

REPORT ON EXAMINATION
OF
JEFFERSON INSURANCE COMPANY
AS OF
DECEMBER 31, 2002

DATE OF REPORT

JUNE 28, 2004

EXAMINER

MARC ALLEN

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

June 28, 2004

Honorable Greg V. Serio
Superintendent of Insurance
Albany, New York 12257

Sir:

Pursuant to instructions contained in Appointment Number 21948, dated October 31, 2002, attached hereto, I have made an examination into the condition and affairs of the Jefferson Insurance Company as of December 31, 2002, and respectfully submit the following report thereon.

The examination was conducted at the Company's administrative office located at 777 San Marin Drive in Novato, CA 94998.

Whenever the designations "Company" or "Jefferson" appear herein without qualification, they should be understood to indicate the Jefferson Insurance Company.

Whenever the designation "Monticello" appears herein, it should be understood to indicate the Monticello Insurance Company, an insurer domiciled in Delaware.

Whenever the designation "Jefferson Group" appears herein, it should be understood to refer to the Jefferson Insurance Company and Monticello Insurance Company.

Whenever the designation "Department" appears herein, it should be understood to indicate the New York State Insurance Department.

1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 1998. This examination covers the four-year period from January 1, 1999 through December 31, 2002. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

The examination was comprised of a complete verification of assets and liabilities as of December 31, 2002, a review of income and disbursements deemed necessary to accomplish such verification and utilized, to the extent considered appropriate, work performed by the Company's independent certified public accountants. A review or audit was also made of the following items as called for in the Examiners Handbook of the National Association of Insurance Commissioners:

- History of the Company
- Management and control
- Corporate records
- Fidelity bonds and other insurance
- Territory and plan of operation
- Market conduct activities
- Growth of the Company
- Business in force
- Loss experience
- Reinsurance
- Accounts and records
- Financial statements

The State of Delaware examined the Monticello Insurance Company, Wilmington, Delaware, a wholly-owned subsidiary of the Jefferson Insurance Company, concurrently with this examination.

A review was also made to ascertain what action was taken with the regard to comments and recommendations 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

The Jefferson Insurance Company of New York was established under the laws of the State of New York on March 15, 1950, under the name, Jefferson Insurance Company. On February 1, 1952, the corporate name was changed to the Jefferson Insurance Company of New York. On July 28, 1999, the corporate name was changed back to Jefferson Insurance Company.

At December 31, 2002, the Company paid in capital consisted of 104,537 shares of common stock with a par value of \$100 per share. All shares were issued and outstanding. Gross paid in and contributed surplus increased by \$17,000,000 during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
1998	Beginning gross paid in and contributed surplus	\$23,979,284
1999	Surplus contribution	<u>17,000,000</u>
2002	Ending gross paid in and contributed surplus	<u>\$40,979,284</u>

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. As of the examination date, the board of directors was comprised of the following eleven members.

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Susan J. Albrecht Chicago, IL	President and CEO, Interstate Insurance Group
Thomas E. Geissler Mill Valley, CA	Executive Vice President, Fireman's Fund Ins. Co.
Peter Huehne Tiburon, CA	Executive Vice President and Chief Financial Officer, Fireman's Fund Ins. Co.
Janet. S. Kloenhamer Larkspur, CA	Senior Vice President, General Counsel and Corporate Secretary, Fireman's Fund Ins. Co.
H. David Lundgren Sausalito, CA	Executive Vice President, Fireman's Fund Ins. Co.
Harold N. Marsh III Sonoma, CA	Senior Vice President, Fireman's Fund Ins. Co.
Victor L. Matthews Syosset, NY	Senior Finance Director, Fireman's Fund Ins. Co.
Arthur E. Moosmann, Jr. East Northport, NY	President, Fireman's Fund Ins. Co.
Jeffrey H. Post Novato, CA	Chief Executive Officer, Fireman's Fund Ins. Co.
Paul M. Saffert Novato, CA	Executive Vice President and Treasurer, Chief Financial Officer, Allianz of America
Alastair C. Shore Novato, CA	Senior Vice President, Fireman's Fund Ins. Co.

The Company's charter and by-laws conform to the provisions of Sections 1201(a)(5)(B)(v) and 1201(a)(5)(B)(vi) of the New York Insurance Law, which require that there be at least thirteen directors and that not less than three directors are residents of the State of New York.

Examination review indicated that as of December 31, 2002, the board of directors was composed of eleven members, of which two were residents of New York State. It was also noted that there were several occasions during the examination period where the number of directors was less than the required thirteen and the number of directors who were residents of New York State was less than the required three.

It is recommended that the Company comply with its by-laws and maintain at least thirteen directors with at least three of them residing in New York State.

The minutes of all the meetings of the board of directors held during the examination period were reviewed. The meetings were generally well attended and each of the directors had a satisfactory attendance record. During calendar years 1999, 2000, and 2001, the board met twice during each calendar year. During calendar year 2002, the board met only once, but also acted via unanimous written consent in lieu of meeting on three occasions.

Examination review of the minutes indicated that the board did not appear to be exercising proper oversight of the Company, as evidenced by the following:

- An extremely high turnover in board members. Only one of the directors who was a board member at December 31, 2001 was still a member at December 31, 2002. Only four of the thirteen board members at March 23, 1999 were still members of the board at October 31, 2001;
- The failure of the board to hold any meetings since April 9, 2002. In addition, the Company indicated that there were no meetings planned and all actions as needed would be handled by unanimous written consent.
- The failure to bring the number of board members up to thirteen as required in the Company by-laws.
- The failure of the board to approve all investment transactions pursuant to Section 1411(a) of the New York Insurance Law.

The failure of the board to properly exercise its management oversight responsibilities has led to a business environment of poor internal controls and accounting deficiencies as indicated in sections 2G and 2J of this report. It also has led to several turnovers in key personnel, resulting in an organization with an almost complete lack of historical knowledge of the Company. These factors substantially increased the time necessary to conduct the examination.

It is recommended that the board meet on a regular basis in order to properly exercise its management oversight responsibilities in accordance with Section 15 of the Company's by-laws. It is further recommended that the board approve all investment transactions as required by Section 1411(a) of the New York Insurance Law.

The principal officers of the Company as of December 31, 2002 were as follows:

<u>Name</u>	<u>Title</u>
Jeffrey Post	Chief Executive Officer
Linda Wright	Senior Vice President, Treasurer
Janet Kloenhamer	Senior Vice President, Corporate Secretary
Peter Heuhne	Executive Vice President, Chief Financial Officer
Harold Marsh III	Senior Vice President, Discontinued Operations

Conflict of Interest

The Company adopted a policy statement pertaining to conflict of interest for its directors and management. However, it was noted that the Company failed to provide conflict of interest statements to its directors and officers for the calendar years 1999 and 2001. It was additionally noted that the Company could not provide conflict of interest declarations for three of its thirteen board members for the year 2000.

It is recommended that the Company require its directors and officers to complete conflict of interest statements on an annual basis.

B. Territory and Plan of Operation

At December 31, 2002, the Company was in run-off status. The only new business written was the mandatory renewal of certain personal lines. During mid-2000, a determination was made by Allianz Aktiengesellschaft, the ultimate parent corporation for the Jefferson Group, to transfer all of the existing business of Jefferson and Monticello to the Interstate National Corporation and other affiliated companies, with the ultimate goal of selling both companies.

At December 31, 2002, the Company was licensed to transact business in the District of Columbia and in all states except Hawaii and Louisiana. The Company was an approved surplus lines carrier in Hawaii and Louisiana.

The Company is licensed to transact the kinds of insurance as set forth in the following numbered paragraphs of Section 1113(a) of the New York Insurance Law:

<u>Paragraph</u>	<u>Kinds of Insurance</u>
3(i)	Accident and health
4	Fire
5	Miscellaneous property
6	Water damage
7	Burglary and theft
8	Glass
9	Boiler and machinery
12	Collision
13	Personal injury liability
14	Property damage liability
16	Fidelity and surety
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 \$1,600,000.

The following schedule shows direct premiums written in the State of New York compared to the direct business countrywide for the four calendar years covered by this examination:

<u>DIRECT WRITTEN PREMIUMS (\$000)</u>			
<u>Calendar Year</u>	<u>In New York State</u>	<u>Total United States</u>	<u>Percentage New York Premiums Written to Total United States Premium Written</u>
1999	\$650	\$55,264	1.2%
2000	\$812	\$53,902	1.5%
2001	\$719	\$38,172	1.9%
2002	\$321	\$15,313	2.1%

The Company's primary business was excess, surplus and specialty lines, concentrating on small commercial and personal exposures that cover substandard risks at surcharged rates. The business was produced through wholesale general agents and wholesale brokers specializing in excess and surplus lines.

C. Reinsurance

Intercompany Pooling Agreement

The Company entered into a reciprocal quota share agreement with its affiliated company, Monticello Insurance Company, effective January 1, 1977. This agreement provides for the Company to assume 100% of the net writings of Monticello Insurance Company and to cede 20% of the combined net writings to Monticello Insurance Company. Underwriting assets and liabilities, as well as all losses,

claims expenses, and underwriting expenses are shared by both companies in accordance with their corresponding pooling percentages of 80% (Jefferson) and 20% (Monticello).

Assumed

In 2002, the Company assumed premiums totaling \$435,500 from an affiliate, Fireman's Fund Insurance Company. The contract was submitted to this Department for non-disapproval in accordance with Section 1505(d)(2) of the New York Insurance Law.

Ceded

Other than the intercompany pooling agreement, there were no current ceded reinsurance agreements in effect at December 31, 2002. The Company allowed its reinsurance contracts to expire at June 30, 2001 in anticipation of its run-off status.

D. Holding Company System

At December 31, 2002, Allianz of America, Inc., ("Allianz") a Delaware company, owned one hundred percent of the outstanding shares of the Company. The ultimate parent of Jefferson Insurance Company is Allianz Aktiengesellschaft Holding, Munich, Germany, an international holding company of numerous insurance entities and related interests.

The Company has filed with the Department the required registration statements pursuant to Section 1503 of the New York Insurance Law and Department Regulation 52.

As of December 31, 2002, in addition to the pooling agreement described in Section 2C herein, there were four agreements in force between the Company and members of its holding company system. The agreements are as follows:

Service Agreement

Effective January 1, 2001, the Company entered into a service agreement with Interstate National Corporation (“Interstate”), a member of the Allianz holding company system. Pursuant to the terms of this agreement, Interstate agrees to provide the Company administrative, professional and clerical personnel and services required for the conduct of business.

This agreement was filed with the Department in accordance with Section 1505(d)(3) of the New York Insurance Law.

In accordance with its service agreement with the Company for 2001 and 2002, Interstate paid various expenses on behalf of the Company for which Jefferson provided reimbursement. The Company was not able to provide a complete supporting schedule for calendar year 2001 expenses. The documentation provided by the Company appeared questionable as well. The examiner sampled forty-four items from the documentation provided. The Company was only able to provide supporting documentation for twenty-five of the forty-four items sampled, which represented approximately eight percent of the dollar volume sampled.

For 2002 expenses, the Company was able to provide adequate support schedules. However, the Company was only able to provide documentation for eighty-three out of ninety-seven items sampled representing ninety-one percent of the dollar volume sampled.

The failure to maintain adequate support schedules and documentation for expenses paid to affiliates appears to be a violation of Section 1505(b) and Section 1217 of the New York Insurance Law.

Section 1505(b) provides the following relative to transactions within a holding company system:

“ The books, accounts and records of each party to all such transactions shall be so maintained as to clearly and accurately disclose the nature and details of the transactions including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties.”

Section 1217 provides the following:

“ 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 and 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 1505(b) of the New York Insurance Law by maintaining its books and records in a way that will enable verification that the agreement has been implemented as represented to this Department. It is further recommended that the Company maintain vouchers for disbursements of one hundred dollars or more in accordance with Section 1217 of the New York Insurance Law.

This agreement was replaced on January 1, 2003, with a service agreement with Fireman’s Fund Insurance Company (“Fireman’s Fund”), an affiliate. The service agreement with Fireman’s Fund was conditionally approved by the Department subject to the Company filing and receiving approval of a plan to move the Company’s records to Novato, California in accordance with Section 325(b) of the New York

Insurance Law. The Company never filed such a plan (refer to Section G of this report) and therefore, the service agreement was not approved by the Department. The Company subsequently entered into the agreement without receiving approval, in violation of Section 1505(d)(3) of the New York Insurance Law, which provides that:

“ The following transactions between a domestic controlled insurer and any person in its holding company system may not be entered into unless the insurer has notified the superintendent in writing of its intention to enter into any such transaction at least thirty days prior thereto, or such shorter period as he may permit, and he has not disapproved it within such period”.

(3) rendering of services on a regular or systematic basis.

It was further noted that Fireman’s Fund began providing services to Jefferson prior to the effective date of its service agreement with Jefferson. Services provided by Fireman’s Fund prior to the effective date included the accounts payable function, effective April 1, 2002, and complaint handling, effective July 1, 2002.

It is recommended that the Company obtain the Department’s non-disapproval in accordance with the provisions of Section 1505(d)(3) of the New York Insurance Law.

Federal Income Tax Allocation Agreement

Effective August 1, 1992, the Company entered into a tax allocation agreement with Allianz of America, Inc. and its subsidiaries and affiliates. Allianz of America, Inc. files a consolidated federal income tax return on behalf of its member companies. The agreement provides for the Company to be charged its share of tax resulting from its taxable income computed on a separate return basis, and if

utilized in the consolidated tax return, to be reimbursed for the tax benefits resulting from its operating and net realized capital losses and tax credits on the same basis.

The agreement was submitted to the Department in accordance with Department Circular Letter 33 (1979).

Claims Third Party Administration Agreement

Effective April 1, 1998, the Company entered into a formal agreement with Fireman's Fund County Mutual Insurance Company regarding claim adjustment services for claims relating to the retrocession agreement between Jefferson and Fireman's Fund Insurance Company (refer to Section 2C of this report).

Investment Service Agreement

Effective September 17, 1992, the Company entered into a formal agreement with Allianz of America Corporation whereby Allianz of America Corporation would provide investment management services with respect to Jefferson's invested assets.

Intercompany Reinsurance Agreement

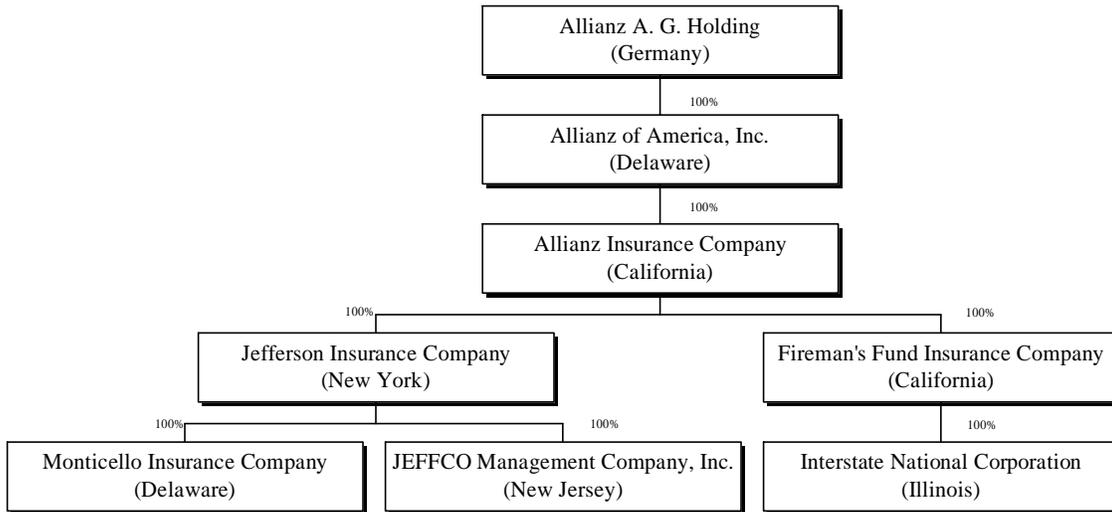
The Company commuted a reinsurance agreement with its ultimate parent-Allianz Aktiengesellschaft at the end of 2001 without filing the commutation agreement with the Department.

This is a violation of Section 1505(d)(2) of the New York Insurance Law, which states:

“ The following transactions between a domestic controlled insurer and any person in its holding company system may not be entered into unless the insurer has notified the superintendent in writing of its intention to enter into any such transaction at least thirty days prior thereto, or such shorter period as he may permit, and he has not disapproved it within such period...(2) reinsurance treaties or agreements.”

It is recommended that the Company file all intercompany reinsurance agreements and commutations of those agreements in accordance with the provisions of Section 1505(d)(2) of the New York Insurance Law.

The following is an abbreviated organizational chart of the holding company system:



E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2002, based upon the results of this examination:

Net premiums written during 2002 to surplus as regards policyholders	.29 to 1
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	101.7%
Premiums in course of collection to surplus as regards policyholders	0%

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 four-year period covered by this examination:

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss adjustment expenses incurred	\$273,872,737	88.1%
Other underwriting expenses incurred	107,230,982	34.5
Net underwriting loss	<u>(70,263,870)</u>	<u>(22.6)</u>
Premiums earned	<u>\$310,839,849</u>	<u>100.00%</u>

F. Abandoned Property Law

Section 1316 of the New York Abandoned Property Law requires that:

“...any amount payable to a resident of this state on or because of a policy of insurance (other than life insurance) which is held by a domestic or foreign insurer authorized to do business in this state, shall be deemed abandoned property if unclaimed for three years by the person entitled thereto...”

The section further requires the filing of a report on such abandoned property by April 1 of each year.

Examination review indicated that the Company failed to file abandoned property reports during the four years covered by this examination. It is recommended that, in the future, the Company comply with the provisions of Section 1316 of the New York Abandoned Property Law and file the required reports. This recommendation was made in the two prior reports on examination and the Company has failed to comply.

A review of the Company's abandoned property procedures revealed that the Company does not have procedures in place for monitoring outstanding checks that may be escheatable. It is recommended that the Company develop formal procedures for monitoring outstanding checks that may be escheatable.

G. Accounts and Records

i. Cash

The Company has not completed adequate bank reconciliations for its various bank accounts. The bank reconciliations reviewed contained an extremely large volume of old reconciling items, including, but not limited to, deposits recorded on bank statements not booked on the ledger, deposits booked on ledger that were never recorded on the bank statement, unrecorded outgoing and incoming wire transfers, and other unexplained reconciling items.

It is recommended that the Company perform and maintain proper bank reconciliations and complete them on a timely basis.

The reconciliations for open bank accounts contained over \$1,000,000 in outstanding checks originally written between 1989 and 2001. In addition, there are over \$263,000 in outstanding checks included in the Company's general ledger cash balance that were written on bank accounts that were closed during 2002.

It is recommended that the Company review its outstanding check listing on a regular basis and write-off all uncashed checks.

Six of the Company's bank statements failed to include the Company's name on the face of the bank statement. The corporate name identified on the bank statement was Interstate National Corporation, an affiliate of the Company that was servicing the Company's business through an intercompany service agreement. The confirmations on these accounts received from the banking institution did identify the account as belonging to the Company.

It is recommended that the Company take the steps necessary to have its name included on all bank accounts.

ii. Reporting of Premiums Written on the Annual Statement

The Jefferson Group failed to record a substantial amount of its premiums writings in the appropriate accounting periods. A review of the Jefferson Group's policy level detail data revealed the following:

- In 2002, the Company reported \$15,313,703 in direct business writings. A review of Jefferson's supporting data indicated that \$3,619,480, or 24% of these premiums represented policies with effective dates prior to January 1, 2002. The \$3,619,480 in late recorded premiums is comprised of \$2,680,668 in premiums representing policies with effective dates in 2001, and \$938,812 in premiums representing policies with effective dates in 2000 and prior years.
- In 2002, the Company reported \$2,048,568 in assumed premiums. \$1,625,045 of this amount was assumed from Monticello Insurance Company. A review of Monticello's policy level detail data indicated that \$1,611,031, or over 99% of these premiums represented policies with effective dates prior to January 1, 2002. The \$1,611,032 in late recorded premiums is comprised of \$725,054 in premiums representing policies with effective dates in 2001, and \$885,977 in premiums representing policies with effective dates in 2000 and prior years.

The failure to report premiums in the correct periods distorts the calculation of the unearned premium reserve and the earned premium calculation. It also results in a distorted Schedule P.

SSAP No. 53 states in part:

“Written premiums for all other contracts shall be recorded on the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired.”

It is recommended that the Company comply with SSAP No. 53 and record premiums in the year corresponding with the effective dates of the policies.

iii. Location of Company’s Records

Section 325(b) of the New York Insurance Law states in part:

“A domestic insurer and a licensed United States branch of an alien insurer entered through this state may keep and maintain its books of account without this state if, in accordance with a plan adopted by its board of directors and approved by the superintendent, it maintains in this state suitable records in lieu thereof...”

The Company moved its administrative operations to Chicago, Illinois in 2001 without filing a Section 325(b) plan with the superintendent. In the latter part of 2002, the Company moved its administrative operations to Novato, California without obtaining the approval required by Section 325(b) of the New York Insurance Law.

It is recommended that the Company file a plan in accordance with Section 325(b) of the New York Insurance Law to move its administrative operations to Novato, California.

iv. Failure to File Timely Certified Public Accountants (“CPA”) Reports

Section 307(b)(1) of the New York Insurance Law, in relevant part, states the following:

“Every licensed insurer...shall be required to file within five months of the end of such calendar year, an annual financial statement...together with an opinion thereon of an independent certified public accountant on the financial statement of such insurer...”

Jefferson failed to submit timely audited statements for the years 2001 and 2002.

It is recommended that the Company comply with Section 307(b) of the New York Insurance Law and file timely audited financial statements with the Department.

v. Annual Statement Preparation Issues

There were a significant number of items reported in the annual statement for which the Company could not provide adequate supporting documentation. These include the following items:

- In its December 31, 2002 filed annual statement, the Company reported a liability for “Ceded reinsurance premiums payable” in the amount of \$1,559,620. The Company could not identify the reinsurance contracts under which this amount was payable. There were no subsequent payments of premiums to reinsurers in 2003.
- In its December 31, 2002 filed annual statement, the Company reported a liability for “Other expenses” in the amount of \$4,088,638. The Company could only provide supporting documentation for \$448,000 of this amount.
- In its December 31, 2002 filed annual statement the Company reported a liability for “Commissions payable” in the amount of \$1,600,000 for which it could not provide adequate support schedules in the form of commission statements or any similar documentation. The number provided was basically a company estimate.
- There was a significant increase in cumulative number of claims closed with loss payments and the cumulative number of claims reported at year-end for the liability-occurrence line, the commercial auto/truck liability line, and the homeowners’ line in 2001, as reported in Schedule P of the 2001 annual statement. The Company could not provide any explanation or support for the marked increase in claim counts.
- The Company failed to report a commutation of a reinsurance agreement with its ultimate parent, Allianz Aktiengesellschaft, in the correct accident years in Schedule P. The Company incorrectly included amounts commuted in the prior accident year column of Schedule P.
- The Company improperly recorded year-end 2001 journal entries prepared by its auditing firm in the 2002 general ledger. These entries distorted cash, paid losses, and ceded case reserves in the filed 2002 annual statement. The entries impacting paid losses and ceded case reserves were adjusted in the first quarterly statement filed by the Company for 2003.
- The Company reported a miscellaneous expense of \$(2,471,112) for which it could not provide adequate documentation.

There was no examination change reflected for unsupported liabilities referred to above. While it appears that these liabilities are overstated, the Company's records could not support an alternate figure.

It is recommended that the Company comply with the annual statement instructions, exercise due diligence in its annual statement preparation, and maintain appropriate supporting documentation for all items in the filed annual statement.

vi. Missing and Incomplete Underwriting and Claim Files

A review of claim files was conducted for 2002 for the Jefferson Group. The Company was able to provide 134 of the 143 claims sampled of which 127 reconciled to the Company's claims run. It should be noted that the sample included 70 open claim files and the Company was not able to provide 7 of these files.

A review of underwriting files was conducted for 2001 and 2002 for the Jefferson Group. A cursory review was conducted for 2001 with an examination sample of 105 files. The Company was only able to provide 98 of the 105 files sampled for 2001 and only 78 of the 98 files contained complete information. (i.e. missing policy and/or declaration page).

A more detailed review was conducted of the 2002 underwriting files to reconcile direct premiums written, which are reported in the Underwriting and Investment Exhibit-part 1B. The Company was able to provide 103 of 105 files sampled. However, the examiner was only able to reconcile premium data for 64 of the files received.

The inability of the Company to provide all files requested and the fact that many of these files did not include information needed for the conduct of the examination is a violation of Section 243.2(b) of Department Regulation 152, which states in part:

“ Except as otherwise required by law or regulation, an insurer shall maintain:

(1) A policy record for each insurance contract or policy for six calendar years after the date the policy is no longer in force or until after the filing of the report on examination in which the record was subject to review, whichever is longer...

(4) A claim file for six calendar years after all elements of the claim are resolved and the file is closed or until after the filing of the report on examination in which the claim file was subject to review, whichever is longer. A claim file shall show clearly the inception, handling and disposition of the claim...”

It is recommended that the Company maintain its underwriting and claim files in accordance with Department Regulation 152.

vii. Custodian Agreement

Management answered affirmatively to the following General Interrogatory:

“Excluding items in Schedule E, real estate, mortgage loans and investments held physically in the reporting entity’s offices, vaults or safety deposit boxes, were all stocks, bonds and other securities, owned throughout the current year held pursuant to a custodial agreement with a qualified bank or trust company in accordance with Part 1-General, Section IV.H-Custodial or Safekeeping Agreements of the NAIC Financial Condition Examiners Handbook.”

However, examination review indicated that the Company’s custodial agreement did not contain all of the protective covenants set forth in Section IV.H of the NAIC Financial Condition Examiners Handbook. It is recommended that the Company amend its custodial agreement to incorporate all of the provisions set forth in the Examiners Handbook.

viii. Internal Controls

The management of the Company has failed to establish an appropriate internal control environment. The lack of effective internal controls has resulted in the following:

- The failure to maintain adequate accounting records, including reconciliations and adequate support documentation, as this report documents particularly in its comments regarding cash, premiums receivable, lack of documentation for expenses, and the inability to support various balance sheet items reported in the filed annual statements. Jefferson's CPA firm noted the lack of accounting records and issued a disclaimer opinion on the Company's balance sheet for 2002.
- The potential loss of Company assets especially in premiums receivable and reinsurance recoverables on loss and loss adjustment expenses.
- The Company failed to send out billings for reinsurance recoverables for over two years. This resulted in a situation where records were lost and potential recoverables from the Company's reinsurers may not be collectible.
- The Company's failure to maintain proper documentation has led to the write-off of its premium receivables. Additionally, the Company has experienced problems in recording its premium writings in the appropriate accounting period. This was attributed to internal processing problems and the failure to receive information from managing general agents in a timely fashion. This lack of policy level detail records combined with the problems with outside agents resulted in the failure of the Company to provide a reconciliation of premiums receivable. The entire receivable figure has been non-admitted per this examination (See item 5, "Agents' balances or Uncollected Premiums")
- The Company has a potential exposure for policies in force that the Company is not aware of due to lack of sufficient internal controls with reference to the processing and reporting issues with managing general agents discussed above.
- The payment of material expenses to the Company's affiliates for which the Company has inadequate supporting documentation.

It is recommended that the Company identify and rate all of its risk areas and put in place the appropriate level of internal controls.

3. FINANCIAL STATEMENTS

A. Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as determined by this examination at December 31, 2002:

<u>Assets</u>	<u>Examination</u>		<u>Company</u>		<u>Surplus Increase (Decrease)</u>
	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Admitted Assets</u>	<u>Admitted Assets</u>	
Bonds	\$159,888,433		\$159,888,433	\$159,888,433	
Preferred stocks	2,561		2,561	2,561	
Common stocks	38,204,950	\$3,129,136	35,075,814	38,204,950	\$(3,129,136)
Cash and short-term investments	(6,524,501)		(6,524,501)	(6,524,501)	
Other invested assets	3,671,022		3,671,022	3,671,022	
Receivable for securities	2,501		2,501	2,501	
Premiums, agents' balances or uncollected premiums	4,292,215	4,292,215		816,547	(816,547)
Funds held by or deposited with reinsured companies	316,839		316,839	316,839	
Reinsurance recoverable on losses and loss adjustment expenses	14,165,715	203,740	13,961,975	14,165,715	(203,740)
Guaranty funds receivable or on deposit	200		200	200	
Electronic data processing equipment and software	480,417	328,938	151,479	151,479	
Interest, dividends and real estate income due and accrued	2,261,152		2,261,152	2,261,152	
Receivable from parent, subsidiaries and affiliates	360,409		360,409	360,409	
Other assets non-admitted	204,410	204,410			
Aggregate write-ins for other than invested assets	<u>56,320</u>	<u>56,320</u>	_____	_____	_____
Total assets	<u>\$217,382,643</u>	<u>\$8,214,759</u>	<u>\$209,167,884</u>	<u>\$213,317,307</u>	<u>\$(4,149,423)</u>

Liabilities, Surplus and Other Funds

<u>Liabilities</u>	<u>Examination</u>	<u>Company</u>	Surplus Increase (Decrease)
Losses and loss adjustment expenses	\$124,897,783	\$113,197,783	\$ (11,700,000)
Reinsurance payable	3,086,563	3,086,563	
Commissions payable, contingent commissions	1,600,000	1,600,000	
Other expenses	4,088,638	4,088,638	
Taxes, licenses and fees	600,053	600,053	
Unearned premium	3,030,298	3,030,298	
Ceded reinsurance premiums payable	1,559,620	1,559,620	
Funds held by company under reinsurance treaties	24,345	24,345	
Provision for reinsurance	8,121,380	3,681,340	\$ (4,440,040)
Funds borrowed dollar rolls	8,837,844	8,837,844	
Pension minimum liability	2,202,408	2,202,408	
Other liabilities	<u>263,861</u>	<u>263,861</u>	_____
Total liabilities	<u>\$158,312,793</u>	<u>\$142,172,753</u>	<u>\$ (16,140,040)</u>
<u>Surplus and Other Funds</u>			
Common capital stock	\$ 10,453,700	\$ 10,453,700	
Gross paid in and contributed surplus	40,979,284	40,979,284	
Unassigned funds	<u>(577,893)</u>	<u>19,711,570</u>	<u>\$ (20,289,463)</u>
Surplus as regards policyholders	<u>\$ 50,855,091</u>	<u>\$ 71,144,554</u>	<u>\$ (20,289,463)</u>
Total liabilities and surplus	<u>\$209,167,884</u>	<u>\$213,317,307</u>	

NOTE: The Internal Revenue Service has performed audits of, and is currently auditing, the Company's consolidated federal income tax returns through tax year 2002. The examiner is unaware of any potential exposure of the Company to any further tax assessment and no liability has been established herein relative to such contingency.

B. Underwriting and Investment Exhibit

Surplus to policyholders decreased \$24,871,669 during the four-year examination period, detailed as follows:

Statement of Income

Underwriting Income

Premiums earned		\$310,839,849
Deductions:		
Losses and loss adjustment expenses incurred	\$273,872,737	
Other underwriting expenses incurred	<u>107,230,982</u>	
Total underwriting deductions		<u>381,103,719</u>
Net underwriting gain or (loss)		\$(70,263,870)

Investment Income

New investment income earned	\$ 52,869,393	
Net realized capital gains	<u>8,111,534</u>	
Net investment gain or (loss)		60,980,927

Other Income

Net gains on agents' balance charged off	\$ (2,287,013)	
Finance and service charges not included in premiums	278,214	
Miscellaneous Income	<u>(1,374,014)</u>	
Total other income		<u>(3,382,813)</u>
Net income before federal income taxes		\$(12,665,756)
Federal income taxes incurred		<u>(8,415,090)</u>
Net income (loss)		<u>\$ (4,250,666)</u>

Capital and Surplus Account

Surplus as regard policyholders, December 31, 1998 per report on examination:			\$75,726,760
	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income (loss)		\$ 4,250,666	
Net unrealized capital losses		18,866,260	
Change in not admitted assets		1,903,479	
Change in reinsurance provision		7,818,117	
Paid in surplus adjustment	\$17,000,000		
Dividends to stockholders		9,033,147	
Total gains and losses	<u>\$17,000,000</u>	<u>\$ 41,871,669</u>	
Net increase (decrease) surplus			<u>(24,871,669)</u>
Surplus as regards policyholders, December 31, 2002 per report on examination			<u>\$ 50,855,091</u>

4. COMMON STOCKS

The examination admitted asset of \$35,075,814 is \$3,129,136 less than the \$38,204,950 reported by the Company in its December 31, 2002 filed annual statement.

The examination decrease represents the change in value of the Company's investment in its subsidiary, Monticello Insurance Company. The change in value reflects the adjustments made to Monticello's loss liability and agents balances by the Delaware Insurance Department in its December 31, 2002 report on examination.

5. AGENTS' BALANCES OR UNCOLLECTED PREMIUMS

The Company reported an admitted asset of \$816,547. Pursuant to the examination the entire balance was non-admitted.

The Company could not provide any form of adequate documentation to support the admitted asset reported in its filed 2002 annual statement. The failure of the Company to disallow receivable balances that could not be supported is in violation of Section 1302(b) of the New York Insurance Law, which states in part:

“All non-admitted assets and all other assets of doubtful value or character included as ledger or non-ledger assets in any statement by an insurer to the superintendent...shall also be reported to the extent of the value disallowed , as deductions from the gross assets of such insurer...”

It is recommended that the Company comply with Section 1302(b) of the New York Insurance Law and non-admit assets of doubtful value.

6. REINSURANCE RECOVERABLE ON LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination asset of \$13,961,975 is \$203,740 less than the \$14,165,715 reported by the Company in its December 31, 2002 filed annual statement. The examination decrease is due to a clerical error in reporting incorrect recoverable figures for two of its reinsurers, resulting in a net overstatement of \$203,740.

It is recommended that the Company exercise greater care in reporting reinsurance recoverable on paid losses In Schedule F.

7. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liabilities for losses and loss adjustment expenses of \$124,897,783 are \$11,700,000 more than the \$113,197,783 reported by the Company in its December 31, 2002 filed annual statement, and were based on the results of an actuarial analysis performed by the Department's Actuarial Unit. The 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.

Relative to the data reported by the Company in its filed annual statements, examination review indicated that there were inconsistencies in the Company's reporting of its asbestos and environmental loss and loss adjustment expense reserves. Specifically, it was noted that the Company erroneously included non-environmental loss information in its response to Note 29 of its "Notes to Financial Statements". It is recommended that the Company comply with the annual statement instructions when completing the "Notes to Financial Statements".

The examination increase to the reserves is primarily due to deficiencies in the Company's other liability line and in its pre-accident year 1994 liabilities, including asbestos and environmental reserves.

8. PROVISION FOR REINSURANCE

The examination liability of \$8,121,380 is \$4,440,040 more than the \$3,681,340 reported by the Company in its December 31, 2002 filed annual statement. This examination change is the result of the following:

- A revision of the aging calculation for reinsurance recoverables on paid losses, which resulted in an increase in the provision for overdue authorized reinsurance of \$4,308,440.
- A recalculation in the provision for unauthorized reinsurance resulting in an increase of \$131,600. The Company did not calculate a provision for the overdue recoverables from unauthorized reinsurers.

A review of Jefferson's aging of its ceded reinsurance recoverables indicated that the Company's starting point for the commencement of the aging process was the billing date to the reinsurer. This is not in compliance with the annual statement instructions, which provides for the aging process to begin at the date provided in the reinsurance agreement at which claims are to be paid by the reinsurer. If a payment date is not provided in the reinsurance contract, the annual statement instructions indicate that the aging process should commence at the date specified in the contract at which claims are to be presented to the reinsurer. When the reinsurance agreement does not specify or provide for the determination of these dates the annual statement instructions provide for the aging period to commence on the date on which the ceding company enters in its accounts a paid loss recoverable.

The Company's reinsurance agreements do not provide for specific payment or presentation dates. The Company recognizes a paid loss recoverable at the same time it pays out the underlying loss payment, therefore, the Company is required to commence the aging process at the paid loss date of the underlying claim.

The commencement of the aging process at the paid loss date rather than the billing date produces materially different results from those reported by the Company in its filed annual statement. The Company failed to bill out its reinsurance recoverables on paid losses for over two years. The Company first sent out billings in October 2002 and April 2003 for paid loss recoverables dating from 2000 through the end of 2002. Accordingly, there is a large disparity between the paid loss date and the billing date.

It was additionally noted that the Company failed to calculate a provision for reinsurance for unauthorized reinsurance. The Company had \$658,000 in reinsurance recoverables on paid losses that it erroneously classified as current recoverables when in fact these balances were well over ninety-days past due. The annual statement instructions require the establishment of a provision for paid loss recoverables over ninety days past due for unauthorized reinsurers. The examiner calculation for this provision is

\$131,600 which when combined with the provision for authorized reinsurers results in a total provision for reinsurance of \$8,121,380.

It is recommended that the Company bill its reinsurance recoverable on paid losses in a timely manner.

It is also recommended that the Company age its reinsurance recoverables on paid losses in accordance with the annual statement instructions in order to allow a proper calculation of the provision for reinsurance.

9. MARKET CONDUCT ACTIVITIES

In the course of this examination, a review was made of the manner in which the Company conducts its business practices and fulfills its contractual obligations to policyholders and claimants. The review was general in nature and is not to be construed as 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 practices of the Company in the following major areas:

- 1) Sales and advertising
- 2) Underwriting
- 3) Rating
- 4) Claims

The Company was only able to provide a complaint log with activity beginning in July 2002. It could not provide a log for the examination period from January 1, 1999 through June 30, 2002. The failure to maintain this complaint log puts the Company in violation of Section 216.4(e) of Department Regulation 64, which states:

“ As part of its complaint handling function, an insurer’s consumer services department shall maintain an ongoing central log to register and monitor all complaint activity.”

It is recommended that the Company maintain a complaint log in accordance with the provisions of Section 216.4(e) of Department Regulation 64.

10. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination contained three comments and recommendations. The current status of these matters is as follows (the page numbers shown below refer to the prior report):

<u>ITEM</u>	<u>PAGE NO.</u>
<p>A. <u>Reinsurance</u></p> <p>It is recommended that the Company ensure that the reinsurance contracts, which protect the Company, contain the proper wording as to ensure their validity.</p> <p>The Company has complied with this recommendation.</p>	<p>11</p>
<p>B. <u>Abandoned Property Law</u></p> <p>It is recommended that the Company comply with the provisions of the New York Abandoned Property Law and file the required reports with the State Comptrollers Office.</p> <p>The Company has not complied with this recommendation and a similar recommendation is contained in this report.</p>	<p>14</p>
<p>C. <u>Accounts and Records</u></p> <p>It is recommended that the Company age its premiums in course of collection by developing an electronic program to run concurrently with the existing premium programs in order to assure that its accounts are being reported in an accurate manner.</p> <p>The Company has not complied with this recommendation and a similar recommendation is contained in this report.</p>	<p>14</p>

11. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>		<u>PAGE NO.</u>
	<u>Management</u>	
A.		
	<u>Board of Directors</u>	
i.		
a.	It is recommended that the Company comply with its by-laws and maintain at least thirteen directors with at least three of them residing in New York State.	5
b.	It is recommended that the board meet on a regular basis in order to properly exercise its management oversight responsibilities in accordance with Section 15 of the Company's by-laws.	6
c.	It is recommended that the board of directors approve all investment transactions pursuant to the provisions of Section 1411(a) of the New York Insurance Law.	6
ii.	<u>Conflict of Interest</u>	
	It is recommended that the Company require its directors and officers to complete conflict of interest statements on an annual basis.	7
B.	<u>Holding Company System</u>	
	<u>Service Agreement</u>	
i.		
a.	It is recommended that the Company comply with Section 1505(b) of the New York Insurance Law by maintaining its books and records in a way that will enable verification that the agreement has been implemented as represented to this Department.	11
b.	It is recommended that the Company maintain vouchers for disbursements of one hundred dollars or more in accordance with Section 1217 of the New York Insurance Law.	11
c.	It is recommended that the Company obtain a non-disapproval notification from the Department in accordance with the provisions of Section 1505(d) of the New York Insurance Law prior to entering into service agreements, involving the rendering of services on a regular basis.	12

<u>ITEM</u>	<u>PAGE NO.</u>
ii. <u>Intercompany Reinsurance Agreement</u>	
It is recommended that the Company file with the Department all intercompany reinsurance agreements and commutations of those agreements in accordance with the provisions of Section 1505(d)(2) of the New York Insurance Law.	14
C. <u>Abandoned Property Law</u>	
i. It is recommended that, in the future, the Company comply with the provisions of Section 1316 of the New York Abandoned Property Law and file the required reports.	15
ii. It is recommended that the Company develop formal procedures for monitoring outstanding checks that may be escheatable.	16
D. <u>Accounts and Records</u>	
i. <u>Cash</u>	
a. It is recommended that the Company perform and maintain proper bank reconciliations and complete them on a timely basis.	16
b. It is recommended that the Company review its outstanding check list on a regular basis and write-off all uncashed checks.	16
c. It is recommended that the Company take the steps necessary to have its name included on all bank accounts.	17
ii. <u>Reporting Premiums Written on the Annual Statement</u>	
It is recommended that the Company comply with SSAP No. 53 and record premiums in the year corresponding with the effective dates of the policies.	18
iii. <u>Locations of Company's Records</u>	
It is recommended that the Company file a plan in accordance with Section 325(b) of New York Insurance Law to move its administrative operations to Novato, California.	18
iv. <u>Failure to File Timely CPA Reports</u>	
It is recommended that the Company comply with Section 307(b) of the New York Insurance Law and file timely audited financial statements with the Department.	19

<u>ITEM</u>	<u>PAGE NO.</u>
v. <u>Annual Statements Preparation Issues</u>	
It is recommended that the Company comply with the annual statement instructions, exercise due diligence in its annual statement preparation, and maintain appropriate supporting documentation for all items in the filed annual statement.	20
vi. <u>Missing or Incomplete Underwriting and Claim Files</u>	
It is recommended that the Company maintain its underwriting and claim files, in accordance with Department Regulation 152.	21
vii. <u>Custodian Agreement</u>	
It is recommended that the Company amend its custodial agreement to incorporate all of the provisions set forth in the Examiners Handbook.	21
viii. <u>Internal Controls</u>	
It is recommended that the Company identify and rate all of its risk areas and put in place the appropriate level of internal controls.	22
H. <u>Agents' Balances or Uncollected Premiums</u>	
It is recommended that the Company comply with Section 1302(b) of the New York Insurance Law when reporting its admitted asset for agents' balances or uncollected premiums.	27
I. <u>Reinsurance Recoverable on Loss and Loss Adjustment Expenses</u>	
It is recommended that the Company exercise greater care in reporting reinsurance recoverable on paid losses and loss adjustment expenses on Schedule F.	27
J. <u>Losses and Loss Adjustment Expenses</u>	
It is recommended that the Company comply with the annual statement instructions when completing the "Notes to Financial Statements".	28
K. <u>Provision for Reinsurance</u>	
i. It is recommended that the Company bill its reinsurance recoverables on paid losses and loss adjustment expenses to its reinsurers in a timely manner.	30
ii. It is recommended that the Company age its reinsurance recoverables on paid losses in accordance with the annual statement instructions in order to allow a proper calculation of the provision for reinsurance.	30

ITEMPAGE NO.L. Market Conduct Activities

It is recommended that the Company maintain a complaint log in accordance with the provisions of Section 216.4(e) of Department Regulation 64.

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Appointment No 21948

STATE OF NEW YORK
INSURANCE DEPARTMENT

I, GREGORY V. SERIO, Superintendent of Insurance of the State of New York,
pursuant to the provisions of the Insurance Law, do hereby appoint:

Marc Allen

as proper person to examine into the affairs of the

JEFFERSON 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 31st day of October, 2002



A handwritten signature in black ink, appearing to read 'Gregory V. Serio', written over a horizontal line.

GREGORY V. SERIO
Superintendent of Insurance