SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

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| PEOPLE OF THE STATE OF NEW YORK, by LETITIA JAMES, Attorney General of the State of New York,<br><br>Plaintiff,<br><br>-against-<br><br>Donald J. Trump, *et al*.,<br><br>Defendants. | Index No. 452564/2022<br><br>Hon. Arthur Engoron<br><br>Motion Seq. No. 39 |

**PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION TO THE JOINT MOTION OF DEFENDANTS AND KNIGHT SPECIALTY INSURANCE COMPANY TO SET ASIDE THE EXCEPTION AND JUSTIFY THE SURETY**

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## PRELIMINARY STATEMENT

The Appellate Division substantially reduced to $175 million the undertaking that Defendants were required to post to stay execution of this Court's judgment pending appeal. After receiving this favorable ruling, rather than select as the surety a large national insurance company licensed in New York, experienced in underwriting surety bonds, and with policyholder surplus far greater than $175 million, Defendants chose instead Knight Specialty Insurance Company ("KSIC"), a small insurer that is not authorized to write business in New York and thus not regulated by the state's insurance department, had never before written a surety bond in New York or in the prior two years in any other jurisdiction, and has a total policyholder surplus of just $138 million. Defendants and KSIC (collectively, "Movants") have failed to justify KSIC as the surety on this extraordinarily large undertaking for a number of reasons.

**First**, Movants fail to meet their burden of establishing that there is sufficiently secure and ascertainable collateral backing the bond. For collateral, the Donald J. Trump Revocable Trust ("Trust") granted KSIC a priority lien on a Schwab brokerage account held by the Trust that Defendants maintain presently has just over $175 million in "cash." But pursuant to the agreements governing how the collateral is pledged and controlled, the Trust retains ownership of the account and can withdraw funds or make trades in the account unless KSIC objects within two business days after receiving notice of the proposed transaction. KSIC does not now have an exclusive right to control the account and will not obtain such control unless and until it exercises a right to do so *on two days' notice*. If the value of the funds held in the account dips below $175 million, the Trust promises to "true up" the balance by depositing additional funds in multiple permitted forms, including stocks—a promise that is hollow if the Trust does not have the funds to do so and concedes the value of the collateral will fluctuate based on market conditions. On the evidence submitted by Movants in support of the Motion, there is insufficient basis for the Court to find that the bond is sufficiently collateralized by identifiable assets.

**Second**, the Court should not rely on KSIC's financial summary attached to the bond as evidence that KSIC has sufficient capacity to justify writing a $175 million bond. That is because KSIC sends 100% of its retained insurance risk to affiliates in the Cayman Islands, where lax regulations allow KSIC to use this risk transfer to reduce the liabilities it carries on its books in a way that artificially bolsters its surplus—a practice New York regulators have dubbed "shadow insurance" and about which they have sounded the alarm.

**Third**, under the regulations that govern the placement of insurance on an excess lines basis, a licensed excess lines broker may place business with an unauthorized insurer like KSIC only if it is satisfied that the insurer's management is trustworthy and competent. KSIC is not qualified to act as the surety under this standard because its management has been found by federal authorities to have operated affiliated companies within KSIC's holding company structure in violation of federal law on multiple occasions within the past several years.

For these reasons, the Court should deny the Motion and require Defendants to post a replacement undertaking within seven days of the Court's ruling.

## BACKGROUND

### A. The Bond

On February 23, 2024, the Clerk of the Court entered judgment in this case against the Defendants in the total sum of $464,576,230.62. NYSCEF No. 1699. On Defendants' motion pursuant to New York Civil Practice Law and Rules ("CPLR") §5519(c), the First Department entered a summary order on March 25, 2024, granting the motion to the extent of staying certain portions of the judgment, including the monetary award of disgorgement, on the condition that Defendants post an undertaking in the reduced amount of $175 million within ten days (by April

4, 2024) and perfect their appeal for the September 2024 Term. *People v. Trump*, Case Nos. 2024-01134, 2024-01135, NYSCEF No. 21. Defendants filed on April 4, 2024, an amended undertaking by KSIC, denoted as Bond No. SA300588,[1] along with a financial summary of KSIC's assets and liabilities for the year ending 2023 and a financial summary of assets and liabilities for the same period for KSIC's parent company, Knight Insurance Company, LTD ("KIC"). *See* NYSCEF No. 1707 (the "Bond").

Tracking the language required for an undertaking pursuant to CPLR §5519(a)(2), the Bond provides that KSIC "undertake[s]" that the Defendants "shall pay to Plaintiff . . . the sum directed to be paid by the Judgment" as affirmed, provided however the amount of the Bond shall not exceed $175 million. Bond at 2-3. This language—which traces back to a predecessor statute in effect over a century ago[2]—creates a binding promise on the part of the surety to pay Plaintiff in the event the judgment debtor does not.[3]

On the same day that Defendants posted the Bond, Plaintiff filed a Notice of Exception to Surety pursuant to CPLR §2506(a). NYSCEF No. 1708.

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[1] Defendants initially filed the undertaking on April 1, 2024, without financial information or a power of attorney for the KSIC signatory, so the Clerk of the Court rejected the filing. *See* NYSCEF No. 1707 and April 3, 2024 "Document Returned for Correction" docket entry.

[2] *See Stapley v. United States Casualty Co.*, 260 N.Y. 323, 325 (1932) (quoting similar language from predecessor statute, Civil Practice Act §594).

[3] *See Timal v. Kiamzon*, 164 Misc. 2d 159, 163 (Sup. Ct. N.Y. Cty. 1995) ("The plaintiff also objects to the undertaking on the grounds that it pledges that the judgment debtors, but not the insurer, will pay the judgment if affirmed. The condition of the undertaking under CPLR 5519(a)(2) is that the *appellant* will pay so much of the judgment as is affirmed, which is precisely what the present undertaking states. . . . Thus, plaintiffs' objections as to the form of the undertaking [is] invalid.") (emphasis added).

### B. The Surety

The surety on the Bond, KSIC, is an insurance company domiciled in Delaware. Affirmation of Amit Shah, sworn to on April 15, 2024 (NYSCEF No. 1722) ("Shah Aff.") ¶3. KSIC is permitted under New York Insurance Law to issue insurance in this state on an excess lines basis through a New York-licensed excess lines broker and is authorized by the Delaware Insurance Department to write surety risks (among other lines of business) as an excess lines company. *See* Affirmation of Gregory Serio, sworn to on April 15, 2024 (NYSCEF No. 1733) ("Serio Aff.") ¶¶18-22; Shah Aff. ¶¶4-8. Prior to issuing the Bond, KSIC had never before underwritten a surety bond in New York, Shah Aff. ¶17, nor has it written any surety business in any other jurisdiction in the past two years, Affirmation of Andrew Amer, dated April 19, 2024 ("Amer Aff."), Exs. 1 at 8, 2 at 8.

For the year ending 2023, KSIC had total "admitted assets" equal to $539,284,552 and total liabilities (including reserves) of $400,842,881. Bond at 7. KSIC's "Surplus to Policyholders," defined as "the excess of total admitted assets over the liabilities," *see* New York Insurance Law ("NYIL") §107(a)(42), equals $138,441,671. Bond at 7. Accordingly, the face amount of the Bond exceeds KSIC's Surplus to Policyholders as of year-end 2023 by just over $36 million.

KSIC is wholly owned by KIC, an insurance company domiciled in the Cayman Islands. Amer Aff., Ex. 1 at 14.5 (note 10 A), 15 (Responses 7.2, 7.21, 7.22). KIC is neither licensed nor admitted in New York, and is therefore considered an "alien insurer" under New York Insurance Law. Amer Aff., Ex. 3 at 22; NYIL §107(a)(5).

### C. The Joint Motion

On April 15, 2024, Defendants and KSIC filed a joint motion to set aside Plaintiff's notice of exception, justify the surety, and award costs. The Motion is supported by an affirmation from KSIC's president, Amit Shah, and an affirmation from Gregory Serio, a former New York State

Insurance Superintendent who is proffered as an insurance expert.[4] Among the exhibits attached to the Shah affirmation are: (i) a single page from KSIC's 2023 Annual Statement showing premiums and losses on business written in New York (but no other pages from the statement); (ii) a single screenshot from the online Schwab brokerage account containing the collateral pledged on the Bond ("Account") (but not the entire Account statement); (iii) the Collateral Account Pledge and Security Agreement[5] ("Pledge Agreement") and Pledged Asset Account Control Agreement ("Control Agreement") that govern the relationship among KSIC, the Trust, and Schwab with respect to the Account; and (iv) a 100% Quota Share Reinsurance Contract between KSIC and KIC.[6] Shah Aff., Exs. D, E, F. G, and I. The Pledge Agreement references a "General Agreement of Indemnity" executed by the Trust in favor of KSIC on April 1, 2024 ("Indemnity Agreement"), which is expressly "incorporated into [the] Pledge Agreement by reference," but is not included as an exhibit to the Shah Affirmation or otherwise made part of Movants' submission. *Id.*, Ex. E at 1 (fourth Whereas clause and ¶1).

[4] Pursuant to CPLR §2507, testimony in support of a motion to justify must be presented by the surety's witnesses at the hearing "to be examined under oath," thereby guaranteeing to the judgment creditor taking exception to the surety the right of cross-examination. CPLR §2507(a). To the extent that Movants' affiants are not present at the upcoming hearing "to be examined under oath," their affirmations should be stricken from the record as inadmissible hearsay.

[5] The Trust signature page of the Pledge Agreement contains an obvious typographical error that needs to be corrected; it refers to the surety as "Federal Insurance Company" rather than KSIC.

[6] The first nine pages of the exhibit appear to be a reinsurance agreement executed by KSIC and KIC on March 6, 2017, with a retroactive effective date of January 1, 2014. Shah Aff., Ex. I at 1, 9. The remaining pages of the exhibit appear to be a different reinsurance agreement with an undated signature page that is effective November 1, 2013. Given the effective dates, it would appear that the November 1, 2013 agreement was superseded by the January 1, 2014 agreement and was included by mistake.

## ARGUMENT

### MOVANTS HAVE NOT MET THEIR BURDEN TO JUSTIFY KSIC AS THE SURETY

Movants seriously misconstrue the reason for Plaintiff's notice of exception, contending that the bases are the mere absence of a certificate of qualification and a misapprehension about the ability of a non-admitted insurer to write business in New York on an excess lines basis. Movants' Memorandum of Law in Support (NYSCEF No. 1735) ("Movants' MOL") at 5, 8. Movants are mistaken on both counts. Under CPLR Article 25, Plaintiff's notice of exception is a bare bones procedural device permitted in the absence of a certificate of qualification that shifts the burden to the Defendants to justify KSIC as the surety. While the absence of the certificate is what allowed Plaintiff to file the notice under CPLR §2506(a), it is not the basis for why the Court should find there is no justification for KSIC to be the surety on a $175 million undertaking. Nor is Plaintiff under any misapprehension about KSIC's ability to write business in New York on an excess lines basis. Rather, KSIC is not an acceptable surety for the Bond because Movants have failed to demonstrate that (i) the face amount of the Bond is sufficiently collateralized by identifiable assets, (ii) KSIC's financial capacity adequately supports this enormous undertaking, and (iii) KSIC's management is sufficiently trustworthy and competent.

The procedure for challenging and justifying an undertaking posted by a judgment debtor to stay execution of judgment pending appeal is governed by Article 25, "one of the most used, but least cited provisions of the CPLR." *City of New York v. Britestarr Homes, Inc.*, 150 Misc. 2d 820, 822 (Sup. Ct. Bronx Cty. 1991). CPLR §§2506 and 2507 provide a simple procedure, derived from long-standing practice pre-dating the CPLR, *see Lowande v Eisenberg Farms,* 285 N.Y. 742, 742 (1941), which allows a judgment creditor to test the validity of an undertaking. *Britestarr*, 150 Misc. 2d at 822. Where, as here, an undertaking is filed without a certificate of qualification pursuant to NYIL §1111, the judgment creditor may challenge the validity of the undertaking by serving a short notice of exception to the surety pursuant to CPLR §2506(a), which "shifts to the proponent of the bond the burden of moving to justify the surety" within 10 days. *Id., see also Breakaway Courier Corp. v. Berkshire Hathaway Inc.*, No. 652316/2017, 2019 WL 3765350, at *3 (Sup. Ct. N.Y. Cty. Aug. 08, 2019); CPLR §§2506(a), 2507(a).

Although "there remains very little authority—at either the trial or the appellate levels—on the CPLR 2506 and 2507 notice of exception and justification procedure," *Breakaway Courier*, 2019 WL 3765350, at *5, the handful of cases that do exist addressing the procedure provide ample guidance for the Court on what Movants must show to prevail. At the justification hearing, Movants must offer "sufficient proof that the face amount of the bond . . . is sufficiently collateralized by identifiable assets," *Centurifico Delveneto, (USA) Ltd. v. Switzerland Gen. Ins. Co.*, 180 A.D.2d 547, 547 (1st Dept 1992), and "prove that [the surety] has the financial capability to meet its obligations under the bond[] and is therefore a 'sufficient' surety," *Breakaway Courier*, 2019 WL 3765350, at *10. In addressing whether KSIC has the financial capability to meet its obligations under the Bond, the Court should look to those provisions of the New York Insurance Law that seek to ensure the financial stability and integrity of insurers doing business in this State for the protection of policyholders.

### A. Movants Fail To Demonstrate That KSIC's Bond Is Sufficiently Collateralized With Identifiable Assets

Movants submit vague, incomplete, and inconclusive evidence on the form of the collateral that is pledged for the Bond. They contend the collateral in the Account is "cash," *see* Shah Aff. ¶22, but they attach only a single screenshot from the Account accessed through the Schwab online client portal that lists as the title of the account "Wasmer Bonds." *Id.*, Ex. F. According to Schwab's website, Wasmer bonds are fixed-income products Schwab offers that include various bond ladder strategies and portfolio options. Amer Decl., Ex. 9. As evidenced by the most recent statement for this same Trust account produced by Defendants in this action (covering the period March 2023), the complete statement for the Account provides detailed information about the asset composition, change in account value over the month and year-to-date, investment detail, and transaction detail, among other things. Amer Aff., Ex. 10.[7]

Putting aside Movants' motivation for submitting just this one paltry screenshot, without the full account statement there is no way to gain any meaningful visibility into the nature of the collateral, test the veracity of the claim that the Account holds only "cash" as opposed to some other form of investment vehicle that fluctuates in value with market conditions, or gain any insight into how the form and market value of the collateral may have changed within the past month and year-to-date. And if the collateral is in the form of Wasmer fixed-income products, there is certainly some inherent risk of fluctuation in value. Amer Aff., Ex. 9 at 8 (small print, second paragraph) ("The Wasmer Schroeder Strategies . . . are subject to various risks including but not limited to interest rate risk, reinvestment risk, credit risk, default risk and event risk" as well as "increased loss of principal during periods of rising interest rates," among others).

But even if the collateral is just "cash" at the moment, there is no restriction in place under the Pledge Agreement that ensures the collateral will remain in the form of "cash" during the pendency of the appeal; rather, funds in the Account can be traded for other investment vehicles (including mutual funds) in accordance with "investment guidelines" that can be amended at any time with KSIC's consent. Shah, Ex. E ¶¶6(a), 15, Attachment 1 ¶5(i). Moreover, the Account

[7] Because Defendants designated this document as "confidential" when produced pursuant to the governing confidentiality order, Plaintiff is filing on the public docket a blank page as a placeholder for this exhibit and will address the matter at the upcoming hearing.

remains in the control of the Trust with KSIC having merely a first priority lien on the funds, unless and until KSIC provides a "Notice of Exclusive Control" to Schwab, which takes effect "within a reasonable period of time not to exceed two Banking Days." *Id.*, Ex. G at 1 (bottom paragraph). Prior to the time such notice is given, if ever, the Trust can withdraw monies or securities from the Account or make trades in the Account with the consent of KSIC, which is *deemed provided* if KSIC does not "expressly consent to any proposed trade within two banking days following any request" from the Trust. *Id.*, Ex. E ¶6(a).

The Pledge Agreement also contains a "true-up" provision that applies when "the market value or marketability of the Collateral . . . is impaired or reduced to an amount less than" $175 million or "the value of the Collateral is reduced by any trade or redemption" consented to (or deemed permitted) by KSIC, and obligates the Trust within five calendar days to restore the value of the collateral to $175 million. *Id.*, Ex. E ¶4. This provision is problematic for two reasons. First, the provision is further evidence that Movants contemplate the collateral will change in form and fluctuate in value based on market conditions and may need to be supplemented to keep the Account balance at $175 million. The provision would be unnecessary if the collateral were locked in as cash and only cash at an amount of $175 million without any possibility of diminution in value due to market volatility.[8] Second, under the provision the Trust may replenish the Account with "investment property, financial assets or like property, or other liquid assets" unrestricted in form by the investment guidelines and expressly defined to have the meanings "set forth in the Uniform Commercial Code as in effect in any applicable jurisdiction," with "financial assets"

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[8] If the intent was truly to keep the collateral as "cash," Defendants could have just as easily deposited the cash with the Court in lieu of posting a bond pursuant to CPLR §2501(2). Should the Court reject KSIC as the surety and order Defendants to post a new undertaking, that remains an option.

deemed to include "without limitation, all property now or at any time hereafter held in the [Account]," and more specifically to include "stocks" and "mutual funds." *Id.* ¶¶1, 4.

The potential under the Pledge Agreement and Control Agreement for the Movants to swap out one form of collateral for another (including replacing "cash" with mutual funds or truing up the balance with investment property) and for the value of the collateral to dip below $175 million due to market conditions matter a great deal under New York Insurance Law given the minimal policyholder surplus carried by KSIC—an amount significantly below $175 million.[9] Under NYIL §1115, New York imposes a limitation on the amount of loss that an insurer can expose itself to on any one risk: "no insurer doing business in this state shall expose itself to any loss on any one risk in an amount exceeding ten percent of its surplus to policyholders," which here is $13.8 million. NYIL §1115(a). Where the surety exposes itself to a loss in excess of this amount, the surety's "act [in issuing the bond] would undoubtedly be ultra vires." *Industrial & General Trust v. Tod*, 56 A.D. 39, 42 (1st Dep't 1900).

When determining the "amount of loss to which [the surety] is exposed by virtue of its acting as surety," a court is required to reduce that amount "to the extent of the value of the collaterals *which have been transferred to and are now held by*" the surety. *Id*. (emphasis added). But that required reduction does not apply here because the Pledge Agreement does not vest KSIC with exclusive control over the Account and permits the Trust to withdraw and trade the collateral, and therefore the collateral has not been "transferred to" and is not now "held by" KSIC. *Industrial & General Trust*, 56 A.D. at 42. Based on KSIC's policyholder surplus in its most recent annual

[9] By contrast, Federal Insurance Company, the surety that posted the undertaking to stay execution of E. Jean Carroll's judgment against Donald Trump, has surplus to policyholders of $4.2 billion, more than *46 times* the face amount of the bond that was posted in that case. Amer Decl., Ex. 11 at 2, 12.

financial statement of $138,441,671, *see* Bond at 7, the limitation of loss on any one risk that KSIC is permitted to write is $13.8 million. The face amount of the bond exceeds this limitation by $161.2 million. Accordingly, the Bond is "ultra vires" and the surety is not justified.[10] *Id.*

Nor does it matter to the outcome that under the "true-up" provision the Trust would be obligated to contribute additional collateral to bring the value back to $175 million if there is a reduction in market value of the collateral. That obligation is nothing more than a promise by the Trust to contribute additional collateral in the future, which the Trust may or may not have the funds to do. For this reason, the promise by the Trust to "true-up" the collateral is without any legal effect because the Trust is effectively acting as its own surety, which is not permitted under well-settled law.[11] *See Breakaway Courier*, 2019 WL 3765350, at *9 ("It has long been held that '[a] party cannot be his own surety.'") (quoting *Alex v. Grande*, 29 A.D. 2d 616, 616 (3d Dep't 1967)); *see also Nichols v. MacLean*, 98 N.Y. 458, 459 (1885). And in any event, the Trust has wide latitude in selecting the form of additional collateral under the "true-up" provision, and can even replenish the Account with "investment property." Shah Aff., Ex. E at 4.

Based on the Trust's continued ownership and control over the Account, the potential change in the form and value of the collateral, and the face amount of the Bond compared to

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[10] Even if the collateral were deemed sufficiently pledged to require a reduction in the amount of loss to which KSIC is exposed by the funds held in the Account, for the reasons stated above concerning the shortcomings of the Pledge Agreement and Control Agreement and the real potential for the value of the collateral to fluctuate, there is no adequate assurance that during the pendency of Defendants' appeal the value of the pledged collateral will not dip below $161.2 million, and hence KSIC's exposure will exceed 10% of its policyholder surplus even with reducing the amount of loss by the collateral.

[11] For the same reason, the Indemnity Agreement executed by the Trust in favor of KSIC and incorporated into the Pledge Agreement (but not submitted), *see* Shah Aff., Ex. E at 1, is irrelevant to the Court's analysis. Such an agreement is merely an improper effort by the Trust to act as its own surety. It also begs the question: why would KSIC need a separate indemnification agreement from the Trust if the collateral was as secure as Movants now claim it is?

KSIC's surplus to policyholders, the Court should find that Movants have failed to meet their burden to demonstrate that the Bond "is sufficiently collateralized by identifiable assets," *Centurifico*, 180 A.D.2d at 547, or that the Bond is not "ultra vires" based on the limitation of loss on any one risk under New York Insurance Law, *Industrial & General Trust*, 56 A.D. at 42.[12]

### B. Defendants Fail to Demonstrate KSIC Is a Financially Sound Surety for the $175 Million Bond Pursuant to Laws Governing Excess Lines Insurance

As Movants correctly note, New York permits unauthorized insurers like KSIC to conduct business in New York, but only through a licensed excess lines broker. *See 3405 Putnam Realty Corp. v. Chubb Custom Ins. Co*., 14 A.D.3d 310, 311 (1st Dep't 2005) (recognizing excess line brokers licensed in New York may "procure insurance from unauthorized insurers under limited circumstances," citing NYIL §§2105[a] and 2117[h] ); *see also* 11 N.Y.C.R.R. §27.0(a). The Court should look to the laws and regulations in New York governing the placement of insurance on an excess lines basis to determine whether Movants have met their burden to justify KSIC as a surety.

In New York, an excess lines broker is required to exercise "due care" when selecting an excess lines insurer, NYIL §2118(a)(1), and "make inquiry sufficient to ascertain the insurer's financial stability and capacity adequate to its business" and "shall not place coverage with an

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[12] New York insurance law provides that for surety risks, the insurer can deduct from the exposure the amount of any reinsurance, but only if the reinsurance is provided by an authorized reinsurer and the reinsurance agreement allows for a direct action by the underlying insured against the reinsurer, recognizing that absent such language the underlying insured has no right to sue the reinsurer. NYIL §4118(a)(1); *Matter of Liquidation of Union Indem. Ins. Co. of New York*, 200 A.D.2d 99, 107 (1st Dep't 1994) ("[T]he reinsurer has no obligation to the original insured, which cannot claim the status of a third-party beneficiary of the reinsurance contract."), *aff'd*, 89 N.Y.2d 94 (1996). Here, while KSIC purportedly reinsures its exposure under the Bond with KIC under a reinsurance agreement, *see* Shah Aff. ¶26 and Ex. I, KIC is not an authorized reinsurer nor does the reinsurance agreement contain a provision that would allow Plaintiff to bring a direct action against KIC, *id*., Ex. I, so the provision allowing the exposure to be reduced on account of reinsurance is inapplicable.

unauthorized insurer, unless the insurer's financial statements or other evidence demonstrate that the insurer . . . has surplus to policyholders sufficient to support its writings, reasonable in relation to its outstanding liabilities, [and] adequate to its financial needs," 11 N.Y.C.R.R. §27.13(a), (b). Further, before placing the insurance with an unauthorized insurer, the excess lines broker "shall make inquiry sufficient to demonstrate that such insurer's . . . management is trustworthy and competent." *Id*. at §27.13(e)(2). Movants have failed to demonstrate that KSIC meets these prerequisites for writing insurance in New York on an excess lines basis, and therefore their motion to justify should be denied.

***1. KSIC Uses "Shadow Insurance" from Its Cayman Islands Affiliates to Artificially Bolster Its Financial Capacity***

Movants attach to the Bond a summary of KSIC's assets and liabilities from the company's Annual Statement for the year ending December 31, 2023, showing a "surplus to policyholders" of $138.4 million (calculated by subtracting total admitted assets from total liabilities). Bond at 7. This, they maintain, demonstrates that KSIC is financially strong and capable of supporting KSIC's $175 million undertaking. But the financial summary fails to disclose that KSIC's liabilities are significantly reduced by "reserve credit" taken by KSIC for the substantial reinsurance[13] it purchases from KIC, its parent company based in the Cayman Islands. That matters because the looser regulatory environment of the Cayman Islands allows KSIC to take this reserve credit without adequate collateral, thereby significantly reducing KSIC's liabilities on its

[13] Reinsurance is a contract between two insurance companies in which the reinsured company agrees to "cede" all or part of its risk to the reinsurer in return for a percentage of the premium and/or a fee. *Century Prop. & Cas. Ins. Corp. v. McManus & Richter*, 205 N.Y.S.3d 57, 64 (1st Dep't 2024); *see also Travelers Cas. And Sur. Co. v. Certain Underwriters at Lloyd's of London*, 96 N.Y.2d 583, 534 (2001); *Turner Construction Co. v. Seaboard Surety Co.*, 85 A.D.2d 325, 327 (1st Dept.1982); 13A J. Appleman, Insurance Law & Practice §7694 (1976).

balance sheet in the absence of a meaningful reduction in KSIC's risk. The New York Department of Financial Services ("DFS") raised the alarm over this practice, dubbed "shadow insurance," in a detailed report issued in June 2013 entitled "Shining a Light on Shadow Insurance: A Little-known Loophole That Puts Insurance Policyholders and Taxpayers at Greater Risk." Amer Aff., Ex. 12 ("DFS Report").[14]

As found by DFS following a year-long investigation, "[i]nsurance companies use shadow insurance to shift blocks of insurance policy claims to special entities—often . . . offshore (e.g., the Cayman Islands)—in order to take advantage of looser reserve and regulatory requirements." DFS Report at 1. The "captive" insurance company, "which is essentially a shell company owned by the insurer's parent" (as is the case here) reinsures a portion of the insurance company's risk "and diverts the reserves that it had previously set aside to pay policyholders to other purposes, since the reserve and collateral requirements for the captive shell company are typically lower." *Id.*; *see also Ross v. AXA Equitable Life Ins. Co*., 115 F. Supp. 3d 424, 430 (S.D.N.Y. 2015), *aff'd*, 680 F. App'x 41 (2d Cir. 2017) (discussing DFS Report findings); *Robainas v. Metro. Life Ins. Co.*, Civ. No. 14-9926, 2015 WL 5918200, at *2 (S.D.N.Y. Oct. 9, 2015), *aff'd sub nom. Ross v. AXA Equitable Life Ins. Co*., 680 F. App'x 41 (2d Cir. 2017) (same). The ceding insurer may then claim "reserve credits" through such arrangements—in essence, reducing the assets the ceding insurer is required to maintain in support of its reserve liabilities. *Ross*, 115 F. Supp. 3d at 428; *see also Robainas*, 2015 WL 5918200, at *2.

[14] The DFS Report is based on an investigation of life insurance companies because the practice "emerged in great part due to a desire from insurers to do an end-run around higher reserve requirements that states established for certain term and universal life insurance policies," but the practice can be employed by any insurance company to the same effect—to "inappropriately us[e] shell games to hide risk and loosen reserve requirements." DFS Report at 4.

But regulators generally regard reinsurance transactions safe enough to allow the ceding insurer a reserve credit only where the reinsurer is "licensed or accredited by the [ceding] insurer's own regulators or the reinsurer posts "sufficient high-quality, easily liquidated collateral to account for potential obligations—typically by maintaining a trust with a United States financial institution or by obtaining an irrevocable and renewable ('evergreen') letter of credit from a United States financial institution." *Ross*, 115 F. Supp. at 428; *see generally* NYIL §1301(a)(9) (allowing as an admitted asset a "reinsurance recoverable" from an insurer that is not authorized or accredited in New York "if such funds are held subject to withdrawal by, and under the control of, the ceding insurer").

As found by DFS, insurers have used captive reinsurance as a way of flouting these regulatory safeguards "by exploiting the looser reserve and capital regulations in the jurisdictions in which the captive reinsurers are based," citing as a specific example of a more lax jurisdiction the Cayman Islands, where KIC is domiciled. *Ross*, 115 F. Supp. 3d at 429 (citing DFS Report at 4-5); *Robainas*, 2015 WL 5918200, at *2 ("Using reinsurers subject to looser regulatory requirements allows the primary insurer to take a reserve credit without meaningfully reducing its own risk."). DFS found the following three specific types of shadow insurance transactions relevant here "present[ed] serious potential risks to policyholders and taxpayers": (1) a "hollow asset" transaction, where a letter of credit with a parental guarantee is recorded as an asset on the books of a captive reinsurer when such a letter of credit is not a "real asset"; (2) a "naked parental guarantee," where the captive reinsurer does not obtain a letter of credit, but simply promises that its parent company will cover its losses; and (3) a "conditional letter of credit," where a letter of credit has stipulated conditions that must be met before it can be drawn upon, which is riskier than an unconditional letter of credit. DFS Report at 4-5; *see generally Robainas*, 2015 WL 5918200, at *3. Through shadow insurance, the ceding insurer effectively conducts an "end-run around higher reserve requirements" and "hid[ing] risk," DFS Report at 4, which has the "effect of making the [ceding] insurer appear more financially stable than it actually is." *Robainas*, 2015 WL 5918200, at *3; *see also Ross*, 115 F. Supp. 3d at 429.

The practice of using shadow insurance describes KSIC's business to a T. KSIC is owned 100% by KIC, an insurance company domiciled in the Cayman Islands. Amer Aff., Ex. 1 at 14.5 (note 10 A), 15 (Responses 7.2, 7.21, 7.22). KSIC cedes 100% of its net insurance risk to KIC through a quota share reinsurance agreement and takes reserve credit for that reinsurance. Shah Aff. Ex. I Art. I.A; Amer Aff. Ex. 3. As detailed in "Schedule F" filed as part of KSIC's 2023 Annual Statement, KSIC ceded $180 million in reinsurance premium to KIC and two other KIC affiliates based in the Cayman Islands out of a total of $225 million ceded to all reinsurers, or approximately 80% of its reinsurance premium. Amer Aff., Ex. 3 at 22-22.1 (Part 3 (Ceded Reinsurance), cols. 1-6). The same schedule shows that KSIC *took reserve credit for ceded reinsurance that reduced its liabilities by $366 million*. *Id.* at 29 (Part 6 (Restatement of Balance Sheet to Identify Net Credit for Reinsurance), row 22, col. 2). As KSIC ceded 80% of all reinsurance premiums to its Cayman Islands affiliates, most of this reserve credit was attributable to "shadow insurance" from its Cayman Islands captives.

Movants have failed to present any evidence indicating the form of security that allowed KSIC to take such a large reserve credit under the lax regulatory rules of the Cayman Islands. The quota share reinsurance agreement between KSIC and KIC merely provides that security shall be posted in a trust account under terms and conditions agreeable to them. Shah Aff., Ex. I at Art. XIII.A(b) (requiring KIC to provide *either* letters of credit or "at the option of the Reinsurer" a security trust account "whose terms and conditions shall be formalized in writing acceptable to the parties."). As the party with the burden of proof to justify the surety under CPLR §2507, *see Britestarr*, 150 Misc. 2d at 822, Movants must demonstrate that KSIC has not artificially bolstered its financial capacity through the use of "shadow insurance" from its Cayman Islands affiliates using "hollow asset" transactions, "naked parental guarantees," and/or "conditional letters of credit." DFS Report at 4-5. They have failed to meet this burden.

Nor is it relevant that KIC appears to have a stronger balance sheet than KSIC. Bond at 8; Movants' MOL at 7-8. KIC is not a co-surety, so it has no obligation to make any payments pursuant to KSIC's undertaking. Bond at 3, 8. And New York Insurance Law expressly precludes KSIC from relying on the quota share reinsurance agreement between KSIC and KIC when evaluating its exposure under the Bond because KIC is not an authorized or accredited reinsurer and the reinsurance agreement does not provide Plaintiff with a direct right of action against KSIC. *See* NYIL §4118(a)(1). Because New York Insurance Law does not allow any consideration of the reinsurance agreement between KSIC and KIC when assessing KSIC's risk under the Bond, neither should the Court.

Even putting aside the DFS Report on "shadow insurance," New York Insurance Law has long required special regulatory approval of reinsurance transactions between affiliates under the Holding Company Act due to the potential for self-dealing and to ensure that the terms of any such transactions are commercially reasonable. *See* NYIL §1505(d)(2); *Vullo v. Park Ins. Co*., 68 Misc. 3d 1226(A), 2020 WL 5667220, at *4 (Sup. Ct. N.Y. Cty. 2020) (reducing reserve credit taken for reinsurance purchased from insurer's Bermuda affiliate because the insurer did not seek or obtain approval for the transaction from DFS under the Holding Company Act), *aff'd*, 194 A.D.3d 627 (1st Dep't 2021), *leave to appeal denied in part and dismissed in part*, 37 N.Y.3d 1090 (2021).

Movants tout that the Excess Line Association of New York ("ELANY") confirmed in a 2021 letter that KSIC meets the minimum requirements to write excess lines business in New York, Shah Aff. ¶10, but that simply means placements with KSIC submitted to ELANY by licensed excess lines brokers will be approved by ELANY in the ordinary course "provided they otherwise meet the legal requirements for excess line transactions." *Id*., Ex. C. ELANY's confirmation of KSIC as an eligible excess lines insurer is no substitute for the requirements under the applicable regulations that "the insurer's financial statements or other evidence demonstrate that the insurer . . . has surplus to policyholders sufficient to support its writings, reasonable in relation to its outstanding liabilities, [and] adequate to its financial needs," 11 N.Y.C.R.R. §27.13(a), (b), and "that such insurer's . . . management is trustworthy and competent," *id*. at §27.13(e)(2). Moreover, ELANY's confirmatory letter concludes by noting "ELANY will conduct a complete analysis to determine if Knight Specialty meets ELANY's requirements for publication of the company's name on ELANY's list of New York [Excess and Surplus] Insurers," Shah Aff., Ex. C, a list "composed of insurers that request to be listed and are approved by ELANY *following a thorough analysis of the insurer's financial security*," Amer Aff., Ex. 13 at 5 ("ELANY INSURER LIST") (emphasis added). KSIC never made the list. Amer Aff., Ex. 14.

Given the size of the Bond in relation to KSIC's *reported* surplus to policyholders, the amount of reserve credit KSIC has taken for reinsurance ceded to its Cayman Islands captives to reduce its liabilities, and the failure of KSIC to obtain ELANY's approval for inclusion on ELANY's list based on a thorough analysis of KSIC's financial security, the Court should find that KSIC is using "shadow insurance" to make itself "appear more financially stable than it actually is," *Robainas*, 2015 WL 5918200, at *3, and on that basis should deny Movants' motion to justify.

### 2. *KSIC's Management Is Neither Trustworthy Nor Competent*

Regulations governing the placement of insurance by an unauthorized insurer through an excess lines broker require the broker to ascertain that the unauthorized insurer's management "is trustworthy and competent." 11 N.Y.C.R.R. §27.13(e)(2). These are terms of art for insurance regulators, employed "in a broader sense than such terms are popularly used." *Nichols v. N.Y. State Dep't of Fin. Servs*., 148 A.D. 3d 1400, 1403 (3d Dep't 2017) (citing *Bowley Assoc. v. State of New York Ins. Dept*., 98 A.D.2d 521, 527 (1st Dep't 1984)). Courts have found insurers untrustworthy and incompetent for a variety of misconduct, including placing misleading ads in newspapers (*Nichols*, 148 A.D.3d at 1403), misappropriating premiums from insureds (*Gould v. Serio*, 298 A.D.2d 304, 304-05 (1st Dep't 2002)), and violating provisions of the Insurance Law (*Glick v. Curiale*, 223 A.D.2d 501, 502 (1st Dep't 1996)). KSIC's management does not meet the "trustworthy and competent" standard under §27.13(e)(2).

Don Hankey is the chairman and chief executive officer of KSIC and Amit Shah is the company's president. Bond at 5, 7; Amer Aff., Ex. 1 at 1. Messrs. Hankey and Shah are both also on KSIC's board of directors. Amer Aff., Ex. 1 at 1. KSIC is part of "The Hankey Group" of companies, which includes insurers and a car leasing and finance company. *Id*., Ex. 4 at 1. "Each Hankey Group company holds a symbiotic relationship to the other." *Id*. In particular, KSIC and KIC work with affiliate Westlake Financial Services LLC ("Westlake"), a company specializing in "the acquisition and servicing of prime to sub-prime automotive retail installment contracts." *Id*. In addition to their leadership positions with KSIC, Mr. Shah is the chief operating officer of The Hankey Group, *id*., Ex. 4, and Mr. Hankey is the chairman and chief executive officer of The Hankey Group, chairman of the board of Westlake, and the "primary stockholder of all Hankey investment-controlled entities, including Westlake Financial," *id*., Ex. 5. As a result, Don Hankey exercises ultimate control over all the business entities that comprise his namesake group.

In September 2015, the U.S. Consumer Financial Protection Bureau ("CFPB") entered a consent order finding that Westlake and its subsidiary Wilshire Consumer Credit, LLC ("Wilshire") had violated numerous federal laws by pressuring borrowers through the use of illegal debt collection tactics, including using phony caller ID information, falsely threatening to refer borrowers for investigation or criminal prosecution, and illegally disclosing information about debts to borrowers' employers, friends and family. *Id.*, Ex. 6 at 5-20. The CFPB ordered the companies to overhaul their debt collection practices, provide restitution to consumers of $44.1 million and pay a civil penalty of $4.25 million. *Id.* at 23-24, 26-31. Just two years later, these same two Hankey Group companies entered into a settlement with the U.S. Department of Justice ("DOJ") to pay restitution and civil penalties totaling $760,788 to resolve charges that they violated the Servicemembers Civil Relief Act ("SCRA") by repossessing 70 vehicles owned by members of the armed forces without first obtaining the required court orders. *Id.*, Ex. 7 at 1, 13-19. The same companies agreed to pay an additional penalty of $225,000 in September 2022 to settle charges by the DOJ that they violated other provisions of the SCRA. *Id.*, Ex. 8 at 2-8.

On this record, Movants cannot demonstrate that KSIC's management meets the requirements of trustworthiness and competence under regulations governing insurance placed through a licensed excess lines broker. Accordingly, this provides a further, independent basis for the Court to deny Movants motion to justify KSIC as the surety.

## CONCLUSION

Based on the foregoing, the People respectfully request that the Court deny Movants' motion to justify the surety, declare the Bond to be without effect, and order that any replacement bond be posted within seven (7) days, along with such other and further relief the Court deems necessary and appropriate.

Dated: New York, New York
April 19, 2024

Respectfully submitted,

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**CERTIFICATION**

In compliance with Rule 202.8-b of the Uniform Civil Rules for the Supreme Court & the County Court ("Uniform Rules"), I certify that, excluding the caption, table of contents, table of authorities, signature block, and this certification, the foregoing Memorandum of Law contains 6,993 words, calculated using Microsoft Word.

Dated: New York, New York
April 19, 2024

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