
**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")**

MEMORANDUM OF PHYSICIANS
INSURANCE COMPANY OF
WISCONSIN, INC. ("PIC") IN SUPPORT
OF ITS REQUESTS FOR DISCOVERY

Case No. 04-C29283

Physicians Insurance Company of Wisconsin, Inc. ("PIC") respectfully submits this memorandum in support of its requests for discovery. PIC has filed and served written discovery requests contemporaneously herewith. Copies of those requests are attached to this memorandum as Exhibits A and B.

Discovery is essential to this proceeding.

PIC has been in the business of providing medical malpractice insurance in the State of Wisconsin for more than 20 years. Through the hard work of many, PIC has gained the confidence and trust of its Wisconsin policyholders. PIC has contributed to a healthy environment for physicians and medical malpractice insurance throughout this state. According to the American Medical Association, Wisconsin is one of only six states in the United States which has a "currently ok" environment for medical malpractice insurance: nearly half of the states in the United States are in "crisis." PIC has earned its well-deserved reputation and excellent A.M. Best financial rating over many years.

The transaction proposed by the would-be acquirors, American Physicians Capital, Inc. and American Physicians Assurance Corporation (collectively, "APC"), will irrevocably alter the fundamental nature of PIC. To date, PIC's shareholders have basically been a widely dispersed collection of Wisconsin physicians and healthcare providers. Many of these shareholders are also policyholders. PIC's board is similarly comprised of prominent Wisconsin physicians and others who take seriously the best interests of Wisconsin policyholders.

By contrast, the proposed transaction would place a controlling block of 24% of PIC's shares in the hands of an out-of-state, publicly-traded, for-profit company. PIC's next largest shareholder owns 3.6% of PIC's stock. Altogether, there are currently 1,190 shareholders, and the average shareholding of the remaining shareholders (if the transaction were allowed to proceed) would be approximately 12.5 shares.

Under these circumstances, a change of real "control" of PIC is plainly at stake. The Wisconsin statute presumes a change of control at a mere 10% shareholding.¹ Here, APC proposes to acquire nearly two and a half times as much. Moreover, as indicated in its amended Form A filing dated April 15, 2005, APC now intends to seek representation on PIC's board. APC is not a "passive" investor. Although APC protests that its intentions stop there, this Commission should not rely on such a self-serving assertion in assessing what is really at stake. In fact, this Commission has previously rejected precisely such statements in the context of the proposed acquisition of 20% of the stock of St. Paul Companies. See In the Matter of the Acquisition of Stock of the St. Paul Companies, Inc., Case No. 88-C20269, Order dated April 7,

¹ Section 600.03 Wis. Stats. provides definitions for terms in chs. 600 to 655, Wis. Stats. Section 600.03(13) states, in part, as follows: "There is a rebuttable presumption of control if a person directly or indirectly owns, holds with the power to vote or holds proxies or vote more than 10% of the voting securities of another person...."

1988, at 20 (“ . . . the purchase of 20% of St. Paul’s stock does give Alleghany control of St. Paul, thus negating any bare statement that Alleghany has no plans at this time to effect any changes”) (a copy is attached as Exhibit C).

APC’s proposed acquisition of the control of PIC merits the closest scrutiny. APC has nowhere near the track record of stability, commitment and success that PIC has earned. It has essentially no track record of commitment to Wisconsin or Wisconsin policyholders. The track record and intentions of APC – both long-term and short-term – will be one of the critical focuses of this proceeding. PIC, on behalf of its policyholders, and this Commission are entitled to fully explore all of the dimensions that are relevant to the statutory criteria that govern this proceeding.

The Written Discovery to Be Answered

Along with this memorandum, PIC has served and filed document requests and interrogatories. As described in Section II below, PIC also proposes to take written discovery from the Selling Shareholders. Given the discovery schedule set by the Commission at the pre-hearing conference on May 31, the document requests and interrogatories call for complete production and responses within 20 days. If these written discovery materials are fully provided and responses to the discovery from the Selling Shareholders are made in a timely manner, then PIC will be able to take and complete the depositions it needs by the end of July, consistent with the schedule proposed by the Commissioner.

The Substance of the Discovery

The discovery that PIC has promulgated is straightforward and plainly relevant.

This discovery, although all interrelated, can be divided into groups.

I. DISCOVERY NEEDED FROM APC

A. **Documents related to APC's financial condition and rating; to APC's business plans and stability; to APC's raising of malpractice insurance premium rates and to its withdrawal from providing malpractice insurance coverage in significant states.**

Many of the statutory criteria in Wis. Stats. § 611.72 (see, e.g., § 611.72(3), (3)(a), (3)(c) and (3)(e)) require examination into the condition, prospects and business plans of the would-be acquiror. Here, the proposed acquiror has undergone dramatic changes in the very recent past. Among other things, APC has replaced its senior management team as recently as 18 months ago (with the termination of Mr. Cheeseman); reviewed all of its strategic options, including the possible sale of the company, as recently as 12 to 15 months ago; been downgraded twice by A.M. Best (in November 2003 and January 2004); decided to exit one of its two principal lines of business (workmen's compensation insurance); decided to exit the entire states of Nevada and Florida with respect to all medical malpractice insurance policyholders; and substantially raised medical malpractice premium rates to all of its remaining policyholders.

This is not the track record of a stable, dependable and healthy company. It must be explored. Document Request Nos. 1, 2, 3, 18, 19, 20, 21, 22, 23, 24, 25 and 26 call for documents relating to these important topics.

B. Documents related to the adequacy of APC's reserves.

APC shocked the insurance industry and its investors in November 2003 when it announced that it had to take a special charge to support the adequacy of its medical malpractice insurance loss reserves. Since that time, APC has emphasized time and again in its public disclosures that the adequacy of its reserves is a serious risk factor to its business. The adequacy of APC's reserves goes to the heart of the statutory criteria for review of the proposed acquisition. (See, e.g., § 611.72 (3)(a), (3)(c) and (3)(e)). Document Request No. 7 inquires directly into the adequacy of APC's reserves.

C. Documents related to the adequacy of APC's internal controls and the dismissal of APC's long-standing auditor.

In its initial Form A filing, APC included its second-quarter 2004 10Q which represented – in fact, certified – that there were no material control weaknesses. APC repeated this representation in its third-quarter 2004 10Q, also filed with this Commission. Subsequently, APC announced in its 10-K for 2004 that, in fact, there was a material control weakness in its New Mexico operations – operations that it has run since 1997. Material control weaknesses are not trivial matters.

Compounding the significance of this material adverse development is that, simultaneous with the announcement of the material control weakness, APC terminated its long-standing, nationally-recognized independent audit firm. That firm has been replaced by a firm not recognized for its insurance expertise.

All of these circumstances justify examination under Section 611.72 of the internal controls, internal audits, management letters and other matters incident to APC's audits,

controls and relations with its external auditors. Those facts go directly to whether APC can satisfy its burden with respect to, inter alia, § 611.72 (3)(a), (3)(c) and (3)(e). These areas are the subject of Document Request Nos. 4, 5, 6, 7, 8, 9, 10 and 11.

D. Documents relating to who controls APC.

APC demutualized and became a public company in late 2000. Since that time, APC has taken the unusual step of entering into standstill agreements with several of its shareholders. One of these shareholders (the Stilwell Group) was given the power to appoint two of APC's nine directors, and also guaranteed membership for one of its representatives on every committee of APC's board of directors. In the past, the Stilwell Group has been able to persuade APC's board to use APC's capital to repurchase APC's stock on the open market, even when \$60 million in stock buybacks were probably contrary to the financial health of APC. These facts suggest that, at the very least, the Stilwell Group is a "control" person of APC, within the meaning of Wis. Stat. Section 600.03.

Document Request Nos. 14, 15, 16 and 17 are designed to establish the facts with respect to these powerful shareholders of APC, and the control they exercise. These inquiries are directly relevant to the identity of the proper applicants in this proceeding as well as to the criteria in Section § 611.72 (3)(d) and (3)(e).

E. APC's power to and practice of moving capital between its business units.

As the parent public company, American Physicians Capital has the power to move capital between and among its various subsidiaries. It has done so in the very recent past. For example, to shore up the inadequacy of capital at American Physicians Assurance in early

2004, APC caused one of its subsidiaries to be merged into APA. By the same token, what APC can give, it can take away – and it did so in December 2004 when it caused APA to upstream an \$8 million dividend and then took \$4 million and placed that in its highly tenuous Insurance Corporation of America subsidiary. Indeed, APC has proclaimed in its public filings that it can upstream as much as \$18 million out of APA without Michigan Department of Insurance approval.

This ability to cause money to be moved about amongst the entities APC controls is plainly relevant to, inter alia, the statutory criteria in Section 611.72(3)(c), (3)(d), and (3)(e). This is the subject of Document Request Nos. 12 and 13.

F. Information regarding the Wisconsin insurance market.

Nothing is more relevant to the Commissioner's review than the impact that the proposed acquisition would have on the Wisconsin insurance market. See, e.g., Section 611.72(3) and (3)(d). Accordingly, Document Request Nos. 27, 28, 29 and 30 are designed to have APC produce materials in its possession relevant to this critical issue.

G. Information regarding APC's intentions regarding PIC.

Documents relating to APC's intentions regarding PIC and its Wisconsin policyholders are plainly relevant, especially in light of APC's numerous representations on these issues in the Form A. See, e.g., Section 611.72(3) and (3)(d). The Commission need not, and should not, simply accept APC's word, but should instead permit discovery on these topics. These matters are the subject of Document Request Nos. 31, 32, 36 and 37.

H. Documents and other written discovery relating to APC's negotiations with the Selling Shareholders, solicitation of other shareholders and steps taken to accumulate APC's proposed 24% position.

The final general category of documents sought by the document requests from APC are documents related to the assemblage of the Selling Shareholders into a group, APC's negotiations with these Selling Shareholders, APC's contacts with other PIC shareholders and APC's promulgation of solicitation materials. All of this information is relevant to, inter alia, Section 611.72(3) because there appear likely to have been violations of both federal and state securities laws in the process by which the Stock Purchase Agreement was put together.

Document discovery, subpoenaed documents and interrogatory answers will shed immediate light on these fundamental issues of integrity, fitness and compliance with law – all critical elements of the statutory test. The relevant Document Requests are Nos. 33, 34, 35 and 38.

II. DISCOVERY NEEDED FROM THE SELLING SHAREHOLDERS

A. Scope of Required Discovery

Section 611.72(3) Wis. Stats. reads, in part, as follows (emphasis added):

(3) GROUNDS FOR DISAPPROVAL. The commissioner shall approve the plan if the commissioner finds, after a hearing . . . **that it would not violate the law** or be contrary to the interests of the insureds of any participating domestic corporation

Direct discovery of the "Selling Shareholders" (the six shareholders of PIC) is necessary as PIC has reason to believe that in putting together this group there may well have been securities law violations, including:

- (1) whether there should have been disclosure of information concerning the compensation of Edelman & Co., Ltd. (the broker) (see Wis. Admin. Code § Ins. 40.02(2)(k));
- (2) whether Dean Health Systems, Inc. (“Dean”), which holds 10.3% of PIC’s voting securities, engaged in conduct, including the formation of the group, that is inconsistent with its April 14, 2003 disclaimer of control and the OCI’s response thereto (Exhibit D);
- (3) whether Dean and the Selling Shareholders as a group (with 24% ownership) were themselves required to file a Form A (see Wis. Admin. Code § Ins. 40.02(3); sec. 611.72, Wis. Stats.);
- (4) whether Dean and the other Selling Shareholders have violated section 13(d) of the Securities and Exchange Act of 1934 (15 U.S.C. § 78(d) (under which any person who acquires more than 5% of the beneficial ownership of a security registered with the SEC or otherwise subject to the jurisdiction of the SEC is required to file Schedule 13D with the SEC within 10 days of the acquisition));
- (5) whether Dean and the other Selling shareholders have violated Sec. 552.03, Wis. Stats. (which requires a filing with the Wisconsin Division of Securities whenever a shareholder acquires more than 5% of the beneficial ownership of a “target company”); and
- (6) whether in entering the September 17, 2004 Agreement (attached as Appendix A to APA’s Form A Application) APC and the Selling Shareholders have attempted to obtain control of PIC without the approval of the Commission in violation of Section 611.72 and Wis. Admin. Code § Ins. 40.02(1).

PIC needs full discovery concerning the contents, timing, purposes, intents and effects of the conduct of each member of the Shareholder Group leading up to and including the consummation of the September 17, 2004 Stock Purchase Agreement.

B. Means of Discovery of Selling Shareholders

PIC understands that the Commissioner has not yet ruled on the motions of the members of the Selling Group to become a party to these proceedings. If any or all is made a party, PIC will pursue the above subjects by a combination of (1) requests for documents and interrogatories followed by (2) oral depositions. It will submit such requests within five (5) days of the Commissioner's rulings, should "party" status be afforded.

If "party" status is not afforded to any or all of the Selling Group movants, PIC will propound subpoenas for each of the members of the group, containing a request for documents tracking the above subjects and requesting the appearance of the person at each selling shareholder, respectively, with the most knowledge of the contents, timing, purposes, intents and effects of the conduct leading to the consummation of the September 17, 2004 Stock Purchase Agreement.

III CONCLUSION

For all of the foregoing reasons, PIC respectfully requests that discovery be permitted to go forward as set forth herein.

Dated this 8th day of June, 2005.

Respectfully submitted,

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