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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

*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, BAIG's Response to the Liquidator's Exceptions,
and the Liquidator's Reply to BAIG's Responses to Liquidator's Exceptions, it is hereby
ORDERED and DECREED that the Liquidator's Exceptions are GRANTED.

It is FURTHER ORDERED and DECREED that the Liquidator's Denial of
BAIG's direct payment request is AFFIRMED.

JAMES GARDINER COLINS, President Judge

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

**LIQUIDATOR'S REPLY TO BAIG'S RESPONSE TO
EXCEPTIONS TO REFEREE'S REPORT AND RECOMMENDATION**

I. INTRODUCTION

The Liquidator of Reliance Insurance Company (the "Liquidator") submits this Reply to BAIG's Response to the Liquidator's Exceptions. BAIG's argument for affirming Referee LaVan's Report and Recommendation is premised on the argument that the right to direct access of reinsurance proceeds should be extended to all fronting arrangements, a proposition that finds no support in law.¹ The gravamen of this case is whether this Court should extend direct access to cases that fall outside the boundaries established in 40 P.S. § 221.34

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 Re: 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.

("Section 221.34") and by the Pennsylvania Supreme Court in *Legion*.² This Court should not expand the holding of *Legion* to include BAIG's direct payment request for all of the following reasons: BAIG essentially admits that it does not meet the factors announced in *Legion*; *Legion* was not intended to apply to all types of fronting arrangements; *Legion* allowed direct payments only where necessary to satisfy the reasonable expectations of the policyholders, who set up the reinsurance arrangement for their benefit, not the reinsurer; and extension to all fronting arrangements would detrimentally affect the rights of all Reliance's policyholders and claimants.

II. ARGUMENT

A. This Court Should Not Grant Direct Access to Cases That Fall Outside of the Factors Announced in *Legion*

As discussed in the Liquidator's Exceptions, the third-party beneficiary analysis applied by the *Legion* Court was meant to apply to the unique circumstances of the policyholder intervenors in *Legion*. *Legion*, 831 A. 2d at 1241. The key factors in *Legion* were common to all of the policyholder-intervenors:

The reinsurer, not Legion, 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 presented at the hearing, these factors were not met in this matter: Reliance retained risk under the ABC Program,³ the policyholders did not set-

² *Koken v. Legion Insurance Company*, 931 A.2d 1196 (Pa Commw. Ct. 2003), *aff'd per curiam*, 878 A.2d 51, 583 Pa. 400 (2005).

³ April 21, 2006 N.T. 293-294 (Nunez)

up the arrangement,⁴ and the policyholders, not Reliance, were the last party to the transaction.⁵ BAIG essentially admits that the BAIG does not meet the requirements announced in *Legion*. See generally BAIG's Brief at 9-12 and Summary Judgment Brief at 7 -10, and 18. Nowhere in BAIG's brief do they argue that they meet all of the factors of *Legion*. Instead, BAIG suggests that *Legion* must be extended on a case-by-case basis until the standard established by Section 221.34 largely disappears. The *Legion* Court, however, clearly announced that direct access will be granted only if certain very particular criteria are met. *Legion*, 831 A.2d at 1241. Here, the record establishes that the unique circumstances of the ABC Program are quite distinct from the arrangements of the four policyholder-intervenors in *Legion*.

B. *Legion* was not intended to apply to every type of fronting arrangement.

Despite BAIG's insistence, the third-party beneficiary analysis discussed in *Legion* was not intended to apply to every fronting situation. The fronting arrangements discussed in *Legion* included an insured establishing a reinsurance coverage relationship with a particular reinsurer for its own benefit, and then after that arrangement was set-up, adding a ceding company as the "last party to the transaction" to secure the coverage. See *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.).⁶

⁴ April 20, 2006 N.T. 161-162 (Cox)

⁵ April 21, 2006 N.T. 301 (Nunez)

⁶ As discussed more fully in *Legion*, the following characteristics of the reinsurance arrangements regarding the four policyholder intervenors were pertinent (emphasis added):

(continued...)

Here, by contrast, the fronting arrangement was put together by an (unlicensed) carrier seeking to sell insurance in certain states (BAIG) and a licensed insurance company that

(continued...)

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

could provide direct coverage to insureds (Reliance), without any involvement by any insured and prior to any insured subscribing for coverage. The insurance product was then marketed to potential policyholders, who could accept the coverage as provided or seek coverage elsewhere. Webster Dep. at 86.⁷ These potential policyholders were not committed in any way to the coverage arrangement, and could take it or leave it as the policyholder pleased.

For purposes of the distribution of reinsurance proceeds under the Pennsylvania insolvency statute, the distinction between these two types of fronting arrangements is significant. The *Legion* case was premised on the Court's desire to satisfy the reasonable expectations of the policyholders. *Legion*, 831 A.2d at 1246. The type of arrangements discussed in *Legion* were set up at the behest of the policyholder, which created the relationship for its own benefit, as illustrated in the case of one of the policyholder-intervenors, Pulte Home:

Since 1991, Pulte has provided for its general liability claims through a *program of its own design* that involves: (1) direct negotiation and purchase of reinsurance for *Pulte's sole benefit*; (2) a licensed fronting, or a pass-through, insurance company to issue certificates of insurance so that Pulte could satisfy financial responsibility requirements; [] and (3) the handling all liability claims by a third-party administrator (TPA) *chosen and compensated by Pulte*.

Id. at 1209 (emphasis added). In the second type of arrangement, which applies here, the fronting arrangement is set up by the reinsurer for its benefit to expand its own risk capacity, with no involvement by policyholders. The *Legion* case was about protecting the interests of the policyholders and fulfilling the reasonable expectations of the policyholders. Here, BAIG wishes to extend that protection to the reinsurer. Nothing in *Legion* supports that extension.

⁷ Robert Webster is an employee of Marsh, a broker for some of the individual insureds in the ABC Program. Parts of his deposition were designated as trial testimony by the parties.

Here, the policyholders did not even participate in this proceeding. By contrast, in *Legion*, the policyholders, not the reinsurers were the parties seeking to enforce the “transaction” they had arranged.⁸ *Legion* makes clear that policyholder interest and expectations at the time of contracting were central. Here, BAIG had no evidence on that crucial issue. Webster Dep. at 134-136.

C. The Affected Assureds Did Not Set Up The ABC Program

Belatedly acknowledging that the question of its coverage arrangement does not fit the *Legion* facts, BAIG attempts to impute other policyholders’ role in the original placement of business under the ABC in 1955 to the present assureds.⁹ They argue that “the affected ABC assureds get the benefit of the acts undertaken for the benefit of the association by ABC Members and former Members.” (BAIG’s Brief at 12). Additionally, BAIG argues that “affected ABC assureds’ agents were involved in establishing the ABC Program,” (BAIG’s Brief at 12), because through certain mergers and acquisitions, certain assureds’ brokers were allegedly acquired by certain original brokers of the ABC. (BAIG’s Brief at 12-13). This is a new argument by BAIG because the testimony of BAIG’s own witnesses clearly establishes that the affected assureds played no role in the establishment of the ABC Program and played no role in setting up the reinsurance relationship. See April 20, 2006 N.T. 144 (Cox); Hardy Dep.I at 16; Webster Dep. at 88. Despite BAIG’s attempt to “grandfather” the rights of the original assureds in 1955 to the affected assureds during the relevant period, the record illustrates that the affected assureds simply “shopped the market” from year to year for insurance and accepted the coverage

⁸ “Evidentiary hearings on the Policyholder Intervenors’ petitions were conducted on March 6, 7, 19, and 20, 2003. The Rehabilitator [(Liquidator)] and Syndicate 271 [(reinsurer of one of the policyholders)] presented evidence on April 3, 2003.” *Legion*, 831 A.2d at 1202.

⁹ Participants in the ABC program often use the term “assured” rather than “policyholder” or “insured”.

arrangement involving BAIG and Reliance, without any say in the creation of the relationship. Webster Dep. at 87-88.

Moreover, the fact that some of the insureds may have had coverage with the ABC in the preceding year does not mean these insureds had anything to do with establishing the reinsurance relationship between BAIG and Reliance. There is no evidence that BAIG even consulted or advised the insureds that they were seeking a different fronting company from the one that was used in the year prior to Reliance's participation. In fact, the evidence shows otherwise. According to Mr. Webster, the broker for many of the assureds, the individual insureds have no ongoing affiliation or "membership" with the ABC Program and insureds join from year to year. Webster Dep. at 113-4. "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); April 21, 2006 N.T. 301 (Nunez); April 20, 2006 N.T. 161-162 (Cox); Hardy Dep. at 98-99; Webster Dep. at 70. Thus, BAIG's argument that affected assureds should receive the benefit of the actions of the original assureds and their brokers is not supported by the evidence.

D. Crawley Warren, the Coordinating Broker, Was Not An Agent for the Affected Assureds.

BAIG relies on the Referee's finding that the coordinating broker (Crawley Warren)¹⁰ acted on behalf of the affected assureds to arrange the reinsurance arrangement. (BAIG's Brief at 14). However, nowhere in the record is there evidence that ABC's coordinating broker acted on behalf of the affected assureds. To the contrary, the testimony of

¹⁰ 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.

BAIG's own witnesses explicitly establishes that the coordinating broker (Crawley Warren) was not an agent of the insureds who placed their insurance with the ABC during the relevant period. Mr. Webster and Mr. Hardy, the employee who handled the ABC Program for the Crawley Warren, stated that Crawley Warren was *not* an agent for the individual insureds. Hardy Dep. I at 17-18; Webster Dep. at 87. Clearly the record establishes that Crawley Warren, was the agent for the ABC Program, but not for any individual insureds:

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?

A: Correct.

Webster Dep. at 85. As discussed in the Liquidator's Exceptions at p. p. 14-15, 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. April 20, 2006 N.T. 58-59; *See also* April 20, 2006 (N.T. 161-62) (Cox); April 21, 2006 N.T. 292-93 (Nunez); and April 20, 2006 N.T. 220-21 (Myers). Furthermore, because the ABC is a continuing facility from year to year does not mean the insureds in any individual year has given any particular authority to the facility or the coordinating broker. *See* April 20, 2006 (N.T. 161-62) (Cox); and April 21, 2006 N.T. 292-93 (Nunez). BAIG cannot ignore its own argument and the testimony of its own witnesses to posit an agency relationship that did not exist.

E. The Single Contract Theory Must Fail Because BAIG Never Established All Purported Contract Documents Created A Single Contract

Finally, Referee LaVan erred in finding that the various documents operated as a single contract. BAIG's single contract theory collapsed under the weight of its own witness' testimony. As discussed in the Liquidator's Exceptions, 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 Exhibit 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 as was shown at trial, Reliance never received the declaration prepared by the individual brokers, (April 21, 2006 N.T. 302-04 (Nunez)) and according to BAIG's underwriter, Martin 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"). Accordingly, there can be no single contract because BAIG failed to establish that the all of the purported documents necessary for this theory were in fact, part of the "single contract."

F. This Court Should Not Create A New Exception

As the Liquidator stated in her Exceptions, the Supreme Court of Pennsylvania has held that the lower court should not stretch the meaning of Pennsylvania insolvency statute to accomplish some sense of equity, or avoid particular results. *See Koken v. Reliance Insurance Company (Appeal of Mawson & Mawson, Inc.)* 893 A.2d 70, 82 (PA 2006). Nor should this Court affirm a decision where the record shows that the facts do not fit within the factors

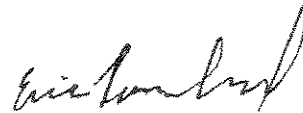
announced in *Legion*. Such an expansion of the *Legion* opinion (and the Pennsylvania insolvency statute) will detrimentally affect the rights of all of Reliance's policyholders and claimants because such proceeds will not be available for distribution as required under the Pennsylvania insolvency statute. This result would be contrary to the insolvency laws, which are designed to protect the interest and rights of all policyholders. See *Foster v. Mutual Fire, Marine and Inland Ins. Co.*, 544 Pa. 387, 676 A.2d 652, 404 (Pa. 1996) ("one of the purposes of the Act is the protection of the interests of insureds, creditors, and the public generally") (quotation omitted); *Koken v. Colonial Assur. Co.*, 885 A.2d 1078, 1095 (Pa. Cmwlth. 2005) ("purpose [of Article V is] to protect the interests of insureds, creditors, and the public generally"); *Koken v. Steinberg*, 825 A.2d 723, 726 (Pa. Cmwlth. 2003) ("It is now settled law in Pennsylvania that an insurance regulator is charged not only with representing the public interest but the interests of policyholders and creditors as well"); *Foster v. Rockwood Holding Co.*, 158 Pa. Commw. 258, 632 A.2d 335, 264 (Pa. Cmwlth. 1993) ("The purpose of Article V ... of Pennsylvania's Insurance Act is to protect the interests of insureds, creditors and the public generally.").

III. CONCLUSION

For the foregoing reasons, the 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,

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Date: September 29, 2006

CERTIFICATE OF SERVICE

I hereby certify that on September 29, 2006, true and correct copies of the Liquidator's Reply to BAIG's Response to Exceptions were served upon the following:

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