IN THE COMMONWEALTH COURT OF PENNSYLVANIA

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| JOEL ARIO, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,<br><br>Plaintiff,<br><br>v.<br><br>PENN TREATY NETWORK AMERICA INSURANCE COMPANY,<br><br>Defendant. | : | DOCKET NO. 5 M.D. 2009 |

Re: Petition to Suspend Agents' Commissions

**REPLY OF PENN TREATY AMERICAN CORPORATION TO THE REHABILITATOR'S MEMORANDUM OF LAW OF JULY 24, 2009**

## I. INTRODUCTION

Penn Treaty American Corporation ("PTAC") responds to certain arguments set forth in the Rehabilitator's Supplemental Memorandum of Law of July 24, 2009. For the sake of efficiency, PTAC refers the Court to the briefing of the other intervenors regarding legal issues raised by the Rehabilitator not responded to herein.

The Rehabilitator has presented the Court with its application to suspend payments of commissions to insurance agents prematurely, prior to filing its plan of rehabilitation with the Court. The Rehabilitator's justifications for suspending commission payments are that it may allow PTNA to pay more policyholder claims in full rather than have benefits limited by state guaranty association maximum limits, and to prevent preferences. The Rehabilitator's request presumes that PTNA will be liquidated rather than rehabilitated, and it fails to consider that if PTNA is rehabilitated, its insurance agents and the relationships they have with PTNA's policyholders will be instrumental in obtaining policy renewals at the higher premium rates that will permit the company to succeed after rehabilitation. Accordingly, the

Court should not consider the Rehabilitator's request until more information is available regarding the feasibility of the proposed rehabilitation plan, which should be filed in early October.

## II. ARGUMENT

### A. The Legion, Reliance, and PHICO Orders Did Not Require Suspension of Earned Renewal Commissions Owed to the Insurance Agents

On July 6, 2009, the Court ordered the Rehabilitator to identify cases from Pennsylvania or other jurisdictions in which courts have specifically ordered the suspension of payments to an insolvent insurer's class of creditors, other than agents, prior to the filing of a rehabilitation plan.

The Rehabilitator cites the three orders that placed Legion, Reliance, and PHICO into rehabilitation for the proposition that "suspension of payments to creditors has routinely been allowed in other rehabilitations and insurance insolvencies." (See Rehabilitator's Brief at 9). These Orders, however, contained specific directives relating to insurance agents. (See Exhibit C to the Rehabilitator's Brief, Legion, Reliance, and PHICO Orders ¶ 7). The Orders directed that:

> All insurance agents, managing general agents, brokers or other persons having sold policies of insurance and/or collected premiums on behalf of [Legion/Reliance/PHICO] shall account for all earned premiums and commissions and shall account for and pay all premiums and commissions unearned due to policies canceled in the normal course of business, directly to the Rehabilitator. . . or appear before this Court to show good cause as to why they should not be required to account to the Rehabilitator. No insurance agent, broker, or other person shall use premium monies owed to [Legion/Reliance/PHICO] for any purpose other than payment to the Rehabilitator.

(emphasis added).

These Orders required the insurance agents to "account for and pay all premiums and commissions unearned due to policies canceled in the normal course of business" directly to the Rehabilitator. (Id.). They did not allow suspension of payments of earned renewal commissions owed to the insurance agents. The insurance agents were entitled to receive their renewal commissions earned from incoming premiums, unless they were cancelled, because these commissions would not be "premium monies owed to [Legion/Reliance/PHICO]."

The apparent rationale for the directives in Paragraph 7 of the Orders was not to confiscate earned renewal commissions from insurance agents. The Legion, Reliance, and PHICO Orders did not affect the insurance agents' entitlement with respect to earned renewal commissions due under premiums for policies not subsequently cancelled.

The Rehabilitator also cites In re Liquidation of Workmen's & Suffolk Mutual Insurance Co., 345 N.Y.S.2d 64 (N.Y. App. Div. 1973), and Commercial National Bank in Shreveport v. Superior Court, 17 Cal. Rptr. 2d 884 (Cal. Ct. App. 1993), in support of the proposition that suspension of payments to creditors has routinely been allowed. (See Rehabilitator's Brief at 10).

In re Liquidation of Workmen's & Suffolk Mutual Insurance Co. is distinguishable on at least two grounds. First, it involved a liquidation, rather than a rehabilitation. Second, the opinion does not involve insurance agents' commissions. The court there simply held that because Suffolk Mutual was a mutual insurance company and all of its policyholders are considered members of the company, it would be most equitable to have matured loss claimants (policyholders with claims) paid prior to unearned premium claimants (policyholders who paid premiums, portions of which were unearned to the extent coverage was not afforded after insolvency was declared). Id., 345 N.Y.S.2d at 66. Here, PTNA is in

rehabilitation, not liquidation. Moreover, PTNA is not a mutual insurance company, and the issue is the right of its insurance agents to earned renewal commissions, not the relative preferences of two classes of policyholders.

The court in Commercial National Bank in Shreveport v. Superior Court stated as part of the procedural history that "[i]mmediately upon his appointment by the court as conservator of the ELIC estate on April 11, 1991, the Commissioner proceeded to sequester and conserve the assets of the insolvent company. The size of the insolvency estate increased as payments to its general creditors ceased (except as necessary to preserve certain assets) and a moratorium was placed on payment of almost all benefits to ELIC policyholders." 17 Cal. Rptr. 2d 884, 887. The issue was the validity of the rehabilitation plan for the business of ELIC as formulated by the Commissioner of Insurance and approved by the trial court. Id., at 886. The appellate court ruled that the plan was legally deficient in three respects: it set up a "two-tier" valuing system for Muni-GIC annuities that was without any basis in law; it established a "dual valuation" system that improperly discriminated between substantially identical policies in the same class; and it selected a liquidation valuation date for those who chose not to accept restructured policies that had no relationship to the amount of assets that were available for distribution. Id., at 887. Although the court ruled that contracts of policyholders were subject to modification through reasonable exercise of the state's police power, it held that the plan breached the Commissioner's fiduciary duty to distribute assets pro rata by relegating certain policyholders to share a fund of lesser value. Id., at 900.

The Rehabilitator also relies on Foster v. Mutual Fire, Marine & Inland Insurance Co., 531 Pa. 598, 629-30 (1992), for the proposition that when presented with a "dire need to economize in order to survive" the Rehabilitator can cause some suffering to private contracting

parties to preserve "the overall good of the general public and the insurer's policyholders." The Rehabilitator also argues that the insurance agents' renewal commissions are contractual rights earned before PTNA was placed in rehabilitation.

Here, the Rehabilitator has not yet proven a "dire need to economize in order to survive," or that the "overall good" is better served by suspending payment of renewal commissions to PTNA's insurance agents. PTAC argues to the contrary: if PTNA is rehabilitated, its insurance agents and the relationships they have with PTNA's policyholders will be instrumental in obtaining policy renewals at the higher premium rates that will sustain the company after rehabilitation. And if PTNA or parts of its business are divested, they will be more marketable to potential acquirers with its network of insurance agents intact. Furthermore, to the extent that the insurance agents continue to do work on behalf of PTNA post-rehabilitation by visiting with policyholders in order to maintain their business, the agents' right to earned renewal commissions is not solely based on their pre-rehabilitation efforts and should thus continue to be honored.

### B. Federal Bankruptcy Law Does Not Support the Rehabilitator's Argument

On July 6, 2009, the Court ordered the Rehabilitator to identify case law precedent under the U.S. Bankruptcy Act of 1938 in which courts have authorized a suspension of payments to one class of creditors in advance of the filing and approval of a Chapter 11 reorganization that addressed the claims of all creditors.

The Rehabilitator states the general proposition that federal bankruptcy law prohibits payment of pre-petition debts in Chapter 11 reorganization proceedings until a reorganization plan is approved. The Rehabilitator concedes that payment of pre-petition debts can be made, however, pursuant to specific court approval if payment to a particular creditor is

necessary to the debtor's continued operations and reorganization. (See Rehabilitator's Brief at 11-12).

The Rehabilitator then argues that "[t]he agents' renewal commissions would clearly be pre-petition debts under bankruptcy law." (Rehabilitator's Brief at 12) (citing In re Tomer, 128 B.R. 746, 761 (Bankr. S.D. Ill. 1991), aff'd 147 B.R. 461 (S.D. Ill. 1992); In re Rankin, 102 B.R. 439, 441 (Bankr. W.D. Pa. 1989)). As explained below, the Rehabilitator's argument is incorrect because (i) these cases are distinguishable as involving individual Chapter 7 discharges rather than Chapter 11 reorganizations, and (ii) later case law precedent holds that portions of renewal commissions are allocable to post-petition services of an insurance agent and thereby excluded from property of the estate under the earnings exception contained in Section 541(a)(6) of the Bankruptcy Code.

In re Tomer and In re Rankin were straight Chapter 7 bankruptcies involving individual debtors employed as insurance agents. In re Tomer and In re Rankin discuss whether renewal commissions are pre-petition or post-petition compensation in the context of an individual's bankruptcy petition. Whether continued payment of the commissions was necessary from the vantage point of a business seeking to reorganize was not at issue because no bankruptcy petitions of a business were involved. Here, PTNA seeks to emerge from rehabilitation as an ongoing business. The Rehabilitator's Preliminary Report and Plan states the possibility that PTNA can be rehabilitated if it increases the premium rates it collects from policyholders. (See Preliminary Report and Plan, Milliman Projections, at 51). For this to occur, however, PTNA will need its network of insurance agents intact. Accordingly, the Court should approve payment of all pre-petition and post-petition commissions as is necessary to enable PTNA to preserve its network of insurance agents, which is in turn necessary for it to emerge

from rehabilitation as an ongoing and successful business that is fully capable of protecting its policyholders.

Furthermore, even if pre-petition commissions are not warranted under the Bankruptcy Code, under later case law precedent, portions of renewal commissions are allocable to post-petition services of an insurance agent and thereby excluded from property of the estate under the earnings exception contained in Section 541(a)(6) of the Bankruptcy Code. See Towers v. Wu (In re Wu), 173 B.R. 411, 414-15 (B.A.P. 9th Cir. 1994); Yoppolo v. Golde (In re Golde), 253 B.R. 843, 849 (Bankr. N.D. Ohio 2000) ("the Court holds that the insurance renewal commissions that the Debtor receives from PLIC require the performance of at least some postpetition services. Thus, in conformance with the holding in *In re Wu*, the Debtor is entitled to keep that portion of the renewal commissions which are allocable to the postpetition services performed by the Debtor."); see also In re Blackerby, 208 B.R. 136, 143 (Bankr. E.D. Pa. 1997) (holding that the test is "whether payment of the commissions or other compensation is for services performed by the debtor after the commencement of the bankruptcy case. . . . If it is, then the commissions are not property of the estate. If payment of the commissions is only for services performed by the debtor pre-petition, then the commissions are property of the estate.") (emphasis added, internal citations omitted). These cases contradict the Rehabilitator's position that all commissions should be suspended.

## III. CONCLUSION

For the reasons stated herein, and in the objections and briefing of the other intervenors, Penn Treaty American Corporation respectfully requests that the Rehabilitator's application for immediate suspension of commissions be denied.

Respectfully submitted,

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Dated: September 4, 2009

*Attorneys for Intervenor*
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## CERTIFICATE OF SERVICE

I, Benjamin M. Schmidt, hereby certify that I have caused to be served today, via hand delivery, a copy of the Reply of Penn Treaty American Corporation to the Rehabilitator's Memorandum of Law of July 24, 2009 on:

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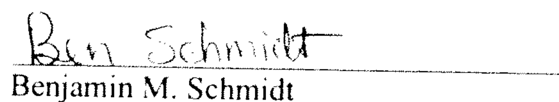
Date: September 4, 2009

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