

**UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF PENNSYLVANIA**

**SECURITIES AND EXCHANGE
COMMISSION,**

Plaintiff,

v.

DAVID L. JOHNSON,

Defendant.

Honorable James T. Giles

**Civil Action No.
05-CV-4789**

COMPLAINT

Plaintiff Securities and Exchange Commission (“Commission”) alleges as follows:

SUMMARY

1. This case involves unlawful insider trading in the securities of PMA Capital Corporation (“PMA”) by David L. Johnson (“Johnson”), a former employee of PMA. Johnson avoided \$325,305 in losses by selling PMA stock after learning material nonpublic information that a subsidiary of PMA had increased its carried loss reserves, and that PMA would no longer pay a common stock dividend. In addition, Johnson tipped that information to his son, who avoided \$56,028 in losses by selling PMA stock before the information was publicly disclosed.

2. More specifically, on October 31, 2003, the individual who was then Chairman of PMA’s Board of Directors (“Chairman”) informed Johnson that PMA Reinsurance (“PMA Re”), a subsidiary of PMA, was increasing its carried loss reserves,

and that PMA was discontinuing payment of its common stock dividend. On the basis of this information, which had not yet been publicly disclosed, Johnson sold 20,000 shares of PMA stock on October 31, 2003, and an additional 20,000 shares on November 3, 2003. As a result, Johnson avoided \$325,305 in losses.

3. On November 3, 2003, Johnson told his son that “it was time to sell” some of his PMA stock. On the basis of this information, Johnson’s son sold 3,300 shares he held jointly with his wife, and 3,600 shares he held in his capacity as custodian for his 2 daughters. By selling when he did, Johnson’s son avoided \$56,028 in losses.

4. On November 4, 2003, PMA publicly announced that, among other things, it was increasing significantly its carried loss reserves and was eliminating its common stock dividend. That day, PMA’s common stock closed at a price of \$5.03 per share, down approximately 62 percent from the prior day’s closing price of \$10.00 per share.

5. By engaging in the conduct described above, and described more fully below, Johnson violated Section 17(a) of the Securities Act of 1933 (“Securities Act”) [15 U.S.C. § 77q(a)] and Section 10(b) of the Securities Exchange Act (“Exchange Act”) [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5].

JURISDICTION AND VENUE

6. The Commission brings this action pursuant to Section 20(b) of the Securities Act [15 U.S.C. § 77t(b)] and Sections 21(d) and 21A of the Exchange Act [15 U.S.C. § 78u(d), 78u-1].

7. The Court has jurisdiction over this action pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77u(a)] and Sections 21(e), 21A and 27 of the Exchange Act [15 U.S.C. 78u(e), 78u-1, 78aa].

8. Venue is proper because acts, transactions, practices and courses of business constituting the violations alleged in this Complaint occurred within the Eastern District of Pennsylvania.

9. In connection with the conduct alleged in this Complaint, Johnson directly or indirectly made use of the means or instruments of transportation or communication in interstate commerce, or the means or instrumentalities of interstate commerce, or the mails, or the facilities of a national securities exchange.

DEFENDANT

10. Johnson, age 75, resides in Havertown, Pennsylvania. From 1954 to 1992, Johnson was an employee of PMA. From 1977 through 1992, when he retired, Johnson held the title of Vice-President of Administration and Vice-President of Safety for PMA. During his time at PMA, Johnson directly reported to the Chairman, who had served as PMA's President and Chief Executive Officer prior to becoming Chairman of its Board of Directors.

OTHER RELEVANT ENTITY

11. PMA is an insurance holding company operating primarily in the eastern United States, with operating subsidiaries providing workers' compensation, disability, and other lines of commercial property and casualty insurance. Through its subsidiary, PMA Re, PMA also sold "reinsurance," a practice by which it charged premiums to other insurers in exchange for assuming the liability of those insurers under policies they had issued to others. PMA is incorporated in Pennsylvania, headquartered in Philadelphia and is publicly traded on the NASDAQ under the symbol "PMACA." PMA's common

stock has been registered with the Commission since 1997 under Section 12(g) of the Exchange Act.

FACTS

12. Beginning in 2000, PMA Re experienced a higher than expected level of reported claims from the companies it insured. PMA subsequently began to monitor more rigorously the level of claims and, in early 2003, PMA's Board of Directors undertook steps to thoroughly analyze the loss reserve issue. As a result, in or around late July 2003, PMA's internal actuaries and PMA's auditor began a comprehensive third quarter reserve review of PMA Re. In early September 2003, PMA hired an actuarial firm to conduct an independent examination of the loss reserves.

The Chairman Knew the Information Surrounding the Reserve Issue and the Dividend was Confidential.

13. The preliminary analysis and recommendation of PMA's internal actuaries was that PMA Re should increase its carried loss reserves by between \$50 and \$60 million. At a meeting held September 30, 2003, that information was disclosed to the Chairman, and to the other members of the Executive Committee of PMA's Board of Directors, by the PMA executive overseeing the internal reserve review. The executive further reported that the company's auditor had not finished its review, and that the independent actuarial firm expected to complete its analysis by the end of the first week of October. Later in that meeting, an investment bank serving as an investment advisor to the Board of Directors, made a presentation regarding possible private equity investment in PMA Re, and other alternatives, including liquidating or spinning off PMA Re. In response, the Chairman inquired whether PMA's common stock dividend would

be reduced if a spin-off occurred. The representative of the investment bank responded that any dividend could be “reduced to half or less of the current dividend.”

14. The Chairman believed that the size of the dividend would be a significant issue for the company that would have a direct impact, not only on PMA’s directors and officers, many of whom were heavily reliant upon dividends, but on all PMA shareholders.

15. The Chairman considered information regarding the reserve issue and the size of the common stock dividend confidential issues that were likely to have a substantial impact on the stock price, the reputation of the company, and the ability of the company to write business. He also was aware that it was company policy that material nonpublic information regarding the company should not be disclosed to the public.

16. On October 29, 2003, PMA’s Audit Committee held a meeting during which the Chief Financial Officer (“CFO”) revealed that third quarter results had been delayed due to the third quarter actuarial reviews being conducted by the actuarial firm and PMA’s auditor. The CFO further stated that PMA would be able to finalize the amount of the reserve charge with PMA’s auditor over the weekend of November 1-2, 2003, and circulated a draft of the auditor’s reserve estimate, which reflected a charge \$48 million higher than the internal reserve estimate. The CFO then reiterated that the internal actuaries estimated that PMA Re’s reserves needed to be increased, this time stating the estimated increase was between approximately \$30 and \$120 million.

Although the Chairman did not attend this meeting, it was the practice of the then President and CEO of PMA (“President”) to update the Chairman about the reserve issues after he was updated by the executive overseeing the internal review.

17. On that same day, the Chairman informed management that he wished to resign from PMA. Although the Chairman previously had been planning to retire, he decided to resign at this time because it was his understanding that a number of major decisions had to be made and he believed he should allow future management to handle those decisions without his input. Although the Chairman did not attend any of the subsequent meetings of the Board of Directors or the Executive Committee, as of the date he announced that he wished to resign he already knew, at least, that there would be a large increase in the loss reserve and there existed a possibility that the dividend could be decreased.

18. On October 30, 2003, PMA's Board of Directors held a regularly scheduled board meeting during which the President stated that although the loss reserves analysis by the actuarial firm and the auditor were not complete, he believed that the reserve charge would be in the range of \$60 to \$125 million for the third quarter. The President further revealed that, although the internal actuaries' range for strengthening reserves was between \$25 and \$120 million, the actuarial firm and the auditor's estimates were higher by between \$60 and \$100 million. The President then reported that depending on the size of the reserve charge, Moody's A- bond rating for PMA could be in jeopardy and that following confidential discussions with Standard & Poor's about the reserve charge, Standard & Poor's likewise indicated that it might change PMA's rating from a consolidated basis to an entity by entity basis, thereby permitting separate ratings for PMA and each of its subsidiaries. There was a concern within PMA that the ratings would be lowered to less than an A-, which is viewed as a negative rating within the industry and would result in a major impact on PMA's financial stability. If this

occurred, the ratings were likely to be lowered as follows: PMA Capital BB-; PMA Capital Insurance Company BBB; The PMA Group BBB+. By this date, several Board members recognized that the dividend likely would be decreased or eliminated due to the reserve charge.

19. During the October 30, 2003 meeting, the President also informed the Board of opportunities and risks facing PMA and PMA Re, and summarized various business scenarios that could be considered, including maintaining the corporate structure, separating the two businesses, divesting one business and selling another. He assured the Board that the Executive Committee was carefully considering these options and would fully analyze them to determine what was in the best interests of PMA and its shareholders. Finally, the Board learned that the Chairman was considering stepping down prior to the next Annual Meeting of the Shareholders.

20. On November 2, 2003, at 8:30 p.m., the PMA Board of Directors held a special telephonic meeting during which the President reported that the third quarter loss reserve analysis had been concluded on October 31, 2003. As a result of that analysis, management had decided that PMA Re should strengthen its loss reserves by approximately \$150 million, from approximately \$570 million to \$720 million.

21. During the November 2, 2003, telephone meeting, the Board also learned that in advance of the meeting, members of PMA had met with A.M. Best Company, a company providing ratings for the insurance industry, to inform it of the reserve charge. Management reported that, after learning the magnitude of the reserve charge, A.M. Best disclosed that PMA Re's rating would not remain at A-. Management, therefore, recommended that PMA discontinue writing new reinsurance as promptly as possible and

determine whether PMA Re could sell all or part of its existing book of business and renewal rights to other insurers. As a result of this decision, the Board unanimously voted to suspend the dividend on PMA's Class A common stock. Management then stated its intention to pre-announce the reserve charge and suspension of the dividend before the earnings release that was scheduled for November 6, 2003. Finally, counsel reminded both the Board and management that all information discussed during the call was confidential and could not be disclosed to anyone outside of the Board.

The Chairman Tipped Johnson.

22. Sometime in the middle of October 2003, a former PMA employee, who was also a friend of Johnson's, forwarded to Johnson an analyst report about PMA from Credit Suisse First Boston ("CSFB"). The analyst report reduced PMA's rating from "neutral" to "underperform" and raised concerns regarding the adequacy of loss reserves.

23. After he received and reviewed the CSFB analyst report, Johnson called the Chairman on October 31, 2003, to see if there was any good news about PMA. During their conversation, the Chairman informed Johnson that he was retired or was about to retire from PMA, and that the company was not doing well financially. The Chairman further stated that PMA was strengthening reserves and eliminating the payment of the common stock dividend. Finally, aware of Johnson's substantial PMA holdings, the Chairman also told Johnson he had "too many eggs in one basket." Johnson stated that an elimination of the dividend was devastating to him and his wife because it was an important portion of their retirement income and they had been receiving the dividend for almost 40 years. At no time during the conversation did the Chairman tell

Johnson that he expected him to keep the information conveyed in their conversation confidential or that he should not trade based on this information.

24. Following the October 31, 2003, phone conversation, Johnson felt it was no longer appropriate for him to be in contact with the Chairman because the Chairman had divulged confidential information about PMA to him. Thereafter, Johnson ceased all interaction with the Chairman.

Johnson Sold PMA Stock on the Basis of the Information Provided to Him Concerning the Reserve Charge and the Discontinuation of the Dividend.

25. As of October 31, 2003, Johnson owned approximately four million shares of PMA stock. Of this amount, 87,750 shares were in his and his wife's Vanguard account. The remaining shares were held in the form of stock certificates. In October and November 2003, his PMA stock accounted for approximately 99% of the joint holdings at Vanguard.

26. On the basis of the information in the CSFB analyst report and the conversation he had with the Chairman, Johnson told his wife that he wanted to sell all the PMA stock in their Vanguard account.

27. On October 31, 2003, Johnson directed his wife to place a call to Vanguard to sell 20,000 shares of PMA stock. All 20,000 shares were sold at an average price of \$13.18. On November 3, 2003, Johnson's wife, again at Johnson's direction, called Vanguard to sell an additional 20,000 shares of PMA stock. All 20,000 shares were sold at an average price of \$13.17.

Johnson Tipped Both His Son, Who Sold Before the Information Was Made Public, and His Daughter Who Sold Afterwards.

28. On November 2, 2003, Johnson contacted his son and told him “it was time to sell” his PMA stock. Johnson’s son replied that he had previously converted some of his PMA stock certificates to his brokerage account and had been planning to sell. Johnson neither told his son about his conversation with the Chairman, nor mentioned the topics he discussed with him. Finally, Johnson told his son that he would be selling some PMA stock himself.

29. Following this advice, on November 3, 2003, Johnson’s son sold 3,300 shares of PMA stock owned jointly with his wife, and 3,600 shares held in his capacity as custodian for his daughters. All of the aforementioned shares were sold at an average price of \$13.15.

30. On November 2, 2003, Johnson also contacted his daughter and told her “it would be a good time to sell” her PMA stock. She did not sell her stock, however, until November 5, 2003, the day after the public disclosure of the information about PMA’s loss reserves and elimination of its common stock dividend.

Johnson Breached His Duty of Trust and Confidence.

31. The information Johnson obtained from the Chairman concerning the loss reserve charge and the discontinuation of the common stock dividend was material and nonpublic. Johnson knew, or was reckless in not knowing, that the Chairman had provided confidential information to him. By disclosing this information to Johnson, the Chairman breached his fiduciary duty to PMA’s shareholders. Therefore, Johnson assumed this duty of trust and confidence to PMA and its shareholders not to trade, or to

direct others to trade, in PMA securities. By trading and by tipping his family members, including his son and daughter, Johnson breached that duty.

PMA's Stock Price Plummeted Following Public Disclosure About Its Loss Reserves and the Elimination of Its Common Stock Dividend.

32. On November 4, 2003, PMA's common stock opened at \$10.00 per share. That same day, at 9:11 a.m., PMA issued a press release that disclosed it had completed a comprehensive review of its loss reserves and would record a pre-tax charge of approximately \$150 million, primarily to strengthen PMA Re's loss reserves. PMA further announced that, as a result of this charge, it was suspending its common stock dividend. Finally, PMA stated that it would release its earnings for the third quarter of 2003 on November 6, 2003. As a result of the announcement, trading was halted at 9:10 a.m. and resumed the same day at 9:47 a.m. PMA's common stock closed at \$5.03 per share, dropping approximately 62 percent from the prior day's closing price of \$10.00. Until November 4, 2003, PMA's historical daily trading volume was 300,191; on November 4, 2003, after the subject news was disclosed, trading volume was 10,857,300.

33. On November 6, 2003, PMA issued a press release announcing a net loss of \$96.4 million, or \$3.08 per diluted share for the third quarter of 2003. The net loss for the third quarter included an after-tax charge of \$97.5 million, or \$3.11 per share to increase PMA Re's loss reserves as of September 30, 2003. PMA disclosed that studies by internal and independent actuaries revealed that PMA Re's higher than expected underwriting losses in the reinsurance business, primarily from casualty business written in accident years 1997 through 2000, necessitated the reserve charge. As a result of this charge and PMA Re's rating downgrade, PMA announced that it decided to withdraw from the reinsurance business. Finally, PMA announced that the Chairman and the

President were resigning their positions, effective immediately. On November 7, 2003, PMA's stock opened at \$4.85, and trading volume was 1,377,800.

The Johnsons Avoid Losses By Selling Before the Public Announcements.

34. Based on the sales on October 31, 2003, and November 3, 2003, Johnson avoided \$325,305 in losses. Johnson's son and his family avoided losses of \$56,028 after his son sold PMA stock on November 3, 2003, based on Johnson's recommendation.

FIRST CLAIM FOR RELIEF
Violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder

35. The Commission realleges and incorporates by reference each and every allegation contained in paragraphs 1 through 34 above, as if the same were fully set forth herein.

36. Johnson, by engaging in the conduct described above, directly or indirectly, in connection with the purchase and/or sale of securities, and by use of the means or instrumentalities of interstate commerce, the mails, or the facilities of a national securities exchange:

- (a) employed devices, schemes or artifices to defraud;
- (b) made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; and
- (c) engaged in acts, practices, and courses of business which operated as a fraud and deceit upon other persons.

37. By reason of the foregoing, Johnson violated Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10-b5].

SECOND CLAIM FOR RELIEF
Violations of Section 17(a) of the Securities Act

38. The Commission realleges and incorporates by reference each and every allegation in paragraphs 1 through 37 above, as if the same were fully set forth herein.

39. Johnson, by engaging in the conduct described above, in the offer or sale of securities, by the use of means or instruments of transportation or communication in interstate commerce, or by use of the mails, directly or indirectly:

- (a) employed devices, schemes or artifices to defraud;
- (b) obtained money or property by means of untrue statements of material fact or omissions to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and/or
- (c) engaged in transactions, practices, or courses of business which operate or would operate as a fraud or deceit upon the purchaser.

40. By reason of the foregoing, Johnson violated Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)].

WHEREFORE, the Commission respectfully requests that this Court:

I.

Issue an order enjoining Johnson from any future violations of Sections 17(a) of the Securities Act of 1933 [15 U.S.C. § 77(e)] and Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78j(b)] and Rule 10b-5 promulgated thereunder [17 C.F.R. § 240.10b-5].

II.

Issue an order requiring Johnson to pay disgorgement in the amount of \$381,334, plus prejudgment interest thereon in the amount of \$23,781.

III.

Issue an order requiring Johnson to pay a civil penalty in the amount of \$381,334.

IV.

Retain jurisdiction of this action for purposes of enforcing the Final Judgment and Order.

Respectfully submitted,

/s/

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