IN THE SUPREME COURT OF PENNSYLVANIA
MIDDLE DISTRICT

NO. 60 MAP 2004

M. DIANE KOKEN,
INSURANCE COMMISSIONER OF THE
COMMONWEALTH OF PENNSYLVANIA,

Appellant,

v.

RELIANCE INSURANCE COMPANY, ET AL.,

Appellees.

IN RE: Baptist Health South Florida, Inc. Objection to the Liquidator's Denial of a Direct Payment Request; Palm Springs General Hospital Objection to the Liquidator's Denial of a Direct Payment Request; the Exceptions to the Report of Referee James Schwartzman

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BRIEF OF *AMICUS CURIAE* NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS IN SUPPORT OF APPELLANT

Appeal from the March 18, 2004 Amended Memorandum Opinion and Order and the April 1, 2004 Order of the Commonwealth Court of Pennsylvania at No. 269 M.D. 2001

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I. INTRODUCTION

The National Association of Insurance Commissioners ("NAIC") files its *amicus curiae* brief to assist this Court with the nationally significant insurance regulatory issues raised in this appeal. This brief attempts to provide a broader perspective on these issues, both in reference to other jurisdictions and historically.

The liquidation of Reliance Insurance Company ("Reliance") must be conducted in an orderly manner by M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania (the "Liquidator") pursuant to Article V of the Insurance Department Act of 1921, Act of May 17, 1921, P.L. 789, *as amended*, 40 P.S. §§ 221.01 through 221.63 (the "Act").[1] The NAIC is concerned that the Reliance liquidation be conducted in a manner that is as orderly as possible. In the orders being appealed, it appears that the Commonwealth Court has equitably apportioned payments to policyholders by permitting them direct access to reinsurance proceeds.[2]

The Commonwealth Court's attempts to work equity for two Reliance policyholders is contrary to the law in Pennsylvania regarding insurance company receiverships,[3] overlooks decades of developments in statutory insurance receiverships and the national system of state-based insurance regulation, and will likely work an inequity for all of the other claimants in Reliance. The order appealed from, if not reversed, will likely cause concerns about the conduct of this receivership for many years, if not decades, to come.

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[1] References herein to section numbers cite to the provisions of the Act.

[2] Direct access to reinsurance proceeds is also known as a "cut-through."

[3] A liquidation is one type of receivership. Herein, the terms "liquidation" and "receivership" are used interchangeably.

II. INTEREST OF *AMICUS CURIAE*

A. Identity Of *Amicus Curiae*

The NAIC is a Delaware non-profit corporation whose membership consists of the principal insurance regulatory officials of the 50 states, the District of Columbia, and the territories and insular possessions of the United States. The NAIC's members are the statutory heads of state departments of insurance having approximately 11,000 staff members, including 282 actuaries, 681 rate and form analysts, and 1,175 financial examiners. *See* NAIC, *2001 Insurance Department Resources Report*, Tables 3 and 6 (2002). Created in 1871, the NAIC is the nation's oldest association of state government officials.

Only a member may request that the NAIC file an *amicus curiae* brief. A request requires approval of the Executive Committee of the NAIC, which is the association's governing body of 16 members comprised of the officers and three representatives of the four geographical zones. *See* Bylaws of the National Association of Insurance Commissioners *at* http://www.naic.org/about/bylaws.htm (last visited August 16, 2004).

The filing of this brief is consistent with the NAIC's mission as set out in its Certificate of Incorporation:

> The mission of the NAIC is to assist state insurance regulators, individually and collectively, in serving the public interest and achieving the following fundamental insurance regulatory goals in a responsive, efficient and cost effective manner, consistent with the wishes of its members: Protect the public interest; Promote competitive markets; Facilitate the fair and equitable treatment of insurance consumers; Promote the reliability, solvency and financial solidity of insurance institutions; and Support and improve state regulation of insurance.

See NAIC Mission Statement *at* http://www.naic.org/about/mission.htm (last visited Aug. 16, 2004).

Each NAIC member promotes the objective of solvent insurance institutions in the member's two distinct capacities as the chief insurance regulator in each state and as the officer charged with handling insurer receiverships for the state. Individually and collectively, the NAIC's members have a wealth of experience in the administration of insurer receiverships. The NAIC's members understand the interests of insurance consumers and others affected by the emergencies arising from insurer insolvency and receivership, and work daily to protect those interests. The NAIC's members are uniquely qualified and situated to assist this Court by presenting the regulatory and public policy concerns involved in this case.

Part of the NAIC's members' mission to support and improve state regulation of insurance was the establishment of the NAIC Financial Regulations Standards and Accreditation Program in June 1989. The accreditation program is intended to ensure that each state satisfies certain baseline requirements deemed necessary to an effective national system of state-based insurance regulation. The role of the insurance commissioner in insurer receivership proceedings is so critical that it is the subject of one of the 18 standards with regard to the laws and regulations that must be in place for a state to be accredited by the NAIC. The standard provides:

> 13. Receivership
>
> State law should set forth a receivership scheme for the administration, **by the insurance commissioner**, of insurance companies found to be insolvent as set forth in the NAIC's Insurers Rehabilitation and Liquidation Model Act.

NAIC Financial Regulation Standards and Accreditation Program (1997) (emphasis added). This standard reflects the belief of the NAIC's members that the commissioner of insurance is

the most appropriate person to be entrusted with the protection of the public interest in dealing with the emergency situations arising from the insolvency or receivership of an insurer.

The NAIC's members are concerned with all aspects of the regulation of the business of insurance. In relation to the mission component of promoting reliability – the ultimate delivery of the product of paid claims under policies of insurance – the NAIC's members are particularly concerned with the administration of insurer receiverships for rehabilitation or for liquidation.

B. Interest Of *Amicus Curiae*

The NAIC's members are charged by statute to represent their respective states in presiding over the rehabilitation of financially troubled insurers and the liquidation of insolvent insurers. There are defined steps in the statutory process of an insurer moving from being a troubled company to rehabilitation, and usually, to liquidation. The rights and liabilities of the insurer and all parties interested in it are fundamentally changed at each step. *See generally* Ch. 1 - Takeover and Administration & Ch. 9 – Legal Considerations, *NAIC Handbook for Insurance Company Insolvencies* (1999).

The Reliance receivership presents matters of great importance for our national system of state-based insurance regulation. The specific orders appealed from in this matter greatly increase the likelihood that many valid claims will be paid at a diminished distribution in the statutory scheme, which is contrary to the existence and purposes of insurance, insurance regulation and the NAIC. The conduct of the Reliance receivership harkens back to the conduct of insurance regulation more than 65 years ago, in the 1930s, before the adoption by the states of statutory receiverships for insurers through the provisions of the NAIC Model Act[4] and the

[4] More detail on the NAIC Insurers Rehabilitation and Liquidation Model Act (the "Model Act"), 3 *NAIC Model Laws, Regulations and Guidelines*, No. 555 (2000) is provided below.

improvements to that Model Act made over the ensuing decades. All of these have developed over the decades to ensure that the primary purpose of insurance – the payment of claims – is fulfilled.

The NAIC files its *amicus curiae* brief in support of the request of M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania, that this Court reverse the Commonwealth Court's March 18, 2004 Opinion and Order and April 1, 2004 Order (collectively, the "Commonwealth Court Opinion and Orders") allowing Appellees direct access to Reliance's reinsurance assets. The interests of the NAIC's members relate to the effect this case may have on other receivership cases pending or that may occur in their states, and the costs of the Reliance receivership that ultimately will be borne by insurance consumers and taxpayers in their states.[5]

III. STATEMENTS OF JURISDICTION, SCOPE AND OTHER STATEMENTS

The NAIC adopts and incorporates the Statement of Jurisdiction, Statement of Scope of Review and Standard of Review, Text of the Orders in Question, Statement of the Questions Involved, and Statement of the Case from the Brief of Appellant.

IV. SUMMARY OF ARGUMENT

The Commonwealth Court erred in ordering the reinsurer American Health Indemnity Company ("AHIC") to make direct payments to Palm Springs General Hospital and Baptist Health South Florida, Inc. (collectively, the "Hospitals" or "Appellees") because to permit direct payment in this instance is contrary to the Pennsylvania statutes governing direct access to reinsurance and establishing the priority of distribution of liquidation estate assets. *See* 40 P.S.

[5] How insurance consumers and taxpayers will ultimately pay the costs of the Reliance receivership is explained *infra*.

§§ 221.34 and 221.44. To sustain the Commonwealth Court's "totality of the circumstances" approach, as opposed to the implementation of the rights and liabilities established by the terms of existing contracts, and the explicit requirements of 40 P.S. § 221.34, would result in courts ignoring state statutes respecting the orderly administration of insolvent insurance estates. *Amicus curiae* NAIC is uniquely positioned to inform the Supreme Court of Pennsylvania of the potentially national ramifications of the Commonwealth Court's orders being appealed.

V. ARGUMENT

A. The NAIC Insurers Rehabilitation And Liquidation Model Act Is The Basis For Pennsylvania's Act

The NAIC provides services to its members through, among other things, the promulgation of model laws and regulations. The NAIC's model laws and regulations serve as standards for the NAIC's members in developing insurance laws and regulations in their individual states, and in carrying out their regulatory and receivership duties. Consistent with its mission, the NAIC helps its members and their respective insurance departments to explain the function and significance of NAIC model laws and regulations to legislatures, courts, other divisions of the executive branch, industry, consumers and the general public.

Among the hundreds of model acts and regulations that the NAIC has promulgated, one of the first to be adopted was the NAIC Insurers Rehabilitation and Liquidation Model Act (the "Model Act"). 3 *NAIC Model Laws, Regulations and Guidelines,* No. 555 (2000). The Model Act was developed following the Great Depression, when the need to deal more effectively with the emergencies related to the insolvency or receivership of insurers was recognized. A 1935 Report of the Special Committee on Interstate Liquidation and Reorganization resolved, in part:

> WHEREAS, Although the institution of insurance is rapidly approaching a state of stabilization and there is ample reason to

> believe that the period of extensive liquidation and rehabilitation has been passed, it is desirable to have available adequate machinery to meet the emergencies that may arise in the future;
>
> NOW, THEREFORE, BE IT RESOLVED, That the [NAIC] urges the enactment into law of the necessary statute or statutes whereby such unitary control of liquidations or rehabilitations may be effected by extending the authority and control of the appropriate Insurance Commissioner ... and the appropriate court....

1 *Proceedings of the Nat'l Ass'n of Ins. Comm'rs* 97 (1935).

In its several versions since 1936, the Model Act has served as a guide for state legislatures as they adopted statutory receiverships for insurers. It has also been a guide to NAIC members in discharging their duties as rehabilitators and liquidators of insurers.

In 1936, the NAIC adopted an early version of the Uniform Insurance Liquidation Act, 13 U.L.A. 321-53 (1986 & Supp. 2002) (the "UILA"), as its Model Act. *See* 1 *Proceedings of the Nat'l Ass'n of Ins. Comm'rs* 29-33 (1936). The NAIC adopted this early version well before the National Conference of Commissioners on Uniform State Laws officially promulgated the UILA in 1939.

The Model Act and its role in the NAIC's accreditation program together serve to promote consistency in the approach to the rehabilitation and liquidation of insurers. This has the effect of encouraging nationally consistent treatment of all the policyholders, claimants and other creditors of and debtors to insolvent insurers. The NAIC tracks the action states take regarding its various model acts. Since 1936, virtually every state has at some point adopted the Model Act. This can be seen in Exhibit "A" hereto, a table published by the NAIC regarding the adoption of the Model Act, which shows in the "MODEL/SIMILAR LEGIS." column that Pennsylvania is among the 33 states that have the post-1969 version of the Model Act.

These 33 states adopted a version substantially comparable to the Model Act after the NAIC itself adopted the Wisconsin Insurers Rehabilitation and Liquidation Act, Wis. Stat. § 645 (1968), as its Model Act (the "1968 Model Act") instead of the UILA. *See* 1 *Proc. of the Nat'l Ass'n Ins. Comm'rs* 168, 241 & 271 (1969). States in the "RELATED LEGIS./REGS." column generally have statutes based on the earlier UILA, but many of these statutes also have been updated. Pennsylvania updated much of its adoption of the Model Act in 1977. *See* 40 P.S. §§ 221.01 through 221.63.

Because every state has some version of the Model Act, and because decisions by courts with similar or identical versions of the Model Act typically are persuasive authority in other jurisdictions, the outcome in this case may affect the dozens of ongoing insurer receivership proceedings in other states. Courts reviewing insurer receivership proceedings frequently review the Model Act and how the states have interpreted it. *See, e.g., Todd v. DSN Dealer Serv. Network*, 861 F. Supp. 1531 (D. Kan. 1994); *Hager v. Anderson-Hutchinson Ins. Agency*, Civ. No. 86-841-E, 1989 U.S. Dist. LEXIS 13614 (S.D. Iowa July 19, 1989); *Oxendine v. Comm'r of Ins. of N.C.*, 494 S.E.2d 545 (Ga. Ct. App. 1997); *Four Star Ins. Agency v. Hawaiian Elec. Indus.*, 974 P.2d 1017 (Haw. 1999); *State ex rel. Angoff v. Wells,* 987 S.W.2d 411 (Mo. Ct. App. 1999); *State ex rel. Sizemore v. United Physicians Ins. Risk Retention Group*, 56 S.W.3d 557 (Tenn. Ct. App. 2001); *Covington v. Ohio Gen. Ins. Co.*, No. 01AP-213, 2001 Ohio App. LEXIS 3929 (Ohio Ct. App. Sept. 6, 2001).

The members of the NAIC share a common interest with the Liquidator in this case in the orderly, efficient and timely resolution of the Reliance receivership. The liquidation of an insurer domiciled in one state usually affects the citizens of other states, because of the national scope of many insurer's books of business. Most unpaid losses due to policyholders and

claimants in any insurer liquidation commonly occur in ancillary states. *See* 40 P.S. § 221.3 (definition of ancillary) and Model Act § 3.B; s*ee generally NAIC Report on Receiverships* (1998). Logically, an insurer authorized in 50 states with its book of business distributed equally among the states will write 98 percent of its policies for citizens of other states.

Given the importance to other state regulators of the orderly conduct of the Reliance liquidation, the Commonwealth Court's "totality of the circumstances analysis" and its concurrent disregard for the terms of the contracts of reinsurance at issue and the explicit requirements of 40 P.S. § 221.34 introduce an unnecessary and undesirable element of uncertainty to the conduct of the Reliance liquidation.

B. The States Must Be Able To Rely On The Domiciliary Liquidator

It is likely that the other states affected by the Reliance receivership have more of the exposure than Pennsylvania in terms of unpaid claims. These states must be able to rely on the Liquidator and the Commonwealth Court to ensure that payments to these claimants continue and that the liquidation is conducted in an orderly manner. The Model Act system for dealing with insolvent insurers has been developed over decades to allow the states to rely on each other to deal with insolvent insurers in a manner that will protect policyholders as well as other creditors in every state. This is the interstate cooperation referenced in the Act, *see* 40 P.S. § 221.1(c)(v),[6] and reflected in the Act's definitions for "ancillary state," "domiciliary state," "general assets," "preferred claim," "reciprocal state," "secured claim" and "special deposit claim." *See* 40 P.S. § 221.3[7]; *see generally* 40 P.S. §§ 221.52 through 221.62.[8] This system of

[6] Model Act § 1.D5.

[7] Model Act § 3.

[8] Model Act §§ 55 through 64.

relying on the domestic state avoids the complications and expense that results from each state having to act independently to protect those in its jurisdiction.

C. How Statutory Receiverships Of Insurers Work

1. Statutory Receiverships Are Different from General Equity Receiverships

Statutory receiverships provide, to the greatest extent possible, legal remedies for the emergencies created by the insolvency or receivership of an insurer. In Pennsylvania, for instance, the Act provides that "No court of this Commonwealth shall have jurisdiction to entertain, hear or determine any delinquency proceeding other than as provided in this article." 40 P.S. § 221.4(a).[9] This provision is based on Model Act § 4.B, which in turn was derived from the 1968 Model Act § 645.04 (3). That section provides:

> (3) Exclusiveness of Proceedings. No court of this state shall have jurisdiction to entertain, hear or determine any complaint praying for the dissolution, liquidation, rehabilitation, sequestration, conservation or receivership of any insurer, or praying for an injunction or restraining order or other relief preliminary to, incidental to or relating to such proceedings other than in accordance with this chapter.
>
> ***
>
> Comment on sub. (3): This subsection makes this chapter the exclusive law for all delinquency proceedings in the courts of this state.... There is no good reason to permit general equity receiverships in this state.... The rules of this chapter are carefully worked out with special reference to the insurance context, with which courts are not generally familiar, and the courts should not have the option of applying other rules developed in connection with other problems. Adequate discretionary power remains in the courts within the framework of the chapter to deal with any special problems that arise.

[9] "Delinquency proceeding" generally means any proceeding instituted against an insurer for the purpose of liquidating, rehabilitating, reorganizing or conserving such insurer, as well as other relief preliminary to, incidental to or relating to such proceedings. 40 P.S. § 221.3.

Most states have adopted this provision from the Model Act. *See* Exhibit "B" hereto. Even in those few states that still allow general equity receiverships, the liquidation court still cannot override matters that are mandated by the liquidation statute.

2. The Importance of the Priority of Distribution

Insurance claimants must be the primary concern of the Reliance receivership proceedings. *See* 40 P.S. § 221.1(c)(iv)[10] ("The purpose of this article is the protection of the interest of insureds, creditors and the public generally ... through ... equitable apportionment of any unavoidable loss").

"Equitable apportionment" does not mean that a court sitting in equity determines what is equitable and apportions payments, as in a general equity receivership. Nor does it mean that all unsecured creditors will share equally. Rather, it means that creditors will share based on the equities worked into the statute. On this point, the 1968 Model Act bears quoting at length:

> When an insurer must be liquidated, the outcome is often tragic. While many of the losers will merely be inconvenienced, others may suffer losses or delays in receiving payment that will subject them at least to hardship and may even deprive them of the necessities of life. It becomes apparent that **claims that are socially more important need to be paid ahead of those that are less important**. Recognition of such social equities is commonplace in the law relating to insolvency and bankruptcy.
>
> In an effort to **minimize the harm** done by liquidation, and especially to lessen it **for those persons least able to bear it**, much thought and consultation went into the structuring of the priority system. The outcome is the classification that follows. Because of the novelty of certain parts of the system, a full explanation for the placement of each category is provided. The basic nature of the system is explained briefly in the following outline, however, to provide an overview.

[10] Model Act § 1.D.4.

The order of distribution is:

(1) Cost of administration. Without this, the liquidation could not proceed and no distribution could be made. These costs generally come first in all priority systems.

(2) Wages, in limited amounts. This is traditionally a high priority and seems obviously meritorious in a society where the majority of people are dependent for a livelihood upon regular receipt of wages.

(3) Loss claims. This is limited to large claims, the **cases where the most hardship will result if full payment is not made reasonably promptly**.

(4) Unearned premium reserve and small loss claims. If this priority can be reached and these claims paid in full, the enterprise will have carried out the social function of insurance in a reasonably adequate way.

(5) Residual classification. This includes ordinary commercial debts and debts owing to governments, such as taxes. It is likely to be small in amount relative to the total of all claims.

(6) Claims based solely on judgments. Those judgments that cannot otherwise be avoided for constitutional reasons are postponed to this class to protect other claimants against inflated claims that are not properly defended because of the deterioration of the company in its last days. If the claim is meritorious, the judgment creditor can elevate his claim to the priority it would otherwise have by proving it in the liquidation on its merits and not on the basis of the judgment. The judgment may, of course, be a very persuasive fact.

(7) Interest on claims paid in the classes of higher priority.

(8) Miscellaneous subordinated claims. **These are left to the last because of their minimal social importance** or because of the necessities of administration. The category includes late claims and claims where the claimant is compensated in other ways, among others.

(9) and (10) Proprietary claims. These claims will be paid in full only if the insurer in liquidation is actually solvent, or

> nearly so. This could happen if a mistake were made originally, in starting the liquidation, or if an insurer is liquidated for reasons other than insolvency because capital is impaired.
>
> This section is **designed to establish a complete system of priorities among unsecured creditors**, based on the relative social and economic importance of the claims likely to be asserted against an insurer. The system is more intricate than any list of priorities provided elsewhere. It would be possible to simplify the system by having fewer categories. This is what the traditional priority system does, for it generally gives priority only to a few kinds of claims - indeed, the traditional pattern is no system at all. Its crude simplicity does crude injustice and fails to carry out sound public policy by minimizing the damage done to the insured community when an insurer fails. The insurance enterprise should be made to do its proper job in the social organism, so far as that is possible with the limited assets that remain in a liquidation.

1968 Model Act § 645.68, introductory comment. Although modified in later versions of the Model Act, most of the distribution provisions have been maintained this day.[11]

Exhibit "C" hereto is a chart showing the adoption of the Model Act's priority-of-distribution section by the various states. All states employ the "absolute priority rule" except Alabama and California. The absolute priority rule requires full payment to be distributed to the members of each class (or that funds be reserved for such) before any payment is distributed to the next class. It is notable that Pennsylvania and 44 other states prohibit the establishment of subclasses within each class.

Priority of distribution is central to the entire Pennsylvania receivership scheme. After all rights and liabilities of interested parties have been fixed by the entry of a liquidation order, *see*

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[11] One major change in the order of distribution has been made in response to the holding in *United States Dep't of Treasury v. Fabe*, 508 U.S. 491 (1993), which determined that only administrative expenses and policy-related claims may be preferred over claims of the federal government in insurer insolvency proceedings without violating the Federal Priority Statute, 31 U.S.C.§ 3713.

40 P.S. § 221.20(d),[12] and the value of claims by and against the estate have been determined in accordance with 40 P.S. §§ 221.23-221.43 and 221.45-221.47,[13] the priority section determines which claims will be paid out of the available assets of the estate left after administrative expenses have been paid.

For the Reliance receivership, it is important to note that the Act's priority-of-distribution section gives access to the general assets of the estate to those with policy-related claims after the classes above it are paid. That is, the statute makes these preferred claims. For example, if the general assets of the estate fall short of satisfying all of the claims against the general assets by 25%, and if the claims' value of the priority class for policy-related claims is 75% or more of all of the claims against the general assets, then those holding claims in the next priority class will not be paid anything.

In the preceding example, if all claims were in the same priority class, then all would get 75% payment on their claims. Because the policy-related claims are preferred claims in a higher priority class, they are paid 100% while the claims in the next priority class are not paid anything. Creation of a preferred class of claims can cause distributions on the claims in the next priority class to be diluted completely.

This is, of course, the most extreme effect of the creation of a preferred class. Lesser dilutions are possible. Whenever a number of claimants are given direct access to a pool of assets that is insufficient to pay all the claims in full, then the other claimants that do not obtain direct access (or preferred claim) status will suffer some dilution in the distribution they would otherwise receive if there were no direct access or preferred claims.

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[12] Model Act § 20.B.

[13] Model Act §§ 24-46, 48-50.

The priority-of-distribution rules in the Model Act give the insurance policy-related claims a preference over general claims to ensure that those with policy-related claims get paid as fully as possible out of an insolvent estate. The priority of distribution defines which claimants will have access to the assets in the estate.

The priority of distribution is the very heart of the entire Model Act. In the states that adopt it, the Model Act represents the legislature's determination of how equity will be worked on a mass scale in the emergency situation created by the insolvency or receivership of an insurer. Liquidators and courts are charged with implementing the statutory system. In the instant case, the Commonwealth Court did not implement the statutory system, but instead tried to work equity for certain claimants. This is evident in the Commonwealth Court's evaluation of the parties' conduct in lieu of the reinsurance agreements at issue.

The result is that an inequity is imposed upon other claimants. The very reason that the Act prohibits the creation of subclasses is to ensure that only the preferred claims as established by the Legislature obtain the extreme advantage that accompanies this status.

3. The Rights of All Interested Parties Are Fixed by the Liquidation Order

That all rights and liabilities of the interested parties are fixed by the entry of a liquidation order is another key element of the statutory insurance receivership. *See* 40 P.S. § 221.20(d).[14] It is necessary to establish a point upon which a liquidator can rely in determining (a) what assets can be collected into the estate and (b) what values should be attached to all of the claims against the estate.

[14] Model Act § 20.B.

From this fixed point in time, a liquidator can review all of the documents that establish the rights and liabilities of the interested parties. Moreover, a liquidator and the interested parties can be assured that after this point none of the interested parties can obtain additional rights. Unless rights and liabilities are fixed as of a certain date, a liquidator could run into difficulties, as interested parties would continually seek to improve their positions.

The documents that establish the rights and liabilities of all the interested parties are the contracts of insurance and reinsurance. While the receivership statute provides how the receivership will proceed, it does not provide all that is needed to determine what will be collected into the estate and what will be paid and to whom. A liquidator cannot determine what rights and liabilities have been fixed without relying upon the contracts to which the insurer was a party prior to liquidation.

4. The Liability of Reinsurers

Reinsurance balances due usually are, in aggregate, the largest assets of an insurer, in liquidation or otherwise. For this reason, provisions regarding reinsurers' liability to an insurer in liquidation are an integral part of the scheme for statutory receiverships. The provision of the Act regarding reinsurer's liability is found at 40 P.S. § 221.34. It mirrors the language of 1978 Model Act § 36, *see* 1 *Proceedings of the Nat'l Ass'n Ins. Comm'rs* 265 (1978), which in turn is based on 1968 Model Act § 645.58. The comment to that section provides:

> This section in effect makes the standard insolvency clause a rule of law. The standard insolvency clause should also be required in every reinsurance agreement subject to the jurisdiction of this state, but such requirement belongs elsewhere in the statutes. An insolvency clause, and this section, prevents use of insolvency as a defense in an action or a reinsurance agreement. **The last sentence is intended to prevent what might in effect be a preferential transfer. Only if the reinsurance contract is for the direct coverage of**

named insureds should the reinsurer be able to make direct payment without going through the liquidator.

(Emphasis added.)

Exhibit "D" hereto, which shows the states that have adopted Model Act § 36 or related provisions regarding reinsurance balances, reflects the importance of these provisions to insurance regulation and the administration of statutory receiverships. For an insurer to take credit for reinsurance on its statutorily required financial statement, "the agreement must contain an acceptable insolvency clause." Statement of Statutory Accounting Principles 62, paragraph 8.a., *NAIC Accounting Practices and Procedures Manual*, 62-4 (2003). An acceptable insolvency clause requires that, in the event of insolvency, the reinsurance will be payable to the ceding insurer or its receiver. This is necessary to the conduct of insurer receiverships, specifically in determining the assets available to pay policy-related claims.

The insolvency clause emerged following the case *Fidelity Deposit Co. of Md. v. Pink*, 302 U.S. 224 (1937). In *Pink*, the United States Supreme Court held that a reinsurer would owe the liquidator based on only the amounts the liquidator actually paid on the underlying claims for which the reinsurance was provided. Thus, in liquidations that could pay nothing to policy claimants, the liquidator could collect no reinsurance. This created a conundrum since most of the assets needed to pay claims had to be collected from the reinsurers. If the liquidator could not collect the reinsurance needed to pay claims, then the liquidator could not pay claims that in turn provided the means to bill the reinsurers. In short, any insurer liquidation would result in a windfall to the reinsurers because no claims could be paid and no reinsurance could be billed.

States corrected this result by enacting laws requiring that reinsurance contracts contain an insolvency clause that provided essentially that the reinsurance was payable in accordance

with the insurer's liability, "without diminution because of the insurer's insolvency or because the liquidator or statutory receiver failed to pay all or a portion of the underlying claims reinsured." Absent the statutory insolvency clause, and statutes requiring reinsurers to pay a liquidator based on the reinsured's liability and not what has been paid, liquidation would have the effect of awarding massive windfalls to the insurer's reinsurers, whereby the reinsurers would keep the entire ceded premium collected while the insurer was ongoing and, after the liquidation, pay little or nothing on the claims under policies of insurance.

By 1985, *Pink* had been statutorily overruled and courts had recognized this fact. *See Arrow Trucking v. Cont'l Ins. Co.*, 465 So.2d 691, 700 (La. 1985) ("[*Pink*] ... has been statutorily overruled to the extent that by statute the reinsurance is payable to the liquidator even without the reinsured's having first sustained a loss"). Today, all states must have enactments substantially similar to the Model Act's insolvency clause provision for their insurance departments to be accredited by the NAIC for their regulation of insurers' solvency. *NAIC Financial Regulation Standards and Accreditation Program* 13 (June 2004) *at* http://www.naic.org/frs/accreditation/docs/frsa_6-04.pdf (last visited Aug. 16, 2004).

If reinsurance balances cannot be collected upon insolvency or those balances can only be applied to certain policy-related claims, then the assets are not actually available in relation to all policy-related claims. "Assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet" of an insurer. Statement of Statutory Accounting Principles 4, paragraph 3, *NAIC Accounting Practices and Procedures Manual*, 4-3 (2003). Reinsurance balances that are payable other than to the ceding insurer or its receiver are assets that are unavailable due to third party interests.

Applying the foregoing Model Act and financial reporting requirements to the instant case, it is highly probable that, leading up to its insolvency, Reliance took credit for the reinsurance ceded to AHIC on its balance sheet. Many Reliance policyholders and creditors will have relied to their detriment upon the insolvent insurer's financial statements representing that its reinsurance balances were not "unavailable due to encumbrances or other third party interests." If the Commonwealth Court's orders were upheld, it would signify that encumbrances or other third party interests can arise in conjunction with or after the entry of a liquidation order. The practical effect of upholding the orders being appealed could be to subject the statutory process of insurer liquidation to uncertainty, disarray and protracted litigation of any agreement subject to collection by the liquidator.

D. The Commonwealth Court Erred By Allowing Common Law And Equity To Supersede The Specific Legislative Directives Contained In The Act

When an act of the Pennsylvania General Assembly bears upon an issue, its directives supersede the common law and a court's equity jurisdiction. With respect to the cut-throughs at issue in the Reliance receivership, the Pennsylvania General Assembly has spoken with clarity:

> 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.

40 P.S. § 221.34 (emphasis added).

The NAIC believes, as argued by the Appellant and other *amici curiae*, that the Appellees do not qualify for direct payment because the statute requires that the reinsurance contract explicitly provide for direct coverage of an individual named insured. It is undisputed, and the

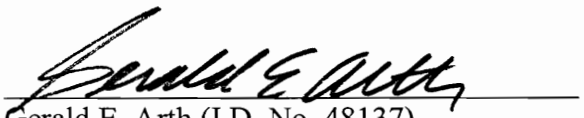
Commonwealth Court found, that the reinsurance contracts at issue here did not provide direct coverage for the Hospitals. Pennsylvania law holds, as does black-letter law across the country, that a named insured is an individual or entity specifically identified by the person or entity's actual name in the policy itself. "Whenever the term 'named insured' is employed, it refers only to the person specifically designated upon the face of the contract...." *Stump v. State Farm Mut. Auto. Ins. Co.,* 564 A.2d 194, 199 (Pa. Super. Ct. 1989) (citing 7 John A. Appleman and Jean Appleman, *Insurance Law and Practice*, § 4354 (1981)). *See also, e.g., Farley v. Am. Auto. Ins. Co.,* 72 S.E.2d 520, 521 (W. Va. 1952) ("It is thus seen that the unqualified phrase 'named insured' has a restricted meaning and does not apply to any persons other than those named in the policy"); Rowland H. Long, *The Law of Liability Insurance* 3-3, § 301 (1988).

The Commonwealth Court's endeavor to find a novation of the contracts of reinsurance at issue disregards the Pennsylvania General Assembly's mandate that the Act serve as the exclusive mechanism for administering insurance receiverships and the statutory priority of distribution. It is certain that 40 P.S. § 221.34 requires that the reinsurance contract provide for direct coverage of that named insured before direct payment from a reinsurer can be permitted in a liquidation proceeding. The orders being appealed here represent an impermissible deviation from this statutory requirement. The parties seeking direct payment in this case seek a result that is inconsistent with what the Pennsylvania General Assembly has enacted.

VI. CONCLUSION

For all of the foregoing reasons, the NAIC respectfully requests that this Court reverse the Commonwealth Court's orders regarding direct access to reinsurance. Should the Court require further information, the NAIC would be pleased to provide it.

Respectfully submitted,



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Dated: August 18, 2004

Exhibit A

INSURERS REHABILITATION AND LIQUIDATION MODEL ACT

The date in parentheses is the effective date of the legislation or regulation, with latest amendments. Related legislation marked with a # is based on or contains provisions of the Uniform Insurers Liquidation Act (UILA) from the National Conference of Commissioners on Uniform State Laws. This uniform law is similar to Article III of the NAIC model. Also see KEY at end of list.

NAIC MEMBER	MODEL/SIMILAR LEGIS.	RELATED LEGIS./REGS.
Alabama		ALA. CODE §§ 27-32-1 to 7-32-41 (1971/1975) #
Alaska	ALASKA STAT. §§ 21.78.010 to 1.78.330 (1966/1990).	
Arizona		ARIZ. REV. STAT. ANN. §§ 20-611 to 20-650 (1954/1997) #
Arkansas		ARK. CODE ANN. §§ 23-68-101 to 23-68-132 (1959/1997) #
California		CAL. INS. CODE §§ 1010 to 1043 (1935/2000); § 1063.6 (1999); §§ 1064.1 to 1064.12 (1988) #
Colorado	COLO. REV. STAT. §§ 10-3-501 to 10-3-559 (1992/2001).	COLO. REV. STAT. §§ 10-3-401 to 10-3-512 (1963) #
Connecticut	CONN. GEN. STAT. §§ 38a-903 to 38a-961 (1979/1998) **[1]**	
Delaware		DEL. CODE ANN. tit. 18 §§ 5901 to 5944 (1953/1995) #
District of Columbia	D.C. CODE ANN. §§ 35-2801 to 35-2857 (1993/2000) **[2]**	
Florida		FLA. STAT. §§ 631.001 to 631.399 (1982/1995) #
Georgia	GA. CODE §§ 33-37-1 to 33-37-50 (1991/1997) **[1]**	
Guam		GUAM GOV'T CODE §§ 43225 to 43238 (1981) #
Hawaii	HAWAII REV. STAT. §§ 431:15-101 to 431:15-411 (1988/1996).	
Idaho	IDAHO CODE §§ 41-3301 to 41-3360 (1981/1999).	
Illinois		215 ILL. COMP. STAT. 5/187 to 5/221.13 (1937/2001) #
Indiana	IND. CODE §§ 27-9-1-1 to 27-9-4-10 (1979/1996).	
Iowa	IOWA CODE §§ 507C.1 to 507C.59 (1984/1997).	
Kansas	KAN. STAT. ANN. §§ 40-3605 to 40-3658 (1991).	
Kentucky	KY. REV. STAT. §§ 304.33-010 to 304.33-600 (1970/1996).	
Louisiana		LA. REV. STAT. ANN. §§ 22:731 to 22:764 (1958/2001) #

INSURERS REHABILITATION AND LIQUIDATION MODEL ACT

NAIC MEMBER	MODEL/SIMILAR LEGIS.	RELATED LEGIS./REGS.
Maine	ME. REV. STAT. ANN. tit. 24-A § 4351 to 4407 (1970/1993) (Much of model).	
Maryland		MD. ANN. CODE Ins. §§ 9-201 to 9-232 (1933/2001) #
Massachusetts		MASS. GEN. LAWS. ANN. ch. 175 §§ 180A to 180L (1939/2000) #
Michigan	MICH. COMP. LAWS §§ 500.8101 to 500.8159 (1990/1996).	
Minnesota	MINN. STAT. §§ 60B.01 to 60B.61 (1969/1999).	
Mississippi	MISS. CODE ANN. §§ 83-24-1 to 83-24-117 (1991/2000).	MISS. CODE. ANN. §§ 83-23-1 to 83-23-9 (1942).
Missouri	MO. REV. STAT. §§ 375.1150 to 375.1246 (1991/2001).	MO. REV. STAT. §§ 375.535 to 375.780 (1939/1996); §§ 375.950 to 375.990 (1976/1986) #
Montana	MONT. CODE ANN. §§ 33-2-1301 to 33-2-1388 (1979/2001) **[1]**	
Nebraska	NEB. REV. STAT. §§ 44-4801 to 44-4861 (1989/1995).	NEB. REV. STAT. §§ 44-120 to 44-133 (1913/1989).
Nevada	NEV. REV. STAT. §§ 696B.010 to 696B.570 (1971/1979) #	
New Hampshire	N.H. REV. STAT. ANN. §§ 402-C:1 to 402-C:61 (1969/1998).	
New Jersey	N.J. STAT. ANN. §§ 17B:32-31 to 17B:32-91 (1992) (Life Insurers).	N.J. STAT. ANN. §§ 17:30C-1 to 17:30C-31 (1975) (P/C Insurers) #
New Mexico		N.M. STAT. ANN. §§ 59A-41-1 to 59A-41-57 (1985/1993) #
New York		N.Y. INS. LAW §§ 7401 to 7435 (1984/1999) #
North Carolina	N.C. GEN. STAT. §§ 58-30-1 to 58-30-305 (1989/2001) **[1]**	
North Dakota	N.D. CENT. CODE §§ 26.1-06.1-01 to 26.1-06.1-59 (1991/1997).	
Ohio	OHIO REV. CODE ANN. §§ 3903.01 to 3903.99 (1982/1995).	
Oklahoma		OKLA. STAT. tit. 36 §§ 1801 to 1812 (1975/2000)(Supervision and Conservatorship); §§ 1901 to 1937 (1957/2001) **[1]** (Rehabilitation and Liquidation) #
Oregon		OR. REV. STAT. §§ 734.010 to 734.440 (1967/1995) **[1]**
Pennsylvania	PA. UNCONS. STAT §§ 40-11-101 to 40-11-511 (1979/1996).	

INSURERS REHABILITATION AND LIQUIDATION MODEL ACT

NAIC MEMBER	MODEL/SIMILAR LEGIS.	RELATED LEGIS./REGS.
Puerto Rico		P.R. LAWS ANN. tit. 26 §§ 4001 to 4024 (1978) #
Rhode Island	R.I. GEN. LAWS §§ 27-14.3-1 to 27-14.3-65 (1993/2001) **[1]**	R.I. GEN. LAWS §§ 27-14.4-1 to 27-14.4-23 (1994/1999) #
South Carolina	S.C. CODE ANN. §§ 38-27-10 to 38-27-1000 (1988/2000).	
South Dakota	S.D. CODIFIED LAWS §§ 58-29B-1 to 58-29B-161 (1989/2001).	
Tennessee	TENN. CODE ANN. §§ 56-9-101 to 56-9-510 (1991/1999).	
Texas		TEX. INS. CODE art. 21.28 (1951/1995); art. 21.28-A (1967/1993); art. 21.28-B (1967).
Utah	UTAH CODE ANN. §§ 31A-27-101 to 31A-27-411 (1986/1999) **[1]**	
Vermont	VT. STAT. ANN. tit. 8 §§ 7031 to 7100 (1991).	
Virgin Islands		V.I. CODE ANN. tit. 22 §§ 1253 to 1285 (1968/1985) #
Virginia		VA. CODE §§ 38.2-1500 to 38.2-1521 (1986).
Washington	WASH. REV. CODE ANN §§ 48.31.030 to 48.31.360 (1947/2001) (Parts of model) **[1]**	WASH. REV. CODE §§ 48.99.010 to 48.99.080 (1947) #
West Virginia		W. VA CODE §§ 33-10-1 to 33-10-39 (1957/1996) #
Wisconsin	WIS. STAT. §§ 645.01 to 645.90 (1967/1989).	
Wyoming		WYO. STAT. §§ 26-28-101 to 26-28-131 (1967/1983) #

KEY:

[1] Contains Section 9 adopted in 1992 to indemnify receivers.

[2] Includes confidentiality provisions adopted by the NAIC in Jan. 2000.

Exhibit B

STATES ADOPTING MODEL § 4
RECEIVERSHIP AS EXCLUSIVE METHOD OF
CONDUCTING DELINQUENCY PROCEEDINGS

Almost every one of 53 jurisdictions, including the District of Columbia, the Virgin Islands and Puerto Rico, has a statute based on § 4 of the Insurers Rehabilitation and Liquidation Model Act, an excerpt of which is reprinted following this table. This section provides that delinquency proceedings initiated pursuant to the respective receivership code shall constitute the sole and exclusive method of liquidating, rehabilitating, reorganizing or conserving an insolvent insurer. The laws of four of 53 jurisdictions have no explicit exclusivity provision. An additional seven jurisdictions have statutes that permit the application of other laws to delinquency proceedings, usually with some limitations.

10/03

STATE	CITATION	ENACTED/AMENDED
AL	§ 27-32-3(d)	1971
AK	§ 21.78.010(a)	1966
AZ	§ 20-612A	1954/1991
AR	§ 23-68-103(c)	1959/1985, 1997
CA	Ins. § 1015[2]	1935
CO	§ 10-3-504	1992
CT	§ 38a-906(b)	1979/1988, 1990, 1992, 1995, 1996
DE	tit. 18 § 5902(d)	1953/1967, 1995
DC	§ 31-1303(b)	1993/1996
FL	§ 631.021(3)	1959/1963, 1969, 1977, 1982, 1983, 1985, 1989, 1997
GA	§ 33-37-4(b)	1991
HI	§ 431:15-104(c)	1987/2002
ID	§ 41-3304(2)	1981
IL	No provision.	
IN	§ 27-9-1-3(b)	1979/1986, 2003
IA	§ 507C.4.2	1984/1992
NY	Not exclusive.[3]	1984

STATE	CITATION	ENACTED/AMENDED
KS	§ 40-3608(b)	1991
KY	Not exclusive.[1]	1970/1990
LA	No provision.	
ME	tit. 24-A§ 4354.4	1969/1973, 1991
MD	Ins. § 9-204	1957/1996
MA	No provision.	
MI	§ 500.8104(2)	1956/1989
MN	§ 60B.04 Subd. 3	1969/1994
MS	§ 83-24-9(2)	1991
MO	§ 375.1154.2	1991
MT	§ 33-2-1305	1979
NE	§ 44-4804(2)	1989/1991
NV	§ 689B.190	1971/1995, 1997
NH	§ 402-C:4 III	1969/1991
NJ	§ 17:30C-3	1975
NM	No provision.	
TN	§ 56-9-104	1991

[1] Section 304.33-040(3) provides that the court may also authorize the receiver to seek injunctive or other appropriate relief from other courts, either within or without this state, if the court finds that such action would aid any delinquency proceeding.

[2] This cited statute provides that upon the appointment of a conservator and the seizure of an insolvent insurer's assets, any proceedings shall be conducted in accordance with "this [a]rticle."

STATES ADOPTING MODEL § 4
RECEIVERSHIP AS EXCLUSIVE METHOD OF CONDUCTING DELINQUENCY PROCEEDINGS

NC	Not exclusive.[4]	1989
ND	§ 26.1-06.1-04.2	1991/2001
OH	§ 3903.04(B)	1982
OK	Not exclusive.[6]	1957/1975, 1983, 1999
OR	§ 734.120(1)	1967/1979
PA	40 P.S. § 221.4(a)	1977
PR	Tit. 26 § 4004(2)	1991
RI	§ 27-14.3-4(b)	1993
SC	§ 38-27-60	1987/1993
SD	§ 58-29B-4	1989

TX	Not exclusive.[5]	1967/1981, 1983, 1987, 1989, 1991, 1993, 1995
UT	§ 31A-27-103(3)	1985/2002, 2003
VT	tit. 8 § 7032(b)	1991
VA	Not exclusive.[7]	1986
VI	No provision.	
WA	§ 48.31.111(2)	1993
WV	Not exclusive[8]	1957/1990
WI	§ 645.04(3)[9]	1969/1979, 1981, 1989
WY	§ 26-28-102(d)	1967/1977, 1983

Section 4. Jurisdiction and Venue

A. No delinquency proceeding shall be commenced under this Act by anyone other than the commissioner of this state and no court shall have jurisdiction to entertain, hear or determine any proceeding commenced by any other person.

B. No court of this state shall have jurisdiction to entertain, hear or determine any complaint praying for the dissolution, liquidation, rehabilitation, sequestration, conservation or receivership of any insurer; or praying for an injunction or restraining order or other relief preliminary to, incidental to or relating to such proceedings other than in accordance with this chapter.

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[3] Insurance Law § 7415 provides that in the event of conflict between provisions of the Uniform Insurance Liquidation Act and other provisions of the insurance code, the Act shall govern.

[4] Section 58-30-1 permits the Commissioner to supplement the insolvency code with those governing receivers of corporations.

[5] Insurance Code Art. 21.28-A § 12 authorizes the use of any other statutes possible of application with the procedures of this section, provided that in the event of conflict between provisions, the receivership article shall govern.

[6] Title 36 § 1902.A provides that the district court shall have exclusive original jurisdiction of delinquency proceedings. Arbitration is an exception: "Except as to claims against the estate, nothing in this article shall deprive a party in interest of any contractual right to pursue arbitration of any dispute under any law." Tit. 36 § 1902.B

[7] Section 38.2-1502 mandates that all delinquency proceedings shall be conducted as a suit in equity.

[8] Section 33-10-2(c) provides an exception to the exclusivity of the insolvency code in cases of administrative supervision, which are governed by another chapter of the insurance code.

[9] Further evidence of the exclusivity of the insolvency code is that an arbitration provision of any contract with an insurer undergoing formal proceedings is not enforceable unless the receiver elects to accept arbitration.

Exhibit C

Dilution Of Payments To Claimants Not Obtaining Direct Access (DA)

(Column A is the percentage of claims value obtaining DA)

Percent Assets Short

A	0%	5%	10%	15%	20%	25%	30%	35%	40%	45%
0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
5%	0.0%	0.3%	0.6%	0.9%	1.3%	1.8%	2.3%	2.8%	3.5%	4.3%
10%	0.0%	0.6%	1.2%	2.0%	2.8%	3.7%	4.8%	6.0%	7.4%	9.1%
15%	0.0%	0.9%	2.0%	3.1%	4.4%	5.9%	7.6%	9.5%	11.8%	14.4%
20%	0.0%	1.3%	2.8%	4.4%	6.2%	8.3%	10.7%	13.5%	16.7%	20.5%
25%	0.0%	1.8%	3.7%	5.9%	8.3%	11.1%	14.3%	17.9%	22.2%	27.3%
30%	0.0%	2.3%	4.8%	7.6%	10.7%	14.3%	18.4%	23.1%	28.6%	35.1%
35%	0.0%	2.8%	6.0%	9.5%	13.5%	17.9%	23.1%	29.0%	35.9%	44.1%
40%	0.0%	3.5%	7.4%	11.8%	16.7%	22.2%	28.6%	35.9%	44.4%	54.5%
45%	0.0%	4.3%	9.1%	14.4%	20.5%	27.3%	35.1%	44.1%	54.5%	66.9%
50%	0.0%	5.3%	11.1%	17.6%	25.0%	33.3%	42.9%	53.8%	66.7%	81.8%
55%	0.0%	6.4%	13.6%	21.6%	30.6%	40.7%	52.4%	65.8%	81.5%	100.0%
60%	0.0%	7.9%	16.7%	26.5%	37.5%	50.0%	64.3%	80.8%	100.0%	
65%	0.0%	9.8%	20.6%	32.8%	46.4%	61.9%	79.6%	100.0%		
70%	0.0%	12.3%	25.9%	41.2%	58.3%	77.8%	100.0%			
75%	0.0%	15.8%	33.3%	52.9%	75.0%	100.0%				
80%	0.0%	21.1%	44.4%	70.6%	100.0%					
85%	0.0%	29.8%	63.0%	100.0%						
90%	0.0%	47.4%	100.0%							
95%	0.0%	100.0%								

Exhibit D

STATES ADOPTING MODEL § 36 OR RELATED PROVISIONS REGARDING REINSURERS LIABILITY

Every state, plus the District of Columbia, the Virgin Islands and Puerto Rico, has a provision that pertains to reinsurers liability. Many are based on prior versions of § 36 of the Insurers Rehabilitation and Liquidation Model Act, an excerpt of which is reprinted following this table. The statute requires that, in the event of the insolvency of a ceding insurer, reinsurance proceeds shall be paid directly to the ceding insurer or receiver. These statutes narrowly restrict direct access ("DA") to reinsurance proceeds by an insured. The most common condition of gaining DA is that the reinsurance contract must expressly provide for direct coverage of a named insured. For ease of presentation, the provisions are classified into six types.

KEY:

Type	Characteristic Language
A	The cited statute is a specific section of the receivership code that restricts DA to limited circumstances: (1) the reinsurance contract provided for direct coverage of a named insured, and (2) the payment was made in discharge of that obligation.
B	This cited provision is usually part of a statute directing that the reinsurance contract must contain certain language in order for a ceding insurer to claim credit for reinsurance on its financial statements. Pursuant to the required language, DA is permitted only if (1) the contract or other written agreement specifically provides another payee of the reinsurance in the event of the insolvency of the ceding insurer, or (2) an assuming insurer, with the consent of a direct insured, has assumed the policy obligations of the ceding insurer to the payees.
C	The cited statute is a specific section of the receivership code that permits DA only if the contract of insurance or reinsurance specifically provides for another payees. In the event of an unsuccessful claim for DA, the receiver and reinsurer are entitled to collect attorney's fees and expenses incurred in preventing DA.
D	The cited statute does not address DA, but provides that an assuming insurer shall pay reinsurance proceeds and that such proceeds shall not be diminished because of the insolvency of a ceding insurer.
E	The cited statute is similar to type A but instead of requirement (2) the statute permits DA only if an assuming insurer, with the consent of a direct insured, has assumed the policy obligations of the ceding insurer to the payees.
F	The statute is unique or includes portions of other types. Exceptions are described when appropriate.

10/03

STATE	CITATION	ENACTED/AMENDED	STATUTE TYPE	EXCEPTIONS
AL	§ 27-32-39	1975/2003	F	Provision relates to moving the books of business out of the insolvent insurer.
AK	§ 21.78.272	1990	A	
AZ	§ 20-673	1977/1998	D	
AR	§ 23-68-133	1997	C	
CA	Ins. § 922.2(a)(2)	1996	F	Similar to type B, but DA is permitted only if the contract of insurance or reinsurance specifically provides another payee in the event of the insolvency of the insurer.

STATES ADOPTING MODEL § 36
REINSURER'S LIABILITY

STATE	CITATION	ENACTED/AMENDED	STATUTE TYPE	EXCEPTIONS
CO	§ 10-3-531	1992/2001	F	Similar to type A, but DA is permitted only if the contract of insurance or reinsurance specifically provides another payee in the event of the insolvency of the insurer.
CT	§ 38a-934	1979/1992, 1998	F	Adds to type A the opportunity for DA when there has been a novation of the underlying policy obligations, an assumption of those obligations by the reinsurer and the proceeds are payable to another payee.
DE	tit. 18 § 914	1991/2000	B	
DC	§ 31-1330	1993/2000	A	
FL	§ 631.205	1983	F	Similar to type A, but DA is permitted only if the contract of insurance or reinsurance specifically provides another payee in the event of the insolvency of the insurer.
GA	§ 33-37-31	1991/2001	E	
HI	§ 431:15-321	1988	A	
ID	§ 41-3332	1981	A	
IL	215 ILCS 5/193(8)	1937/last amended 1995	F	DA permitted only if the reinsurance agreement lawfully provides for payment to the insured by the reinsurer.
IN	§ 27-9-3-30.1	1999	E	
IA	§ 507C.32	1984/1998	E	
KS	§ 40-3634	1991/1999	E	
KY	§ 304.33-350	1970	A	
LA	§ 22:941G(2)	1958/last amended 1995	B	
ME	tit. 24-A§ 731-B(5)	1989/last amended 2001	B	
MD	Ins. § 5-904(a)	1957/1995, 2003	B	
MA	§ 175:20A(4)	1993/2000	D	
MI	§ 500.8132	1989/2000	F	Similar to type A, but DA permitted only if (1) the reinsurance contract or (2) an endorsement to the reinsured policies signed by the reinsurer requires direct payment to the payees.
MN	§ 60B.365	1999	B	
MS	§ 83-24-63	1991	A	
MO	§ 375.1202	1991/2002	E	
MT	§ 33-2-1361	1979	A	
NE	§ 44-4832	1989	A	
NV	§ 681A.230.1	1995/1997, 2001	B	
NH	§ 402-C:36	1969/2003	B	

STATES ADOPTING MODEL § 36
REINSURER'S LIABILITY

STATE	CITATION	ENACTED/AMENDED	STATUTE TYPE	EXCEPTIONS
NJ	§ 17B:32-61	1992	A	
NM	§ 59A-7-11B	1984/1993, 1994	F	Similar to type B, but DA is permitted only if an assuming insurer, with the consent of a direct insured, has assumed the policy obligations of the ceding insurer to the payees.
NY	Ins. Law § 1308(a)(2)	1984/1985, 1989, 1999	B	
NC	§ 58-30-170	1989	E	
ND	§ 26.1-06.1-31	1991	A	
OH	§ 3903.32	1984/1994, 2001	F	Similar to type A, but DA is permitted only if the contract of insurance or reinsurance specifically provides another payee in the event of the insolvency of the insurer.
OK	tit. 36 § 711A	1957/1984, 1993, 2000	B	
OR	§ 731.508(3)	1967/1993, 1995, 2001	B	
PA	40 P.S. § 221.34	1977	A	
PR	Tit. 26 § 4029	1991	D	
RI	§ 27-14.3-36	1993	A	
SC	§ 38-27-510	1987/1998	E	
SD	§ 58-29B-94	1989	A	
TN	§ 56-2-207(2)	1947	D	
TX	I.C. Art. 5.75-1(i)	1955/last amended 1995	B	
UT	§ 31A-22-1201	1985	B	
VT	tit. 8 § 7071	1991	A	
VA	§ 38.2-1316.5	1991	B	
VI	Tit. 22 § 514	1968	D	
WA	§ 48.31.135	1993	A	
WV	§ 33-4-15(c)	1957/1991, 1992, 1993	D	
WI	§ 645.58	1967/1989, 2003	E	
WY	§ 26-5-115	1992	D	

Section 36. Reinsurer's Liability

A. The amount recoverable by the liquidator from reinsurers shall not be reduced as a result of the delinquency proceedings, regardless of any provision in the reinsurance contract or other agreement.

B. All reinsurance contracts to which an insurer domiciled in this state is a party that do not contain the provisions required with respect to the obligation of reinsurers in the event of insolvency of the reinsured in order to obtain credit for reinsurance or other applicable statutes, shall be construed to contain the following provisions:

(1) In the event of insolvency and the appointment of a receiver, the reinsurance obligation shall be payable to the receiver upon demand, with reasonable provision for verification, on the basis of claims

allowed pursuant to Section 48 of this Act, without diminution because of the insolvency or because the receiver has failed to pay all or a portion of any claims. Payments by the reinsurer as set forth above shall be made directly to the ceding insurer or to its receiver; and

(2) [Omitted.]

C. Payments by the reinsurer as set forth shall be made directly to the ceding insurer or its receiver, except where the contract of insurance or reinsurance specifically provides for another payee in the event of insolvency of the ceding insurer in accordance with any applicable requirements of statutes, rules or orders of the domiciliary state of the ceding insurer. The receiver shall be entitled to recover from any person, who unsuccessfully makes a claim directly against the reinsurer, the receiver's attorneys' fees and expenses incurred in preventing any collection by such person.

A

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania, Plaintiff	:	
v.	:	
Reliance Insurance Company, Defendant	:	No. 269 M.D. 2001

IN RE: *Baptist Health South Florida, Inc. objection to the Liquidator's denial of a direct payment request; Palm Springs General Hospital objection to the Liquidator's denial of a direct payment request; the Exceptions to the Report of Referee James Schwartzman*

AMENDED MEMORANDUM OPINION and ORDER[1]

The Court has reviewed the report of the Referee entered in "The Objection of Palm Springs General Hospital" and "The Objection of Baptist Health South Florida Hospital" to the Liquidator's denial of a direct payment request. Before the Court for consideration are the exceptions filed by Palm Springs General Hospital and Baptist Health South Florida Hospital to the Referee's recommendation. The Liquidator has filed a response to the exceptions requesting that this Court adopt the findings of the Referee. Further, the Liquidator did not

[1] This Court filed a Memorandum Opinion and Order on March 17, 2004 which incorrectly stated that the Liquidator had not filed a response to the Exceptions filed by Objectors Palm Springs General Hospital and Baptist Health South Florida Hospital. In fact, the Liquidator did file a response and that response was considered when the Court reached the decision set forth herein.

contest the factual findings of the referee. Accordingly, the Court adopts the following findings made by Referee Schwartzman.

FINDINGS OF FACT

1. Palm Springs General Hospital (Objector Palm Springs) was insured by Reliance Insurance Company (Reliance).

2. Baptist Health South Florida Hospital (Objector Baptist) was insured by Reliance Insurance Company (Reliance).

3. The Insurance Commissioner of Pennsylvania, acting as Statutory Liquidator for Reliance Insurance Company (Liquidator), has filed with the Commonwealth Court a petition seeking approval of guidelines for the direct payment of reinsurance proceeds (Guidelines).

4. No objections to the Guidelines have been filed by reinsurance companies.

5. Reliance Insurance Company of Illinois issued a contract of insurance to Palm Springs General Hospital, located in Florida; Reliance reinsured 100% of the risk with American Healthcare Indemnity Company (AHIC).

6. Reliance Insurance Company of Illinois issued a contract of insurance to Baptist Health South Florida Hospital, located in Florida; Reliance reinsured 100% of the risk with American Healthcare Indemnity Company (AHIC).

7. Reliance issued reinsurance certificates to, and entered into reinsurance agreements with, AHIC. AHIC is a subsidiary of Southern California Physician's Insurance Exchange (SCPIE).

8. The business covered by the reinsurance agreements were policies written through the Health Care Division of Reliance, and SCPIE Management Services, Inc., acted as program manager.

9. The policies written by Reliance were 100% reinsured by AHIC, and Reliance was required to pay 100% of the premiums it received to AHIC, less a 5% ceding commission.

10. The reinsurance agreement between Reliance and Southern California Physician's Insurance Exchange does not contain a written "cut-through" clause allowing for the direct payment of reinsurance proceeds to an insured.

12. Objector Baptist and Objector South Florida obtained professional liability insurance through a program of reinsurance that was marketed and administered by SCPIE.

13. Objector Baptist and Objector South Florida dealt only with SCPIE, which managed all aspects of the reinsurance program.

14. The reinsurance agreements at issue here are between Reliance and AHIC and provide that, in the event of the insolvency of Reliance the proceeds of the reinsurance would be paid directly to Reliance, its liquidator, or other listed person.

15. Reliance was placed into liquidation by order of this Court dated October 3, 2001.

16. The Liquidator developed Guidelines for Enforcement of 40 P.S. §221.34, which set forth the procedures by which a reinsurer or an individual insured could apply for a direct payment of reinsurance proceeds.

17. Under the Guidelines, the Liquidator will make direct payment of reinsurance proceeds only where a reinsurance agreement contains a provision for direct payment of proceeds to an insured or where the reinsurer, with the consent of the direct insured, has assumed the policy obligations of the fronting company.

18. In November 2001, SCPIE submitted to the Liquidator a request for novation of AHIC's reinsurance agreements with Reliance, pursuant to which AHIC would assume direct liability for the Objectors for their insurance claims.

19. Applying the Guidelines, the Liquidator found that the reinsurance agreements failed to identify the insured who was to receive direct payment, that the reinsurer had not obtained the named insured's informed consent to the substitution of the reinsurer for Reliance in the coverage relationship, and that the reinsurer had not submitted documentary proof of its unequivocal assumption of Reliance's obligations to the insured.

20. SCPIE did not file objections to the denial of the request for novation.

20. The Objectors filed objections to the Liquidator's denial of novation.

21. The Objectors seek the direct payment of the proceeds of reinsurance, discovery of documents in addition to the reinsurance agreements between Reliance and AHIC, and a stay of proceedings until our Supreme Court renders a decision in *Koken v. Legion Insurance Co.*, 831 A.2d 1196 (Pa. Cmwlth. 2003).

The Court makes the additional findings of fact:

22. Neither AHIC nor its subsidiary SCPIE have been joined to this action.

23. Neither AHIC nor its subsidiary SCPIE have participated in this action.

DISCUSSION

Where an insurance company enters into a reinsurance agreement to reinsure certain of its business and that reinsurance agreement contains no cut-through clause of direct payment of reinsurance, the issue is whether the conduct of the parties can modify the reinsurance agreement or cause a novation of the written reinsurance agreement, so as to create a third-party beneficiary contract. In the matter *sub judice,* the Objectors seek to recover from the reinsurer on the theory that they are third-party beneficiaries under the reinsurance contract.

Understanding that reinsurance is a contract of indemnity and not liability, the focus is generally on the relationship between the primary insurer and the reinsurer. Those two parties are in contractual privity, and the terms of the contract cannot be ignored in determining the proper recipient of the proceeds. *See Fisher v. Excess Insurance Company of America,* 31 F. Supp. 651 (N.D. Iowa 1940), *aff'd,* 115 F.2d 755 (8th Cir. 1940). Thus, where the primary insurer, i.e., the ceding company, becomes insolvent and may merely pay its own insured a fraction of the claim or, worse yet, nothing, the reinsurer is liable to pay the amount it would have paid had the ceding company not become insolvent. *Id.* However, the common practice is for reinsurance contracts to contain an "ultimate net loss" clause that defines "ultimate net loss" as the amount actually paid by the

reinsured in the settlement of losses under its policies. *Id.* It has been held that there being no privity of contract between the reinsurer and the insured, the insured cannot maintain a direct action against a reinsurer of an insolvent insurer for costs of defense of a litigation that insurer was not contractually obligated to pay. *Eastern Engineering & Elevator Company v. American Re-Insurance Company,* 455 A.2d 1235 (Pa. Super. 1983). Neither can a state guaranty fund recover directly from a reinsurer of an insolvent ceding company. *Excess and Cas. Reinsurance Assocation v. Insurance Commissioner,* 656 F.2d 491 (9th Cir. 1981). Nevertheless, that principle may be modified where the reinsurance contract has language that allows for a direct payment to the insured or where a novation has occurred. Furthermore, because contractual privity is not limited solely to instances of a writing, and words and conduct can give rise to a contractual relationship, that principle may also be modified by the conduct of the parties. Issue resolution is not promoted by limiting review to the contract of reinsurance between the primary insurer (Reliance) and the reinsurer. Instead, a totality of the circumstances analysis is necessary with consideration given to the tripartite nature of the relationship. There must be a determination as to whether there is a pass-through relationship between the parties or whether the primary insurer barred access to the reinsurer, or, whether there was even knowledge of the reinsurer. Further, consideration must be given to all the contractual writings between all the parties, which includes the reinsurance contract, and any other writings that are common to the all the parties. This is of particular importance since documents pertaining to the same transaction will be read together as one contract. *Koken v. Legion Insurance Company,* 831 A.2d 1196 (Pa. Cmwlth. 2003), *citing, Huegel v.*

Mifflin Construction Company, Inc., 796 A.2d 350, 354-55 (Pa. Super. 2002); *International Milling Co. v. Hachmeister*, 110 A.2d 186, 190 (Pa. Super. 1955).

Herein, there is evidence of record that the reinsurer has requested to assume the direct liability of the original insured. There is also evidence that suggests that a familiar relationship existed between the three principals, *i.e.*, the insured (Objectors herein), the primary insurer (Reliance herein), and the reinsurers (AHIC and SCPIE). It is suggested that the insureds, herein Objectors, had little or no contact with Reliance and seemingly exclusive contact with the reinsurer. These facts suggest that the conduct of the parties has worked a novation of the reinsurance agreement. Where an insured successfully establishes that the conduct of the parties has caused a novation of a contract of reinsurance, and the insured elects to seek recovery not from the primary insurer but from the reinsurer, the insured effectively releases the primary insurer of any all liability that may have resulted under the primary insurance contract, and the insured then stands in the shoes of the primary insurer and elects to accept as its exclusive remedy recovery under the reinsurance agreement.

Therefore, this Court concludes that:

1. Objector Palm Springs General Hospital and Reinsurer AHIC through their regular course of interaction with one another caused a novation of the reinsurance agreement between Reliance and AHIC.

2. Objector Baptist Health South Florida Hospital and Reinsurer AHIC through their regular course of interaction with one another caused a novation of the reinsurance agreement between Reliance and AHIC.

3. Direct access to reinsurance proceeds is permissible where there is a contractual provision providing for a direct payment obligation.

4. Direct access to reinsurance proceeds is permissible where the conduct of the insured, the primary insurer, and the reinsurer works a novation of the reinsurance agreement between the primary insurer and the reinsurer.

5. When an insured seeks to circumvent the primary insurer and seeks direct access to reinsurance proceeds, the insured causes a release of any and all claims it may have against the primary insurer.

Considering that the Liquidator disallowed a novation of the reinsurance agreement on the premise that certain prerequisites were not met, and the Objectors have advanced the position that the reinsurer continues to seek a novation, whether the prerequisites can and will be met was not adequately presented before the Referee. This Court concludes that no further discovery is necessary to determine whether the Objectors are entitled to direct payment under the reinsurance agreements themselves. This Court further concludes that the conduct of the parties has been such as to have caused a novation of the agreement, thereby allowing direct access to the reinsurance policy.

Finally, this Court concludes that where the insured and the reinsurer have caused a novation of the reinsurance contract, such as is the case here, any liability the primary insurer may have or does owe to the insured is discharged, and any and all liability the primary insurer may have had under the insurance contract is assumed by the reinsurer. Thus, herein, Objectors may have direct access to the reinsurance proceeds since the insured through its course of conduct caused a novation of the reinsurance agreement between Reliance and AHIC. Further, any and all insurance obligations existing between Reliance and Objector Palm Springs

General Hospital and Reliance and Objector Baptist Health South Florida Hospital are assumed by the reinsurer, AHIC.

The Liquidator shall serve a copy of this order upon those listed on the master service list, and file an affidavit with the Court setting forth that service was made on or before March 31, 2004.

JAMES GARDNER COLINS, President Judge

D

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania, Plaintiff	:	
v.	:	
Reliance Insurance Company, Defendant	:	No. 269 M.D. 2001

In Re: Statutory Liquidator's motion for post-trial relief of the March 18, 2004 Amended Memorandum Opinion and Order

AND NOW this 1st day of April, 2004, this Court having considered the motion for post-trial relief of the March 18, 2004 amended memorandum opinion and order filed on behalf of M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania, in her capacity as Liquidator of Reliance Insurance Company, said motion is **DENIED.**

Further, the Liquidator is directed to serve this Order upon those listed on the master service list, and to submit an affidavit of service to the Court on or before April 6, 2004

JAMES GARDNER COLINS, President Judge

CERTIFICATE OF SERVICE

I hereby certify that two (2) copies of the foregoing Brief of *Amicus Curiae* National Association of Insurance Commissioners in Support of Appellant have been served on this date upon the individuals and in the manner indicated below, which service satisfies the requirements of Pa. R.A.P. 121:

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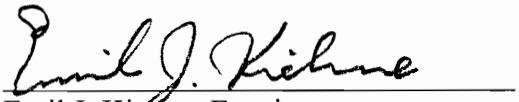

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