

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

M. Diane Koken,
Insurance Commissioner of the
Commonwealth of Pennsylvania,

Plaintiff

v.

RELIANCE INSURANCE COMPANY

Defendant

Docket No. 669 M.D. 2001

OBJECTION OF IHS
LIQUIDATING, LLC. TO
NOTICE OF DETERMINATION
ON PROOF OF CLAIM NUMBER
2058472

**REPORT AND RECOMMENDATION OF REFEREE, CHARLES C. COYNE,
REGARDING THE "OBJECTION OF CLAIMANT IHS LIQUIDATING LLC TO
THE STATUTORY LIQUIDATOR'S NOTICE OF DETERMINATION"**

Charles C. Coyne, having been appointed Referee in the above-captioned matter by order of the Honorable James Gardner Colins, President Judge of the Commonwealth Court, order dated October 16, 2003, hereby makes the following Report and Recommendation regarding the Objection of Claimant IHS Liquidating LLC to the Statutory Liquidator's Notice of Determination regarding Proof of Claim No. 2058472 filed on December 2, 2003, by IHS Liquidating LLC pursuant to the Reliance claims procedure, as provided for in the Settlement Agreement previously approved by the Court.

1. The Reliance Insurance Company ("Reliance") issued certain policies to International Health Services, Inc. ("IHS") for the policy year 1999, including but not limited to certain workers compensation policies, automobile liability policies, and the Health Care Medical Liability and General Liability Insurance Policy, NGB0151564-00 ("PL/GL [professional liability/general liability] Policy", collectively the "Policies").

Under the terms of the Policies and also pursuant to the terms of a Program for Risk Management, Reliance, as insurer, is obligated to pay claims falling within the coverage of the Policies, subject to IHS's obligation to reimburse Reliance for payments made on claims up to the deductible amount set forth in the Policies and the Program for Risk Management; IHS posted collateral (the "Collateral") with Reliance to secure its payment obligations to Reliance (See Settlement Agreement, at pages 1-2; see also Petition to Approve Settlement, Para 6).

2. On February 2, 2000, IHS filed a Petition for Relief Under Chapter 11 of the Bankruptcy Code with the U.S. Bankruptcy Court for the District of Delaware, being In re: Integrated Health Services, Inc., et al., Ch. 11 Case No. 00-389 (MFW) (the "IHS Bankruptcy Case"). The case was referred to the Honorable Mary F. Walrath, Chief United States Bankruptcy Judge, no Trustee was appointed, and the Debtor, IHS, was allowed to continue to operate its affairs as Debtor-in-Possession.

3. By order of the Commonwealth Court dated October 3, 2001, Reliance was placed into liquidation, and the Insurance Commissioner of the Commonwealth of Pennsylvania, then M. Diane Koken, was appointed Statutory Liquidator (the "Liquidator"). All assets being held by Reliance, including the Collateral referred to in Paragraph 1, supra, were transferred to the Liquidator.

4. On July 17, 2003, IHS filed with the Commonwealth Court a "Petition to Intervene for Purposes of Filing an Action for Declaratory Judgment", seeking, inter alia, permission to seek a declaratory judgment for determination of the value and ownership of the Collateral (the "Collateral Issue"), and also seeking determination of the amount due under the Policies, the extent and coverage of which were disputed by Reliance (the

“Coverage Issue”). By order dated September 6, 2002, the Commonwealth Court granted IHS’s Petition to Intervene.

5. On September 2, 2002, IHS filed a Complaint for Declaratory Judgment against the Liquidator.

6. Counts IV and V of the Complaint related to the issue of the amount of coverage provided for, seeking, inter alia, judgment declaring that the \$4.5 million limit of coverage under the PL/GL policy (See Para. 1, supra) was or should be reinstated to provide IHS with an additional \$4.5 million of professional liability (“PL”) coverage for a combined PL policy limit of \$9 million (See Petition to Approve Settlement, Para. 15; see also Settlement Agreement, attached as Exhibit A to the Petition to Approve Settlement, page 3).

7. On October 10, 2002, Liquidator filed Preliminary Objections to the IHS Complaint for Declaratory Judgment on the ground, inter alia, that the Complaint for Declaratory Judgment circumvented the mandatory proof of claim procedure applicable to all claimants against insurance companies in liquidation, as set forth in Article V of the Pennsylvania Insurance Company Department Act of 1921, 40 P.S. §§221.1-221.63 (the “Act”).

8. On May 12, 2003, the Bankruptcy Court in the IHS Bankruptcy Case issued an order of confirmation (the “IHS Confirming Order”), confirming the “Amended Joint Plan of Reorganization of Integrated Health Services, Inc. and Its Subsidiaries Under Chapter 11 of the Bankruptcy Code” (the “IHS Plan”). The IHS Plan provides, inter alia, for the liquidation of the assets of IHS, under the supervision and control of a new entity, IHS Liquidating LLC, a newly created Delaware limited liability company, as successor

to IHS. The IHS Plan became effective September 9, 2003 (See IHS Plan, attached as Exhibit B to the Petition to Approve Settlement).

9. On December 1, 2003, the parties entered into a Settlement Agreement which partially disposed of the outstanding disputes. Pursuant to Paragraph 1 of the Settlement Agreement, (See Settlement Agreement, page 7, Para. 1), and also pursuant to paragraph 35 of the Petition to Approve Settlement, IHS Liquidating LLC, as successor to IHS, agreed to dismiss with prejudice Counts I, II and III of the IHS Complaint (the Collateral Issue) as to the Liquidator and Reliance.

10. Pursuant to Paragraph 10 of the Settlement Agreement, (See Settlement Agreement, page 10, Para. 10), and also pursuant to paragraph 36 of the Petition to Approve Settlement, IHS and IHS Liquidating LLC agreed to dismiss with prejudice Counts IV and V, being all of the remaining counts of the IHS Complaint (the Coverage Issue) with prejudice “... **save for IHS’s right to pursue these claims and any to determine the PL [professional liability] policy limit under the PL/GL [professional liability/general liability] Policy exclusively through the proof of claim process in the Reliance liquidation** ...” [emphasis added.] (Petition to Approve Settlement, Para. 36).

11. Pursuant to Paragraph 6 of the Settlement Agreement, (See Settlement Agreement, page 9, Para. 6), and also pursuant to paragraph 43 of the Petition to Approve Settlement, “... IHS Liquidating LLC shall have an Allowed Proceeds Claim in the Reliance proof of claim process in the amount of:

a. \$778,906.00, relating to coverage under the PL/GL [professional liability/general liability] Policy for claims of general liability; plus

b. the limits of liability under the PL/GL policy for claims of professional liability, whether determined to be \$4.5 million or some larger number, less the Aggregate Loss Payment Amount..." (Settlement Agreement, page 9, Para 6; See also Petition to Approve Settlement, Para. 43).

12. On December 2, 2003, IHS Liquidating LLC filed Proof of Claim No. 2058472 in the Reliance liquidation proceeding (the "Proceeds Claim") and on December 22, 2003, a Notice of Determination was issued by Liquidator objecting thereto. Robert N. Gawlas, Jr., Esq., of the firm of Rosenn Jenkins & Greenwald, LLP, Wilkes-Barre, PA, has been retained as Counsel for Liquidator in the Reliance claims procedure before Referee, Charles C. Coyne.

13. On December 11, 2003, Reliance Insurance Company (In Liquidation) issued a "Notice of Determination" providing that Priority Level (b) had been assigned, and that "Your claim against the Estate of Reliance has been valued and allowed in the amount of \$1,626,766.00."

14. Claimant, HIS Liquidating, LLC, filed an Objection of Claimant IHS Liquidating, LLC to the Statutory Liquidator's Notice of Determination, dated December 22, 2003, seeking a determination that the proper amount is \$6,126,766.

15. Reliance Insurance Company (In Liquidation) by letter dated January 12, 2003, denied the Objection of Claimant HIS Liquidating, LLC to the Statutory Liquidator's Notice of Determination.

16. Referee conducted a series of conference calls to establish working procedures to determining the IHS Proof of Claim. As part of those procedures, Referee permitted discovery to be conducted by all parties.

17. Liquidator issued Interrogatories to Claimant, IHS Liquidating, LLC.

18. Claimant, IHS Liquidating, LLC., filed written responses which it believed in good faith give the most information available to them, objecting to certain others..

19. Liquidator filed a Liquidator's Motion to Overrule Objections and to Compel Discovery, dated December 13, 2004; and a Response of IHS Liquidating, LLC to Liquidators Motion to Overrule Objections, dated January 11, 2005, has also been filed. Referee conducted a hearing on the discovery issue on April 27, 2005, giving all parties an opportunity to fully present such additional material as they considered appropriate.

20. Elements of Liquidator's Objection related to the alleged failure to provide factual information; however, other elements ran to the alleged failure of Claimant to fully support the basis of its Objection to Determination.

21. On October 10, 2005, Referee issued a Report and Determination of Referee, Charles C. Coyne, Regarding the "Liquidator's Motion to Overrule Objections and to Compel Discovery" determining that as to factual evidence, Liquidator has a right to all available information, but as to the basis of the Objection to Determination, Liquidator was seeking conclusions of law. Referee required Claimant, IHS Liquidating, LLC, within thirty (30) days of the date of the Report and Determination, to provide Liquidator with all additional information within its possession and control which assist in the discovery all relevant facts, all knowledgeable parties who may be available to interview or deposition, and all available documentary evidence, and precluding Claimant IHS from presenting at time of hearing any evidence, notice of which has not

been timely provided to Liquidator. All other issues raised in Liquidator's objection were preserved and deferred until time of hearing on the underlying Objection to Determination.

22. A series of pre-trial conference calls were conducted and a proposed Joint Pre-Trial Order was requested from both parties setting forth the issues of fact and law. The Joint Pre-Trial Order as approved and issued by the Referee on March 6, 2006, is attached hereto and incorporated herein.

23. By conference call, pre-trial briefs were requested, and a hearing was conducted on Wednesday, March 15, 2006. A transcript was taken, and post-trial submissions were allowed and submitted.

DISCUSSION:

The Claimant, IHS Liquidating Trust LLC, is the successor to Integrated Health Services, Inc., a nationwide provider of health services, which was required by various states authorities to provide evidence of professional liability policies from an insurance provider acceptable to the various licensing authorities. To fulfill this requirement, they developed a Program for Risk Management with Reliance Insurance which provided for a series of policies to be issued, one of which, the professional liability policy, was a form of policy known as a "100% matching deductible". A 100% matching deductible basis is a form of policy under which the insured has a deductible in the full amount of the policy; on its face, such a policy would appear to be no insurance at all, but as the insurer (Reliance) issues a policy under which it is responsible for any loss, the requirements of the various licensing authorities are fulfilled, and the risk being assumed by the insurer is that the insured will not be able to pay the deductible (the amount of the loss.) To

protect the insurer, a collateral requirement is set, requiring the insured (IHS) to maintain a cash balance with the insurer (Reliance) in an amount sufficient to protect against anticipated losses. It is undisputed that the Program for Risk Management, and the policies issued pursuant to that agreement, provided for \$4.5 million of professional liability coverage on a 100% matching deductible basis, with a collateral requirement.

However, the Program for Risk Management had a "reinstatement" provision as follows:

*-Policy will contain reinstatement language stipulating we will agree to reinstate the aggregate limits when the aggregate limits are exhausted on a paid basis. The first reinstatement endorsement charge is \$500 unless the limits are requested to be increased then the premium charge will be determined at that time.

Reinstatement language will parallel the following: "In the event the amount you become legally obligated to pay as Damages and Claims Expenses for claims first made against you during the Policy Period and any extended reporting period exceeds the Limit of Insurance stated in the Declarations as "Aggregate", we will, upon receipt of an additional premium which we shall determine in our reasonable sole discretion, reinstate such Aggregate Limit of Insurance ..." (Risk Management Program, page 7 at Section I.)

This language was unfortunately not included in the policies subsequently issued. A reinstatement provision states that upon the exhaustion of the initial coverage (in this case \$4.5 million), the insured has the right to request an additional amount of coverage in the face ("aggregate") amount. Accordingly, if this policy was at any point "reinstated", the full coverage would become \$9.0 million. Although Liquidator initially disputed the existence of a reinstatement clause, after subsequent review that objection is not being pursued and there seems to be no substantial dispute that a reinstatement clause was

intended to be included in the policy, in the form specified in the Program for Risk Management. This language seems to require that some affirmative act be done by the insured to request reinstatement, and at the time of request of reinstatement, some additional demands could be set by the insurer. Accordingly, the only substantial issue is whether reinstatement at any point actually took place. After full consideration, the opinion of the Referee is no.

Claimant can point to no point in time during the ordinary course of business between Reliance and IHS when reinstatement was formally requested. There is a good business reason for this; IHS had already been advised by Reliance that the collateral which had been posted to cover the deductible under the primary coverage was insufficient, and although Reliance at no point declared the policy to be in default, Reliance had advised that the policy was not going to be renewed. If reinstatement had been requested, IHS would have been required to post additional collateral to cover the increased risk, which IHS would have been unable to do, and a default could have been declared under the policy, jeopardizing the primary coverage of \$4.5 million as well as the reinstated amount. As Jack O'Connell, the witness for the Liquidator, testified:

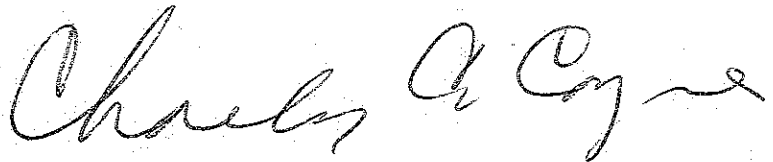
If I may add also on the reinstatement issue, it's not a common request. In my 41 years, I probably can count a request for reinstatement limits four or five times, I can count them on one hand, it's not an automatic request. Normally, it's requested when the payments are about to exhaust the policy limits in a policy that has expired and the insured requests a reinstatement of those limits. Before the carrier agrees to do that, they want to make sure the account is in good standing, is not in default, if there is collateral—if there is collateral in place. (Transcript, pp. 183-184)

While it is arguable that the subsequent demand presented by IHS prefatory to its action for Declaratory Judgment constituted a request for reinstatement, at that point both IHS

and Reliance were insolvent, IHS had no ability to meet any additional requirements, Reliance had no ability to provide additional coverage, and no good faith request for additional coverage could have been made.

In the absence of a good faith formal request for reinstatement, the amount of coverage remained at \$4.5 million. In light of this determination, the discovery issue is moot.

WHEREFORE, in consideration of the foregoing, after review of all pleadings, and after all proceedings had before him, Charles C. Coyne, the Referee in the above-captioned matter, recommends that this honorable court enter an order dismissing the Objection of HIS Liquidating, LLC to Notice of Determination on Proof of Claim Number 2058472.



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Dated: September 5, 2006

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