COMMONWEALTH OF KENTUCKY
SUPREME COURT OF KENTUCKY
NO. 2008-SC-000381-TG

ON APPEAL FROM FRANKLIN CIRCUIT COURT
CASE NO. 04-CI-1067
TRANSFERRED FROM COURT OF APPEALS
CASE NO. 2008CA000945

GALLATIN HEALTHCARE, LLC,
LOUDEN & COMPANY, LLC,
APPALACHIAN REGIONAL HEALTHCARE, INC.,
AND MODCO TRANSPORT **APPELLANTS**

v.

JULIE MCPEAK, JOHN BURKHOLDER, SUCCESSOR IN CAPACITY AS EXECUTIVE DIRECTOR KENTUCKY OFFICE OF INSURANCE; AIK COMP F/K/A ASSOCIATED INDUSTRIES OF KENTUCKY SELECTIVE SELF-INSURED FUND, ET AL. **APPELLEES**

BRIEF FOR APPELLANTS (SUBSTITUTED BRIEF)

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CERTIFICATE OF SERVICE REQUIRED BY CR 76.12(6)

I hereby certify that on this 30 day of April, 2009, true and accurate copies of this Substituted Brief have been served by first class mail upon Sally Jump, Clerk, Franklin Circuit Court, Courthouse, 214 St. Clair Street, P.O. Box 678, Frankfort, Kentucky

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INTRODUCTION

This is a case in which Appellants challenge the compromise and dismissal of their claims by Appellee and the Trial Court where Appellants were not parties to settlement, where Appellee did not own the claims which it purported to settle, and where the court did not follow the requirements of Rule 23 in the dismissal of those claims.

STATEMENT CONCERNING ORAL ARGUMENT

Appellants request oral argument in this matter. Appellants believe that oral argument would be helpful to the Court in deciding the issues presented in light of the extremely convoluted history and procedural posture of this litigation.

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STATEMENT OF THE CASE

A. Procedural Posture

This case arises out of the rehabilitation of AIK Comp f/k/a Associated Industries of Kentucky Selective Self-Insurance Fund ("AIK Comp"). AIK Comp was placed into rehabilitation in 2005, but it was not until late 2007 that the settlement which gives rise to the issues raised in this appeal was initially presented to the Franklin Circuit Court. Record on Appeal ("R.A."), Tab 54, at S0001254. In that settlement, the Rehabilitator presented a settlement with the officers and trustees of AIK Comp which purported to dismiss the claims of Appellants and all members of the putative class as asserted in Appellants' Complaints. R.A., Tab 54, at S0001267. In this appeal, Appellants challenge the ability of the Rehabilitator to compromise, settle, and dismiss Appellants' claims against the officers and trustees. Additionally, the Appellants challenge the method by which the Trial Court purported to compromise and dismiss those claims.

AIK Comp was placed into Rehabilitation on August 3, 2004, under Kentucky Revised Statutes Chapter 304, when the Rehabilitator filed his Original Verified Petition (the "Petition") and Consented Motion for an Order Directing Rehabilitation. R.A., Tab 2, at S0000015. In essence, the Rehabilitator found that there was a significant deficiency in the Fund and a substantial risk that AIK Comp would not be able to pay its workers' compensation claims as they became due.

On June 15, 2005, the Rehabilitator filed a 2005 Assessment and Reorganization Plan, which stated that the amount of the assessment necessary to offset the deficit was in excess of $97,000,000. R.A., Tab 18, at S0000224. Neither the Assessment Plan nor the Plan of Reorganization tendered in June 2005 mentioned the pursuit of claims against others allegedly responsible for the deterioration of the fund – even though at that time

the Rehabilitator, through counsel, stated that such claims were to be "pursued aggressively." Prior to that time, the Franklin Circuit Court had issued a stay preventing the pursuit of the claims against the third parties which had already been filed by group members while the assessment phase was underway. R.A., Tab 14, at S0000198. The Rehabilitator was not subject to this stay and could, if he had so elected at the time, have pursued claims against these third parties and insiders, but he did not. Under the terms of the June 2005 Plan, the decision of the Rehabilitator, allegedly made "in the exercise of his discretion" and in the "best interest" of AIK Comp, was instead to assess the group members (Appellants and putative class members herein) of the Fund and then engage in a "self run-off" of the claims. R.A., Tab 18, at S0000253. The Rehabilitator had embarked on this path to assess the group members, without at the same time aggressively pursuing those responsible, even though there were numerous factors pointing towards the tortious and negligent conduct of the officers, trustees, and others which led to AIK Comp's financial crisis. The stay imposed by the Franklin Circuit Court prevented Appellants and other group members from pursuing their claims against the officers, trustees, and culpable third parties for an extended period of time. R.A., Tab 14, at S0000198.

As acknowledged in the 2005 Plan of Reorganization, the need for additional funds was crucial to the success of any efforts towards the rehabilitation of AIK Comp. Appellants and other group members did not dispute that there was a need for additional funds to satisfy AIK Comp's deficit. They did object, however, to the strategy followed by the Rehabilitator – to pursue only the assessment path rather than pursue both assessment and the third party claims at the same time. R.A., Tab 19, at S0000259.

Various objections were filed to the June 2005 Assessment and Reorganization Plan. Expedited discovery was undertaken in the summer/early fall of 2005 to examine these objections and to examine challenges to the proposed plan. R.A., Tab 24, at S0000420. All the while, the claims against others responsible languished. The Franklin Circuit Court further ordered the parties to engage in mediation, which occurred at the end of the initial discovery phase. R.A., Tab 24, at S0000420. As a result of those efforts, a settlement agreement was reached which resulted in a modified plan and ultimately this modified plan was approved by the Franklin Circuit Court. R.A., Tab 22, at S0000376. Under the terms of that Settlement Agreement, the Franklin Circuit Court issued various Findings of Fact and Conclusions of Law. R.A., Tab 24, at S0000412.

Under the terms of the Settlement Agreement, the Rehabilitator and certain group members of AIK Comp (which had participated in the mediation process) agreed that the amount of the deficiency was $92,257,762. R.A., Tab 22, at S0000389. Following adjustments for actuarially determined loss reserves (discounted to present value), estate closing costs, and anticipated uncollectible assessments, the final assessment amount was determined to be $90,775,754. R.A., Tab 22, at S0000378. Further, the Settlement Agreement provided that, once 80% of the agreed deficiency was paid through cash or the execution of contingent callable promissory notes (under the agreed hardship provisions), the joint and several liability as required by statute and the Indemnity Agreement that was originally signed by the members of AIK Comp would be converted into *pro rata* liability. R.A., Tab 22, at S0000378. As part of the settlement, the parties agreed to provide contingent, callable promissory notes which, under certain conditions, could be called by the Rehabilitator. The Settlement Agreement also obligated the

Rehabilitator to meet with representatives of the group members to discuss how best to proceed with claims against officers, trustees, and third party professionals under a variety of theories for damages which resulted in AIK Comp's severe financial distress. R.A., Tab 22, at S0000383.

Appellants and other group members of AIK Comp which had taken an active role in the negotiations of the Settlement Agreement met with the Rehabilitator to discuss how best to proceed against culpable third parties. Unfortunately, those efforts to reach an agreement on how best to proceed in a coordinated fashion were not successful. As a result, certain group members filed a Renewed Motion to Lift Stay. R.A., Tab 31, at S0000483. The Rehabilitator opposed the Motion to Lift Stay and, just prior to the hearing on that motion, contended that group members had "ceded" to AIK Comp their rights to pursue the third party claims. R.A., Tab 32, at S0000494. The current trustees of AIK Comp, who were never elected by the members of AIK Comp, filed a pleading in support of the opposition to the Motion to Lift Stay, claiming that the "ownership" of the underlying claims must first be determined prior to the pursuit of the claims. R.A., Tab 36, at S0000811. After an extensive briefing and argument, Judge Graham entered an Order on May 25, 2006, holding that Appellants and putative class members owned certain claims. R.A., Tab 38, at S0000876. In particular, Judge Graham held that:

> [p]ursuant to KRS 304.33-160, the Rehabilitator 'may pursue all appropriate legal remedies on behalf of the insurer.' The word may is permissive, thus not exclusive. Furthermore, the powers of the Rehabilitator are separate and distinct from those of a Liquidator. As such, the Rehabilitator is limited in the claims he may pursue whereas the Class Action Plaintiffs may pursue a broader array of claims.
>
> With that in mind, the Court hereby finds that under these circumstances, the Rehabilitator does not have exclusive ownership over claims against the alleged third-party tortfeasors. The Court finds a more efficient and expeditious resolution of claims against the alleged third-party tortfeasors

> will be encouraged by participation of class action lawyers who answer directly to certain group members. This is particularly true in light of the fact that all of the funds paid to the Rehabilitator to AIK Comp come directly from the pockets of the group members.

(Emphasis added.)[1] R.A., Tab 38, at S0000876-877. In issuing this ruling, Judge Graham properly found that the powers of the Rehabilitator under KRS 304.33-160 are not as broad as the powers granted to a liquidator, leading to the conclusion that "the Rehabilitator does not have exclusive ownership over claims against the alleged third party tortfeasors." R.A., Tab 38, at S0000877.

B. The Dubious Underpinning For The Claim To Ownership Of Appellants' Claims

AIK Comp was formed as a group self-insurer for workers' compensation liabilities in the late 1970's. R.A., Tab 24, at S0000416. One of the essential documents in the creation of AIK Comp (and the means by which companies joined AIK Comp) was an Indemnity Agreement which employers were required to sign in order to become group members of the association. R.A., Tab 34, at S0000701. The 1979 Indemnity Agreement identified the original three-person Board of Trustees. R.A., Tab 34, at S0000701. Further, the Indemnity Agreement clearly provided "the members [would] select succeeding trustees for [the] fund." R.A., Tab 34, at S0000701. Clearly, the group members were to have an active, direct role in the selection of the trustees to manage the fund that they were joining. The basis for this right is abundantly clear and reasonable – they had the joint and several liability to pay their claims such that they should select the people to manage their affairs.

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[1] The Rehabilitator filed an appeal and a CR 65.07 Motion for Relief with regard to this Order. R.A., Tab 47, at S0001097. Both the appeal and Motion for Relief were denied by the Kentucky Court of Appeals. Therefore, the May 25, 2006 Order is unquestionably the law of the case.

At some time after the execution of the 1979 Indemnity Agreement, but without the input or vote from the members of AIK Comp, the Self-Insurance Fund's By-Laws were apparently amended or modified to usurp the group members' role in the selection of trustees. R.A., Tab 34, at S0000706. The amended By-Laws placed the power to appoint trustees in the sole control of the chairman of AIK Comp. In fact, the present trustees were not elected by AIK Comp group members. These same trustees, however, managed the affairs of AIK Comp in such a manner that the deficit was created and then voted to put AIK Comp into Rehabilitation. R.A., Tab 24, at S0000417. Further, they have opposed the efforts of the group members to have any role in the management of the Fund (notwithstanding the significant financial contribution of AIK Comp group members towards the Rehabilitation). The trustees have also opposed the efforts of the group members to assert a decisive role in the pursuit of the claims against officers, trustees (which would include the trustees themselves), and culpable third parties who the group members believe caused the economic conditions that led to the need for the Rehabilitation. R.A., Tab 34, at S0000646-647.

The By-Laws which apparently allowed for the election of these non-representative trustees are the same By-Laws which the Rehabilitator now claims form the basis for the argument that the group members have ceded to the Board, and therefore by operation of law to the Rehabilitator, the control over the claims against the third parties as well as the officers and trustees themselves. The irony in this argument is readily apparent.

C. Prior Regulatory Issues

This is not the first time that AIK Comp has run afoul of Kentucky regulators. By an Agreed Order signed on November 13, 1997, the Kentucky Department of Workers

Claims, Office of the Commissioner, made certain findings with regard to the operation of AIK Comp. R.A., Tab 34, at S0000742. Those findings included the sponsoring organization, Associated Industries of Kentucky, had not exercised appropriate control over the Fund to ensure that the self-funded plan was being administered for the optimal benefit of AIK Comp's group members. R.A., Tab 34, at S0000742. Further, the Agreed Order found: (1) that the Board of Trustees had members with direct and significant familial relationships with service providers; (2) that the Board of Trustees had failed to create adequate books and records that reflected the true operation and management of the Fund; (3) that there was no conflict of interest policy; and (4) that there were inadequate safeguards prohibiting arms-length transactions between the trustees and service providers. R.A., Tab 34, at S0000742-743. The findings went further to hold that there were failures of internal and external controls to ensure that AIK Comp was being operated for the ultimate benefit of group members. R.A., Tab 34, at S0000743.

Additionally, the November 13, 1997 Order held that the manner in which the fund selected its trustees violated the then-governing administrative rules found in 803 KAR 25:026, § 1. R.A., Tab 34, at S0000743. Specifically dealing with the manner in which trustees are to be elected or appointed, 803 KAR 25:026, § 1(18) defined "trustees" as meaning "persons elected by the group members or appointed by the board of directors of the sponsoring trade association or association of governmental entities to oversee the administration of the group self-insurance fund." (Emphasis supplied). This administrative regulation was not followed by AIK Comp to select its trustees.[2]

[2] This regulation was eliminated in 2005 after AIK Comp was placed into rehabilitation.

This trustee selection methodology used by AIK Comp was in direct contravention of the clear and unambiguous terms of the 1979 Indemnity Agreement and the then controlling 803 KAR 25:026. The Board of Trustees at the time of the Rehabilitation were not elected by the members. Indeed, none of the trustees of AIK Comp came from members of AIK Comp (who were and remain at risk) and were not elected by the members of AIK Comp (who have paid their assessments of more than $80,000,000).

These same trustees, who were not selected by the group members, played a direct role in placing AIK Comp into rehabilitation.[3] R.A., Tab 24, at S0000433. As shown above, the trustees were appointed or elected in violation of the original Indemnity Agreement and applicable regulatory guidelines. Accordingly, the legitimacy of their status with regard to this proceeding must be called into question.

The Rehabilitator uses these "amended" By-Laws to argue that the members of AIK Comp "ceded" to AIK Comp and its trustees control over the claims which are at issue in this appeal. R.A., Tab 32, at S0000498. Adopting the interpretation of the By-Laws advanced by the Rehabilitator means that the group members (who were at the time jointly and severally liable for any deficiency) gave or "ceded" to the trustees (who themselves contributed to the events that led to the deficiency) control over the claims against the trustees and others who caused the loss. Such an argument is circular at best and closer to illogical.

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[3] KRS 304.33-140(1)(m) requires that two-thirds of the Board of Trustees of AIK Comp consent to the Rehabilitation.

ARGUMENT

For the reasons stated herein, Appellants submit that the Order Approving Proposed Settlement entered April 17, 2008, by the Franklin Circuit Court should be reversed.

I. THE TRIAL COURT ERRED IN PERMITTING THE REHABILITATOR TO SETTLE AND COMPROMISE CLAIMS WHICH HE DOES NOT OWN

The Rehabilitator is a creature of statute and has no authority except that which the statute confers upon him. *Kentucky Central Life Insurance Co. v. Stephens*, Ky., 897 S.W.2d 583 (1995). With regard to rehabilitation, the provisions of KRS 304 create a special statutory proceeding left largely to the supervision of the trial court and the exercise of sound judicial discretion. *Id.* KRS 304.33-140 sets forth the grounds for rehabilitation. These grounds are separate and apart from the grounds that would allow for liquidation under KRS 304.33-190. By its nature, rehabilitation envisions a process whereby the affairs of the insurer are, for a limited period of time, administered by a rehabilitator and supervised by the Court with the ultimate goal of having the operations returned to management after rehabilitation has been concluded. The powers of a rehabilitator are set forth in KRS 304.33-160. Included in that list of powers and duties is the following:

> Pursuit of insurer's claims against insiders. If the Rehabilitator finds that there has been criminal or tortious conduct or breach of any contractual or fiduciary obligation detrimental to the insurer by any officer, manager, agent, employee or other person, he ***may*** pursue all appropriate legal remedies on behalf of the insurer.

KRS 304.33-160 (emphasis supplied). This statutory language only empowers a rehabilitator to pursue the insurer's claims against insiders—not claims that are owned by policyholders or members of self-funded groups.

KRS 304.33-160 also defines the general powers of a rehabilitator. Those general powers are described as follows:

> General Power. The Rehabilitator may take action as he deems necessary or appropriate to reform and revitalize the insurer. He shall have all the powers of the directors, officers, managers, whose authority shall be suspended, except as they are redelegated by the Rehabilitator. He shall have all power to direct and manage, to hire and discharge employees subject to any contract rights they may have, and to deal with the property and business of the insurer.

Again, this statutory provision illustrates that the role of a rehabilitator is to step into the shoes of the insolvent insurer and utilize the powers of the insurer as if acting through the insolvent entity's directors, officers, and managers.

To understand the issue before the Court, the powers of a rehabilitator must be juxtaposed and compared to the powers of a liquidator. *See* KRS 304.33-240. As the Court will note, the mere volume and description of the powers of a liquidator as compared to a rehabilitator are substantial. In this case, the most substantial difference is set forth in KRS 304.33-240(14), which explicitly provides that the liquidator has certain powers including the following:

> Prosecute any action which may exist on behalf of the creditors, members, policyholders, or shareholders of the insurer against any officer of the insurer or any other person.

When comparing this statutory grant of power to the regulatory authority provided to a rehabilitator, it is abundantly clear that a liquidator has the right to pursue claims on behalf of a whole host of entities including: creditors, members, policyholders or shareholders. The grant of power to a liquidator stands in stark contrast to the limited rights of a rehabilitator to pursue claims on behalf of the insurer alone. This difference is substantial. When liquidation is the chosen course for the insolvent insurer, the economic viability of the entity has been predetermined and the goal of the proceeding is to

maximize the payment of insurance claims. The parties to a liquidation proceeding understand that not all claims will be paid and that creditors and investors will not receive payment for 100% of their claims or the return of their investment. On the other hand, in a rehabilitation, the goal is to have the proceeding move towards a resolution which would be either: (1) transformation to liquidation or (2) return of the entity's management to the original owners. *See* KRS 304.33-180. Liquidation has only one potential conclusion—an orderly distribution of estate assets to policyholders and creditors in an order of preference set forth in KRS 304.33-430.

It is clear, therefore, that the rehabilitation and liquidation processes are separate and distinct. Likewise, the statutory powers granted to a rehabilitator and a liquidator are separate and distinct. Growing from those two statutory frameworks are the separate duties and powers of the rehabilitator on the one hand and the liquidator on the other. At the heart of this distinction, is the breadth of the powers granted by statute to a rehabilitator to pursue claims against third parties as opposed to the ability of the members of a self-funded plan which have paid assessments in excess of $80,000,000.

A. The Statutes Governing The Rehabilitator's Power To Pursue Claims Against Insiders Are Permissive – Not Mandatory – Leading To The Conclusion That The Rehabilitator Does Not Possess The Sole Right To Pursue Such Claims

KRS 304.33-160(4) sets forth the powers and duties of a rehabilitator and provides that a rehabilitator ***may*** bring actions against insiders of the insurer. The statutory language is clearly permissive and not mandatory—leading to the conclusion that under KRS 304.33-160(4) a rehabilitator is not vested with sole discretion to pursue "insider" claims. Further, the statutory scheme does not confer upon the Rehabilitator the

sole and unfettered right to seize all claims and causes of action against parties potentially responsible for the losses incurred by the group members of AIK Comp.

KRS 446.010 codifies the manner in which Kentucky's statutes are to be interpreted. Under this analysis, the term "may" is permissive and the term "shall" is mandatory. *See* KRS 446.010(20) and (29). In KRS 304.33-160(4), the General Assembly provided that a rehabilitator "may" pursue appropriate remedies against the insiders. Accordingly, the General Assembly has given a rehabilitator the option, but not the obligation, to pursue such claims. When read in the context of the rehabilitation proceeding, a rehabilitator is not vested as a matter of law with ownership of all causes of action against the insiders; instead, a rehabilitator has the right, but not the sole authority, to present such claims.

In the liquidation context, the General Assembly granted the liquidator the right to pursue claims on behalf of creditors, shareholders and policyholders. *See* KRS 304.33-240(14). This grant of authority to the receiver acting as a liquidator is clearly broader than the authority granted to the receiver acting as a rehabilitator. Had the General Assembly intended that a rehabilitator have standing to assert claims on behalf of this wider classification of persons against potentially all parties responsible for the downfall of the carrier, it clearly had the ability to do so as it did in the liquidation setting. Accordingly, the Rehabilitator does not have the broad rights which it now claims since it is limited by the statutory grant of power. *See Burgin v. Forbes*, Ky.App., 169 S.W.2d 321 (1943) (When certain persons or things are specified in a law, contract, or will, an intention to exclude all others from its operation may be inferred.); *see also Louisville*

Water Co. v. Wells, Ky. App., 664 S.W.2d 525 (1984) (enumeration of particular things excludes other items which are not specifically mentioned.)

The Rehabilitator has been granted the discretionary powers and duties to pursue the insurer's claims against insiders of AIK Comp. Being a creature of statute, the Rehabilitator is limited by the General Assembly's grant of authority. The Group Members, having paid their assessments in accordance with their obligations, have their own individual claims against the officers, trustees, and others which they may pursue. The claims asserted by Appellants and on behalf of the putative class members are now and will remain personal. The claims based on indemnity alone are substantial and personal to Appellants. Kentucky recognizes the common law right of total indemnity when a party who is secondarily liable pursues a party who is primarily liable. *See Degener v. Hall Construction Co.,* Ky., 27 S.W.3d 775 (2000). The right to pursue the indemnity claim arises after the payment has been made. *See Commonwealth, Department of Transportation v. All Points Construction Co.,* Ky. App., 566 S.W.2d 171 (1977).

The Rehabilitator does not have exclusive ownership of the claims asserted by Appellants. R.A., Tab 38, at S0000876-877. As such, the Rehabilitator, with or without the assistance of the Franklin Circuit Court, cannot compromise, settle and dismiss Appellants' claims.

II. THE TRIAL COURT ERRED IN TERMINATING THE CLAIMS OF APPELLANTS AND THE PUTATIVE CLASS MEMBERS WITHOUT FOLLOWING THE PROCEDURE SPECIFIED IN CIVIL RULE 23

The Franklin Circuit Court sanctioned the Rehabilitator's attempt to compromise and settle Appellants' claims even though the Rehabilitator did not have sole ownership of those claims. R.A., Tab, 100, at S0002275; *see also* R.A., Tab 101, at S0002295.

Moreover, in compromising the claims of Appellants and the putative class members, the Franklin Circuit Court did not follow the procedure in CR 23, *et seq*.

Civil Rule 23.05 provides:

> A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.

Civil Rule 23.05 applies to putative and absent class members as well as to members of a certified class. *See Doe v. Lexington-Fayette Urban County Gov't*, 407 F.3d 755, 761 (6th Cir. 2005) (citing Alba Conte & Herbert B. Newberg, NEWBERG ON CLASS ACTIONS § 8:18 (4th ed. 2002); *see also Culver v. City of Milwaukee*, 277 F.3d 908, 915-15 (7th Cir. 2002)).

The Franklin Circuit Court's Order Approving Proposed Settlement explicitly dismisses the claims of Appellants and the putative class members as to the officers and trustees (herein "Settling Defendants"). R.A., Tab 101, at S0002296. Although the Court purported to follow CR 23.05 in providing notice to the putative class members, it nevertheless explicitly refused to consider the requirements of CR 23.01 or 23.02 in connection with the order. R.A., Tab 100, at S0002278-2279. Findings pursuant to CR 23.01 and 23.02 are mandatory. *Wiley v. Adkins,* Ky., 48 S.W.3d 20, 23 (2001).

In particular, the Franklin Circuit Court never certified a class or adhered to the protections afforded by the class action procedure. CR 23.03(2) requires that class members receive notice advising each member that "the court will exclude him from the class if he so requests by a specified date." No such notice or opportunity was offered to the putative class members here and that omission runs afoul of the protections explicitly stated in the rule. *Eisen v. Carlisle & Jacqueline,* 417 U.S. 156, 173-77 (1974).

The Court here did not certify any class—much less a non-opt out class under other provisions of CR 23. Accordingly, there was no consideration of and therefore no finding that a non-opt out class was appropriate here. Without the appropriate findings of fact, the Court cannot certify a class. *Brockman v. Jones*, Ky. App., 610 S.W.2d 943 (1980). Without certification, the absent putative class members cannot be bound by the Court's Order Approving Settlement.

The Court's finding that the non-class action settlement satisfied the class action notice requirements and therefore, was binding upon putative class members as in a class action is wholly unsupported in the Civil Rules, Kentucky law, or the law of any jurisdiction in this country. As such, the Order Approving Proposed Settlement should be reversed.

III. THE TRIAL COURT'S APPROVAL OF THE REHABILITATOR'S UNILATERAL DECISION TO SETTLE ALL CLAIMS AGAINST THE OFFICER AND TRUSTEE DEFENDANTS MUST BE REVIEWED UNDER A "FAIR AND REASONABLE" STANDARD.

The Kentucky Supreme Court has determined that insurance rehabilitation/liquidation proceedings are *special statutory proceedings*. *See Kentucky Central Life Insurance Co. v. Stephens*, 897 S.W.2d 583, 588 (Ky. 1995) (emphasis added). In *Kentucky Central Life Insurance Co.* the Kentucky Supreme Court acknowledged that:

> Not always does due process require a trial or the strict application of evidentiary rules and/or unlimited discovery. The Court may construct, especially under special statutory proceedings, a more flexible procedure to account for the affected interest or potential deprivation. Procedural due process is not a static concept, but calls for such procedural protections as the particular situation may demand.

Id. at 590 (emphasis added); *citing Morrissey v. Brewer*, 408 U.S. 471, 92 S.Ct. 2593, 33 L. Ed. 484 (1972); *see also Minor v. Stephens*, 898 S.W.2d 71, 75 (Ky. 1995)

("rehabilitation and liquidation of an insolvent insurance company is a special statutory proceeding and that the application and utilization of special statutory rules may be left largely to the supervision of the trial judge in the exercise of sound judicial discretion.")

Moreover, insurance rehabilitation and liquidation law is designed to provide comprehensive, efficient, and orderly procedures for liquidating/rehabilitating insurance companies while protecting the rights of interested parties. *Minor*, 898 S.W.2d at 75 (emphasis added); *see also* KRS 304.33-010, *et seq.* Indeed, the central purpose of the Kentucky Insurers Rehabilitation and Liquidation Law is the protection of the interests of insureds, creditors, and the general public. *See* KRS 304-33-010 (emphasis added). In the matter at hand, the AIK Comp group members have not only paid the vast assessment to fund the Rehabilitation, but they are also the policyholders of AIK Comp – the intended beneficiaries of the protection afforded by Kentucky's Insurers Rehabilitation Statute. These group members collectively have paid millions into the AIK Comp estate (and in so doing paid the entire amount necessary to fund the Rehabilitation).

Moreover, the group members have not only paid the assessment to fund the Rehabilitation, but they are also the policyholders of AIK Comp and the intended beneficiaries of the protection afforded by Kentucky's Rehabilitation statute. *See Kentucky Central Life Insurance Co.*, 897 S.W.2d 583. As such, the Commonwealth's Rehabilitation Statute mandates that the Franklin Circuit Court review the terms of the proposed settlement to ensure that the agreement's provisions "are fair reasonable, and in the best interest of AIK Comp, its group members, injured employees of group members, beneficiaries, claimants, creditors and the people of the Commonwealth of Kentucky." R.A., Tab 63, at S0001604.

IV. THE TRIAL COURT ERRED IN THAT THE PROPOSED SETTLEMENT IMPOSED UNREASONABLE RESTRICTIONS ON THE ABILITY OF APPELLANTS AND THE PUTATIVE CLASS MEMBERS TO PURSUE THEIR INDEPENDENT CLAIMS

The Franklin Circuit Court recognized that Appellants and group members have valid claims against alleged tortfeasor third party professionals, trustees, and officers which they should be permitted to pursue. R.A., Tab 38, at S0000876-877. The Settlement Agreement approved by the Circuit Court, however, contains a number of provisions which seek to restrict and/or eliminate Appellants' right to pursue their claims. R.A., Tab 101, at S0002295-2297.

Under Section 3.1 of the Settlement Agreement, each Settling Defendant has a duty to cooperate and be available for "[. . .] discussion, consultation or interview at reasonable and mutually agreeable times and places to assist the Rehabilitator in the conduct of the Rehabilitation and pursuing claims against persons who the Rehabilitator believes have breached duties owed to AIK Comp." R.A., Tab 54, at S0001278. Critically, however, Section 3.1 goes much further and orders the Settling Defendants:

> ***[T]o refuse*** to provide informal interviews or discussions with any other person about the same topics unless given permission in writing by the Rehabilitator. The Rehabilitator shall be responsible for the reasonable costs and legal fees incurred by any Settling Defendant in meeting their duty to cooperate.

Id. (emphasis added)

Section 3.1 clearly restricts the ability of Appellants to pursue their claims. Section 3.1 effectively prevents Appellants from preparing their case by interviewing third party witnesses (assuming the Settling Defendants have been dismissed as parties), and it effectively shifts to the Rehabilitator sole and exclusive power to control these crucial witnesses and access to their information. This restriction is clearly unreasonable,

especially in light of the fact that the Settlement Agreement makes Appellants responsible for the costs and legal fees incurred by any Settling Defendant in meeting their duty to cooperate. Moreover, this provision is in express violation of the trial court's May 25, 2006 Order. R.A., Tab 38, at S0000876-877. Appellants have been unreasonably fettered in prosecuting their respective claims with a requirement to obtain the Rehabilitator's prior approval to interview the Settling Defendants who by that time may only be third party witnesses and not parties.

Moreover, Section 2.4(d) of the Settlement Agreement sets forth an indemnity provision which provides that:

> The Settling Defendants, having settled with the Rehabilitator, remain susceptible to having other nonsettling defendants assert claims against them. The indemnity and hold harmless protection set forth in this Agreement are intended to protect the Settling Defendants, after the Effective Date, against any liability or expense or having to defend, participate or be added to or remain as parties of record and obligated to participate in any proceeding (including trial). This protection includes, but is not limited to, actions to determine whether any Settling Defendant was a tortfeasor such that other non-settling defendants and/or others may be entitled to a credit, setoff, or reduction of any verdict. In the event Rehabilitator seeks testimony or documents from any of the Settling Defendants, the Rehabilitator will provide written notice to that Settling Defendant who, as set forth later in this Agreement, may have personal counsel.

R.A., Tab 54, at S0001277. Accordingly, in exchange for the payment of the proceeds of the Settling Defendants' liability policy, the Rehabilitator granted broad indemnification to all of the Settling Defendants. In fact, the Settlement Agreement converts the Settling Defendants' insurance policy with separate defense and liability obligations into a "burning" policy where the liability limits are diminished as defense costs are incurred. However, under the Rehabilitator's Settlement Agreement, this risk is shifted from the tortfeasors to Group Members. The Appellants maintain that in approving the

Settlement, despite the unreasonable restrictions set forth herein, the Franklin Circuit Court failed to meet the "fair and reasonable" standard of review demanded by the Court's own December 10, 2007 Order and the Kentucky's Insurers Rehabilitation Statute. *See* § III, *supra; see also* R.A., Tab 63, at S0001604.

CONCLUSION

For all the foregoing reasons, Appellants respectfully request that the Franklin Circuit Court's Order entered April 17, 2008 be REVERSED.

Respectfully submitted,

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