COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION

COMMONWEALTH OF VIRGINIA, ex rel. STATE CORPORATION COMMISSION,	§	
Applicant,	§	
v.	§	Case No. INS-2003-00024
RECIPROCAL OF AMERICA and THE RECIPROCAL GROUP,	§	
Respondents.	§	

APPLICATION FOR ORDER AUTHORIZING THE CONTINUATION OF WORKERS' COMPENSATION DISABILITY PAYMENTS BY RECIPROCAL OF AMERICA AND THE RECIPROCAL GROUP FOR WORKERS' COMPENSATION CLAIMS DENIED COVERAGE BY STATE GUARANTY ASSOCIATIONS

TO THE HONORABLE JUDGES OF THE COMMISSION:

Alfred W. Gross, as Deputy Receiver (the "Deputy Receiver") of Reciprocal of America ("ROA") and The Reciprocal Group ("TRG") (collectively, the "Companies"), pursuant to Va. Code Ann. § 38.2-1519 (Michie 2002)[1] and 5 VAC 5-20-80, respectfully makes this his Application for Order Authorizing the Continuation of Workers' Compensation Disability Payments by Reciprocal of America and The Reciprocal Group for Workers' Compensation Claims Denied Coverage by State Guaranty Associations, seeking that the Commission enter an order: (1) authorizing the Deputy Receiver to continue payment of medical and recurring partial or total disability payments ("Disability Payments") for workers' compensation claims which were assumed by ROA through assumption reinsurance, or similar transactions, and denied or likely to be denied coverage by the applicable state guaranty associations.

[1] All references herein are to the Virginia Code unless specified otherwise.

I. BACKGROUND

1. On January 29, 2003, pursuant to Title 38.2, Chapters 12 and 15 of the Virginia Code and other applicable Virginia law, the Circuit Court for the City of Richmond (the "Court") entered its Final Order Appointing Receiver for Rehabilitation or Liquidation (the "Receivership Order") which appointed the State Corporation Commission of the Commonwealth of Virginia (the "Commission") as Receiver (the "Receiver"), Alfred W. Gross, the Commissioner of Insurance of the Commonwealth of Virginia as Deputy Receiver (the "Deputy Receiver"), and Melvin J. Dillon as Special Deputy Receiver (the "Special Deputy Receiver"), and authorized and directed them to administer the business and affairs of the Companies and to do all acts necessary or appropriate for the rehabilitation or liquidation of the Companies.

2. In the Receivership Order, the Court found that ROA and TRG (as ROA's attorney-in-fact) were insurers for purposes of Title 38.2, Chapter 15, of the Virginia Code. The Court also found that ROA and TRG (as ROA's attorney-in-fact) were engaged in the business of issuing reciprocal insurance as reciprocal insurance is defined by Virginia Code § 38.2-1201, entering into reinsurance agreements with respect to same, and were engaged in the business of insurance as defined by Virginia Code § 38.2-100.

3. In the Receivership Order, the Court found that ROA and TRG (as ROA's attorney-in-fact) were in a condition where any further transaction of business would be hazardous to the policyholders, creditors, members, subscribers, and the public.

4. As a result of the Receivership Order, the affairs and business of the Companies are administered by the Receiver, the Deputy Receiver, and the Special Deputy Receiver, who are

vested, *inter alia,* with all the powers and authority expressed or implied under the provisions of Title 38.2, Chapters 12 and 15 of the Virginia Code.

5. On April 30, 2003, the Deputy Receiver of the Companies filed an Application for Orders Setting Hearing on Liquidation of ROA and TRG, Establishing Response Dates, Ordering Liquidation, Approving Claims Bar Dates, and Related Matters (the "Application"). The Application discussed the events that precipitated the Application, the proposed plan of liquidation devised by the Deputy Receiver, and the Deputy Receiver's request that the Commission schedule two hearings for consideration of the Application.

6. On May 2, 2003, the Commission entered an Order Setting Hearing on Liquidation of Reciprocal of America and The Reciprocal Group, Establishing Response Date, and Related Matters. Pursuant to that order a "Liquidation Hearing" was held on June 19, 2003, to consider the merits of the Application.

7. On June 20, 2003, the Commission entered an Order of Liquidation with a Finding of Insolvency and Directing the Cancellation of Direct Insurance Policies (the "Liquidation Order"). The Liquidation Order: (1) declared ROA and TRG to be insolvent; (2) directed the Deputy Receiver to proceed with the liquidation of ROA and TRG in accordance with provisions of Title 38.2, Chapter 15, of the Virginia Code, other applicable Virginia law, and the orders of the Commission, and all subject to further orders of the Commission; (3) pending further Orders of the Commission, the Deputy Receiver was authorized to continue making Disability Payments arising under ROA workers' compensation insurance policies until such time as such Disability Payments can be made by guaranty associations; and (4) the Deputy Receiver was also authorized to cancel all direct insurance policies issued by ROA, such cancellation to be effective on or before the last

date for which claims arising thereunder would be covered by the applicable insurance guaranty association.

8. Pursuant to the Liquidation Order, ROA has arranged to make Disability Payments until such time as the guaranty associations can make such payments. However, the guaranty funds have denied or likely will deny coverage of certain workers' compensation claims.

9. The guaranty associations of the applicable states have refused, or likely will refuse, to make Disability Payments for workers' compensation claims that ROA assumed from Self-Insured Trusts ("SITs") in Alabama, Arkansas, Kentucky, and Missouri and Group Self-Insurance Associations ("GSIAs") in Mississippi, North Carolina, Tennessee, and Virginia (collectively referred to as the "Assumed Businesses") as a result of assumption reinsurance or similar transactions ("Assumed Claims"). ROA assumed all the liabilities, including all claims, and all the assets of the Assumed Businesses through merger agreements or different forms of assumption agreements (singularly referred to as "Agreement", collectively referred to as the "Agreements").

10. The applicable guaranty associations have refused or likely will refuse to make Disability Payments for the Assumed Claims because the Assumed Businesses were not member insurers and/or the policies under which the claims arose were not ROA policies. The weekly Disability Payments that the Deputy Receiver fears may not be deemed covered by the state guaranty associations total approximately $125,139.

11. However, the Deputy Receiver has concluded that the insureds of the Assumed Businesses are direct insureds of ROA and, due to the necessity of Disability Payments, requests authorization from the Commission to continue making Disability Payments for the Assumed Claims.

II. Assumed Business Insureds Are Direct Insureds of ROA

12. There are numerous factors that indicate that the insureds of the Assumed Businesses are direct insureds of ROA and therefore are a direct responsibility of ROA.

13. ROA assumed the liabilities of a total of nine workers' compensation SITs and GSIAs.[2] The Agreements for the SITs were titled "Acquisition of Assets and Assumption of Liabilities Agreement," or "Assumption Agreement" while the GSIAs entered into "Merger Agreements" with ROA (then referred to as "The Virginia Insurance Reciprocal" or "TVIR") except for SunHealth Group Self-Insurance Association of North Carolina, which entered into an "Acquisition of Assets and Assumption of Liabilities and Reinsurance Agreement". It is evident by these Agreements that in exchange for the assets of the Assumed Businesses, it was ROA's intent to become directly liable to their policyholders.

14. ROA's intent to become directly liable to the insureds of the Assumed Businesses was further demonstrated by its subsequent actions and the actions of the policyholders and the Assumed Businesses. In most, if not all, transactions ROA issued its own policies the day after the closing date of the Agreement. Where applicable, ROA paid the premium tax for each of the Assumed Businesses and ROA also paid the guaranty fund assessment for each of the Assumed Businesses. Further, ROA characterized these acquisitions as direct insurance as opposed to reinsurance in its

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[2] The assumed workers' compensation SITs were the Healthcare Workers Compensation Self-Insured Fund (Alabama), Arkansas Hospital Association Workers' Compensation Self-Insured Trust, Compensation Hospital Association Trust (Kentucky), and MHA/MSC Compensation Trust (Missouri). The assumed workers' compensation GSIAs were MHA Private Workers' Compensation Group (Mississippi), MHA Public Workers' Compensation Group (Mississippi), SunHealth Self-Insurance Association of North Carolina, THA Workers' Compensation Group (Tennessee), and Virginia Healthcare Providers Group.

financial documentation (*e.g.*, Annual Statements). There is also evidence that at least in the majority of cases, the policyholders were sent invoices for premium payments for the policies that ROA issued, as well as invoices for premium assessments for the prior year. There is documentation in the case of at least some of the transactions that ROA and the Assumed Businesses sought, and received, regulatory approval of the department of insurance for the relevant state. Many, if not all, of the GSIAs dissolved after the transaction. It is clear that ROA considered the ROA insureds resulting from these transactions as ROA direct insureds.

15. It is clear that ROA intended to enter into assumption reinsurance transactions with the Assumed Businesses. ROA was originally the reinsurer for the Assumed Businesses. Assumption reinsurance allows the reinsurer to assume all of the ceding insurer's liability under the policies it issued. This assumption of liability is consistent with general contract law, "[u]nder the common law of contracts, an obligor may generally delegate performance of his contractual duty to another." <u>Security Benefit Life Ins. Co. v. Fed. Deposit Ins. Co.</u>, 804 F. Supp. 217, 225 (D. Kan. 1992). The Supreme Court discusses two types of reinsurance, assumption reinsurance and indemnity reinsurance, but makes it a point to differentiate them:

> In the case of assumption reinsurance, the reinsurer steps into the shoes of the ceding company with respect to the reinsured policy, assuming all its liabilities and its responsibility to maintain required reserves against potential claims. The assumption reinsurer thereafter receives all premiums directly and becomes directly liable to the holders of the policies it has reinsured.
>
> In indemnity reinsurance . . . it is the ceding company that remains directly liable to its policyholders, and that continues to pay claims and collect premiums. The indemnity reinsurer assumes no direct liability to the policyholders. Instead, it agrees to indemnify, or reimburse, the ceding company for a specified percentage of the claims and expenses attributable to the risks that have been reinsured, and the

> ceding company turns over to it a like percentage of the premiums generated by the insurance of those risks.

Colonial Am. Life Ins. Co. v. Commissioner, 491 U.S. 244, 247 (1989).

16. An assumption reinsurance transaction requires notice of the transaction to the policyholders as well as a novation from the policyholders. In order for the policyholder to properly consent to the assumption reinsurance transaction, the policyholder must be provided with notice. See Security Benefit, 804 F. Supp. at 228. This notice is usually provided in the form of a certificate of assumption mailed to the policyholder along with an accompanying letter. See, e.g., Vandeventer v. All Am. Life & Cas. Co., 2003 Tex. App. LEXIS 2216, *6. In the case where the policyholder is also the shareholder in the ceding insurance company, the policyholder must be notified of a meeting where he or she will vote to consent officially to the assumption reinsurance agreement. See, e.g., Goodall v. Cook, 203 Ill. App. 69, 74 (1916). A novation occurs when the policyholder not only consents to the transaction, but also consents to release the ceding insurer from liability, thus the policyholder is left only with a claim against the reinsurer. Security Benefit, 804 F. Supp. at 225.

17. In the cases at issue, there is a lack of documentation indicating that the policyholders received a certificate of assumption with an accompanying letter, *per se*, but there is other documentation that indicates that for many of the transactions the policyholders received some form of notice. In some cases, policyholders or members were sent a letter notifying them that a member vote regarding the assumption was going to take place and in some instances that vote would also address the dissolution of the underlying business. In some cases, there were letters discussing the assumption with attached consent forms that the members were to fill out. There were also some

instances in which the members were sent a letter indicating that the board of directors had voted in favor of the assumption. It is evident that notice is important, however, consent is even more so.

18. The clearest indication that there was consent or a novation by the policyholders is within the Agreements themselves. All but one of the Agreements contain an "Authority Clause" that indicates that the business whose liabilities and assets were being assumed had obtained the requisite consent from the members and/or board of directors to proceed with the transaction and thereby had the authority to do so. For some transactions, there is documentation that indicates that members voted to approve the transaction and, in some cases, the dissolution of the underlying business. The Agreements explicitly state that ROA is to assume *all* of the liabilities of the Assumed Businesses. When members agreed to the transaction, they arguably consented to relieving the ceding insurer of liability because the ceding insurer's liability is part of the liability being assumed by ROA. This argument is further strengthened when members agreed to the dissolution of the underlying business because it is not truly possible to hold a non-existent entity liable. There is documentation indicating approval by the board of directors for some of the transactions as well. The Agreement of Assumption of the Kentucky Compensation Hospital Association Trust ("C-HAT") does not contain an Authority Clause or related clause. However, the workers' compensation claims that ROA assumed from C-HAT, as well as the other Assumed Claims, were all treated as direct insurance of ROA.

19. The Agreements themselves provide a very strong confirmation of the intent of the parties to enter into an assumption reinsurance transactions. Under the Agreements, ROA was to assume *all* of the liabilities in exchange for *all* of the assets for the businesses that it assumed, thereby indicating that ROA was intending to step into the shoes of the ceding insurer and become

directly liable to the ceding insurer's policyholders, as is required for an assumption reinsurance transaction. More importantly, in that the ceding insurer was necessarily left without assets, it makes no sense to interpret the transaction as one in which (unlike assumption reinsurance) the policyholder retained principal rights against the *ceding* insurer.

20. Despite whether there is a question as to whether the original policyholder *actually* consented to release the ceding insurer, the policyholder should still be construed as a direct insured of ROA. The court in Epland addresses the issue of the effect of an assumption agreement between two insurance companies in which there was a transfer of direct liability and whether the consent of the insured is necessary to effectuate such an assumption agreement. Epland v. Meade Ins. Agency Assocs., Inc., 564 N.W.2d 203 (Minn. 1997). The court held that "such consent is necessary only to release the first insurer from liability under the insurance contract and the lack of consent does not invalidate the assumption agreement nor constitute a breach of the insurance contract." Epland, 564 N.W.2d at 205. This scenario could be considered "coinsurance" as discussed in Fontenot v. Marquette Casualty Co., when the court stated that "when the contract of reinsurance expressly and specifically provides for direct liability to the original insured . . . this . . . is not really a contract of reinsurance but a type of *coinsurance*." 247 So. 2d 572, 576 (La. 1971) (emphasis added). Thus, the insureds of the Assumed Businesses are direct insureds of ROA.

III. The Nature of Disability Payments Requires Continued Payment by ROA

21. As demonstrated previously to, and found by, the Commission, the Disability Payments are a necessity for those that receive them. The livelihood of many injured workers is dependent upon receipt of those payments. If Disability Payments were discontinued for any period of time, the recipients would suffer a substantial hardship. Accordingly, pursuant to the Liquidation

Order, the Commission has recognized this fact by authorizing the Deputy Receiver to continue making Disability Payments arising under ROA workers' compensation insurance policies until such time as such Disability Payments can be made by guaranty associations.

22. Although the Assumed Claims may not have arisen under ROA policies, as demonstrated above, ROA has treated the Assumed Claims as direct insurance and as a direct responsibility. Even if the Assumed Businesses' insureds were also considered direct insureds of the ceding insurers, the ceding insurers have no means to take responsibility for the Disability Payments because the ceding insurers either dissolved or had all of its assets assumed by ROA.

23. Since the applicable state guaranty associations refused, or likely will refuse, coverage of the Assumed Claims, only ROA's assets are available to ensure that approximately 450 injured workers receive their Disability Payments.

WHEREFORE, PREMISES CONSIDERED, the Deputy Receiver requests an order:

a. Authorizing the Deputy Receiver to continue Disability Payments for workers' compensation claims which were assumed by ROA through assumption reinsurance, or similar transactions, and denied or likely to be denied coverage by the applicable state guaranty associations.

b. Providing such other and further relief that the Commission deems appropriate under the circumstances.

Respectfully submitted,

Alfred W. Gross, Commissioner of Insurance, State Corporation Commission, Bureau of Insurance, as Deputy Receiver of Reciprocal of America and The Reciprocal Group

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