

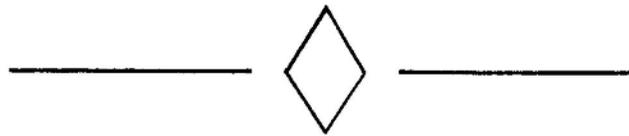
REPORT ON EXAMINATION
OF THE
AMERIHEALTH CASUALTY INSURANCE COMPANY
AS OF
DECEMBER 31, 2003

State of Delaware



Department of Insurance

Dover, Delaware



I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of December 31, 2003 of the

AMERIHEALTH CASUALTY INSURANCE COMPANY

is a true and correct copy of the document filed with this Department.

ATTEST BY: *Antoinette Handy*

DATE: 17 November 2005



In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 17TH DAY OF NOVEMBER 2005 .

Matthew Denn

Insurance Commissioner

Deputy Insurance Commissioner

REPORT ON EXAMINATION
OF THE
AMERIHEALTH CASUALTY INSURANCE COMPANY
AS OF
December 31, 2003

The above captioned Report was completed by examiners of the Delaware Insurance Department.

Consideration has duly been given to the comments, conclusions, and recommendations of the examiners regarding the status of the Company as reflected in the Report.

This Report is hereby accepted, adopted, and filed as an official record of this Department.



MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 17TH day of November, 2005.

TABLE OF CONTENTS

| | Page |
|--|-------|
| SALUTATION | 1 |
| SCOPE OF EXAMINATION | 1 |
| HISTORY | 2 |
| MANAGEMENT AND CONTROL | 2 |
| GROWTH OF COMPANY | 3 |
| TERRITORY AND PLAN OF OPERATION | 4 |
| REINSURANCE | 5 |
| HOLDING COMPANY SYSTEM | 7 |
| INTER-COMPANY AGREEMENTS | 7 |
| SIGNIFICANT OPERATING RATIOS | 9 |
| ACCOUNTS AND RECORDS | 9 |
| FINANCIAL STATEMENTS | 10-12 |
| SCHEDULE OF EXAMINATION ADJUSTMENTS | 12 |
| NOTES TO FINANCIAL STATEMENTS | 13-18 |
| MARKET CONDUCT | 19 |
| STATUS OF PREVIOUS EXAMINATION RECOMMENDATIONS | 19 |
| RECOMMENDATIONS | 19-21 |
| SUMMARY COMMENTS | 21 |
| CONCLUSION | 22 |

January 6, 2005

Honorable Mathew Denn
Insurance Commissioner
State of Delaware
Rodney Building
841 Silver Lake Boulevard
Dover, Delaware 19901

Dear Commissioner:

In compliance with instructions contained in Certificate of Authority No. 04.02, an examination has been made of the affairs, financial condition and management of the

AMERIHEALTH CASUALTY INSURANCE COMPANY

hereinafter referred to as "ACIC" or "Company", incorporated under the laws of the State of Delaware. The examination was conducted at 1880 John F. Kennedy Boulevard, Philadelphia, Pa. 19103.

The report of such examination is respectfully submitted herewith.

SCOPE OF EXAMINATION

The last examination was an organizational examination conducted as of August 31, 1998. This examination covers the period September 1, 1998 to December 31, 2003, and consisted of a general survey of the Company's business policies and practices; management, any corporate matters incident thereto; a verification and evaluation of assets and a determination of liabilities. Transactions subsequent to the latter date were reviewed where deemed necessary.

The format of this report is designed to explain the procedures employed on examination and the text will explain changes wherever made. If necessary, comments and recommendations have been made in those areas in need of correction or

improvement. In such cases, these matters were thoroughly discussed with responsible officials during the course of the examination.

The general procedures of the examination followed the rules established by the National Association of Insurance Commissioners (NAIC) Committee on Financial Condition Examiners Handbook, and generally accepted statutory insurance examination standards.

In addition to items hereinafter incorporated as part of the written report, the following were checked and made a part of the workpapers of this examination:

Corporate Records
Fidelity Bond & Other Corporate Insurance
All asset and liabilities items not mentioned

HISTORY

ACIC was incorporated on November 12, 1997. The Company commenced operations in 2000. Since inception, the Company has been a subsidiary of AmeriHealth Inc., in turn a subsidiary of Independence Blue Cross, of Philadelphia, Pa.

MANAGEMENT AND CONTROL

The control and management of the Company is vested in the Board of Directors. The persons elected and serving as Directors of the Company at December 31, 2003 were:

| <u>Director</u> | <u>Principal Occupation</u> |
|-----------------------|--|
| G. Fred DiBona Jr. | President and CEO, Independence Blue Cross |
| Robert J. Fascia | Senior Vice President, Independence Blue Cross |
| Christopher D. Butler | Chief Marketing Executive, Independence Blue Cross |

The officers of ACIC are elected by the Board of Directors annually. Those persons serving as of December 31, 2003 were:

| <u>Name</u> | <u>Title</u> |
|-----------------------|---|
| G. Fred DiBona Jr. | Chairman |
| Robert J. Fascia | Vice Chairman |
| Donald J. Liskay | President |
| John G. Foos | Treasurer & CFO |
| Joseph A. Frick | Senior Vice President |
| Christopher D. Butler | Chief Marketing Officer |
| Paul A. Tufano | Senior Vice President, General Counsel & Secretary |

GROWTH OF COMPANY

The following information was obtained from the Company's filed Annual Statements and covers the five preceding years. The amounts presented are prior to any examination financial adjustments.

| | 2003 | 2002 | 2001 | 2000 | 1999 |
|--------------------------|--------------|--------------|--------------|-------------|-------------|
| Assets | \$57,958,874 | \$21,322,095 | \$19,782,102 | \$1,783,928 | \$1,315,788 |
| Policyholder Surplus | 23,987,328 | 2,737,555 | 943,889 | 1,330,579 | 1,281,183 |
| Underwriting gain (loss) | -251,978 | -754,343 | -645,713 | -3,690 | -4,605 |
| Net Income | -805,872 | -472,334 | -386,690 | 49,396 | 28,102 |
| Premiums written | | | | | |
| Direct | 5,217,289 | 0 | 0 | 0 | 0 |
| Assumed | 49,868,433 | 41,308,961 | 30,882,532 | 1,607,585 | 0 |
| Ceded | 18,087,020 | 37,941,954 | 24,451,901 | 1,029,658 | 0 |
| Net Premiums Written | 36,998,702 | 3,367,007 | 6,430,631 | 577,927 | 0 |

As indicated by the above chart:

The Company's Policyholder Surplus increased significantly in 2003, due to the issuance of additional stock and a \$20 million surplus contribution.

The Company began operations in 2000. For that year and 2001 and 2002, ACIC ceded a significant portion of its assumed premiums. In 2003, the Company began writing direct business and also began retaining most of its direct and assumed premiums.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to transact business in the states of Delaware, Pennsylvania, and South Carolina.

As per a revision effective to the Company's Certificate of Authority issued by the Delaware Insurance Department, the Company is authorized to write the following lines of business: property; casualty, including liability; burglary & theft; personal property floater; and glass.

Since the commencement of operations, ACIC has only written workers compensation and employers liability insurance. All of the Company's business, both direct and assumed, is produced by its sole agent and affiliate, CSI Services Inc. (CSI). From the inception of operations through March 1, 2003, all business produced by CSI was written directly by non-related insurers and ceded to ACIC. The Company, in turn, retroceded almost all of the business to an affiliate, QCC Insurance Company.

Effective March 1, 2003, ACIC will write directly as much of the CSI-produced business as possible. In situations where the policyholder is located in a state where the Company is not licensed (New Jersey being the leading example), or where the policyholder requests an insurer with an A.M.Best Rating, a non-related insurer will write the business and cede the exposure to ACIC.

ACIC has been advised by A.M.Best that five years of operations will be necessary to obtain a rating. It should be noted that ACIC is only licensed in South Carolina to avoid an authorized reinsurance penalty for its current fronting company, Companion Property and Casualty Company. (See following Section).

REINSURANCE

For 2003, ACIC reported the following distribution of premiums:

| | |
|----------------------|-----------------------|
| Direct | \$5,217,289 |
| Assumed | 49,868,433 |
| Ceded | <u>18,087,020</u> |
| Net Premiums Written | \$36,998,702 ===== |

Assumed

From 2000 to March 1, 2003, ACIC's sole source of gross written premiums were assumptions of workers compensation and employers liability business generated by an affiliate, CSI Services Inc. (CSI) and written directly by non-related insurers. Almost all of this assumed business was immediately retroceded to an affiliated insurer, QCC Insurance Company.

Commencing March 1, 2003, it is the intent of ACIC to write as much direct business as possible. In situations where an insurer with a A.M. Best Rating is needed or where the policyholder is located in a jurisdiction where ACIC is not licensed, a designated non-related insurer will write the business directly and cede the business 100% to ACIC. Ceded excess of loss coverage will be purchased but ACIC will retain most of the risk for both the direct and assumed business.

Effective March 1, 2003, ACIC entered into a contract with Companion Property & Casualty Insurance Company, domiciled in South Carolina. Companion will cede 100% of the workers compensation and employers liability business generated by CSI, with a limit of \$1 million ceded for each policy. Ceded excess of loss reinsurance covers claims in excess of \$1 million. Assumed premiums for 2003 from Companion were \$31,857,208.

Effective September 1, 2000 and March 1, 2002, ACIC entered into fronting contracts with companies in the ACE INA Group whereby the ACE companies wrote directly the workers compensation business produced by CSI Services and ceded this business to ACIC. Under the 2000 contract, a maximum of \$250,000 per accident was ceded to ACIC, with ACE purchasing excess of loss coverage for claim amounts in excess of that amount. In 2002, the maximum cession to ACIC by ACE was raised to \$500,000 per occurrence. Premiums assumed by ACIC under the ACE contract in 2003 were \$18,011,225.

Ceded

From 2000 to March, 2003, the business that ACIC assumed from ACE (as noted above) was almost entirely ceded to an affiliate, QCC Insurance Company. ACIC retained the employers liability coverage while the workers compensation component was ceded to QCC. In 2003, ACIC retroceded premiums of \$17,909,000 to QCC.

Effective March 1, 2003, ACIC began to write business directly and retain a significant portion of exposure for both direct and assumed business. As of March 1, 2003, ACIC entered into two excess of loss contracts with non-related insurers. The first contract provides coverage of \$9 million in excess of \$1 million retention per occurrence. The second contract provides \$20 million in coverage in excess of the \$10 million provided by the underlying excess layer.

During the review of assumed and ceded reinsurance contracts, exceptions were noted in the Company's accrual and settlement of reinsurance balances. These exceptions are discussed in the Notes to the Financial Statements Section of this report under the appropriate Annual Statement line item.

HOLDING COMPANY SYSTEM

ACIC is ultimately owned by Independence Blue Cross (IBC), a non-profit health service corporation that is the largest provider of health insurance in the Delaware Valley area consisting of the Southeastern Pennsylvania, Southern New Jersey and Northern Delaware. IBC reported the following at December 31, 2003:

| | |
|------------------|-----------------|
| Assets | \$1,301,265,537 |
| Liabilities | 460,348,873 |
| Unassigned Funds | 840,916,664 |
| Revenue for 2003 | 415,894,165 |

Holding Company statements have been filed on the Company's behalf. The 2003 Form B filed April 30, 2004 contained incorrect amounts for the fees ACIC paid to two affiliates, CSI Services and CompServices for services in 2003. (See the following Section of this report). The Form B Holding Company statement also did not disclose that ACIC's 99% retrocession with an affiliate, QCC Ins Co. was discontinued effective March 1, 2003.

It is recommended the Company provide accurate and complete information on Holding Company Statement filings.

INTER-COMPANY AGREEMENTS

As of December 31, 2003, ACIC had the following inter-company agreements in effect:

Underwriting Agency Agreement between ACIC and CSI Services, Inc. For a consideration of 16% of earned premiums, CSI will solicit and bind risks on ACIC's behalf and perform all other functions necessary for the production of business. The Company commenced writing direct business March 1, 2003 yet did not submit this

agreement (or the Third Party Claims Administration Agreement with CompServices) until December, 2003). Both agreements were approved by the Department, after revisions.

Third Party Claims Administration Agreement between ACIC and CompServices Inc.

For a consideration of 5% of earned premiums, CompServices will investigate and adjust all claims on the Company's behalf.

As noted above, both the Underwriting Agency and Claims Administration Agreements were utilized when the Company began writing business on March 1, 2003. The Company filed the agreements with the Delaware Insurance Department in December, 2003, stating the agreements were effective June 1, 2003. Section 5005 a.2 of the Delaware Insurance Code requires that such inter-company agreements be filed with the Insurance Department at least 30 days prior to their effective date.

It is recommended the Company comply with Section 5005 A.2 of the Delaware Insurance Code and file all inter-company agreements at least 30 days prior to implementing said agreements.

In addition, ACIC has Administrative Services and Tax Sharing Agreements with the ultimate parent, Independence Blue Cross (IBC). Under the Administrative Services Agreement, IBC will provide any services needed to ACIC, for a consideration of the cost of providing the service. Also under the Agreement, ACIC may provide services to IBC. In practice, the Administrative Service Agreements are used within the IBC Group to permit affiliates to perform services for other affiliates. For example, in 2003, ACIC paid no service fees to IBC but paid small amounts to its immediate parent, AmeriHealth Inc. and to an affiliate, Keystone Health Plans East.

SIGNIFICANT OPERATING RATIOS

As noted previously, ACIC's operations changed considerably in 2003. The Company began to write business directly and concurrently began to retain most of the risk for all the business it wrote. Also in 2003, ACIC received capital and surplus infusions of \$20,750,000 which increased policyholder surplus by 750%.

Due to these changes, ACIC reported values outside the usual range for five (5) NAIC IRIS Ratios in 2003.

ACCOUNTS AND RECORDS

For the period under examination, the Company's accounts and records were audited by the accounting firm of Deloitte and Touche (D&T). The workpapers from D&T's 2003 audit were reviewed by the examination and utilized to the fullest extent possible.

In the course of the examination, several instances of non-compliance with SAAP and NAIC Annual Statement Instructions were noted. Recommendations regarding these exceptions are included in the Notes to the Financial Statement Section of this report under the appropriate Annual Statement line item.

FINANCIAL STATEMENTS

The Company's financial position on December 31, 2003 and the results of operations for 2003 are presented in the following statements:

ASSETS

| | <u>Assets</u> | Nonadmitted <u>Assets</u> | Net Admitted <u>Assets</u> | <u>Notes</u> |
|--|---------------------|------------------------------|-------------------------------|--------------|
| Bonds | \$1,306,075 | | \$1,306,075 | 1 |
| Common Stocks | 10,317,116 | | 10,317,116 | |
| Cash | 20,027,217 | | 20,027,217 | |
| Agents' balances or uncollected premiums: | | | | |
| Premiums and agents' balances in course of collection | 20,387,264 | | 20,387,264 | 2 |
| Reinsurance recoverables on loss and loss adjustment expense payments | 14,018 | | 14,018 | |
| Net deferred tax asset | 1,587,000 | | 1,587,000 | |
| Amounts receivable from uninsured plans | 27,426 | | 27,426 | |
| Receivable from parent, subsidiaries and Affiliates | 4,198,192 | | 4,198,192 | 3 |
| Federal Income Taxes Receivable | 1,689,086 | | 1,689,086 | 4 |
| Interest and dividends income due and Accrued | 94,566 | | 94,566 | |
| Other assets nonadmitted | <u>1,317,704</u> | <u>1,317,704</u> | <u> </u> | |
| TOTALS | <u>\$60,965,664</u> | <u>\$1,317,704</u> | <u>\$59,647,960</u> | |

LIABILITES, SURPLUS AND OTHER FUNDS

| | | Notes |
|--|-------------------------|-------|
| Losses | \$10,369,071 | 5 |
| Loss adjustment expenses | 836,168 | 5 |
| Commissions payable | 4,480,693 | 2 |
| Other expenses | 533,119 | 6 |
| Unearned premiums | 19,933,200 | |
| Payable to parent, subsidiaries and affiliates | <u>2,385,619</u> | 3 |
| Total liabilities | <u>\$38,537,870</u> | |
| Common capital stock | \$1,500,000 | |
| Gross paid in and contributed surplus | 22,725,000 | |
| Unassigned funds (surplus) | <u>(3,114,910)</u> | |
| Surplus as regards policyholders | <u>\$21,110,090</u> | |
| TOTAL | <u>\$59,647,960</u> | |

UNDERWRITING AND INVESTMENT EXHIBIT

| | |
|--------------------------------------|--------------------------|
| Premiums earned | <u>\$17,153,252</u> |
| Losses incurred | \$11,326,062 |
| Loss expenses incurred | 933,539 |
| Other underwriting expenses incurred | <u>9,885,953</u> |
| Total underwriting deductions | <u>22,145,554</u> |
| Net underwriting gain (loss) | <u>\$(4,992,302)</u> |
| Net investment income earned | \$742,987 |
| Net realized capital gains | <u>525,119</u> |
| Net investment gain | <u>\$1,268,106</u> |
| Net Income before federal taxes | <u>(3,724,196)</u> |
| Federal taxes incurred | <u>\$(41,086)</u> |
| NET INCOME | <u>\$(3,683,110)</u> |

CAPITAL AND SURPLUS ACCOUNT

| | | |
|---|--------------------|---------------------|
| Surplus as regards policyholders, December 31, 2002 | | \$2,737,555 |
| Net income | \$(3,683,110) | |
| Net unrealized capital losses | 684,349 | |
| Change in net deferred income tax | 1,927,000 | |
| Capital Paid In | 750,000 | |
| Surplus Paid In | 20,000,000 | |
| Change in nonadmitted assets | <u>(1,305,704)</u> | |
| Change in surplus as regards policyholders for the year | | <u>\$18,372,535</u> |
| Surplus as regards policyholders, December 31, 2003 | | <u>\$21,110,090</u> |

SCHEDULE OF EXAMINATION ADJUSTMENTS

| <u>Annual Statement Item</u> | <u>Company</u> | <u>Examination</u> | <u>Increase/ (Decrease) To Pol. Surplus</u> |
|--|----------------|--------------------|---|
| Federal Income Taxes Receivable | \$0 | \$1,689,086 | \$1,689,086 |
| Loss Adjustment Expenses | 714,000 | 836,168 | (122,168) |
| Commissions Payable | 0 | 4,480,693 | (4,480,693) |
| Current Federal Income Taxes | 174,000 | 0 | 174,000 |
| Other Expenses | 395,656 | 533,119 | <u>(137,463)</u> |
| Total Examination Adjustments | | | \$(2,877,238) |
| Company Surplus As Regards Policyholders | | | <u>\$23,987,328</u> |
| Examination Surplus As Regards Policyholders | | | <u>\$21,110,090</u> ===== |

NOTES TO FINANCIAL STATEMENTS

Note #1 Invested Assets

ACIC reported the following invested assets at December 31, 2003

| | |
|---------------------------------|-------------|
| Bonds | \$1,306,075 |
| Common Stocks | 10,317,116 |
| Cash and Short-Term Investments | 20,027,217 |

The Company's invested assets are held under a custody agreement with Wachovia Bank. While no exceptions were noted in the review of invested assets, it was noted that the Company's custody agreement does not contain the Indemnification Language recommended by the NAIC Examiners' Handbook.

It is recommended that ACIC amend its custody agreement with Wachovia Bank to include the Indemnification Language recommended by the NAIC Financial Condition Examiners' Handbook.

Note #2 Uncollected Premiums and Agents Balances Commissions Payable

For the 2003, ACIC reported the following Agents Balances:

| | |
|---------|-------------------|
| Direct | \$2,269,876 |
| Assumed | <u>18,117,388</u> |
| Total | \$20,387,264 |

ACIC reports the exact same amounts for the Uncollected Premiums receivable and the Unearned Premium Reserve. All of the Company's business, both direct and assumed, is produced and managed by its agent and affiliate, CSI Services Inc. (CSI). It is the procedure of CSI to bill the policyholders and collect all premiums. Cash collected for premiums is placed in CSI's bank accounts and remitted to ACIC as the premium is earned. Permitting CSI the use of funds collected from ACIC's policyholders (and the investment income therein) benefits CSI at the expense of ACIC. This is a violation of

Section 50 of the Delaware Insurance Code which requires that all transactions between affiliates to be fair and reasonable,

It is recommended that ACIC require CSI Services to remit collected premiums to the Company on a timely basis, with a no more than a monthly lag in the remittance of collected funds to ACIC.

During the review of the assumed reinsurance contract between Companion P&C and ACIC, it was noted that the contract provides for monthly settlements between the parties. The monthly settlements are based on a calculation that includes premiums written. CSI Services uses earned premium in the monthly settlement calculation with ACIC. This is contrary to the contract terms. As noted previously, this procedure allows CSI to hold funds that belong to ACIC.

It is recommended that ACIC require CSI Services to remit assumed premiums to ACIC in accordance with the terms of the reinsurance contract between Companion Property and Casualty Insurance Company and ACIC.

ACIC reports its agents balances gross of commissions. Section 1101 of the Delaware Insurance Code and SSAP #6 require that premiums receivable/agents balances be reported net of commissions.

It is recommended that ACIC comply with Section 1101 of the Delaware Insurance Code and SAAP, and report premiums receivable net of commissions.

To reflect the Company's Uncollected Premiums/Agents Balances properly reported in accordance with the Delaware Insurance Code and SAAP, the examination has accrued a Commissions Payable liability of \$4,480,693. This adjustment will be reflected as a decrease to policyholders surplus in the financial statements of this report.

Note #3 Receivables/Payables from Parents, Affiliates and Subsidiaries.

On the 2003 Annual Statement, ACIC reported the following:

| | |
|---|-------------|
| Receivable from Parent, Subsidiaries and Affiliates | \$4,198,192 |
| Payable to Parent, Subsidiaries and Affiliates | \$2,385,619 |

An analysis of the inter-company receivable noted that \$4,197,444 was due ACIC from CSI Services and represented the direct and assumed premiums due the Company for December, 2003. The inter-company payable includes two amounts, \$1,742,925 and \$454,064, payable to ACIC's affiliated reinsurer, QCC Insurance Company.

The following exceptions are noted: premiums receivable should be reported in the Annual Statement line item: Uncollected Premiums/Agents Balances. In addition, the NAIC Annual Statement Instructions specifically prohibit reinsurance balances from being included in the receivables/payables from parents, subsidiaries and affiliates. Because the Company reported its reinsurance balances improperly, Schedule F of the Annual Statement is inaccurate.

It is recommended the Company comply with the NAIC Annual Statement instructions. Premiums receivable should be reported in the designated Annual Statement line item. Reinsurance balances should also be reported correctly in the Annual Statement on Schedule F.

Note # 4 Federal Income Taxes Receivable

On the 2003 Annual Statement, the Company reported a liability of \$174,000 for Current Federal Income Taxes. To reflect the tax consequences of the above examination financial adjustments, a credit of \$1,863,086 has been allowed by the Company. Applying this credit brings the Company's current tax position from a liability of \$174,000 to a receivable of \$1,689,086.

Note #5 Losses and Lost Adjustment Expenses.

At December 31, 2003, the Company reported the following reserves for Unpaid

Losses:

| | |
|----------------------------------|----------------------|
| Reported Losses | |
| Direct | \$ 1,414,520 |
| Assumed | 17,989,264 |
| Ceded | <u>(15,105,618)</u> |
| Net Reported Reserves | <u>\$ 4,298,166</u> |
| Incurred but not reported (IBNR) | |
| Direct | 951,075 |
| Assumed | 15,511,868 |
| Ceded | <u>(10,392,038)</u> |
| Net IBNR | <u>\$ 6,070,905</u> |
| Total reserve for Losses | <u>\$ 10,369,071</u> |

Also at December 31, 2003, ACIC reported the following for reserves for

Unpaid Loss Adjustment Expenses (LAE):

| | |
|------------------------------|---------------------------|
| Defense and Cost Containment | \$714,000 |
| Adjusting & Other Expense | <u>0</u> |
| Total reserve for LAE | <u>\$714,000</u> ===== |

The actuarial firm of INS Consultants, Inc. was retained by the Delaware Insurance Department to conduct an independent review of the Company's Loss Reserves as of December 31, 2003. The Company's Loss and LAE data was tested through a review of the open claim files and claim payments during the examination as per the following:

- A review of the workpapers of the Company's audit firm.
- A review of claim file reserves performed by an outside actuarial firm.
- A review of internal controls
- A review of paid and open claim files.
- A review of reported claim file development in 2004.

The examination review indicated that the Company's reserves for reported claim files at December 31, 2003 were understated.

It is recommended the Company take remedial action to remove the reserving deficiencies noted in the actuarial claim study. The Company should institute regular, mandated supervisory review of all claim files.

The report of INS Consultants, Inc. noted the Company's reserves for Losses and LAE were understated by \$5,668,208 on a gross basis. Because ACIC only began to retain significant risk on March 1, 2003, most of the examination deficiency will be ceded to an affiliate, QCC Insurance Company. Therefore, the examination will not adjust the Company's reserve liability for Losses.

As noted above, the reserve liability for Unpaid Loss Adjustment Expenses consists of two components: Defense and Cost Containment, and Adjusting & Other Expense. ACIC accrues no liability for Adjusting & Other Expense because the Company pays an affiliate, CompServices Inc., 5% of premiums earned to perform claims adjusting services. Basically, the Company considers the Adjusting & Other Expense component to be pre-paid. The Company's practice is contrary to Section 1103 of the Delaware Insurance Code which requires insurers to accrue liabilities to pay all unpaid losses together with the expenses of adjustment thereof. INS Consultants has estimated that an Adjusting & Other Expense reserve of \$122,168 at December 31, 2003 will be necessary to comply with Section 1103. The examination will accrue that amount which will be reflected as a decrease to Policyholders Surplus in the financial statements of the examination. Therefore,

It is recommended the Company comply with Section 1103 of the Delaware Insurance Code and accrue liabilities for the Adjusting & Other Expense component of Unpaid Loss Adjusting Expenses.

Note #6, Other Expenses

In the 2003 Annual Statement, ACIC reported a liability balance of \$395,656 for Other Expenses. Included in this accrual were two amounts that were mis-reported: \$178,496 for Ceded Reinsurance Premiums Payable (to non-related reinsurers) and \$103,160 for Premium Taxes.

Ceded Reinsurance Premiums Payable and Premium Taxes (Taxes, Licenses and Fees) each have annual statement line items designated for reporting.

It is recommended that the Company report Ceded Reinsurance Premiums Payable and Premium tax Payable in accordance with the NAIC Annual Statement Instructions.

The examination also noted that the Company's accrual for Ceded Reinsurance Premiums Payable was understated by \$137,463. ACIC used earned premiums as the basis for accruing the payable while the reinsurance contract states that ceded premiums are calculated using written premiums. The examination adjustment of \$137,463 will be reflected as a decrease to policyholder surplus in the financial statements of this report.

MARKET CONDUCT

A limited scope market conduct review was conducted. One exception was noted: ACIC does not maintain a complaint register in accordance with Section 2304 of the Delaware Insurance Code.

It is recommended the Company comply with Section 2304.17 of the Delaware Insurance Code and maintain a register of complaints received.

STATUS OF PREVIOUS EXAMINATION RECOMMENDATIONS

The previous examination of ACIC was an organizational examination that made no recommendations.

RECOMMENDATIONS

The Company's attention is directed to the following examination recommendations:

- It is recommended the Company provide accurate and complete information on its Holding Company filings. (See Holding Company System, page 7).
- It is recommended the Company comply with Section 5005 A.2 of the Delaware Insurance Code and file all inter-company agreements at least 30 days prior to implementing said agreements. (See Inter-Company Agreements, page 7).
- It is recommended that ACIC amend its custody agreement with Wachovia Bank to include the Indemnification Language recommended by the NAIC Financial Condition Examiners' Handbook. (See Note #1 Invested Assets, page 13).
- It is recommended that ACIC require CSI Services to remit collected premiums to the Company on a timely basis, with a no more than a monthly lag in the

- remittance of collected funds to ACIC. (See Note #2, Uncollected Premiums/Agents Balances, page 14).
- It is recommended that ACIC require CSI Services to remit assumed premiums to ACIC in accordance with the terms of the reinsurance contract between Companion Property and Casualty Insurance Company and ACIC. (See Note #2, Uncollected Premium/Agents Balances, page 14).
 - It is recommended that ACIC comply with Section 1101 of the Delaware Insurance Code and SAAP, and report premiums receivable net of commissions. (See Note #2, Uncollected Premium/Agents Balances, page 14)
 - It is recommended the Company comply with the NAIC Annual Statement instructions. Premiums receivable should be reported in the designated Annual Statement line item. Reinsurance balances should also be reported correctly in the Annual Statement on Schedule F. (See Note #3, Receivable/Payable to Parent, Subsidiaries and Affiliates, page 15)
 - It is recommended the Company take remedial action to remove the reserving deficiencies noted in the actuarial claim study. The Company should institute regular, mandated supervisory review of all claim files. (See Note #5, Losses and Loss Adjustment Expenses, page 17).
 - It is recommended the Company comply with Section 1103 of the Delaware Insurance Code and accrue liabilities for the Adjusting & Other Expense component of Unpaid Loss Adjusting Expenses. (See Note #5, Losses and Loss Adjustment Expenses, page 17).

- It is recommended that the Company report its reinsurance payable and premium tax payable in accordance with the NAIC Annual Statement Instructions. (See Note #6, Other Expenses, page 18).
- It is recommended the Company comply with Section 2304.17 of the Delaware Insurance Code and maintain a register of complaints received. (See Market Conduct, page 19).

SUMMARY COMMENTS

The following items of significance were noted during the examination:

Since the Company commenced operations in 2002, ACIC has only written workers compensation and employers liability insurance. All of the Company's business, both direct and assumed, is produced by its sole agent and affiliate, CSI Services Inc. (CSI). From the inception of operations through March 1, 2003, all business produced by CSI was written directly by non-related insurers and ceded to ACIC. The Company, in turn, retroceded almost all of the business to an affiliate, QCC Insurance Company.

Effective March 1, 2003, ACIC will write directly as much of the CSI-produced business as possible. In situations where the policyholder is located in a state where the Company is not licensed (New Jersey being the leading example), or where the policyholder requests an insurer with an A.M.Best Rating, a non-related insurer will write the business and cede the exposure to ACIC. ACIC will purchase excess of loss reinsurance and retain up to \$1 million per occurrence.

-In 2003, ACIC received capital and surplus infusions of \$20,750,000, which significantly increased the Company's Surplus as Regards Policyholders.

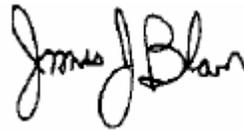
CONCLUSION

The following schedule shows the results of this examination and the results of the prior examination with changes between the examination periods:

| <u>Description</u> | <u>Current Examination</u> | <u>8/31/98 Examination</u> | <u>Changes Increases (Decreases)</u> |
|----------------------|----------------------------|----------------------------|--------------------------------------|
| Assets | \$59,647,960 | \$1,022,217 | \$58,625,743 |
| Liabilities | 38,537,870 | 10,000 | 38,527,870 |
| Policyholder Surplus | 21,110,090 | 1,012,217 | 20,097,873 |

The examination was conducted by the undersigned.

Respectfully submitted,



James J. Blair Jr., CFE, CPA
Supervisor
Insurance Department
State of Delaware