

REPORT ON EXAMINATION

OF THE

CONSTITUTION INSURANCE COMPANY

AS OF

DECEMBER 31, 2011

DATE OF REPORT

APRIL 30, 2013

EXAMINER

RYAN HAVICK, CFE

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NEW YORK STATE
DEPARTMENT *of*
FINANCIAL SERVICES

Andrew M. Cuomo
Governor

Benjamin M. Lawsky
Superintendent

April 30, 2013

Honorable Benjamin M. Lawsky
Superintendent of Financial Services
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 30912 dated January 4, 2013, attached hereto, I have made an examination into the condition and affairs of Constitution Insurance Company as of December 31, 2011, and submit the following report thereon.

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

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

The examination was conducted at the Company’s administrative office located at 10805 Old Mill Road, Omaha, Nebraska 68154.

1. SCOPE OF EXAMINATION

The Department has performed an individual examination of the Company, a multi-state insurer. The previous examination was conducted as of December 31, 2006. This examination covered the 5 year period from January 1, 2007 through December 31, 2011. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

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

All financially significant accounts and activities of the Company were considered in accordance with the risk-focused examination process. The examiners also relied upon audit work performed by the Company’s independent public accountants when appropriate.

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

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

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

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

2. DESCRIPTION OF COMPANY

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

In July 1996, 100% of the outstanding stock of the Company was purchased by Gerling Konzern Rueckversicherungs Aktiengesellschaft of Cologne, Germany. In December 1996, the Company’s name was changed to Gerling Global Reinsurance Corporation of America (“GGRCA”).

On October 27, 1998, the Company’s parent acquired EXOR-CRC Inc. (later renamed Gerling Global Holdings Inc.), a Delaware investment holding company, which owned Constitution Holding Inc. (“CHI”), a United States holding company. After restructuring the Gerling Group’s US operations, the Company adopted its current title on May 21, 1999.

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

On July 24, 2008, Constitution Group, LLC (“Constitution Group”) and Steven Menzies filed an application with the Department to acquire control of the Company. Constitution Group, a New York limited liability company, is owned 100% by Steven Menzies. Steven Menzies by virtue of his

100% ownership in Constitution Group is deemed to be the ultimate controlling person of the Company. The acquisition was completed on May 6, 2009.

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

Capital paid in is \$4,200,002 consisting of 509,709 shares of \$8.24 par value per share common stock. Gross paid in and contributed surplus is \$7,960,945. Gross paid in and contributed surplus decreased by \$40,011,192 during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
2007	Beginning gross paid in and contributed surplus	\$47,972,137
2008	Paid In Surplus Reduction	\$(30,408,000)
2009	Paid In Surplus Reduction- Quasi Reorganization	\$ <u>(9,603,192)</u>
	Total Paid in Surplus Reductions	\$ <u>(40,011,192)</u>
2011	Ending gross paid in and contributed surplus	\$ <u>7,960,945</u>

The Company maintains an office in Omaha, Nebraska where the accounting function is performed and an office in New York where sales and systems are maintained. Pursuant to Section 325(b) of the New York Insurance Law the Company received approval to maintain its books of account outside the State of New York.

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 13 nor more than 21 members. Since the acquisition of the Company, all actions of the board have been by unanimous written consent in lieu of a meeting. At December 31, 2011, the board of directors was comprised of the following 13 members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Catherine L. Menzies-Ansonia Syracuse, NY	Retired Account Executive, A. G. Edwards
John M. Ansonia Syracuse, NY	Marketing Representative, Constitution Group, LLC
Eric L. Butler San Francisco, CA	Senior Vice President, Applied Underwriters, Inc.
Linda S. Davis LaVista, NE	Executive Administrative Assistant, Applied Underwriters, Inc.
Sidney R. Ferenc Highland Beach, FL	Chief Executive Officer, Applied Underwriters, In.
John W. Green Northport, NY	Accountant, Marcum, LLP
Xiaoyun A. Hu San Mateo, CA	Executive Administrative Assistant, Applied Underwriters, Inc.
Ann E. Menzies Syracuse, NY	Retired
Steven M. Menzies Hillsborough, CA	President, Treasurer and Chief Operating Officer, Constitution Insurance Company
Jeffrey A. Silver Omaha, NE	Secretary/General Counsel, Applied Underwriters
Mary F. Silver Omaha, NE	Retired
Marc M. Tract Brookville, NY	Attorney, Katten, Muchin, Rosenman, LLP
Katy M. Van Horn Castro Valley, CA	Business Person, Self Employed

As of December 31, 2011, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Steven M. Menzies	President, Treasurer and Chief Operating Officer
Sidney R. Ferenc	Vice President
Jeffrey A. Silver	Secretary

B. Territory and Plan of Operation

As of December 31, 2011, the Company was licensed to write business in 44 states and the District of Columbia and was qualified in the State of Maine.

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

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

Based on the lines of business for which the Company is licensed and the Company's current capital structure, and pursuant to the requirements of Articles 13 and 41 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of \$4,400,000.

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

<u>Calendar Year</u>	<u>New York State</u>	<u>Total Premiums</u>	Premiums Written in New York State as a <u>percentage of Total Premium</u>
2007	\$0	\$ (51)	0.00%
2008	\$0	\$ 0	0.00%
2009	\$0	\$ 0	0.00%
2010	\$0	\$378,000	0.00%
2011	\$0	\$ 7,550	0.00%

The Company resumed writing business in 2010, specializing primarily in claims made niche products including employment practices liability insurance, defense costs only for small to medium sized employers.

C. Reinsurance

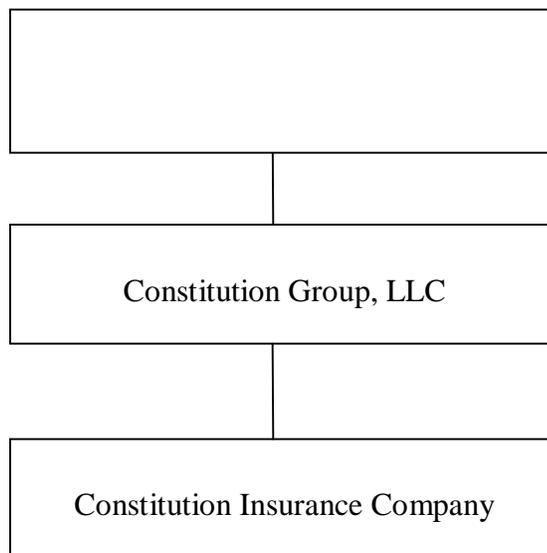
The Company did not have any assumed or ceded reinsurance contracts in effect as of December 31, 2011.

D. Holding Company System

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

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

The following is a chart of the holding company system at December 31, 2011:



At December 31, 2011, the Company was a party to the following agreements with other members of its holding company system:

Management Services Agreement

Effective May 6, 2009, Constitution Group, LLC has agreed to provide accounting services, financial statement, tax returns, actuarial services, claim services, reinsurance, accounts receivable, depositing of monies received, accounts payable, underwriting, computer equipment, computer systems and software, purchasing and mail services, personnel and administrative services and loss prevention services to the Company. This agreement was filed with the Department pursuant to Section 1505 of the New York Insurance Law.

Based upon a review of the agreement and the transactions surrounding this agreement, it appears that the Company and Constitution Group, LLC are not complying with the terms of the agreement. The agreement requires the Company to, at the beginning of each month, estimate and make such allocations among Constitution Group, LLC and the Company as required, such estimate not to exceed the actual costs and expenses of the next preceding month. Constitution Group, LLC shall bill the Company for its allocable portion of such estimated costs and expenses for such month. All billings between Constitution Group, LLC and the Company shall be settled within thirty (30) days after the last day of each month for the net amount of all such monthly allocated costs and expenses. On or before the last day of each quarter, the Company and Constitution Group, LLC shall adjust all costs and expenses allocated amongst them for the preceding quarter and payment in accordance with such final adjustment shall thereupon be made by the Company to Constitution Group, LLC. Records reflect the recording of costs and expenses on a quarterly basis and various payment amounts over various periods. The truing up of costs and expenses appears to be performed only yearly.

It is recommended that the Company follow the agreed upon terms contained within the Management Services Agreement.

Sublease Agreement

Effective May 6, 2009, Constitution Group, LLC has agreed to sublease certain real estate located at 109 South Warren Street, Suite 316, Syracuse, New York to the Company. This agreement was filed with the Department pursuant to Section 1505 of the New York Insurance Law.

Investment Advisory Agreement

Effective May 6, 2009, Constitution Group, LLC has agreed to act as investment advisor and to exercise the investment discretion as established by the Board of Directors of the Company. This agreement was filed with the Department pursuant to Section 1505 of the New York Insurance Law.

Tax Allocation Agreement

Effective May 6, 2009, Constitution Group, LLC and Constitution Insurance Company as member companies of an affiliated group wish to file consolidated federal income tax returns. The agreement provides for the methods to be utilized to calculate each members' share of the consolidated tax (benefit) on an individual basis. This agreement was filed with the Department pursuant to Section 1505 of the New York Insurance Law.

E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2011, based upon the results of this examination:

Net premiums written to surplus as regards policyholders	N/A
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	1%
Premiums in course of collection to surplus as regards policyholders	N/A

The second ratio falls 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 five-year period covered by this examination:

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss adjustment expenses incurred	\$(2,055,204)	(543.70)%
Other underwriting expenses incurred	1,741,125	460.61
Net underwriting gain	<u>692,079</u>	<u>183.09</u>
Premiums earned	<u>\$ 378,000</u>	<u>100.00%</u>

F. Accounts and Records

Custodial Agreements

At December 31, 2011, the Company's investments were held pursuant to custodian services agreements with two entities, CitiBank and Union Bank.

In regards to these custodian services agreements, Management answered affirmatively to the following General Interrogatories in the 2011 Annual Statement: "Excluding items in Schedule E-Part 3-Special deposits, 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 through the current year held pursuant to a custodial agreement with a qualified bank or trust company in accordance with Section 1, III Conducting Examinations, F-Custodial or Safekeeping Agreements of the NAIC Financial Condition Examiners Handbook?"

However, examination review indicated that the Company's custodial agreements lacked the protective covenants set forth in Section 1, III of the NAIC Financial Condition Examiners Handbook.

It is recommended that the Company amend its custodial agreements to include the minimum safeguards and controls as set forth in the NAIC Financial Condition Examiners Handbook.

Conflict of Interest Policy

The Company has a conflict of interest policy in place which requires all directors and officers sign an annual conflict of interest statement; however, the conflict of interest policy does not require key employees to sign an annual conflict of interest statement. A statement was signed by all officers and directors for the years 2009, 2010 and 2011.

It is recommended that the Company amend its conflict of interest policy and require key employees to make annual conflict of interest statements.

Fidelity Bond Coverage

The Company does not maintain fidelity bond coverage for its directors, officers and key employees in the event of material acts of dishonesty or theft. Based upon the financial condition of

the Company as of December 31, 2011, the NAIC Financial Condition Examiners Handbook requires a minimum of \$100,000 coverage.

It is recommended that the Company obtain a fidelity bond of no less than \$100,000 as required by the NAIC Financial Condition Examiners Handbook.

3. FINANCIAL STATEMENTS

A. Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2011 as determined by this examination and as reported by the Company:

<u>Assets</u>	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>
Bonds	\$11,675,303	\$ 0	\$11,675,303
Cash, cash equivalents and short-term investments	499,304		499,304
Investment income due and accrued	65,067		65,067
Uncollected premiums and agents' balances in the course of collection	37,954		37,954
Net deferred tax asset	5,601,882	5,601,354	528
Electronic data processing equipment and software	7,106	7,106	0
Receivables from parent, subsidiaries and affiliates	111,860		111,860
Aggregate write-ins for other than invested assets	<u>60,721</u>	<u>51,837</u>	<u>8,884</u>
Total assets	<u>\$18,059,197</u>	<u>\$5,660,297</u>	<u>\$12,398,900</u>
 <u>Liabilities, surplus and other funds</u>			
<u>Liabilities</u>			
Losses and loss adjustment expenses			\$ 0
Other expenses (excluding taxes, licenses and fees)			54,101
Taxes, licenses and fees (excluding federal and foreign income taxes)			13,325
Unearned premiums			<u>7,550</u>
Total liabilities			\$ 74,976
 <u>Surplus and other funds</u>			
Common capital stock		\$4,200,002	
Gross paid in and contributed surplus		7,960,945	
Unassigned funds (surplus)		<u>162,977</u>	
Surplus as regards policyholders			<u>12,323,924</u>
Total liabilities, surplus and other funds			<u>\$12,398,900</u>

Note: The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2009 through 2011. The examiner is unaware of any potential exposure of the Company to any tax assessment and no liability has been established herein relative to such contingency.

B. Statement of Income

Surplus as regards policyholders decreased \$24,026,617 during the 5-year examination period January 1, 2007 through December 31, 2011, detailed as follows:

Underwriting Income

Premiums earned \$ 378,000

Deductions:

Losses and loss adjustment expenses incurred \$(2,055,204)

Other underwriting expenses incurred 1,741,125

Total underwriting deductions (314,079)

Net underwriting gain or (loss) \$ 692,079

Investment Income

Net investment income earned \$2,929,931

Net realized capital gain 238,658

Net investment gain or (loss) 3,168,589

Other Income

Net gain or (loss) from agents' or premium balances charged off \$(38,103)

Aggregate write-ins for miscellaneous income 27,163

Total other income (10,940)

Net income before dividends to policyholders and before federal and foreign income taxes \$3,849,728

Dividends to policyholders 0

Net income after dividends to policyholders but before federal and foreign income taxes \$3,849,728

Federal and foreign income taxes incurred (39,260)

Net income \$3,888,988

Surplus as regards policyholders per report on examination as of December 31, 2006			\$36,350,541
	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income	\$ 3,888,988		
Net unrealized capital gains or (losses)	480,482		
Change in net deferred income tax		439,320	
Change in non-admitted assets	1,810,178		
Change in provision for reinsurance	641,053		
Capital changes paid in	2		
Surplus adjustments paid in		40,011,191	
Aggregate write-ins for gains and losses in surplus	<u>9,603,191</u>		
Total gains or losses in surplus	<u>\$16,423,882</u>	<u>\$40,450,511</u>	
Net increase (decrease) in surplus			<u>\$(24,026,617)</u>
Surplus as regards policyholders per report on examination as of December 31, 2011			\$ <u>12,323,924</u>

4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for the captioned items of \$0 is the same as reported by the Company as of December 31, 2011. The examination analysis was conducted in accordance with generally accepted actuarial principles and practices and was based on statistical information contained in the Company's internal records and in its filed annual statements.

5. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination contained one recommendation as follows (page number refers to the prior report):

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Investments</u>	
It was recommended that the Company take the necessary steps to ensure future compliance with Section 1402(a) of the New York Insurance Law.	11
The Company has complied with this recommendation.	

6. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Holding Company</u>	
<u>Management Services Agreement</u>	
i. It is recommended that the Company follow the agreed upon terms contained within the Management Services Agreement.	8
B. <u>Accounts and Records</u>	
<u>Custodial Agreements</u>	
i. It is recommended that the Company amend its custodial agreements to include the minimum safeguards and controls as set forth in the NAIC Financial Condition Examiners Handbook.	10
<u>Conflict of Interest Policy</u>	
ii. It is recommended that the Company amend its conflict of interest policy and require key employees to make annual conflict of interest statements.	10
<u>Fidelity Bond Coverage</u>	
iii. It is recommended that the Company obtain a fidelity bond of no less than \$100,000 as required by the NAIC Financial Condition Examiners Handbook.	11

Respectfully submitted,

/s/
Ryan Havick, CFE

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

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

/s/
Ryan Havick

Subscribed and sworn to before me

this _____ day of _____, 2013.

APPOINTMENT NO. 30912

NEW YORK STATE

DEPARTMENT OF FINANCIAL SERVICES

I, **BENJAMIN M. LAWSKY**, Superintendent of Financial Services of the State of New York, pursuant to the provisions of the Financial Services Law and the Insurance Law, do hereby appoint:

RYAN HAVICK, CFE

as a proper person to examine the affairs of the

CONSTITUTION INSURANCE COMPANY

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

COMPANY

with such other information as he shall deem requisite.

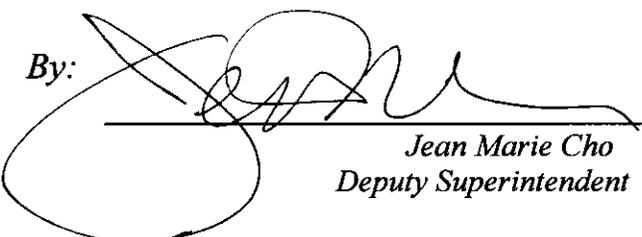
In Witness Whereof, I have hereunto subscribed by name
and affixed the official Seal of the Department
at the City of New York

this 4th day of January, 2013

BENJAMIN M. LAWSKY
Superintendent of Financial Services



By:



Jean Marie Cho
Deputy Superintendent