4/16/04

THE STATE OF NEW HAMPSHIRE

MERRIMACK, SS. SUPERIOR COURT

Docket No. 03-E-0106

In The Matter Of The Liquidation Of
The Home Insurance Company

BENJAMIN MOORE & CO.'S SUPPLEMENTAL MEMORANDUM OF LAW ON THE ISSUE OF WHETHER, AS A MATTER OF LAW, THE LIQUIDATOR'S PROPOSED AGREEMENT WITH THE AFIA CEDENTS VIOLATES THE LIQUIDATION STATUTE

In his Reply In Support Of Motion For Approval Of Agreement And Compromise With AFIA Cedents, the Liquidator sets out to demonstrate that the proposed agreement is authorized by the liquidation statute and does not violate the statutory order of distribution set forth in RSA 402-C:44. In support of this effort, the Liquidator makes the following arguments:

1. The proposed agreement is authorized under the Liquidator's general powers to collect and preserve assets;
2. Any payments to the AFIA cedents under the proposed agreement constitute administrative "costs" of collection and preservation of estate assets;
3. The reordering of statutory priorities effected by the proposed agreement does not violate the liquidation statute because it is being done to generate a benefit for the estate as a whole; and
4. The proposed agreement is supported by equitable doctrines.

As explained in this memorandum, these arguments are untenable and inconsistent with the clear and unambiguous language of the statute. As a matter of law, the proposed agreement violates the statute, and, therefore, the Liquidator's motion must be denied.

I. The Liquidator May Not Rely Upon General Grants Of Power Concerning His Authority To Collect Assets To Violate Specific, Mandatory Provisions Governing The Distribution Of Those Assets.

In his original motion, the Liquidator cited no authority to establish that the proposed agreement was lawful. After the objecting parties challenged the agreement on grounds, *inter alia*, that the agreement violates the statute, the Liquidator argued in reply that his general authority to marshal assets provides the statutory authority for the proposed agreement.

Specifically, the Liquidator relies upon two provisions of the "Powers Of Liquidator" section of the statute: (1) the Liquidator "may" "[c]ollect all debts and monies due" and "do such other acts as are necessary or expedient to collect, conserve or protect [estate] assets," RSA 402-C:25 VI; and (2) the Liquidator "may" perform acts that are "necessary or expedient for the accomplishment of or in aid of the purpose of liquidation," RSA 402-C:25 XXII. Contrary to the Liquidator's arguments, however, these provisions do not authorize the proposed agreement.

First, these statutory provisions only outline general powers that the Liquidator "may" exercise in the administration of the estate. These general grants of authority do not trump other specific provisions that directly limit his authority. For example, RSA 402-C:44 states that the distribution of estate assets "shall" be in accordance with the detailed priorities set forth in that section of the law. The term "shall" is mandatory. N.H.—Vermont Health Service v. Commissioner of Insurance, 122 N.H. 268, 272 (1982)("The word 'shall,' generally regarded as a command, . . . , indicates that a statute was intended to be mandatory.")(citations omitted).[1]

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[1] The mandatory nature of Section 44's priority scheme is bolstered by the fact that the legislature used the word "may" in defining the Liquidator's general grants of authority. N.H.—Vermont Health Service, 122 N.H. at 272. By using the word "shall" to define the order of distribution and the word "may" to describe the Liquidator's general powers, the legislature clearly intended the order of distribution to be mandatory in nature, not a provision that may yield to the Liquidator's desire for an "expedient" exercise of permissive authority.

Construing the statute as a whole, and applying the plain and ordinary meaning of the words used, Pennelli v. Town of Pelham, 148 N.H. 365, 366 (2002), it is clear that the distribution of assets must comply with the order of distribution set forth at RSA 402-C:44, and the Liquidator cannot deviate from this order based solely upon a general grant of authority to administer the estate.

Second, the Liquidator's general authority to collect debts and preserve assets does not support the proposed agreement, because this is not what he is doing. As the Liquidator represented at the status conference held on April 9, 2004, no AFIA cedents have filed claims. Accordingly, it is misleading for the Liquidator to characterize his action as an effort to collect a debt or protect an estate asset. A more accurate description of the agreement is that it reflects an effort to offer an incentive to claimants to file claims so that a reinsurance claim may then arise. In any event, any resulting reinsurance claims of the estate become estate assets that can be distributed only accordingly to the mandatory provisions of RSA 402-C:44. The Liquidator has no authority to divert a full 50% of the proceeds of such reinsurance claims to a subclass of general creditor claimants based on his general authority to collect debts owed to the estate in the first instance.

The Liquidator's argument, if accepted, would permit the Liquidator to ignore any statutory limitations or restrictions he deems to be inconsistent with his general power to perform acts "necessary or expedient to the liquidation." The statute's plain language reflects the Legislature's intent to grant no such broad discretionary power to the Liquidator.

II. As A Matter Of Law, Payments To The AFIA Cedents Based On Claims Filed Against The Estate Do Not Constitute "Costs" Or "Expenses" Of Estate Administration.

The Liquidator argues that the proposed agreement does not offend the distribution provisions of the liquidation statute because any payments to the AFIA cedents are "costs" of collection of an asset. To reach this conclusion, the Liquidator first characterizes the payments to the AFIA cedents as the "allocation of proceeds." Liquidator's Reply at 14, 15. The Liquidator then argues that the "allocation of proceeds" is merely the "price" of collecting and preserving a valuable asset, and is therefore an administrative "cost" entitled to Class I priority. Id. Thus, in one breath the Liquidator justifies the agreement as necessary to collect a substantial asset for the estate, and then in another breath denies that he proposes an improper distribution of estate assets on the basis that the AFIA cedents' share of "proceeds" is merely a cost of estate administration. These obvious inconsistencies in the Liquidator's argument highlight the absurdity in characterizing the proposed payments to AFIA cedents as administrative costs.

According to the statute, "administrative costs" entitled to Class I priority include: "the actual and necessary costs of preserving or recovering the assets of the insurer; compensation for all services rendered in the litigation; any necessary filing fees; the fees and mileage payable to witnesses; and reasonable attorney's fees." RSA 402-C:44 I. Partial payments of the AFIA cedents claims against the estate do not fit within this list of costs. The Liquidator relies on the general "actual and necessary costs of …recovering the assets" language, but this general language must be read in light of the more specific language that follows. See Crowley v. Frazier, 147 N.H. 387, 391 (2001)("we ordinarily construe a general term in a statute in light of related, specific terms"). The more specific language refers to outlays made to pay post-liquidation order expenses incurred in pursuing recovery of assets, not pre-liquidation claims.

When properly construed, the term "administrative costs" cannot include payments to claimants on account of pre-liquidation claims. See Oxedine v. Commissioner of Insurance, 494 S.E.2d 545, 548 (Ga. App. 1998)(payments under settlement agreements made during rehabilitation were not "costs" or "expenses" of administration under liquidation scheme, because the settlement payments would be for claims asserted against the estate, not costs or expenses incurred); In re Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004)("Pre-filing debts are not administrative expenses; they are the antithesis of administrative expenses).

The Liquidator also suggests that his proposed distribution of over $50,000,000.00 to a small select subgroup of Class V claimants is still a "cost" despite the magnitude of the amount. See Liquidator's Reply at 14, n.5. According to the Liquidator, the statute does not impose a limit on the amount of a "cost." However, while the Liquidator is correct that the statute does not contain an express limit on the amount of specific "costs" incurred by the estate, the enormity of the proposed distribution is the best indication that the payment is not really a "cost." The proposed payment is clearly a huge distribution of an estate asset, to be made on account of the pre-liquidation claims of the AFIA cedents who, according to the Liquidator, would otherwise collect nothing from the estate.

According to the Liquidator, the AFIA cedents have claims against the estate (even though no claims have yet been filed). The proposed agreement would result in payment to the AFIA cedents based upon their claims. Thus, in fact, the "allocation of proceeds" proposed by the liquidator represents the settlement of these claims. Clearly, the settlement of a claim is not a "cost" of administration. Oxedine, 494 S.E.2d at 548. The Liquidator seeks to avoid the conclusion reached by the court in Oxedine by maintaining that Oxedine involved settlements made while the insurer was in rehabilitation, not liquidation. This is a distinction without a

difference. The court's reasoning in Oxedine was totally unrelated to the fact that the settlement in that case was reached while the insurer was in rehabilitation. Rather, the court relied upon the definition of "costs and expenses of administration" and concluded that "[n]o reasonable definition of 'costs' or 'expenses' can include the claims which appellees assert." Id. at 548. Construing the statute in light of the plain meaning of the language, and in light of "common sense and sound reasoning," the court rejected the "strained construction of 'costs and expenses'" advanced by the liquidator in that case. Id. Like the Liquidator here, the liquidator in Oxedine argued that by settling the claims at issue, he "in effect preserved the assets of the estate" and the settlement payments thus constituted "costs." Id. Just as the court in Oxedine rejected that argument, this court should decline to adopt the strained and unsupported argument advanced by the Liquidator.

III. The Liquidator Has No Statutory Power To Enter Into A Compromise That Violates The Statutory Priority Scheme, Even If He Believes The Compromise Will Benefit The Estate As A Whole.

The Liquidator's powers are derived exclusively from statute. The New Hampshire statute does not grant the Liquidator any specific power as relates to the compromise of claims, except the power to "compound, compromise or in any other manner negotiate the amount for which claims will be recommended to the court." RSA 402-C:45, I (emphasis added). There is no statutory grant of authority to the Liquidator or the Court to make or approve compromises with respect to the priority to be accorded to certain claimants.

The California decisions cited by the Liquidator do not aid his argument, as they are based on a different statutory scheme, and presented issues very different from those presented here. Commercial National Bank v. Superior Court, 14 Cal. App. 4th 393, 17 Cal. Rptr. 2d 884 (2d Dist. 1993), dealt with numerous issues in connection with the approval of a rehabilitation plan, including claims by some policyholders that the plan discriminated unfairly in favor of

other policyholder claimants. On this issue, the court said that California law allows some leeway for something less that "precisely equal" treatment of all policyholder claimants, 17 Cal. Rptr. 2d at 412, but it did not deal at all with a situation involving the complete reordering of statutory priorities in connection with a settlement with one subclass of junior claimants. Nor did In re Executive Life Inc. Co., 32 Cal. App. 4th 344, 38 Cal. Rptr. 2d 453 (2d Dist. 1995), deal with a proposed settlement by which a liquidator proposed to give a class of claimants with undisputed general creditor status a super-priority administrative claim status, as is the case here. Instead, that case dealt with a rehabilitator's decision to give certain claimants the priority they legitimately claimed, even though the rehabilitator had some questionable grounds for challenging that status. Id. at 474. The court found this to be a reasonable exercise of discretion because the Liquidator's potential challenge was "most unlikely to succeed." Id. These decisions provide no authority for the action the Liquidator proposes to take in this case, particularly given the language of the New Hampshire law.

Despite this absence of any statutory authority to alter statutory priorities via settlement of a claim, and the explicit language of RSA 402:C-44, the Liquidator argues that this power should be implied in order to "further the underlying legislative intent." Liquidator's Reply, , p. 17. In this regard, the Liquidator says that "perfect compliance" with the statutory scheme is not required, so long as he can show the compromise provides "a benefit to the estate as a whole." Id., p. 15.

With all due respect, it is the Liquidator's burden to show that his actions comply in all respects with the statutory scheme under which he functions as an officer of the Court. Moreover, the language of the statute determines whether a compromise concerning priorities is permissible, not the Liquidator's view of the legislative intent.

The starting and ending point for the Court's interpretation of the statute is its language, which states in plain and unambiguous words that the order of distribution "shall" be as provided in Section 402:C-44. Because the language of section of the law is plain and unambiguous, the Court need not look beyond it for further indications of legislative intent. In re Jacobson, ___N.H.___, 842 A.2d 77 (2004). The Court must also look at the statute in the context of the overall statutory scheme, id., but there is no language in the rest of the statute suggesting an intent to give the Liquidator discretionary power to depart from the priority scheme set forth in Section 402:C-44. The Liquidator cites the language from RSA 402-C:1, IV, stating that one of the law's general purposes is the "equitable apportionment of any unavoidable loss," which he says can only be achieved here by approving this agreement. What the Liquidator overlooks is that the Legislature's judgment as to how to achieve such equitable apportionment is embodied in the mandatory order of distribution provisions of Section 402:C-44. It is the Legislature's function, not the Liquidator's, to determine the best way to accomplish an equitable apportionment of the losses that inevitably occur in a liquidation proceeding.

Finally, the Liquidator argues that it would be absurd for the Court to apply the priority statute as written, because this would preclude him from bringing assets into the estate via this settlement. The Liquidator's answer to this is to imply an exception to the priority rules allowing his proposed agreement under the guise of the rule of statutory construction that the Court should construe statues to avoid absurd or unreasonable results. There is nothing absurd about applying a statutory order of liquidation priority as enacted by the Legislature, as numerous court have done faithfully in the past. See In re: Liquidation of Coronet Insurance Company, 698 N.E.2d 598, 603 (Ill. App. 1st Dist. 5th Div. 1998)(court lacked the power to deviate from the statutory priority scheme); State v. Interstate Casualty Insurance Company, 464 S.E.2d 73, 77 (N.C. App.

1995)(in light of comprehensive statutory scheme for the determination of claim priority, court could not invoke equitable doctrines to deviate from order of distribution); Couch On Insurance § 6:8 (3d ed.)("Statutory priorities are generally regarded as exclusive and should not be disturbed by the creation of equitable priorities"). Indeed, an order that the Liquidator can disregard the express language of the statute in this manner would turn the priority scheme established by the Legislature on its head. The Liquidator's authority to deviate from the priority scheme would not be limited to the AFIA Cedents – he could pay any and all lower priority ceding insurers ahead of policyholders so long as those ceding insurers are heavily reinsured.

IV. The Liquidator Cannot Invoke Inapplicable Equitable Doctrines To Override The Explicit Statutory Scheme.

As the statutory priority scheme does not give the Liquidator discretion to make an agreement with the AFIA cedents in violation of its explicit terms, the Liquidator falls back upon equitable doctrines as a source of discretion to depart from the statutory scheme. Benjamin Moore has already cited in its Response and Objection multiple cases from other jurisdictions rejecting various efforts to circumvent a statutory priority scheme in insurance insolvency proceedings. The Liquidator has not distinguished these cases on any principled basis, nor cited any authorities upholding any equitable exceptions to a statutory priority scheme like New Hampshire's. Moreover, the authority cited by the Liquidator is outdated and inapplicable bankruptcy case law that cannot alter New Hampshire's statutory scheme.

The absolute priority rule is codified in New Hampshire's insurance liquidation statute to achieve the legislature's vision of an equitable distribution in an insurance company liquidation. The Liquidator's suggestion that this statutory scheme of priority was not intended to apply here flies in the face of the statutory language. The legislature could have created an exception to the rule for this situation, but it did not. Given the statute's plain and unambiguous language, the

Court may not consider what the legislature might have said or add language that the legislature did not see fit to incorporate into the statute. State v. Rix, 150 N.H. 131, 132 (2003). The absolute priority rule adopted by the Legislature cannot be ignored by the Liquidator because he does not think it was intended to apply here.

The Liquidator's reliance on the necessity doctrine is badly misplaced. This doctrine originated in the old railroad reorganization cases cited by the Liquidator, and had its genesis in the public interest in maintaining functioning railroads in the late nineteenth century. This common law doctrine has been used in more recent Chapter 11 reorganization cases as justification for paying "critical vendors" of the debtor seeking to reorganize, although this practice was recently called into serious question by the Seventh Circuit in In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004). The Kmart court specifically noted that the 1978 Bankruptcy Code superceded any common law necessity doctrine. Id. at 871.

The New Hampshire liquidation statute says nothing about paying certain claimants deemed by the Liquidator to be worthy of preference outside the normal priority scheme, for any reason. It could have done so in theory, if it felt such discretion should be vested in the Liquidator, but it did not. Allowing the Liquidator to deviate from the statutory priority scheme in such an extreme fashion is to read language into the statute that is not there and cannot be fairly implied from other related provisions of the statute.

The Liquidator cites portions of Sections 402:C-25 and 29 of the statute as justification for the AFIA agreement, but nothing in these sections of the statute evince any hint of intent to allow the Liquidator to deviate from the priority rules in Section 402:C-44. Section 402:C-25 enumerates specific powers exercisable by the Liquidator in the conduct of the liquidation, but noticeably absent is any power to make agreements elevating the priority of certain claims in the

way that is proposed here. Nor does Section 402:C-29, II grant such discretion. It merely requires the Liquidator to reduce the assets of the estate "to a degree of liquidity that is consistent with the effective execution of the liquidation as rapidly and economically as he can." That the Liquidator believes the AFIA agreement will further the general purposes of the liquidation statute is of no moment, as he is charged with execution of the law, not its enactment or interpretation.

The Liquidator's reliance on the new value corollary to the absolute priority rule is difficult to fathom. Even if this equitable exception could apply notwithstanding the clear language of he statute, what new capital are the AFIA cedents contributing to this liquidation? The answer is <u>none</u>! Instead, they are being invited by the Liquidator to file potentially inflated claims, which the Liquidator will be inclined to allow as a means of maximizing the estate's reinsurance claims.[2] The AFIA cedents will do nothing more under this agreement than file claims and be paid off the top for doing so, at an astounding cost of 50% of the claims filed. This is the antithesis of "new value." Rather than being "alive and well in New Hampshire," as asserted by the Liquidator, these principles are dead on arrival in the face of the clear statutory language and the Liquidator's abject failure to show any contribution of new capital by the AFIA cedents in exchange for the highly preferred treatment the Liquidator proposes to accord them.

Blithely characterizing the proposed payments to the AFIA cedents as "discretionary payment by the Liquidator to further the interests of the estate" does not change the hard fact that the claims of these claimants are being settled in exchange for a remarkable enhancement of their

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[2] During the April 9 hearing before this Court, counsel for ACE indicated that such efforts to induce the filing of inflated claims could have repercussions for the collectability of reinsurance for those claims. Indeed, the Liquidator has already indicated that he believes ACE will engage in costly and time-consuming litigation over the collectibility of reinsurance. Rather than increasing the assets of the estate, the Liquidators' attempts to deviate from the statutory scheme have the potential to put the collectibility of those very assets in peril, assets which rightfully should be paid to higher priority creditors such as Benjamin Moore.

statutory priority. This is prohibited by the clear language of the statute, and the Liquidator has no power or discretion under the law to make such an agreement.

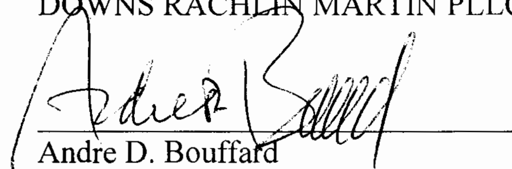
V. Conclusion

For all the foregoing reasons and the reasons set forth in Benjamin Moore's Response and Objection to the Liquidator's Motion for Approval, the Court should deny the Motion because, as a matter of law, it violates the statutory priority scheme.

Respectfully submitted,

April 16, 2004

DOWNS RACHLIN MARTIN PLLC



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CERTIFICATE OF SERVICE

I hereby certify that on this day 16 of April, 2004, Benjamin Moore & Co.'s Supplemental Memorandum Of Law On The Issue Of Whether, As A Matter Of Law, The Liquidator's Proposed Agreement With The AFIA Cedents Violates The Liquidation Statute

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