

REPORT ON EXAMINATION

OF THE

LIBERTY INSURANCE UNDERWRITERS INC.

AS OF

DECEMBER 31, 2005

DATE OF REPORT

OCTOBER 31, 2007

EXAMINER

MOSES EGBON

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

October 31, 2007

Honorable Eric Dinallo  
Superintendent of Insurance  
State of New York  
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 22545, dated September 13, 2006, attached hereto, I have made an examination into the condition and affairs of Liberty Insurance Underwriters Inc., as of December 31, 2005, and submit the following report thereon.

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

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 administrative office located at 55 Water Street New York, New York 10041.

**1. SCOPE OF EXAMINATION**

The previous examination was conducted as of December 31, 2001. This examination covered the four-year period from January 1, 2002 through December 31, 2005. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

The examination comprised a verification of assets and liabilities as of December 31, 2005. The examination included a review of income, disbursements and company records deemed necessary to accomplish such analysis or verification and utilized, to the extent considered appropriate, work performed by the Company's independent certified public accountants ("CPA"). 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 ("NAIC"):

- History of Company
- Management and control
- Corporate records
- Fidelity bond and other insurance
- Territory and plan of operation
- Growth of Company
- Business in force by states
- Loss experience
- Reinsurance
- Accounts and records
- Financial statements

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

The Company, formerly named Albany Insurance Company, is a domestic property and casualty insurer that was incorporated in the State of New York on March 8, 1811. Its current name was adopted on August 30, 1999. The Company is a wholly-owned subsidiary of Peerless Indemnity Insurance Company (“Peerless”), an Illinois insurer, and is ultimately controlled by Liberty Mutual Holding Company, Inc., a Massachusetts holding corporation. Prior to its 2002 re-domestication to the State of Illinois, Peerless was a New York domiciled property and casualty insurer that existed under the name, “Atlas Assurance Company of America.”

On May 10, 1999, Liberty Mutual Insurance Company (“Liberty Mutual”), a Massachusetts stock insurer authorized in New York, acquired the Company and Peerless from Guardian Royal Exchange International (Holdings) BV (Netherlands). The transaction did not require a formal application filing for acquisition of control of insurers pursuant to Section 1506 of the New York Insurance Law.

On October 31, 2006, through a series of stock dividends, 100% of the Company’s stock was dividended to Liberty Mutual. As a result, the Company became a wholly-owned subsidiary of Liberty Mutual.

Capital paid in is \$3,500,000 consisting of 50,000 shares of \$70 par value per share common stock. Gross paid in and contributed surplus is \$60,029,767. Gross paid in and contributed surplus increased by \$50,000,000 during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
2001	Beginning gross paid in and contributed surplus	\$10,029,767
2003	Surplus contribution	<u>50,000,000</u>
2005	Ending gross paid in and contributed surplus	<u>\$60,029,767</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 twenty-one members. The board meets four times during each calendar year. At December 31, 2005, the board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Michael Abdallah Kenthurst, Australia	Executive Vice President, Liberty Insurance Underwriters Inc.
Anthony Carroll Yorktown Heights, NY	Senior Vice-President, Liberty Insurance Underwriters Inc.
Nick Creatura Toronto, ON	President, Liberty International Underwriters Inc.
Daniel Forsythe Marblehead, MA	Executive Vice-President, Liberty Insurance Underwriters Inc.
James Kelleher Belmont, MA	General Counsel, Liberty International Underwriters Inc.
Dennis Langwell Franklin, MA	Vice-President and Controller, Liberty Mutual Insurance Company
Christopher Mansfield Dedham, MA	Vice-President and General Counsel, Liberty Mutual Insurance Company
Gordon McBurney Marblehead, MA	Chief Executive Officer, Liberty Insurance Underwriters Inc.
Joseph Gerard Merten Bernardsville, NJ	Chief Operations Officer, Liberty International Underwriters Inc.
Frank O'Connor Mississauga, ON	Executive Vice- President, Liberty International Underwriters Inc.
Christopher Locke Peirce North Attleboro, MA	Director, Liberty Insurance Underwriters Inc.
George John Perrotta Scarsdale, NY	Senior Vice President, CFO, Liberty International Underwriters Inc.
Thomas C. Ramey Cambridge, MA	Executive Vice-President, Liberty Mutual Insurance Company

A review of the minutes of the board of directors' meetings held during the examination period indicated that the meetings were generally well attended with the exception of one member who did not attend any of the meetings for which he was eligible to attend.

Members of the board have a fiduciary responsibility and must evince an ongoing interest in the affairs of the insurer. It is essential that board members attend meetings consistently and set forth

their views on relevant matters so that the board may reach appropriate decisions. Individuals who fail to attend at least one-half of the regular meetings do not fulfill such criteria.

It is recommended that board members who are unable or unwilling to attend meetings consistently should resign or be replaced.

As of December 31, 2005, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Nick Creatura	President
Laurance Henry Soyer Yahia	Treasurer
Dexter Robert Legg	Secretary

B. Territory and Plan of Operation

As of December 31, 2005, the Company was licensed to write business in fifty States and the District of Columbia. It 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 damage
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
19	Motor vehicle and aircraft physical damage
20	Marine and inland marine
21	Marine protection and indemnity

Under paragraphs 20 and 21 above, the Company is authorized to write such workers' compensation insurance coverage incidental therewith, including insurances described in the Longshoremen's and Harbor Workers' Compensation Act (Public Law No. 803 69<sup>th</sup> Congress, as

amended; 33 USC Section 901 et. seq. as amended). The Company is also authorized to write special risk insurance as defined in Article 63 of the New York Insurance Law. Effective April 19, 2004, the Company amended its license to include authority to write insurance of every kind or description outside of the United States and reinsurance of every kind or description pursuant to Section 4102(c) of the New York Insurance Law.

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, 41 and 63 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of \$35,000,000.

Below is a summary of the Company's 2005 direct written premiums by State:

<u>State</u>	<u>Amount</u>	<u>Percentage of Total</u>
New York	\$62,715,614	22.9%
California	36,941,896	13.5
Illinois	20,198,698	7.4
Texas	19,005,668	6.9
All other States	<u>134,696,293</u>	<u>49.2</u>
Totals	<u>\$273,558,169</u>	<u>100.0%</u>

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

DIRECT PREMIUMS WRITTEN

<u>Calendar</u>			<u>Premiums Written in New York State</u>
<u>Year</u>	<u>New York State</u>	<u>Total United States</u>	<u>as a Percentage of United States</u>
			<u>Premiums Written</u>
2002	\$32,112,200	\$175,598,699	18.3%
2003	\$45,577,329	\$281,684,471	16.2%
2004	\$58,747,844	\$288,270,389	20.4%
2005	\$62,715,614	\$273,558,169	22.9%

The Company wrote business under Liberty International Underwriters Inc. ("LIU"), a trade name for a strategic business unit ("SBU") of Liberty Mutual. LIU was formed in 1999 as Liberty Mutual's global specialty lines unit, with an emphasis on niche insurance products distributed through an independent broker network. LIU serves both the United States and international (global)

markets. LIU (United States) operates through the Company, Liberty Surplus Insurance Corporation (“LSIC”) and Liberty Mutual. LSIC is a New Hampshire domiciled insurer that operates as a surplus lines carrier in all fifty states. LIU (United States) operations are headquartered in New York with branch offices in several major cities throughout the United States. The main insurance lines marketed by the United States operations are ocean and inland marine, energy and engineering, specialty casualty and casualty.

The Company’s specialty casualty and casualty business includes directors’ & officers’ liability, errors & omissions, environmental impairment liability, financial products, primary casualty and excess casualty.

### C. Reinsurance

#### Assumed

The Company assumed a relatively minor volume of business as compared to its direct writings.

#### Ceded

##### i. 100% Quota Share Reinsurance Agreement

Effective January 1, 2000, the Company entered into a 100% quota share agreement with Liberty Mutual Insurance Company (“LMIC”), pursuant to which, the Company cedes a 100% quota share participation in the net retained insurance liability after outside reinsurance.

The following is a description of the Company’s ceded reinsurance program in effect as of December 31, 2005. The reinsurance program covers business written by Liberty International Underwriters Inc., including business written by the Company.

#### Type of Treaty

#### Cession

Marine, engineering and energy quota share  
Off-Shore energy quota share  
100% Unauthorized

50% of \$30 million any one platform and/or complex.

Property and energy quota share  
58.40% Authorized  
41.60% Unauthorized

32% of \$100 million subject maximum aggregate limit liability of \$300 million.

Type of TreatyCession

Engineering quota share 12.50% Authorized 87.50% Unauthorized	40% of \$50 million each and every risk.
Cargo surplus 100% Authorized	2 lines surplus share above Company retention of \$10 million any one vessel, aircraft, or conveyance, any one cover.
Cargo obligatory excess of loss 100% Authorized	\$40 million excess of \$30 million any one vessel, aircraft, or conveyance, any one cover.
Marine excess of loss (Non E&P) 100% Authorized	\$3 million excess of \$2 million each and every risk.
Marine 1st excess of loss 44.35% Authorized 55.65% Unauthorized	\$5 million excess of \$5 million, each and every loss and/or occurrence.
Marine 2nd excess of loss 42.22% Authorized 57.78% Unauthorized	\$10 million excess of \$10 million, each and every loss and/or occurrence.
Marine 3rd excess of loss 39.90% Authorized 60.10% Unauthorized	\$15 million excess of \$20 million, each and every loss and/or occurrence.
Marine 4th excess of loss 33.98% Authorized 66.02% Unauthorized	\$20 million excess of \$35 million, each and every loss and/or occurrence.
Non-Marine 25% Authorized 75% Unauthorized	50% of \$2.65 million excess of \$7.35 million any one risk, maximum recoverable in one event is \$2.65 million.
Non-Marine 1st excess of loss 48.13% Authorized 51.87% Unauthorized	\$15 million excess of \$10 million, each loss, any one risk, subject to a limit of liability to the reinsurers of \$15 million each occurrence.
Non-Marine 2nd excess of loss 45.07% Authorized 54.93% Unauthorized	\$15 million excess of \$25 million each loss, any one risk, subject to a limit of liability to the reinsurers of \$15 million each occurrence.
Non-Marine 3rd excess of loss 41.91% Authorized 58.09% Unauthorized	\$15 million excess of \$40 million each loss, any one risk, subject to a limit of liability to the reinsurers of \$15 million each occurrence.
Non-Marine excess of loss 100% Authorized	60% of \$4 million excess of \$1 million, any one risk, subject to a limit of liability to the reinsurers of \$8 million any one occurrence.

Type of TreatyCession

Property, energy/COC	100% of \$15 million excess of \$10 million, each occurrence,
26.38% Authorized	subject to a limit of liability to the reinsurers of \$15 million
73.62% Unauthorized	each occurrence.

Special Casualty Program

Special quota share –section- A	66.5% of 100% quota share of net liability in respect of an
92.5% Authorized	acceptance by the reinsured of up to \$25 million any one
7.5% Unauthorized	insured, each and every loss occurring and/or claim made
	and/or occurrence reported.

Special excess of loss-section-B	66.5% of \$9.0 million excess of \$1 million each and every
92.5% Authorized	loss.
7.5% Unauthorized	

Special business program quota share	15.0% of first \$1 million each and every loss.
100% Authorized	

Architects and engineering liability	80% of 100% quota share of net liability in respect of an
100% Authorized	acceptance by the reinsured of up to \$10 million any one
	insured, each and every loss occurring and/or claim made
	and/or occurrence reported.

Kidnap & ransom quota share	100% of \$35 million each and every risk.
100% Authorized	

Casualty Program

US auto buffer first loss	90% of \$1 million excess of \$1 million, any one insured, each
100% Authorized	and every occurrence.

US casualty without terrorism cap	85% of 100% quota share of net liability in respect of an
91% Authorized	acceptance by the reinsured of up to \$50 million any one
9% Unauthorized	insured, each and every loss occurring and/or claim made
	and/or occurrence reported.

Environmental impairment liability (EIL)	60% - 75% of \$25 million gross liability, subject to a
Quota share (terrorism cap)	maximum cession of \$18.75 million each policy, each loss.
100% Authorized	

Casualty umbrella	85% of \$5 million each and every risk.
100% Authorized	

US primary general TPL	100% of \$1.75 million excess of \$250,000 each and every
100% Authorized	loss.

<u>Type of Treaty</u>	<u>Cession</u>
<u>Non- marine</u>	
2 <sup>nd</sup> Whole account excess of loss 58% Authorized 42% Unauthorized	\$15 million excess of \$55 million, each and every loss.
3 <sup>rd</sup> Whole account excess of loss 22% Authorized 78% Unauthorized	\$15 million excess of \$70 million, each and every loss.
4 <sup>th</sup> Whole account excess of loss 100% Authorized	\$10 million excess of \$85 million each and every loss.
5 <sup>th</sup> Whole account excess of loss 100% Authorized	\$15 million excess of \$95 million each and every loss.
<u>Non-marine property</u>	
Terrorism 1st excess of loss 100% Authorized	\$25 million excess of \$250,000 each and every risk.
Terrorism 2nd excess of loss 100% Authorized	\$25 million excess of \$25 million each and every risk.
Terrorism 3rd excess of loss 100% Authorized	\$25 million excess of \$50 million each and every risk.
Quota share (all lines) 100% authorized	100% of net retained liability on each and every risk for policies in force on January 1, 2000 and all new and renewal policies attaching thereafter.

Assumed reinsurance accounted for less than 1% of the Company's gross premium written at December 31, 2005. During the period covered by this examination, the Company's assumed reinsurance business has remained stable since the last examination. The Company's assumed reinsurance program consists mainly of property coverage assumed on excess of loss basis. The Company utilizes reinsurance accounting as defined in the NAIC Accounting Practices and Procedures Manual Statement of Statutory Accounting Principle ("SSAP") No. 62 for all of its assumed reinsurance business.

Reinsurance agreements with affiliates were reviewed for compliance with Article 15 of the New York Insurance Law. It was noted that all affiliated reinsurance agreements were filed with the Department pursuant to the provisions of Section 1505(d)(2) of the New York Insurance Law.

It is the Company's policy to obtain the appropriate collateral for its cessions to unauthorized reinsurers. Letters of credit and trust accounts obtained by the Company to take credit for cessions to

unauthorized reinsurers were reviewed for compliance with Department Regulations 133 and 114, respectively and no exceptions were noted.

All ceded reinsurance agreements in effect as of the examination date were 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 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 Department Circular Letter No. 8 (2005).

D. Holding Company System

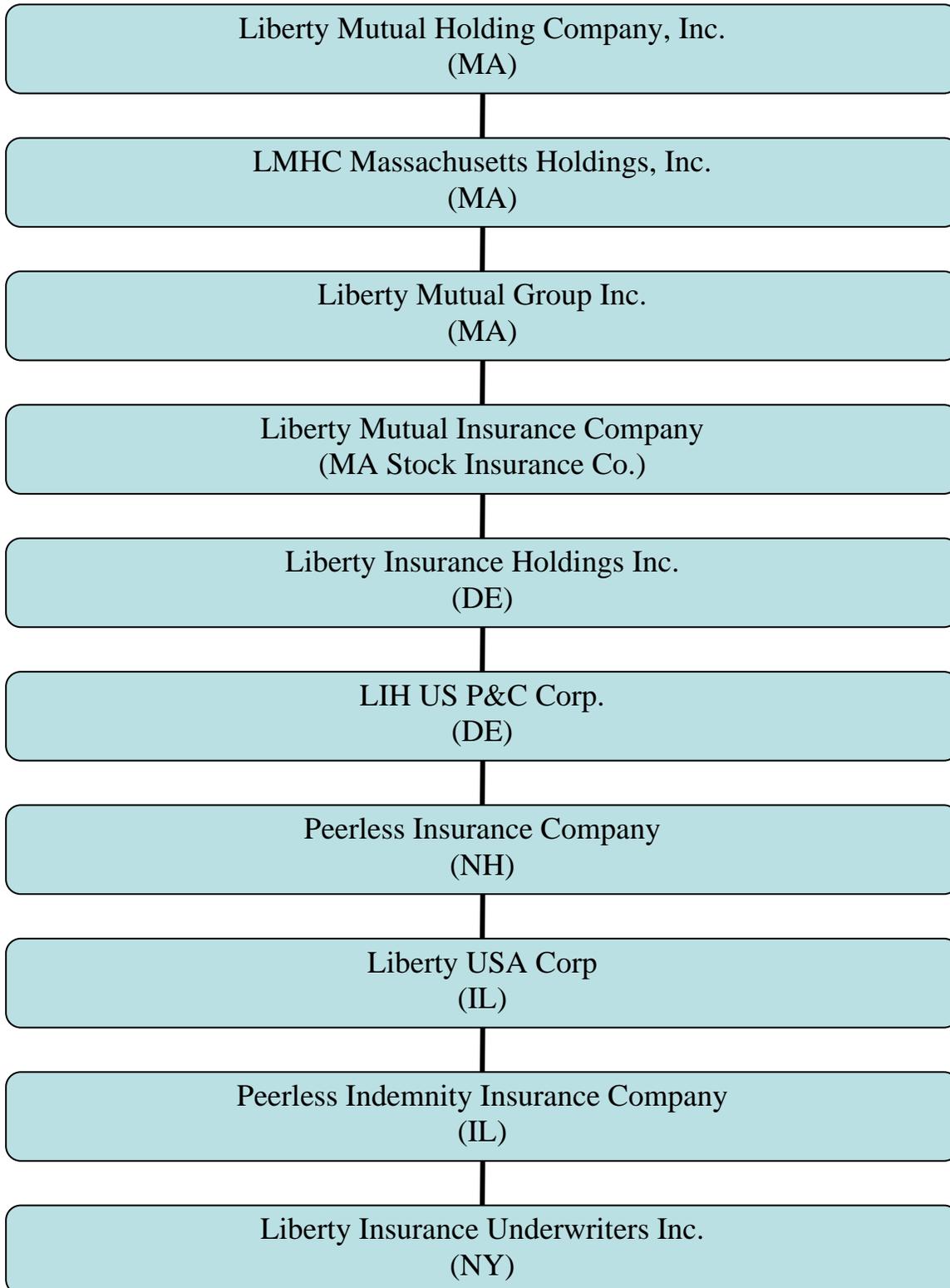
At December 31, 2005, Liberty Insurance Underwriters Inc. was a wholly-owned subsidiary of Peerless Indemnity Insurance Company ("PIIC"), an Illinois property and casualty company, and was ultimately controlled by Liberty Mutual Holding Company, a Massachusetts holding company.

Effective November 13, 2001, Liberty Mutual Insurance Company was reorganized from a mutual insurer to a mutual holding company. Prior to the reorganization, the Company was exempt from the holding company statute. The Company was advised that the agreements in effect prior to the reorganization should be filed with the Department for information purposes. Agreements entered into after that date or any amendments to agreements would have to be submitted pursuant to Section 1505 of New York Insurance Law.

On October 31, 2006, through a series of stock dividends, 100% of the Company's stock was dividended to Liberty Mutual. As a result, the Company became a wholly-owned subsidiary of Liberty Mutual.

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 an abbreviated chart of the Company's holding company system as of December 31, 2005:



At December 31, 2005, the following inter-company agreements were in effect between the Company and certain affiliates:

#### Tax Sharing Agreement

Effective January 1, 2001, the Company became a party to the Tax Sharing Agreement with Liberty Mutual and other Liberty companies (“Liberty Mutual Group”). The Company files as a member of Liberty Mutual Group’s federal consolidated income tax return. The Agreement, as amended January 25, 2002, was filed with the Department on April 24, 2003.

#### Service Agreement

Under the terms of this agreement effective May 10, 1999, Liberty Mutual Insurance Company provides underwriting, claims, investment, accounting and other administrative services to the Company. The agreement was filed with this Department on May 9, 2002.

#### Property and Casualty Quota Share Reinsurance Agreement

Effective January 1, 2000, the Company executed an agreement to cede to Liberty Mutual Insurance Company, a 100% of the net retained liability after the reinsurance cession to third party reinsurers. The agreement was filed with this Department on December 22, 1999.

#### Cash Management Agreement

Effective December 17, 2004, the Company adopted the previous agreement entered with Liberty Mutual Investment Advisors LLC. The agreement gives the investment manager the power to manage the Company’s short-term investments portfolio. The agreement was filed with the Department on August 9, 1999.

#### Investment Management Agreement

The Company entered into the captioned agreement effective May 1, 2000, authorizing Liberty Mutual Investment Advisors LLC, an affiliate, to manage the Company’s investments portfolio. The agreement was revised in 2006 and was submitted to the Department on October 16, 2006.

It is recommended that the Company file its inter-company agreements and amendments prior to implementation, both in accordance with the New York State Insurance Department's directives and pursuant to the requirements of Section 1505(c) and (d) of the New York Insurance Law.

Pursuant to the inter-company agreements, the Company shares expenses (underwriting and administrative) with its affiliates. Such expenses are allocated as a percentage of each entity's gross written premiums. The Company ultimately reallocates these expenses to Liberty Mutual Insurance Company pursuant to a 100 percent quota share agreement between them.

#### Revolving Loan Agreement

Subsequent to the examination date, the Company entered into a revolving loan agreement with Liberty Mutual Insurance Company. The agreement allows the Company to be able to borrow up to or to be given a line of credit up to \$50,000,000 for operating liquidity to accommodate fluctuations in daily cash flow. The agreement was submitted to the Insurance Department pursuant to Section 1505(c) of the New York Insurance Law and was approved by letter dated May 1, 2006.

#### E. Abandoned Property Law

Section 1316 of the New York Abandoned Property Law provides that amounts payable to a resident of this state from a policy of insurance, if unclaimed for three years, shall be deemed to be abandoned property. Such abandoned property shall be reported to the New York State Comptroller Office on or before the first day of April each year. Such filing is required of all insurers regardless of whether or not they have any abandoned property to report.

The prior report on examination noted that the Company had not filed abandoned property reports for the period under examination and contained a recommendation that the Company establish an abandoned property policy and file its abandoned property reports on a timely basis pursuant to Section 1316 of the New York Abandoned Property Law. The Company subsequently established an abandoned property policy, which was provided to the examiners during the current examination. Additionally, on March 5, 2005, the Company entered into a Voluntary Compliance Agreement with the New York State Comptroller's Office to negotiate a mutually agreeable settlement covering reportable periods from 1996 through 2004. As of the date of this report, the parties were having ongoing discussions toward resolving this issue.

F. Significant Operating Ratios

The following ratios have been computed as of December 31, 2005 based upon the results of this examination:

Net premiums written to Surplus as regards policyholders	0.0 to 1
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	52%
Premiums in course of collection to Surplus as regards policyholders	0%

All the ratios above fall within the benchmark range set forth in the Insurance Regulatory Information System (“IRIS”) of the National Association of Insurance Commissioners.

G. Accounts and Records

Cash Account

The Company established one operating account in the name of Liberty Insurance Underwriters, Inc., into which it deposited the cash receipts of the Company as well as two of its affiliates. The balance remaining in the account at the end of each day was swept overnight into an account in the name of Liberty Mutual Insurance Company. The Company would record the amounts deposited for the other companies as inter-company balances due affiliates. The commingling of cash among the various companies made it difficult for the Company to reconcile its cash account.

It is recommended that the Company’s establish separate operating accounts for each of its affiliates in order to enable the Company to reconcile its cash account and maintain adequate internal control over its cash.

### 3. FINANCIAL STATEMENTS

#### A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2005 as determined by this examination and as reported by the Company:

Assets	<u>Examination</u>		<u>Company</u>		Surplus Increase (Decrease)
	<u>Assets</u>	Assets Not <u>Admitted</u>	Net Admitted <u>Assets</u>	Net Admitted <u>Assets</u>	
Bonds	\$90,476,893	\$ 0	\$90,476,893	\$90,476,893	\$ 0
Cash, cash equivalents and short-term investments	31,617,713	20,340,341	11,277,372	31,617,713	(20,340,341)
Other invested assets	1,039,486		1,039,486	1,039,486	
Investment income due and accrued	1,126,363		1,126,363	1,126,363	
Amounts recoverable from reinsurers	10,789,799		10,789,799	10,789,799	
Net deferred tax asset	907,000	827,900	79,100	79,100	
Other non-admitted assets	961,403	961,403			
Leasehold improvements	1,025,711	1,025,711			
Other assets	<u>(10,615)</u>	<u>0</u>	<u>(10,615)</u>	<u>(10,615)</u>	<u>0</u>
Totals assets	<u>\$137,933,753</u>	<u>\$23,155,355</u>	<u>\$114,778,398</u>	<u>\$135,118,739</u>	<u>\$(20,340,341)</u>

<u>Liabilities, Surplus and Other Funds</u>			Surplus Increase (Decrease)
<u>Liabilities</u>	<u>Examination</u>	<u>Company</u>	
Losses and loss adjustment expenses	\$ 0	\$ 0	
Other expenses (excluding taxes, licenses and fees)	6,733,665	6,733,665	
Current federal and foreign income taxes	638,673	638,673	
Ceded reinsurance premiums payable (net of ceding commissions)	22,947,584	22,947,584	
Provision for reinsurance	10,000,404	10,000,404	
Payable to parent, subsidiaries and affiliates	27,836,146	27,836,146	
Payable for securities	<u>235,403</u>	<u>235,403</u>	
Total liabilities	\$68,391,875	\$68,391,875	
<u>Surplus and Other Funds</u>			
Common capital stock	\$ 3,500,000	\$ 3,500,000	
Gross paid in and contributed surplus	60,029,767	60,029,767	
Unassigned funds (surplus)	<u>(17,143,244)</u>	<u>3,197,097</u>	<u>\$(20,340,341)</u>
Surplus as regards policyholders	<u>46,386,523</u>	<u>66,726,864</u>	<u>\$(20,340,341)</u>
Totals liabilities, surplus and other funds	<u>\$114,778,398</u>	<u>\$135,118,739</u>	

NOTE: The Internal Revenue Service (“IRS”) is currently auditing Liberty Mutual Group’s consolidated tax returns for the tax years 1999 through 2005. The IRS has not identified any exposures of the Company relating to any tax deficiencies, and no liability has been established herein relative to such contingency. 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 increased \$31,627,380 during the four-year examination period January 1, 2002 through December 31, 2005, detailed as follows:

Underwriting Income

Premiums earned \$ 0

Deductions:

Investment Income

Net investment income earned	\$ 13,818,788	
Net realized capital gain	<u>2,061,604</u>	
Net investment gain or (loss)		<u>15,880,392</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$ 15,880,392
Federal and foreign income taxes incurred		<u>7,230,962</u>
Net Income		<u>\$ 8,649,430</u>

C. Capital and Surplus Accounts

Surplus as regards policyholders per report on examination as of December 31, 2001 \$14,759,143

	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income	\$ 8,649,430	\$ 0	
Net unrealized capital gains or (losses)		108,956	
Change in net deferred income tax	907,000		
Change in nonadmitted assets		21,056,312	
Change in provision for reinsurance		7,244,431	
Cumulative effect of changes in accounting principles	7,090		
Surplus adjustments paid in	50,000,000		
Aggregate write-ins for gains and losses in surplus	<u>473,559</u>	<u>0</u>	
Total gains and losses	<u>\$60,037,079</u>	<u>\$28,409,699</u>	
Net increase (decrease) in surplus			<u>31,627,380</u>
Surplus as regards policyholders per report on examination as of December 31, 2005			<u>\$46,386,523</u>

#### **4. CASH AND SHORT-TERM INVESTMENTS**

The examination admitted asset of \$11,477,840 is \$20,340,341 less than the \$31,818,181 reported by the Company in its December 31, 2005 filed annual statement.

At December 31, 2005, the Company reported an investment in a money market fund in the amount of \$31,818,181, which represented 24% of its reported admitted assets. Pursuant to Section 1409(a) of the New York Insurance Law:

“...no domestic insurer shall have more than ten percent of its admitted assets as shown by its last statement on file with the superintendent invested in, or loaned upon, the securities (including for this purpose certificates of deposit, partnership interests and other equity interests) of any one institution.”

The examination change represents the disallowance of the Company’s investment in the money market mutual fund in excess of 10% of its admitted assets. It is recommended that the Company limit its investments in any one institution to no more than 10% of its admitted assets, pursuant to the provisions of Section 1409(a) of the New York Insurance Law.

#### **5. LOSSES AND LOSS ADJUSTMENT EXPENSES**

The Company reported no loss and loss adjustment expense reserves as of December 31, 2005. The Company cedes approximately 30% of its business to outside reinsurers. The Company then cedes all net policy liabilities remaining after its cessions to third party reinsurers to Liberty Mutual Insurance Company (“Liberty Mutual”) pursuant to a 100% all-lines quota share reinsurance agreement. The agreement also provides that Liberty Mutual will reimburse the Company for any uncollectible reinsurance balances due from third party reinsurers.

**6. 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 practices of the Company in the following areas:

- A. Sales and advertising
- B. Underwriting
- C. Rating
- D. Claims and complaint handling

No problem areas were encountered.

## 7. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Management</u> It is recommended that the Company's board of directors hold at least one board meeting each year.  The Company has complied with this recommendation.	5
 It is recommended that the Company comply with Section 1411(a) of the New York Insurance Law and require board approval of all investment transactions. Such investment activities shall be documented in the board of directors' minutes.  The Company has complied with this recommendation.	5
B. <u>Territory and Plan of Operation</u> It is recommended that the Company cease and desist from reinsuring and insuring risks outside the United States in violation of Sections 4102(c) and 4103(a)(4) of the New York Insurance Law.  The Company has complied with this recommendation.	9
C. <u>Reinsurance</u> It is recommended that the Company report its direct and assumed premiums written in accordance with the annual statement instructions.  The Company has complied with this recommendation.	10
 It is recommended that the management institute internal controls so that the information reported in its filed financial statements is a true indication of its reinsurance operations.  The Company has complied with this recommendation.	15
 It is recommended that the Company complies with the NAIC's Annual Statement Instructions, as well as SSAP No. 62 of the NAIC Accounting Practices and Procedures Manual when completing its annual statement.  The Company has complied with this recommendation.	16
 It is recommended that the Company ensure that all executed interest and liability statements contain dates in order to determine whether Company reinsurance cession contracts were executed properly within	16

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the nine month period prescribed under paragraph 23 of SSAP No. 62.

The Company has complied with this recommendation.

It is recommended that the Company amend its reinsurance contracts to comply with the insolvency clause required pursuant to Section 1308(a)(2) of the New York Insurance Law. 16

The Company has complied with this recommendation.

It is recommended that the Company amend its reinsurance contracts to add the required reinsurance intermediary clause required by part 125.6(a)(1) of Department Regulation No. 20. 16

The Company has complied with this recommendation.

D. Holding Company System

It is recommended that the Company file all new inter-company agreements and current amendments to the existing agreements with this Department pursuant to Section 1505(c) and (d) of the New York Insurance Law. 20

The Company has not fully complied with this recommendation. A similar recommendation is stated in the report.

It is recommended that the Company comply with Department Circular Letter No. 33 (1979) by giving thirty days prior notification to the Department regarding any amendments to or termination of its tax allocation agreements. 21

The Company has complied with this recommendation.

E. Abandoned Property Law

It is recommended that the Company establish an abandoned property policy and file its abandoned property reports on a timely basis pursuant to Section 1316 of the New York Abandoned Property Law. 22

The Company has established an abandoned property policy. Additionally, the Company has entered into a Voluntary Compliance Agreement with the New York State Comptroller's Office to negotiate a mutually agreeable settlement covering reportable periods from 1996 through 2004. As of the date of this report, the parties were having ongoing discussions toward resolving this issue.

F. Audited Annual Statement

It is recommended that management file its certified public accountants audited annual statement timely in compliance with Section 307(b)(1) of the New York Insurance Law. 22

The Company has complied with this recommendation.

- G. Accounts and records  
 It is recommended that the Company establish an internal control structure that includes a systematic audit trail to enable the proper verification of the account balances. 23
- The Company has complied with this recommendation.
- It is recommended that the Company routinely reconcile its inter-company receivable and payable accounts and resolve all unapplied and misapplied amounts accordingly. 23
- The Company has complied with this recommendation.
- It is recommended that management maintains copies of the Company's board of directors' minutes and accounts and records per Section 325(a) of the New York Insurance Law. 24
- The Company has complied with this recommendation.
- H. Facilitation of Examination  
 It is recommended that management takes the necessary steps to fully cooperate with the examiners in future examinations of the Company by furnishing all information requested in compliance with Section 310 of the New York Insurance Law. 24
- The Company has complied with this recommendation.
- I. Cash and Short-Term Investments  
 It is recommended that the Company strengthen its internal controls over its cash accounts by reconciling its accounts on a monthly basis. 29
- The Company has complied with this recommendation.
- It is recommended that the Company investigate all unapplied cash amounts and apply to the appropriate accounts in a timely manner. 29
- The Company has complied with this recommendation.
- It is recommended that the Company monitor its investment portfolio at all times to ensure compliance with Section 1409 of the New York Insurance Law. 30
- The Company has not complied with this recommendation. A similar recommendation is stated in this report.

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It is recommended that the company monitor its activity to ensure compliance with the cash management agreement. 30

The Company has complied with this recommendation.

It is recommended that the cash management agreement be amended to include the provisions stated in this report. 31

The Company has complied with this recommendation.

J. Provision for Reinsurance

It is recommended that the Company maintain adequate documentation to verify the account and comply with the annual statement instructions for this liability. 32

The Company has complied with this recommendation.

It is recommended that the Company report the liability Provision for reinsurance in accordance with the annual statement instructions. 32

The Company has complied with this recommendation.

It is recommended that the Company refrain from securing letters of credit otherwise not held in the Company's name as required under Department Regulation 133. 33

The Company has complied with this recommendation.

K. Payable to Parent, Subsidiaries and Affiliates

It is recommended that the Company record all payments made to the account in order to report the proper account balance in the annual statement. 34

The Company has complied with this recommendation.

It is recommended that management maintain documentation that clearly supports the settlement of the Company's inter-company payable account. 34

The Company has complied with this recommendation.

## 8. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>	<u>PAGE NO.</u>
<p>A.     <u>Management</u></p> <p>It is recommended that board members who are unable or unwilling to attend meetings consistently should resign or be replaced.</p>	<p>5</p>
<p>B.     <u>Holding Company System</u></p> <p>It is recommended that the Company file its inter-company agreements and amendments prior to implementation, pursuant to the requirements of Section 1505(c) and (d) of the New York Insurance Law.</p>	<p>14</p>
<p>C.     <u>Accounts and Records</u></p> <p>       <u>Cash Account</u></p> <p>It is recommended that the Company's establish separate operating accounts for each of its affiliates in order to enable the Company to reconcile its cash account and maintain adequate internal control over its cash.</p>	<p>15</p>
<p>D.     <u>Cash and Short Term Investments</u></p> <p>It is recommended that the Company limit its investments in any one institution to no more than 10% of its admitted assets, pursuant to the provisions of Section 1409(a) of the New York Insurance Law.</p>	<p>19</p>



Appointment No 22545

**STATE OF NEW YORK  
INSURANCE DEPARTMENT**

I, HOWARD MILLS, Superintendent of Insurance of the State of New York,  
pursuant to the provisions of the Insurance Law, do hereby appoint:

**Moses Egbon**

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

**LIBERTY INSURANCE UNDERWRITERS**

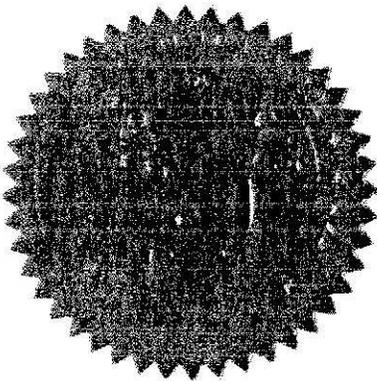
*and to make a report to me in writing of the condition of the said*

**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 13th day of September, 2006*



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HOWARD MILLS  
Superintendent of Insurance