called Benfields) on behalf of the ABC facility. Webster Dep. at 87. Crawley Warren is *not* an agent for the individual insureds. Webster Dep. at 87. The individual insureds have no ongoing

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[2] Martin Cox is an underwriter for BAIG who testified for BAIG at the hearing.

[3] For example, in 1995, the participating insurers were BAIG (17.5%, except in New Jersey, Michigan, Connecticut, New Jersey), Ariel (9%), Reliance (3%, except 20.5 % in New Jersey, Michigan, Connecticut, New Jersey), Various other Lloyd's Underwriters (46% (9% to Ariel)), ERH (5.5%); Various other I.L.U Companies (22.5% (17.5% to BAIG), General Accident Insurance Company of America (2%), Indemnity Insurance Company of North America (5%), Skandia International Insurance Corp. (3%), Arkwright Mutual (4%), Ace (9%). *See* Trial Exh. 5.

[4] In the years relevant to this dispute, Ariel was also a lead underwriter. *See* April 20, 2006 N.T. 82 (Cox).

affiliation or "membership" with the ABC Program. Webster Dep. at 114.[5] Crawley Warren goes about setting up the coverage for the program each year, including any fronting reinsurance arrangements, without any commitment from any insured that they will participate in the program that year. Webster Dep. at 113.

After Crawley Warren has arranged the coverage that will apply to the ABC Program each year, including any fronting arrangements, it communicates those arrangements to potential policyholders. Trial Exh. 5-8. Insureds have no input in these arrangements. They must either accept them or purchase insurance elsewhere. For the insureds, the ABC Program is simply no more and no less than an insurance product that they can purchase or decline depending on their commercial needs and interests.

For the years 1995, and through 1997, Reliance subscribed for a 3% share in the program, in the capacity of a following insurer. *See* April 21, 2006 N.T. 279 (Nunez). In 1998, it reduced its share to 2%, and the following year ended its participation in the program. *See* Trial Exhibit 43. None of that share was reinsured to BAIG. *See* Trial Exhibits 40-43. During those same years, BAIG subscribed for 17.5%. (The remaining 79.5% to 80.5% of the coverage for the program was provided by other insurers that are not party to this dispute). *See. e.g.* Trial Exh. 5. In four states, New Jersey, Michigan, Connecticut and Massachusetts (the "affected states"), however, BAIG could not write the program directly. *See* April 20, 2006 N.T. 212 (Myers). Accordingly, in 1995, Crawley Warren, acting on behalf of BAIG, asked Reliance to write an additional 17.5% of the program in those four states, along with its own 3% (or 2%) participation for a total of 20.5% (or 19.5%) participation, and then reinsure that 17.5%

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[5] Robert Webster is an employee of Marsh, a broker for some of the individual insureds in the ABC Program. Parts of his deposition was designated as trial testimony by the parties.

participation with BAIG. *See* Trial Exhibits 40-43. Reliance agreed to this proposal. *See Id.* "No individual assured played any role in making the reinsurance arrangement between British Aviation and Reliance." David Hardy Dep (4/19/2006) (Hardy Dep. II at 16).

The written documentation of the reinsurance agreements between Reliance and BAIG for this 17.5% share are Cover Notes prepared by Crawley Warren. Trial Exhibits 40-43; Hardy Dep. I at 23. The reinsurance agreements require BAIG to reinsure 17.5% of 20.5% (or 19.5%) of 100% for each insured in the affected states. Trial Exhibit 40-43.

When Crawley Warren arranged the reinsurance between BAIG and Reliance it was doing it on behalf of the ABC facility, not any individual insured. The reinsurance arrangement between BAIG and Reliance (and other reinsurance arrangements among the participants) were established before any company placed business with the program. *See also* April 20, 2006 (N.T. 161-62) (Cox); April 21, 2006 N.T. 292-93 (Nunez). The insureds had to accept that arrangement or seek coverage elsewhere. Webster Dep. at 87-88.

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. *See* Trial Exhibits 40-43. This was expressly admitted by BAIG's witnesses. (Hardy Dep. I at 69); April 20, 2001 N.T. 163 (Cox). The subject of allowing direct payments during insolvency never came up in the negotiation of the reinsurance agreements. *See* April 21, 2006 N.T. 298 (Nunez).

The companies who are the subject of BAIG's cut-through request acted through their own brokers, not Crawley Warren, when they placed insurance with ABC. Hardy Dep. I at

17-18.[6] As explained above, those companies had no authority to change the composition of insurers, or any reinsurance arrangements those insurance companies had entered into. Webster Dep. at 87-88. The insured companies were made aware of the coverage arrangements applicable to their policies, but had no influence or control over them. *Id.*

When placing business with the program, the brokers for the individual assureds would prepare a slip indicating the insurance coverage, which went to all participating insurers including Reliance. An example of this type of document was introduced as Trial Exhibit 11. According to Martin Cox of BAIG, this document bound coverage in the program. April 20, 2006 N.T. 97-99. In addition, in those states where Reliance was reinsuring BAIG for 17.5% of its 20.5% participation the insured's broker prepared a slip reflecting the reinsurance arrangement. An example of this type of document was introduced as Trial Exhibit 12. That slip was sent to BAIG only, not Reliance. April 21, 2006 N.T. 302-04 (Nunez). The Referee's Recommendation is incorrect in stating that "a copy of [the reinsurance slip] was sent to all the following insurance companies, including Reliance." Recommendation at 15 (emphasis in original). There is no evidence supporting this finding, and Reliance's Louis Nunez expressly denied it. April 21, 2006 N.T. 302-04. In addition, according to Mr. Cox, the reinsurance slip was solely for the administrative purpose of facilitating the collection of claims – it had nothing to do with binding coverage, and was not a contractual document. April 20, 2006 N.T. 105-106 ("It's more an administrative function as opposed to contractually binding the risk . . ."); 107 ("for administration purposes").

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[6] Crawley Warren can place business for policyholders, but did not do so for any of the policyholders who would benefit from BAIG's direct payment request. Hardy Dep. II at 33.

Claims against policyholders in the ABC Program were adjusted by Mendes and Mount, the law firm affiliated with the program. *See* April 20, 2006 N.T. 119 (Cox). The lead underwriters, which included BAIG, had authority to resolve claims. *See* April 21, 2006 N.T. 166 (Cox). Following insurers such as Reliance were required to accept the determination of the leads, and pay their proportionate share of the claim. *See* April 21, 2006 N.T. 285 (Nunez).

The insureds' brokers were responsible for collecting payment of claims on behalf of insureds. April 21, 2006 N.T. 314-317 (Nunez). For insureds in the states where Reliance fronted for BAIG, the insureds' brokers would also arrange collection of reinsurance on behalf of Reliance, for eventual payment to insureds. April 21, 2006 N.T. 205-207 (Nunez). This was done monthly by bordereaux, so claim and reinsurance payments were set off by accounting entry, rather than being paid claim by claim amongst the parties. Webster Dep. at 79-80. This process for reconciling claims by bordereaux was not unique to the ABC Program; it was general practice in the industry. Webster Dep. at 80-81; April 21, 2006 N.T. 313-314 (Nunez).

II. PROCEDURAL BACKGROUND

Reliance was placed in liquidation by the Court, by Order dated October 3, 2001. Pursuant to that Order, the provisions of the insolvency act went into effect, including 40 P.S. § 221.34 dealing with payments owed by reinsurers. On April 26, 2002, this Court approved "Cut-Through Guidelines" to implement Section 221.34 for the Reliance estate. Trial Exhibit 53.

Following liquidation, Robert Webster of Marsh, who served as broker for many of the individual policyholders in the ABC Program, investigated whether there was a cut-through clause in the reinsurance contracts between BAIG and Reliance. Webster Dep. at 116-117. He testified that he was not aware of any other basis that would justify collecting direct payments for his clients from BAIG. Webster Dep. at 139-41. He told BAIG because "there is

no cut-through clause ... we can't collect your share and pay it directly." Webster Dep. at 120. Upon finding that no cut through language existed, Marsh did not request that the Liquidator allow direct payments from BAIG to the Reliance insureds Marsh represented. Webster Dep. at 124.

BAIG did request that the Liquidator permit it to make direct payments to Reliance insureds in the four states where Reliance was fronting for BAIG. By letter dated March 4, 2002, David Hardy of Crawley Warren asked, on behalf of BAIG:

> In essence 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.

Trial Exhibit 55. Mr. Hardy did not suggest in the letter that such a cut-through arrangement was required by the parties' contracts, or any other aspects of the reinsurance arrangement. The Liquidator denied that request because the reinsurance contracts did not have any language about direct payments during insolvency that would satisfy the statute and Guidelines. Trial Exh. 61.

BAIG filed Objections to the Liquidator's denial, which were assigned to Referee LaVan. While discovery was underway between the parties, the Commonwealth Court issued its decisions in *Legion* (Leavitt, J.) and *Baptist Health* (Colins, J.) interpreting Section 221.34 to permit cut-throughs under some circumstances, despite the absence of specific language in the contract providing for direct payments. Both those decisions were appealed to the Supreme Court. While the Supreme Court appeals were pending, the parties to this dispute agreed and this Court approved a stay of the proceedings. Following the Supreme Court's opinion in Legion, affirming the Commonwealth Court, the stay was lifted. The parties completed discovery, and proceeded to a two day hearing on April 20-21, 2006, before Referee LaVan. At that hearing, British Aviation called as a live witness, Martin Cox, an underwriter for BAIG. Reliance called

as live witnesses, former Reliance underwriter Louis Nunez, and current employee Diane Myers. The parties also submitted deposition testimony from David Hardy, a representative from ABC's broker-administrator Crawley Warren, and from Robert Webster, who works for Marsh, a broker for many of the individual insureds. No individual insured testified in the case. In fact, no insured has even submitted a written consent to BAIG assuming Reliance's liability to pay claims to the insureds, as is required by the Guidelines.

III. REFEREE LAVAN'S REPORT AND RECOMMENDATION

On July 25, 2006, Referee LaVan issued his decision, approving direct payments from BAIG to Reliance's insureds for the 17.5% share in the four states. In making his ruling, Referee LaVan made the following findings in support of his decision:

> (1) ABC is an association made up entirely of the individual insureds, (some of whom sit on the Board of Trustees), who with their coordinating broker, developed the terms and conditions of its Master Policy Insurance Slip and Cover Note; (2) that Reliance merely fronted the reinsurance policy and took only a small fee for its participation, and Reliance did not share in the premium; (3) I find the affected individual policyholders, through their respective American and/or London brokers (agents), prepared the individual line slips and reinsurance line slips which incorporated the original reinsurance Cover Note scratched by Reliance. These reinsurance documents were prepared for the benefit of the affected insureds in the four states; (4) that Reliance took no real underwriting risk. The reinsurer BAIG paid 100% of the reinsurance directly to the insureds' brokers for the insureds. Reliance only paid 3% of the insurance coverage (not reinsurance) as a "following" insurer of claims; (5) that BAIG as a lead underwriter negotiated and handled all claims requiring payment of reinsurance. Reliance never handled a claim; (6) that Reliance was "the last party to the table" as the original reinsurance slip was scratched by BAIG, prepared by the coordinating broker of ABC for the benefit of all affected insureds prior to Reliance scratching the Cover Note. Reliance, other than signing (scratch), had no role in the establishment of the terms and conditions of the Cover Note. The Cover Note, as scratched by Reliance, is bound to the terms of the Master Line Slip and Master Policy; (7) I find that the affected individual insureds had a reasonable expectation that BAIG would pay the 100% of its obligation (17.5%) due under the reinsurance Cover

> Note directly to the London brokers for the individual members' claims. Reliance did not pay those sums and was never expected to pay those sums. The individual policyholder, BAIG and the coordinating broker intended that the insureds should have direct access to the payment of the reinsurance proceeds. All parties recognized the individual insureds' rights to collect those reinsurance sums. The sums were used exclusively and entirely for the payment of the individual policyholders' claims.

Recommendation at 23.

IV. ARGUMENT

The determination of whether a reinsurer can make direct payments to a policyholder of an insolvent insurer is governed by 40 P.S. § 221.34, which provides that:

> 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").

In *Legion*, the Court made clear that Section 221.34 is satisfied only if the right to direct payments is explicit in the reinsurance contract, or "the reinsurance was placed by the policyholder . . . for the policyholder's benefit." *Id.* at 1247.[7] Specifically, after closely

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[7] This court has also suggested 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)* that cut-throughs may be approved if a novation occurs. BAIG has not argued that basis in this case.

examining the facts presented by the four policyholder intervenors,[8] the *Legion* court found that direct payments were required because:

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[8] 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).
>
> *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*

(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). As the opinion makes explicit, the *Legion* court was not permitting direct payments for all fronting arrangements, only those where the policyholder and reinsurer joined first, and brought in the fronting insurer as the last participant. This makes perfect sense, for it is only when the policyholder has arranged the coverage that direct payments are necessary to vindicate the policyholder's expectations. *Id.* at 1247.

The parties agree, and the Referee found, that there is no contractual language permitting direct payments. Recommendation at 22. Therefore, the only way that direct payments could be allowed is if "the reinsurer was chosen by the policyholder" and "[t]he fronting company was the last party to the transaction." *Id.* at 1241. The evidence does not support a finding that the arrangement was developed in this manner; indeed, counsel for BAIG did not even seriously argue it.

None of the individual insureds that are the subject of BAIG's direct payment request were among the original insureds that set up the ABC facility in the 1950s. April 20, 2006 N.T. 144 (Cox). This distinguishes this case from *Legion*, where insureds like American Airlines and Pulte Homes were the original insureds that created the coverage arrangement. Moreover, the evidence is equally clear that the later insureds had no role in setting up the ABC

(continued...)

> *access to the reinsurers in the event of LIC's insolvency. (See Legion,* 831 A.2d at 1217- 1223).

facility, including the BAIG-Reliance reinsurance arrangement, year to year Every witness who testified in support of direct payments – Martin Cox of BAIG, David Hardy of the administrative broker Crawley Warren, and Robert Webster of the individual insureds' broker Marsh – admitted that all aspects of the insurance security for the ABC facility, including the BAIG-Reliance reinsurance arrangement ***were in place before any policyholder subscribed for coverage.*** April 21, 2006 N.T. 301 (Nunez); April 20, 2006 N.T. 161-162 (Cox); Hardy Dep. at 98-99.. The policyholders, not the fronting insurer, were the last parties to the transaction. Counsel for BAIG did not dispute this – the most that she could argue was that the policyholders became "aware" of the reinsurance arrangement when they subscribed for coverage. April 21, 2006 N.T. 417-418. There is nothing in the *Legion* decision which suggests that a policyholder's mere awareness of a reinsurance arrangement that pre-existed the policyholder's involvement in the transaction is sufficient to require direct payments.

Despite the fact that BAIG's witnesses testified that these later insureds had no role in setting up the reinsurance, Referee LaVan held that the "individual insureds ... with their coordinating broker, developed the terms and conditions of [the reinsurance] Cover Note," and that "Reliance was 'the last party to the table' as the original reinsurance slip was scratched by BAIG, prepared by the coordinating broker of ABC for the benefit of all affected insureds prior to Reliance scratching the Cover Note." Recommendation at 24. These conclusions misapply the *Legion* decision by treating the activities of the coordinating broker Crawley Warren in setting up the ABC facility each year as the equivalent of the policyholder or the policyholder's own broker actually arranging the reinsurance.

Referee LaVan's error arose in part from his mistaken understanding that insureds were ongoing members of ABC. *See, e.g.,* Recommendation at 13 ("ABC is made up of its

members."); at 14 ("ABC is nothing but a conglomerate of its individual insureds."); at 15 ("the insureds are ABC."); at 23 ("ABC is an association made up entirely of the individual insureds"). That is exactly the opposite of how BAIG's own witnesses characterized the situation. ABC is simply an insurance facility. The insureds are not "members" or part of ABC until they take out a policy – which is after all the reinsurance arrangements are made. For example, Mr. Webster of Marsh testified as follows:

> Q: How do you acquire the status of "member"?
>
> A: Once your contract is written through the ABC, you're a member of the ABC scheme.
>
> Q: So, year to year?
>
> A: Year to year.
>
> Q: Okay. You're not an ongoing member; you have to have coverage?
>
> A: No. You have to, each year, place your insurance contract, annual basis.
>
> And you would be a member of the ABC scheme whilst you were insuring through the ABC scheme.
>
> **Q: The day before you subscribe for coverage, you're not a member?**
>
> **A: Correct.**

Webster Dep. at 114 (emphasis added). In other words, an insured is not part of ABC until it places its insurance – by which time the reinsurance is already in place. Mr. Cox of BAIG did not even agree that there was such a thing as "membership" in ABC. April 20, 2006 N.T. 150.[9]

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[9] The policyholders of ABC are clearly distinguishable from members of the American Psychiatric Association, who were interveners in *Legion*. The members of APA are members separate and apart from their purchase of insurance. *Legion*, 831 A.2d at 1211. The ABC policyholders only become part of ABC when they purchase insurance each year.

Referee LaVan was also incorrect in finding that "Mr. Hardy [at Crawley Warren] is the insureds' broker through ABC. He is first to the table on their behalf." Recommendation at 17. Crawley Warren, is the agent for the ABC Program, <u>but not for any individual insureds:</u>

> Q: When Crawley Warren is undertaking that role, they're doing that for the ABC facility.
>
> Correct?
>
> A: Correct.
>
> Q: And not on behalf of any particular assured[10]?
>
> A: Correct.

Webster Dep. at 87. If there was any doubt about this, it was confirmed by BAIG's express representation to the Referee in response to questions by the Referee about this very issue of agency, at the beginning of the hearing:

> With respect to the agency relationships with the parties at issue, it's a little complex one, but David Hardy, from the coordinating broker's office, he is in what is termed the ABC office. There are only two gentleman in that office, and <u>he acts as an agent for the board of trustees for the Aircraft Builders Council. That is his role</u>.
>
> While Benfields, which was then called Crawley Warren, could be a broker for an assured, it would not be done through his office. <u>The brokers of the assureds are agents of the assureds</u>. They negotiate directly with the insurers, and by custom and practice in the insurance industry, and even more so in the London insurance market, an insurer would never speak to an assured directly. They go only through a broker. And if there is an assured present, their broker is always present as well.
>
> MR. ROTHSCHILD: And I agree that the brokers for the affected assureds, which happens to be in this case not Crawley Warren/Benfields, it's companies like Marsh, are agents for the insureds.

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[10] Participants in the ABC program often use the term "assured" rather than "policyholder" or "insured".

April 20, 2006 N.T. 58-59 (emphasis added). *See also* April 20, 2006 (N.T. 161-62) (Cox); April 21, 2006 N.T. 292-93 (Nunez); April 20, 2006 N.T. 220-21 (Myers).

Moreover, as Mr. Webster explained, by the time the insureds "came to the table," the arrangements were fixed and the insureds had no authority to change them:

> Q: In fact, no assured subscribes for coverage in a program year until all of the security has been arranged and the reinsurance arranged?
>
> A: Correct.
>
> Q: And if an assured for any reason was dissatisfied with the composition of carriers or reinsurance arrangements, they have no option to change that.
>
> Correct?
>
> ...
>
> A: Are you saying after they bind or before they bind, under the program?
>
> Q: Before they bind, there is nothing they can do to change the security behind the facility.
>
> Correct?
>
> A: They can't change the security behind the facility.
>
> Q: Okay. And any reinsurance arrangements for unlicensed carriers who are participants is also set?
>
> A: That's correct.
>
> Q: Okay. And non negotiable?
>
> A: Correct.

Webster Dep. at 87-88.

Counsel for BAIG had every opportunity to claim that Crawley Warren was acting for the individual insureds when it participated in the reinsurance arrangements between BAIG and Reliance, but could not in good faith do so.

In summary, Crawley Warren was setting up the ABC facility when it arranged the reinsurance between BAIG and Reliance. It did not act on behalf of the eventual insureds when it arranged the reinsurance.

When this error is corrected, it can no longer be maintained that "the Policyholder Intervenors, through their consultants and agents, chose their reinsurers as the intended source of their coverage." or that "the fronting company was the last party to the transaction," as *Legion* requires. The fronting company, Reliance, entered into the reinsurance contract with BAIG. Then the policyholders subscribed. The policyholders, not Reliance, were "last to the table."

Referee LaVan also erred in reaching the conclusion that "individual policyholder[s] intended that the insureds should have direct access to the payment of reinsurance proceeds." Recommendation at 24. There was no evidence in the record to support this conclusion. No insured made a direct payment request, nor did any insured testify in the proceeding about its intent or expectations regarding direct payments when it entered into its insurance policy. In fact, no insured has even submitted its written consent to BAIG assuming Reliance's liabilities and making direct payments. The broker for the individual insureds that testified in the case, Robert Webster of Marsh had nothing to do with placing the reinsurance arrangements between Reliance and BAIG that applied to the individual insureds' risks. Webster Dep. at 70. He has no personal knowledge about what the insureds' expectations were at the time of placement regarding whether they would receive direct payments from Reliance during insolvency. Webster Dep. at 100-01; 134-35.

Moreover, Mr. Webster admitted that, after the insolvency, he investigated whether there was a cut-through clause in the reinsurance contact between Reliance and BAIG, which was the only basis he was aware of for seeking direct payments. Webster Dep. at 116-

118. He was not aware of any facts about the parties' relationships or contracts that supported direct payments. *Id.* (By contrast, in *Legion,* the Court heard testimony from American Airlines' broker AON that "it was the intent of the parties that in the event Legion should become insolvent [the reinsurer] would make direct payments directly to American.", *id.* at 1218.) Clearly, if the insureds had expectations that direct payments from BAIG would occur during insolvency, their broker would be aware of that. There is no basis for the Referee to infer such expectations in the face of this evidence. The only inference that can be drawn from this collective evidence is that the insureds had no expectation that they would receive direct payments during insolvency, and can identify no basis that would support them doing so.

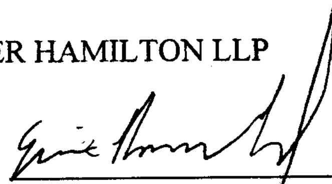
Finally, Referee LaVan erred in finding that the various documents operated as a single contract. BAIG argued that a particular group of documents together comprised a "single contract": the master policies, (Trial Exhibits 1-4), the reinsurance Cover Notes, (Trial Exhibits 40-43), the slips issued by the insureds' brokers to each participating insurer to bind the risk (Trial Exhibits 11), and the slips prepared by insureds' brokers to reflect the reinsurance between BAIG and Reliance (Trial Exhibit 12). BAIG's Summary Judgment Brief at 17-18, 20; April 21, 2006 N.T. 356. But at trial, BAIG's witness, Martin Cox, explained – on direct examination – that Trial Exhibit 12 was prepared for administrative purposes only, not a contractual document. April 20, 2006 N.T. 105-106 (Cox). Moreover, that document was never sent to Reliance, one of the parties to this supposed "single contract." April 21, 2006 N.T. 303-304 (Nunez). When counsel for the Liquidator invoked these defects to declare "the single contract theory is dead," April 20, 2006 N.T. 378, counsel for BAIG had no response. April 20, 2006 N.T. 395.

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 reversing the Referee's Report and Recommendation, and affirming the statutory Liquidator's denial of the BAIG Companies' direct payment request.

Respectfully submitted,

PEPPER HAMILTON LLP

By: 

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her official capacity as Statutory Liquidator
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Date: August 9, 2006

CERTIFICATE OF SERVICE

I hereby certify that on August 9, 2006, true and correct copies of the Liquidator's Exceptions to Referee's Report and Recommendations, Appendix and Proposed Order were served upon the following:

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Via Notice of Filing

Members of Reliance Master Service List

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