

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

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|-----------------------------|---|-------------------|
| JOEL S. ARIO, INSURANCE | : | |
| COMMISSIONER OF THE | : | |
| COMMONWEALTH OF | : | |
| PENNSYLVANIA, | : | |
| | : | Petitioner, |
| | : | |
| and | : | No. 269 M.D. 2001 |
| | : | |
| RELIANCE INSURANCE COMPANY, | : | |
| | : | |
| | : | Defendant. |
| | : | |

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 COMMONWEALTH COURT
 OF PA (PHILA)
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IN RE: REPUBLIC WESTERN INSURANCE COMPANY

**THE LIQUIDATOR’S MEMORANDUM OF LAW
 IN SUPPORT OF HIS PRELIMINARY OBJECTIONS**

The Statutory Liquidator of Reliance Insurance Company (In Liquidation) (“the Liquidator”) submits this memorandum of law in support of his Preliminary Objections to the Petition of Republic Western Insurance Company to Declare Right of Setoff and for Injunctive Relief (“Petition”). Pursuant to Rules 1028 and 106 of the Pennsylvania Rules of Appellate Procedure, the Liquidator’s Preliminary Objections should be granted because Republic Western’s Petition fails to state a cause of action for which relief can be granted. “A preliminary objection in the nature of a demurrer is properly granted where the contested pleading is legally insufficient.” *Hess v. Rothschild*, 925 A.2d 798, 805 (Pa. Super. 2007) (citation omitted).

By its Petition, Republic Western seeks to offset balances between and among several reinsurance contracts with Reliance. However, the offsets Republic Western requests fail to meet the requirements under Pennsylvania law because the contracts at issue restrict offset and

do not permit “cross-contract” offset of balances, as Republic Western demands in its Petition. As set forth in the Reinsurance Offset Guidelines (“Offset Guidelines”) adopted by Reliance and the Pennsylvania Department of Insurance to apply Section 221.32 (Setoffs and Counterclaims) of the Pennsylvania Insurance Insolvency Act,¹ these contractual limitations prevent setoff in the Reliance estate:

In the administration of the estate of Reliance Insurance Company (In Liquidation), reinsurers may apply offsets to balances owed to Reliance Insurance Company (In Liquidation) if the debts and credits are mutual, and only where allowed under (1) Pennsylvania statute, (2) the terms of the specific reinsurance contracts involved provided the contract is not inconsistent with the statute, and (3) the parameters outlined in any applicable scenario below. All these conditions must be satisfied.

Offset Guidelines, Exhibit “1” at p. 3. As set forth more fully below, because of the language in the contracts upon which Republic Western bases its relief, its Petition fails as a matter of law on all three measures: due to the contractual limitations found in each of the reinsurance contracts, the debts and credits are not mutual, the offsets sought are not permitted by the specific contracts involved and Republic Western’s purported offset does not comply with the parameters established by the Liquidator.

In addition, Republic Western’s request for declaratory and injunctive relief to reduce an arbitration award is invalid as it constitutes an impermissible collateral attack on an arbitration award.

¹ Article V of the Insurance Department Act of 1921, Act of May 17, 1921, P.L. 789, added by Section 2 of Act of December 14, 1977, P.L. 280 as amended, 40 P.S. §§ 221.1 – 221.63 (hereinafter, “Insurance Insolvency Statute”).

I. STATEMENT OF QUESTIONS INVOLVED

Question: Should Republic Western be granted preferential treatment in relation to similarly situated creditors of the Estate of Reliance by setting off its obligation to the Liquidator with balances under other contracts, when such cross-contract offsets are prohibited by the Insurance Insolvency Statute, the specific contracts involved and the Reinsurance Offset Guidelines adopted for and applied in the Reliance Estate?

Answer: No.

II. BRIEF STATEMENT OF FACTS

A. The Reinsurance Agreements Republic Western Seeks to Setoff

Prior to Reliance's liquidation, Republic Western and Reliance were reinsurance partners under several agreements: (1) the Non-Obligatory Excess Workers' Compensation and Employers' Liability Variable Excess of Loss Reinsurance Agreement ("Excess Treaty"); (2) various Certificates of Facultative Reinsurance ("Facultative Certificates"); and (3) Automobile Quota Share Reinsurance Treaty ("RISE Treaty"). On the Excess Treaty, Reliance was the ceding company and Republic Western the reinsurer. As to the Facultative Certificates and the RISE Treaty (collectively referred to as the "Assumed Contracts"), Republic Western was the ceding company and Reliance was the reinsurer. In its Petition, Republic Western seeks to offset amounts that it owes Reliance under the Excess Treaty with balances purportedly owed by Reliance to Republic Western under the Assumed Contracts.

Each of these reinsurance contracts contains language which explicitly state when an offset may be taken.

1) The Excess Treaty provides that offsets may only be allowed with respect to balances due between Reliance and Republic Western under the Excess Treaty itself --

“Offset this Contract only.” 1997 and 1998 Excess Treaty Slips at “CLAUSES”, attached as Exhibits “D” and “E” to the Petition.²

2) According to the Petition at ¶ 7, the various Facultative Certificates each contain the same “General Conditions.” The General Conditions provide that the parties may offset balances “due from one party to the other under this CERTIFICATE, or any other agreement on business produced by the same intermediary named herein.” Facultative Certificates at ¶ 13, attached as Exhibit “B” to the Petition.³ Accordingly, offset was limited to balances within the Facultative Certificates because the intermediaries, or brokers, through which the Facultative Certificates were placed are different from the intermediaries involved in the placement of the Excess Treaty or the RISE Treaty.

3) Under the RISE Treaty, the parties agreed that setoff rights would be narrow as against the RISE Treaty only; the parties “may offset any balance or balances ... due from one part to the other under this Treaty” RISE Treaty at Art. 24, attached as Exhibit “C” to the Petition (emphasis added).⁴

² Exhibits “D” and “E” to the Petition are placement slips which were signed and fully executed by both parties. Only Reliance signed the full reinsurance contract wording of the Excess Treaty, attached as Exhibit “2.” Like the placement slips, the full wording also prohibits cross-contract offsets. *See* Exhibit “2” at Art. XXVII (“[Reliance] and the Reinsurer shall have the right to offset any balance or amounts due from one party to the other under the terms of this Contract.”).

³ The intermediary under the Excess Treaty is Arthur J. Gallagher Intermediaries, Inc. Exhibit 2, Excess Treaty at Art. XXXV. The intermediary under the Facultative Certificates is Self-Funded Alternatives, for Reliance Insurance Company. *See* Facultative Certificates, attached as Exhibit “A” to the Petition.

⁴ Additionally, as with the Facultative Certificates offsets under the RISE Treaty must be “in accordance with applicable statutes and regulations” in the event of insolvency of one of the parties. (RISE Treaty at Art. 24, attached to Petition as Exhibit “C”).

B. The Panel Issues Arbitration Award In Reliance's Favor on the Excess Treaty For Amounts Owed.

In the normal course of business, Reliance billed Republic Western for amounts due and owing under the Excess Treaty. Republic Western did not pay its bills from Reliance. Following its liquidation, Reliance continued to seek payment from Republic Western for amounts due prior to liquidation and for balances as they became due under the Excess Treaty. Because Republic Western failed to make *any* payments to Reliance under the Excess Treaty, the Liquidator commenced an arbitration against Republic Western in September of 2007 requesting payment for the substantial balances outstanding. *See* Petition at ¶¶ 35-36. In the arbitration, Republic Western counter-claimed for balances it was allegedly owed under the Facultative Certificates and RISE Treaty by way of an offset. The Liquidator objected both to the claimed offset itself and to Republic Western's right to assert an affirmative claim against the Liquidator in the arbitration. After extensive discovery and briefing by both parties, a nine-day hearing was held before a panel of arbitrators in January and February, 2009.

On March 8, 2009, the Panel issued its Award ("Award") ordering Republic Western to pay the Liquidator a confidential amount within 30 days of the issuance of the Award. *See* Award at ¶ 1, Exhibit "D" to Republic Western's June 5, 2009 Petition For Leave to File Confidential Arbitration Materials Under Seal; Petition at ¶¶ 39 and 40.⁵ The Panel did not decide Republic Western's counter-claims; "the Panel makes no determination on the merits of claims asserted by Republic Western against Reliance and leaves those claims for determination in the Reliance liquidation proceeding." Award at ¶ 2; Petition at ¶ 41. Thereafter, the Panel clarified its Award, stating that Republic Western was obligated to pay the full amount of the

⁵ By Order dated August 7, 2009, this Court ruled that the Award was confidential.

Award to the Liquidator, specifically stating that “the use of an offset to reduce the award is not permitted.” See sealed April 15, 2009 email from Umpire, Exhibit “M” to Republic Western’s June 5, 2009 Petition For Leave to File Confidential Arbitration Materials Under Seal. In direct contravention to the Award, Republic Western nevertheless deducted over \$2 million from the amount awarded to the Liquidator under the Award as the amount “for which RepWest now seeks to enforce its right of setoff.” Petition, ¶ 42. That portion of the Award that Republic Western remains unpaid.

After improperly withholding the full amount of the Award, Republic Western filed this Petition seeking declaratory relief that Republic Western is entitled to setoff, a permanent injunction against enforcing the Award as to the amount not paid by Republic Western, and declaratory relief as to future claims under the Assumed Contracts.

III. ARGUMENT

A. Standard of Review

“Where the complaint fails to set forth a valid cause of action, a preliminary objection in the nature of a demurrer is properly sustained.” *Lerner v. Lerner*, 954 A.2d 1229, 1235 (Pa. Super. 2008) (quoting citation omitted). “A demurrer is an assertion that a complaint does not set forth a cause of action or a claim on which relief can be granted.” *Id.*, at 1234 (citations omitted). The role of the court on ruling on preliminary objections is to determine whether or not the facts pleaded are legally sufficient to permit the action to continue. *Firing v. Kephart*, 466 Pa. 560, 563, 353 A.2d 833, 834 (1976). Here, as demonstrated below, even

assuming all facts of Republic Western's pleadings to be true, Republic Western does not have a cause of action for setoff as a matter of law.⁶ See Pa. R. Civ. P. 1028(a)(4).

B. Republic Western Has No Legal Right to Offset Against the Excess Treaty.

There is no question but the right of setoff is well-recognized, well-accepted and generally employed in the commercial practice of reinsurance. As reflected in the caselaw, setoff is practical; it "reduc[es] paperwork, simplif[ies] dispute resolution and provid[es] security for performance." *Koken v. Legion Ins. Co. ("GE Frankona")*, 865 A.2d 945, 954 (Pa. Cmwlth. Ct. 2005) (citations omitted). In ordinary commercial transactions, it avoids "making A pay B when B owes A." *Koken v. Legion Ins. Co. ("Bank of America")*, 900 A.2d 418, 423 (Pa. Cmwlth. Ct. 2006). See also *Koken v. Reliance Ins. Co. ("New Mexico")*, 846 A.2d 778, 782 (Pa. Cmwlth. Ct. 2004); *Dickerson v. Dickersons Overseas Co.*, 369 Pa. 244, 249, 85 A.2d 102, 104 (1952).

But the salutary purposes of permitting offset in ordinary commercial practice have been held to give way to the larger issues and public policy considerations governing an insurance insolvency. It is black-letter law in Pennsylvania that the administration of an insolvent estate must be performed equitably and uniformly; creditor preferences must be avoided. Accordingly, setoff is not regularly allowed as a general commercial remedy, nor is it broadly applied. Cf. *GE Frankona*, 865 A.2d. at 954 ("The question is under what circumstances it will govern post-receivership account reconciliations."). See *Bank of America*, 900 A.2d at 423, 427 ("As in bankruptcy, the mutuality requirements of setoff must be strictly construed because setoff is an exception to the principle that no creditor receive preferential treatment.");

⁶ Reliance reserves all rights with respect to the merits of Republic Western's request for setoff.

“The setoff mutuality requirements are strictly construed because setoff is an exception to the orderly procedures for discharging claims against an insolvent debtor.”⁷

Section 221.32 of the Insurance Insolvency Statute is the operative provision for determining setoffs in liquidations, and places “strict limits on the use of setoff....” *Bank of America*, 900 A.2d at 429. Only “mutual” obligations are allowable for offset. “*Mutual* debts or *mutual* credits between the insurer and another person in connection with any action or proceeding under this article shall be setoff and the balance only shall be allowed or paid” 40 P.S. § 221.32(a) (emphasis supplied).⁸

⁷ Republic Western cites *Foster v. Mut. Fire, Marine and Inland Ins. Co.*, 531 Pa. 598 (1992), *cert. denied sub nom Allstate Ins. Co. v. Maleski*, 506 U.S. 1080 (1993) for the proposition that setoff is an equitable right. (Petition, ¶ 49). However, although *Mutual Fire* referred to 40 P.S. § 221.32, it was not a liquidation case, and instead involved the development of a proposed plan of rehabilitation. Moreover, Republic Western did not cite the key language of the opinion: “The setoff is being permitted, therefore, only to the extent that it encourages and facilitates the ultimate goal of rehabilitation.” *Id.* at 621. As stated throughout the *Mutual Fire* opinion, “we must look to the broad powers afforded to the Commissioner granted in order to effectuate equitably the intent of the [insolvency] statutes, i.e., to minimize harm to *all* affected parties. As such, she has a fiduciary duty to marshal and preserve all assets of the insolvent entity.” *Id.* at 614.

⁸ Section 221.32 provides in full :

(a) Mutual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this article shall be setoff and the balance only shall be allowed or paid, except as provided in subsection (b).

(b) No setoff or counterclaim shall be allowed in favor of any person where:

(1) the obligation of the insurer to the person would not at the date of the filing of a petition for liquidation entitle the person to share as a claimant in the assets of the insurer;

(2) the obligation of the insurer to the person was purchased by or transferred to the person with a view to its being used as a setoff;

(3) the obligation of the person is to pay an assessment levied against the members or subscribers of the insurer, or is to pay a balance upon a subscription to the capital stock of the insurer, or is in any other way in the nature of a capital contribution; or

(4) the obligation of the person is to pay premiums, whether earned or unearned, to the insurer.

In applying Section 221.32, the “threshold to the use of setoff is the existence of a contract between the parties...” *Bank of America*, 900 A.2d at 427. “[M]utual debts and credits arise from contractual relationships.” *Id.* at 426. *See also Sherry v. Financial Indem. Co.*, 160 Wash.2d 611, 619 (Wash. 2007) (“Nor does an insurer have a right of offset, setoff, or reimbursement without an authorizing contract provision.”). Thus, an examination of whatever contractual rights the parties had prior to liquidation is the first step in determining their rights in liquidation. Upon issuance of the order of liquidation, “the rights and liabilities of any such insurer and of its creditors, policyholders, shareholders, members, and all other persons interested in its estate shall become fixed as of the date of filing of the petition for liquidation.” 40 P.S. § 221.20(d). “The Liquidator is without authority to restructure those rights and liabilities.” *GE Frankona*, 865 A.2d at 958. *See, e.g., Koken v. Cologne Reins. (Barbados), Ltd.*, 34 F. Supp. 2d 240, 243 (E.D. Pa. 2004) (interpreting setoff rights where contract was amended pre-liquidation to permit cross-contract offset); *GE Frankona*, 865 A.2d 945 (reviewing reinsurance contract and pre-liquidation course of conduct in respect of the contract); *New Mexico*, 846 A.2d 778 (reviewing reinsurance contracts to determine parties involved).

Where the contracts, as here, expressly limit the application of setoff rights, and do not permit cross-contract setoff, then the obligations under the contracts are not mutual obligations and setoff must not be allowed. “To be mutual, the preliquidation debts or credits must be “*in the same right* and between the same parties, standing in the same capacity.” *Bank of America*, 900 A.2d at 423, quoting 4 *Collier on Bankruptcy*, § 68.04 [2.1] at 867. While the parties are titularly the same on the multiple contracts, the contracts do not create common rights among them; as such, there are no “mutual debts or mutual credits” between Reliance and

Republic Western.⁹ See *Dickerson*, 85 A.2d at 104 (“Set-offs and counterclaims are procedurally available only when there are mutual demands.”); *Warrington Mkt. v. Fleming Cos.*, No. 02-CV-719, 2003 U.S. Dist. LEXIS 19845, *5 (E.D. Pa. Oct. 10, 2003) (“setoff is appropriate to adjust the mutual rights and obligations of the parties”).

This principle of mutuality was incorporated into and formed the basis for the Liquidator’s Offset Guidelines. “The underlying principle of these guidelines is that the statute requires mutuality of debts for an offset to be allowed.” Offset Guidelines, Exhibit “1” at p. 2. “These guidelines do not create new policy. They are based on the Pennsylvania Liquidation State and provide an outline of how the statute applies to some common fact situations.” *Id.* “In the administration of the estate of Reliance Insurance Company (In Liquidation), reinsurers may apply offsets to balances owed to Reliance Insurance Company (In Liquidation) if the debts and credits are mutual, and only where allowed (1) under Pennsylvania statute, (2) the terms of the specific reinsurance contracts involved provided the contract is not inconsistent with the statute, and (3) the parameters outlines in any applicable scenarios below. All these conditions must be satisfied.” *Id.* at p. 3. In every single “scenario” involving cross-contract offsetting, the Offset Guidelines state that to permit cross-contract offset, “[t]he reinsurance agreements must not contain a provision limiting offsets to within same contract.” *Id.* at pp. 3-4, II.D, III.F, IV.H. These are the Offset Guidelines that the Liquidator issued in 2002 so that the fundamental rules of offset would be applied clearly and consistently within the Reliance Estate to all of its reinsurers.

⁹ While the case law and treatises typically have referred to mutuality in terms of capacity and timing (even where there are multiple contracts between the parties), see, e.g., *GE Frankona*, 865 A.2d at 954, citing authorities, it is equally true that if the applicable contracts do not contain reciprocal rights, then the obligations that arise from them are not mutual.

Republic Western has made no attempt whatsoever to articulate why it should be treated differently than all of Reliance's other reinsurers,¹⁰ or why the Liquidator's development of uniform principles, based upon its expertise as the regulatory body assigned to supervise the insolvency of insurance companies, should be ignored. In *Winslow-Quattlebaum v. Maryland Ins. Group*, 561 Pa. 629, 636, 752 A.2d 878, 881 (2000), the Supreme Court of Pennsylvania held that "our courts will not disturb [the Insurance Commissioner's] administrative discretion in interpreting legislation within [the Insurance Department's] own sphere of expertise absent fraud, bad faith, abuse of discretion or clearly arbitrary action." See also *Alpha Auto Sales, Inc. v. Dept. of State, Bureau of Professional and Occupational Affairs*, 537 Pa. 353, 357, 644 A.2d 153, 155 (1994) ("[w]e have long held that the 'contemporaneous construction of a statute by those charged with its execution and application...is entitled to great weight....'"); *Donnelly v. Bauer*, 553 Pa. 596, 608, 720 A.2d 447, 453 (1998) (stating that "[c]ourts traditionally accord an interpretation of a statutory provision by an administrative agency charged with administering that statute some deference") (citations omitted); *Koken v. Colonial Assur. Co.*, 885 A.2d 1078, 1095 (Pa. Cmwlth. Ct. 2005) ("[T]he Court must defer to the Liquidator's authority and discretion in the administration of liquidation and rehabilitation proceedings unless there has been an abuse of that discretion.").

C. No Relief Is Appropriate to Interfere with the Award.

Notwithstanding Republic Western's statement that it is not seeking review of the Award issued in the arbitration (Petition at ¶ 2), Republic Western nonetheless seeks declaratory

¹⁰ At ¶ 33 of its Petition, Republic Western simply speculates (without foundation or fact) that "[u]pon information and belief, the Liquidator has acknowledged rights of setoff under contracts with the same or substantially similar setoff provisions." Even if this speculation were correct (and it is not), it provides no legitimate basis for departure from the Insurance Insolvency Statute, the Offset Guidelines, or the contracts.

and injunctive relief requesting this Court to reduce the amount of the award by over \$2 million. However Republic Western attempts to characterize the relief it seeks in its Petition, it is absolutely clear that this Court may not modify, correct or vacate (in whole or in part) a valid arbitration award except upon a timely petition to vacate. *See* 42 Pa. C.S. § 7342; *Sage v. Greenspan*, 765 A.2d 1139, 1142 (Pa. Super. Ct. 2000) (“[Section 7342(b)] has consistently been interpreted to require that any challenge to the arbitration award be made in an appeal to the Court of Common Pleas by the filing of a petition to vacate or modify the arbitration award within 30 days of the date of the award.”). “The award of an arbitrator in a nonjudicial arbitration ... is binding and may not be vacated or modified unless it is clearly shown that a party was denied a hearing or that fraud, misconduct, corruption or other irregularity caused the rendition of an unjust, inequitable or unconscionable.” *Hade v. Nationwide Ins. Co.*, 519 Pa. 227, 229, 546 A.2d 615, 616 (1988).

As Republic Western did not petition to vacate the award¹¹ (and has no legal basis to do so), this Court has no authority to overturn the Award as a matter of law. Pennsylvania courts have uniformly held that where a remedy or method of procedure is provided by statute, such as here, the statutory remedy or procedure must be strictly pursued and exclusively applied. *Bartron v. Northampton County*, 342 Pa. 163, 168, 19 A.2d 263, 265 (1941); *Concerned Taxpayers of Beaver County v. Beaver County Bd. of Assessment Appeals*, 75 Pa. Cmwlth. 443, 446-47, 462 A.2d 347, 349 (1983); *Dep't of Env. Resources v. Williams*, 57 Pa. Cmwlth. 8, 11, 425 A.2d 871, 872-73 (1981).

¹¹ Republic Western could have asserted its right to offset with this Court against future amounts due under the Excess Treaty after paying the full amount of the Award, as ordered. Contravening the Award was unnecessary for Republic Western to pursue its ultimate offset goal.

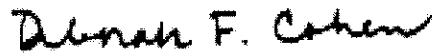
IV. STATEMENT OF RELIEF SOUGHT

The Liquidator requests that this Court sustains its Preliminary Objections and dismiss with prejudice Republic Western's Petition.

V. CONCLUSION

For the above-stated reasons, the Liquidator preliminarily objects to all three applications for relief and requests that they be dismissed with prejudice.

Respectfully submitted,



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Date: September 14, 2009