REPORT ON EXAMINATION

OF THE

HEREFORD INSURANCE COMPANY

AS OF

DECEMBER 31, 2002

DATE OF REPORT	APRIL 28, 2004
EXAMINER	KENNETH MERRITT

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

April 28, 2004

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

Dear Sir:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 22087 dated August 6, 2003 attached hereto, I have made an examination into the condition and affairs of Hereford Insurance Company as of December 31, 2002, and submit the following report thereon.

Wherever the designations “the Company” or “Hereford” appear herein without qualification, they should be understood to indicate Hereford Insurance Company.

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 offices located at 24-25 Jackson Avenue, Long Island City, New York 11101.

1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 1998. This examination covered 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 comprised a complete verification of assets and liabilities as of December 31, 2002, 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 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 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 was incorporated under the laws of the State of New York on October 5, 1982 and commenced business on April 1, 1986,

The Company's paid in capital is $1,000,000, comprised of 1,000,000 shares of $1 par value per share common stock. Gross paid in and contributed surplus is $709,200, which remains unchanged from the prior examination period.

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 members. The following individuals comprised the Company's board of directors at December 31, 2002:

Name and Residence	Principal Business Affiliation
Vincent P. Bitet Smithtown, NY	President, Bitet Insurance Brokerage, Inc.
Paul E. Boucher Pocono Summit, PA	Retired, Political Consultant
Richard Chin Wantagh, NY	Chief Operating Officer, Pearland Brokerage
Karen Greenbaum Roslyn, NY	Vice President & Secretary, Hereford Insurance Company
Neil Greenbaum Roslyn, NY	President, Hereford Insurance Company

Name and Residence	Principal Business Affiliation
Pearl Greenbaum Boynton Beach, FL	Treasurer, Hereford Insurance Company
Eugene Haber, Esq. Roslyn, NY	Partner, Colbert, Haber & Haber
Barbara Hamill Avon, CT	Vice President, Hereford Insurance Company
John Hamill Avon, CT	President, Suburban Greater Hartford Realty Mgmt. Corp.
Lisa K. Kuba, Esq. Syosset, NY	Attorney, Private Practice
Steven Nadler Riverhead, NJ	Senior Vice President, PNC Bank
David Pollack Washingtonville, NY	Executive Director, Committee for Taxi Safety
Annie Weinstein Baldwin, NY	Senior Vice President, Hereford Insurance Company

During each year of the examination period, the Company held one annual board meeting, as called for in the by-laws. A review of the minutes of the board of directors' meetings held during the examination period revealed that the directors participated in the meetings either by actual attendance or via telecommunication access. However, the Company's by-laws do not provide for directors' participation by telecommunication medium. It is recommended that the Company amend its by-laws to allow for attendance via conference call.

A review of the minutes of the board of directors' meetings revealed that the directors did not approve any of the Company's investment transactions during the examination period. Section 1411(a) of the New York Insurance Law provides that:

"No domestic insurer shall make any loan or investment, unless authorized or approved by its board of directors or a committee thereof responsible for supervising or making such investment or loan. The committee's minutes shall be recorded and a report submitted to the board of directors at its next meeting".

It is recommended that the Company comply with the provisions of Section 1411(a) of the New York Insurance Law.

As of December 31, 2002, the following were the principal officers of the Company:

Name	Title
Neil Greenbaum	President
Annie Weinstein	Senior Vice President
Karen Greenbaum	Secretary and Vice President
Pearl Greenbaum	Treasurer
Lisa Kuba	Vice President
Barbara Hamill	Vice President
John Hamill	Vice President

Examination review indicated that Karen Greenbaum, Lisa Kuba, Barbara Hamill, and John Hamill are vice presidents of the Company. Article IV, Section 4 of the Company by-laws state the duties of officers of the company are as follows:

"4. VICE-PRESIDENTS

During the absence or disability of the president, the vice president … shall have all the powers and the functions of the president. Each vice-president shall perform such other duties as the board shall prescribe."

None of the vice presidents have any active roles in the management of company. Furthermore, none of the vice presidents are on-site at the Company's office. Therefore, it appears that all of the vice presidents of the Company would be unable to discharge the duties associated with their office.

Examination review also indicated that Pearl Greenbaum, Company treasurer, is not an active participant in the operations of the Company. Ms. Greenbaum resides in Florida and does not appear to be discharging the duties of treasurer, as set forth in Article IV, Sections 4 and 7 of the Company's by-laws, which states as follows:

"The treasurer shall:

(a) have the custody of the corporate funds and securities;
(b) keep full and accurate accounts of receipts and disbursements in the corporate books;
(c) deposit all money and other valuables in the name and to the credit of the corporation in such depositories as may be designated by the board;
(d) disburse the funds of the corporation as may be ordered or authorized by the board and preserve proper vouchers for such disbursements;
(e) render to the president and board at the regular meetings of the board, or whenever they require it, an account of all his transactions as treasurer and of the financial condition of the corporation;
(f) render a full financial report at the annual meeting of the shareholders if requested;
(g) be furnished by all corporate officers and agents at his request with such reports and statements as he may require as to all financial transactions of the corporation;
(h) perform such other duties as are given to him by these by-laws or as from time to time are assigned to him by the board or the president."

It is recommended that the Company comply with Article IV, Sections 4 and 7 of its by-laws by having its vice presidents and treasurer be full-time active members of the Company's executive management and fulfill their duties, as indicated in the Company's by-laws, as officers of the Company.

Furthermore, it was noted that the Company's signed financial statements are sworn to by Karen Greenbaum as corporate secretary and Pearl Greenbaum as treasurer. These responsibilities require persons with a working knowledge of the business affairs of the Company only attainable by actively participating in the management of the Company.

It is recommended that the Company's financial statements be sworn to by those principal officers that are fully knowledgeable with the corporate and financial affairs reported in the Company's filed financial statements.

The prior report on examination of the Company contained a recommendation that the Company refrain from paying salaries to family members of the Company's president who are not active employees of the Company. The annual salaries ranged from $10,800 to $18,000. As indicated in the prior reports on examination, Section 1217 of the New York Insurance Law states in part 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 or services rendered for the company, and correctly describing the consideration for the payment….."

It is again recommended that the Company cease disbursing funds to those individuals who are not providing either goods or service to the Company. It is further recommended that the Company comply with the provisions of Section 1217 of the New York Insurance Law. The Company is reminded of its fiduciary responsibility to protect the interest of Hereford's policyholders and of its obligation to disburse Company's funds in a prudent manner.

<u>Conflict of Interest Statements</u>

The Company has an internal policy requiring each officer and director to complete a conflict of interest questionnaire statement annually. Management was unable to provide completed conflict of interest statements for all of its directors and officers. Relative to the conflict of interest statements that management was able to provide to the examiners, it was noted that a number of directors and officers did not fully complete the form and/or failed to disclose potential conflicts. For example, it was noted that two directors are associated with outside firms that provide certain services to the Company. Such interests were not disclosed in those directors' conflict of interest statements.

It is recommended that the Company ensure that the officers and directors properly disclose all required information on their conflict of interest statements.

Fidelity Coverage

A review of the Company's fidelity bond currently in force indicated that the bond's limit of liability was insufficient based on the Company's exposure. According to the NAIC Financial Condition Examiners' Handbook, the Company's fidelity bond coverage should be in the range of $350,000 to $400,000. It is recommended that the Company obtain adequate fidelity bond coverage commensurate with its exposure.

B. Territory and Plan of Operation

As of December 31, 2002, the Company was licensed to write business in New York only.

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

Paragraph	Line of Business
8	Glass
13	Personal injury liability
14	Property damage liability
15	Workers' compensation and employers' liability
19	Motor vehicle and aircraft physical damage

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

DIRECT PREMIUMS WRITTEN

Year	Direct Premiums Written
1999	$ 2,449,769
2000	4,777,531
2001	19,141,890
2002	34,754,930
Total	$ 61,124,120

Based upon the lines of business for which the Company is licensed, and the Company 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 $1,300,000.

The Company offers workers' compensation to medallion taxi carriers and commercial automobile liability coverages to black cars, luxury cars, and car service carriers in the New York City area. The commercial automobile liability program was introduced in March 2001. The dramatic increase in premiums written between calendar years 2000 and 2001 is attributable to the Company's entrance into the commercial automobile liability market

The Company utilizes a network of brokers for the production of business. The majority of the business is written through Pearland Brokerage ("Pearland"). Pursuant to the provisions of Department Regulation 52-A, Pearland is deemed a controlling producer of the Company. This is further discussed in Item 2D, "Holding Company System".

C. Reinsurance

Assumed

The Company does not assume any reinsurance business.

Ceded

The following is a description of the Company's ceded reinsurance program in effect at December 31, 2002:

Type of Treaty	Cession
Workers' Compensation:	
Quota share 100% Authorized	75% each occurrence, up to $100,000 per occurrence.
First Excess of Loss 100% Authorized	100% of $900,000 excess of $100,000 each and every occurrence.
Second Excess of Loss 100% Authorized	100% of $4,000,000 excess of $1,000,000 any occurrence.
Commercial Automobile Liability	
Quota Share (2 layers) 100% authorized	79% quota share
Commercial Automobile Liability	
Per Policy Excess of Loss (3 layers) 100% authorized	First layer, $250,000 excess of $250,000 each and every occurrence. This layer covers only extra contractual obligation
	Second layer, $500,000 excess of $500,000 each and every occurrence. This layer covers extra contractual obligation, extra policy liabilities, clash and multiple personal injury protection.
	Third layer, $1,750,000 excess of $1,000,000 each and every occurrence. This layer covers extra contractual obligations, extra policy liabilities, clash and multiple personal injury protection.

The Company's retention for the workers' compensation business decreased from 70% for the first $100,000 of loss to $25,000 for the first $100,000 of loss. Additionally, the Company increased its total excess of loss coverage to $4 million from $2 million between the prior examination and current examination periods.

The Schedule F data as contained in the Company's filed annual statement was found to accurately reflect its reinsurance transactions.

The examiner reviewed all ceded reinsurance contracts in effect at December 31, 2002. The contracts all contained the standard insolvency clause meeting the requirements of Section 1308 of the New York Insurance Law. It was noted, however, that the one of the Company's excess of loss agreements indicated that relative to arbitration, "…(i) insofar as the arbitration panel looks to substantive law, it shall consider the law of the State of Illinois…" The Department requires that arbitration clauses be governed by the laws of the State of New York. It was also noted that the offset clause in the same agreement did not make reference to Section 7427 of the New York Insurance Law.

It is recommended that the Company amend its excess of loss reinsurance agreement to specify that any arbitration proceedings will be governed by New York Law and that any offsets are in accordance with Section 7427 of the New York Insurance Law.

Regarding the workers' compensation and commercial automobile liability quota share agreements, the Company did not file these agreements with the Department for prior approval pursuant to Section 1308(e)(1) of the New York Insurance Law which states in part the following:

> "During any period of twelve consecutive months, without the superintendent's permission: (A) no domestic insurer, except life, shall by any reinsurance agreement or agreements cede an amount of its insurance on which the total gross reinsurance premiums are more than fifty percent of the unearned premiums on the net amount of its insurance in force at the beginning of such period………".

Under the taxi liability quota share agreement, it was further noted that the Company amended the 2002 and 2003 Agreements. The amendments included increases to the quota share percentages and reinsurance premiums received by Transatlantic. Such amendments were never filed with the Department for prior approval pursuant to Section 1308(e)(1) of the New York Insurance Law.

It is recommended that prior to effecting new reinsurance agreement(s) or amendment(s) to existing agreements, the Company file such transactions with the Department for review pursuant to Section 1308(e)(1) of the New York Insurance Law. Subsequent to this examination, management complied with examiners' request by filing both workers' compensation and taxi liability quota share agreements with the Department for review.

Provisional Commissions

Under its current workers' compensation quota share agreement, the reinsurer allows the Company a 30% provisional ceding commission on the ceded net subject premiums. The provisional ceding commission becomes adjustable on a sliding scale basis upward or downward contingent on the Company's loss ratios. The provisional ceding commission may reach a maximum of 50% on a 32% Company loss ratio or reduce to a low of 13% subject to a 79% Company loss ratio.

Under the liability quota share agreement, there is also a 30% initial provisional ceding commission with sliding scale adjustments of upwards to 50% maximum ceding commissions on a

Company loss ratio of 30% and a minimum ceding commission of 18% subject to a 80% loss ratio by the Company.

The ceding commissions allowed under these agreements enabled the Company to report ceding commission income of approximately $4,000,000 during calendar year 2002. This caused the Company to score a value of 22% on the “Surplus Aid to Surplus” ratio, which exceeded the benchmark of 15% established by the National Association of Insurance Commissioners (“NAIC”). This is the second consecutive year that the Company exceeded the NAIC’s benchmark for this ratio. This ratio increases to 29% when calculated using the surplus to policyholders as determined by this examination. Users of the Company’s financial statements should be aware of the possible distortive effects of ceding commission income on the Company’s surplus position.

D. Holding Company System

The Company is a wholly-owned subsidiary of Hereford Holding Corporation (“HHC”), a non-operating New York shell corporation, which is ultimately controlled by the Greenbaum Family. The majority interest in HHC is held by Hereford Insurance Company’s president, Neil Greenbaum, who directly owns 50% of HHC stock, with an additional 30% controlled by other immediate family members. Mr. Greenbaum also holds 10% interest in Pearland Brokerage, which is the Company’s primary producer. In addition to his insurance operation, Mr. Greenbaum owns other businesses, including a fleet of medallion automobiles and medallion management services for entrepreneurs in the New York City. All of Mr. Greenbaum’s businesses are operated at the same Long Island City location as Hereford Insurance Company.

For the years 1999 through 2003, the Company failed to file holding company registration statements with the Department. Pursuant to Part 80-1.4 of Department Regulation 52, all controlled insurers are required to file an annual holding company registration statement (Form HC-1) within 120 days following the end of its ultimate holding company's fiscal year. As of the date of this report, the Company has not filed the required Forms HC-1 for the years indicated above.

It is recommended that the Company file annual holding company registration statements for all prior years under the current examination period as well as for the 2003 year pursuant to Part 80-1.4 of Department Regulation 52.

Pursuant to Part 80-2.2 of Department Regulation 52-A, a controlled insurer in any calendar year receiving from a controlling producer total gross written premiums equal to or greater than five percent of the admitted assets of the controlled insurer as reported in the quarterly financial statement filed as of September 30th of the prior year, is subject to the following reporting requirements with the superintendent on or before each April 1st:

1) "Obtain the independent opinion of a member casualty actuary of the American Academy of Actuaries or of any other independent loss reserve specialist on the adequacy of the loss and loss adjustment expenses established by the controlled insurer as of December 31, for each line of insurance on the annual statement on any business placed by a controlling producer; and

2) A report consisting of the following:
   i. (a) the amount of premiums on the insurance business placed with the controlled insurer by the controlling producer;
      (b) the amount of commissions, charges or other fees paid by the controlled insurer to the controlling producing during the previous calendar year; and
      (c) the amounts owed to the controlling producer on the business by line of insurance on the annual statement; and

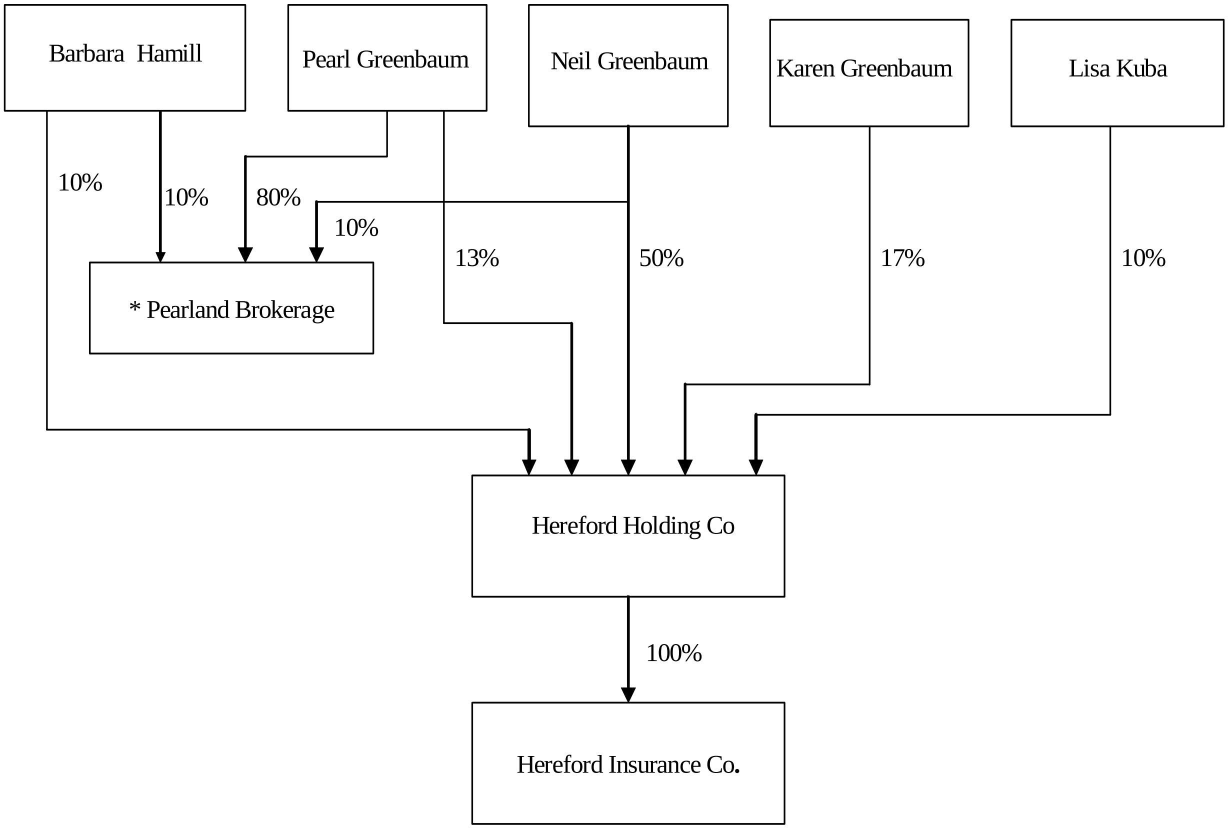
   ii. the percentage that the amounts specified in subparagraph of this paragraph (i) represent of the controlled insurer's net premiums written for each such line of insurance."

The Company failed to file a report on its controlling producer for the examination year 1999.

It was noted that for the years 2000 through 2002 in which reports were filed by the Company, only the 2000 report was filed in a timely manner by the April 1st deadline as required pursuant to Regulation 52-A.

It is recommended that the Company fully comply with the Department Regulation 52-A by filing in a timely manner its controlling producer report no later than April 1st of each year as required.

The following is an abbreviated holding company chart of the insurer as of December 31, 2002:



*Pearland Brokerage is owned by Pearl Greenbaum 80%, Neil Greenbaum 10%, and Barbara Hamill 10% respectively.

At December 31, 2002, the Company was party to the following agreements with other members of its holding company system:

Brokerage Agreement between Hereford Insurance Company and Pearland Brokerage dated February 12, 1998 and as amended June 27, 2003,

Pursuant to the captioned agreement, Pearland Brokerage places business for the Company. This agreement was previously approved by the Department.

Commercial Lease Between All Taxi Management Corporation (Landlord) and Hereford Insurance Company dated September 14, 1999

The Company is a sub-lessee of All Taxi Management Corporation under a five year commercial lease which expired on September 30, 2003. The Company occupies 40% of the office space and is allocated the same percentage of the costs of certain office equipment, utilities, repairs and building renovations. Since the lease's 2003 termination, the Company currently remains on the premises subject to a month-by-month lease. Management is currently in the processing of vacating this location and leasing office space in property recently acquired by the Greenbaum family.

Based on a recommendation in the prior report on examination, the Company filed the captioned inter-company sub-lease agreement with the Department in 2001.

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 comptroller 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 Company's abandoned property reports for the period of this examination were all filed on a timely basis pursuant to the provisions of Section 1316 of the New York State Abandoned Property Law.

F. Significant Operating Ratios

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

Net premiums written 2002 to surplus as regards policyholders	171.9%
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	88.7%
Premiums in course of collection to surplus as regards policyholders	2.0%

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:

	Amounts	Ratios
Losses and loss adjustment expenses incurred	$ 9,699,285	70.9%
Other underwriting expenses incurred	2,755,384	20.1
Net underwriting gain	1,224,438	9.0
Premiums earned	$13,679,107	100.0%

G. Accounts and Records

Account reporting involving the Company's investments, reinsurance and loss accounts are handled by the Company's outside accountant, reinsurance intermediary and actuary, respectively. The cash accounts and general ledger functions are performed by in-house staff. Based on a review of the Company's accounts and records, the following discrepancies were noted:

1. Cash Accounts

Three of the vice presidents denoted in Section 2B of this report have authorized access and check issuing authority to some of the Company's cash accounts, despite the fact that they are not active employees of the Company. These individuals include Karen Greenbaum, Pearl Greenbaum and Lisa Kuba. Such authority should be limited to only active employees of the Company and not shareholder family members.

There appeared to be an improper segregation of duty caused by procedures in the Company's payroll system. The accounting manager solely responsible for preparing the payroll including issuing checks and depositing cash, also reconciles Company monthly cash records to the bank records and performs posting to the Company general ledger.

The Company maintains regular liquid cash on hand in its Fleet Bank custodial account and management does not prepare any bank reconciliation for this account.

Only the president is listed as an authorized signatory on the Company's North Fork Bank trust account with in excess of $4 million of cash at year-end 2002. In the North Fork Bank checking account, checks were found to be outstanding for more than a year.

Relative to the above findings, it is recommended that:

- Only full-time active employees of the Company be listed as signatories for the Company's bank accounts. All signatories should be approved by the Company's board of directors;
- The Company implement proper segregation of duties regarding the Company's payroll, bank reconciliation and general ledger maintenance functions;
- Management reconcile all bank accounts on a monthly basis in order to ensure greater internal control over Company cash accounts;
- Management include more than one authorized signatory to each Company bank account; and
- Long-standing open checks be researched and cancelled or re-issued, if necessary.

2. Investments

A review of the bonds as reported in Schedule D of the 2002 Annual Statement revealed several newly acquired investments which the Company had not filed with the NAIC for security ratings. The NAIC Securities Valuation Office ("SVO) requires companies to file for rating designations of a new investment within 120 days upon acquisition by an insurer. It is also noted that this conflicts with the signed NAIC SVO Compliance Certification by the Company's president, which indicates that all newly acquired investments reported in the Company's annual statement were submitted to the SVO within 120 days of purchase.

The Company receives investment management services as well as custodial services from North Fork Bank, pursuant to the terms of an investment management agreement. Under Article II of the agreement, North Fork Bank is given absolute authority to manage and supervise Company assets. It appears that the Company has not provided the bank with formal written investment guidelines.

The Company answered affirmatively to the following General Interrogatory in its filed annual statement as of December 31, 2003:

> "Excluding items in Schedule E, real estate, mortgage loans and investments held physically in the reporting entity's office, 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?"

The Company's existing custodial agreement lacks substantially all of the standard protective covenants for custody agreements set forth in the Examiners Handbook.

Based upon the above mentioned concerns regarding the Company's investment records, the following recommendations are hereby stated:

- It is recommended that the Company file all newly acquired investments for security rating with the NAIC SVO;
- It is also recommended that the Company verify and ensure the validity of the investment information contained in the Company's signed NAIC SVO Compliance Certification filing;
- It is recommended that the Company implement a separate custodial agreement with North Fork Bank ("NFB") applicable to Company investments both managed and held by NFB, pursuant to the parties' investment management agreement;
- It is recommended that management establish formal written investment guidelines. Management should further provide any investment manager of the Company with the guidelines to be followed by the managers in their decision making and administration of the Company's investment functions; and
- It is recommended that the Company amend its existing custodial agreement to incorporate the standard protective clauses prescribed by the NAIC and also acknowledged by the Department

as good public policy.

3. Allocation of Expenses

The Company is not reporting expenses in the proper accounts in the Annual Statement Underwriting and Investment Exhibit – Part 3, in accordance with Sections 105.5 and 105.16 of Department Regulation 30. For example, the Company reported charitable contributions as an advertisement expense and security filing fees as cost or depreciation of electronic data processing equipment and software.

Also, the Company in the Underwriting and Investment Exhibit – Part 3 allocated ceded reinsurance commissions to both loss adjustment expenses and other underwriting expenses. Section 107.4 of Department Regulation 30 describes ceded reinsurance commission as policy acquisition, field supervision and collection expenses and therefore, requires the entire ceded reinsurance commissions to be allocated to other underwriting expenses. Management indicated the Company allocates the ceding reinsurance commissions between the two reporting lines because its ceding reinsurance commission is significantly higher than the Company actual overhead and therefore, it appears appropriate to allocate a portion of the total ceding commission refund to the costs of claims handling and management.

It is recommended that management comply with Sections 105.5 and 105.16 of Department Regulation 30 by reporting expenses in the proper expense accounts.

It is recommended that management comply with Section 107.4 of Department Regulation 30 by allocating all ceding reinsurance commissions to other underwriting expenses in the Company's filed annual statements.

4. Record Retention

During the course of this examination, the Company could not provide electronic files to premium and loss reports. Management indicated that only original hardcopy reports were maintained after the 2002 annual statement date. To accommodate the examiners' requests, management over several months created electronic reports necessary for the examiners to perform certain account verifications and sampling procedures. Once the electronic files were made available to the examiners, there was an additional problem of the re-created premium and loss reports not reconciling to the annual statement accounts. Immaterial differences were noted between the updated electronic files and the annual statement amounts due to a cut-off period issue with the reports. The considerable delay in getting information caused an increase in examination time.

It is recommended that management update its year-end record retention procedures to include electronic files in addition to the Company's hardcopy files.

Based on a discussion with management, it was revealed that the Company does not have an adequate back-up data system to its workers' compensation records and files. Management indicated its current off-site back-up procedure applicable to its workers' compensation Company records entails one Company employee transporting to his home on weekends a tape reel containing Company workers' compensation records and files.

It is recommended that management refrain from its current practice of maintaining the Company's back-up workers' compensation electronic data file off-site at the home of a staff employee. Instead, management should establish a more reliable back-up procedure such as an alternative back-up of Company files at an alternative off-site facility.

5. Certified Public Accountant ("CPA")

In the Company's December 31, 2002 filed CPA report, there was no information on the independent accountant's evaluation of the Company's internal control system. Section 307(b)(1) of the New York Insurance Law states in part the following:

> "……Each insurer shall furnish the superintendent with an evaluation by such accountant of the accounting procedures and internal control systems of the insurer that are necessary to the furnishing of the opinion……"

A similar condition was noted during the previous examination.

It is recommended that management comply with Section 307(b)(1) of the New York Insurance Law.

3. FINANCIAL STATEMENTS

A Balance Sheet

The following compares the assets, liabilities and surplus as regards policyholders as determined by this examination with those reported by the Company as of December 31, 2002:

	Examination			Company	
Assets	Assets	Assets Not Admitted	Net Admitted Assets	Net Admitted Assets	Surplus Increase (Decrease)
Bonds	$12,443,926	$0	$12,443,926	$12,443,926	0
Preferred stocks (stocks)	47,500	0	47,500	47,500	0
Common stocks (stocks)	278,820	0	278,820	278,820	0
Cash and short-term investments	7,630,052	0	7,630,052	7,630,052	0
Aggregate write-ins for invested assets	0	0	0	0	0
Premiums and agents' balances in course of collection	99,408	25,119	74,289	74,289	0
Premiums, agents' balances and installments booked but deferred and not yet due	3,382,895	0	3,382,895	3,382,895	0
Reinsurance recoverables on loss and loss adjustment expense payments	1,342,863	0	1,342,863	1,342,863	0
Federal and foreign income taxes recoverable	662,538	662,538	0	0	0
Interest, dividends and real estate income due and accrued	166,118	0	166,118	166,118	0
Total assets	$26,054,120	$687,657	$25,366,463	$25,366,463	0

Liabilities, Surplus and Other Funds

	Examination	Company	Surplus Increase (Decrease)
Losses	$ 5,701,924	$ 5,301,924	$ 400,000
Loss adjustment expenses	1,412,175	1,412,175	
Other expenses (excluding taxes, licenses and fees)	72,395	72,395	
Taxes, licenses and fees (excluding federal and foreign income taxes)	277,318	277,318	
Federal and foreign income taxes	225,882	225,882	
Unearned premiums	1,898,785	1,898,785	
Ceded reinsurance premiums payable (net of ceding commissions)	7,473,220	6,642,000	831,220
Funds held by company under reinsurance treaties	1,277,325	1,277,325	0
Amounts withheld or retained by company for account of others	3,282,212	3,282,212	0
Total liabilities	$21,621,236	$20,390,016	$1,231,220
Surplus and Other Funds			
Common capital stock	$ 1,000,000	$ 1,000,000	$ 0
Gross paid in and contributed surplus	709,200	709,200	0
Unassigned funds (surplus)	2,036,027	3,267,247	(1,231,220)
Surplus as regards policyholders	$ 3,745,227	$ 4,976,447	$(1,231,220)
Total liabilities, surplus and other funds	$25,366,463	$25,366,463	

Note: The Internal Revenue Service has never audited the Company's federal income tax returns under the current ownership. 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 $1,024,503 during the examination period January 1, 1999 through December 31, 2002, detailed as follows:

Statement of Income

Underwriting Income		
Premiums earned		$ 13,679,107
Deductions:		
Losses incurred	$ 6,643,288	
Losses adjustment expenses incurred	3,055,997	
Other underwriting expenses incurred	2,755,384	
Total underwriting deductions		12,454,669
Net underwriting gain		$ 1,224,438
Investment Income		
Net investment income earned	$ 1,513,189	
Net realized capital losses	(231,523)	
Net investment gain or (loss)		1,281,666
Aggregate write-ins for miscellaneous income		201
Net income before dividends to policyholders and before federal and foreign income taxes		$ 2,506,305
Dividends to policyholders		0
Net income, after dividends to policyholders and before federal and foreign income taxes		$ 2,506,305
Federal and foreign income taxes incurred		958,214
Net income		$ 1,548,091

Capital and Surplus Account

Surplus as regards policyholders per report on examination as of December 31, 1998			$2,720,724
	Gains in Surplus	Losses in Surplus	
Net income	$1,548,091		
Net unrealized capital gains or (losses)		$ 163,456	
Change in non-admitted assets		610,639	
Cumulative effect of changes in accounting principles	369,690		
Aggregate write-ins for gains and losses in surplus	0	119,183	
Total increases and decreases	$1,917,781	$ 893,278	
Net increase (decrease) in surplus			1,024,503
Surplus as regards policyholders per report on examination as of December 31, 2002			$3,745,227

4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for the captioned items of $7,114,099 is $400,000 more than the $6,714,099 reported by the Company in its December 31, 2002, filed annual statement. The examination change is due to the following: The $400,000 additional reserve amount represents an increase to the Company's overall net carried reserves as determined by the actuarial analyses performed by the Department, conducted in accordance with generally accepted actuarial principles and was based on statistical information contained in the Company's internal records and in its filed annual statements.

There were numerous problems with the year-end loss reports that the Company provided to the examiners to support the Company's Schedule P reporting, including errors relating to duplicate claim payments and loss reserve amounts.

Additionally, the Company continues to omit in its Schedule P reporting actual and anticipated subrogation amounts on paid and outstanding losses and reports incomplete claim count information in Schedule P to the Company's 2002 Annual Statement.

Based on examination review, it is recommended that:

- Management maintain complete internal records to support the paid and outstanding loss information reported in Schedule P of the Company's workers' compensation insurance line;
- It is recommended that management maintain complete internal records to support the paid and outstanding loss information reported in the Schedule P of the Company's commercial automobile liability insurance line;
- It is again recommended that the Company follow the NAIC Annual Statement Instructions by reporting in Schedule P amounts received and anticipated for salvage and subrogation;
- It is recommended that the Company follow the Annual Statement Instructions by reporting complete and accurate claims count information in each of the required sections of Schedule P.

5. CEDED REINSURANCE BALANCES PAYABLE

The examination liability of $7,473,220 is $831,220 greater than the $6,642,000 reported by the Company in its December 31, 2002 filed annual statement. The examination increase is attributable to a calculation error made by the Company in computing the amount of 2002 fourth quarter ceded reinsurance payable to its reinsurer.

6. 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 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):

ITEM		PAGE NO.
A	Management	
i.	It was recommended that board members who are unable or unwilling to attend meetings resign or be replaced. The Company has complied with this recommendation.	5
ii.	It is recommended that the Company comply with its by-laws and only pay directors' fees to those board members who actually attend board meetings. The Company has complied with this recommendation.	5
iii.	The Company pays compensation to three officers whose job functions are not performed at the Company's site. There is no documentation of	6

ITEM		PAGE NO.
	their work product or services performed. It is recommended that the Company comply with Section 1217 of the New York Insurance Law when disbursing Company funds by maintaining proper documentation for goods and services paid for.	
	The Company did not comply with this recommendation. A similar recommendation is stated under the current examination	
B.	Territory and Plan of Operation	
	The Company increased its capital stock account without amending its charter as required pursuant to Section 1206 of the New York Insurance Law. It is recommended that the Company comply with said insurance statute prior to implementing changes to its capital stock account.	7
	This recommendation does not apply as there were no capital stock changes during the current examination.	
C.	Reinsurance	
	It is recommended that the Company secure signatures from all its reinsurers in order to properly execute its reinsurance agreements.	8
	The Company has complied with this recommendation.	
D.	Holding Company System	
i.	It is recommended that the Company comply with the NAIC Annual Statement Instructions and complete Schedule Y reflecting the Company together with each affiliated person within the holding company system on its organizational chart.	9
	The Company has complied with this recommendation.	
ii.	It is recommended that the Company pursuant to the Department's Regulation 52 file an amended organizational chart with its annual holding company registration statement that is reflective of those affiliates currently comprising Hereford's holding company system.	9
	The Company complied with this recommendation.	

ITEM		PAGE NO.
iii.	The Company has an existing sub-lease agreement with an affiliate for rental of its current office facility which was not submitted for the Department's approval pursuant to Section 1505(d) of the New York Insurance Law. It is recommended that the Company file the subject agreement pursuant to the aforementioned statute. The Company has complied with this recommendation.	10
iv.	It is further recommended that the shared construction and other incidental costs between Hereford and any member of the holding company system be submitted to the Department for approval pursuant to Section 1505(d) of the New York Insurance Law. The Company has complied with this recommendation.	10
E.	<u>Conflict of Interest Statements ("CIS")</u>	
i.	It is recommended that the Company exercise greater care in maintaining CIS records and obtaining completed CIS from officers and directors. The Company did not comply with this recommendation. A similar recommendation is stated in this report on examination.	10-11
ii.	The Company should establish procedures for enforcing its conflict of interest policy enabling its board of directors to properly oversee and handle any potential conflict of interest. The Company did not comply with this recommendation. A similar recommendation is stated in this report on examination.	10-11
iii.	The board of directors should maintain complete minutes of its proceedings involving conflicts of interest. The Company did not comply with this recommendation. A similar recommendation is stated in this report on examination.	10-11
F.	<u>Abandoned Property Law</u>	
	It is recommended that the Company make appropriate abandoned property filings with the State and submit unclaimed funds in accordance with Section 1316 of the New York Abandoned Property Law. The Company has complied with this recommendation.	12

ITEM		PAGE NO.
G.	Accounts and Records	
i.	Relocation of Home Office	
	It is recommended that the Company file an amended charter pursuant to Section 1206 reflecting the change of location of its home office.	12
	This recommendation no longer applies as the Company's current statutory home office remained at the same location as the prior address.	
ii.	Annual Statement	
(a)	It is recommended that the Company exercise greater care in preparing Company accounting and financial reporting information.	13
	The Company did not comply with this recommendation. A similar recommendation is stated in this report on examination.	
	It is recommended that the Company's CPA report include information about the Company's internal control system as required by Section 307(b)(1) of the New York Insurance Law and by Department Regulation 118.	13
	The Company did not comply with this recommendation. A similar recommendation is stated in this report on examination.	
iii.	Reinsurance	
(a)	It is recommended that the Company calculate ceded reinsurance premiums and commissions in accordance with the reinsurance contract and annual statement instructions.	13
	The Company did not comply with this recommendation. A similar recommendation is stated in this report on examination.	
(b)	It is further recommended that the ceded reinsurance premiums account balance agree between the annual statement and the Company trial balance.	13
	The Company has complied with this recommendation.	

ITEM		PAGE NO.
iv.	Cash Account	
(a)	It is recommended that the Company exercise greater care to eliminate clerical errors when preparing its monthly reconciliations and reconcile differences between ledger accounts and cash journals. The Company has complied with this recommendation.	13-14
(b)	It is recommended that the Company cancel uncashed checks after six months have passed and issue replacement checks. The Company did not comply with this recommendation. A similar recommendation is stated in this report on examination.	14
(c)	It is recommended that no Company officer be allowed to issue checks payable to him or her self and that checks may only be issued to officers by other officers. The Company has complied with this recommendation.	14
v.	Investments	
(a)	It is recommended that the Fleet Statement include the CUSIP numbers to bonds reported, that bonds acquired by the Company investment broker be deposited in a bank custodial account and the Company file with the NAIC SVO to have its newly acquired securities valued within a reasonable time frame. The Company complied with all of the recommendations except for filing with the NAIC SVO newly acquired securities for rating within a reasonable time frame. This recommendation is stated in this report on examination.	14
(b)	It is further recommended that the Company report its stock investments in the proper account in accordance with the NAIC annual statement instructions. The Company has complied with this recommendation.	14
(c)	It is recommended that the Company establish a bank custodial agreement for safekeeping purposes. The Company did not comply with this recommendation. A similar recommendation is stated in this report on examination.	14

ITEM		PAGE NO.
vi	Losses	
(a)	It is recommended that the Company establish and maintain accounting records of its anticipated subrogation.	15
(b)	In addition, it is recommended that the Company report both paid and unpaid losses net of its subrogation in Schedule P of its annual statement. The Company has not fully complied with this recommendation.	15
(c)	It is recommended that the Company and its claims administrator update and coordinate claims payments and reserves information in order to eliminate discrepancies between the two. This recommendation no longer applies due to the Company's claims and loss management performed in-house.	15

8. SUMMARY OF COMMENTS AND RECOMMENDATIONS

ITEM		PAGE NO.
A.	Management	
i	It is recommended that the Company amend its by-laws to allow for attendance via conference call.	4
ii	It is recommended that the Company comply with the provisions of Section 1411(a) of the New York Insurance Law.	5
iii	It is recommended that the Company comply with Article IV, Sections 4 and 7 of its by-laws by having its vice presidents and treasurer be full-time active members of the Company's executive management and fulfill their duties, as indicated in the Company's by-laws, as officers of the Company.	6
iv	It is recommended that the Company's financial statements be sworn to by those principal officers that are fully knowledgeable with the corporate and financial affairs reported in the Company's filed financial statements.	6
v	It is again recommended that the Company cease disbursing funds to those individuals who are not providing either goods or service to the Company. It is further recommended that the Company comply with	7

ITEM		PAGE NO.
	the provisions of Section 1217 of the New York Insurance Law. The Company is reminded of its fiduciary responsibility to protect the interest of Hereford's policyholders and of its obligation to disburse Company's funds in a prudent manner.	
vi	It is recommended that the Company ensure that the officers and directors properly disclose all required information on their conflict of interest statements.	7
vii	It is recommended that the Company obtain adequate fidelity bond coverage commensurate with its exposure.	8
B.	Reinsurance	
i	It is recommended that the Company amend its excess of loss reinsurance agreement to specify that any arbitration proceedings will be governed by New York Law and that any offsets are in accordance with Section 7427 of the New York Insurance Law.	11
ii	It is recommended that prior to effecting new reinsurance agreement(s) or amendment(s) to existing agreements, the Company file such transactions with the Department for review pursuant to Section 1308(e)(1) of the New York Insurance Law. Subsequent to this examination, management complied with examiners' request by filing both workers' compensation and taxi liability quota share agreements with the Department for review.	12
C.	Holding Company System	
i	It is recommended that the Company file annual holding company registration statements for all prior years under the current examination period as well as for the 2003 year pursuant to Part 80-1.4 of Department Regulation 52.	14
ii	It is recommended that the Company fully comply with Department Regulation 52-A by filing in a timely manner its controlling producer report no later than April 1st of each year as required.	15
D	Accounts and Records	
	Cash Accounts	
i	It is recommended that only full-time active employees of the Company be listed as signatories for the Company's bank accounts. All signatories should be approved by the Company's board of directors.	20
ii	It is recommended that the Company implement proper segregation of	20

ITEM		PAGE NO.
	duty regarding the Company's payroll, bank reconciliation and general ledger maintenance functions.	
iii	It is recommended that management reconcile all bank accounts on a monthly basis in order to ensure greater internal control over Company cash accounts.	20
iv	It is recommended that management include more than one authorized signatory to each Company bank account.	20
v	It is recommended that long-standing open checks be researched and cancelled or re-issued, if necessary.	20
	Investment Accounts	
i	It is recommended that the Company file all newly acquired investments for security rating with the NAIC SVO.	21
ii	It is also recommended that the Company verify and ensure the validity of the investment information contained in the Company's signed NAIC SVO Compliance Certification filing.	21
iii	It is recommended that the Company implement a separate custodial agreement with North Fork Bank ("NFB") applicable to Company investments both managed and held by NFB pursuant to the parties' investment management agreement.	21
iv	It is recommended that management establish formal written investment guidelines. Management should further provide any investment manager of the Company with the guidelines to be followed by the managers in their decision making and administration of the Company's investment functions.	21
v	It is recommended that the Company amend its existing custodial agreement to incorporate the standard protective clauses prescribed by the NAIC and also acknowledged by the Department as good public policy.	21
	Allocation of Expenses	
i	It is recommended that management comply with Sections 105.5 and 105.16 of Department Regulation 30 by reporting expenses in the proper expense accounts.	22
ii	It is recommended that management comply with Section 107.4 of Department Regulation 30 by allocating all ceding reinsurance	22

ITEM		PAGE NO.
	commissions to other underwriting expenses in the Company's filed annual statements.	
	Record Retention	
i	It is recommended that management update its year-end record retention procedures to include electronic files in addition to the Company's hardcopy files.	23
ii	It is recommended that management refrain from its current practice of maintaining the Company's back-up workers' compensation electronic data file off-site at the home of a staff employee. Instead, management should establish a more reliable back-up procedure such as an alternative back-up of Company files at an alternative off-site facility.	23
	Certified Public Accountant ("CPA")	
	It is again recommended that management comply with Section 307(b)(1) of the New York Insurance Law.	24
E.	Losses and loss adjustment expenses	
i	It is recommended that management maintain complete internal records to support the paid and outstanding loss information reported in Schedule P of the Company's workers' compensation insurance and commercial automobile lines.	29
ii.	It is again recommended that the Company follow the NAIC Annual Statement Instructions by reporting in Schedule P amounts received and anticipated for salvage and subrogation.	29
iii	It is recommended that the Company follow the NAIC Annual Statement Instructions by reporting complete and accurate claims count information in each of the required sections in Schedule P.	29

Respectfully submitted,

/S/

Kenneth I. Merritt
Senior Insurance Examiner

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

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

/S/

Kenneth Merritt

Subscribed and sworn to before me

this__________ day of ____________________, 2005.

Appointment No ***22087***

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:*

Kenneth Merritt

as proper person to examine into the affairs of the

HEREFORD 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 6th day *of August, 2003*

GREGORY V. SERIO
Superintendent of Insurance