

STATE OF WISCONSIN

BEFORE THE OFFICE OF THE COMMISSIONER OF INSURANCE

2005 JUN 17 AM 11:33

RECEIVED
WISCONSIN COMMISSIONER
OF INSURANCE

In the Matter of:

Proposed Acquisition of Control of
Physicians Insurance Company of Wisconsin, Inc., by
American Physicians Capital, Inc. and
American Physicians Assurance Corporation ("Applicants")

Case No. 04-C29283

**APPLICANTS' BRIEF IN RESPONSE TO THE DISCOVERY PROPOSED
BY PHYSICIANS INSURANCE COMPANY OF WISCONSIN, INC.**

The Applicants hereby submit this memorandum in opposition to the discovery proposed by Physicians Insurance Company of Wisconsin ("PIC") in this proceeding. As predicted, PIC seeks the production of information that is well beyond the scope of the statutory criteria, and would entail the production of so many documents that this proceeding would drag on for another year. The Applicants have objected to PIC's status as a party, and to any discovery by PIC in this proceeding. The Applicants do not waive these objections by submitting this memorandum, but are providing the Commissioner with their views on the broad and irrelevant nature of many of the requests in the event that these objections are overruled.¹ To assist the Commissioner's review of the numerous requests that have been proposed, the Applicants will

¹ PIC Wisconsin purported to "serve" the discovery requests on the Applicants, even though PIC has not been admitted as a party, and the Commissioner has not ruled on its motion to permit discovery. The Commissioner made both these points clear during the prehearing conference, and in the prehearing memorandum. Based on the statements in the Brief filed by PIC, it is apparent that they are trying to set up the argument that because the Applicants do not respond to these requests within 20 days of service (even though they are not obligated to do so), that this will force a delay in the proceedings. To the contrary, the Commissioner established the hearing date with full knowledge that a decision on PIC's participation and its right to discovery, if any, would not be made until late June/early July. Furthermore, APA has been offering to meet with PIC's Board and exchange documents since December 2004 – an offer that PIC has had ample opportunity to accept, if it was truly interested in an objective fact-finding mission.

first discuss several basic issues that are problematic throughout the requests, and then review the requests by category.

**The Wording Of the Requests Would Require The Production
Of Nearly Every Document Maintained by the Applicants**

Throughout the requests, PIC asks for “all documents concerning” the various topics. Under the proposed definitions, “Concerning” means “relating to, referring to, describing, evidencing or constituting.” “Documents” are defined to include all electronic databases, all drafts, and privileged information. A sample of the breathtaking expanse of the application of these definitions demonstrates their overbreadth. Document Request 1, for example, requests:

All documents concerning Your “current business operations, and ... plan for the future” (Form A at 3), including but not limited to any budgets, forecasts or business models prepared by or on Your behalf.

Every piece of paper at American Physicians Assurance Corporation (“APA”) is responsive to this request. Every policy issued by APA concerns its business operations. Every document within the marketing department, the accounting department, claims, and underwriting is within the scope of this request. All communications with policyholders and potential policyholders, with agents, and with regulators, etc. would also be responsive to this request. This same problem permeates all of the document requests because they all ask for “all documents concerning,” rather than just asking for specific documents.

The requests are also uniformly problematic because they are not limited to documents that reflect the decision of management or the Board of Directors on any particular issue. Another problem with the overbroad nature of the requests is that they cover drafts, notes, e-mails that bear either no or remote relevance to these proceedings. What is relevant are the official actions of the Company. For example, it is irrelevant what an employee in marketing thinks the business plan of the Company should be. Multiple drafts of the Company’s business

plan are irrelevant to APA's final business plan that the Board approved. Only the final business plan, reviewed and approved by the Board, should be produced in response to this type of request (if any). Therefore, to the extent the Commissioner authorizes any of these requests to go forward, the production should be limited to final documents prepared by management, and/or documents reflecting plans or actions presented to and approved by the Board. Privileged documents should also be excluded from any response.

To facilitate the Commissioner's review of the discovery requests, the Applicants have broken the requests into the following categories:

1. Documents regarding the transaction at issue in this proceeding;
2. Documents regarding the Applicants' business plans;
3. Documents regarding privileged communications with accountants, auditors and actuaries;
4. Documents regarding the change in auditors;
5. Documents regarding AP Capital's Sarbanes-Oxley Report;
6. Information regarding APA's activities in other markets;
7. Shareholder information;
8. Discovery from the selling shareholders; and
9. Interrogatories.

The Applicants review each of these categories.

Documents Regarding The Transaction At Issue In This Proceeding

In various requests, PIC seeks documents exchanged between the Applicants and the selling shareholders pertaining to the transaction that is at issue in the Form A, and its plans for PIC following the acquisition. These are the interrogatories and document requests 29-38. If so requested by the Commissioner, APA is willing to produce responsive documents and answer the interrogatories, subject to objections based on attorney-client privilege and the joint interest privilege.² Documents exchanged with the selling shareholders prior to the execution of the Share Purchase Agreement would be produced.

Documents Regarding the Applicants' Business Plans

PIC seeks documents regarding APA's current business operations and plans (Document Request #1). APA is willing to produce its current strategic business plan, its budget for 2005 and its forecasts of income in response to this request.³

PIC also requests "all documents concerning 'the fundamental changes undertaken by new management' of APA and the 'new operating philosophy' of APA described in the Form A." (Request #23.) APA would be willing to produce the final decisions of the Board of Directors of AP Capital, and the management presentations implementing these changes. Every document "concerning" these changes would once again require the production of every piece of paper within the Company, and is so broad as to be meaningless.

PIC's requests cross the line when they seek documents concerning the review conducted by the Applicants in late 2003 and early 2004 regarding the strategic options facing the Company (Request #26). During this process, the Company engaged the services of an investment banking

² As addressed *infra*, one of these interrogatories should be narrowed.

³ All offers for production are subject to the entry of an appropriate protective order, as discussed at the prehearing conference.

firm to assist in its evaluation of whether the Company should continue forward with its revised business plan, or consider a potential sale or merger with another company. At the end of the process, the Board of AP Capital determined that the interests of its shareholders and policyholders were best served by AP Capital continuing as a stand-alone company providing professional liability insurance to physicians. The documents associated with this review are voluminous, and almost all of them are subject to confidentiality agreements with parties with whom the Company had discussions, which would preclude their production here. Most importantly, however, none of these documents are relevant to this transaction or Applicants' current business. AP Capital announced on June 24, 2004 that it had determined that it is in the best interests of its shareholders for it to remain as a stand-alone company. Due diligence documents and explorations of other alternatives are not relevant, as ultimately the alternatives were rejected by the Board. This request is nothing more than a fishing expedition that is harassing and irrelevant to whether the Applicants' acquisition satisfies the statutory tests under Wisconsin law.

**Documents Regarding Privileged Communications with
Accountants, Auditors and Actuaries**

PIC seeks all documents from AP Capital's independent auditors, including management letters and reports, all documents regarding internal audit activities, everything provided to the Audit Committee and minutes of those meetings, and all documents "concerning" actuarial studies and reports. (Requests #4-7.) As an initial matter, none of these documents are relevant to these proceedings. APA will be a minority shareholder in PIC, with no ability to purchase additional shares as a result of the poison pill adopted by the PIC Board. APA's financial condition as a shareholder does not get reported on PIC's financial statements, does not impact those statements, and does not effect the business operations of PIC or its entrenched

management in any way. The Applicants have further committed in the Form A that they have no plans to dissolve PIC, require it to pay dividends, or change any of the fundamental business practices of PIC, even if it had the power to do so (which it will not).

The audited financial statements of the Applicants for the last three years have been filed with the Commissioner. Those contain certifications from the auditors that the financial statements are fairly stated, including the provisions for losses through its the reserves. In addition, the Applicants receive an actuarial certification on their reserves which is filed with its domiciliary regulator, the State of Michigan. The Applicants' financial information is not only available to PIC from the filings made in this case, but available on the internet with a couple of clicks of a mouse. To say that something more is needed, such as draft reports, internal audit documentation (which is an immense number of documents as a result of Sarbanes-Oxley, to which AP Capital is subject), and underlying loss run data, once again threatens to make this proceeding a circus, rather than a proceeding focused on the statutory criteria.

Moreover, the documents sought are privileged under Michigan law. Michigan recognizes the common-law privilege between a company and its accountant, and has codified this privilege in Mich. Comp. Laws § 339.732(1).⁴ In addition, documents generated during an insurance company's self-audit process are absolutely privileged under the Michigan Insurance Code, Mich. Comp. Laws § 500.221, which provides:

⁴ This statute provides:

Except by written permission of the client ... to whom the information pertains, a licensee, or a person employed by a licensee, shall not disclose or divulge and shall not be required to disclose or divulge information relating to and in connection with an examination or audit of, or report on, books, records, or accounts that the licensee or a person employed by the licensee was employed to make. Except as otherwise provided in this section, the information derived from or as the result of professional service rendered by a certificate public accountant is confidential and privileged.

Except as otherwise provided in this section, an insurance compliance self-evaluative audit document is privileged information and is not discoverable or admissible as evidence in any civil, criminal or administrative proceeding. (emphasis added)

The documents sought are privileged under these statutes, which govern APA's privileges as a Michigan domestic company. These statutory privileges should not be abrogated in this proceeding.

If required by the Commissioner, the Applicants are willing to produce the summary reports of the actuaries for the year ended December 31, 2004, and a report on reserves as of June 30, 2005 when it is prepared, in exchange for the same documentation from PIC. This should provide more than ample information to PIC and any "expert" that it seeks to retain. The production of any of the other documents sought, in light of the huge volume of financial information available on the Applicants, is unnecessary, burdensome, and inappropriate.

Document Request #2 suffers from the same deficiencies, when it seeks all documents "concerning" the "financial difficulties" experienced by APA in November, 2003. As explained in the Form A and accompanying detailed financial disclosures filed by APA, the "difficulty" experienced by APA in November, 2003 was that it determined that its loss reserves needed to be strengthened because of an increase in the severity of the claims being filed against the company, particularly in some of the states the company was exiting because of the lack of effective tort reform and the accompanying poor loss experience. To respond to this request as drafted would require the production of reams of paper and data concerning the loss trends and policy information that led APA's internal and external actuaries to conclude that the reserves should be strengthened. If there is something specific sought in this request, it cannot be identified.

If Request #2, like Request #3, is limited to presentations made to A.M. Best and correspondence regarding APA's ratings during November 2003 and 2004, APA would be willing to provide this information.

Documents Regarding The Change In Auditors

Document Requests 8 and 9 seek information regarding AP Capital's decision to change auditors from PriceWaterhouseCoopers ("PWC") to BDO Seidman, LLP. This information is irrelevant, as demonstrated by AP Capital's public filings which show (1) there was no disagreement between AP Capital and PWC which led to the change, and (2) PWC's public filing agreeing with AP Capital's statement on this issue. If the Commissioner nonetheless deems this relevant, AP Capital is willing to provide the bid documentation that shows that AP Capital acted like any prudent corporation and sought bids from qualified auditing firms for its work, that BDO has extensive experience auditing insurance companies, and the substantial difference (approximately \$500,000) in bids submitted by the two companies.⁵

Documents Regarding AP Capital's Sarbanes-Oxley Report

As required by Sarbanes-Oxley, AP Capital was required to undertake a massive project for the purpose of identifying, evaluating, testing, and analyzing all of its internal controls. This was an especially challenging task for 2004, when the guidance and interpretations from the auditors and regulators evolved constantly. AP Capital spent nearly one million dollars during 2004 as a result of the establishment of its process for Sarbanes compliance, and hundreds of hours of its personnel in satisfying the requirements of the act.

⁵ PIC asserts that BDO is a firm "not recognized for its insurance expertise." (PIC Brief, p. 5.) What is the basis for this defamatory and untrue statement? BDO exams a number of insurance carriers in Michigan, and has a national practice. To disparage AP Capital's auditors without basis is truly representative of the lengths to which PIC will go in this proceeding.

At the end of the process, as fully disclosed in AP Capital's 10-K for the year-ended December 31, 2004, AP Capital determined that it had a material weakness in the controls regarding its New Mexico operations. The majority of these internal control deficiencies have already been addressed during 2005. The balance of the issues are expected to be addressed when AP Capital converts its New Mexico computer system to the system used in AP Capital's home office. The New Mexico computer system is antiquated, and simply does not have the appropriate kinds of security bells and whistles that are now required in the post-Sarbanes world.

The key point regarding the material weakness, however, is that both management and the external auditors concluded that the material weakness had no impact on the accuracy of the financial statements of AP Capital. (See 10-K, pp. 47-49, 89-90). While a potential for a problem was identified as existing in 2004 and the first quarter of 2005, no problem actually developed. If the Commissioner orders the production of any further information on this issue, the production should be limited to the documentation and testing associated with the New Mexico business which was assembled during the Sarbanes testing.

Information Regarding APA's Activities in Other Markets

PIC seeks all documents concerning APA's decision to exit the Florida and Nevada markets (Requests #18 and 19). As the Commissioner is aware, the American Medical Society considers both Florida and Nevada to be crisis states, in large part because of their lack of effective tort reform. In its financial disclosures filed with the Commissioner, APA provided detailed information regarding the losses it incurred in Florida and Nevada which resulted in its decision to exit those markets. PIC has those documents. The documents now sought by PIC would require the production of mountains of statistical data underlying the loss reserves for those states, as well as all claim files, policy files, and communications with agents and

policyholders. In the final analysis, production of this information provides no additional insights into what was a straightforward business decision to exit a market in crisis. It is no different than PIC's decision to exit a number of markets over the years, with its recent exodus from Cook County serving as a prime example. No further production should be required on this issue.

PIC also seeks "all documents concerning" rate increases instituted by APA over the past three years (Request #21). Once again, this would be an enormous task to produce all the documents that would fall within the scope of this extremely broad request. Nor is the information relevant to these proceedings. As a minority shareholder, APA has no ability to change PIC's rating structure. Moreover, even if APA had such an ability, the rates charged in other states are based on APA's experience in those particular states. The rates charged in Florida have nothing to do with the rates charged in Wisconsin. If the Commissioner requires the production of any information on this issue, the request should be limited to a summary of the rate increases, and not the production of all the voluminous underlying data that goes into the calculation of the rates.

Document Request 22 is similarly overbroad. It requests all documents "concerning" examination reports by any state insurance department from January 1, 2000 to date. The Applicants have filed their most recent examination reports from their domiciliary regulator for the year-ended 2003, with the Commissioner. Prior exam reports are irrelevant to the current activities of APA, and irrelevant to these proceedings.

PIC also requests all documents "concerning" APA's "loss of endorsement" of the Kentucky Medical Society (Request #20). The Kentucky Medical Society is not currently endorsing any professional liability insurer, as no insurer is willing to insure all members of the

Medical Society without underwriting those risks. If the Commissioner believes that this is somehow relevant, APA would be willing to produce the correspondence exchanged with the Kentucky Medical Society that documents this issue.

Document Request #25 seeks all documents “concerning” APA’s reduction in the number of medical malpractice insurance policyholders over the past three years. This is extremely overbroad, and would literally require the production of each policy renewal package for each policyholder who elected not to renew their policy at any time during the last three years. This information is not relevant to these proceedings, and represents another fishing expedition. The total number of policyholders is contained in the financial reports filed by the Applicants with the Commissioner. If the Commissioner wants to review a breakdown by State, the Applicants can provide this information.

Shareholder Information

Document Requests 14 through 17 request information regarding shareholder standstill agreements in place with any AP Capital shareholder. The Applicants have filed the current standstill agreement between AP Capital and the Stilwell Group. As stated in that document, the Stilwell Group may nominate directors for 2 seats on the Board of Directors of AP Capital. The standstill agreement contractually precludes the Stilwell Group from (1) purchasing ten percent or more of the outstanding shares of AP Capital, (2) entering into any voting trusts or voting agreements with any other shareholder of AP Capital, or (3) acquiring additional representation on the Board of Directors. As a result, they are not acquiring persons under Wisconsin law. Other documents which might “concern” this Agreement are not relevant, as the final agreement is the one filed with the SEC and the Commissioner.

AP Capital has one other standstill agreement with a minority shareholder and director, Mr. Daniel Gorman. Mr. Gorman's standstill agreement permits him to serve as a director of AP Capital, bars him from purchasing more than 5% of the shares of AP Capital, precludes him from entering into any voting trusts or voting agreements with any other shareholder of AP Capital, and limits his Board representation to the one seat. This agreement is available in AP Capital's public filings, but the Applicants are willing to file it with the Commissioner if deemed appropriate.

PIC also requests documents regarding the "repurchase or potential repurchase" by AP Capital of its stock (Request #24.) The only purported relevance of this information, which is publicly available in AP Capital's filings, is PIC's assertion that if the Stillwell Group "persuaded" the Board to repurchase stock, that shows that they have "control" of AP Capital. (PIC Brief, p. 6.) This is a test for "control" that is not recognized in any state in the country. The fact that one director out of nine, or even two out of nine, may suggest a course of action and ultimately persuade other directors as to the wisdom of that course of action is not "control" within the meaning of any statute. Rather, the control test in Michigan and in Wisconsin is the ability to direct the activities of the company – which the Stilwell Group (with 2 of 9 seats) is not able to do. Mich. Comp. Laws § 500.115(b); Wis. Stats. § 600.03(13).

Finally, PIC requests documents "concerning" a dividend from APA to AP Capital, and a surplus contribution by AP Capital to Insurance Corporation of America. These dividends are irrelevant to this proceeding, where the Applicants have stated that they have no plan to seek to compel PIC-Wisconsin to pay dividends to its shareholders. AP Capital has never paid dividends to its shareholders.

PIC disingenuously claims that APA has “proclaimed in its public filings” that it can upstream as much as \$18 million out of APA without Insurance Division approval, as if APA has announced a plan to do so. (PIC Brief, p. 7.) As is evident from a reading of the truncated sentence in context in APA’s filing, this is nothing more than full disclosure to the shareholders that there are limitations imposed by Michigan law (like Wisconsin law) which prevent a dividend in excess of 10% of surplus earnings to be declared without prior Commissioner approval. It is not a statement that APA intends to declare such a dividend, but simply a disclosure required by law. If PIC was required to make disclosures to its shareholders, it would have to make an identical disclosure with the appropriate dollar amount inserted.

Discovery Sought From The Selling Shareholders

At pages 8-10 of its Brief, PIC states its intention to seek discovery from the shareholders as to alleged “securities law violations.” PIC then proceeds to delineate the alleged violations by the shareholders. Of course, the Commissioner will note that the points (1), (2), (3) and (6) in PIC’s list do not bear any relation to the “securities laws.” Instead, they are arguments regarding whether certain information should have been in the Form A, and whether Dean or the selling shareholders as a group should have filed a Form A. Whether the selling shareholders should have made certain filings or not, that is irrelevant to whether the current Form A should be approved under Wis. Stats. § 611.72(3).

Moreover, the absurdity of PIC’s position is that if the selling shareholders had “control” over the direction and management of PIC, none of us would be spending our time in a contested case proceeding – the selling shareholders would have had the ability to replace the Board, replace the management, and direct the approval of this transaction. The argument is a smokescreen, and should be treated as such.

PIC's points (4) and (5) are equally irrelevant under Wis. Stats. § 611.72(3). Even assuming *arguendo* that the provisions apply, Section 13D of the federal securities law, and the Wisconsin equivalent, require filings only after a person acquires the beneficial ownership of shares. SEC Reg. § 240.13d-1.(a) ("Any person who, *after* acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section ..."); Wis. Stats. § 552.03(1) ("Any person who, *after* acquiring directly or indirectly the beneficial ownership of any equity security of a target company ..."). Because APA has not acquired the beneficial ownership of *any* shares of PIC, it is not yet required to file anything pursuant to these provisions, even if they apply.

Moreover, the Applicants have stated that they are willing to produce the information exchanged with the selling shareholders which led to the Stock Purchase Agreement. Chasing down the selling shareholders and dragging them through discovery, thereby further delaying the infusion of the proceeds of this transaction into health care in Wisconsin, is frivolous and unconscionable.

Interrogatories

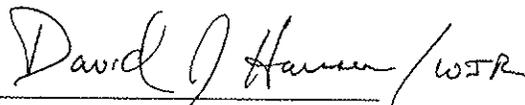
PIC has also promulgated eight proposed interrogatories. The Applicants are willing to respond to these requests up to the date of the Stock Purchase Agreement, subject to objections based on applicable privileges, with one exception. Interrogatory 7 requests all communications concerning "any PIC Wisconsin shareholder other than the Selling Shareholders." This request is so broad that it would sweep in any person who at one time may have been a policyholder of PIC Wisconsin and is now (or was) a policyholder of APA. To the extent that APA can even discern this information from its policy files, it would require a file by file review. The Applicants are willing to provide communications regarding PIC Wisconsin shareholders who

have made unsolicited contacts with the Applicants, expressing an interest in selling their shares, which is presumably what PIC-Wisconsin is seeking in these requests.

Conclusion

In the event that the Commissioner allows PIC to participate as a party and authorizes discovery, the Applicants submit that the disclosures that they have identified in this Brief are appropriate and, coupled with the extensive filings already made by the Applicants, provide more than sufficient documentation for these proceedings to go forward.

Respectfully submitted this 17th day of June, 2005:



David J. Hanson
Michael Best & Freidrich LLP
One South Pinckney Street
Madison, WI 53701-1806

Lori McAllister
Dykema Gossett PLLC
124 W. Allegan, Suite 800
Lansing, MI 48933