REPORT ON EXAMINATION

OF THE

MERCHANTS PREFERRED INSURANCE COMPANY

AS OF

DECEMBER 31, 2008

| | |
|---|---|
| DATE OF REPORT | SEPTEMBER 25, 2009 |
| EXAMINER | ADEBOLA AWOFESO |

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STATE OF NEW YORK
INSURANCE DEPARTMENT
25 BEAVER STREET
NEW YORK, NEW YORK 10004

September 25, 2009

Honorable James J. Wrynn
Superintendent of Insurance
Albany, New York 12257

Sir:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 30310 dated March 12, 2009 attached hereto, I have made an examination into the condition and affairs of Merchants Preferred Insurance Company as of December 31, 2008, and submit the following report thereon.

Wherever the designation "the Company" appears herein without qualification, it should be understood to indicate Merchants Preferred Insurance Company.

Wherever the designation "MNIC" appear herein without qualification, it should be understood to indicate Merchants National Insurance Company, a newly formed subsidiary of Merchants Mutual Insurance Company ("MMIC").

Wherever the designation "MNH" appears herein without qualification, it should be understood to indicate Merchants Insurance Company of New Hampshire, the former subsidiary of MMIC now known as American European Insurance Company ("AEIC").

Wherever the term "Department" appears herein without qualification, it should be understood to mean the New York Insurance Department.

The examination was conducted at the Company's home office located at 250 Main Street, Buffalo, NY 14202.

## 1. SCOPE OF EXAMINATION

The Department has performed a multi-state examination of Merchants Preferred Insurance Company. An examination on organization was conducted as of January 5, 2007. This examination covered the period from January 6, 2007 through December 31, 2008. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

This examination was conducted in accordance with the National Association of Insurance Commissioners ("NAIC") Financial Condition Examiners Handbook, which requires that we plan and perform the examination to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the Company including corporate governance, identifying and assessing inherent risks within the Company and evaluating system controls and procedures used to mitigate those risks. This examination also includes assessing the principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation, management's compliance with Statutory Accounting Principles and annual statement instructions when applicable to domestic state regulations.

All financially significant accounts and activities of the company were considered in accordance with the risk-focused examination process. This examination also included a review and evaluation of the Company's own control environment. The examiners also relied upon audit work performed by the Company's independent public accountants when appropriate.

This examination report includes a summary of significant findings for the following items as called for in the Financial Condition Examiners Handbook of the NAIC:

Significant subsequent events
Company history
Corporate records
Management and control
Fidelity bonds and other insurance
Pensions, stock ownership and insurance plans
Territory and plan of operation
Growth of Company
Loss experience
Reinsurance
Accounts and records
Statutory deposits
Financial statements
Summary of recommendations

A review was also made to ascertain what action was taken by the Company with regard to comments and recommendations contained in the prior report on examination.

This report on examination is confined to financial statements and comments on those matters, which involve departures from laws, regulations or rules, or which are deemed to require explanation or description.

## 2. DESCRIPTION OF COMPANY

Merchant Preferred Insurance Company is a stock property casualty company that was incorporated under the laws of the State of New York on September 29, 2006 and commenced business on February 26, 2007.

Capital paid in is $4,200,000 consisting of 100,000 shares of common stock at $42 par value per share. Gross paid in and contributed surplus was $10,800,000 as of December 31, 2008. Effective May 18, 2007 the Company's charter was amended and restated to increase the par value of its common stock from $10 per share to $42 per share resulting in an increase in capital paid in of $3,200,000 and a decrease of $3,200,000 in gross paid in and contributed surplus from $14,000,000 to $10,800,000.

### A. Management

Pursuant to the Company's charter and by-laws, management of the Company is vested in a board of directors consisting of not less than thirteen nor more than fifteen members. The board met at least four times during each calendar year. At December 31, 2008, the board of directors was comprised of the following thirteen members:

| Name and Residence | Principal Business Affiliation |
|---|---|
| Franklyn S. Barry, Jr.<br>Buffalo, NY | Retired, Former President and Chief Executive Officer,<br>Aethlon Medical, Inc. |
| Gary M. Brost<br>Buffalo, NY | Chairman and Chief Executive Officer,<br>Strategic Investments & Holdings, Inc. |
| Randall L. Clark<br>East Amherst, NY | Chairman,<br>Dunn Tire Corporation, LLC |

| Name and Residence | Principal Business Affiliation |
|---|---|
| Linda P. Duch<br>Naples, FL | President,<br>Partners for Business |
| John T. Hoskins<br>Lakeview, NY | Chairman and Chief Executive Officer,<br>Curtis Screw Company, Inc. |
| Muriel A. Howard<br>Buffalo, NY | President,<br>Buffalo State College |
| Margaret N. Kafka<br>Cheektowaga, NY | Vice President, Corporate Services,<br>Merchants Insurance Group |
| Brian J. Lipke<br>Derby, NY | Chairman & Chief Executive Officer,<br>Gibraltar Industries |
| Bryant H. Prentice III<br>Jacksonville, FL | Chairman and Chief Executive Officer,<br>Bryant & Stratton College |
| Kurt Weidenhaupt<br>East Aurora, NY | Retired,<br>Former President and Chief Executive Officer,<br>American Precision Industries |
| Edward Wright<br>Hamburg, NY | President and Chief Executive Officer,<br>W. J. Cox Associates, Inc. |
| Robert M. Zak<br>Buffalo, NY | President and Chief Executive Officer,<br>Merchants Mutual Insurance Company<br>Merchants Preferred Insurance Company<br>Merchants National Insurance Company |
| Ronald K. Zoeller<br>Orchard Park, NY | Chief Executive Officer,<br>Azeros Health Care |

A review of the minutes of the board of directors' meetings held during the examination period indicated that the meetings were generally well attended and each board member has an acceptable record of attendance.

As of December 31, 2008, the principal officers of the Company were as follows:

| Name | Title |
|---|---|
| Robert M. Zak | President and Chief Executive Officer |
| Fred A. Hildebrand | Senior Vice President, Insurance Operations |
| Charles E. Makey, III | Vice President, Regional Manager |
| Edward M. Murphy | Vice President, Investments and Secretary |

| Name | Title |
|---|---|
| Kenneth J. Wilson | Vice President, Chief Financial Officer and Treasurer |
| Robert H. Fagerburg | Vice President, Claims |
| Camilla G. Belser | Vice President, Regional Manager |
| Margaret N. Kafka | Vice President, Corporate Services |
| Thomas B. Harris | Vice President, Underwriting |
| Clark M. Sykes | Vice President, Information Technology |
| Daniel J. Bierbrauer, Jr. | Vice President, Sales and Marketing |
| Salvatore T. LaDuca, III | Vice President, Finance and Chief Actuary |

## B. Territory and Plan of Operation

As of December 31, 2008, the Company was licensed to write business in the following fourteen states:

| | |
|---|---|
| Delaware | New Jersey |
| Indiana | New York |
| Maine | Ohio |
| Maryland | Pennsylvania |
| Massachusetts | Rhode Island |
| Michigan | Vermont |
| New Hampshire | Virginia |

As of the examination date, the Company was authorized to transact the kinds of insurance as defined in the following numbered paragraphs of Section 1113(a) of the New York Insurance Law:

| Paragraph | Line of Business |
|---|---|
| 3 | Accident & health |
| 4 | Fire |
| 5 | Miscellaneous property |
| 6 | Water damage |
| 7 | Burglary and theft |
| 8 | Glass |
| 9 | Boiler and machinery |
| 10 | Elevator |
| 11 | Animal |
| 12 | Collision |
| 13 | Personal injury liability |
| 14 | Property damage liability |
| 15 | Workers' compensation and employers' liability |
| 16 | Fidelity and surety |
| 17 | Credit |
| 19 | Motor vehicle and aircraft physical damage |
| 20 | Marine and inland marine |

| Paragraph | Line of Business |
|---|---|
| 21 | Marine protection and indemnity |
| 26(a)(b)(c)(d) | Gap |
| 29 | Legal services |

Based on the lines of business for which the Company is licensed and the Company's current capital structure, and pursuant to the requirements of Articles 13 and 41 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of $6,400,000.

The following schedule shows the direct premiums written by the Company both in total and in New York for the period under examination:

DIRECT WRITTEN PREMIUMS ($000 Omitted)

| Calendar Year | New York State | Total Premiums | Premiums Written in New York State As A Percentage of Total Premium |
|---|---|---|---|
| 2007 | $ 8,207 | $10,561 | 77.71% |
| 2008 | $30,867 | $55,250 | 55.87% |

The Company is a northeast regional property and casualty insurer. The Company's business is split 80% commercial lines and 20% personal lines. Commercial lines operations are focused on small "main street" businesses with fewer than twenty-five employees and small artisan contractors. Commercial coverages include special multiple peril ("SMP"), business owners' packages ("BOP"), commercial automobile, general liability and workers' compensation. Personal lines coverages focus on middle to upper-middle income individuals who own homes and own/lease automobiles. Business is generated through approximately 650 independent agents. Business centers are maintained in Bedford, NH; Mt. Laurel, NJ; Buffalo, NY; Hauppauge, NY; Albany, NY; and Dublin, OH. The Company services its agents from these six business centers and its home office in Buffalo, NY. Personal lines growth plans call for expansion into Ohio, Michigan, Massachusetts and Pennsylvania.

C. Reinsurance

Assumed

Assumed reinsurance accounted for 19% of the Company’s gross premium written at December 31, 2008. The Company’s assumed reinsurance program consists mainly of its participation in the intercompany pooling agreement noted below. Additionally, the Company's participation in various mandated pools is reflected in its assumed reinsurance activity.

Effective January 1, 2007, MMIC, MNIC and the Company became parties to a reinsurance pooling agreement (“Merchants Pooling Agreement”), whereby the three companies agree to pool their traditional insurance business. Under the terms of the agreement, MNIC and the Company cede to MMIC all of their premiums, losses and underwriting expenses and then assume from MMIC a percentage of the pooled business. MMIC, MNIC and the Company’s shares of the pooled business are 70%, 20% and 10%, respectively.

The Company utilizes reinsurance accounting as defined in the NAIC Accounting Practices and Procedures Manual, Statement of Statutory Accounting Principles ("SSAP") No. 62 for all of its assumed reinsurance business.

Ceded

The Company structured its ceded reinsurance program on its direct business to limit its maximum exposure through various excess of loss and quota share reinsurance treaties. The Company utilizes facultative reinsurance for policies with limits exceeding a threshold specific to each product line. The Company also purchased catastrophe reinsurance covering property and workers’ compensation. The following is a description of the Company’s ceded reinsurance program in effect at December 31, 2008:

| Type of treaty | Cession |
|---|---|
| Property: | |
| Excess of Loss<br>2 Layers<br>100% Authorized | $6,500,000 excess of $500,000 each risk, each occurrence (including terrorism and fire). |

| Type of treaty | Cession |
|---|---|
| Catastrophe Excess of Loss<br>3 Layers<br>51%, 45%, and 31% Authorized | \$85,000,000 limit, \$10,000,000 retention, \$10,000,000 excess of \$10,000,000 1st layer, \$45,000,000 excess of \$20,000,000 2nd layer and \$20,000,000 excess of \$65,000,000 3rd layer. 10% coinsurance contribution on all layers above retention. |
| <u>Casualty</u>:<br>Excess of Loss<br>3 Layers<br>100% Authorized | \$9,250,000 excess of \$750,000 each occurrence. |
| <u>Workers' Compensation:</u><br>Catastrophe Excess of Loss<br>1 Layer<br>100% Authorized | \$15,000,000 excess of \$10,000,000 each claimant each occurrence. Limited to \$30,000,000 all occurrences each calendar year. |
| <u>Personal Umbrella Liability</u><br>Quota Share<br>100% Authorized | Cede 75% quota share of the first \$1,000,000, and 100% of amounts in excess of \$1,000,000, not exceeding \$5,000,000 each occurrence. |
| <u>Commercial Umbrella Liability</u><br>Quota Share<br>100% Authorized | Cede 75% quota share of the first \$1,000,000 plus 100% of amounts in excess of \$1,000,000, not exceeding \$5,000,000 each occurrence. |
| <u>Monoline Commercial Umbrella Liability</u><br>Quota Share<br>100% Authorized | Cede 90% quota share of the first \$1,000,000 each occurrence, and 100% of amounts in excess of \$1,000,000 resulting from each occurrence not exceeding \$10,000,000. |

In addition to its treaty reinsurance program, the Company also obtained automatic facultative reinsurance coverage in addition to its basic coverage for property losses. The facultative treaty will provide coverage of \$13,000,000 excess of \$7,000,000.

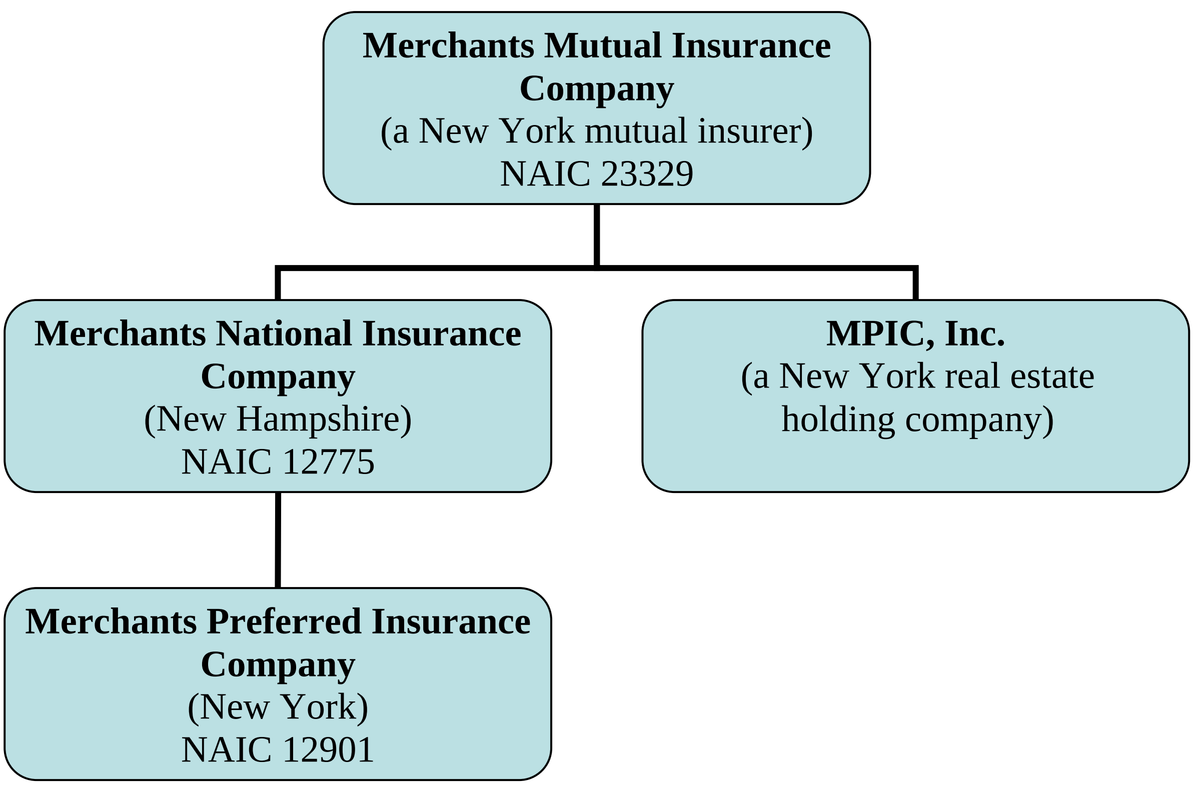
The ceded reinsurance agreements in effect as of the examination date were reviewed and found to contain the required standard clauses, including an insolvency clause meeting the requirements of Section 1308 of the New York Insurance Law.

Examination review of the Schedule F data reported by the Company in its filed annual statement was found to accurately reflect its reinsurance transactions. Additionally, management has represented that all material ceded reinsurance agreements transfer both underwriting and timing risk as set forth in SSAP No. 62. Representations were supported by appropriate risk transfer analyses and an attestation from the Company's Chief Executive Officer pursuant to the NAIC Annual Statement Instructions. Additionally, examination review indicated that the Company was not a party to any finite reinsurance agreements. All ceded reinsurance agreements were accounted for utilizing reinsurance accounting as set forth in SSAP No. 62.

D. Organization Chart

The Company is a member of the Merchants Insurance Group. The Company is 100% owned by MNIC, a New Hampshire corporation, which is ultimately controlled by MMIC. As the Company's ultimate parent is a mutual insurer, the Company is not subject to the provisions of Article 15 of the New York Insurance Law. However, the Company is required to submit an annual holding company registration statement with this Department pursuant to the provisions of Circular Letter 16 (2009). The Company made the required filings on a timely basis.

The following is an organization chart of the Company and its affiliated entities at December 31, 2008:



At December 31, 2008, the Company was party to the following agreements with other members of its holding company system:

Management Agreement

Effective October 18, 2006, the Company entered into a management agreement with MMIC and MNIC. Pursuant to the terms of the agreement, MMIC agreed to provide the Company and MNIC with facilities, management and personnel required to operate their business. This agreement was approved by the Department.

Tax Allocation Agreement

Effective October 18, 2006, the Company became a party to a federal income tax sharing agreement with the other members of its holding company system, which formed a consolidated group. Pursuant to the terms of the agreement, the parties will file a consolidated federal income tax return. The agreement provides that the Company's tax liability on a consolidated basis will not exceed the liability had it filed its tax return on a stand alone basis. This agreement was filed with the Department.

Department Circular Letter No. 33 (1979) states in part:

> "To help assure the domestic insurer's enforceable right to recoup federal income taxes in the event of future net losses an escrow account consisting of assets eligible as an investment for the domestic insurer shall be established and maintained by the parent in an amount equal to the excess of the amount paid by the domestic insurer to the parent for federal income taxes over the actual payment made by the parent to the Internal Revenue Service".

Pursuant to Department Circular Letter No. 33 (1979), this provision would help assure the related insurers' enforceable right to recoup federal income taxes in the event of future net losses. During the review of this agreement the Company advised that no escrow account is established as stated therein.

It is recommended that the Company comply with the provision of its approved tax allocation agreement and Department Circular Letter No. 33 (1979) and have its parent establish an escrow account to assure the Company's enforceable right to recoup federal income taxes in the event of future losses.

License and Renewal Rights Agreement

On March 30, 2007, MGI (former subsidiary of the MMIC) consummated an agreement and plan of merger with American European Group, Inc. ("AEG"), a Delaware Corporation, and American European Financial, Inc., a newly-formed Delaware corporation that is a wholly owned subsidiary of AEG ("Merger Sub"), pursuant to which, Merger Sub merged with and into MGI with MGI surviving the merger. At the completion of the merger, MGI became a wholly-owned subsidiary of AEG. As part of the merger, and pursuant to an agreement entered into in December 2006 by and among the Company, MMIC, MPIC Inc., MGI, MNH and AEG, MNH sold the renewal rights to all its traditional business to MPIC Inc. The agreement is effective for twenty-four months from its effective date of August 9, 2007.

The license and renewal agreement allowed:

(a) MNH to grant MPIC Inc. an exclusive license and authorized MPIC Inc. and any of its insurance subsidiaries to use and access policy, insured, agent, and producer data related to in-force policies of MNH.

(b) The Pooling agreement between MMIC and MNH/AEIC (the "AEIC Pooling Agreement") to continue through December 31, 2009 during which time the respective shares of pooled premiums, losses and loss adjustment expenses ("LAE") incurred remain at 75% for MMIC and 25% for MNH/AEIC.

(c) The underwriting and claims annexes of the services agreement to continue through the term of the AEIC Pooling Agreement.

(d) MGI and MNH to change their corporate and trade names to delete all references to "Merchants" and cease to use the Merchants name. MNH has since changed its name to American European Insurance Company.

E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2008, based upon the results of this examination:

| | |
|---|---|
| Net premiums written to surplus as regards policyholders | .98:1 |
| Liabilities to liquid assets (cash and invested assets less investments in affiliates) | 59% |
| Premiums in course of collection to surplus as regards policyholders | 3% |

All of the above ratios fall within the benchmark ranges set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners.

The underwriting ratios presented below are on an earned/incurred basis and encompass the two year period covered by this examination:

| | Amounts | Ratios |
|---|---|---|
| Losses and loss adjustment expenses incurred | $ 16,289,289 | 64.74% |
| Other underwriting expenses incurred | 12,050,637 | 47.90 |
| Net underwriting gain (loss) | (3,181,046) | (12.64) |
| Premiums earned | $25,158,880 | 100.00% |

F. Accounts and Records

Minimum Capital Investments

Section 1402(a) of New York Insurance Law states, in part:

> "Before investing its funds in any other investments, every domestic insurer shall invest and maintain an amount equal to the greater of the minimum capital required by law or the minimum surplus to policyholders required to be maintained by law for a domestic stock corporation authorized to transact the same kinds of insurance, only in investments of the types specified in this section which are not in default as to principal or interest. . . ."

A review of Company's investment portfolio as of the exam date indicated that it did not have the minimum capital investments as required by Section 1402(a) of the New York Insurance Law.

It is recommended that the Company comply with Section 1402 of the New York Insurance Law. Prior to the conclusion of the examination, the Company purchased a United States Treasury Note with a par value of $2,000,000 and is now in compliance of with Section 1402(a) of New York Insurance Law.

## 3. FINANCIAL STATEMENTS

### A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2008 as determined by this examination and as reported by the Company:

| Assets | Assets | Assets Not Admitted | Net Admitted Assets |
|---|---|---|---|
| Bonds | $27,029,444 | $ 0 | $27,029,444 |
| Preferred stocks | 316,600 | | 316,600 |
| Cash, cash equivalents and short-term investments | 450,175 | | 450,175 |
| Investment income due and accrued | 356,761 | | 356,761 |
| Uncollected premiums and agents' balances in the course of collection | 401,356 | 52,539 | 348,817 |
| Deferred premiums, agents' balances and installments booked but deferred and not yet due | 3,612,047 | | 3,612,047 |
| Net deferred tax asset | 937,000 | 675,000 | 262,000 |
| Receivables from parent, subsidiaries and affiliates | 837,088 | | 837,088 |
| Prepaid expenses | 131,347 | 131,347 | 0 |
| Equities and deposits in pools and associations | 3,886 | 0 | 3,886 |
| Total assets | $34,075,704 | $858,886 | $33,216,818 |

Liabilities, Surplus and Other Funds

| | | |
|---|---|---|
| **Liabilities** | | |
| Losses and loss adjustment expenses | | $ 9,198,783 |
| Commissions payable, contingent commissions and other similar charges | | 1,385,347 |
| Other expenses (excluding taxes, licenses and fees) | | 1,457,738 |
| Taxes, licenses and fees (excluding federal and foreign income taxes) | | 629,052 |
| Net deferred tax liability | | 100,000 |
| Unearned premiums | | 6,810,275 |
| Advance premium | | 59,930 |
| Dividends declared and unpaid: Policyholders | | 18,000 |
| Ceded reinsurance premiums payable (net of ceding commissions) | | 290,115 |
| Amounts withheld or retained by company for account of others | | 180,724 |
| Total liabilities | | $20,129,964 |
| **Surplus and Other Funds** | | |
| Common capital stock | $ 4,200,000 | |
| Gross paid in and contributed surplus | 10,800,000 | |
| Unassigned funds (surplus) | (1,913,146) | |
| Surplus as regards policyholders | | 13,086,854 |
| Total liabilities, surplus and other funds | | $33,216,818 |

NOTE: The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2007 through 2008. The examiner is unaware of any potential exposure of the Company to any tax assessment and no liability has been established herein relative to such contingency.

B. Underwriting and Investment Exhibit

Surplus as regards policyholders decreased $1,977,315 during the two-year examination period January 6, 2007 through December 31, 2008, detailed as follows:

| | | |
|---|---|---|
| Underwriting Income | | |
| Premiums earned | | $25,158,880 |
| Deductions: | | |
| Losses incurred | $12,677,547 | |
| Loss adjustment expenses incurred | 3,611,742 | |
| Other underwriting expenses incurred | 12,037,792 | |
| Aggregate write-ins for underwriting deductions | 12,845 | |
| Total underwriting deductions | | 28,339,926 |
| Net underwriting gain or (loss) | | $(3,181,046) |
| Investment Income | | |
| Net investment income earned | $ 1,818,352 | |
| Net realized capital gain | (465,267) | |
| Net investment gain or (loss) | | 1,353,085 |
| Other Income | | |
| Net gain or (loss) from agents' or premium balances charged off | $ (42,789) | |
| Finance and service charges not included in premiums | 307,716 | |
| Aggregate write-ins for miscellaneous income | 396 | |
| Total other income | | 265,323 |
| Net income before dividends to policyholders and before federal and foreign income taxes | | $(1,562,638) |
| Dividends to policyholders | | 31,219 |
| Net income after dividends to policyholders but before federal and foreign income taxes | | $(1,593,857) |
| Federal and foreign income taxes incurred | | 13,233 |
| Net income | | $(1,607,090) |

C. Capital and Surplus Account

| | Gains in Surplus | Losses in Surplus | |
|---|---|---|---|
| Surplus as regards policyholders per report on examination as of January 5, 2007 | | | $15,064,169 |
| Net income | | $1,607,090 | |
| Net unrealized capital gains or (losses) | | 297,339 | |
| Change in net deferred income tax | $ 786,000 | | |
| Change in nonadmitted assets | | 858,886 | |
| Capital changes paid in | 3,200,000 | | |
| Surplus adjustments paid in | 0 | 3,200,000 | |
| Total gains and losses | $3,986,000 | $5,963,315 | |
| Net increase (decrease) in surplus | | | (1,977,315) |
| Surplus as regards policyholders per report on examination as of December 31, 2008 | | | $13,086,854 |

## 4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for the captioned items of $9,198,783 is the same as reported by the Company as of December 31, 2008. The examination analysis was conducted in accordance with generally accepted actuarial principles and practices and was based on statistical information contained in the Company's internal records and in its filed annual statements.

Upon review of the Actuarial Report ("Report") underlying the Company's reported loss and loss adjustment expense reserves, it was found that the Report was not clearly documented and the exhibits underlying the analysis were not easily mapped to the top-level summary exhibits and the Actuary's conclusions. Therefore, the Report did not meet the NAIC requirement to "provide sufficient documentation and disclosure for another actuary practicing in the same field to evaluate the work." It is recommended that in the future, the Actuarial Report be improved to meet the NAIC requirements.

## 5. MARKET CONDUCT ACTIVITIES

In the course of this examination, a review was made of the manner in which the Company conducts its business and fulfills its contractual obligations to policyholders and claimants. The review was general in nature and is not to be construed to encompass the more precise scope of a market conduct investigation, which is the responsibility of the Market Conduct Unit of the Property Bureau of this Department.

The general review was directed at the Company's claims practices. No problem areas were encountered.

## 6. COMPLIANCE WITH PRIOR REPORT ON ORGANIZATION

The report on organization contained two recommendations as follows (page numbers refer to the prior report):

| ITEM | | PAGE NO. |
|---|---|---|
| A. | Custodial Agreement | |
| | It is recommended that the Company procure a custodial agreement that complies with the guidelines set forth in the NAIC Examiners Handbook. | 7 |
| | Prior to the conclusion of the current examination, the Company amended its custodial agreement to include the required safeguards and guidelines as set forth in the NAIC Examiners Handbook. | |
| B. | Tax Allocation Agreement | |
| | It is recommended that the Company amend its agreement to comply with Department Circular letter No. 33 (1979). | 11 |
| | The Company has complied with this recommendation. | |

## 7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

| ITEM | | | PAGE NO. |
|---|---|---|---|
| A. | Tax Allocation Agreement | | |
| | | It is recommended that the Company comply with the provision of its approved tax allocation agreement and Department Circular Letter No. 33 (1979), and have its parent establish an escrow account to assure the Company's enforceable right to recoup federal income taxes in the event of future losses. | 10 |
| B. | Minimum Capital Investments | | |
| | | It is recommended that the Company comply with Section 1402(a) of the New York Insurance Law. | 12 |
| | | Prior to the conclusion of the examination, the Company purchased a United States Treasury Note with a par value of $2,000,000 and is now in compliance of with Section 1402(a) of New York Insurance Law. | |
| C. | Losses and Loss Adjustment Expenses | | |
| | | It is recommended that in the future, the Actuarial Report be improved to meet the NAIC requirements. | 16 |

Respectfully submitted,

/s/
Adebola Awofeso
Senior Insurance Examiner

STATE OF NEW YORK )
)SS:
)
COUNTY OF NEW YORK )

ADEBOLA AWOFESO, being duly sworn, deposes and says that the foregoing report, subscribed by him, is true to the best of his knowledge and belief.

/s/
Adebola Awofeso

Subscribed and sworn to before me

this__________ day of ____________________, 2010.

***Appointment No.*** 30310

*STATE OF NEW YORK*
*INSURANCE DEPARTMENT*

*I,* Eric R. Dinallo, *Superintendent of Insurance of the State of New York, pursuant to the provisions of the Insurance Law, do hereby appoint:*

**Adebola Awofeso**

*as proper person to examine into the affairs of the*

**MERCHANTS PREFERRED INSURANCE COMPANY**

*and to make a report to me in writing of the condition of the said*

**Company**

*with such other information as he shall deem requisite.*

*In Witness Whereof, I have hereunto subscribed by the name and affixed the official Seal of this Department, at the City of New York,*

*this* 12th *day of* March, *2009*

*ERIC R. DINALLO*
*Superintendent of Insurance*