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ATTORNEY FOR PETITIONER

**IN THE DISTRICT COURT OF SHAWNEE COUNTY, KANSAS  
DIVISION 7**

VICKI SCHMIDT,	)	
COMMISSIONER OF	)	
INSURANCE,	)	
<i>In her Official Capacity</i>	)	
	)	
Petitioner,	)	
	)	Case No. 2019 CV 351
vs.	)	
	)	
PHYSICIANS STANDARD INSURANCE	)	
COMPANY	)	
	)	
Respondent.	)	

**PETITION FOR REHABILITATION OF DOMESTIC INSURER**

Commissioner of Insurance, Vicki Schmidt, by and through counsel, petitions the Court for an order authorizing the Commissioner to rehabilitate Physicians Standard Insurance Company pursuant to the Insurers Supervision, Rehabilitation, and Liquidation Act, K.S.A. 40-3605, *et seq.*

**Nothing in this Petition may be construed as alleging “final order of liquidation” or a finding that Physicians Standard is “impaired” or “insolvent” and, until further order or action by this Court, Physicians Standard Insurance Company shall not be considered an “insolvent insurer” within the meaning of the K.S.A. 40-3607.**

In support of this Petition, the Commissioner states as follows:

### **THE PARTIES**

1. Vicki Schmidt is the duly-elected Commissioner of Insurance of the State of Kansas (“Commissioner”) and is the chief executive of the Kansas Insurance Department (“Department”) pursuant to K.S.A. 40-102. The Commissioner is responsible for the supervision, control and regulation of companies authorized to transact the business of insurance in Kansas pursuant to K.S.A. 40-103, and is authorized to bring this action pursuant to K.S.A. 40-3608 and 40-3616. The Commissioner is the chief executive of the Kansas Insurance Department (“Department”) pursuant to K.S.A. 40-102. The Commissioner is exempt, pursuant to K.S.A. 60-2005, from depositing court costs required by any law of this state in any civil action in which it is involved.

2. Physicians Standard Insurance Company (“PSIC”) is a stock insurance company organized under the laws of the State of Kansas. PSIC’s statutory home office is located at 2101 SW 21<sup>st</sup> Street, Topeka, KS 66604 and its main administrative office is located in Union, Missouri.

### **JURISDICTION**

3. Venue and Jurisdiction are proper in this Court pursuant to K.S.A. 40-3616.

### **FACTUAL ALLEGATIONS**

#### **Historical Background**

4. In 2010, MPM Insurance Company of Kansas, Inc. (“MPM-KS”) was incorporated as a Kansas Stock casualty insurance company.

5. In 2012, Missouri Professionals Mutual (“MPM-MO”), a Missouri association malpractice insurer, organized under Chapter 383 of the Missouri Revised Statutes, proposed to

acquire control of MPM-KS by purchasing all of the outstanding shares of stock of MPM-KS, previously owned by Timothy H Trout, for the purchase price of \$2,515,000.

6. On December 20, 2012, the Commissioner issued an Order approving the proposed acquisition of control of MPM-KS by MPM-MO. *See Exhibit 1*, Final Order Issued December 20, 2012.

7. On December 15, 2014, MPM-MO merged with and into Physicians Professional Indemnity Association (“**PPIA**”) to form Missouri Professionals Mutual- Physicians Professional Indemnity Association (“**MPM-PPIA**”). *See Exhibit 2*, Missouri Secretary of State Filing, December 15, 2014.

8. As a result of the 2014 merger between MPM-MO and PPIA, MPM-PPIA became the sole shareholder of MPM-KS.

9. In April 2017, MPM-KS changed its name to Physicians Standard Insurance Company (or PSIC), which the Commissioner approved on April 28, 2017. *See Exhibit 3*, Approval of Name Change.

10. On June 14, 2017, PSIC filed their policy forms through the Department’s online application.

11. On June 21, 2017, the Department sent a notice through the online application stating:

Several of the forms submitted appear to be specific to Missouri. You might want to check these and see if they have anything to do with Kansas. If not, please withdraw them accordingly.

\* \* \*

It appears many of the forms you have listed as being replaced have never been approved by Kansas in the first place.

Conclusion: In view of the above, this entire filing is disapproved for use in Kansas. If this submission includes rates, the rates shall not become effective until approved.

See Exhibit 4, SERFF Notice June 21, 2017.

12. After not receiving a response, the Department sent a follow up message on June 28, 2017. On July 5, 2017, the Department closed the file based on No Action. See Exhibit 5, SERFF Notice July 5, 2017.

13. Upon information and belief, these forms are being utilized in Kansas by PSIC without Departmental approval.

14. Upon information and belief, the PSIC Board of Directors was unaware PSIC was using forms not approved by the Department.

#### Merger of PSIC with Physicians Re, Inc.

15. On December 21, 2017 the Department received a letter from Johnathan Downard, PSIC's CEO and MPM-PPIA's Executive Vice President, providing formal notice of the proposed merger and acquisition of Physicians Re, Inc. ("**Physicians Re**"), a Utah captive reinsurer, with and into PSIC. The notice requested a waiver of the prior approval requirements of K.S.A. 40-3304. See Exhibit 6, December 21, 2017 letter.

16. The Commissioner approved the exemption under K.S.A. 40-3304(e) on February 26, 2018. See Exhibit 7, February 26, 2018 Approval Letter. As a result of the transaction, 1,094,023 shares of PSIC went to individuals or entities that previously owned shares of the Utah captive insurer, Physicians Re, Inc.

#### Execution of Policy Acquisition Agreement

17. During the review and approval of the filing requirement exemption, no notice was given to the Kansas Insurance Department of an anticipated transaction with MPM-PPIA.

18. On March 1, 2018, the Board of PSIC voted to approve a policy acquisition agreement (“the Policy Acquisition Agreement”) with MPM-PPIA. *See Exhibit 8*, March 1, 2018 PSIC Board Meeting Minutes.

19. On March 10, 2018, MPM-PPIA held a special membership meeting, in which fourteen (14) members voted to approve the Policy Acquisition Agreement with PSIC and to surrender MPM-PPIA’s certificate of authority to the Missouri Department of Insurance. *See Exhibit 9*, March 10, 2019 MPM-PPIA Board Meeting Minutes.

20. The Policy Acquisition Agreement was executed on March 10, 2018 and the transaction was completed on March 12, 2018. *See Exhibit 10*, Policy Acquisition Agreement; and *Exhibit 11*, email correspondence between PSIC and Department staff between April 11, 2019 and April 19, 2019 at p. 6

21. At no time prior to the board meeting or the execution of the policy acquisition agreement did PSIC notify the Department or seek prior approval of the transaction as required by K.S.A. 40-3306 and K.A.R. 40-1-28, which incorporates the Department’s Policy and Procedure Providing Insurance Holding Company System Reporting Forms and Instructions.

22. On March 16, 2018 Johnathan Downard and Sean DeVore, Controller of Corporate Insurance Services (“CIS”), a third party administrator of PSIC and wholly owned by Johnathan Downard, initiated a phone call with Department staff. During the phone call, Mr. Downard and Mr. DeVore informed the Department of the Policy Acquisition Agreement and requested clarification as to whether prior approval was required.

23. On March 20, 2018, PSIC sent the Department a letter summarizing the March 16, 2018, phone call and attaching a copy of the Policy Acquisition Agreement by and between

MPM-PPIA. See Exhibit 10, Policy Acquisition Agreement; and Exhibit 12, March 16, 2018 letter.

24. The Policy Acquisition Agreement laid out the following terms, which included, *inter alia*:

D. Physicians Standard will agree to provide additional benefits to MPM-PPIA policyholders as part of the consideration received from MPM-PPIA and to provide to current policyholders a three year rate guarantee provided there are no claims activity and no underwriting changes and will offer non-assessable policies in substitution of the MPM-PPIA policies.

E. As additional consideration MPM-PPIA will transfer to Physicians Standard, Physicians Standard stock currently held by MPM-PPIA in an amount equal to the difference between MPM-PPIA policy premiums and Physicians Standard policy premiums for a three year premium period, and the premium of Physicians Standard for the transfer of the extended reporting policies, said sum equal to the approximate amount of 1,477,174 shares of Physicians Standard Stock previously issued by MPM-PPIA.

F. MPM-PPIA will provide the option to Physicians Standard to purchase all remaining Physicians Standard stock from MPM-PPIA for the sum of One Million Dollars (\$1,000,000) to be paid within thirty days from the date of this agreement.

\* \* \*

Completion Date- This approval, completion of the merger and transfer of the stock as set forth herein shall take place no later than March 12, 2018 or immediately upon approval of Membership of MPM-PPIA and the Board of Directors of MPM-PPIA.

See Exhibit 10, Policy Acquisition Agreement.

25. Per the Policy Acquisition Agreement, MPM-PPIA and PSIC valued the 1,477,174 shares of PSIC stock at \$3,870,196.

26. As of December 31, 2018, PSIC held a policyholder surplus of \$2,766,568.00.

27. The Policy Acquisition Agreement was more than 3% of Admitted Assets (\$3,762,200\*.03 = \$112,866) and more than 25% of Policy Holder Surplus (\$3,127,575\*.25 =

\$781,893.75) at the time of the transaction. *See Id*; and Exhibit 13, Annual Financial Statement as of December 31, 2018, at 2 line 28, and at 3 line 37.

28. On April 9, 2018, Tish Becker, Chief Financial Analyst for the Kansas Insurance Department, now Interim Financial Director, sent Mr. DeVore an email indicating the Department was in the process of reviewing the information submitted on March 20, 2018. *See Exhibit 14*, March 20, 2018 Letter from Tish Becker to Mr. DeVore.

29. Concerned with the actuarial sufficiency of the underwriting and reserves, given the three-year rate guarantee, the Department notified Mr. Downard that a limited-scope examination of PSIC had been called. The notice was delivered via email on May 3, 2018. *See Exhibit 15*, Notice of Limited Scope Examination.

30. The Department informed PSIC, in writing on May 7, 2018, that the Policy Acquisition Agreement is subject to review and prior approval by the Department, and requested a Form D be filed with the Department, in accordance with K.S.A. 40-3306 and K.A.R. 40-1-28, which incorporates the Department's Policy and Procedure Providing Insurance Holding Company System Reporting Forms and Instructions. *See Exhibit 16*, May 7, 2018 Department letter to PSIC regarding necessity for review and approval of Policy Acquisition Agreement.

31. On May 11, 2018, PSIC filed a Form D regarding the Policy Acquisition Agreement.

32. On June 11, 2018, the Department sent PSIC a letter stating: "we are unable to approve the proposed Policy Acquisition Agreement ("Agreement") by and between PSIC and MPM-PPIA. We would be happy to reconsider your request for approval if you would provide the necessary revisions and/or information in response to the following comments regarding the

Form D and the Agreement...” See Exhibit 17, June 11, 2018 Department letter regarding Form D filed May 11, 2018.

33. On the eve of an August 24, 2018 meeting with the Department, PSIC, through its counsel, delivered an updated Form D regarding the Policy Acquisition Agreement in response to the June 11, 2018 denial. See Exhibit 18, Secondary Form D filed August 24, 2018.

34. On September 21, 2018, the Department once again disapproved the Form D in connection with the Policy Acquisition Agreement and cited the deficiencies. See Exhibit 19, September 21, 2018 letter regarding Form D filed August 24, 2018.

35. To date, PSIC continues to operate under the Policy Acquisition Agreement, notwithstanding the disapproval of the transaction by the Department.

36. On December 11, 2018, the Department and PSIC entered into a Consent Agreement, whereby PSIC agreed to be placed under a period of oversight. During the period of oversight PSIC would submit to an actuarial examination, file a Form A in accordance with K.S.A. 40-3304 and K.A.R. 40-1-28, file all rates and forms for prior approval, and comply with all information requests within 10 days of the request being made. See Exhibit 20, Consent Agreement.

37. PSIC Filed the Form A on December 27, 2018. The Form A continues to be under review by the Department.

38. On December 20, 2018, Johnathan Downard sent a letter to the Department, stating: “PSIC hereby confirms that such form, rate and rule filings are the most current filings of PSIC and remain in effect.” See Exhibit 22, December 20, 2018 letter. On the date this letter was sent, no forms had been approved by the Department.

#### Financials



39. Since entering into the Consent Agreement PSIC's financial condition has continued to decline.

40. PSIC filed its Annual Financial Statement as of December 31, 2018 ("2018 Financial Statement") on March 1, 2019. *See Exhibit 13*, Annual Financial Statement as of December 31, 2018.

41. Upon information and belief, the 2018 Financial Statement was not presented to the Board in its final form prior to its submission.

42. The 2018 Annual Statement showed PSIC failed nine (9) of the thirteen (13) National Association of Insurance Commissioners (NAIC) Insurance Regulatory Information System (IRIS) financial ratios.

43. The 2018 Annual Statement showed PSIC's surplus at \$2,766,586 at the end of 2018, and \$3,127,575 at the end of 2017, a decline of 11.5%. Since 2014, policyholder surplus has decreased 23.18%. *See Exhibit 21*, Financial Indicators (calculated from the Annual Financial Statement as of December 31, 2018).

44. PSIC has a combined ratio of 113.4%, signifying that it spends \$1.13 for every dollar of earned premium on claims payments and administrative costs. A combined ratio below 100% indicates an underwriting gain. *See Id.*

45. PSIC has had an underwriting loss ("Combined Ratio") since 2015. *See Id.*

46. The last time PSIC reviewed and amended their rating manual was 2011. *See Exhibit 22*, SERFF Rating Filing from 2011.

47. PSIC has an expense ratio of 36.6%, meaning it spends 36.6% of its written premium on agent commissions, state and municipal taxes, salaries, benefits, and other

operational expenses. The industry average expense ratio is 27%. *See Exhibit 21, Financial Indicators.*

48. The Department believes the high expense ratio is due to high commissions and brokerage fees, as well as excessive salaries, third party agreements, and other operating expenses.

49. In 2018, PSIC earned a 1% yield, which was its highest investment yield in the last 5 years. Since 2014, PSIC has averaged a 0.4% return on investment. The target return for insurance carriers of this size and type is 2%-5.5%. *See Id.*

50. Upon information and belief, the Board of Directors does not review PSIC's investment strategy.

51. PSIC has a 93.2% liquidity ratio, indicating 93.2% of its liquid assets have already been set aside to cover its liabilities, leaving 6.8% to cover future, unanticipated liabilities. The industry average is 79.7%. *See Id.*

52. PSIC's reinsurance program covered all losses above \$500,000, exposing the company to 18% individual risk to policyholder surplus. *See Exhibit 23, Reinsurance Treaty.*

#### Financial Filings Untrustworthy

53. The 2018 Annual Statement listed \$3,109,777 in assumed premium. PSIC later confirmed at an April 3, 2019 meeting with the Department that no premium had been assumed in 2018 and the entry had been made in error. *See Exhibit 13, Annual Financial Statement as of December 31, 2018, at 8, line 11.2, column 3.*

54. The 2018 Annual Statement mischaracterized payments made in 2018 to Mr. Trout, the former owner of MPM-KS, under a non-compete agreement with MPM-PPIA ("Non-Compete Agreement"), as "contractor services." Upon information and belief, Mr. Trout

provided no contractor services during 2018. *See* Exhibit 24, Trout Non-Compete Agreement; and Exhibit 25, Overflow Page for Miscellaneous Expenses.

55. PSIC began making payments to Mr. Trout in August 2018. Prior to August 2018, PSIC assured the Department, on three separate occasions, that it would not be responsible for payments under the Non-Compete Agreement, as it is not a signatory to the contract. *See* Exhibit 26, Letter from Sean DeVore dated May 15, 2015, at 3; and Exhibit 27, Letter from Randy Snodgrass, CPA, dated April 28, 2016; line 21; and Exhibit 28, letter from Randy Snodgrass, CPA, dated May 15, 2017, line 21.

56. PSIC failed to establish a liability for future payments to Mr. Trout under the Non-Compete Agreement. Failing to book a liability inflated the policyholder surplus and misrepresented PSIC's true net worth. *See* Exhibit 13, Annual Financial Statement as of December 31, 2018.

57. PSIC failed to disclose material related-party transactions in the Annual Report and Quarterly Reports.

58. PSIC failed to report the third party administration agreement with CIS. CIS is wholly owned by Johnathan Downard. *See* Exhibit 29, Note 10 of Annual Financial Statement as of December 31, 2018.

59. PSIC failed to report a retainer agreement with the law firm of Hansen, Stierberger, Downard, Schroeder & Head. Hansen Stierberger, Downard, Schroeder & Head is a law firm in which Johnathan Downard is a named partner. *See* Id.

60. PSIC failed to report a lease agreement with Baltic & Mediterranean, LLC. Baltic & Mediterranean owns the property PSIC leases for its office space. Johnathan Downard had a financial or other interest in Baltic & Mediterranean. *See* Id.

61. PSIC failed to report an agency agreement with AMC-Medpro. Johnathan Downard has a financial or other interest in AMC-Medpro. *See Id.*

62. PSIC failed to report a transaction with Bank of Sullivan. Johnathan Downard is Chairman of the Board of Bank of Sullivan. *See Id.*

63. Mr. Downard has financial or other interest in every transaction listed in paragraphs 58-63. *See Exhibit 30*, Downard Conflict of Interest Statement as of May 2, 2018.

64. Upon information and belief, the PSIC Board of Directors did not obtain external bids for these transactions, nor otherwise established that these were arms-length transactions.

#### Adverse Findings in Actuarial Report

65. On March 1, 2019 the Company actuary, Stephen J. Streff, drafted his Statement of Actuarial Opinion as of December 31, 2018. In this opinion, he stated:

I have examined the three NAIC IRIS tests that relate to reserves. The Company failed all three tests. The Company failed the One-Year Reserve Development to Surplus test with a value of 23.9% and the Two-Year Reserve Development to Surplus test with a value of 43.5%. This is the result of claims settling for more than expected and a declining surplus base. The Company also failed the Current Reserve Deficiency to Surplus Test with a value of 850.3%.

*See Exhibit 31*, Statement of Actuarial Opinion as of December 31, 2018.

66. On March 21, 2019, Mr. Streff filed his Actuarial Opinion Summary (“Summary”). In the Summary, Mr. Streff included a range of reasonable reserves between \$1.817 million and \$3.271 million. In between these numbers he provided his best reserve estimate of \$2.43 million. PSIC did not carry their reserves at the midpoint but significantly below the midpoint at \$1.978 million. Reserving below the midpoint can artificially increase policyholder surplus. *See Exhibit 32*, Actuarial Opinion Summary as of December 31, 2018.

67. Upon information and belief, the Board of Directors did not approve reserving below the midpoint.

### **GROUND FOR REHABILITATION**

68. Paragraphs 1-67 are incorporated by reference.

69. K.S.A. 40-3616 sets forth the grounds for the Commissioner to seek an order to rehabilitate an insurer domiciled in Kansas, which include, *inter alia*:

(a) the insurer is in such condition that the further transaction of business would be hazardous to its policyholders, creditors, or the public.

70. PSIC's consistent underwriting loss, under-reserving, low investment yields, and high expense ratios demonstrate a substantially deteriorating financial position, increasing the risk to policyholders, creditors and the public.

71. Pursuant to K.S.A. 40-3306 all "Sales, purchased, exchanges, loans or extensions of credit, guarantees or investments" shall not be entered into without prior approval, unless the transaction is under 3% of the insurer's admitted assets or 25% of surplus.

72. The exchange of 1,477,174 shares of PSIC stock exceeded 3% of PSIC's admitted assets or 25% of its policyholder surplus, necessitating a filing pursuant to K.S.A. 40-3306. Prior to the execution of the Policy Acquisition Agreement, no request for prior approval was filed with the Department.

73. The purchase option of \$1,000,000 for the remaining PSIC shares of stock held by MPM-PPIA exceeded 3% of PSIC's admitted assets or 25% of its policyholder surplus and necessitated a filing pursuant to K.S.A. 40-3306. Prior to the option being realized, no request for prior approval was filed with the Department.

74. K.S.A. 40-216 requires prior approval, or deemer, of all policy forms prior to their usage. PSIC failed to obtain approval prior to using the forms and upon information and belief continues to use the unapproved forms.

75. Pursuant to K.S.A. 40-1107 no domestic insurance company shall “expose itself to loss on any one risk or hazard to an amount exceeding ten percent of its paid-up capital and surplus” unless it secures reinsurance for the remainder. Ten percent of PSIC’s surplus on December 31, 2018 is \$276,700. To be in compliance with K.S.A. 40-1107, PSIC must secure reinsurance to cover all losses above \$276,700. The company’s current reinsurance program only covers all losses above \$500,000 leaving a gap of \$223,300 above the statutory limit.

76. PSIC’s management filed false or misleading financial statements when they indicated the company had received assumed premium, when in fact it had not.

77. PSIC’s management filed false or misleading financial statements when they indicated Mr. Trout had performed “contractual services.”

78. PSIC’s management filed a false or misleading financial statement when they did not set up a liability on their balance sheet for future payments to Mr. Trout, inflating PSIC’s policyholder surplus.

79. PSIC has consistently entered into agreements in which Mr. Downard had a financial interest, without first establishing that these transactions are arms-length and reasonable in light of what might be charged by comparable entities.

**RELIEF REQUESTED**

WHEREFORE, pursuant to K.S.A. 40-3605, *et seq.*, Petitioner requests the following relief:

- A. A finding that sufficient cause exists for rehabilitation of PSIC;
- B. A finding that the further transaction of business by PSIC would be hazardous financially to its policyholders, creditors or to the public;
- C. Entering an Order of Rehabilitation against PSIC, ordering the following:
  - 1. The appointment of Vicki Schmidt, Commissioner of Insurance for the State of Kansas and her successors, as Rehabilitator;
  - 2. Directing that the Rehabilitator appoint a Special Deputy Rehabilitator, and that the Rehabilitator may consult with and obtain the assistance and advice of insurance experts, attorneys, and consultants;
  - 3. The Rehabilitator shall have all the powers of the officers, directors, trustees, managers, and employees, whose authority shall be suspended, except as they are specifically re-delegated by the Rehabilitator;
  - 4. Directing the Rehabilitator to secure and take possession of all the assets, property, books, records, accounts and other documents of PSIC;
  - 5. Prohibiting all officers, directors, employees, or agents from disposing, using, transferring, removing or concealing any property of PSIC, without the express written authority of the Rehabilitator;
  - 6. Prohibiting any bank, savings and loan association or other financial institution or other legal entity from disposing of, allowing to be withdrawn or concealing in any manner any property or assets of PSIC, except under the express authorization of the Rehabilitator or by the further order of this Court;
  - 7. Staying any of the following actions:

- a. The commencement or continuation of a judicial, administrative, or other action or proceeding against PSIC, either before or after the commencement of this action;
- b. The enforcement, against PSIC or its property, of a judgment obtained before the commencement of this case;
- c. Any act to obtain possession of property of PSIC or to exercise control over property of PSIC;
- d. Any act to create, perfect or enforce any lien against property of PSIC;
- e. Any act to create, perfect or enforce against property of PSIC any lien to the extent that such lien secures a claim that arose before the commencement of this case;
- f. Any act to collect, assess, or recover a claim against PSIC that arose before the commencement of this case; and
- g. The setoff of any debt owing to PSIC that arose before the commencement of this case against any claim against PSIC.

8. Investing in the Rehabilitator all of the powers granted pursuant to K.S.A. 40-3618; and

9. Such further decrees, orders and judgments under and within the provisions of K.S.A. 40-3605, *et seq.*, as the Court shall find advisable or necessary.

Respectively submitted,

/s/Justin L. McFarland  
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ATTORNEY FOR PETITIONER  
Vicki Schmidt, Commissioner of Insurance

**CERTIFICATE OF SERVICE**

The undersigned hereby certifies that he served a true and correct copy of the above and foregoing **Petition for Rehabilitation** on this 10th day of May 2019 by causing the same to be placed in the United States Mail, first class postage prepaid and electronic mail (when available) addressed to the following:

**Steve Imber**

**Zach Dyer**

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*Respondent*

**/s/Justin L. McFarland**

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