

THE COMMONWEALTH COURT OF PENNSYLVANIA

M. DIANE KOKEN, :
Insurance Commissioner of the :
Commonwealth of Pennsylvania, :
: :
Plaintiff, :
: :
v. :
: :
RELIANCE INSURANCE COMPANY, :
: :
Defendant. :

LEXINGTON INSURANCE COMPANY, :
: :
Petitioner, :
: :
v. :
: :
M. DIANE KOKEN, :
Insurance Commissioner of the :
Commonwealth of Pennsylvania, :
: :
Respondent. :

CSW

Docket No. 269 M.D. 2001

DEC 19 2003

**STATUTORY LIQUIDATOR'S RESPONSES TO LEXINGTON INSURANCE
COMPANY'S OBJECTIONS TO THE LIQUIDATOR'S
DENIAL OF ITS DIRECT PAYMENT REQUEST**

M. Diane Koken, Commissioner of the Insurance Department of the
Commonwealth of Pennsylvania, in her official capacity as Statutory Liquidator (the "Statutory
Liquidator") of Reliance Insurance Company ("Reliance"), hereby responds to the Objections of
Lexington Insurance Company to the Liquidator's Denial of A Direct Payment Request as
follows:

PARTIES

1. Admitted.

2. Admitted.

JURISDICTION

3. Admitted.

PROCEDURAL HISTORY AND OVERVIEW

4. Admitted.

5. Admitted in part, denied in part. It is admitted only that the Statutory Liquidator denied Lexington's request for direct payment. As to the contents of the October 30, 2003 correspondence, the letter speaks for itself. It is denied as to the categorization of the letter as a "form" letter as the letter was specially designed for the specific purpose for which it was used. It is also denied as to the date Lexington received the October 30, 2003 letter because the Statutory Liquidator is without knowledge and information as to the date the letter was received by Lexington.

6. Denied as stated. The October 30, 2003 letter is a document in writing, which speaks for itself.

7. Denied. The October 30, 2003 letter is a document in writing, which speaks for itself. For reasons set forth in the accompanying Memorandum of Law, the Lexington and Magellan/RBH Petitions¹ contained different material facts. The Magellan/RBH Petitions were approved because they satisfied the Guidelines. The petition filed by Lexington did not. The remaining averments are denied as incorrect conclusions of law as set forth in the accompanying Memorandum of Law. The Statutory Liquidator lacks sufficient information as to

¹ Magellan Reinsurance Company Ltd. and RBH Reinsurance Ltd. Petitions (collectively, the "Magellan/RBH Petitions) were approved by this Court because they satisfied the requirements of the Guidelines.

whether Lexington has responded within 30 days as required by the Guidelines because the Statutory Liquidator does not know when Lexington received the denial letter.

8. Admitted in part, denied in part. It is admitted only that on or about October 10, 2002, the Court entered two orders (collectively, the "Magellan/RBH Orders") approving cut-through petitions pursuant to 40 P.S. § 221.34 and the Guidelines with respect to two fronting programs with Megellan and RBH. The Orders speak for themselves. As fully explained in the accompanying Memorandum of Law, the Statutory Liquidator denies that the Magellan and/or the RBH reinsurance agreements present identical "identification" issues as are presented here.

9. Denied. The Reinsurance Agreement speaks for itself.

10. Denied. The Guidelines and 40 P.S. 221.34 require the insureds be named in the reinsurance contract. The alleged fact that the parties were known, even if true, does not satisfy the Guidelines. Additionally, since the Reinsurance Cover Slip set out the terms of the Reinsurance Agreement and was executed on January 19, 1998, (before the insureds were known to Reliance and Lexington), the insureds were not known when the reinsurance arrangement was entered into. The remaining averments in this paragraph are denied as conclusions of law. By way of further answer, the Reinsurance Agreement speaks for itself.

11. Denied. Reliance only advised Lexington to fund claims as it has done prior to rehabilitation. After Reliance's Liquidation, Lexington, through its agents, was told to stop paying claims.

12. Denied. As discussed in the accompanying Memorandum of Law, the Statutory Liquidator notified Lexington, AIG and/or their agent, Claims America, Inc. on several occasions regarding the manner by which claims should be administered. Prior to Reliance's

insolvency, Lexington was permitted to fund claims as it had before rehabilitation. The Statutory Liquidator never authorized a “cut-through” for Lexington. In fact, upon Reliance’s insolvency, the Statutory Liquidator specifically informed Lexington, through its agent, Claims America, to cease making payments. The letter providing this directive speaks for itself. The remaining averments are denied as conclusions of law.

13. Denied. As set forth in the accompanying Memorandum of Law, the Magellan/RBH Petitions were approved because they complied with the requirements of the Guidelines and 40 P.S. 221.34. The Lexington Reinsurance Agreement did not. More specifically, the key material distinctions between the Magellan/RBH Petitions and the Lexington Petition is that the Magellan/RBH Petitions specifically identified the insureds entitled to direct payment and the Lexington Petition did not. The remaining averments are denied as conclusions of law. By way of further answer, as discussed in the accompanying Memorandum of Law, the Statutory Liquidator used the same standards in the Magellan/RBH Petitions as she used here but reached different conclusions because the facts were different.

FACTUAL BACKGROUND

14. Denied. The averments in this paragraph are denied for reasons specifically set out below and further explained in the accompanying Memorandum of Law.

The Fronted Embassy Program

15. The agreements speak for themselves.

16. The Cover Slip speaks for itself.

17. It is admitted that Reliance entered into a management agreement with Embassy but the management agreement speaks for itself. The Program Manager’s Agreement speaks for itself.

18. The Cover Slip speaks for itself.

19. Denied. The Cover Slip and the TPA Agreement speak for themselves.

Claims America entered into a claims handling agreement with Lexington, and thus, was Lexington's agent. By way of further answer, as set forth in the accompanying Memorandum of Law, the Reinsurance Agreement explicitly requires reinsurance proceeds be paid to the Statutory Liquidator in the case of Reliance's insolvency. Therefore, Lexington is not relieved of their payment obligation. The remaining averments are denied as the Liquidator is without information or knowledge sufficient as to these averments because they are conclusions of law.

20. The Reinsurance Agreement speaks for itself.

The Closed Block of Identifiable Policies

21. The Reinsurance Agreement speaks for itself

22. The Reinsurance Agreement speaks for itself.

23. Denied. The Reinsurance Agreement speaks for itself. By way of further answer, as set forth in the accompanying Memorandum of Law, the fact that the insureds were not individually named in the Reinsurance Agreement is evidence that the parties never intended them to be named in the Reinsurance Agreement as entitled to direct payments. Additionally, the Cover Slips established the reinsurance relationship in January 1998, and at that time, upon information and belief, all of the insureds were not known to the parties.

24. Denied. Denied as to Reliance's motivation for insuring the Embassy Program as this is an opinion of Lexington and not a fact. As to the remaining averments, the Reinsurance Agreement speaks for itself. By way of further answer, as set forth in the accompanying Memorandum of Law, Reliance, and only Reliance, as the licensed insurer, was liable to the Embassy insureds.

Status of Reinsured Policies and Consents

25. The policies speak for themselves.

26. Denied. The Statutory Liquidator is without information or knowledge sufficient to form a belief as to the averments in this paragraph.

27. Denied. As to the averment concerning the number of informed consents received by Lexington, the Statutory Liquidator is without information or knowledge sufficient to form a belief and so this averment is denied. The averment that Lexington has obtained signed "informed consents" substantially similar to the form prescribed by the liquidator is denied because the Guidelines speak for themselves. By way of further answer, the Statutory Liquidator has not received informed consents from all of the insureds under the Embassy Program as required by this Court's Order and Guidelines and the Reinsurance Agreement.

Reliance Previously Approved Cut-through Payments under the Embassy Program

28. Denied. The averment in this paragraph implies that Ms. Clausen has or had the authority to permit Lexington to bypass the statutory requirements of 40 P.S. § 221.34 and that any permission granted to Lexington and Claims America extended from the rehabilitation of Reliance into the Liquidation of Reliance. As set forth in the accompanying Memorandum of Law, during rehabilitation, Lexington was only permitted to fund claims directly, as it had before. Only upon liquidation, were reinsurance proceeds then required to be paid to the Statutory Liquidator.

29. Admitted in part, denied in part. Admitted that Hayes sent a letter, which is a document that speaks for itself. Denied for reasons set forth in Response Number 28 and in the accompanying Memorandum of Law.

30. Denied. The letter is a document in writing, which speaks for itself.

31. Denied. As set out in the accompanying Memorandum of Law, the Statutory Liquidator never authorized a "cut-through." The request for a "cut-through" was

denied. Moreover, notice that payment must be made to the liquidator was sent to Claims America, Lexington's TPA, Lexington, or AIG² on several occasions after Reliance's liquidation. All of these notices were ignored. By way of further answer, as set forth in the accompanying Memorandum of Law, the Reinsurance Agreement and 40 P.S. § 221.34 require that reinsurance proceeds be paid to the Statutory Liquidator upon insolvency of Reliance. The other averments are denied as conclusions of law.

32. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, as set out in the accompanying Memorandum of Law, the Statutory Liquidator has never authorized "cut-through" payments. Reliance permitted Lexington to fund claims directly, as it had been prior to Reliance's liquidation, and during Reliance's rehabilitation. There was no authorization of a "cut-through" and thus, no detrimental reliance. The liquidation statute and the insolvency clause in the Reinsurance Agreement require that the reinsurance proceeds be paid to the Statutory Liquidator upon Reliance's insolvency.

OBJECTIONS

I. LEXINGTON SATISFIES THE REQUIREMENTS OF THE GUIDELINES FOR CUT-THROUGH TREATMENT.

33. Denied. The averments in the paragraph are denied as conclusions of law. By way of further answer, as set forth in the accompanying Memorandum of Law, Lexington fails to satisfy the requirements of 40 P.S. § 221.34 and this Court's Order and Guidelines because the Reinsurance Agreement fails to identify insureds entitled to direct payments, all of the insureds have not given their informed consent for the substitution of Lexington for

² AIG, American International Group, is the parent of Lexington.

Reliance's obligation, and Lexington has yet to execute an assumption of Reliance's obligation agreement. The Guidelines speak for themselves.

34. Denied as a conclusion of law. The Reinsurance Agreement speaks for itself. By way of further answer, as set forth in the accompanying Memorandum of Law, the Reinsurance Agreement fails to name direct insureds entitled to direct payment as required by Article XX: (Insolvency) of the Reinsurance Agreement. The Reinsurance Agreement does not specifically provide for another payee of the reinsurance proceeds in the event of the insolvency of Reliance.

The Reinsurance Agreement (Article XX) Identifies the Insureds with the Particularity Required by the Guidelines and 40 P.S. § 221.34

35. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, as fully set out in the accompanying Memorandum of Law, Lexington and Reliance failed to name the insureds entitled to direct payment in their Reinsurance Agreement (and the Reinsurance Cover Slip) in the case of Reliance's insolvency. For this reason, no cut-through is authorized under this Court's Order and Guidelines or 40 P.S. § 221.34. The fact that the parties were known at the time of the execution of the Reinsurance Agreement and were not included in the Reinsurance Agreement as entitled to direct payment evidences an intent not to create a direct payment on their behalf.

36. Denied. As set out in the proceeding Memorandum of Law, the Magellan/RBH petitions were granted because their contracts *do* satisfy the requirements of the Guidelines and 40 P.S. § 221.34, not because the Statutory Liquidator used extrinsic evidence to satisfy the identification requirement.

37. Denied. As set forth in the accompanying Memorandum of Law, the Statutory Liquidator only looked to the Reinsurance Agreements in Magellan/RBH Petitions to

identify the individual insured entitled to direct payment. Extrinsic evidence was not necessary to determine the identity of the direct insured entitled to direct payment.

38. Denied. As fully set out in the accompanying Memorandum of Law, the reinsurance contracts in Magellan and RBH both contained exhibits identifying the individual insureds entitled to direct payment.

39. Denied. As set forth in the accompanying Memorandum of Law, the Magellan/RBH Petitions materially differed from the Lexington Petition because the Magellan and RBH contracts identified the insureds entitled to direct payment whereas the Lexington Petition does not.

40. Denied. As set forth in the accompanying Memorandum of Law, the reinsurance contracts in Magellan and RBH both contained exhibits identifying the individual insureds entitled to direct payment. By way of further answer, the automobile dealers identified as the direct insureds under the contract were identified as direct payees sufficient to satisfy the Guidelines, while the Lexington contract does not name any insureds in any way.

41. Denied. The reinsurance contracts speak for themselves. The averment of this paragraph is a mischaracterization of the reinsurance contracts. For reasons fully set out above and in the accompanying Memorandum of Law, the material distinction between the Magellan/RBH Petitions and the Lexington Petition is that the Magellan and RBH reinsurance contracts specifically identify insureds and the Lexington Reinsurance Agreement does not.

42. Denied. The averments of this paragraph are denied because the Reinsurance Agreement speaks for itself. By way of further answer, as fully set out in the accompanying Memorandum of Law, the Reinsurance Agreement simply memorialized the Cover Slip, which the parties operated under for nearly a year prior to the execution of the

Reinsurance Agreement. Therefore, when the reinsurance relationship was first established all the insureds were not known to Lexington and Reliance. Moreover, “looking to the policies” to identify the insureds does not satisfy the identification requirement in the Court’s Order and Guidelines or 40 P.S. § 221.34.

43. Denied as a conclusion of law. For reasons stated above and in the accompanying Memorandum of Law, Lexington is not entitled to the same cut-through treatment approved by the Court in the Magellan/RBH Petitions because the Magellan/RBH Petitions and the Lexington Petition differ materially in that the Magellan and RBH reinsurance contracts specifically identify the insureds entitled to direct payment and the Lexington Reinsurance Agreement does not.

44. Denied. The averments in this paragraph are denied as conclusions of law and for the reasons stated in Responses 41-43.

45. Denied as a conclusion of law. For reasons set out above and in the accompanying Memorandum of Law, the Magellan/RBH Petitions did not require extrinsic evidence to identify the direct insureds. Once again, the material difference is that the Magellan and RBH reinsurance contracts contained the requisite language to authorize direct payments. See Responses 41-43.

46. Denied as a conclusion of law. For reasons set out above and in the accompanying Memorandum of Law, the legal standards and procedures used by the Statutory Liquidator and approved by this Court in the Magellan/RBH Orders do not allow for an exception to the rule that the insured must be identified with particularity either by name or policy number in the reinsurance contract.

47. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, as set forth in the accompanying Memorandum of Law, it is denied that extrinsic evidence was used to approve the Magellan/RBH Petitions. Moreover, the Reinsurance Agreement explicitly requires the reinsurance proceeds go to the Statutory Liquidator upon Reliance's insolvency as was the case here.

48. Denied as a conclusion of law. For reasons made clear above and in the accompanying Memorandum of Law, it is denied that the facts in the Magellan/RBH program are identical to the facts in the Embassy program and it is denied that Lexington in any way satisfied the identification requirements of 40 P.S. § 221.34 and the Guidelines.

49. Denied as a conclusion of law. For reasons made clear above and in the accompanying Memorandum of Law, it is denied that the Statutory Liquidator's refusal to allow direct payments to Lexington is an error of law. It is further denied that that the denial of the Lexington Petition violates the constitutions of Pennsylvania or the United States Constitution. The Statutory Liquidator's conduct does not constitute an abuse of discretion and it is neither arbitrary nor capricious because she has applied the Guidelines based on the requirements of 40 P.S. § 221.34. The Statutory Liquidator also incorporates Responses 41-43.

Lexington Obtained All Required Informed Consents

50. Denied. The Guidelines Petition speaks for itself.

51. Denied. The Guidelines speak for themselves and the averment is a conclusion of law. By way of further answer, the requirement for informed consent is derived from the statute and is also a condition of the Reinsurance Agreement.

52. Denied as a conclusion of law. The Guidelines and the Reinsurance Agreement require consent from all insureds. As set forth in the accompanying Memorandum of Law, without all insureds' consent, Reliance, and only Reliance is liable to the Embassy

Insureds. The Statutory Liquidator is without information or knowledge sufficient to form a belief as to the remaining averments in this paragraph.

53. Denied as a conclusion of law. The Guidelines and the Reinsurance Agreement require consent from all insureds. As set forth in the accompanying Memorandum of Law, without all insureds' consent, Reliance, and only Reliance is liable to the Embassy Insureds.

54. Denied. The Statutory Liquidator is without information or knowledge sufficient to form a belief as to the averment in this paragraph.

55. Denied. The Statutory Liquidator is without information or knowledge sufficient to form a belief as to the averment in this paragraph.

56. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, the Statutory Liquidator incorporates Response 52-53.

57. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, the Statutory Liquidator incorporates Response 52-53.

58. Denied as a conclusion of law. The Statutory Liquidator is without information or knowledge sufficient to form a belief as to the averments in this paragraph.

59. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, the Statutory Liquidator incorporates Response 52-53.

60. Denied. Reliance never authorized a "cut-through." As set forth in the accompanying Memorandum of Law, the July 2001 letter only confirms that Lexington could continue to fund claims directly as it had been doing prior to Reliance's insolvency. Therefore, there is no detrimental reliance because the letter did not change any circumstance. The only

change occurred when Reliance became insolvent. At that time, reinsurance proceeds became an asset of the Reliance Estate. The remaining averments are denied as conclusions of law.

Lexington Will Execute Assumption and Substitution Agreements

61. Denied. The Statutory Liquidator is without information or knowledge sufficient to form a belief as to the averment in this paragraph. Moreover, even if the Assumption and Substitution Agreements were executed, Lexington's request would still be denied because an assumption and substitution agreement will not satisfy the identification requirement of 40 P.S. § 221.34 or the Guidelines.

62. Denied. The averments in this paragraph are denied as conclusions of law. Denied also because the Statutory Liquidator is without information or knowledge sufficient to form a belief as to the averments in this paragraph.

63. Denied as a conclusion of law. Consent of all insureds entitled to direct payment is required under the Reinsurance Agreement and the Guidelines.

II. THE DENIAL FOR CUT-THROUGH TREATMENT TO LEXINGTON VIOLATES THE EQUAL PROTECTION GUARANTEES UNDER THE UNITED STATES AND PENNSYLVANIA CONSTITUTIONS.

64. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, as set forth in the accompanying Memorandum of Law, the Magellan/RBH Petitions were approved because the Magellan and RBH reinsurance contracts satisfied the requirements of 40 P.S. § 221.34 and the Guidelines. As stated herein, the Magellan/RBH contracts identified the individual named insureds whereas the Lexington agreement does not.

**III. ESTOPPEL PRECLUDES THE LIQUIDATOR FROM DENYING
LEXINGTON'S DIRECT PAYMENT REQUEST.**

65. Denied as a conclusion of law. As set forth in the accompanying Memorandum of Law, the Magellan/RBH Petitions were treated differently than the Lexington Petitions because the Magellan and RBH reinsurance contracts satisfied the requirements of 40 P.S. § 221.34 and the Guidelines by identifying the individual named insureds where as the Lexington did not.

66. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, as set forth in the accompanying Memorandum of Law, the Statutory Liquidator has never authorized "cut-through" payments. Reliance's liquidation triggered the insolvency clause in the Reinsurance Agreement and 40 P.S. § 221.34, thus requiring the reinsurance proceeds be paid directly to the Statutory Liquidator. Prior to liquidation, Lexington was required to fund claims directly as it had prior to rehabilitation.

67. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, as set forth in the accompanying Memorandum of Law, Reliance's liquidation triggered the insolvency clause in the Reinsurance Agreement and 40 P.S. § 221.34 thus, requiring the reinsurance proceeds be paid directly to the Statutory Liquidator. Nevertheless, in this proceeding, Reliance is not seeking payment for claims already paid. While Reliance and the Statutory Liquidator reserve their rights to reinsurance proceeds under the Reinsurance Agreement and 40 P.S. § 221.34, they are not seeking these proceeds in this proceeding. Moreover, there is no reliance because the July 2001 letter did not change anything with respect to how claims should be funded under the Embassy Program. Reliance's insolvency, however, did change to whom funds would be paid directly.

IV. RELIANCE IS IN CONSTRUCTIVE RECEIPT OF FUNDS PAID DIRECTLY BY LEXINGTON TO OR ON BEHALF OF INSUREDS.

68. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, as set forth in the accompanying Memorandum of Law, Reliance's liquidation triggered the insolvency clause in the Reinsurance Agreement and 40 P.S. § 221.34; thus, requiring the reinsurance proceeds be paid directly to the Statutory Liquidator. Nevertheless, in this proceeding, Reliance is not seeking payment for claims already paid. While Reliance and the Statutory Liquidator reserve their rights to reinsurance proceeds under the Reinsurance Agreement and 40 P.S. § 221.34, they are not seeking those proceeds in this proceeding. Moreover, there can be no reliance because the Statutory Liquidator has never authorized a "cut-through." As stated above, the July 2001 letter did not change anything with respect to how claims should be funded under the Embassy Program. Reliance's insolvency, however, did change the way claims should be funded.

V. THE COURT SHOULD EXERCISE ITS EQUITABLE POWERS TO PREVENT THE UNJUST ENRICHMENT OF THE RELIANCE ESTATE THAT WOULD RESULT FROM THE LIQUIDATOR'S DENIAL OF LEXINGTON'S DIRECT PAYMENT REQUEST.

69. Denied. The averments in this paragraph are denied as conclusions of law. By way of further answer, the Statutory Liquidator incorporates responses 67 and 68 herein.

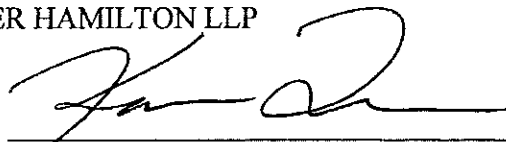
WHEREFORE, for the reasons set forth above and in the accompanying Memorandum of Law, submitted herewith, the Statutory Liquidator requests the following:

1. that this Court deny and dismiss the Objections filed by Lexington;
2. that this Court approve the Statutory Liquidator's denial of Lexington's direct payment request; and
3. that this Court award the Statutory Liquidator such other and further relief as is just under the circumstances.

Respectfully submitted,

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Dated: December 19, 2003

VERIFICATION

I, Mark J. Fisher, Senior Vice President, Deputy General Counsel, of Reliance Insurance Company (In Liquidation), am authorized to make this Verification on behalf of Reliance Insurance Company. I verify that I have reviewed the foregoing Statutory Liquidator's Response to the Objections of Lexington Insurance Company to the Denial Of A Direct Payment Request and supporting Memorandum of Law, and that the allegations of fact contained therein are true and correct to the best of my knowledge, information and belief. This verification is made pursuant to 18 P.S. § 4904 relating to unsworn falsifications to authorities.

Dated: December 19, 2003

By: 
MARK J. FISHER

DEC 19 2003

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v.

Reliance Insurance Company

No. 269 M.D. 2001 (Commonwealth Court of Pennsylvania)

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