

REPORT ON EXAMINATION

OF

CONSTITUTION INSURANCE COMPANY

AS OF

DECEMBER 31, 2016

DATE OF REPORT

FEBRUARY 9, 2018

EXAMINER

SHEIK H. MOHAMED

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NEW YORK STATE
DEPARTMENT *of*
FINANCIAL SERVICES

Andrew M. Cuomo
Governor

Maria T. Vullo
Superintendent

February 9, 2018

Honorable Maria T. Vullo
Superintendent
New York State Department of Financial Services
Albany, New York 12257

Madam:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 31672 dated September 19, 2017, attached hereto, I have made an examination into the condition and affairs of Constitution Insurance Company as of December 31, 2016, and submit the following report thereon.

Wherever the designation “the Company” appears herein without qualification, it should be understood to indicate Constitution Insurance Company.

Wherever the term “Department” appears herein without qualification, it should be understood to mean the New York State Department of Financial Services.

The examination was conducted at the Company’s administrative office located at 10826 Old Mill Road, Omaha, Nebraska 68154.

SCOPE OF EXAMINATION

The Department has performed an examination of the Company, a multi-state insurer. The previous examination was conducted as of December 31, 2011. This examination covered the five- year period from January 1, 2012 through December 31, 2016. 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 (“Handbook”), which requires that we plan and perform the examination to evaluate the financial condition and identify current and 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 New York Laws, statutory accounting principles, and annual statement instructions.

This examination report includes, but is not limited to, the following:

- Company history
- Management and control
- Territory and plan of operation
- Holding company description
- Reinsurance
- Loss review and analysis
- Financial statement presentation
- Significant subsequent events
- 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 that involve departures from laws, regulations or rules, or that are deemed to require explanation or description.

2. DESCRIPTION OF COMPANY

The Company was incorporated under the laws of the State of New York on February 10, 1992 as the Folksamerica National Reinsurance Company (“FNRC”). It commenced business on September 1, 1992. On December 31, 1992, substantially all of the assets and liabilities of FNRC and its underwriting and investment activities were transferred to Folksamerica Reinsurance Company. In December 1996, the Company’s name was changed to Gerling Global Reinsurance Corporation of America (“GGRCA”).

In August 2002, the Company voluntarily ceased writing new business. In 2007, management decided to pursue the sale of the Company. Effective January 1, 2008, the Company commuted a 3% assumed quota share agreement with Global Reinsurance Company of America (“GRCA”), and at the same time, increased a 97% ceded quota share agreement with GRCA to 100%. The Company also transferred all of its direct policy obligations to GRCA pursuant to an Assumption Agreement, which was approved by this Department. As a result of these transactions, the Company became a clean shell with no remaining underwriting liabilities.

On July 24, 2008, Constitution Group, LLC (“Constitution Group”) and Steven Menzies filed an application with the Department to acquire control of the Company from GRCA. Constitution Group, a New York limited liability company, is owned 100% by Steven Menzies. Steven Menzies by virtue of his 100% ownership in Constitution Group is deemed to be the ultimate controlling person of the Company. The acquisition was completed on May 6, 2009.

To effectuate the acquisition, on December 30, 2008, the Company increased the par value of its common stock from \$1 per share to \$8.24 per share and redeemed 3,690,291 of its 4,200,000 common shares at a cost of \$30,408,000. On May 21, 2009, the Company received permission from the Department to amend its license to remove the authority to reinsure risks of every kind or description pursuant to Section 4102(c) of the New York Insurance Law, which reduced its minimum required surplus from \$35,000,000 to \$4,400,000. Additionally, effective July 2, 2009, the Department approved a Plan of Quasi-Reorganization, whereby the Company reset its unassigned funds of \$(9,603,191) as reported as of December 31, 2008 to \$0 through a transfer from Gross paid in and contributed surplus.

A. Corporate Governance

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 twenty-one members. Since the acquisition of the Company, all actions of the board have been by unanimous written consent in lieu of a meeting. At December 31, 2016, the board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Catherine L. Menzies-Ansonia Syracuse, NY	Financial Analyst, Wells Fargo
Eric L. Butler San Francisco, CA	Financial Analyst, Applied Underwriters, Inc.
Linda S. Davis LaVista, NE	Executive Administrative Assistant, Applied Underwriters, Inc.
Carl J. DeBarbrie, New York, NY	Principal, Remco Insurance Agency
Sidney R. Ferenc Highland Beach, FL	Insurance Executive, Applied Underwriters, Inc.
Xiaoyun A. Hu Burlingame, CA	Entrepreneur
Ann E. Menzies Syracuse, NY	Retired
Steven M. Menzies Hillsborough, CA	President, Constitution Insurance Company
David S. Percey Cambridge, NY	Director - IT Systems, Constitution Insurance Company
Jeffrey A. Silver Omaha, NE	Attorney
Mary F. Silver Omaha, NE	Retired
Marc M. Tract Brookville, NY	Attorney, Katten, Muchin, Rosenman, LLP

Name and ResidencePrincipal Business Affiliation

Katy M. Van Horn
Castro Valley, CA

Business Person,
Self Employed

A review of the minutes of the board of directors' meetings held during the examination period indicated that all board meetings were held by written consent in lieu of a meeting.

Board Meetings

The by-laws state, "The Board of Directors shall hold an annual meeting for the purpose of organization and the transaction of any business immediately after the annual meeting of the Shareholders, provided a quorum is present the Board of Directors shall hold at least one (1) regular meeting during each calendar quarter period." The by-laws also state, "Any action without a meeting of the Board shall be limited to those situations where time is of the essence and not in lieu of a regularly scheduled meeting."

It is recommended that the Company comply with its by-laws and hold regular board meetings and not substitute these for meetings held by written consent.

As of December 31, 2016, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Steven M. Menzies	President and Treasurer
Jeffrey A. Silver	Secretary

B. Territory and Plan of Operation

As of December 31, 2016, the Company was licensed to write business in 44 states and the District of Columbia and is an accredited reinsurer in the State of Maine.

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:

<u>Paragraph</u>	<u>Line of Business</u>
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
21	Marine protection and indemnity

Based upon 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 \$4,400,000.

The following schedule shows the direct premiums written by the Company for the period under examination:

<u>Calendar Year</u>	<u>Premiums Written</u>
2012	\$ 365,625
2013	\$4,054,137
2014	\$6,933,576
2015	\$6,997,752
2016	\$5,260,214

The Company's predominant lines of business are employment practices liability insurance and fire, which accounted for 92.08% and 7.92%, respectively, of the Company's 2016 direct written premiums.

In 2010, the Company began writing Employment Practices Liability Insurance (“EPLI”) through the Remco Insurance Agency, an independent agent, located in Hempstead, New York. The EPLI coverage was written on a claims made basis and written through an association with coverage provided to its members. The EPLI product was quite profitable for the Company with minimal claims. However, recently the EPLI market has changed dramatically with a softening of rates and increased indemnity limits. Based on these two factors, the Company ceased marketing its EPLI product in the fourth quarter of 2016.

Coincidental with withdrawing from the EPLI market, the Company began writing Dwelling Fire Coverage in the New York metropolitan area. This coverage is written through the Simon Agency NY Inc. The company expects this product to produce a significant amount of premium in the future. The business is written on properties located sufficiently inland to minimize wind related catastrophe events.

The Company is currently planning to expand its product lines to include homeowners insurance to be written in California. The company plans to insure properties located in areas with low exposure to wildfires such as metropolitan Los Angeles. This business will be produced through a third party independent agent.

Assumed Reinsurance

The Company did not assume business during the examination period.

C. Reinsurance Ceded

The Company retained 100% of each and every risk for its EPLI and New York Dwelling Fire business until March 30, 2016. The Company purchased catastrophe excess of loss reinsurance coverage for the New York Dwelling Fire business which went into effect on March 31, 2016.

Ceded Reinsurance Program

The Company has structured its ceded reinsurance program as follows:

<u>Type of Treaty</u>	<u>Cession</u>
<u>Property Catastrophe</u>	
2 layers	
100% authorized	
First layer	\$3,000,000 excess of \$2,000,000 ultimate net loss, each and every loss occurrence.
Second layer	\$5,000,000 excess of \$5,000,000 ultimate net loss, each and every loss occurrence.

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

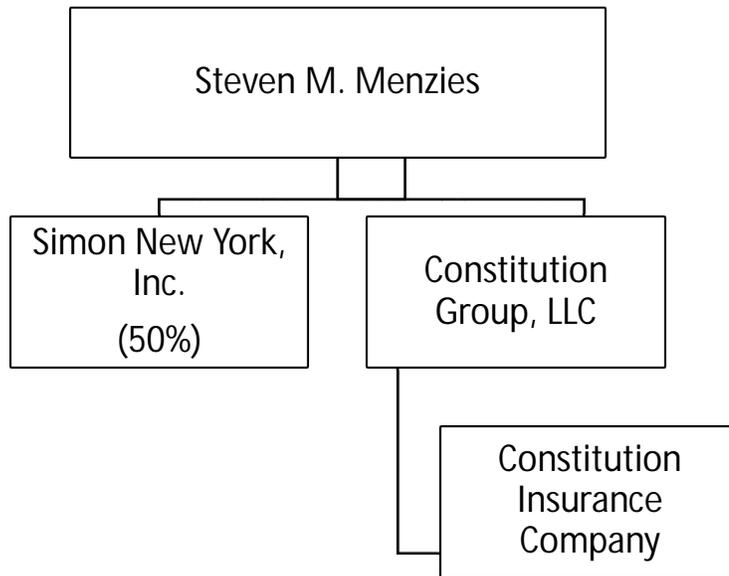
Examination review found that the Schedule F data reported by the Company in its filed Annual Statement accurately reflected its reinsurance transactions. Additionally, management has represented that the ceded reinsurance agreement transfers both underwriting and timing risk as set forth in SSAP No.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

D. Holding Company System

The Company is a member of the Constitution Group, LLC. The Company is 100% owned by Constitution Group, LLC, a New York corporation, which is ultimately controlled by Steven M. Menzies.

A review of the Holding Company Registration Statements filed with this Department indicated that such filings were complete and were filed in a timely manner pursuant to Article 15 of the New York Insurance Law and Department Regulation 52.

The following is a chart of the holding company system at December 31, 2016:



At December 31, 2016, the Company was party to a Management Services Agreement with Constitution Group, LLC, a member of its holding company system, which was effective May 6, 2009.

Under the agreement, Constitution Group, LLC provides accounting services, financial statement preparation, tax returns, actuarial services, claim services, reinsurance, accounts receivable, depositing of monies received, accounts payable, underwriting, computer equipment, computer systems and software, purchasing and mail services, personnel and administrative services and loss prevention services to the Company. This agreement was filed with the Department pursuant to Section 1505 of the New York Insurance Law.

Based upon a review of the agreement and the transactions surrounding this agreement, it appears that the Company and Constitution Group, LLC are not complying with the terms of the agreement. The agreement requires Constitution Group, LLC to provide monthly accounting to the Company of the payments which Constitution Group, LLC has made on the Company's behalf. Also, Constitution Group, LLC shall bill the Company for its allocable portion of such estimated costs and expenses for such month. Such bill shall be accompanied by such other documentation and information as shall be necessary to comply with the requirements of Section 1217 of the New York Insurance Law.

It is recommended that the Company follow the agreed upon terms contained within the Management Services Agreement. A similar comment was included in the prior report on examination.

During this examination the following weaknesses in the internal accounting controls over expenses were noted:

- Documentation supporting the Company's credit card expenditures was found to be insufficient. The supporting documentation consists solely of the credit card billing statements without any charge slips attached. Further, there is nothing provided to identify the business purpose for the expenditures. Without adequate documentation supporting the business purpose for the expenditures, there is no viable way to determine which expenses relate to the insurance entity versus other entities or even personal expenditures.
- Expenses incurred are not reported in the correct period. 2014 and 2015 expenses were paid in 2016 along with 2016 expenses and were not reported in the 2014 and 2015 financial statements.

The lack of adequate supporting documentation is a violation of Section 1217 of the New York Insurance Law which states, in part:

“No domestic insurance company shall make any disbursement of one hundred dollars or more unless evidenced by a voucher signed by or on behalf of the payee as compensation for goods or services rendered for the company, and correctly describing the consideration for the payment. If such disbursement be for services and disbursements, such vouchers shall set forth the services rendered and itemize the disbursements; if it is in connection with any matter pending before any legislative or public body or before any government department or officer, the voucher shall correctly describe also the nature of the matter and the company's interest therein. If such a voucher is unobtainable, the disbursement shall be evidenced by a statement of an officer or responsible employee affirmed by him as true under the penalties of perjury, stating the reasons therefor and setting forth the particulars above mentioned.”

It is recommended that the Company comply with Section 1217 of the New York Insurance Law.

It is recommended that the Company strengthen its internal controls over expenses by requiring all expenditures be adequately supported by vouchers that sufficiently identify the services rendered, the nature of the disbursement and the business purpose as it relates to the insurer.

It is further recommended that all approvals to disburse funds from the insurer be appropriately documented, in writing, by an officer or responsible employee of the insurer. Such documentation must support the legitimate purpose of the expense as it relates to the insurance entity.

E. Significant Operating Ratios

The Company's operating ratios, computed as of December 31, 2016, fall within the benchmark ranges set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners.

Net premiums written to policyholders' surplus	24%
Adjusted liabilities to liquid assets	8%
Two-year overall operating ratio	50%

Underwriting Ratios

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

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss adjustment expenses incurred	\$ 2,027,924	9.89%
Other underwriting expenses incurred	9,583,726	46.73
Net underwriting gain	<u>8,896,391</u>	<u>43.38</u>
Premiums earned	<u>\$20,508,041</u>	<u>100.00%</u>

The Company's reported risk based capital score ("RBC") was 2,254% at 12/31/16. The RBC is a measure of the minimum amount of capital appropriate for a reporting entity to support its overall business operations in consideration of its size and risk profile. An RBC of 200% or below can result in regulatory action.

There were no financial adjustments in this report that impacted the Company's RBC score.

3. FINANCIAL STATEMENTS

A. Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2016, as reported by the Company:

<u>Assets</u>	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>
Bonds	\$18,028,048	\$ 0	\$18,028,048
Cash, cash equivalents and short-term investments	2,793,251		2,793,251
Investment income due and accrued	86,654		86,654
Uncollected premiums and agents' balances in the course of collection	1,323,003		1,323,003
Deferred premiums, agents' balances and installments booked but deferred and not yet due	2,771,992		2,771,992
Other amounts receivable under reinsurance contracts	38,000		38,000
Net deferred tax asset	3,628,288	2,479,399	1,148,889
Electronic data processing equipment and software	51,743	51,743	0
Furniture and equipment, including health care delivery assets	2,957	2,957	0
Other assets	<u>20,310</u>	<u>20,310</u>	<u>0</u>
Total assets	<u>\$28,744,246</u>	<u>\$2,554,409</u>	<u>\$26,189,837</u>

Liabilities, Surplus and Other Funds

Liabilities

Losses and loss adjustment expenses	\$ 2,010,221
Commissions payable, contingent commissions and other similar charges	504,029
Other expenses (excluding taxes, licenses and fees)	111,358
Taxes, licenses and fees (excluding federal and foreign income taxes)	(23,613)
Current federal and foreign income taxes	(1,061,906)
Unearned premiums	2,996,813
Ceded reinsurance premiums payable (net of ceding commissions)	(38,000)
Payable to parent, subsidiaries and affiliates	<u>36,706</u>
Total liabilities	\$ 4,535,608

Surplus and Other Funds

Common capital stock	\$4,200,002
Gross paid in and contributed surplus	7,960,945
Unassigned funds (surplus)	<u>9,493,282</u>
Surplus as regards policyholders	<u>21,654,229</u>
Total liabilities, surplus and other funds	<u>\$26,189,837</u>

Note: The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2012 through 2016. 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. Statement of Income

The net income for the examination period, as reported by the Company, was \$8,198,023 as detailed below:

Underwriting Income

Premiums earned		\$20,508,041
Deductions:		
Losses and loss adjustment expenses incurred	\$2,027,924	
Other underwriting expenses incurred	<u>9,583,726</u>	
Total underwriting deductions		<u>11,611,650</u>
Net underwriting gain		8,896,391

Investment Income

Net investment income earned	569,999	
Net realized capital gain	<u>111,384</u>	
Net investment gain		681,383

Other Income

Finance and service charges not included in premiums	<u>1,636</u>	
Total other income		<u>1,636</u>
Net income before federal income taxes		9,579,410
Federal income taxes incurred		<u>1,381,387</u>
Net income		\$ <u>8,198,023</u>

C. Capital and Surplus Account

Surplus as regards policyholders increased \$9,330,305 during the five-year examination period January 1, 2012 through December 31, 2016 as reported by the Company, detailed as follows:

Surplus as regards policyholders as reported by the Company as of December 31, 2011			\$12,323,924
	<u>Gains in</u>	<u>Losses in</u>	
	<u>Surplus</u>	<u>Surplus</u>	
Net income	\$ 8,198,023		
Change in net deferred income tax		1,973,607	
Change in non-admitted assets	<u>3,105,889</u>	<u>0</u>	
Total gains and losses	<u>11,303,912</u>	<u>1,973,607</u>	
Net increase in surplus			<u>9,330,305</u>
Surplus as regards policyholders as reported by the Company as of December 31, 2016			<u>\$21,654,229</u>

Capital paid in is \$4,200,002 consisting of 509,709 shares of \$8.24 par value per share common stock. Gross paid in and contributed surplus is \$7,960,945. Gross paid in and contributed surplus did not change during the examination period.

4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for the captioned items of \$2,010,221 is the same as reported by the Company as of December 31, 2016. The examination analysis of the Loss and loss adjustment expense reserves was conducted in accordance with generally accepted actuarial principles and statutory accounting principles, including the NAIC Accounting Practices & Procedures Manual, Statement of Statutory Accounting Principle No. 55 (“SSAP No. 55”). The reserves are concentrated in the employers practices liability line.

5. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Holding Company</u>	
i. <u>Management Services Agreement</u> It was recommended that the Company follow the agreed upon terms contained within the Management Services Agreement.	8
The Company has not complied with this recommendation. A similar comment is made in this report.	
B. <u>Accounts and Records</u>	
i. <u>Custodial Agreements</u> It was recommended that the Company amend its custodial agreements to include the minimum safeguards and controls as set forth in the NAIC Financial Condition Examiners Handbook.	10
The Company has complied with this recommendation.	
ii. <u>Conflict of Interest Policy</u> It was recommended that the Company amend its conflict of interest policy and require key employees to make annual conflict of interest statements.	10
The Company has complied with this recommendation.	
iii. <u>Fidelity Bond Coverage</u> It was recommended that the Company obtain a fidelity bond of no less than \$100,000 as required by the NAIC Financial Condition Examiners Handbook.	10
The Company has complied with this recommendation.	

6. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>		<u>PAGE NO.</u>
A.	<u>Corporate Governance</u>	
	It is recommended that the Company comply with its by-laws and hold regular board meetings and not substitute these for meetings held by written consent.	5
B.	<u>Holding Company System</u>	
i.	It is recommended that the Company follow the agreed upon terms contained within the Management Services Agreement. A similar comment was included in the prior report on examination.	9
ii.	It is recommended that the Company comply with Section 1217 of the New York Insurance Law.	10
iii.	It is recommended that the Company strengthen its internal controls over expenses by requiring all expenditures be adequately supported by vouchers that sufficiently identify the services rendered, the nature of the disbursement and the business purpose as it relates to the insurer.	10
iv.	It is recommended that all approvals to disburse funds from the insurer be appropriately documented, in writing, by an officer or responsible employee of the insurer.	10

Respectfully submitted,

Sheik H. Mohamed,
Associate Insurance Examiner

STATE OF NEW YORK)
)ss:
COUNTY OF NEW YORK)

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

Sheik H. Mohamed

Subscribed and sworn to before me

this _____ day of _____, 2018.

NEW YORK STATE

DEPARTMENT OF FINANCIAL SERVICES

I, Maria T. Vullo, Superintendent of Financial Services of the State of New York, pursuant to the provisions of the Financial Services Law and the Insurance Law, do hereby appoint:

Sheik Mohamed

as a proper person to examine the affairs of the

Constitution Insurance Company

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

COMPANY

with such other information as he shall deem requisite.

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

this 19th day of September, 2017

MARIA T. VULLO
Superintendent of Financial Services



By:

Joan P. Riddell

Joan Riddell
Deputy Bureau Chief