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Kingsway Proves Once Again It is Better to Give Than to Receive

A Pennsylvania state Commonwealth Court (the “Court”) issued a decision on April 1, 2010, dismissing the Pennsylvania Insurance Department’s (the “Department”) challenge to the highly creative stock plan that Kingsway Financial Services (“Kingsway”) executed to distribute shares of its subsidiary Lincoln General Insurance Company (“Lincoln”). (See *Pennsylvania Insurance Department v. Kingsway Financial, Inc., et al.* 2010 WL 1236303.)

Background

According to the Court, in 2005 Lincoln began experiencing financial distress and a deteriorating financial condition, and, in March 2009, Lincoln signed an agreement with the Department to “run-off” Lincoln’s book of business. Lincoln is a Pennsylvania domestic insurance company, owned by its sole shareholder Walshire Assurance Company (“Walshire”), a Pennsylvania corporation, which is wholly-owned by Kingsway America, a Delaware Corporation. Kingsway, an insurance holding company incorporated in Ontario, Canada, is the parent company of Kingsway America.

After signing the run-off agreement, Lincoln began to review the adequacy of its reserves, but before Lincoln completed its review, Kingsway decided to divest its entire interest in Lincoln by donating 5 percent of Walshire’s stock (the “Stock”), plus \$20,000, to each of 20 charities. Kingsway reportedly contacted the charities on a Friday inquiring whether they would be present the following Monday to accept a donation, without providing specifics regarding the donation. The following Monday, Kingsway’s officers visited the charities to hand over the donation of the money and the Stock. Upon receipt, a charity’s representative was required to sign a gift receipt and have their photograph taken with the Stock certificate to acknowledge receipt. After the gifts were made, Kingsway informed the Department of the transactions.

In October 2009, the Department sent a letter to Kingsway stating its belief that the transaction was illegal and also advised five of the charities known to have received the donation to return the Stock to Kingsway. At least one charity attempted to do so, but Kingsway refused to accept the Stock. On November 20, 2009, the Department filed a petition in Pennsylvania state court alleging that the trans-

action violated three provisions of the Pennsylvania Insurance Code.

In announcing its lawsuit, the Department called Kingsway’s actions “sham transactions for the sole purpose of evading its obligations under multiple provisions of insurance law designed to protect an insurance subsidiary from being abandoned by its parent holding company.” Kingsway disputed this characterization, stating its view that the donation of the Stock to the charities was entirely legal. The Department sought a declaration from the Court that Kingsway’s divestiture of the Stock was illegal and an injunction to “unwind” the transaction as well as payment of certain expenses.

Majority Opinion

First, the Department alleged a violation of section 1402(a)(1) of the Pennsylvania Insurance Holding Companies Act (the “Act”), which prohibits a person from entering into an agreement to “acquire control” of a domestic insurer unless (1) the person has filed with the Department and sent to the insurer a statement containing certain information (a “Form A”), and (2) the agreement or acquisition has been approved by the Department. By examining the plain language of the statute, the Court found there was no requirement to file a Form A as each charity only acquired 5 percent of the Stock, and the Department failed to demonstrate that any of the charities had *control* of Lincoln by virtue of their holding 5 percent of the Stock.

Second, the Department also alleged that the transaction violated section 1405(a)(2) of the Act, which prohibits certain transactions “involving a domestic insurer and any person in its holding company system” unless (1) the insurer has given prior written notice to the Department (a “Form D”), and (2) the Department has not disapproved it. Here, the transaction involved 20 charities, none of which were in the holding company system, so this provision of the Holding Company Act was likewise inapplicable.

Finally, the Department alleged that the transaction violated section 205(a) of the GAA Amendments Act of 1990 (“GAA Act”), which states that any “asset transfer ... of any insurance corporation” shall become effective only if approved by the

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Department. The Court, examining the plain language of the provision, found that this provision pertains only to the transfer of assets of "insurance corporations," which the GAA Act defines as "domestic insurance companies." The Stock was an asset of Kingsway America, a Delaware corporation, which is not an insurance corporation as defined by the GAA Act. Thus, this provision too was inapplicable.

Concurring Opinion

While the concurring opinion agreed with the majority that none of the above statutory provisions were violated, it highlighted Kingsway's "improper use of charitable corporations to accept its detritus." It questioned whether the \$20,000 check was intended as a "bribe" rather than a "gift" and as a "scheme" by Kingsway "to jettison its failing subsidiary...by bribing 20 charities..."

The concurring opinion reasoned that "Kingsway concocted an elaborate scheme to completely divest itself of Lincoln with minimal cost to itself...to rid itself of Lincoln before its ultimate demise..." The concurring opinion reasoned: the fact that one charity refused to accept the Stock—and the accompanying photograph— and was replaced by another charity, demonstrated that this was not a bona fide donation, but rather a bribe. The concurring opinion believed the "\$20,000 check was a *quid pro quo* in return for accepting the [S]tock." At least one of those charities attempted to return both the Stock and money to Kingsway, whereby Kingsway "responded by asserting that it would not accept the return of the [S]tock, essentially stating that the charities were stuck with it whether they liked it or not."

The concurring opinion highlighted additional points that made it skeptical of the bona fide nature of the "scheme." "First, all of these charities were located in the New York City area and, thus, conveniently out of reach of Pennsylvania authorities." Second, no charity "had any history of owning insurance companies or had the capacity or the resources to figure out how to meet Lincoln's obligations to its customers." "Third, Kingsway did not notify the [Department] of the transaction until the day it occurred." The concurring opinion was also critical of Kingsway's refusal to provide requested documentation to the Department as evidence of an "obvious attempt to cover-up the true nature of its scheme."

The concurring opinion continued: that "because the nature of the debt covenants and other obligations Kingsway may have had, the end result of the scheme is that Kingsway has no obligation to cover Lincoln's debts to its insureds, potentially costing taxpayers of Pennsylvania who bear the ultimate cost of Lincoln General's failure to meet its obligations." The concurring opinion concluded: "While its scheme may not have violated the insurance laws of Pennsylvania, it is well within the powers of the Attorney General of Pennsylvania and the Attorney General of New York to investigate whether Kingsway's use of charitable corporations was improper or any fraud occurred."

Response

After the decision Kingsway issued a statement that it "has met and will continue to meet all of its regulatory and contractual obligations in respect of Lincoln." The Department is reportedly "disappointed" with the Court's decision and "plans to appeal."

About the Authors

R. Dean Conlin is a partner at Locke Lord. He has more than 30 years of experience in a wide range of health care, insurance regulatory and corporate matters. Mr. Conlin has focused on managed health care since the early stages of preferred provider networks. His clients include regulated insurers and alternative risk vehicles that provide managed health care coverage. His work for these clients, including preferred provider organizations, has ranged from product development to regulatory counseling, including counseling on the impact of ERISA on managed health care. In addition, Mr. Conlin has organized insurers and reinsurers and counseled them on a full range of regulatory and corporate issues. In this connection, he leads our firm's longstanding representation of Old Republic International Corporation and American Fuji Fire and Marine Insurance Company. He also counsels Lloyd's Illinois, Inc., which is the corporate Illinois Attorney-in-Fact for Underwriters at Lloyd's, London.

Timothy S. Farber is an associate at Locke Lord. He practices in the area of corporate law, where his focus is on general corporate law, mergers and acquisitions, securities and insurance regulatory matters. Mr. Farber has experience representing issuers and underwriters in debt and equity financing matters for both public and private companies.