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Robert B. Flanders, Chairman
The New Hampshire Senate
Banks and Insurance Committee
107 North Main Street
Concord, New Hampshire 03301

RE: SENATE BILL 74

Dear Senator Flanders:

This firm represents Century Indemnity Company ("Century"), ACE Property and Casualty Insurance, Pacific Employers Insurance Company and ACE American Reinsurance Company (collectively, the "ACE Companies"). We respectfully submit this letter in connection with the Banks and Insurance Committee's consideration of Senate Bill 74 ("S.B. 74").

Section 5 of S.B. 74, if approved by the New Hampshire Legislature, would add the following language to RSA 402-C:44:

"This section shall not be construed to prohibit any payments, as administrative costs, made to claimants in lower priority classes where those payments assist or result in the collection or recovery of assets or property, including debts, moneys due or claims belonging to the insurer for the benefit of claimants in higher priority classes."

The ACE Companies believe that the adoption of Section 5 would be harmful to New Hampshire consumers, would establish a precedent that could detrimentally affect future liquidations in New Hampshire and elsewhere in the United States, and would interfere with the New Hampshire courts as they consider the issues that are raised by the proposed amendment. As discussed below, Section 5 would alter RSA 402-C:44 in a way that would disrupt the orderly payment of claims in liquidations and would likely raise the cost of insurance for New Hampshire residents. It would also cause other claimants to seek to recast their liquidation claims as administrative expenses, thereby increasing the amount of litigation over the classification of such claims and reducing the funds available to the estate. Furthermore, the amendment in Section 5 is contrary to the intent of the model act on which RSA 402-C:44 is based; the drafters of the model provisions recently resisted the same proposed change to the administrative expense section. The courts have similarly refused to allow deviations from the carefully crafted order of distribution in statutes like RSA 402-C:44, even where, as here, the claimants assert that their claims are administrative expenses. Finally, Section 5 would intrude upon the ongoing litigation between the ACE Companies and the Liquidator of The

Home Insurance Company ("Home"), who has argued that certain proposed payments to Home's claimants may be characterized as administrative expenses. The New Hampshire Supreme Court has considered this issue already and will likely be doing so again in the near future. Deleting Section 5 from S.B. 74 would allow the New Hampshire judicial system to continue its review of the administrative expense issue without interference.

For these reasons, the ACE Companies urge the Committee to reject Section 5.

Background

I. The Order of Distribution Statute

The relevant provisions in RSA 402-C:44 are attached to this letter as an Appendix. The statute sets forth the strict order in which claimants in an insurance liquidation will receive funds from the insurer's estate. (Claimants are grouped together in a "class" under the statute.) The preamble states that this "order of distribution of claims from the insurer's estate shall be as stated in this section." (emphasis added) The statute further provides that "every claim in each class shall be paid in full or adequate funds retained for the payment before the members of the next class receive any payment. No subclasses shall be established within any class." (emphasis added) Thus, the order of distribution in RSA 402-C:44 is mandatory and cannot be varied for any reason. The statute also expressly prohibits payments to some members of a class and not to others.

The relevant classes for the purposes of this discussions are Classes I, II and V. RSA 402-C:44 gives the highest priority ranking to "administrative costs" under Class I, which the statute describes as "[t]he costs and expenses of administration, including but not limited to the following: the actual and necessary costs of preserving or recovering the assets of the insurer; compensation for all services rendered in the liquidation; any necessary filing fees; the fees and mileage payable to witnesses; and reasonable attorney's fees." RSA 402-C:44, I. It is well established that payments for administrative costs relate to expenses that occur post-liquidation; such payments are made to those who are engaged after the insurer is placed in liquidation to assist in the operation of the insurer's estate. The purpose of this section is to make sure that the liquidation does not discourage professionals and others from providing services to the estate for fear that they will not be paid. It is not intended to benefit creditors of the estate who have claims that arose pre-liquidation.

Class II includes claims by the insurer's policyholders, which refers to the beneficiaries of a direct policy issued by the insurer. RSA 402-C:44, II. Class V is the "residual classification," and it includes, among other things, claims by insurance companies (known as "cedents") who purchased reinsurance from the insurer. RSA 402-C:44, V.

II. New Hampshire Court Proceedings Regarding Administrative Costs

In the current liquidation proceedings involving Home, the Liquidator has sought final Court approval for a scheme (the "Proposed Agreement") under which he would settle the claims of a subclass of Class V creditors (known as the "AFIA Cedents") by paying them 50% of the net proceeds (after certain deductions) that are recovered by the estate under reinsurance provided to Home.¹ The

¹ The AFIA Cedents are reinsured by Home, which is reinsured by Century. Valid payments to the AFIA Cedents under Home's reinsurance contracts would trigger Century's reinsurance obligations.

Liquidator has estimated that the amount of the proposed payments to the AFIA Cedents would be approximately \$72 million. In return, the AFIA Cedents agreed to file claims in the liquidation under their reinsurance contracts with Home. It is the Liquidator's position that, absent the incentive payments under the Proposed Agreement, the AFIA Cedents would not bother to file their reinsurance claims and the proceeds under Home's reinsurance would not come into the estate. The Liquidator has, among other things, tried to justify the proposed payment of tens of millions of dollars as "administrative costs" under Class I.

The ACE Companies and others opposed the Proposed Agreement, pointing out that it would violate the mandatory order of distribution set forth in RSA 402-C:44 because it would allow the Liquidator to (i) make claims payments to Class V creditors ahead of other creditors; and (ii) make those payments to a subclass of Class V creditors. The ACE Companies also demonstrated that such a scheme is unprecedented in the United States and would undermine similar statutory provisions in other states. Despite these objections, earlier this year the New Hampshire Superior Court held that the Proposed Agreement was permissible under the Liquidator's broad array of powers. The Superior Court did not expressly address the argument that the proposed payments to the AFIA Cedents could be classified as administrative expenses under Class I.

On appeal, the New Hampshire Supreme Court reversed the Superior Court and remanded the case for further proceedings. The Supreme Court voiced considerable doubt at oral argument that the proposed payments to the AFIA Cedents could be characterized as administrative expenses. The following exchange between the Court and counsel for the Liquidator occurred:

THE COURT:

Let me see if I understand. If this is not an administrative expense, but a payment of a claim to a Class 5 creditor, is that being paid before all of the claimants in Class 2, 3 or 4 are paid?

PETER ROTH:

That is correct.

THE COURT:

That violates the statute.

PETER ROTH:

We are sort of going around in circles, I understand. But it is an administrative expense because it is not in satisfaction of their Class 5 claim.

...

THE COURT:

Why is it an expense? It doesn't look or sound like an expense.

PETER ROTH:

Well, the statute was written very broadly and the statute — excuse me a minute. § 44(1) doesn't speak of how you can parse it out and say well, it's too big or it's to the wrong people. All it says is "including, but not limited to, the actual necessary [sic] costs of preserving or recovering the assets of an insurer" and the courts around the country that have interpreted administrative expenses have looked at that language in similar circumstances in bankruptcy contexts because it is very similar to what is the treatment in bankruptcy courts that finders fee, a percentage of the action, or a contingent fee for a lawyer also can be an administrative claim. Sometimes these claims can be very large — so the size and nature of the payee doesn't determine whether it is an administrative expense or not.

THE COURT:

Well, it looks to me like you are paying and distributing an asset to a claimant that doesn't look and sound like an expense of collecting assets.

(Hearing transcript at 14-15; bold added.)²

In an order issued on September 13, 2004, the Supreme Court required the Superior Court to consider on remand whether the payments would fall under Class I. The Supreme Court also ordered the Superior Court to make a full evidentiary record and to support its conclusions with factual findings. However, without allowing discovery on this issue or conducting an evidentiary hearing, the Superior Court ruled that the proposed payments to the AFIA Cedents could be classified as administrative expenses. The parties, at the urging of the Superior Court, requested that the Supreme Court review this ruling on an interlocutory appeal. The Supreme Court declined, which means that the administrative expense issue will be considered after the Superior Court issues a final order on the Liquidator's request for approval of the Proposed Agreement. The parties are currently involved in the discovery process, which will lead to an evidentiary hearing on the issues before the Superior Court. The ACE Companies plan to file an appeal to the Supreme Court if, after the hearing, the Superior Court leaves its ruling on the administrative expense issue intact.

Problems Created By The Proposed Amendment

As the foregoing discussion shows, the proposed amendment is clearly aimed at dictating a result that the Liquidator has thus far been unable to obtain in the New Hampshire court system. New Hampshire should not permit frustrated litigants — whose rights and obligations are being adjudicated in a pending court case — to turn to the Legislature for relief. As a matter of public policy, the Legislature should safeguard the operation and independence of the judicial system. Here, the Liquidator might argue that the proposed amendment has codified his interpretation of the statute, which, as noted above, the Supreme Court has questioned and will be considering again.

² Counsel for the Liquidator referred to finders' fees and contingent payments in a bankruptcy matter, but those examples only serve to prove the ACE Companies' point. Those types of payments are to creditors whose claims arise post-petition when they perform services for the debtor; the administrative expense provisions in the Bankruptcy Code do not apply to pre-petition claims.

In addition to violating public policy and interfering with the judicial process, the proposed amendment would have adverse ramifications for consumers in New Hampshire and for future insurance liquidations, both in New Hampshire and elsewhere.

First, by allowing liquidators to make payments to lower classes of creditors, the amendment would create an incentive for "side deals" with claimants. Some claimants would rush to enter into those arrangements to the detriment of others, creating inevitable litigation over the validity of the deals (because there would still be an argument that the payments do not constitute administrative expenses). This would increase the cost of liquidations in New Hampshire, which would result in less money for distribution to all creditors. The payment of incentives to Class V creditors to file claims would also increase the likelihood of invalid or even fraudulent claims. Indeed, in the Home liquidation, the ACE Companies have seen the submission of reinsurance claims that were previously rejected as invalid.

Second, the proposed amendment would wreak havoc on the orderly liquidation process that reinsurers expect when conducting business in New Hampshire. It is likely that this uncertainty would cause reinsurers to either withdraw from the New Hampshire market or increase the costs for New Hampshire insurers who purchase reinsurance from them. This in turn would increase the cost of insurance products for New Hampshire consumers.

Third, the proposed amendment would have a detrimental effect on liquidations in New Hampshire and elsewhere. The order of distribution in RSA 402-C:44 is based on a model provision that has been adopted in the majority of jurisdictions in the United States. The fixing of priorities in the model act is the result of many years of debate and careful consideration, and it reflects the judgment of the highly experienced professionals involved in insurance liquidations. Those professionals have rejected attempts to give claims under reinsurance contracts a higher ranking, and recently turned down an amendment to the model act provisions that is similar to Section 5.

The courts have also refused to vary the order of distribution, and, in one case directly on point, the court held that lower priority claims may not be reclassified as administrative expenses. See *Oxendine v. Commissioner of Ins. of N.C.*, 494 S.E.2d 545 (Ct. App. Ga. 1997). In *Oxendine*, creditors who had settled claims against the estate prior to the company's rehabilitation argued that the settlements should be considered administrative expenses under the Georgia code (which contains the same language as the current RSA 402-C:44). The *Oxendine* court stated that: "No reasonable definition of 'costs' or 'expenses' can include the claims which appellees assert. These claims are for money which appellees claim from [the] estate and not administrative costs or expenses incurred." *Id.* at 548. The *Oxendine* court also noted that the effect of allowing pre-liquidation claims to be classified as administrative expenses "would be to render meaningless the priority of claims established [by the Georgia statute]." *Id.* Here, too, allowing the Liquidator to transform the payments of the AFIA Cedents' claims into administrative expenses would rewrite the order of distribution and render RSA 402-C:44 meaningless. It would also encourage liquidators in other states that have adopted the model provisions to try to pursue similar schemes, to the detriment of the carefully constructed order of distribution.

* * * *

Accordingly, the ACE Companies respectfully request that the Committee delete Section 5 from S.B. 74. We thank the Committee for accepting this letter and would be happy to provide any further information to assist in its consideration of the proposed amendment.

Respectfully submitted,



Pieter Van Tol

cc: . George Roussos, Esq.

Appendix

402-C:44 Order of Distribution. – The order of distribution of claims from the insurer's estate shall be as stated in this section. The first \$50 of the amount allowed on each claim in the classes under paragraphs II, V, and VI except claims of the guaranty associations as defined in RSA 404-B, 404-D, and 408-B shall be deducted from the claim. Claims may not be cumulated by assignment to avoid application of the \$50 deductible provision. Subject to the \$50 deductible provision, every claim in each class shall be paid in full or adequate funds retained for the payment before the members of the next class receive any payment. No subclasses shall be established within any class.

I. **ADMINISTRATION COSTS.** The costs and expenses of administration, including but not limited to the following: the actual and necessary costs of preserving or recovering the assets of the insurer; compensation for all services rendered in the liquidation; any necessary filing fees; the fees and mileage payable to witnesses; and reasonable attorney's fees.

II. **POLICY RELATED CLAIMS.** All claims by policyholders, including claims for unearned premiums in excess of \$50, beneficiaries, and insureds arising from and within the coverage of and not in excess of the applicable limits of insurance policies and insurance contracts issued by the company, and liability claims against insureds which claims are within the coverage of and not in excess of the applicable limits of insurance policies and insurance contracts issued by the company and claims of the New Hampshire Insurance Guaranty Association, the New Hampshire Life and Health Insurance Guaranty Association and any similar organization in another state. All claims under life insurance and annuity policies, whether for death proceeds, annuity proceeds or investment values, shall be treated as loss claims. That portion of any loss for which indemnification is provided by other benefits or advantages recovered or recoverable by the claimant shall not be included in this class, other than benefits or advantages recovered or recoverable in discharge of familial obligations of support or by way of succession at death or as proceeds of life insurance, or as gratuities. No payment made by an employer to an employee shall be treated as a gratuity.

III. **CLAIMS OF THE FEDERAL GOVERNMENT.**

IV. **WAGES.**

(a) Debts due to employees for services performed, not to exceed \$1,000 to each employee which have been earned within one year before the filing of the petition for liquidation. Officers shall not be entitled to the benefit of this priority.

(b) Such priority shall be in lieu of any other similar priority authorized by law as to wages or compensation of employees.

V. **RESIDUAL CLASSIFICATION.** All other claims including claims of any state or local government, not falling within other classes under this section. Claims, including those of any non-federal governmental body, for a penalty or forfeiture, shall be allowed in this class only to the extent of the pecuniary loss sustained from the act, transaction or proceeding out of which the penalty or forfeiture arose with reasonable and actual costs occasioned thereby. The remainder of such claims shall be postponed to the class of claims under paragraph VIII.