IN THE MATTER OF THE LIQUIDATION OF INTEGRITY INSURANCE COMPANY	SUPERIOR COURT OF NEW JERSEY CHANCERY DIVISION-BERGEN COUNTY GENERAL EQUITY PART DOCKET NO. C-7022-86 Civil Action

POST-TRIAL MEMORANDUM OF REINSURANCE ASSOCIATION OF AMERICA

Joseph J. Schiavone
Jeffrey S. Leonard
Budd Larner, P.C.
150 John F. Kennedy Parkway, CN 1000
Short Hills, NJ 07078-0999
973.379.4800

Debra J. Hall
Reinsurance Association of America
1301 Pennsylvania Avenue, N.W.
Suite 900
Washington, D.C. 20004
202.638.3690

Attorneys for Respondent
Reinsurance Association of America

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PRELIMINARY STATEMENT

The Reinsurance Association of America ("RAA"), on behalf of its member companies,[1] submits this Post-Trial Memorandum in support of its request that this Court disapprove the Liquidator's Fourth Amended Final Dividend Plan ("Plan"), reconsider its November 15, 1996 order regarding IBNR and reconsider its December 3, 2002 ruling regarding arbitration. A number of the RAA's member companies have reinsurance agreements with the insolvent Integrity Insurance Company ("Integrity" or the "Estate") and those members are directly and substantially affected by the terms of the Liquidator's proposed Plan and the above referenced rulings.

This dispute involves far more than the approval of a final dividend plan for Integrity. It has far-reaching implications on the insurance industry, the on-going business of insurance and reinsurance and the way it is transacted among solvent entities both within and outside the United States, the way receiverships are conducted across the nation, and ultimately it has significant implications for the insurance-buying public in New Jersey and throughout the country.

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[1] The members of the RAA include the following reinsurance companies:

ACE Tempest Re USA, Inc.; American Re-Insurance Company; Arch Reinsurance Company; AXIS Reinsurance Company; Chubb Re, Inc.; CNA Re; Employers Reinsurance Corporation; Endurance Reinsurance Corp. Of America; Folksamerica Reinsurance Company; General Reinsurance Corporation; Partner Reinsurance Company of the U.S.; Platinum Underwriters Reinsurance; PXRE Reinsurance Company; QBE Reinsurance Corporation; SCOR Reinsurance Company, a member of the SCOR Group; Signet Star; Swiss Reinsurance America Corporation; XL Re America.

In addition, the RAA has life/health reinsurance companies as affiliates that might also be affected by this Court's interpretation of New Jersey law. Those affiliates include:

General Re Life Corporation; ING Reinsurance; Revios Life Reinsurance Company; RGA Reinsurance Company; Swiss Re Life & Health America; and Transamerica Occidental Life Insurance Company.

The transaction of commerce relies upon established laws and contracts to provide certainty to contracting parties in their dealings with each other. The insurance industry plays an integral role in the nation's economy and the financial health of New Jersey residents -- reinsurers play a significant role in providing the necessary insurance capacity to make that insurance available and affordable.[2] New Jersey has explicit laws that provide the basis for conducting the receiverships of insolvent companies. Consumers, insurers, reinsurers and other stakeholders in the process rely upon those laws. The Liquidator urges this Court to interpret New Jersey law in a manner that is inconsistent with other courts and inconsistent with the plain meaning of New Jersey statutes, eliminating the legal certainty upon which insurers and reinsurers rely in their ongoing business transactions in this State.

Additionally, Integrity, as a formerly solvent, regulated entity, entered into thousands of insurance contracts that defined the parameters of Integrity's liabilities to its policyholders and third parties. Likewise, Integrity entered into thousands of reinsurance contracts that set forth both the obligations it owed to its reinsurers and the obligations the reinsurers owed to Integrity. The Liquidator urges this Court to approve a Plan that would vitiate the explicit terms of those contracts in order to make reinsurers pay the Estate on a basis that is wholly inconsistent with their contracts. Attempts to re-write insurance and reinsurance contracts have been repeatedly opposed by the industry and must be defeated if trading partners are to have any confidence that third parties will respect and enforce the plain meaning of the terms to which they agree going forward.

[2] RAA Deposition Designations, Robert H. Zetterstrom, February 11, 1998, Page 101, Line 18 through Page 102, Line 9 (hereinafter "Zetterstrom").

Reinsurers, like other persons and entities, are guaranteed the protection of our laws through the New Jersey and United States Constitutions. The Liquidator's Plan would violate provisions of both in disregard of reinsurers' rights with respect to impairment of their contracts, violate both procedural and substantive due process and eliminate their right to plenary adjudication of disputes, including their right to a jury trial.[3]

The Federal Arbitration Act and New Jersey law preserve the contractual arbitration rights of all persons and entities in the face of past antagonism toward arbitration in this country.[4] The Liquidator seeks to disregard contractual arbitration rights of reinsurers preserved by such laws because the Liquidator views it as expedient to do so.

The Liquidator's Fourth Amended Final Dividend Plan represents an unprecedented approach to closing the estate of an insolvent insurance company. Although it is aimed at doing what the Liquidator perceives as fair and equitable to one group of affected stakeholders in the Integrity receivership – large corporate policyholders – it is at the expense of other stakeholders, including small and medium-size businesses, guaranty associations and reinsurers. Fairness and equity are not the exclusive province of a limited group of interested parties. The Liquidator's skewed

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[3] The United States and New Jersey Constitutions provide that state action shall not deprive any person of life, liberty, or property, without due process of law. U.S. Const. Amend. XIV, N.J. Const. art. I, para. 1. State action includes action by a governmental agency, and government employees are deemed to be acting for the government unless their actions are clearly outside their formal and *de facto* authority. *Grifin v. Maryland*, 378 U.S. 130 (1964).

[4] 9 U.S.C. §§ 1-16; N.J. Stat. § 2A:24-1 (2003) provides that "A provision in a written contract to settle by arbitration a controversy that may arise therefrom or a refusal to perform the whole or a part thereof or a written agreement to submit, pursuant to section 2A:24-2 of this title, any existing controversy to arbitration, whether the controversy arise out of contract or otherwise, shall be valid, enforceable and irrevocable, except upon such grounds as exist at law or in equity for the revocation of a contract."

perception of fairness and equity will not only deprive other affected stakeholders of the fairness and equity to which they are similarly entitled, it will result in injustices of a long-term nature as the effects of the Court's decision become precedent across the nation, forcing contracting parties to change the way in which they do business, making reinsurance less available and less affordable to New Jersey insurers, and in the end, affecting the New Jersey insurance-buying public as the increased costs of insurance are passed on to them. Additionally, the RAA asserts that should this Court accept the Liquidator's misinterpretation of statutory language, that same misinterpretation can and will be applied against the guaranty associations of New Jersey and other states, shifting additional guaranty association costs onto the nation's taxpayers, insurance-buying public and the insurance industry.

For these and other reasons, the RAA maintains that this Court should disapprove the Liquidator's proposed Plan and require the Liquidator to administer the Integrity Estate pursuant to the laws of New Jersey and consistent with the contracts to which Integrity is obligated. If the Liquidator believes that those laws fall short in terms of the options that should be available to this Estate or to other estates in the future, the RAA urges the Commissioner to take the necessary steps to change those laws by seeking the lawful authority of the New Jersey Legislature. Public policy issues of this magnitude must be carefully weighed and considered by the elected officials that are responsible for establishing New Jersey public policy. This Court is without jurisdiction to bring into this proceeding the various interests affected by those public policy choices and should interpret the law as it exists in New Jersey – not the law as the Liquidator would like it to be.

STATEMENT OF FACTS

An understanding of the parties and the business of reinsurance are essential to illuminate the Plan's flawed approach.

I. The Reinsurance Association of America

The RAA is a non-profit trade association incorporated in the District of Columbia, having its principal place of business in the District. The member companies who make up the RAA are principally engaged in the business of reinsuring property and casualty risks underwritten by primary insurance companies.[5] These members are either domestic U.S. companies or U.S. branches of foreign reinsurers. Together, RAA member companies write approximately two thirds of all reinsurance assumed by U.S. property and casualty reinsurers. The RAA's principal purpose is to promote the interests of the property-casualty reinsurance industry and its members before Congress and state legislatures, federal and state regulatory authorities, courts and the general public. Members of the RAA are reinsureds (or "cedents"), reinsurers and retrocessionaires of Integrity.

The RAA has a compelling interest in the outcome of these proceedings. Because reinsurance proceeds typically represent the greatest source of funds available to an insolvent insurer's estate, this Court's approval of the Liquidator's proposed Plan will expose RAA members to substantial unanticipated liability under their reinsurance contracts with Integrity. The RAA's unique role as representative of reinsurers' interests gives the RAA standing to oppose confirmation of the Plan. *See Crescent Park Tenants Ass'n. v. Real Equities Corp.*, 58 N.J., 98, 103-04, 275 A.2d 433, 435-36 (1971) (an

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[5] Sixteen (16) of the RAA's seventeen (17) member companies are licensed or authorized in New Jersey.

association has standing if it has "concern with the subject matter" of the dispute indicating a sufficient stake in the outcome of the controversy "as to assure that concrete adverseness which sharpens the presentation of issues").

II. The Business of Reinsurance

Reinsurance may be described as insurance of insurance. It is a transaction whereby the reinsurer, for a reinsurance premium (equal to some portion of the underlying primary insurance premium), agrees to indemnify the ceding insurer (the "cedent") against all or part of the cedent's liability under its primary insurance policies.[6]

The reinsurer's obligations under its reinsurance contract are derivative of those of the primary insurer. Thus, the reinsurer's obligation to make payment to the primary insurer ordinarily arises only when the primary insurer makes a payment to, or on behalf of, its insured. The primary insurer retains the principal responsibility to adjust and pay the loss in the first instance. *See e.g., American Re-Insurance Co. v. Insurance Comm'n*,

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[6] *See also Aetna Cas. & Sur. Co. v. International Re-Insurance Corp*., 117 N.J. Eq.190, 201-202, 175 A. 114, 121 (1934) (reinsurance is defined as a transaction "whereby [an] insurance company is indemnified against all or part of liability on an ordinary or usual contract of insurance written by it."); *In the Matter of Pritchard & Baird, Inc., 8 B.R. 265, 267-268, 270 (N.J. 1980) (citing Aetna Cas. & Sur., supra*); *see Unigard Sec. Ins. Co., Inc. v. North River Ins. Co*., 4 F.3d 1049, 1053 (2d Cir. 1993) (a contract of reinsurance is one by which an insurer procures a third person to insure him against loss or liability by reason of such original insurance). In reinsurance parlance, a reinsurer is said to "assume" a risk from a primary insurer that "cedes" or passes the risk to the reinsurer. National Association of Insurance Commissioners, *Accounting Practices and Procedures Manual for Fire and Casualty Companies* 22-1 (1990); *see also Unigard* 4 F.3d at 1053; *Colonial Am. Life Ins. Co. v. Commissioner of Internal Revenue*, 491 U.S. 244, 246-47 (1989).

This transfer of risk may occur in either of two ways – proportionally or non-proportionally, 1 Robert C. Reinarz, *et al*., *Reinsurance Practices 101* (1990). Under a proportional reinsurance agreement, the cedent and reinsurer share the premium, the losses and the expenses of adjusting losses in an agreed amount or proportion (e.g., 25%-75%). Under a non-proportional agreement, the reinsurer pays all loss above an agreed amount, called a "retention" and the loss adjustment expense is allocated accordingly. *Id*. At 141.

Reinsurance agreements may be further subdivided into types – facultative and treaty. *See generally* Mindy Pollack, *The Reinsurance Contract, in Reinsurance Contract Wording* 4-8 (Robert W. Strain ed. 1992). Facultative reinsurance generally is written on a risk-by-risk basis, while treaty reinsurance is written to cover an entire "book" or class of business (*e.g*., all automobile policies written on New Jersey automobiles within specific limits). 1 Reinarz, *supra*, at 16-17; *In the Matter of Pritchard & Baird, Inc*. 8 B.R. at 268 n.6; *Unigard*, 4 F.3d 1049, 1053 – 54.

527 F. Supp. 444, 453 (C.D. Cal. 1981); *Aetna Cas. & Sur. Co*., 117 N.J. Eq. at 201-203, 175 A. at 121.

Reinsurance serves important private and public interests. Some risks are too large for individual insurers to cover alone. For example, the liability arising out of the September 11, 2001, terrorist attack on the World Trade Center would quickly deplete an insurer's financial resources.[7] Insurance companies are able to neutralize or manage such liability by sharing that risk with, or "spreading" it among other insurers or reinsurers, like the RAA's member companies.

By permitting insurers to spread their risks in this manner, reinsurance facilitates the coverage of large, open-ended risks, such as unexpected, catastrophic losses from natural or environmental disasters; permits smaller insurers to compete with larger ones; and contributes to the solvency of insurers by stabilizing their operating and financial results. Bernard L. Webb *et al. I Insurance Operations* 1-3 (1st ed. 1992).[8] In so doing, reinsurance makes primary insurance more affordable and more widely available.

[7] It is estimated that U.S. and Non-U.S. reinsurers will ultimately bear approximately two thirds of the estimated $40 billion loss arising from September 11, 2001. Morgan Stanley, *Insurance – Property-Casualty*, November 28, 2001; Insurance Information Institute, *Terrorist Attacks of September 11, 2001: Impact and Implications for the Insurance Industry*, November 2001; Gordon Crutcher, Towers Perrin Reinsurance, *Impact of the September 11th Terrorist Attacks on the Insurance Industry – The Reinsurance Perspective*, Presentation of the Canadian Institute of Actuaries Annual Meeting, June 27, 2002.

[8] Insurance companies are required both to post reserves of cash or other assets to pay losses, and to record those reserves in the balance sheet portion of the financial statements they must file annually with state departments of insurance. Insurers also must maintain statutorily prescribed minimum amounts of capital and surplus (the equivalent of retained earnings), which are intended to protect policyholders. Unless the cedent posts additional assets to cover its reserves for new business, it must reduce its surplus to fund the new reserves. The amount of reserves that an insurer must maintain effectively is decreased via reinsurance because "financial statement credit" is given for reinsurance ceded to other insurers or reinsurers. In other words, reinsurance reduces the liability side of the cedent's balance sheet, and reduces the "drain" on the company's surplus capital caused by writing new business. *See, generally*, Robert A. Baker, *The Purpose of Reinsurance*, in Reinsurance 32, 37-39 (Robert W. Strain ed. 1980).

III. Reinsurance is an International Business

The effect of this Court's decision will have wide-ranging ramifications to the insurance and reinsurance industries, particularly, because of its great size and international scope. Non-U.S. reinsurers account for a large portion of the U.S. reinsurance market. In 2002, there were more than 2,200 companies from 96 non-U.S. jurisdictions that assumed U.S. reinsurance risks or owed reinsurance recoverables to U.S. insurers.[9] Reinsurers outside the United States account for approximately 46 percent of all reinsurance assumed from insurers in the United States.[10]

To better understand the vast size and complexity of the reinsurance market, consider that a treaty reinsurer will have an in-force treaty count ranging from several hundred to perhaps a few thousand contracts. The contract counts for a facultative reinsurer are substantially greater, reaching from 20,000 to more than 200,000 in-force agreements. Therefore, a reinsurer with just 100,000 contracts would be a small operation while a large reinsurer may have contracts that number in the seven digits.[11] Additionally, reinsurers often reinsure their risks with other reinsurers (retrocessionaires),[12] further spreading the risk of loss and further complicating the interrelationships in the industry. Reinsurers spread their risks both nationally and internationally, and the U.S market depends heavily on this international capacity. Where contracts commonly cross numerous national boundaries, consistency in the

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[9] RAA, *Alien Reinsurance in the U.S. Market 2002 Data* 3 (2003).

[10] *Id*. at 13.

[11] Ross Phifer, *Reinsurance Fundamentals* 193 (1996).

[12] *See supra* note 6.

interpretation of contractual liability reduces the expense and costliness of international recovery efforts by insurers.

It is in this factual context of a large, complex and global reinsurance network that this Court should consider the issues at bar. An adverse decision will have far-reaching effects outside the present litigation and beyond the borders of the United States.

IV. Categories of Insurance "Loss"

In order for the Court to appreciate the deficiencies of the Plan, it is important to understand that insurance "losses" can be categorized into three types:

1. A "paid loss" is one where, in the case of liability insurance coverage, liability has been established against the policyholder, damages have been determined, and the insurer has paid the loss. For example, if a policyholder is found liable in a lawsuit and the insurer has satisfied the judgment, the insurer has incurred a "paid loss." With paid losses, the claim against the insurer is no longer contingent. In the normal course of business, the insurer will seek indemnification from its reinsurers for amounts paid. For "paid losses," there is an identifiable claimant, a specific set of facts associated with the loss, and a fixed sum in compensation for the loss.
2. Losses that "have occurred that are known to an insurer but have not yet been settled" are "outstanding losses." *Rupp's Insurance and Risk Management Glossary*, at 322 (2nd ed. 1996). Thus, for outstanding losses, the insurer's liability and the amount of the liability are contingent on settlement of the claim. For example, if a policyholder is sued and the lawsuit has yet to go to judgment, the policyholder will notify its insurer of the underlying action and,

in this way, make a "claim" under its insurance policy. With outstanding losses, liability has not been established and damages are not determined, however, as with paid losses, there are identifiable claimants and specific sets of facts associated with the losses. In the normal course of business, both the insurer and the reinsurer establish reserves based on the anticipated outcome of the matter. These reserves are often referred to as "case reserves."

3. Incurred-but-not-reported ("IBNR") refers to an estimate of "losses occurring over a specified period that have not been reported to the insurers." *Rupp's,* at 231. For example, liability insurers that were doing business in the U.S. in the 1970s and 1980s know—based on past loss history—that they will likely face exposure from asbestos claims. "Losses" have "occurred" to the extent that individuals have inhaled asbestos fibers; however, these individuals have yet to make claims for damages against producers of asbestos-containing products and, in turn, the producers/policyholders have not made a "claim" under their insurance policies. Significantly, from the standpoint of an insurer (as well as reinsurers), there is no identifiable policyholder, claimant, or specific set of facts associated with IBNR. The concept of IBNR is most often associated with an insurer's financial statements. Insurers and reinsurers post IBNR reserves in order to make a conservative provision against possible future losses. These reserves are neither based on actual claims made under specific policies nor are they tied to specific policyholder activity, but rather are "bulk" reserves on the insurer's or reinsurer's entire business, based on

estimates of actuaries. [13] More importantly, IBNR reserves are frequently adjusted, again based on actuarial projections, as to an appropriate level of conservatism for financial statement use.

ARGUMENT

I. There Exists No Statutory Authority or Contractual Basis to Allow Claims on the Basis of Estimated IBNR

This proceeding presents a legal issue of first impression under New Jersey law that is of immense importance to Integrity, its reinsurers, policyholders and creditors: the legal authority of the Commissioner of Banking and Insurance ("Commissioner" or "Liquidator") under New Jersey's Insurer Liquidation Act ("Act"), N.J.S.A. §§ 17:30C, *et seq.,* to allow claims and bill reinsurers based on projected or theoretical losses that have not been reported and may never have occurred at all. [14]

Section 17:30C-28a of the Act expressly prohibits the liquidator of an insolvent insurer from approving a contingent claim unless the claim "becomes absolute." This prohibition is evidenced by the statute's plain language, by judicial decisions relying on the plain language of similar statutes in other states that prohibit approval of claims based on IBNR, and by virtually identical New York statutes which prohibit approval of unliquidated, undetermined claims.

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[13] Actuaries project the number, size and timing of claims and, often, their net present value based on projected rates of return on investments.

[14] Joint Trial Exhibit (hereinafter "JTE") 40, Stipulation of Facts, Stipulation #23. The parties have stipulated that the Liquidator estimates that as of Dec 31, 2002, Integrity's total liabilities are over $2 billion and the total amount of reinsurance in respect of contingent claims and IBNR to be collected in the future is approximately $428 million.

Although this Court has defined the issue in this matter as including the legal authority to estimate and value case reserves, *see In the Matter of the Liquidation of Integrity Ins. Co.*, 299 N.J. Super. 677 at 679, 680; 691 A. 2d 898 at 899, 900 (1996), this Memorandum is focused primarily on the ability to estimate and bill reinsurers for IBNR. See section I.F. of this Memorandum for a discussion of the RAA's objections with respect to case reserves.

Although the mandate of § 17:30C-28a may result in some unreported claims not qualifying for eventual participation in an insolvent estate's assets, the statutory prohibition reflects the Legislature's judgment that an insolvent insurer's assets should be allocated to claims as to which liability has been proven and the amount of damages definitely established.

Despite the statute's clear prohibition against approval of contingent claims and its mandate that claims be made absolute, the Liquidator has proposed a plan that purports to give her the authority to approve payment for estimates of IBNR attributable to theoretical "claims," to the detriment of policyholders and claimants with actual claims covered by Integrity policies and reinsurers who will be billed for a portion of these speculative losses.

A. This Court May Reconsider its Order of November 15, 1996 Based on the New Factual Record

In 1996, the Liquidator proposed that this Court bifurcate these proceedings into two phases, the first of which would determine the statutory authority to approve IBNR estimates and contingent claims, and the second of which would address the remaining issues relative to approval of the Plan. This Court agreed with the Liquidator and, on September 19, 1996, held a limited hearing on the Liquidator's statutory authority to approve IBNR estimates and contingent claims. Although the Court expressly observed that the plain language of Section 17:30C-28a prohibits approval of contingent claims unless they become absolute, it concluded in its November 15, 1996 Order ("Interim Order") that the Liquidator may do so. Pursuant to that Interim Order, the Court paved the way for the determination of the remaining issues relevant to the approval of the Plan, including issues of feasibility, fairness and equity.[15] A hearing on those matters was held before the Court on November 18, 19 and 20, 2003.

This Court's Interim Order was rendered without the benefit of the factual context that was subsequently provided at the hearing on this matter. Pursuant to established New Jersey case law, while this Court retains jurisdiction over this matter, its Interim Order may be amended.[16]

This Court has clearly retained jurisdiction over this matter, and thus possesses the discretion to amend the Interim Order. The development of the factual context at the November hearing presents exactly the situation contemplated by New Jersey courts in allowing judicial discretion to review and amend prior decisions. Further, even considering the "law of the case" doctrine, which prevents the re-litigation of issues already decided, the application of that doctrine is discretionary and allows for the reconsideration of prior decisions on legal issues when there is substantially different evidence at a subsequent trial, new controlling authority, or the prior decision was clearly erroneous. *Baker v. Nat'l State Bank*, 353 N.J. Super. 145 (N.J. Super. Ct. 2002). In fact, the concept has been described as merely a non-binding decisional guide addressed to the good sense of the court in the form of a cautionary admonition against re-litigation when the occasion demands it. *State v. Powell*, 176 N.J. Super. 190; 422 A.2d 777 (N.J. Super. Ct. 1980). As evidenced by the November hearing, the matter at bar has the benefit of

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[15] Memorandum of Munich Reinsurance Company In Support of Motion For Summary Judgment Dismissing the Final Dividend Plan on the Ground That it Lacks an Essential Element of the Liquidator's Proof—The Actuarial Plan, August 30, 2001 (hereinafter "Munich"), 34, citing Ex. DD.

[16] Even in the instance where an issue has been heard and ruled on, a court is not conclusively bound by a prior ruling. *State v. Reldan*, 100 N.J. 187; 495 A.2d 76 (1985).

substantially different evidence and, as will be shown, the prior decision was clearly erroneous. For these reasons the Court should reconsider its Interim Order.

B. IBNR Does Not Constitute a Claim Under New Jersey Law

Section 17:30C-20 of the Act sets forth the requirements of a proof of claim. By its terms it requires that a specific claim be reported:

> All claims against an insurer against which delinquency proceedings have been begun shall set forth in reasonable detail the amount of the claim, or the basis upon which such amount can be ascertained, the facts upon which the claim is based, and the priorities asserted, if any. All such claims shall be verified by the affidavit of the claimant, or someone authorized to act on his behalf and having knowledge of the facts, and shall be supported by such documents as may be material thereto.

IBNR cannot constitute a "claim" within the meaning of § 17:30C-20 because IBNR, by definition, is an unreported event, the facts and the detail of which are not yet known. Moreover, supporting documentation based upon so-called "actuarially sound techniques" cannot be based on specific facts because actuarial estimates are, by their very nature, based on statistical assumptions – not "facts upon which the claim is based." [17] Neither can a claimant with "knowledge of the facts" execute the proof of claim or submit an affidavit verifying the facts because there is no claimant in possession of any known facts. Until the event is known and reported to Integrity, it cannot constitute a "claim" under New Jersey statutory law. Indeed, the Liquidator does not dispute the fact

[17] JTE 53 at 4, The Effects of Uncertainty in Actuarial Methods Used In Property & Casualty Insurance Insolvencies, Tillinghast-Towers Perrin (hereinafter "Tillinghast-Towers Perrin Report"). Trial Transcript, November 19, 2003, Direct Testimony of Christopher Diamantoukos (hereinafter "Diamantoukos Direct"), Page 96, Lines 13 through 24, noting that in the last 10 years the dissemination of knowledge, methodologies, benchmarks and metrics have enabled actuaries to establish a "ballpark estimate" of liability for asbestos and pollution enabling more in-depth analyses; *Id*. at Page 105, Line 17 through Page 107, Line 6, discussing the estimates that actuaries perform of a total book of exposure and the subsequent estimates for size of loss distribution and assignment to individual reinsurance contracts on the basis of estimates; JTE 38,describing the simulation models used by actuaries to estimate exposure.

that claims heretofore recognized and allowed in the Integrity estate have been for known events.[18] Other courts around the country interpreting similar statutory language have recognized that IBNR is not a "claim."[19]

Moreover, it is axiomatic that a claim filed for compensation pursuant to an insurance policy must, in fact, constitute a covered claim under such policy. New Jersey law preserves this requirement in the context of a receivership proceeding. Section 17:30C-26 of the Act sets forth the order of priority for the distribution of estate assets. Fourth on the list – behind the payment of administrative expenses, compensation of employees of the estate, and taxes – is the payment of claims by policyholders and third-party claimants. For a claim to be categorized as a "Priority 4" Claim, pursuant to § 17:30C-26(c)(4), claims by policyholders and third-party claimants must be "within" the coverage of the policies issued by the insolvent insurer:

> Claims by policyholders, beneficiaries and insurers **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 insurers 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 …(emphasis added)

[18] Trial Transcript, November 18, 2003, Direct Testimony of Richard L. White (hereinafter "White Direct"), Page 17, Lines 5 through 8, noting that in a "typical claim" the insured would know what his/its claim is, they have an event that is clear. JTE 40, Stipulation of Facts, Stipulation #21, throughout the Integrity liquidation the Liquidator has billed reinsurers for allowed non-contingent claims.

[19] *In Matter of Ideal Mutual Ins. Co.; Midwest Steel Erection Co., Inc. v. Illinois Ins. Guar. Fund*, 578 N.E. 2d 1235 (Ill. App. 1991), the court interpreted § 209(1) of the Illinois Insurance Code to require that a specific claim be identified, rejecting the concept of policyholder protection claims. Other cases have reached the same conclusion and rejected policyholder protection or IBNR "claims." *See, e.g., Union Gesellschaft Fur Metal Industries Co. v. Illinois Ins. Guar. Fund*, 546 N.E. 2d 1076 (Ill. App. 1989); *Kent County Mental Health Center,Inc. v. Cavanaugh*, 659 A.2d 120(R.I. 1995); *Monical Machinery Co. v. Michigan Prop. & Cas. Guar. Assn.*, 473 N. W.2d 808 (Mich. App. 1991).

Events that do not meet this statutory definition are not eligible as fourth priority claims and are not, therefore, entitled to share in the assets of the estate as a policyholder or third party claimant. Unlike paid losses and outstanding losses, with IBNR, "the [insurance] company has not received notices or reports of losses." *See Maryland Savings-Share Ins. Corp. v. United States*, 644 F.2d 16, (Ct. Cl. 1981)(citation omitted). Clearly, under any insurance policy, notice of a claim is a pre-requisite to coverage. Likewise, in order to obtain coverage under any liability policy, the policyholder must be able to identify the specific claimant, the specific type of loss, and the specific facts associated with the loss. Because these essential elements of notice are, by definition, absent with respect to IBNR, claims for IBNR cannot be recovered from an insurance policy. *See, e.g. Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1097 (Pa. 1992) *cert. denied*, 113 S. Ct. 1047 (1993) (holding that because "[c]ase reserves and IBNR are at most calculations or estimates of future potential liabilities, which often times are contingent upon a later development or growth of the claim…[t]heir speculative and intangible nature…[d]o not warrant their being available for setoff against more due and owing or mature obligations.")

IBNR by definition is unreported and theoretical. It is impossible to determine whether there is an event that has occurred that is "within the coverage of" the insurance policy. As noted in the following section of this Memorandum, IBNR does not constitute a claim that is covered under any insurance policy or reinsurance contract to which Integrity was a party.

C. IBNR Does Not Constitute a Claim Under an Integrity Insurance Policy or its Reinsurance Contracts

It is a fundamental tenet of insurance law that for a policyholder or third party to recover under an insurance policy there must be an event that produced a loss that was covered under an insurance contract.[20] The Plan would, if approved, violate contractual rights and obligations under Integrity's reinsurance contracts by ignoring the coverage provisions of those agreements. English law is like the prevailing law in the U.S: a receiver steps into the shoes of the insolvent insurer, taking both the benefits and the burdens of the contracts to which it entered into.[21] As Mr. Crystal stated in his report:

> It is fundamental to an English liquidation that a liquidator takes the assets of the company in liquidation as he finds them. This rule applies to contracts with the company as it does to all other forms of property. In asserting rights in the name of the company, the liquidator stands in no better position than the company itself. There is no principle of English law whereby either a liquidator or a Court can seek to alter or affect the rights of debtors to the company. Whilst the rights of creditors are affected by the liquidation, the rights of debtors to the company remain the same, save where any particular contract with any particular debtor itself makes express provision for alteration of those rights upon liquidation.[22]

Under the New Jersey Liquidation Act, similar laws enacted throughout the United States and the general law of receiverships, the Liquidator may not assume Integrity's contractual rights under insurance policies and reinsurance contracts without

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[20] Lee R. Russ & Thomas F. Segalla, *Couch on Insurance 3d* §1:10 (1997).

[21] *Grode v. Mutual Fire, Marine & Inland Ins. Co*., 8 F.3d 953 (3d Cir. 1993); *Bennett v. Liberty Nat'l Fire. Ins. Co*., 968 F.2d 969, 972 n.4 (9th Cir. 1992); *Todd v. Deposit Guar. Nat'l Bank*, 849 F. Supp. 1149 (S.D. Miss. 1994).

[22] JTE 104, Crystal Report, page 16 paragraph 42.

also accepting the burdens.[23] Notwithstanding this well-established doctrine, the provisions of the Plan would vitiate key coverage provisions of the reinsurance contracts as noted below.[24]

i. The Liability of A Reinsurer is Based on Integrity's Liability as Set Forth in its Insurance Policies

A representative collection of Integrity reinsurance contracts was introduced as Joint Trial Exhibit 22. Those contract terms make it clear that the liability of the reinsurer is based upon the liability of Integrity's underlying policies. The first contract in that exhibit states in the prefatory language:

> The Company [Integrity] obligates itself to cede to the Reinsurers, and the Reinsurers obligate themselves to accept from the Company, a 95% share of the **Company's liability under [various Integrity policies]** subject to a total limit of liability of $1,000,000 (100%) Each and Every Loss Occurrence, and in the aggregate where, applicable, any one original Policy, and subject to the terms and conditions of this Agreement. (emphasis added)[25]

Article I of the representative reinsurance agreement provides:

> This Agreement shall become effective at 12:01 a.m., Standard Time, July 1, 1978, and shall remain in full force and effect until terminated in accordance with the provisions of ARTICLE XVIII-TERMINATION. Standard Time is understood to mean Local Standard Time **at the place where the loss occurs**. (emphasis added)[26]

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[23] *Grode v. Mutual Fire, Marine & Inland Ins. Co.*, 8 F.3d 953 (3d Cir. 1993); *Bennett v. Liberty Nat'l Fire. Ins. Co.*, 968 F.2d 969, 972 n.4 (9th Cir. 1992); *Todd v. Deposit Guar. Nat'l Bank*, 849 F. Supp. 1149 (S.D. Miss. 1994).

[24] The Plan would also violate the coverage provisions of Integrity primary insurance policies. The Deputy Liquidator concedes this. RAA Deposition Designations, Richard L. White, September 24, 1997 (hereinafter "White Dep. September 24, 1997"), Page 445, Lines 19 through 25. Because reinsurance is, in large part, derivative of the underlying policy, the RAA's arguments are equally applicable to the violation of the underlying insurance policies.

[25] JTE 22, Bates Stamp #14423.

[26] JTE 22, Bates Stamp #14423.

Similarly, Article II of the representative reinsurance agreement provides:

> This Agreement shall apply to losses arising out of Policies issued or renewed during the term of this Agreement in the United States of America, its territories and possessions, and Canada **as covered by the original Policies**. (emphasis added)[27]

Consistent with the foregoing examples, Article III, section B of the representative reinsurance agreement defines the term "Each and Every Occurrence" as:

> …any accident or loss or series of accidents and/or losses arising out of or caused by one event occurring during the period of this Agreement, **and as covered under the original policies of the** Company, in respect of business the subject of this Agreement.[28]

Additionally, Integrity's reinsurance contracts define what constitutes a "loss" within the meaning of the reinsurance agreement. The "Loss Settlements" clause states

> A. The term "Losses" as used in this Agreement shall mean the amount for which [Integrity] becomes liable to pay, …
>
> …
>
> C. All loss settlements by the Company shall be binding upon the Reinsurers provided that such settlements are within the terms and conditions of the original Policy(ies) and within the terms and conditions of this Agreement.[29]

[27] JTE 22, Bates Stamp #14424.

[28] JTE 22, Bates Stamp #14424.

[29] Bates Stamp #s 14426 and 14427. Section A. also requires that "[a]ll salvages, recoveries or payments recovered or received subsequent to loss settlement hereunder shall be applied as if recovered or received prior to the aforesaid settlement and all necessary adjustments shall be made by the parties hereto." The reinsurer is thereby entitled to receive such recoveries. Salvage and other recoveries from collateral sources represent an overpayment to the policyholder by the insurer and similarly an overpayment by the reinsurer to the insurer. But no recoveries can be made or credited to the Integrity Estate or to its reinsurers for such overpayments if there is no specific claim identified.

In order for a claim to constitute a liability within the terms of a reinsurance contract the claim must constitute a liability under the insurance policy.[30] Under the Loss Settlements clauses of the reinsurance contracts, Integrity must pay a loss before the reinsurer is required to indemnify Integrity. By proposing to require payment from reinsurers for IBNR on the basis of theoretical estimates rather than for known losses that claimants have actually sustained, the Plan violates the Loss Settlements clause and the other aforementioned provisions of Integrity's reinsurance contracts.

The kinds of events that constitute a loss, for which indemnity is owed under the Loss Settlements clause of Integrity's reinsurance contracts, are determined by the terms of Integrity's excess insurance policies. By allowing claims on a basis other than for losses the claimant has sustained, the Plan would inflate and accelerate the reinsurers' liability to Integrity by calling upon them to indemnify Integrity for theoretical "losses" that do not constitute losses under Integrity's policies and that may never be reported.

The amount of indemnity that reinsurers must pay to Integrity is also determined by provisions in Integrity's insurance policies providing for specific coverage determinations, per claim limits, aggregate limits, exclusions[31] and attachment points of coverage. In proposing to allow "claims" on a basis other than for losses claimants have actually sustained, the Plan would violate these provisions to the detriment of Integrity's reinsurers, whose obligations are defined by such provisions, and to the detriment of policyholders without IBNR "claims," whose actual claims would be diluted by theoretical IBNR that New Jersey statutes require the Estate to ignore.

[30] RAA Deposition Designations, Robert F. Craig, September 11, 2003 (hereinafter "Craig"), Page 210, Line 10 through Page 213, Line 20.

[31] JTE 68 at 2, Letter from Cameron General Corp. noting that they have never been advised that Integrity has, in fact, enforced their pollution exclusion which was contained in Integrity's umbrella contracts.

Even if the Liquidator was authorized by New Jersey statutes to allow such "claims," the allocation of theoretical IBNR cannot be attributed to a specific policyholder, insurance policy or reinsurance contract and any such attempted allocation by the Liquidator on the basis of speculation would alter and may inflate reinsurers' liability. As one actuarial firm noted:

> As noted above uncertainty generally increases as the calculation moves away from the aggregate towards the specific. Assuming that the aggregate amount of liabilities could be estimated with a tolerable level of uncertainty, the allocation of this amount to reinsurance layers may be highly problematic. Proportional treaties would tend to have a similar level of uncertainty to the aggregate. This level of uncertainty would increase with excess of loss treaties, and tend to be greater for higher layers than for lower layers. If facultative covers were used, the uncertainty related to these covers would depend on the concentration of certificates amongst reinsurers. A small number of reinsurers writing a large number of facultative certificates would have the same uncertainty characteristics as treaty reinsurance for a comparable layer. Reinsurers writing only a small number of certificates are in a comparable position to a single case reserve – it would be unusual to be able to estimate the ultimate value with a high degree of certainty.[32]

The Liquidator's attempted allocation of IBNR to individual insurance policies and reinsurance contracts would violate reinsurers' contractual rights and force them to pay for losses that they never underwrote.[33]

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[32] JTE 53 at 7 (Tillinghast-Towers Perrin Report).

[33] Diamantoukos Direct at 103, Lines 16 through 19 (testifying that the likelihood that actuarial estimates of non-extraordinary hazard losses are going to be "exactly accurate" is "zero"); White Dep. September 24, 1997 at 523, Line 4 through Page 525, Line 7 (acknowledging that the Plan does not require the "traditional indicia" to justify entitlement to a "claim" and that reinsurers are thereby required to pay for amounts to which they are not obligated pursuant to their contracts).

ii. No Payment is Required Under Integrity's Insurance Policies in the Absence of a Specific, Identifiable, Known Loss Event

While it is beyond debate that the reinsurance agreements entered into by Integrity premised liability upon the occurrence of covered claims under Integrity's policies of insurance, it is also acknowledged by the Liquidator that those Integrity insurance policies required the occurrence of a specific, identifiable, known event. The Deputy Receiver has repeatedly conceded this fact in both deposition and hearing testimony. For example:

- The Deputy Receiver testified that the reference to "loss occurrence" in the prefatory language in the representative reinsurance agreement quoted in the foregoing section of this Memorandum contemplates a specific event.[34]

- The Deputy Receiver agreed Article I of the representative reinsurance agreement quoted in the foregoing section of this Memorandum also contemplates a specific loss event as it defines the effective period of the contract with reference to Local Standard Time at the place where the loss occurs.[35]

- The Deputy Receiver agreed that Article II of the representative reinsurance agreement quoted in the foregoing section of this Memorandum contemplates that a specific event occur in the referenced geographical locations under the original Integrity policy.[36]

- The Deputy Receiver agreed that Article III of the representative reinsurance agreement quoted in the foregoing section of this Memorandum contemplates the occurrence of a specific loss event when it defines in subsection B the meaning of "Each and Every Loss Occurrence".[37]

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[34] Trial Transcript, November 18, 2003, Cross Examination of Richard L. White (hereinafter "White Cross November 18, 2003"), Page 116, Line 7 through Page 117, Line 9.

[35] White Cross November 18, 2003 at 117, Lines 16 through 24.

[36] White Cross November 18, 2003 at 117, Line 15 through Page 118, Line 20.

[37] White Cross November 18, 2003 at 118, Line 21 through Page 119, Line 3.

- The Deputy Receiver testified in both his deposition and at trial that Integrity policies required the occurrence of a specific loss event:

Q. Are you aware of any insurance policies of Integrity that didn't require a specific loss event before payment by Integrity absent insolvency?
A. I am not.[38]

…

Q. Absent the operation of the Final Dividend Plan, would you agree that a policyholder could not obtain recovery under a typical insurance policy issued by Integrity without being able to identify the specific loss event involved and to quantify the amount of that loss?
A. Yes.[39]

Moreover, the reinsurers' expert witness confirmed that he has **never** seen an insurance policy that compensated claimants on the basis of anything other than a known event. Robert Craig, an experienced bankruptcy practitioner and US insurance receiver[40] testified at deposition that IBNR is not covered under an insurance policy:

A. I have never seen an underlying policy that allows claims against an insurance company for something that has never happened and can't be quantified.
Q. How about something that has happened but has just not been reported? Do policies cover that stuff?
A. Same thing as far as there has to be a claim before it will be allowed. It may - - the policy may have coverage for every certain set of facts but until that certain set of facts comes to be, whether there's an actual claim, the answer is no. There isn't an actual claim.[41]

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[38] White Cross November 18, 2003 at 118, Lines 17 through 20. *See also Id*. at Page 119, Lines 8 through 13.

[39] White Dep. September 24, 1997 at 445, Lines 19 through 25. *See also Id*. at 443, Lines 19 through 25.

[40] JTE 103, Resume of Robert F. Craig.

[41] Craig at 213 Line 23 through Page 214, Line 10.

…

Q. Why, then, in that case if the Liquidator allows GAF's IBNR claim for product liabilities based on an actuarial estimation, why isn't that now a liability of the company, which the reinsurer must pay its share of under the insolvency clause?

A. Let me back up and say I'm not sure what you mean by "general provisions of a product liability policy." I've seen lots of different policies. I don't recall ever seeing a policy, perhaps you can give me one, that allows an insured an enforceable claim under an insurance policy for an event that has not happened.

Q. No. And my hypothetical is that the IBNR losses have happened. They just haven't been reported yet.

A. I'd say the same thing. I don't recall ever seeing a policy that would provide an enforceable claim, by which I mean to the extent it could be taken to judgment against the live insurance company, for an event that might or might not have happened but for which there is no evidence of the occurrence and no quantification of the liability.[42]

Given this overwhelming and uncontroverted evidence, on what basis then does the Liquidator ask this Court to disregard the explicit and acknowledged requirements that in order for a reinsurer to be liable for a claim, that claim must be within the coverage of the underlying insurance policy and must be a specific, known event? The basis is her erroneous theory that the Insolvency Clause of those same reinsurance contracts trumps all other clauses and transforms the reinsurance contract into a contract of liability – and not just "liability" as defined in all of the above referenced contract clauses – but a wholly different definition of "liability."[43] There is no support in the insurance and reinsurance contracts for this theory.

[42] Craig at 220 Line 17 through Page 221, Line 15.

[43] While IBNR is listed as a "liability" on an insurer's financial statements, an insurer is not actually liable to any claimant or policyholder for the projected IBNR "losses." IBNR is merely included as a liability in financial statements in order to assess the insurer's liquidity.

D. Receivership Does Not Transform a Contract of Indemnity Into a Contract of Liability

The Liquidator argues that all of the aforementioned contract terms are no longer relevant once a company is placed into liquidation. Indeed, the only relevant term in the reinsurance contract at that point, according to her theory, is the Insolvency Clause.

i. Alleged Transformation of the Reinsurance Contract

Although the Liquidator contends that the fact of receivership somehow transforms a reinsurance contract from a contract of indemnity into a contract of liability,[44] nothing in Integrity's reinsurance contracts or the law of New Jersey supports that view. Indeed, New Jersey law requires that a compensable policyholder or third party insurance claim be one that is covered under the insurance policies issued by the insolvent insurer;[45] Integrity policies require that compensation be based on actual sustained loss occurrences;[46] Integrity reinsurance contracts require that the reinsurers' liability be based on "losses" under the underlying insurance policy;[47] and New Jersey statute requires that any such claim be made absolute before it can be allowed and participate in the distribution of estate assets.[48]

The Liquidator claims that the "insolvency clause" contained in Integrity's reinsurance contracts transforms the nature of the contract to one of liability, presumably

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[44] White Dep. September 24, 1997 at 512, Lines 19 through 25, Page 513, Lines 1 through 23; White Direct at 52, Lines 19 through 25, Page 53, Lines 1 through 4.

[45] § 17:30C-26(c)(4).

[46] White Dep. September 24, 1997 at 443, Lines 19 through 25, 445, Lines 19 through 25.

[47] JTE 22, Bates Stamp #s 14423, 14424, 14426 and 14427.

[48] § 17:30C-28a.

because the insolvency clause refers to payment "on the basis of the liability" of the insolvent insurer. The reinsurance treaties and facultative certificates that Integrity entered into generally contain an Insolvency Clause that provides

> In the event of insolvency of the (Integrity), this reinsurance shall be payable directly to the Company, or to its liquidator, receiver, conservator, or its statutory receiver **on the basis of the liability** of the Company without diminution because of the insolvency of the Company or because the liquidator, receiver, conservator or statutory successor of the Company has failed to pay all or a portion of any claim. It is agreed, however, that the liquidator, receiver, conservator or statutory [successor] of the Company shall give written notice to the Reinsurer of the pendency of a claim against the Company indicating the policy or bond reinsured which claim would involve a potential liability on the part of the Reinsurer within a reasonable time after such claim is filed in the conservation or liquidation proceeding or in the receivership, and that during the pendency of such claim, the Reinsurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated, any defense or defenses that it may deem available to the Company or its liquidator, receiver, conservator, or statutory [successor].(emphasis added)[49]

The advent of the insolvency clause is well-known and established in receivership law as the regulatory response to the decision of the U.S. Supreme Court in *Fidelity & Deposit Co. of Maryland v. Pink, Superintendent of Insurance of State of New York,* 302 U.S. 224, 58 S. Ct. 162 (1937).[50] Superintendent Pink, as receiver of Southern Surety Company, had brought an action against a reinsurer, Fidelity & Deposit Co. of Maryland,

[49] JTE 40, Stipulation of Facts, Stipulation #20.

[50] JTE 103, Expert Report of Robert F. Craig (hereinafter "Craig Expert Report"), Page 10. Regulators quickly responded to the ruling in the *Pink* case and in 1939, New York became the first state to mandate an insolvency clause. NY CLS Ins § 1308. The courts of New York have not interpreted the insolvency clause to alter the nature of the reinsurance agreement (*Kemper Reinsurance Co. v. Corcoran (In re Midland Ins. Co.)*, 590 N.E.2d 1186 (N.Y. 1992)) and do not permit estimation or acceleration of claims. *See discussion infra.*

to recover on a claim against Southern Surety. The Supreme Court held that because reinsurance agreements are in the nature of indemnity agreements, a reinsurer ordinarily is liable only for claims actually paid by the insolvent insurer or the liquidator to insureds on the underlying policies, not for amounts the insolvent insurer was obligated, but was unable to pay. *Fidelity & Deposit Co. v. Pink*, 302 U.S. 224, 228-29 (1937).

Nationally, the response to the *Pink* decision was what is now referred to as the "insolvency clause."[51] In order for an insurer to take financial statement credit for reinsurance it has ceded to a reinsurer, the reinsurance contract must contain such a clause.[52] The purpose of an insolvency clause is to provide the liquidator "with the same rights and obligations of the insolvent insurer pursuant to the terms of the reinsurance contract."[53] This language merely provides that the reinsurer is obligated to pay the receiver without diminution due to the insolvency.[54] The Deputy Receiver acknowledges this fact:

> Q. Can you explain to the Court how this insolvency clause operates?
>
> A. The insolvency clause is designed to ensure that in the event the cedent becomes insolvent, that its reinsurers or reinsurers participating in the given contract will pay to the liquidator, receiver or so on the full liability of the company, and the reason for it is that the reinsurance treaty typically requires reinsurers to pay for payments that a cedent makes, and in a sense in the world of insolvency, typically exclusively, probably the cedent would not be able to pay the full amount of its liability. So what the insolvency clause does is ensure that when it bills its reinsurance, it

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[51] JTE 103, Craig Expert Report at 10.

[52] *Id*.

[53] *Prudential Reinsurance Co. v. Superior Court*, 842 P.2d 48, 58 (Cal. 1992); *In re Midland Ins. Co.*, 590 N.E.2d 1186, 1191-92 (N.Y. 1992).

[54] JTE 103, Craig Expert Report at 10-11.

> will be able to recover the full amount of the liability and not just _de_ _minimus_ payment that the insolvent is able to make.[55]

But the Deputy Receiver then goes on to somehow expand the purpose of the clause into a far broader interpretation -- that the contract is "transformed:"

> Q. Does the insolvency clause change the contract of reinsurance with regard to the reinsurers right to participate in the defense of claims?
>
> A. Yes. As I said – referred to earlier, the normal situation is that reinsurers only are required to pay under these contracts as the cedent pays. That is to say it is a contract of indemnity that cedent and reinsurer have entered, once there is an order of liquidation and we have an insolvency. [T]his clause transforms the contract in my judgment from a contract of indemnity to one of liability.[56]

The reinsurers' expert disagreed with the Liquidator's transformation argument, testifying that:

> [r]espectfully, it is a leap of meaningful proportion to suggest that the insolvency clause can be turned on its head to the extent necessary to materially alter the contractual undertaking of the reinsurer to pay only those claims that have sufficiently crystallized to enable the parties to consider them in anything other than an actuarial abstract.[57]

The insolvency clause does not and was never intended to transform the contract of insurance from one of indemnity into one of liability. Indeed such an interpretation would render the other portions of the reinsurance contract a nullity. But even, assuming _arguendo_, that it **does** have that effect, it still does not result in the reinsurer being liable to pay on the basis of IBNR. As noted in the foregoing section of this Memorandum, the testimony in this case is overwhelming and uncontroverted: the "liability" of the reinsurer

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[55] White Direct at 52, Line 3 through 18.

[56] *Id*. at 52, Line 19 through Page 53, Line 4.

[57] JTE 103, Craig Expert Report at 11.

is based upon the "liability" of Integrity under its policies of insurance and the "liability" of Integrity under those policies is premised on the occurrence of a specified, known event. Those policies do not provide for the payment of theoretical IBNR to claimants either before or after the date of insolvency. Nothing in the law gives the Liquidator a blank check to pay amounts to theoretical claimants for theoretical losses that are not covered under the Integrity contracts and that are not paid in accordance with the New Jersey Liquidation Act. Because the basis for liability of Integrity to its insureds and third parties does not change upon insolvency, neither does the basis of a reinsurer's obligation to Integrity change – whether the contract is called one of indemnity or one of liability. To do otherwise would unjustly enrich some creditors at the expense of others.

What the Liquidator does not explicitly say – but what is fundamental to her argument – is the absurd notion that the term "liability" in the Insolvency Clause has a different meaning than the identical term has in the other provisions of the reinsurance contract. This suggestion is without any basis whatsoever and is contrary to traditional rules of construction.[58] The Liquidator's suggestion in this regard would suddenly and inexplicably sweep into **one clause** of the reinsurance contract the accounting definition of "liabilities" while leaving the other contractual references to "liabilities" as having a wholly different meaning.[59] A contract must be read in its entirety. The liability at issue

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[58] An insurance policy is to be interpreted by the same general rules as any other written contract and the words of an insurance policy are to be given their plain, ordinary meaning. *Zacarias v. Allstate Ins. Co.*, 168 N.J. 590 (2001); *Spaulding Composites Co. v. Liberty Mut. Ins. Co.*, 346 N.J. Super. 167 (N.J. Super. Ct. 2001). The fundamental rule of construction is to arrive at and determine the intention of the parties as demonstrated by the language employed, when read and considered as a whole. *Boswell v. Travelers Indem. Co.*, 38 N.J. Super. 599 (N.J. Super. Ct. 1956).

[59] The Receiver's expert witness, Christopher Diamantoukos testified about the accounting requirements that mandate the reporting of estimated IBNR on insurer's financial statements. *See* Diamantoukos Direct at 78, Line 7 through Page 80, Line 20. This testimony goes to the accounting definition of "liabilities." However, the reinsurance contracts contain their own definition of "liabilities" for purposes of the contract

in the Insolvency Clause is no different than it is in the other provisions of the reinsurance contract.

Indeed, while the Deputy Receiver claims on the one hand that the Insolvency Clause magically transforms the reinsurance contract from a contract of indemnity into a contract of liability, the Deputy Receiver concedes that a reinsurer is not liable unless the Estate itself is liable under its policies of insurance.[60] Not even the Liquidator claims that there is any transformation that takes place in receivership with respect to the underlying insurance policies. Nor does she point to any language in Integrity's insurance policies that would provide for such an interpretation. At best, she would have to turn to New Jersey statutes to assist her in that regard, but there she comes up short as well. Section 17:30C-26(c)(4) makes it clear that to share in the distribution of estate assets as a fourth priority claimant, the policyholder or third-party claimant must prove a claim that is "within the coverage" of the insolvent insurer's insurance policies. In order to prove a "claim," that claim must either "become absolute" pursuant to § 17:30C-28a or meet the criteria set forth in § 17:30C-28b. A liability under an insurance policy that existed prior to receivership is a liability under that same policy after the receivership date. Witnesses on both sides agree that IBNR does not constitute a covered claim under an Integrity insurance policy absent the Plan – and the Plan cannot lawfully change that.

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as noted herein (see section I.C. of this Memorandum) and there is no reason why that definition should not apply to the entire contract. Either the reinsurer was obligated to pay on the basis of accounting "liabilities" throughout the term of the contract (including for estimated IBNR), even before insolvency, or it was obligated to pay on the basis of the contractual definition of "liabilities" throughout the term of the contract, including post-insolvency. Clearly it was the latter because the contract could have but did not define "liabilities" as those amounts recorded for financial statement purposes. Instead it keyed the liability of the reinsurer to the underlying liability on the insurance policies, which **no one** suggests included obligations to pay for estimated IBNR.

[60] RAA Deposition Designations, Richard L. White, October 9, 1997, Page 794, Line 19 through Page 795, Line 21.

ii. The "Without Diminution" Language of the Insolvency Clause Does Not Require Reinsurers to Pay More Than They Would Have Paid Absent Insolvency

To the extent that the Liquidator relies on the "without diminution" language of the Insolvency Clause, her arguments are equally misplaced. The plain meaning of that language indicates that the reinsurer is required to pay in insolvency the same amount, not less, than it otherwise would have paid had the insurer remained solvent. But contrary to the Liquidator's view, the Insolvency Clause does not mandate that the reinsurer pay **more** than it was otherwise obligated to pay under the reinsurance contracts it entered into with Integrity.

Courts have repeatedly struck down past attempts by receivers to use this "without diminution" language of the Insolvency Clause as a basis for denying offset rights provided by reinsurance contracts and state laws. The theory by receivers advancing this view is that "without diminution" nullifies the statutory recognition of setoffs, thereby increasing the insolvent insurer's recoveries from reinsurers. Similarly, the Liquidator's view in the case at bar might be that the same language nullifies the statutory requirements that claims constitute specific losses pursuant to § 17:30C-20, that fourth priority claims be "within the coverage" of the insolvent insurer's insurance policies pursuant to § 17:30C-26, and that claims be made absolute pursuant to § 17:30C-28a –with the same result—increasing the insolvent insurer's recoveries from reinsurers.

But the line of cases rejecting this theory began in 1892, when the United States Supreme Court held that the right to assert set-off in insolvency was customary both statutorily and as a matter of equity. Indeed, the Court stated "where the mutual obligations have grown out of the same transaction, insolvency on the one hand justifies the set-off of the debt due upon the other." *Scott v. Armstrong*, 146 U.S. 499, 507 (1892). The Court went on to hold that "where a set-off is otherwise valid, it is not perceived how its allowance can be considered a preference, and it is clear that it is only the balance, if any, after the setoff is deducted, which can justly be held to form part of the assets of the insolvent."[61] Subsequently, the New York Court of Appeals upheld the right of setoff where a contract contained the statutorily mandated insolvency clause. *In re Midland Ins. Co.*, 79 N.Y.2d 253 (N.Y. 1992) The New York court found that the insolvency clause did not preclude the reinsurer from exercising its right of offset because neither the statute's language nor legislative history supported the conclusion that it was enacted to destroy that right. *Id*. at 264. The United States Court of Appeals for the Eighth Circuit used the same reasoning in *Transit Cas. Co. v. Selective Ins. Co.*, 137 F.3d 540 (8th Cir. 1998), to hold that the parties' contractual right of set-off did not conflict with the insolvency clause in their contracts and did not violate state public policy.

In the same way, in the matter at bar, the "without diminution" language does not alter the nature of the reinsurance arrangement and void the contractual liability provisions on which payment of a claim is based. As explained herein, the insolvency cause exists for a single, defined purpose – to ensure that the reinsurer will continue to be obligated to pay where the liquidator merely *allows* the loss in the context of the liquidation proceeding, even though the liquidator of an insolvent insurer does not actually *pay* the loss. Neither the insolvency clause, nor any statutory provision in New Jersey law, requires the reinsurer to pay "claims" that are not due, that will not become

[61] 146 U.S. at 510. Similarly, the reinsurance recoverables on IBNR that might one day be reported to Integrity and potentially due the Estate, are not an asset of the Estate and not subject to this Court's jurisdiction as discussed in section IV of this Memorandum; *Sunset Commercial Bank v. Florida Dept. of Ins.*, 509 So.2d 366 (Fla. App. 1987); *O'Connor v. Ins. Co. of North America*, 622 F.Supp. 611 (N.D. Ill. 1985).

due for years or even decades, and that may never be owed at all. Attempts to extend the purpose of the insolvency clause to alter other contractual terms have repeatedly failed, and should similarly fail here.

iii. Reinsurers' Rights to Investigate/Interpose Defenses

Moreover, the Insolvency Clause contained in Integrity's reinsurance contracts, like the standard clauses found throughout the industry, contain language giving reinsurers the right to: (1) receive notice of a claim against an Integrity policyholder indicating the contract reinsured, (2) investigate the claim; and (iii) interpose any coverage defense that might be available to Integrity.[62] The Plan would deprive reinsurers of these valuable rights by imposing indemnity obligations upon them for IBNR, which by definition does not constitute a claim capable of investigation or defense. As noted by the reinsurers' expert:

> At the end of the day, the insolvency clause does two things. It modifies the triggering event from payment of a claim to the establishment of liability for a claim. And, it preserves the right of the impacted reinsurer to oppose the claim on any appropriate basis. It does not permit the liquidator to ignore contractual defenses for the sake of convenience.[63]

The notice and defense provisions of the standard Insolvency Clause represent a quid pro quo. While reinsurers are required to pay on the basis of claims allowed by the receivership court, instead of on the basis of claims actually paid by the ceding insurer, reinsurers are given additional rights to interpose defenses in the adjudication of a claim.

[62] While the Deputy Receiver noted during testimony that to his knowledge no reinsurer had ever availed itself of the right to interpose a defense in the Integrity proceedings (White Direct at 54, Lines 8 through 13), he also acknowledged that thus far, reinsurers had only been billed for non-contingent claims (JTE 42, Stipulation of Facts, Stipulation #21). That is clearly not the intent under the proposed Plan.

[63] JTE 103, Craig Expert Report at 11.

This trade-off recognizes the fact that prior to the insolvency of the ceding insurer, there was a commonality of interest between the parties. The ceding insurer owed fiduciary duties to the reinsurer to act in good faith.[64] It had no incentive to inflate the claims that it would have to pay to an insured. But once the ceding insurer is placed into receivership, that commonality of interest ends. Unlike a solvent ceding company, a liquidator has no financial incentive to reduce filed claims. Policyholders and cedents, knowing they may only receive pennies on the dollar for their claims (to the extent not covered by guaranty associations or in excess of guaranty association limits or statutory defenses), may be tempted to exaggerate them, especially if they are invited to claim based on estimates of unreported claims. Receivers seeking to augment the estate assets at the expense of reinsurers, regardless of their contractual obligations, may be tempted to do so. As one commentator has noted:

> An insolvent estate . . . frequently pays an insured a fraction of its actual claim – 10 cents on the dollar is not uncommon. But the insolvency clause requires the reinsurer to pay 100 cents on the dollar . . . Accordingly, a claim liquidated for \$100,000 which is 90% reinsured might net the estate \$90,000 from the reinsurer for the general assets of the estate. If nonetheless the general assets of the estate are sufficient to pay only 10 cents on the dollar, the cost to the estate of approving the claim is only \$10,000, the estate realizes an \$80,000 bonanza.

David Spector, *Rights and Obligations of Reinsurers of an Insolvent Ceding Company*, in ABA Tort & Insurance Practice Section, *Law & Practice of Insurance Revisited* 685, 708-09 (1989).

[64] Kenneth R. Thompson, *Reinsurance* 90 (4[TH] ED. 1966); *Sun Mut. Ins. Co. v. Ocean Ins. Co.*, 107 U.S. 485, 510 (1883); *Unigard Sec. Ins. Co. v. North River Ins. Co.*, 762 F. Supp. 566 (S.D.N.Y. 1991); *Aetna Cas. & Sun Co. v. Home Ins. Co.*, 882 F. Supp. 1328 (S.D.N.Y. 1995).

Thus, the reinsurer in many cases must increase its involvement in the claims allowance process to ensure that claims are being thoroughly analyzed and, where appropriate, properly challenged. In recognition of this trade-off, New Jersey regulation allows the reinsurer to recoup the costs of its successful challenge to the claim against the assets of the estate, *not as a general creditor but as an expense of administration—a Priority 1 Claim.*[65]

The Plan disregards the rights of reinsurers mandated by the Insolvency Clause in the reinsurance contracts that Integrity entered into and mandated by New Jersey regulation N.J.A.C. § 11:2-28.12, providing that in order for a ceding insurer to take financial statement credit for ceded reinsurance, the reinsurance contract must:

> Include[s] an insolvency clause which shall provide the following:
>
> i. In the event of a receivership, the reinsurance recoverables due under any reinsurance contract shall be payable by the reinsurer directly to the receiver, after reasonable provision for verification, on the basis of claims allowed against the insolvent company by any court of competent jurisdiction having authority to allow such claims or allowed by the receiver as a result of the conclusion of the claim filing, approval and appeal process before the receiver. Regardless of any provision in the reinsurance contract or other agreement to the contrary, payment shall be made without diminution because of such insolvency or because the receiver has failed to pay all or a portion of any claims;
>
> ii. The receiver of a ceding insurer shall give or arrange to give to the reinsurer, written notice of the pendency of a claim against the ceding insurer, within a reasonable period of time after the initiation of the receivership. Failure to give such notice shall not excuse the obligation of the reinsurer unless it is substantially prejudiced thereby. **The reinsurer may interpose, at its own expense, in the proceeding where such claim is to be adjudicated, any defense or defenses which it may deem available to the ceding company or its receiver. The reasonable expense thus incurred by the reinsurer shall be payable, subject to court approval, out of the estate of the insolvent ceding insurer as part of the expense of the receivership to the extent of a proportionate share of the benefit which may accrue to the ceding insurer in**

[65] N.J.S.A. § 17:30C-26.

> **receivership, solely as a result of the defense undertaken by the reinsurer;** and
>
> iii. Payments by the reinsurer shall be made directly to the receiver of the ceding insurer except where the contract of insurance or reinsurance specifically provides another payee for such reinsurance in the event of the insolvency of the ceding insurer.

The reinsurer is incapable of investigating and interposing a defense to a "claim" where no notice has been received, the identity of the claimant and the nature of the claim are unknown and it is unknown whether an event has even occurred. The reinsurer's right to participate in proceedings to determine claims, as provided for in reinsurance agreements pursuant to N.J.A.C. § 11:2-28.12, is an obligation the Liquidator inherited from Integrity and must satisfy. This right is an essential contract right that protects the reinsurer from the possibility of exaggerated claims.

E. The Plain Language Of Section 17:30C-28a Prohibits Approval Of Contingent Claims Unless They "Become Absolute"

While the RAA asserts that IBNR does not constitute a claim under New Jersey statutes, and is not a covered claim under Integrity's insurance policies or reinsurance contracts, assuming <u>arguendo</u> that this Court found that it was a claim within the meaning of both the statute and the contracts, it is at best a "contingent claim" under New Jersey law. Section 17:30C-28a provides that "[n]o contingent claim shall share in a distribution of the assets of an [insolvent insurer]" unless "[s]uch claim becomes **absolute** against the insurer on or before the last day fixed for filing proofs of claim against the assets of such insurer." N.J.S.A. § 17:30C-28a. (emphasis added).

Although the statute does not define the term "absolute," the ordinary meaning of the term is:

> [C]omplete; perfect; final; without any condition or incumbrance; as an absolute bond… Unconditional;

> complete and perfect in itself; without relation to or dependence on other things or persons. Free from conditions, limitations or qualifications, not dependent, or modified or affected by circumstances; that is, without any condition or restrictive provisions…

Black's Law Dictionary 9 (6th ed. 1990). *See In the Interest of S.M.*, 284 N.J. Super 611, 666 A. 2d 177, 181 (1995) (words in a statute should be given ordinary meaning, which may be ascertained from a dictionary). By any definition, IBNR cannot be considered "complete," "final," or "unconditional." The Liquidator has acknowledged this plain meaning of "absolute" throughout the liquidation proceedings.[66]

IBNR is an actuarial estimate of future losses that **may** result from pre-liquidation events that have not been reported. An actuarial estimate that a loss **may** have occurred; that the insurer **may** face liability; and that the loss **may** be valued at some point in the future is not an "absolute" determination. Moreover, because IBNR estimates are by nature uncertain as to the identity of any potential claimant, the type of loss, if any, and the value of any resulting claims, there is no way to even attribute specific IBNR losses to particular insurance policies let alone particular reinsurance contracts. *See*, *e.g.*, *Foster*, 531 Pa. at 620, 614 A. 2d at 1097.

Indeed, the Liquidator has conceded as much, defining IBNR in the original Final Liquidation Dividend Plan as losses incurred "during a period covered by a policy, but

[66] For example, on June 14, 1996, the Receiver submitted a proposed Final Liquidation Dividend Plan. Section 4.2 of that plan, similar to the current Plan at Part 4, paragraph 4.4, permitted the Receiver to "deem" a claim to be absolute through estimation. The Receiver acknowledged the plain meaning of "absolute" in that original proposed plan which defined an "Absolute Claim" as "[a]ny claim which is not a Contingent Claim." JTE 62 at 5, defining IBNR as a loss that is not absolute as to coverage, liability and amount; White Cross November 18, 2003 at 130, Lines 14 through 25, Page 131, Lines 1 through 8, conceding that run-off or actual emergence of a policyholder's claim would be different than the estimates under the Plan.

for various reasons **has not been reported and become absolute** as to coverage, liability and amount." (emphasis added).[67]

The fact that IBNR is **not** absolute is clear in the record. For example

- The Deputy Receiver states that the Plan will maximize Integrity's assets by terminating the liquidation many years before "the claims would otherwise become absolute…"[68] The same document notes that the traditional method of liquidation is a run-off until "substantially all claims had become absolute."[69]

- A Deputy Director of the Department of Banking and Insurance (at the time of the statement) admitted that the Plan would allow claims other than those that were "absolute, liquidated and mature."[70] He admitted that the Department considered lobbying the legislature for statutory authority to estimate.[71]

- The Liquidator's witness, Lauren Kingsmore, testified that with respect to the asbestos project, the standard used was whether the Integrity policy was "more probable than not" to pay.[72] A "more probable than not" standard is a far cry from "absolute."

- The parties' stipulations state that approximately 17,000 contingent claims for policyholder protection remain that have not yet matured into reported claims or been otherwise liquidated. It is unknown what percentage of these contingent claims for policyholder protection will ultimately develop into reported claims.[73] Unreported claims cannot, by definition, be made absolute.

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[67] Although the Fourth Amended Final Dividend Plan defines IBNR differently, the Plan still characterizes IBNR as losses incurred "during the period covered by the policy of insurance or reinsurance contract, but no report or notice of a claim against the insured arising out of or relating to such losses have been made or given to Integrity or the Liquidator." *See* JTE 24, Fourth Amended Final Dividend Plan at part 1, paragraph 1.21.

[68] JTE 62, Certification of Richard L. White in Support of Liquidator's Application for an Order to Show Cause to Establish Procedures for Court Approval of Liquidator's Final Dividend Plan (hereinafter "White Certification"), Page 2.

[69] *Id*. at 7.

[70] Zetterstrom at 132, Lines 8 through 13.

[71] Zetterstrom at 133, Line 24 through page 134, Line 19.

[72] RAA Deposition Designations, Lauren Kingsmore, January 28, 1998, Page 193, Line 24 through Page 194, Line 1.

[73] JTE 40, Stipulation of Facts, Stipulation #33.

- The parties' stipulations state that it may take an additional 25 years for all losses to be reported and become liquidated.[74]

- The parties' stipulations concede that there are wide variations in actuarial estimates.[75]

- The Liquidator's expert actuary testified that there is no specific book that he is aware of that advises actuaries on how to estimate extraordinary-hazard exposure and that he personally had collected 7 feet of literature to aide him in this task.[76]

- The Liquidator's expert actuary testified about the numerous simulation models that exist within the actuarial profession for estimating environmental exposure and the significant differences between those models.[77]

- So great is the uncertainty surrounding Integrity's estimated losses that the Liquidator's actuary, Mary Lou O'Neil, could not even stake out a reasonable range between her high and low estimates of Integrity's loss exposure: "It's quite a wide range, with a factor of 2 between a high and low number."[78] Of course, determining a reasonable range is important because in the words of the Ernst & Young actuary who performed the peer review, "[t]he range is meant to express an upper and lower bound of what would be deemed reasonable estimates of loss reserves in the context."[79]

- In the certification executed by Ms. O'Neil and submitted to this Court in support of the Liquidator's motion for approval of the FDP, Ms. O'Neil estimated that the ultimate losses for Integrity "will range from $1.6 billion to $3.2 billion" This range of estimates corresponded to a range of IBNR estimates of $.9 billion to $2.5 billion.[80] A range of this magnitude speaks for itself. In effect, Ms. O'Neil was telling this Court that her estimate of the liabilities of the Integrity estate could be off by more than $1 billion.

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[74] JTE 40, Stipulation of Facts, Stipulation #35.

[75] JTE 40, Stipulations of Fact, Stipulation #15.

[76] RAA Deposition Designations, Christopher Diamantoukos, August 5, 1998 (hereinafter "Diamantoukos Dep. August 5, 1998"), Page 809 Line 20 through, Page 811 Line 23.

[77] Id at Page 848, Line 25 through Page 860 Line 3.

[78] Munich, Exhibit E at 91, *See also* Exhibit E at 67-68, Exhibit X.

[79] Munich, Exhibit Y at 61.

[80] Munich, Exhibit P at paragraph 8.

- The reinsurers' expert actuary, when asked what an "acceptable degree of accuracy" is with respect to IBNR estimates on the Integrity book of business stated that it would be in the order of 20% plus or minus the ultimate outcome of actual claims.[81] While this may be "actuarially acceptable," it is certainly not statutorily acceptable when the statutory mandate is that claims must be made "absolute."

- The reinsurers' economist testified that actuarial numbers vary enormously.[82]

The Liquidator attempts to re-write New Jersey statutes or side-step the specific limitation of § 17:30C-28a by empowering the Liquidator to simply "deem" theoretical IBNR projections as "absolute" and not requiring the estimated loss to actually "become absolute."

By "deeming" a policyholder's "claim" for IBNR as "absolute," the Plan contravenes the plain and ordinary meaning of the statutory requirement. The Plan also ignores judicial decisions in other states relying on similarly worded statutes. For example, New York Insurance Law § 7433, virtually identical to § 17:30C-28a, states that:

> [n]o contingent claim shall share in a distribution of the assets of an insurer which has been adjudicated to be insolvent…except such claims shall be considered if properly presented, and may be allowed to share where (a) such claim becomes absolute against the insurer on or before the last day fixed for the filing of proofs of claim against the assets of such insurer…

In interpreting § 7433 of the New York Insurance Law, courts have consistently held that a contingent claim does not become "absolute" until the insurer's liability becomes fixed. *See In re Nat'l Sur. Co.*, 26 N.Y.S.2d 370, 373 (Spec. Term

[81] RAA Deposition Designations, Bryan Joseph, April 23, 1998, Page 555, Line 16 through Page 558, Line 7.

[82] RAA Deposition Designations, Neil A. Doherty, January 16, 1998, Page 64, Line 6 through Page 65, Line 9.

1941)(Liquidation court held that the policyholder's claim did not become absolute because "[n]ot being a judgment [the referee's finding] did not have the effect of making the claim absolute."); *In re Sur. Co.*, 296 N.Y.S. 651 (App. Div. 1937)(Rejecting a bondholder's claim because the claim did not become absolute before the filing deadline.); *In re Concord Cas. & Sur. Co.*, 297 N.Y.S. 583 (1937)(rejecting contingent claim under workers compensation policy based on contingent claim statute); *People v. Metropolitan Sur. Co. (H.B. Smith Co., Claimant)*, 105 N.E. 99 (N.Y. 1914)(rejecting contingent claim under surety bond based on contingent claim statute); *People v. Metropolitan Sur. Co. (Fleet, Claimant)*, 98 N.E. 412 (N.Y. 1912)(rejecting contingent claim under surety bond based on contingent claim statute).

Relying on the plain language of California Insurance Code § 1025, which is similar to § 17:30C-28a,[83] the California Court of Appeal has rejected precisely the estimation theory proposed by the Liquidator here. *Quackenbush v. Mission Ins. Co.*, 54 Cal Rptr. 2d 112 (Cal. Ct. App. 1996). In *Quackenbush,* the California receiver of the Mission Insurance Company, like the Liquidator here, proposed a plan that would have allowed him to approve IBNR losses and contingent claims solely on the basis of actuarial estimates of how much those "claims" were worth. Various parties, including Mission's reinsurers (through the RAA and others), challenged this aspect of the plan on

[83] California Code § 1025 reads as follows:

> Claims founded upon unliquidated or undetermined demands must be filed within the time limit provided in this article for the filing of claims, but claims founded upon such demands shall not share in any distribution to creditors of a person proceeded against under Section 1016 **until such claims have been definitely determined, proved and allowed.** Thereafter, such claims shall share ratably with other claims of the same class in all subsequent distributions.
>
> An unliquidated or undetermined claim or demand withint the meaning of this article shall be deemed to be any such claim or demand upon which a right of action has accrued at the date of the order of liquidation and upon which the liability has not been determined or the amount thereof liquidated.

the ground that it violated the plain language of California insurance Code § 1025. The California receiver made, in essence, the same argument offered by the Liquidator here – that § 1025 permitted him to "estimate the likelihood of contingent claims becoming sure as to liability, and unliquidated claims becoming sure as to amount, based on standard actuarial principles, and compel the reinsurers to pay those estimated amounts now…"[84] The California receiver asserted that, notwithstanding § 1025's plain language prohibiting approval of contingent claims, "his generally broad discretion permits him to adopt a plan which better protects the rights of potential claimants to receive compensation soon, rather than delay compensation into the future…"[85] The California Superior Court approved the plan and the reinsurers appealed.

The California Appellate Court reversed the trial court's approval of the plan on the ground that the plan violated the express language of § 1025:

> [a]ppellants argue section 1025, on its face, prohibits payments of contingent claims until the reinsurer's liability is determined, and unliquidated claims until their amounts are determined. We agree the statute can have no plainer meaning. Section 1025 expressly forbids claimants with contingent or unliquidated claims from participating in a liquidation plan. While the Commissioner's policy and economic arguments may be persuasive, they cannot trump section 1025's express language.[86]

While the RAA maintains that IBNR does not constitute a "claim" under New Jersey law, the Liquidator concedes that, at the very least, IBNR constitutes a "contingent

[84] 54 Cal Rptr. 2d at 117.

[85] *Id*.

[86] *Id*.

claim" under New Jersey statutes.[87] Section 17:30C-28a is explicit as to what standard must be met to allow an insured's contingent claim. That is -- it must be made "absolute." Instead of complying with the statute and disallowing all contingent claims that have not been made absolute by a date certain, or extending the claims allowance date to provide sufficient time for those claims to be made absolute, the Liquidator has concocted a notion of "deeming " claims to be made absolute. (*e.g*. Sections 4.3 and 4.4 of the Plan) The Liquidator cannot, by fiat, deem an uncertain claim to be absolute. To do so would render § 17:30C-28a meaningless.

F. The Plan Violates New Jersey Statute by Permitting the Allowance of Contingent Claims Inconsistent with § 17:30C-28b

While New Jersey law requires that policyholder claims be made "absolute" in accordance with § 17:30C-28a, it permits a third-party claimant with a cause of action against the insolvent insurer to prove his claim pursuant to § 17:30C-28b. In order to have a third-party cause of action, the claim must be known and, therefore, by definition, cannot be IBNR. In the Interim Order, this Court characterized such losses as "case reserves." The RAA does not object to the Liquidator's approval and valuation of such claims as long as the Liquidator meets the standards required by § 17:30C-28b: that the claim constitute a known event; that it be covered under an Integrity insurance policy; and that it not exceed the insurer's total liability under that policy. To the extent that such losses are allowed pursuant to § 17:30C-28b and are covered under a reinsurance contract, the RAA does not object to the Liquidator billing reinsurers for such amounts as long as reinsurers' arbitration and other contractual rights are met.

[87] JTE 24, Fourth Amended Final Dividend Plan, Part 1, paragraph 1.1 defining a "contingent claim" to include both reported and unreported claims. JTE 62, White Certification at 5, paragraph 9, noting that contingent claims are comprised of case reserves and IBNR.

The Liquidator's Plan, however, violates New Jersey law to the extent that it (1) permits a **policyholder's** claim to be allowed pursuant to the standards of § 17:30C-28b, and (2) provides for the allowance of third party claims inconsistent with the requirements of that section.

i. The Plan Violates the Act Because it Allows Speculative Contingent Claims of Policyholders – Claims That Can Only be Allowed for a Third-Party Claimant

As noted above, § 17:30C-28b allows *third-party claimants* to file more speculative contingent claims than those contemplated by § 17:30C-28a, but such claims must be allowed within the limitations of the statute.

Contrary to those limitations, Section 4.3 of the proposed Plan impermissibly allows *policyholders* with alleged speculative IBNR losses to provide the proof described in § 17:30C-28b, and thus share in the distribution of estate assets:

> The Liquidator shall recommend that the Liquidation Court approve all or any part of a Claim for IBNR that is deemed Absolute as of the Claims Valuation Date. The Liquidation Court may only approve a Claim or that part of a Claim for IBNR that is deemed to be Absolute. *A policyholder Claimant must submit information to value its Claim for IBNR which complies fully with the requirements contained in the Proof of Claim in the format annexed hereto as Exhibit A*. (emphasis added)[88]

Even assuming, arguendo, that the Plan's treatment of third-party contingent claims under § 17:30C-28b was lawful (*see* discussion in subsection ii below) – its extension to policyholder claims would violate the explicit limitations of the statute. Section 17:30C-28b on its face is limited to "any person who has a cause of action against an insured of [an insolvent insurer]." *i.e.,* a third party claimant, and does not extend to policyholders. The Plan fails to make this distinction and thereby exposes the

[88] JTE 24, Fourth Amended Final Dividend Plan, Part 4, paragraph 4.3.

Estate to speculative contingent claims, to the detriment of both policyholders and third-party claimants with actual, known identifiable and verifiable claims and to the detriment of reinsurers from whom the Liquidator will seek reinsurance recoveries.

ii. The Plan Improperly Allows Third-Party Claimants to File Unsubstantiated Claims in the Liquidation Proceeding in Violation of New Jersey Law

As discussed above, § 17:30C-28b allows third-party claimants to file "contingent claims" but only if the claimant provides sufficient supporting evidence:

> (1) If it may be reasonably inferred from the proof presented upon such claims that such person would be able to obtain a judgment upon such insured; and
> (2) If such person shall furnish suitable proof that no further valid claims against such insurer arising out of his cause of action, other than those already presented, can be made: and
> (3) If the total liability of such insurer to all claimants arising out of the same act of its insured shall be no greater than its maximum liability would be, were it not in liquidation. (N.J.S.A. § 17:30C-28).

Under the Plan, third-party claimants seeking compensation for IBNR need not establish, or even disclose, the facts of the claim or the potential coverage for the claim. There is no requirement for claimants to submit documentation supporting the essential element of coverage under the Integrity policies. The only requirement under the Plan for claimants to prove their contingent claim is to provide "[s]upporting documentation employing standard reserving practices and claim adjustment procedures." Similarly, the requirement for proving a "claim" for IBNR requires "supporting documentation employing actuarially sound techniques." [89]

An actuarial estimate plainly does not provide proof that a third-party claimant "would be able to obtain a judgment" against the policyholder. It does not provide proof

[89] JTE 24, Exhibit A.

that no further valid claims exist against Integrity *arising out of this cause of action* because no specific loss is identifiable. Nor can the total liability of the insurer be ascertained because the specific event is not identifiable, the specific policy that may be implicated is not ascertainable, and other claimants relating to the same event are unknown. As noted, such studies merely establish that there is a possibility that the claimant may incur a loss. By lowering the standard of supporting documentation required for filing proofs of claim pursuant to § 17:30C-20 and the requirements of proof mandated by § 17:30C-28b to conjecture, the Plan operates to the detriment of policyholders and claimants with known, identifiable and verifiable claims as well as the reinsurers from whom the Liquidator will seek to recover.

G. The Court's Discretion is Limited by New Jersey Statute

Insurance liquidation proceedings are governed by the New Jersey Insurer Liquidation Act, N.J.S.A., §§ 17:30C *et. seq.* Section 17:30C-3 of the Act provides that "delinquency proceedings pursuant to this act shall constitute the sole and exclusive method of liquidating, rehabilitating, organizing or conserving an insurer…" N.J.S.A., § 17:30C-3.

Section 17:30C-15e of the Act makes clear that, although the Liquidator has broad discretion in choosing among lawful alternative methods of administering an insolvent insurer's estate, the Liquidator has no power to act contrary to the Act's provisions. That section empowers the Liquidator, upon commencement of insolvency proceedings, to "conduct the business of the insurer or to **take such steps as are authorized by the laws of this State** for the purpose of liquidating, rehabilitating, reorganizing, or conserving the affairs of the insurer." N.J.S.A. § 17:30C-15e (emphasis added); *see also Clifford v. Concord Ins. Co.,* 114 N.J. Super. 495; 277 A. 2d 400 (App. Div. 1971) (Receiver's authority is limited by the Act). *Motor Club of America Ins. Co. v. Phillips*, 66 N.J. 277, 330 A.2d 360 (1974); *Henry v. Rahway State Prison*, 81 N.J. 571, 410 A.2d 686 (1980); *In re Aetna Casualty and Surety Co.*, 248 N.J. Super. 367, 591 A.2d 631 (N.J. Super. Ct. 1991). Although the determination of an administrative agency is entitled to deference where agency expertise is involved, *see Mayflower Securities Co. v. Bureau of Securities*, 64 N.J. 85, 92-93, 312 A.2d 497 (1973); *In re Aetna Casualty Surety Co.*, 248 N.J. Super. 367, 376, 591 A.2d 631 (App. Div.), certif. denied, 126 N.J. 385 (1991), *cert. denied*, 502 U.S. 1121, 112 S. Ct. 1244, 117 L. Ed. 2d 476 (1992), an agency's interpretation with respect to a matter of statutory construction stands on a different footing. *New Jersey Guild of Hearing Aid Dispensers v. Long,* 75 N.J. 544, 575, 384 A.2d 795 (1978); *Mayflower Securities Co. v. Bureau of Securities*, *supra* (64 N.J. at 93).

The Act vests the liquidator with the rights to "all property, contracts and rights of action" of an insolvent insurer. N.J.S.A. § 17:30C-15(b) Conversely, with these contractual rights comes corresponding contractual obligations; the liquidator "stands in the shoes" of the insolvent insurer and remains bound to the contractual obligations entered into by the insurer prior to insolvency. *See Newman v. Hatfield Wire & Cable Co.,* 113 N.J.L. 484, 490, 174 A. 491, 494 (1934) *citing Receivers v. Paterson Gas Light Co.*, 23 N.J.L. 283, 297 (1852). ("Credits of an insolvent [insurance] company…are not changed in condition because they come into the hands of a receiver but are subject to the same equities as when in the hands of the company prior to the plight of insolvency."); *Bohlinger v. Zanger*, 117 N.E.2d 338, 341 (N.Y. 1954) ("[T]he liquidator for all practical purposes takes the place of the insolvent insurer…[T]he liquidator should not and may not be placed in a better position than the company he takes over and demand that which is not owed."); *Kaiser v. Monitrend Inv. Mgmt., Inc.,* 672 A.2d 359, 364 n.5 (Pa. Commw. Ct. 1996)(citations omitted)("[B]ecause the Statutory Liquidator is seeking to enforce a contract via the rights of the insurer, the Statutory Liquidator is just as bound by the terms of that contract as would be the insurer.").

In light of these limitations, it is not surprising that a receiver may only exercise the rights and obligations existing in Integrity's reinsurance contracts when seeking to collect proceeds from reinsurers. The Plan, however, goes far beyond the mandate of the Act by fundamentally altering the coverage of Integrity's reinsurance contracts and nullifying many of the reinsurers' rights. The Act attempts to protect against such unlawful acts by a receiver by expressly mandating that the receiver's actions be *authorized by the laws of this State.*[90]

II. Estimation and Acceleration of IBNR is Unfair and Inequitable

The Plan would allow for the estimation of IBNR and the involuntary acceleration of reinsurance recoveries on the basis of those estimates contrary not only to New Jersey law and the terms of the reinsurance contracts entered into with Integrity—but inconsistent with the use of such estimates around the world. The Plan would permit the estimation of amounts that are not capable of being made absolute and cannot be estimated in a reasonable manner for the purposes for which the estimates are to be used. Approval of the Plan will provide advantages to large policyholders at the expense of medium and small businesses, individual policyholders and reinsurers.

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[90] N.J.S.A. § 17:30C-15(e)

Seven years ago this Court directed the Liquidator to "submit a Final Dividend Plan including information sufficient to apprise the Court and all interested parties of the procedures and methodology whereby the Liquidator intends to estimate claims and allocate liability for such estimated claims to reinsurers."[91] The Court imposed this condition because it recognized how utterly indispensable the estimation methodology and supporting expert evidence are to determining the validity of the Plan. As the Court noted:

> [I]t's not simple. The hard part is can you estimate those claims, can you do it **fairly and equitably**, that's the problem. If you can do so, it seems the other part is pretty easy. The hard part is how to do it. You estimate them. How do you allocate? Those are the serious problems, but I don't – even begin to know, I'm not an actuary.[92]

The Liquidator has failed to produce sufficient evidence at trial to prove that the Plan, as proposed, is fair, equitable or feasible. Indeed the overwhelming evidence produced by the RAA is to the contrary.

A. The "Pervasive Use" of IBNR Estimates in the Insurance Industry

The Liquidator's expert, Loren Kramer, authored a report entitled "The Pervasive Use of Estimates in Financial Reporting by Business Enterprises."[93] Essentially, the report was produced for the purpose of suggesting that since the insurance industry uses IBNR estimates on a routine basis, there should be nothing wrong with using them for purposes of accelerating reinsurance recoveries from Integrity's reinsurers. Aside from the fact that doing so violates New Jersey law and the terms of the reinsurance

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[91] Munich at 17, citing Exhibit CC at 2-3.

[92] Munich, Exhibit DD at 34.

[93] JTE 4.

agreements, the problem is that estimates of IBNR were never intended nor have they ever been used in the industry for similar purposes.

The RAA does not dispute the fact that the industry and regulators rely on actuarial estimates of IBNR for certain limited purposes. It would be a foolish insurer or reinsurer and an incompetent regulator that would require insurers and reinsurers to maintain only the amount of reserves necessary to cover known claims. But those familiar with the actuarial estimation of insurance liabilities recognize the uncertainties inherent in them and limit their use to appropriate purposes that reflect that uncertainty. That is, actuarial estimates are used pervasively within the insurance industry for the **limited** purposes of consensual/voluntary commercial transactions and other self - correcting purposes.[94]

In his expert report, Mr. Kramer cites various examples of the use of actuarial estimates.[95] For example, he notes that shares of publicly traded insurance company stocks are bought and sold based on an analysis of the company's financial condition.[96] But when asked about this example in his deposition, he acknowledged that decisions by investors to buy, sell or hold stock are voluntary ones.[97] Mr. Kramer cites as another example the decision to extend credit but readily admits that this, too, is a voluntary decision.[98] Similarly, Mr. Kramer cites other examples of the "pervasive use" of

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[94] White Cross November 18, 2003 at 132, Lines 22 through 24, Page 133, Line 5 through Page 135, Line 13.

[95] JTE 4 at 3.

[96] JTE 4 at 3.

[97] RAA Deposition Designations, Loren B. Kramer, February 4, 1998 (hereinafter "Kramer"), Page 63, Line 19 through Page 66, Line 9.

[98] Kramer at 66, Lines 10 through 24.

actuarial estimates, e.g. mergers and acquisitions and commutations, but acknowledged during his deposition that to the best of his recollection all the examples cited in his report are consensual transactions with the exception of the filing of tax returns.[99] Indeed, during direct examination, the Liquidator's expert actuary, Christopher Diamantoukos, testified that it was commercially reasonable to estimate Integrity's liabilities.[100] But when asked on cross-examination about his definition of "commercially reasonable," he testified that his use of the term presupposes a consensual transaction.[101]

Other examples of the use of actuarial estimates cited in Mr. Kramer's report include the use of estimates for purposes of setting reserves and the filing of tax returns. But the Liquidator agrees that these examples are self-correcting in nature. A company that underestimates its liabilities in one quarter can boost those reserves in another reporting period.[102] Likewise, a company that overestimates its tax liability in one year can adjust that liability in a succeeding year, like any other tax filer.[103]

What the industry does **not** do and what the nation's insurance regulators do **not** require is the involuntary payment of insurance liabilities or reinsurance recoveries on the basis of estimated IBNR. Mr. Kramer knows this and acknowledged it when he testified that during his 30-year career he is unaware of an insurance company being compelled to

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[99] Kramer at 66, Line 25 through Page 67, Line 13.

[100] Diamantoukos Direct at 107, Lines 7 through 23.

[101] Trial Transcript, November 19, 2003, Cross-examination of Christopher Diamantoukos (hereinafter "Diamantoukos Cross"), Page 125, Line 18 through Page 126, Line 23.

[102] White Cross November 18, 2003 at 133, Lines 5 through 16; JTE 108, documenting reserve changes for U.S. property/casualty insurers and reinsurers for the period 1996 – 2002; JTE 53 at 4-5 (Tillinghast-Towers Perrin Report), noting that reserves are self-correcting over time.

[103] White Cross November 18, 2003 at 133, Line 17 through Page 134, Line 4.

pay on the basis of actuarial estimates.[104] Similarly, Mr. Kramer noted that he has never seen a court order an insurer to pay out their liability on the basis of financial estimates.[105] Indeed, the parties stipulated to the extent of industry use of IBNR:

> [e]stimation of liabilities is employed in the insurance industry in a variety of contexts including, but not limited to, mergers and acquisitions, retrospective premium rating, reinsurance commutations, financial statement reporting, and regulation. Estimates of IBNR, however, are not customarily used to define a reinsurer's indemnity or payment obligation, and it is not customary for a reinsurer to be required, without its consent, to indemnify a ceding company for the present value of an estimate of IBNR.[106]

The RAA does not mean to understate the importance of the insurance industry's reliance upon actuarial estimates. However, it does maintain the need to restrict the use of such estimates to the consensual and self-correcting purposes for which they have been used in the past and which are consistent with the precautions that the actuaries themselves urge users to heed.[107]

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[104] Kramer at 78, Line 25 through page 81, Line 8.

[105] Kramer at 79, Lines 7 through 14.

[106] JTE 40, Stipulation of Facts, Stipulation #49.

[107] Actuaries provide precautionary disclaimer language similar in substance to the following language in use by at least one large actuarial firm:

It must be understood that projections of loss and LAE liabilities are subject to large potential errors of estimation, due to the fact that the ultimate disposition of claims incurred prior to the financial statement date, whether reported or not, is subject to the outcome of events that have not yet occurred. Examples of these events include jury decisions, court interpretations, legislative changes, changes in the medical condition of claimants, public attitudes, and social/economic conditions such as inflation. Any estimate of future costs is subject to the inherent limitation on one's ability to predict the aggregate course of future events. It should therefore be expected that the actual emergence of losses and LAE will vary, perhaps materially, from any estimate. Thus, no assurance can be given that ABC's actual loss and LAE liabilities will not ultimately exceed the estimates contained herein. In our judgment, we have employed techniques and assumptions that are appropriate, and the indications presented herein are reasonable, given the information currently available. We have not anticipated any extraordinary changes to the legal, social, or economic environment that might affect the cost, frequency, or future reporting of claims. In addition, our estimates make no provision for potential future claims arising from loss causes not represented in the

B. IBNR Estimates Do Not Produce Absolute Results

While New Jersey law requires that contingent claims be made "absolute," the evidence is overwhelming that actuarial estimates of IBNR do not produce absolute results. In fact, such estimates are anything but absolute. For example:

- The Deputy Receiver readily admitted that actuarial estimates **will** result in different payments than actual development. In fact, in an article that Mr. White wrote, he states that it is axiomatic that an actuarial methodology will provide some creditors with greater recovery and some with less recovery than that which would result from a complete runoff of claims.[108]

- The Liquidator's actuarial expert, Mr. Diamantoukos, testified that the probability that estimates will result in the same numbers as actual development is zero.[109]

- The reinsurers' expert, a Professor of Insurance and Risk Management at the Wharton School in Pennsylvania, states in his report that while the Liquidator acknowledges that the estimation process will not value all claims with 100% exactitude:

  > 'Not 100% exactitude' seems to suggest that valuation can come reasonably close to the true underlying values of claims. As argued above, the degree of exactitude may be closer to 0% than 100%.[110]

- The actuarial firm, Tillinghast-Towers Perrin noted in a report:

  > IBNR, as well as policyholder protection claims, are by necessity, statistical forecasts, and must, by their very nature be uncertain. There is simply no way to definitively calculate the value of claims that have not yet been reported.[111]

- Tillinghast-Towers Perrin observes that the inherent uncertainty surrounding IBNR is well-recognized in the actuarial literature and cites for that

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historical data (e.g., new types of mass torts or latent injuries, terrorist acts, etc.) except insofar as claims of these types are included but not identified in the reported claims and are implicitly analyzed.

[108] JTE 109 at 27.

[109] Diamantoukos Direct at 103, Lines 16 through 19.

[110] JTE 107 at 16.

[111] JTE 53 at 4 (Tillinghast-Towers Perrin Report).

proposition from The Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves:

> The uncertainty inherent in the estimation of required provisions for unpaid losses or loss adjustment expenses implies that a range of reserves can be actuarially sound. The true value of the liability for losses or loss adjustment expenses at any accounting date can be known only when all attendant claims have been settled.[112]

- The Liquidator's actuarial expert, Mr. Diamantoukos testified that actuarial methodology has come a long way in the past 10 years[113] but one need only read his most recent article to determine that it has a long way to go before it can begin to approach any degree of certainty:

> [t]here is a great deal of uncertainty surrounding the ultimate cost of pollution clean up from inactive hazardous waste sites in the country. Unfortunately, the model presented herein, as well as any other, will for some considerable length of time suffer from model specification error of immeasurable magnitude.[114]

- Mr. Diamantoukos is obliged to testify in a manner that conveys the inherent uncertainty of IBNR projections:

> [a]ctuarial forecasts or projections have a degree of uncertainty because they are based on the probability of occurrence of future contingent events. One of the most important duties of an actuarial expert witness, and perhaps the most difficult, is to convey the inherent uncertainty of actuarial estimates or forecasts. The actuary giving expert testimony should state that a forecast necessarily has a degree of uncertainty associated with it.[115]

The reserve estimation process is subject to a variety of influencing factors including, though not necessarily limited to: social, environmental, technological,

[112] *Id*.

[113] Diamantoukos Direct at 86, Line 17 through Page 88, Line 5.

[114] JTE 38 at 100.

[115] JTE 53 at 4 (Tillinghast-Towers Perrin Report, citing Actuarial Standard of Practice No. 17, Expert Testimony by Actuary, promulgated by the Actuarial Standard Board, January, 1991).

medical, judicial and legislative changes.[116] Those factors can have a profound effect upon an insurer's and reinsurer's estimated liability as noted by one actuarial firm:

> In addition, the reserve estimation process is subject to adverse or favorable events that are unknowable, or at best speculative. Prior to the enactment of CERCLA, potential pollution liabilities would have been unknowable. Today, liability associated with tobacco or electromagnetic fields would have to be considered speculative. Such liability is being discussed, but there is not yet a body of judicial decisions that indicates that such claims will ultimately prevail.
>
> It should not be assumed that all such unknowable or speculative events are adverse. Changes in CERCLA and related legislation could have a **profoundly favorable** effect on insurance liabilities. The recent trend in judicial decisions related to expert testimony ("junk science") could also materially reduce future claims values.[117]

Indeed Senate Bill 1125 as passed by the U.S. Senate Judiciary Committee, legislation currently pending in Congress to address asbestos reform, could indeed have profound effects upon the liability of insurers and, in particular, insolvent insurers. However, those effects cannot be projected or measured at his point in time.[118]

In addition to the uncertainty of asbestos-related legislation, recent asbestos-related judicial decisions illustrate the continuing uncertainty surrounding insurers' liability. For example, the New York Supreme Court recently decided in *Appalachian Insurance Company v. General Electric Company*, No. 122807/96 N.Y. Sup., N.Y. Co. (April 7, 2003) that each claimant's exposure to asbestos constituted a separate "occurrence," therefore the underlying insurance without aggregate limits had not been exhausted and the company's excess layer of insurance had not been reached. This

[116] Diamantoukos Cross at 118, Line 9 through Page 119, Line 9.

[117] JTE 53 at 5 (Tillinghast-Towers Perrin Report).

[118] Diamantoukos Cross at 119, Line 12 through Page 120, Line 3.

decision is likely to have significant favorable effects on insurers,' and in turn on reinsurers,' asbestos liability.

Similarly, a recent decision in September 2003 by the U.S. District Court in *Travelers Casualty & Surety Co. v. Gerling Global Reinsurance Corp. of America*, 285 F. Supp. 2d 200 (D. Con. 2003), granting the reinsurer's motion for summary judgment, found that the reinsurer was not bound by the insurer's allocation of settlement payments to its insured. While Travelers argued that Gerling was bound to accept its allocation of the settlement it made with Owens-Corning, the court found that the reinsurer was not so bound under the "follow-the-fortunes" or "follow-the-settlements" doctrine. *See*, *infra*, discussion at section III. B. ii. This decision will likely have significant favorable effects on reinsurers' asbestos liability.

Actuaries cannot predict future legislative changes any more than they can predict shifts in judicial decisions. As observed by both Mr. Diamantoukos and Tillinghast-Towers Perrin, the only way to achieve certainty in actuarial projections is the passage of time.[119]

The RAA recognizes that this Court approved the estimation and acceleration of IBNR in its Interim Order, but it did so on a purely legal basis, without the benefit of a factual record. Given that the testimony of both parties clearly demonstrates that IBNR estimates are **far** from "absolute," what does "deeming" claims to be absolute mean in the context of the statutory mandate? If claims can be deemed absolute by fiat, even though they really are not absolute, then the statutory requirement has no meaning.

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[119] RAA Deposition Designations, Christopher Diamantoukos, October 26, 2001 (hereinafter "Diamantoukos Dep. October 26, 2001"), Page 1017 Line 24 through Page 1018, Line 14; JTE 53 at 7 (Tillinghast-Towers Perrin Report).

C. There is a Wide Variance in IBNR Estimates

In addition to being far from absolute, the evidence adduced in this matter demonstrates that there is a **wide** variance in the actuarial estimates of IBNR. This evidence was elicited from both the Liquidator and the reinsurers and was stipulated to by the parties.

While the actuarial study of the Liquidator's actuary, Mary Lou O'Neil, is outdated, a review of the record reveals the significant differences between the way in which various actuaries have received her analyses. Ms. O'Neil received a number of communications from industry actuaries objecting to her methodology.[120] Previous parties to this matter had hired the actuarial firm of Milliman & Robertson to produce a report that criticized Ms. O'Neil's work. [121] Additionally, criticism was received from the actuarial firm of Tillinghast.[122] Actuaries from the firm performing a peer review of Ms. O'Neill's work (Ernst & Young) had yet other comments and criticisms with respect to it and agreed that various methodologies that she used could overestimate asbestos and environmental liabilities.[123] Indeed, Ms. O'Neil amended her methodology to some

[120] JTE 67, actuary for Underwriters Reinsurance Company declining commutation because O'Neil IBNR analysis used assumptions that were "untenable;" JTE 68, letter from Cameron General Corporation noting "strong disagreement" with O'Neil's methodology on behalf of reinsurer, RCA; JTE 69, letter from Mead Reinsurance Corporation noting that Integrity's estimate of liabilities is significantly higher than that of their independent actuaries and stating that they cannot justify the Integrity numbers to either their regulators or their retrocessionaires; JTE 70, letter from Insurance Corporation of Hannover noting that Integrity's IBNR studies are "extremely questionable." Hannover observed that "[t]he bulk (80%) of the projected IBNR pertains to asbestos and environmental claims. The future development in these areas is everybody's guess but it is safe to assume that it will take a very long time for these losses to become paid." Diamantoukos Direct at 68, Lines 6 Through 13.

[121] JTE 106.

[122] JTE 64.

[123] RAA Deposition Designations, Christopher Diamantoukos, February 19, 1998 (hereinafter "Diamantoukos Dep. February 19, 1998"), Page 238, Line 19 through Page 239, Line 10 (agreeing that the O'Neil methodology was not the preferred approach and "in fact might be rejected in comparison to others;" Page 238, Lines 6 through 18 ([t]he methodology, as I described it earlier, with the successive

degree based on criticisms she received.[124] The point is not which firm was closer to being on target with respect to the estate's ultimate liabilities (something that will not be known for years) but rather the fact that there is substantial disagreement among the major U.S. actuarial firms concerning Integrity's liabilities and those disputes have never been resolved,[125] nor are they susceptible to resolution.

Mr. Diamantoukos has testified in this matter that the estimation of extraordinary hazards is complex, subjective and subject to substantial variation. In fact, Mr. Diamantoukos testified in court and in his deposition that in estimating extraordinary-hazards there is an incredible amount of literature that an actuary can rely on,[126] that there is no consensus in the actuarial profession concerning the appropriate method [127] and that it requires a customized and subjective process:

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application of factors by year, would indeed or could indeed, could overestimate the liabilities of asbestos and environmental."

[124] RAA Deposition Designations, Christopher Diamantoukos, April 1, 1998 (hereinafter "Diamantoukos Dep. April 1, 1998"), Page 262, Line 23 through Page 265, Line 25, Page 269, Line 1 through Page 271, Line 14.

[125] The estate subsequently abandoned its effort to estimate the estate's overall liabilities and perform a top-down estimation and amended the Plan to provide for a ground-up estimation whereby claimants must submit their own projected IBNR. But regardless of which estimation approach is pursued by the Liquidator, the inability of the nation's largest actuarial firms to coalesce around a common view of Integrity's asbestos and environmental exposures is clear evidence of the fact that these estimates cannot be made "absolute" and any attempt by the Liquidator to do so is unfair and inequitable.

[126] Diamantoukos Dep. August 5, 1998 at 810, Line 22 through Page 811, Line 23 (in response to a question whether he had tried to collect the literature on estimation of extraordinary-hazard exposure, the witness responded that he had "made some vain attempt to do that, I have two shelves in my office that has nothing else but such information. I'm afraid though, it is probably still incomplete."

[127] Diamantoukos Dep. August 5, 1998 at 809, Line 5 through 19 (testifying that "[t]he actuarial literature, per se, as would be encompassed by the advises of the American Academy of Actuaries, would offer no consensus as to how to estimate it, and the literature to date to my knowledge really provides alternatives, more than one method that could be employed depending on the situation, and, indeed, some of the literature to date is not explicit in terms of describing in full the mechanics, the actual details of the calculations underlying those methods.")

Q. It sounds like it's something that's a process that's fairly customized to what each particular actuary – the construct each particular actuary brings to what they're doing. Is that accurate?
A. Yes, it is. It's quite accurate. In my recent experiences I am actually surprised at the diversity that exists in this area.
Q. I think one of the things that I've been pressing for, somewhat unsuccessfully, is to get the road map for how it's done, assuming there's only one and we can find it. I take it from what you're saying there isn't just one?
A. No, there isn't, and it's my intent to publish it, at least my approach to the problem, and I'm sure once I do, it will be attacked and torn to shreds, and the process will then start to disclose some of these methodologies, and I guess someone has to take the first lumps.[128]

Mr. Diamantoukos also noted the problems that the nation's rating agencies have had with trying to estimate asbestos and environmental exposures.[129] In 1994, A.M. Best predicted that the combined asbestos and environmental exposures of the industry was a best-case scenario of $55 billion and a worst-case scenario of $623 billion. [130] Interestingly, Mr. Diamantoukos testified that when actuaries produce a range, that each number within the range must be as likely as any other to represent the appropriate liability.[131] Only two years later, A. M. Best revised these numbers and reduced the worst-case scenario from $623 billion to $92 billion, an 85% reduction.[132] One does not have to be an actuary to note the huge variance between those numbers. While A.M. Best, and others were clearly having difficulty in the 1994 to 1996 period getting an

[128] Diamantoukos Dep. August 5, 1998 at 813, Line 14 through Page 814, Line 7.

[129] Diamantoukos Dep. April 1, 1998 at 285, Line 19 through Page 288, Line 2.

[130] JTE 54 at 6-7.

[131] Diamantoukos Dep. February 19, 1998 at 61, Line 3 through Page 62, Line 5. As previously noted herein, so great is the range surrounding Integrity's estimated losses that the Liquidator's actuary could not even stake out a reasonable range between a high and low estimate. *See supra* footnote 76.

[132] JTE 55 at 1.

accurate picture of the industry's asbestos and environmental exposures, Mr. Diamantoukos provided some context to the problem and testified in 1998 that these difficulties persisted:

> [a]n order of magnitude change over that period of time begs the question as to whether or not those that constructed these methodologies understand well enough the problem at hand and are making assumptions that are reasonable or perhaps being borne out in practice. I would like to think that sometime soon we can agree on an order-of-magnitude estimate and then worry about should it be 60 billion or 70 billion, $80 billion or perhaps $40 billion. I'm not convinced that we are at that level yet.[133]

Since that time, the evidence shows that environmental liabilities have continued to go down while asbestos liabilities have increased.[134] While these aggregate estimates for the entire industry have been and continue to be subject to tremendous fluctuations, it is significant to note that Mr. Diamantoukos further testified that emergence patterns are **virtually impossible** to ascertain at the insured level because of low frequency, and a lack of actual loss information to observe and measure.[135]

The important points to take away from these documented examples is the wide variance among different actuaries; the wide variance among the same actuaries over time; the extreme difficulty in estimating industry-wide exposures, not to mention the virtual impossibility of accurately estimating emergence at an individual claimant level; and the enormous inconsistency between these variations juxtaposed to the New Jersey

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[133] Diamantoukos Dep. April 1, 1998 at 287, Line 17 through Page 288, Line 2.

[134] Diamantoukos Dep. April 1, 1998 at 290, Line 1 through 20; Page 293, Line 5 through 11. JTE 51; JTE 57; JTE 56.

[135] Diamantoukos Dep. October 26, 200 at 1053, Line 9 through Page 1054, Line 16; JTE 53 at 5-6, Tillinghast-Towers Perrin Report noting that "[i]n general, uncertainty increases as the calculations move away from the aggregate toward the specific. Loss reserves for the entire company typically have less uncertainty than projections for specific layers of loss such as ceded excess of loss reinsurance. Estimates for the whole are typically less uncertain than estimates for individual policyholders."

statutory mandate that all claims be made absolute. There is no disagreement among the parties that actuarial projections vary widely as they stipulated to that fact before the hearing.[136]

Indeed, in order for the Plan to be considered fair and equitable, the Deputy Receiver has admitted that the estimates must be subject to estimation in a commercially reasonable manner:

> Q. Would you agree that the Final Dividend Plan in order to be approved must be determined to be commercially reasonable?
> A. Yes.
> Q. In your mind what does commercially reasonable mean in that context?
> A. It should be demonstrated that the features of the plan, the structure of the plan is such that those affected by it are so affected by methodologies or procedures that comport with current business practice in the specific area, be it systems, actuarial techniques, claims evaluation techniques and so forth.
> Q. Does commercially reasonable have any element of ultimate dollar result reasonably similar to the results for which the party contracted?
> A. Yes.[137]

In fact, the Liquidator's expert witness reports, deposition testimony and trial testimony all lead up to this one point, a point that their expert actuarial witness made at trial during direct examination:

> Q. In your opinion, can [IBNR] losses on extraordinary – [IBNR] on extraordinary hazard losses be allocated to reinsurers in a commercially reasonable fashion?
> A. Yes, they can…
> Q. And do you have an opinion as to whether or not [IBNR] on non-extraordinary hazard losses can be allocated to reinsurers in a commercially reasonable fashion?
> A. Yes, and for the same reasons I just mentioned.[138]

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[136] JTE 40, stipulation #15.

[137] White Dep. September 24, 1997 at 425, Line16 through Page 426, Line 8. The Deputy Receiver also acknowledged that reinsurers are "substantially affected" by the Plan. *Id*. at 381, Lines 19 through 24.

But what did Mr. Diamantoukos mean by "commercially reasonable"? He meant that the estimates could be made but that the parties would have to use those estimates to negotiate a consensual commutation. Indeed his answer to that question was clear on cross-examination:

> Q. What do you – what you meant by commercially reasonable, can you – can you give me a definition what you mean by commercially reasonable in a context in which you testified today?
> A. The context that I testified, I was dealing with a situation where you had two entities, insurer, reinsurer that were knowledgeable in these areas and could actually exchange money relating to a transfer or release of an obligation or a liability.
> Q. A consensual transaction, that is correct[?]
> A. Yes, similar to the commutations we talked about earlier, yes.[139]

The Liquidator's expert did not testify that IBNR was susceptible to estimation in a commercially reasonable manner for the purposes that the Liquidator seeks to use IBNR estimates under the Plan, compelling involuntary payment by reinsurers. In fact, he stressed that the estimates must be used for consensual, negotiated purposes in order to be commercially reasonable:

> Q. Then in the context in which you testified today that you believe that Integrity's liabilities can be estimated by a commercially reasonable fashion, do you believe that is the case with respect to compelling [IBNR] payments from reinsurers[?]
> MR. NOVAK: I'm going to object to the form of that question.
> THE COURT: I'll allow it.
> A. The commercially reasonable context in which I quoted this was not one of compelling one side to do one thing or the other. The context was again, I think you used the word consensual, and in my opinion what could be done is that in a commercially reasonable fashion that Integrity could engage in separate commutations with each and every individual reinsurer where they would consensually agree to exchange money, and in that regard would actually exchange money related to [IBNR].

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[138] Diamantoukos Direct at 107, Lines 7 through 23.

[139] Diamantoukos Cross at 124, Line 20 through Page 125, Line 6.

Q. And then, I take it, you're not rendering an opinion today as to whether or not it would be commercially reasonable to use these estimates – liabilities – estimated liabilities of Integrity for the purpose of compelling payment to reinsurers?

A. My opinion is that you would have to go through this entire process with all the reinsurers to come up with that answer, because now everyone has agreed and there would be no compelling anymore.

Q. It would have to be consensual?

A. Exactly.[140]

Mr. Diamantoukos, an experienced actuary in the industry knows well the limitations of his profession. They have no crystal balls. They have done the best they can to improve the techniques used in their profession. This means better reserving for insurance and reinsurance companies, which leads to, among other benefits, earlier detection of potential problems. But the fundamental principle remains – actuarial projections are just that – predictions of future results. But New Jersey law, and the insurance and reinsurance contracts into which Integrity voluntarily entered, demand more. The Liquidator has produced no evidence to the contrary.

III. Public Policy Considerations Should be Determined by the Legislature Not the Courts

When it comes to public policy determinations it is important that the People's chosen policymakers have the opportunity to weigh and debate the various and often-competing interest of stakeholders. Legislatures are uniquely structured and appropriately charged with that responsibility. A court's function is not to rewrite legislation, and it should not attempt to do so simply because the legislation does not comport with the court's idea of how the statute should read. New Jersey's 1947 Constitution allocates the writing of legislation to the Legislature, N.J. Const. art. IV, and interpretation of the laws to the Judiciary. N.J. Const. art. VI. *See also* N.J. Const. art. III (separation of powers). It

[140] Id. at Page 125, Line 19 through Page 126, Line 23.

is, of course, not for the courts to write or rewrite legislation. *Rollins Leasing v. Director of Taxation*, 279 N.J. Super. 540, 551, 14 N.J. Tax 289, 653 A.2d 1131 (App. Div. 1994); *Space v. Division of Employment Security, Department of Labor*, 60 N.J. Super. 380, 390, 159 A.2d 131 (App. Div. 1960).

The RAA has maintained since the initial filing of the Plan that it is contrary to New Jersey law and recognizes that it implicates important public policy issues. But the New Jersey Legislature, not this Court, must resolve those issues. Other courts have recognized this and other legislatures have weighed and debated the issues and determined that the public interest was against a change in the law that would permit estimation and acceleration of IBNR. While two legislatures have decided otherwise, the regulators in those states have understood that the determination was one which the legislature, not the courts should make.

A. Status of Claim Estimation/Acceleration Laws in the U.S.

The issue of claim estimation and acceleration of reinsurance recoveries has been addressed by a number of legislatures and insurance departments throughout the country as noted in the deposition of Robert Craig, a bankruptcy practitioner and U.S. insurance receiver.[141] Mr. Craig's deposition exhibit illustrates that claim estimation has been defeated in bills in Alabama, California (introduced and defeated three years in a row), Idaho, Mississippi, Oklahoma, Pennsylvania, Rhode Island and Tennessee. [142]

[141] JTE 90.

[142] JTE 90.

Additionally two states have enacted laws that permit claim estimation but explicitly prohibit the use of such estimates to accelerate reinsurance recoveries.[143] Two other states have enacted laws permitting claim estimation but those statutes incorporate important limitations with respect to estimation and procedural protections for reinsurers. The Illinois statute only permits the estimation of IBNR for ceding insurers, not for policyholders in recognition of the fact testified to by experts for both the Liquidator and the reinsurers -- that estimates become more speculative as one moves toward the policyholder level.[144] While the Utah statute permits the estimation of a claimant's IBNR, the recovery from reinsurers on the basis of estimated IBNR is achieved through an arbitration process with various safeguards built in to protect the reinsurer, e.g., the appointment of an arbitration panel with representatives selected by both the liquidator and the reinsurer, the submission of commutation proposals by both the liquidator and the reinsurer, the prohibition against accelerated payment of IBNR if it would impair the financial condition of the reinsurer, and the preservation of contractual commutation clauses which supersede the statutory process.[145]

B. The Use of Schemes of Arrangement in the U.K.

The Liquidator's expert witness, Vivien Tyrell, a London solicitor, has submitted a report that discusses the use of schemes of arrangement in England and Wales (the

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[143] MO rev. Stat. § 375.1220; Conn. Gen. Stat. § 38a-939.

[144] 215 ILCS 5/209. The RAA does not acknowledge that this statute would result in the acceleration of reinsurance recoveries. As noted by the reinsurers' expert, Robert Craig, the fact that a receivership court allows an IBNR "claim" does not necessarily mean that "claim" is covered by the reinsurance contract and can be recovered from the reinsurer. Craig Dep., September 11, 2003, Page 213, Lines 15 through 20.

[145] Utah Code Ann. §31A-27-330.6. Nothing herein should be construed to suggest that the RAA believes that the Utah statute is an appropriate resolution to these issues.

"UK").[146] Ms. Tyrell describes the legal basis for estimation in the UK[147] and the methods employed.[148] She goes on to note that:

> [w]hilst it is trite to say that the only thing certain about an estimate is that it will be wrong, creditors have surrendered the concept of absolute precision in return for the following advantages: [listing earlier distribution, time value of money, earlier certainty of the value of claims, set-off, and time limit for determination of claims]."[149]

The reinsurers also produced an expert to testify about UK schemes of arrangement. As a partner for Coopers & Lybrand and the named scheme actuary or peer review actuary in many schemes of arrangement, Bryan Joseph specializes in providing actuarial services to liquidators and companies in run-off.[150] Mr. Joseph describes in his expert report the various methods for winding up the affairs of an insurer in the UK, the problems associated with run-offs and insolvencies, the two types of schemes of arrangement used in the UK and two case studies.[151]

Both the expert reports of Ms. Tyrell and Mr. Joseph demonstrate that UK schemes of arrangement employ an estimation methodology. What Ms. Tyrell also makes clear is that estimation is **pursuant to statute.** [152] Indeed she cites Section 6 and Schedule 1 of the *Insurance Companies (Winding-Up) Rules,* 1985. Therefore, unlike New Jersey law, which **mandates** that claims be made **absolute** before they may be

[146] JTE 8.

[147] JTE 8 at 4.

[148] JTE 8 at 13.

[149] JTE 8 at 9.

[150] JTE 105, Appendix B, curriculum vitae of Bryan R P Joseph.

[151] JTE 105. Mr. Joseph also notes that schemes of arrangement have been employed in other jurisdictions, including: Bermuda, Ireland, Singapore, Israel, Hong Kong and Mauritius. *Id*. at page 13.

[152] JTE 105 at 5.

allowed, UK law **mandates** that certain types of claims be **estimated**. Therein lies a fundamental difference between the laws of New Jersey and the United Kingdom.

i. Estimations are not Binding on Debtor Reinsurers Under English Law

There is another significant difference between what the Liquidator attempts to do by way of the Plan and the manner in which schemes of arrangements are carried out that directly impacts the issue at bar-- whether the estimations of creditor claims can be binding upon the reinsurers as debtors to the estate. Mr. Joseph made it abundantly clear in his report, when he stated:

> In the UK and its legislatively related territories reinsurers are **not** bound to respond to contracts, except on the basis of actual settled (or agreed) claims. Therefore, in those circumstances where the IBNR component is substantial and non-specific (described as omnibus IBNR in the Integrity Final Dividend Plan) companies involved in cut-off arrangements would normally enter into commutation negotiations with each reinsurer or group of reinsurers to obtain the value of the contracts before any distribution of assets is contemplated. Commutations are voluntary arrangements conducted on commercial terms between the insurer and its reinsurers. This allows the reinsurers to consider the basis of the evaluation of claims and IBNR and then seek to reach agreement on commercial terms. If agreement cannot be reached, then the reinsurer may discontinue the negotiations. (emphasis added) [153]

While Ms. Tyrell notes in her report that Mr. Joseph is not a lawyer[154] and seems to suggest that the estimation of claims utilized in the UK might be binding upon reinsurers,[155] she acknowledges in her deposition testimony that in the UK, reinsurers are

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[153] JTE 105 at 31, para. 918.

[154] JTE 8 at 21, paragraph 4.1.

[155] JTE 8 at 15, paragraph 2.4; *Id*. at 16, section 3 generally.

not bound by law as debtors.[156] Indeed, the reinsurers' expert witness, a Queen's Counsel (barrister) and current Deputy High Court Judge,[157] authored an expert report that clarified a number of issues and confirmed that debtor reinsurers are not bound by estimation of IBNR under English law.[158] In his deposition, Mr. Crystal testified:[159]

> Q. You have repeatedly stated both in your report and in today's testimony that a liquidator can bind creditors of the Estate under certain circumstances, but can't bind debtors of the Estate. What is the source of that rule?
>
> A. Well, what I have said is that the company binds liquidators, and the creditors can enter into a scheme of arrangement which binds the creditors and affect their rights. That's the first. I have also said that, that being the philosophy, the liquidator or the company can't affect the rights the debtors to the company have under the terms of their contractual arrangement with the company. The source of the rule is that liquidation does not affect the rights of debtors to the Estate.
>
> Q. And is that set forth in a rule, a statute, or a case?
>
> A. Well, it's set forth in the principles that in liquidation a statutory scheme comes into existence which affects the rights of those interested in the Estate. And those who are interested in the Estate for this purpose are the creditors and the company.
>
> Q. So basically that rule is a function of a lack of statutory authorization to bind debtors?
>
> A. No. It's a function of a fundamental of English liquidation law which is only intended to affect the rights of creditors. It's not intended to affect such rights as debtors to the Estate may have.
>
> Q. Where is that principle embodied?

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[156] RAA Deposition Designations, Vivien Mary Tyrell, December 3, 1997 (hereinafter "Tyrell Dep. December 3, 1997"), Page 109, Line 6 through Page 110 Line 18.

[157] JTE 104, Appendix 1, Curriculum Vitae for Michael Crystal; RAA Deposition Designations, Michael Crystal, March 16, 1998 (hereinafter "Crystal Dep. March 16, 1998"), Page 15, Line 23 through Page 17, Line 17 noting that barristers, not solicitors (Ms. Tyrell is a solicitor), are the individuals who traditionally opine on the likely outcome of a decision and are the specialists as opposed to the generalists.

[158] JTE 104.

[159] Crystal Dep. March 16, 1998 at 29, Line 17 through Page 30, Line 17, noting that the Tyrell report was wrong as a matter of law and authored by someone with insufficient expertise to give evidence on English law.

A. It's embodied in the provisions of the act which explain what the nature of the statutory scheme is which arises on liquidation, which you'll find in the Insolvency Act, 1986.[160]

…

Q. This page [page 25 of Crystal's report] addresses the liquidator's attempt to bind debtor reinsurers to estimated IBNR amounts. Correct?
A. Amongst other things. Yes.
Q. And in Paragraph 59 you say that the English Court would regard any attempt to bind debtor reinsurers as highly objectionable. Do you see that?
A. Yes.
Q. Is the reason for this comment that under English law the scheme of arrangement is an arrangement solely between the liq—the Estate and its creditors?
A. The two reasons. That's the first reason. Yes.
Q. What's the second?
A. There's no direct linkage of the amount of what's to be passed on to the insurers to actual loss. And the English Court would regard the latter as an unwarranted interference.
Q. What do you mean by "actual loss"?
A. What I mean by "actual loss" is this. You start with a contract of insurance which provides for payment on an occurrence and loss related to the occurrence. That is then sought to be passed on under the reinsurance contract to the reinsurer. If one is calculating the claim on an entirely mathematical formula you never, for the purposes of the reinsurance contract, under English law have a loss which falls within the terms of the policies.
So that's the second reason why the English court wouldn't take any notice of any attempt to bind the reinsurers.[161]

Mr. Joseph noted that although debtor reinsurers are not bound by estimated IBNR, reinsurers "have been positive" about both estimation and reserving schemes once it is demonstrated to them that the methodology and assumptions being used are valid and provide commercially sound results.[162] It is important to note that absent compulsion, the

[160] Crystal Dep. March 16, 1998 at 116, Line 21 through page 118, Line 7.

[161] Crystal Dep. March 16, 1998 at 133, Line 19 through page 134 Line 6.

[162] JTE 105 at 14, para. 503 and 505.

UK experience shows that reinsurers desire the certainty of a reasonable commutation and are willing to engage in meaningful negotiations to achieve that result.[163] Meaningful negotiations, however, cannot be conducted when one side has the ultimate power of compulsion. It is the process of two parties wanting to achieve a desired result, both with the ability to walk away from the table, that defines the term "negotiation" and it is, according to the Liquidator's own actuarial expert, the consensual nature of the process that makes it commercially reasonable.

ii. Follow the Fortunes Does Not Compel Payment from Reinsurers on the Basis of Estimates

Although Ms. Tyrell suggests in her report that reinsurers might be obliged to pay estimated claims pursuant to a "follow-the-settlements" clause in their reinsurance contract,[164] she admits in her deposition testimony that the matter has never been addressed in a UK court.[165]

A follow the fortunes clause in a reinsurance contract obligates the reinsurance company to abide by the claims handling decisions of the ceding insurance company, so long as those claims handling decisions were made in good faith and in a reasonable and professional manner, and so long as the payment is one that is proper under both the insurance contract and the reinsurance contract.[166]

A reinsurer always is affected by the fortunes of its ceding insurer in a general sense, and in that sense, follows the ceding insurer's fortunes. However, notwithstanding

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[163] JTE 105 at 14, para. 504 and 505.

[164] JTE 8, Page 16, section 3.

[165] Tyrell Dep. December 3, 1997 at 78, Lines 10 through 19.

[166] *North River Ins. Co. v. CIGNA Reinsurance Co.*, 52 F.3d 1194 (3d Cir. 1995); *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.*, 4 F.3d 1049 (2d Cir. 1993).

the follow the fortunes principle, a reinsurer is only obliged to reimburse the reinsured for the kind of loss reinsured.[167] Thus, a reinsurer is not obligated to indemnify a reinsured for payments clearly outside the terms of the original policy, which in the case at bar includes estimated IBNR.[168] The obligation of a reinsurer to abide by the claims handling decisions of the ceding insurer exists only if the reinsurer agrees in a specific contractual provision not to exercise a separate defense to policy loss as between reinsured and reinsurer. Therefore, unless the reinsurance contract contains a follow the fortunes clause, the reinsurer is not barred from reviewing the ceding insurer's claims handling decisions as a *de novo* matter:

> It must be recalled that each contract of reinsurance is a separate contract, and not an extension of an insurance contract. Within the concept of following fortunes, a reinsurer usually agrees as a specific contractual provision not to exercise a separate defense to policy loss as between reinsured and reinsurer. Otherwise, as a matter of separable interest, such a separate defense could be made by the reinsurer.[169]

It is precisely because the reinsurer may assert all defenses the ceding insurer could have raised against the policyholder due to the indemnity nature of reinsurance contracts that a "follow the fortunes" clause in a reinsurance contract is necessary. In fact, since the mid-nineteenth century, courts wisely have rejected arguments that there exists an implied duty of "follow the fortunes" in reinsurance contracts, and no published court opinions

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[167] *American Ins. Co. v. North American Co. for Propery and Cas. Ins.*, 697 F.2d 79, 81 (2d Cir.1982).

[168] *Id*.

[169] Kramer, *The Nature of Reinsurance, in Reinsurance* 1-31 at 12 (R. Strain 1980); Debra Baker, *The Effect of Evidence of Industry Custom and Practice and the Parties' Course of Dealing on the Application of "Follow the Fortunes" in Reinsurance Contracts*, 31 Tort & Ins. L.J. 947, 950-951, 956 n. 17 (1996).

since the mid-990s have accepted the argument that a duty to follow the fortunes is implied as a matter of law.[170]

As one court explained, "it would be an unwarranted and indeed tortured construction of [the follow the fortunes] clause to hold a reinsurer bound . . . to pay if the [ceding] insurer paid moneys to its insured on a claim completely without the scope of the policy and not in good faith."[171] Rather, a reinsurer is bound to pay when ceded claims reasonably fall within the scope of the reinsured coverage and the cedent has acted in good faith. For this reason, a reinsurer is entitled to inquire whether a cedent has presented covered claims. A follow the fortunes clause is also limited by and subject to all of the other terms of the reinsurer's coverage. A reinsurance contract may contain an exclusion or other term that precludes coverage for certain losses covered by the underlying policy. Under these circumstances, a follow the fortunes clause does not require a reinsurer to pay for losses outside the terms of the reinsurance contract. A follow the fortunes clause cannot create liability that is inconsistent with the actual provision defining the scope of the reinsurance.[172] A follow the fortunes clause is

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[170] *New York State Marine Ins. Co. v. Protection Ins. Co,* 18 F. Cas. 160 (D. Mass. 1841); *Village of Thompsonville v. Federal Insurance Co.*, 233 Mich. App. 422 (1999); *Int'l Surplus Lines Ins. Co. v. Certain Underwriters at Lloyd's of London*, 868 F.Supp. 917 (S.D. Ohio 1994); *Mentor Ins. Co. (UK) Ltd. v. Norges Brannkasse*, 996 F.2d 506 (2nd Cir. 1993); *Unigard Security Ins. Co. v. North River Ins. Co.*, 762 F.Supp. 566 (S.D.N.Y. 1991); *Christiania General Ins. Corp. of New York v. Great American Ins. Col.*, 979 F.2d 268 (2nd Cir. 1992).

[171] *Insurance Co. of North America v. United States Fire Ins. Co.*, 322 N.Y.S.2d 520, 523 (N.Y. Supp. 1971).

[172] *Calvert Fire Ins. Co. v. Yosemite Ins. Co.*, 573 F.Supp. 27 (D.C.N.C. 1983); *Bellefonte Reinsurance Co. v. Aetna Cas. and Sur. Co.*, 903 F.2d 910 (2nd Cir. 1990); *see also American Marine Ins. Group v. Neptunia Ins. Co.*, 775 F. Supp. 703, 708 (S.D.N.Y 1991) ("the reinsurer is only required to reimburse the reinsured for the type of loss that is covered by the policy of reinsurance"); Kramer, *The Nature of Reinsurance in Reinsurance*, at 13 (R. Strain ed. 1980) ("In a word, the concept of follow the fortunes cannot create a reinsurance where none existed").

therefore not an unsophisticated mandate to a reinsurer to blindly follow a cedent's insurance fortunes.

As noted in I. C. i. of this Memorandum, Integrity's reinsurance contracts contain a Loss Settlements clause with subsection B giving Integrity broad discretion to adjust, settle or compromise "losses" and providing that the reinsurer shall be bound in proportion to its participation on the risk.[173] However, the discretion granted by subsection B is then limited by subsection C which states:

> [a]ll loss settlements by [Integrity] shall be binding upon the Reinsurers **provided that such settlements are within the terms and conditions of the original policy(ies) and within the terms and conditions of this Agreement**.[174]

The follow the fortunes clause is a specific contract provision that was developed for a specific business reason. Although essential to the reinsurance business, the principle of follow the fortunes was never intended to insulate the cedent from the consequences of its own poor judgment, careless adjusting practices, or unreasonable coverage decisions. Likewise, a receiver cannot use the principles of follow the fortunes to broaden reinsurance coverage by approving estimated IBNR as a claim. As noted, the Liquidator's experts have implied that reinsurers should be bound to pay on the basis of IBNR because of the "follow the fortunes" doctrine. This speculation in not only unfounded, but application of such a standard, would create incentives for improper behavior by cedents and receivers alike in regard to their reinsurers.

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173 JTE 22, Bates Stamp # 14426.

174 JTE 22, Bates Stamp #14427.

C. The Plan Favors Large Policyholders at the Expense of Individual Policyholders, Small-Medium Size Businesses and Claimants with Absolute Claims

The Plan creates advantages for large policyholders to the detriment of individual policyholders and small and medium size businesses because large policyholders have the loss experience and the wherewithal to hire actuaries to produce an IBNR estimate. The fact that a large policyholder has these resources does not diminish the fact that there are other policyholders who may have suffered a loss of which they are not yet aware—and for which they will be unable to claim any IBNR component to compensate their future loss.

One need not look far to see how the Plan—while unlawfully depriving reinsurers of their contractual rights—also will harm policyholders, especially individuals and small, less sophisticated entities. In recent years, there have been a growing number of asbestos claims against "peripheral defendants." A.M. Best, *Largest Increase in A & E Losses to Date Seen in 2001*, at 1 (Oct. 28, 2002). Most of these new defendants have not previously faced asbestos exposure. If this trend continues – and there is no reason to believe it will not – there are numerous policyholders who have yet to receive an asbestos claim, but will do so in the future.[175] These new "peripheral" asbestos defendants may not

[175] While Mr. Diamantoukos testified that it was unlikely that such policyholders would be disadvantaged by the Plan (Diamantoukos Direct, Page 113, Line 14 through Page 116, Line 1), he also testified that it will likely take at least another 41 years for non-extraordinary-hazard losses to develop and another 50 years for extraordinary-hazard losses to develop (Diamantoukos Direct, Page 99, Line 8 through Page 100, Line 12). His estimate of development makes his testimony with respect to the first point, difficult at best, to comprehend. Tillinghast-Towers Perrin predicts that "[l]atent injury claims such as those arising from asbestos and silicone implants may take in excess of thirty years to ermerge (JTE 53 at 6). The fact that Mr. Diamantoukos testified that the Integrity book of business is now at a 20 to 21 year development (Diamantoukos Direct Page 100, Lines 2 through 4) mens that some claims have not ermerged and those claims can certainly be the claims of individuals and entities other than large corporate insureds whose "claims" will be cut off by the Plan. Mr. Diamantoukos also conceded that there are new causes of loss emerging on a continuous basis (Diamantoukos Cross, Page 117, Line 17 through Page 118, Line 8.)

presently know of their potential asbestos exposure, may lack the resources to obtain an actuarial study to support a "claim" for IBNR losses, and /or may simply lack the loss experience to support actuarial projections. Therefore, with respect to these policyholders, the plan is contrary to the interest of justice and in violation of the Act. N.J.S.A.§ 17:30C-4(d).

Mr. Crystal recognized this fact that certain policyholders would be benefited at the expense of others when he stated in his report:

> Thirdly, it may be that certain classes of policyholders will be better placed than others to file specific claims for IBNR, rather than leaving it to the independent actuary to make the calculations. It appears that large policyholders will be best placed to make those calculations, as they will have the actual loss experience on which to base their figures, and perhaps the actuarial skills to make the necessary calculations. Similarly, it may also be the case that policyholders who have taken out cover for certain classes of business are disadvantaged, if that type of business has not yet yielded any significant loss experience, for example, a sole practitioner or small firm of professionals insuring against long tail risks which happen thus far not to have produced any known claim.[176]

The actuarial firm, Tillinghast-Towers Perrin has also noted the inequities that would result from the use of actuarial projections in insurance insolvencies:

> Each policyholder would be allowed to estimate the value of all claims known and unknown. While at first glance this appears to treat all policyholders in a comparable manner, because of the increased uncertainties associated with estimating loss reserves for smaller segments, this process will tend to favor larger policyholders. The larger policyholders may have a sufficient base to form a reasonable estimate, subject always to effects of currently unknowable events. The smaller policyholders do not necessarily have such volume and estimates for currently unknown claims would have considerable uncertainty,

[176] JTE 104, Crystal Report, page 27, paragraph 63.

> perhaps to the point of not being useful. The smaller policyholders would also be similarly disadvantaged in the estimation of the ultimate liability for known claims.
>
> …
>
> A distribution of the assets of an insolvent insurer based on such estimates would overpay policyholders whose claims would have ultimately settled below the estimated reserve level and underpay those whose claims would have ultimately settled for more. This estimation increases the risk [of] uncertainty for the policyholder versus waiting for all claims to reach natural adjudication. This is counter to the rationale for the original purchase of insurance –the transfer of the risk of loss in exchange for a fixed premium.[177]

The Plan's preferential treatment of large corporate insureds will result in some of the largest and most notorious polluters and asbestos manufacturers being the primary beneficiary of the claim estimation process. This reverse "Robin Hood" effect, wherein the poor subsidize the rich may not only result in windfalls to large corporations at the expense of other claimants – it will deprive reinsurers of funds they may never owe to the advantage of corporate insureds that dwarf them in size.[178]

In addition to the disadvantages that will be borne by individual policyholders and small and medium size businesses that cannot produce estimates for potential future claims, all claimants that have reported and allowed claims that become absolute in accordance with § 17:30C-28a or are properly allowed pursuant to § 17:30C-28b, will suffer the dilution of their claims as the speculative IBNR "claims" of large policyholders share in assets that New Jersey law requires be preserved for those with claims that meet

[177] JTE 53 at 6.

[178] Integrity insured many Fortune 1000 companies including, but not limited to: Dow Chemical, Revlon, W.R. Grace and Pfizer, the latter with a shareholder equity of $70 billion, entities with far more net worth than any of the world's reinsurance companies. *See* White Cross November 18, 2003, Page 107, Line 15 through Page 108, Line 19.

the statutory mandate for allowance. It is axiomatic that in the context of an insolvency, paying some policyholders that ought not to be paid or paying them in excess of what the contract and the law allows will result in some policyholders being unduly enriched while others are disenfranchised.[179]

While this disparate treatment might not be fatal to a scheme of arrangement under UK law because the applicant proposing the scheme could separate out various classes for separate treatment (but must still obtain the voting approval of the subordinated class),[180] that remedy is not available in the United States. New Jersey, like most if not all other states, has a statute that prohibits the creation of subclasses. N.J. Stat. §§ 17:30C-26; 17B:32-71.

If New Jersey had a law that authorized schemes of arrangements and provided for the vote of the various affected classes, there might be a broader range of possible options for dealing with the Integrity estate. But the law does not authorize such options and the proper place for weighing the interests of the various stakeholders, including large and small policyholders, guaranty associations and reinsurers, is in the State legislature.

D. The Interim Order Permitting Estimation/Acceleration of IBNR Harms the Guaranty Associations and the Public

In its Interim Order, the Court found that public policy considerations support the estimation and acceleration of IBNR, in part, because of the effect that reinsurance

[179] To the extent that the claims of such claimants are fully covered by guaranty associations, they may not receive less recovery. However, those claims that are in excess of guaranty association coverage or are excluded or subject to statutory defenses will be subject to dilution. Similarly, the claims of guaranty associations will be subject to such dilution, to the detriment of policyholders, taxpayers, and the solvent insurance industry, all of who fund the cost of guaranty association coverage throughout the U.S.

[180] JTE 104, Crystal Report, page 27, paragraph 64.

recoveries would have on insurance guaranty associations, and in turn, on the public.[181] But the Court's Interim Order will, in the long run, harm the nation's insurance guaranty associations and be costly to the public.

As noted in section I. B. of this Memorandum, neither policyholders nor third parties can share in the distribution of estate assets as fourth priority claimants unless their claims "aris[e] from and [are] within the coverage of and not in excess of the applicable limits of insurance policies and insurance contracts" of Integrity.[182] Similarly, the nation's insurance guaranty associations, like the New Jersey Property-Liability Insurance Guaranty Association, pay claims to the extent that such claims are "covered claims" within the statutory definition of their applicable guaranty association act. Section 17:30 A-5 of the New Jersey Property-Liability Insurance Guaranty Association Act ("GA Act") defines a "covered claim" using identical language to that found in § 17:30C-26(c)(4), providing

> "Covered Claim" means an unpaid claim, including one of unearned premiums, which arises out of and is within the coverage, and not in excess of the applicable limits of an insurance policy to which this act applies…[183]

Indeed, if this Court can interpret the language of § 17:30C-26(c)(4) as including IBNR within the statutory definition of a fourth priority claim, then this Court, or another Court, can certainly consider IBNR a "covered claim" for purposes of guaranty association coverage under the virtually identical language contained in § 17:30A-5(d) and the virtually identical statutory language in guaranty association acts throughout the

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[181] Interim Order, pg. 7.

[182] § 17:30C-26 (c)(4).

[183] § 17:30A-5(d).

United States. The obligation of insurance guaranty associations to pay for IBNR as covered claims under policies issued by insolvent insurers throughout the nation will greatly increase the liability of those associations and, in turn, the taxpayers, future policyholders and the solvent insurance industry – all of who fund the nation's guaranty association assessments.[184]

The RAA respectfully submits that this, and other important public policy arguments illustrate that the public policy considerations are not as clear and straightforward as this Court determined in its Interim Order. Once again, the need for and the wisdom of deferring such considerations to the legislative entities created and the policymakers elected to address them is clear. This Court should not legislate what the New Jersey Legislature has declined or never been given the opportunity to address.

E. The Need to Weigh other Legislative Alternatives

Recommendations for receivership reform in the United States date back more than a decade.[185] For years the RAA, on behalf of its member companies, has been instrumental in advancing reform efforts.[186] In fact, the RAA has continuously urged the Liquidator to resolve the current dispute by adopting procedures and recommending legislation similar to the Uniform Receivership Law ("URL").[187] The URL was an

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[184] State laws vary as to whether insurers' guaranty association assessments are passed on to policyholders through surcharges, to taxpayers through a tax credit or retained by the insurance industry. *See supra* note 169 for discussion of how the plan will harm guaranty associations and those that fund them.

[185] JTE 103, Craig Expert Report at 11, noting that in the mid-1990s a number of states entered into an interstate compact for the purpose of devising a more effective system for the administration of insurer insolvencies. Hall & Hall, *Insurance Company Insolvencies: Order Out of Chaos*, 12 Journal of Insurance Regulation 188 (1993).

[186] Trial Transcript, November 19, 2003, Redirect Examination of Richard L. White (hereinafter "White Redirect"), Page 39, Lines 16 through 20, testifying that "the RAA has been tireless in trying to develop means and techniques of resolving these situation[s]."

[187] White Redirect at 39, Line 21 through Page 41, Line 2, Page 36 Lines 9 through 12.

attempt by insurance department regulators and receivers, insurance guaranty associations and other effected stakeholders to draft an improved receivership model law.[188] Among the provisions in the URL that would be available to receivers is the use of a liquidating trust, similar to the concept utilized in bankruptcy proceedings.[189] A liquidating trust could be used in lieu of the current proposal to estimate and accelerate reinsurance recoveries. The reinsurers' expert, Robert Craig testified that the concept and structure of the URL (e.g. the liquidating trust) "are far preferable to the FDP approach."[190]

The Deputy Receiver testified about how the Department had considered what he referred to as a cut-off arrangement whereby the Court would "establish a date at which time all claims had to be proven up not on an estimated basis, **but actually determined…"** When asked what would happen to those claimants whose claims had not matured by the cut-off date, the Deputy Receiver testified that " [t]hose claimants, unfortunately would not be able to participate in any distribution from the estate."[191] But that is precisely what the Plan currently provides—to the extent that claimants do not have the wherewithal or the claims volume or history to establish an actuarial estimate of IBNR—any future loss that they do, in fact, sustain will be cut off. A liquidating trust would avoid that result.

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[188] Trial Transcript, November 19, 2003, Cross Examination of Richard L. White (hereinafter "White Cross November 19, 2003"), Page 27, Line 12 through Page 28, Line 15; JTE 103, Craig Expert Report at 11-12.

[189] JTE 103 at 7-8 and 11-12.

[190] JTE, 103 at 12.

[191] White Direct at 73, Line 18 through Page 74, Line 9.

Although the Deputy Receiver criticized this approach because long-tail claimants might receive a smaller dividend than short-tail claimants,[192] he acknowledged that if the actuarial projections in establishing the trust were accurate both types of claimants should receive the same amount.[193] He also acknowledged that the risk of receiving less than other claimants—if the actuarial projections establishing the trust were wrong—was better than the risk of receiving nothing.[194] It is important and curious to note that while the Liquidator seems to have an inordinate trust in the ability of actuaries to produce "accurate" estimates for purposes of the Plan and billing reinsurers—the Deputy Receiver seems to lack that same confidence in the ability of actuaries to project future liabilities of Integrity for purposes of setting aside funds in a liquidating trust.

Another alternative identified by the reinsurers' expert witness is a loss portfolio transfer, whereby a company in the business of buying run-off insurance risks agrees to assume the liabilities of the insolvent insurer in exchange for a guaranteed rate of distribution to claimants that ensures the assuming company a reasonable rate of return on their investment.[195] Berkshire Hathaway presented such a proposal to the Liquidator, a proposal that the Deputy Receiver testified that he recommended that the Department accept in the first quarter of 1999.[196] However, the Deputy Receiver's recommendation

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[192] White Redirect at 38, Line 3 through Page 39, Line 2.

[193] White Cross November 19, 2003 at 32, Lines 2 through 6.

[194] White Cross November 19, 2003 at 31, Line 13 through Page 32, Line 1.

[195] JTE 103 at 8-9; White Direct at 89, Line 17 through Page 90, Line 3. The Deputy Receiver refers to this as a market-based plan and testifies that it would be a "home run."

[196] White Direct at 94, Line 15 through Page 95, Line 22; White Cross November 19, 2003 at 19, Lines 6 through 9. Mr. White noted that the proposal provided that claims would be handled by National Indemnity, the only triple A rated reinsurer in the world. *Id*. at page 24, Line 9 through Page 25, Line 3.

was never acted upon in 1999.[197] The Department never accepted or rejected the offer in the year 200 either, [198] despite a letter from Berkshire Hathaway to the Department urging them to make a decision.[199] Incredibly enough, the Department still made no decision to accept or reject the Berkshire Hathaway proposal in the year 2001.[200] A response--rejection of the proposal—was finally forthcoming in 2002.[201] Among the matters that concerned the Department was the fact that the entity handling the claims would have a pecuniary interest in the transaction,[202] the level of Department oversight required on an ongoing basis,[203] and whether the Department could delegate its statutory responsibilities to a private entity.[204] These are precisely the types of matters that can be dealt with through legislation providing for expanded alternatives for the administration of insurance receiverships and are among the issues addressed in the URL. When asked if Mr. White had recommended to the Department legislation that would provide him with these additional tools he testified that he had not.[205]

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[197] White Cross November 19, 2003, Page 19, Lines 10 through 18.

[198] *Id*. at Page 19, Lines 20 through 22.

[199] *Id*. at Page 19, Line 23 through Page 21, Line 8.

[200] *Id*. at Page 21, Lines 17 through 20.

[201] Id at Page 21, Line 21 through Page 22, Line 7.

[202] Id at Page 25, Line 4 through Page 26, Line 24. Mr. White conceded that every insurance company has a pecuniary interest in the handling of their claims and that this issue is addressed and monitored by state regulators through market-conduct regulation. *Id*. at 25, Line 4 through Page 26, Line 21.

[203] JTE 86 at 4.

[204] *Id*.

[205] White Cross November 19, 2003 at 36, Lines 20 through 23.

The Deputy Receiver testified that while the Estate has commuted with approximately 130 reinsurers,[206] approximately 130 reinsurers have not yet commuted,[207] and approximately 50 reinsurers have become insolvent, impaired or are in financial difficulty.[208] When asked if it would be useful to have the statutory authority to compel collateral from reinsurers that are in financial difficulty (as provided for in the URL) to ensure that the Estate had access to funds it might not otherwise realize, the Deputy Receiver replied in the affirmative, stating "[i]t would. Any of these provisions that assist the liquidator I would embrace…"[209] Yet when Mr. White was asked if he had recommended to the Department legislation that would give him the ability to obtain collateralization for troubled companies, he testified that he had no recollection.[210]

Witnesses for both the Liquidator and the reinsurers have testified about schemes of arrangement employed in a number of jurisdictions. The Liquidator's economist witness testified about two alternatives, suggesting a modification to the Plan[211] and an "auction" concept, his "preferred alternative."[212] Whether any of or all of these alternatives are worth considering, legislation could be enacted that would give the receiver the authority to employ a number of useful strategies or some combination of

[206] White Direct at 57, Lines 5 through 25.

[207] White Direct at 58, Lines 4 through 14.

[208] White Direct at 64, Line 5 through 18. It should be noted that some of these reinsurers preceded Integrity in insolvency.

[209] White Cross November 19, 2003 at 34, Line 10 through Page 35, Line 5.

[210] White Cross November 19, 2003, Page 36, Lines 14 through 19.

[211] Trial Transcript, November 20, 2003, Cross Examination and Redirect Examination of David Friedman, Page 38, Line 21 through Page 44, Line 6.

[212] Trial Transcript, November 20, 2003, Direct Examination of David Friedman, Page 25, Line 5 through Page 28, Line 11.

strategies for administering an estate, including improving the effectiveness of the traditional run-off approach. But these, and other issues, must be considered and weighed by the New Jersey Legislature. The Department, to date, has chosen not to pursue legislation that would expand its ability to address these issues and must, therefore, administer the Integrity Estate in accordance with the statutes that exist today. The RAA, and its member companies, have stood ready for years to assist the Department in this regard—but neither the RAA nor this Court can do it for them.

IV. The Liquidation Court Lacks the Power to Determine the Rights and Obligations between Integrity and its Reinsurers

The Liquidation Court lacks the power and jurisdiction to determine rights and obligations between the Integrity Estate and its reinsurers. The Court lacks the power to do so because under longstanding principles, well established in New Jersey, a Liquidation Court sits as a court of summary jurisdiction.[213] Both state and federal law draw a distinction between (1) a liquidation court's *in rem* or equity jurisdiction to decide matters affecting its control of estate assets, i.e., the authority to fix the time and manner of asset distribution, and (2) a liquidation court's *in personam* or "at law" jurisdiction to decide parties' common law rights vis-à-vis the insolvent, i.e., the authority to establish the existence and amount of claims pursued by the liquidator.[214] In fact, the Third Circuit made this very distinction in these proceedings noting, in *Suter*, that there was no inconsistency between the Liquidation Act's conferral of "original jurisdiction" on the Superior Court and finding removal jurisdiction in other courts to adjudicate claims

[213] *Suter v. Munich Reinsurance Co.*, 223 F.3d 150 (3rd Cir. 2000).

[214] *See e.g.*, *Strubinger v. Mid-Union Indem. Co.*, 352 S.W.2d 397, 407-408 (Mo. App. 1961); *Morris v. Jones*, 329 U.S. 545 (1947).

asserted by the Liquidator.[215] Courts make this distinction, in part, due to the requirements of the Seventh Amendment to the U.S. Constitution: that mandate guarantees a "plenary proceeding" to all parties involved in "suits in which legal rights were to be ascertained and determined, in contradistinction to those where equitable rights alone were recognized, and equitable remedies were administered." Because the Liquidation Court presides exclusively over summary proceedings, it lacks subject-matter jurisdiction to adjudicate disputes in which a receiver (such as the Liquidator) seeks to recover property not in the receivership's actual or constructive possession, against third parties (such as the reinsurers) holding substantial, adverse claims to the property. The liquidation court has *in rem* jurisdiction over equity matters involving the timing and manner of asset distribution. Since these do not involve determination of legal rights, the abbreviated summary proceedings of liquidation courts are adequate. On the other hand, *in personam* jurisdiction involves legal rights in damages or contract disputes, requiring a plenary proceeding which offers parties the full array of rights guaranteed by due process and other Constitutional precepts, including the right to a jury trial. Such disputes must be adjudicated in plenary proceedings before a court of general jurisdiction. The dispute resolution provisions of the Plan constitute an impermissible attempt to employ summary proceedings, through the artifice of a Special Master, to accomplish precisely what the law prohibits.

Even if the Court presiding over liquidation proceedings possessed subject-matter jurisdiction in the general case to adjudicate such disputes between a receiver and third parties, no New Jersey court has the power to abrogate a contractual agreement to arbitrate such disputes. The Plan would unlawfully deprive reinsurers of their contractual

[215] 223 F.3d at 161.

rights to arbitrate disputes with Integrity, in violation of the Federal Arbitration Act (9 U.S.C. § 1 *et seq.*) and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (9 U.S.C. § 201 *et seq.*). And even if the Court could lawfully exercise jurisdiction over disputes between the Liquidator and the reinsurers, the dispute resolution procedures of the Plan would, if approved, deprive the reinsurers of their rights to have the Liquidator's legal claims for sums allegedly owed the Integrity estate pursuant to the terms of the reinsurance agreements tried before a jury, as guaranteed to litigants under Article I, Paragraph 9 of the New Jersey Constitution.

The dispute resolution procedures of the Plan would, if approved, violate R. 4:41-1 of the New Jersey Court Rules by requiring factual disputes to be submitted to Special Masters without the reinsurers' consent and in the absence of extraordinary circumstances. The Plan's dispute resolution mechanism would explicitly and blatantly abrogate any arbitration provisions contained in Integrity's reinsurance agreements. Plan, Part 5, Sections 5.4, 5.5 and 5.6. Specifically, Section 5.6(c) disallows arbitration of the allocation of allowed claims to reinsurance contracts. The allocation of allowed claims, especially in a liquidation, is exactly the type of dispute the arbitration clause was designed to address and clearly requires the exercise of *in personam* jurisdiction – requiring a plenary proceeding beyond the purview of this Court. The prohibition on arbitration is particularly offensive where, as in the case at bar, the Liquidator intends to estimate and allow IBNR, thereby altering the coverage provided under the reinsurance contracts and Integrity's underlying insurance policies. The abbreviated dispute resolution procedures of the Plan would, if approved, deprive the reinsurers of valuable property rights without affording them procedural due process as guaranteed by the

United States and New Jersey Constitutions, by impairing the reinsurers' ability to defend against the Liquidators' legal claims for reinsurance proceeds, by impermissibly shifting the burden of proof from the Liquidator to the reinsurers, and by depriving the reinsurers of the procedural protections inherent in plenary proceedings.

In fact, the Federal Court of Appeals in New Jersey has already recognized the validity and enforceability of arbitration agreements in the context of the Integrity receivership in the *Suter* case. 223 F.3d 150 (3rd Cir. 2000). In *Suter*, the Court of Appeals held that a reinsurer's contractual arbitration rights are clear and unambiguous, valid and enforceable, and that the Liquidator has no lawful power to abrogate such rights. *See Suter*, 223 F.3d at 161. Further, the *Suter* court rejected the Liquidator's contention that compelled arbitration would impair the Liquidation Act. *Id*. Yet this Court ruled on that very point in denying Munich Reinsurance Co.'s motion to dismiss the Final Dividend Plan, stating:

> Munich argues that the Liquidator no longer can be heard to argue that the Final Dividends Plan's abrogation of Munich Re's arbitration rights may be legitimized by the New Jersey Liquidation Act and the Liquidator's duty to liquidate Integrity's liabilities because the Liquidator has already advanced her arguments in *Suter* . . . and she lost. This Court Disagrees. In *Suter* the Court dealt with the arbitrability of reinsurance due on a limited number of matured claims. Here, the Court is presented with a much broader issue – whether it would impair the operation of the New Jersey Liquidation Act to require arbitrability relating to reinsurance for the approximately twenty-five thousand plus claims incurred but not reported.[216]

There is no valid basis for making a distinction between the arbitrability of mature claims versus unknown "claims." Given this inconsistency between this Court's ruling and the well-established law, the RAA urges this court to reconsider it's December 3,

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[216] In the Matter of the liquidation of Integrity Insurance Company, Transcript of Judge's Decision, December 3, 2002 at 9, Line 14 through Page 11, Line 2.

2002 ruling. The validity and enforceability of reinsurers' rights to arbitrate contractual disputes arising from claims by the Liquidator to recover reinsurance recoverables has been litigated and decided, and nothing about the issues in the case at bar should permit the Liquidator to avoid the *Suter* decision's on-point resolution of the issue.

CONCLUSION

This dispute is **not** an attempt by reinsurers to second-guess the lawful alternatives considered by the Liquidator for closing the Integrity estate. The evidence adduced during deposition testimony and trial make it clear that the proposed Plan is unlawful for a variety of reasons, including: (1) IBNR does not constitute a "claim within the meaning of New Jersey statutes, *e.g.* §§ 17:30C-20 and 17:30C-26 (c)(4); (2) IBNR cannot be made or "deemed" absolute consistent with the mandate of New Jersey law providing for the allowance of claims against an insolvent estate pursuant to § 17:30C-28a; (3) contingent claims of policyholders cannot be allowed pursuant to § 17:30C-28b; (4) "contingent claims" for IBNR cannot be allowed for third-parties pursuant to § 17:30C-28b; (5) the Liquidator cannot vitiate the contractual arbitration rights of reinsurers guaranteed pursuant to the U.S. Constitution (U.S. Const. Art. I, Section 10, Para. 1, Clause 8, U.S. Const. Amendments V, VII, XIV), Federal Arbitration Act (9 U.S.C. § 1 *et seq.),* the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (9 U.S.C. § 201 *et seq*.), the New Jersey Constitution (N.J. Const. art. I), and R. 4:41-1 of the New Jersey Court Rules.

This dispute is also **not** an attempt by reinsurers to avoid their lawful obligations to the Integrity estate. The Liquidator testified that approximately 130 reinsurers have voluntarily commuted all of their obligations, past, present and future, to the Estate.[217] The Deputy Receiver concedes that some of the reinsurers that have declined, thus far, to commute have no unpaid claims outstanding,[218] making it difficult to commute with them

[217] White Direct at 57, Lines 5 through 25.

[218] White Cross November 19, 2003 at 16, Line 12 through Page 17, Line 4.

because they do not necessarily agree with the Liquidator's projection of the losses that may one day be reported to them.[219] Others have expressed a willingness to commute and to entertain a "reasonable" proposal but have heretofore found the work of the Liquidator's actuary an unacceptable starting point to even begin negotiations.[220] Further, the Liquidator acknowledges that Integrity's attempts at seeking commutations have not been as robust as they were in the past due to the diversion of this litigation.[221]

This dispute **is** focused on the need to ensure that: (1) a complex and diverse international industry can continue to rely on the terms and conditions of their contracts with insurers who become insolvent; (2) an insurance receiver accepts the contractual burdens as well as the benefits of the contracts she administers in the context of insolvency; (3) the plain meaning of New Jersey statutes are enforced by the courts of this State; and (4) a statutorily-appointed receiver exercises discretion in administering the estate of an insolvent insurer within the explicit statutory bounds established by the Legislature.

This dispute **is** concerned with ensuring that all stakeholders in an insurance receivership are treated in an equitable manner. It is imperative that: (1) "claims" of large corporate policyholders are not enhanced at the expense of individual policyholders and small and medium size businesses; (2) statutorily-authorized claims of some are not diluted by the unauthorized claims of others; (3) liability of guaranty associations across the country is not multiplied by the misapplication of laws identical to New Jersey's being enforced against the interests of insurers and reinsurers; (4) costs to future

[219] White Cross November 19, 2003 at 17, Lines 5 through 25.

[220] JTE 67.

[221] White Cross November 19, 2003 at 9, Line 12 through Page 10, Line 3.

policyholders, taxpayers and the solvent insurance industry are not increased in a short-sighted attempt to benefit a limited segment of claimants in one estate; and (5) reinsurers are not singled out as the guarantors of last resort for insolvent insurers.

And finally, this dispute **is** about the necessary, appropriate and constitutionally mandated process by which public policy issues are to be resolved in this nation. Courts are required to enforce the laws as written – not as certain stakeholders might want them to be. Public policy is the province of the legislature; not the courts.

The RAA urges this Court to reconsider its Interim Order and find that IBNR (1) does not constitute a "claim" under New Jersey law, and (2) cannot be made or "deemed" absolute within the meaning of § 17:30C-28a. The RAA further urges this Court to reconsider its ruling of December 3, 2002 abrogating reinsurers' contractual arbitration rights and recognize, consistent with the Third Circuit's ruling in *Suter*, the validity and enforceability of arbitration agreements in the context of the Integrity receivership. And finally, the RAA requests that this Court disapprove the Liquidator's Fourth Amended Final Dividend Plan pursuant to the reasons set forth herein.

DATED: February _____, 2004

Respectfully Submitted,

Joseph J. Schiavone
Jeffrey S. Leonard
Budd Larner, P.C.
150 John F. Kennedy Parkway, CN 1000
Short Hills, NJ 07078-0999
973-379-4800

By: ______________________________
Joseph J. Schiavone
Jeffrey S. Leonard

Debra J. Hall
Reinsurance Association of America
1301 Pennsylvania Avenue, N.W.
Suite 900
Washington, D.C. 20004
202-638-3690

By: ______________________________
Debra J. Hall

Attorneys for
Respondent Reinsurance
Association of America