

REPORT ON ORGANIZATION

OF THE

MERCHANTS PREFERRED INSURANCE COMPANY

AS OF

JANUARY 5, 2007

DATE OF REPORT

JANUARY 10, 2007

EXAMINER

ADEBOLA AWOFOESO

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

January 10, 2007

Mr. Louis W. Pietroluongo
Acting Superintendent of Insurance
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 22584 dated January 3, 2007 attached hereto, I have made an examination on organization of Merchants Preferred Insurance Company as of January 5, 2007, and submit the following report thereon.

Wherever the designations “the Company” or “Merchants Preferred” appear herein without qualification, they should be understood to indicate Merchants Preferred 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 administrative offices located at 250 Main Street. Buffalo, New York 14202.

1. SCOPE OF EXAMINATION

The examination comprised a complete verification of the issuance of the Company's capital stock, the receipt of the capital and surplus funds, and the determination of the Company's assets and liabilities. The records examined were the declaration of intention and charter, the by-laws, the certificate of incorporation, the corporate minutes, the stock register and the inter-company and custodial agreements entered into by the Company as of the examination date. In addition, an affidavit, appended hereto, was obtained from two officers of the Company indicating that the transactions noted in this report were lawful and bona fide.

2. INCORPORATION

Merchants Preferred Insurance Company was incorporated under the laws of the State of New York on September 29, 2006. The Department approved the Company's declaration of intention and charter on the same date.

As of the examination date, the Company's board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Franklyn S. Barry, Jr. Buffalo, NY	President, Aethlon Medical, Inc.
Gary M. Brost Buffalo, NY	President and Chief Executive Officer, Strategic Investments and Holdings, Inc.
Randall L. Clark East Amherst, NY	Chairman, Dunn Tire Corp.
Linda P. Duch Naples, FL	President, Partners for Business

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
John T. Hoskins Buffalo, NY	Chairman, Curtis Screw Co., Inc.
Dr. Muriel A. Howard Buffalo, NY	President, Buffalo State College
Margaret N. Kafka Buffalo, NY	Vice President, Corporate Services of Merchants Mutual Insurance Company (“Mutual”) and Merchants Insurance Company of New Hampshire, Inc. (“MNH”)
Brian J. Lipke Buffalo, NY	Chairman and Chief Executive Officer, Gibraltar Industries, Inc.
Bryant H. Prentice, III Buffalo, NY	Chairman of the Board of Mutual, Chairman of Bryant and Stratton Schools.
Kurt Wiedenhaupt East Aurora, NY	Retired Chairman of the Board, President and Chief Executive Officer, American Precision Industries Inc.
Edward G. Wright Clarence, NY	President and Chief Executive Officer, W.J. Cox Associates President, Lumbermen’s Insurance Company, Ltd.
Robert M. Zak Buffalo, NY	President and Chief Executive Officer, Merchants Mutual Insurance Company and Merchants Insurance Company of New Hampshire, Inc. Chief Operating Officer, Senior Vice President and Secretary, Merchants Group, Inc
Ronald K. Zoeller West Seneca, NY	Chief Executive Officer, Azeros Health Care

A review of the minutes of the board of directors shows that there were no meetings held during the examination period. In lieu of meetings, all actions were taken by signed written consent of all directors.

As of January 10, 2007, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Bryant H. Prentice, III	Chairman of the Board
Robert M. Zak	President and Chief Executive Officer
Kenneth J. Wilson	Chief Financial Officer, Vice President and Treasurer
Fred A. Hildebrand	Senior Vice President
Margaret N. Kafka	Vice President- Corporate Services
Edward M. Murphy	Vice President , Chief Investment Officer and Secretary
Robert H. Fagerburg	Vice President-Claims
Thomas B Harris	Vice President-Underwriting
Clark M. Sykes	Vice President-Information Technology

3. CAPITALIZATION AND SUBSCRIPTION

Merchants Preferred Insurance Company's authorized capital of \$1,000,000 consists of 100,000 shares of common stock at \$10 par value per share. On October 30, 2006, the Company issued 100,000 share of its 200,000 authorized common stock to Merchants National Insurance Company for an aggregate amount of \$15,000,000 consisting of \$2,000,000 in cash and marketable securities with an aggregate fair market valuation of not less than \$13,000,000.

In order to fulfill the deposit requirement of Section 4104 of the New York Insurance Law, the Company has placed securities with a par value of \$500,000 in a custodial account in the name of the Superintendent of Insurance of New York in trust for the security of the policyholders of Merchants Preferred Insurance Company, within the United States, its territories and possessions.

4. BALANCE SHEET

The following shows the assets, liabilities and surplus as regards policyholders as determined by this examination as of December 31, 2006 and as reported by the Company:

Assets

Bonds		\$12,828,131
Short-term investment		2,114,221
Interest due and accrued		<u>170,858</u>
Total admitted assets		<u>\$15,113,210</u>

Liabilities

Federal income tax		<u>\$38,000</u>
Total liabilities		\$38,000

Capital and Surplus

Common capital stock	\$1,000,000	
Gross paid in and contributed surplus	14,000,000	
Unassigned funds (Surplus)	<u>75,210</u>	
Surplus as regards policyholders		<u>15,075,210</u>
Total liabilities, capital and surplus		<u>\$15,113,210</u>

5. CUSTODIAL AGREEMENT

The NAIC Financial Condition Examiners Handbook Part 1-General, Section IV.H-Custodial or Safekeeping Agreements requires insurance companies to maintain custodial agreement with the following guidelines:

- a. That the national bank, state bank, or trust company, as custodian is obligated to indemnify the insurance company for any insurance company's loss of securities in the custodian's custody, except that, unless domiciliary state law, regulation, or administrative action otherwise require a stricter standard (Section 2.b. sets forth an example of such a stricter standard), the bank or trust company shall not be so obligated to the extent that such loss was caused by other than the negligence or dishonesty of the custodian;
- b. If domiciliary state law, regulation, or administrative action requires a stricter standard of liability for custodians of insurance company securities than that set forth in Section 2.a., then such stricter standard shall apply. An example of a stricter standard that may be used is that the custodian is obligated to indemnify the insurance company for any loss of securities of the insurance company in the custodian's custody occasioned by the negligence or dishonesty of the custodian's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction;
- c. That in the event of a loss of the securities for which the custodian is obligated to indemnify the insurance company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced;
- d. That the national bank, state bank or trust company as custodian shall not be liable for any failure to take any action required to be taken hereunder in the event and to the extent that the taking of such action is prevented or delayed by war (whether declared or not and including existing wars), revolution, insurrection, riot, civil commotion, act of God, accident, fire, explosions, stoppage of labor, strikes or other differences with employees, laws, regulations, orders or other acts of any governmental authority, or any other cause whatever beyond its reasonable control;
- e. That in the event that the custodian gains entry in a clearing corporation through an agent, there should be a written agreement between the custodian and the agent that the agent shall be subjected to the same liability for loss of securities as the custodian. If the agent is governed by laws that differ from the regulation of the custodian, the Commissioner of Insurance of the state of domicile may accept a standard of liability applicable to the agent that is different from the standard liability;

f. That if the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn, the custodian shall provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner;

g. That during regular business hours, and upon reasonable notice, an officer or employee of the insurance company, an independent accountant selected by the insurance company and a representative of an appropriate regulatory body shall be entitled to examine, on the premises of the custodian, its records relating to securities, if the custodian is given written instructions to that effect from an authorized officer of the insurance company;

h. The custodian and its agents, upon reasonable request, shall be required to send all reports which they receive from a clearing corporation or the Federal Reserve book-entry system which the clearing corporation or the Federal Reserve permits to be redistributed and reports prepared by the custodian's outside auditors, to the insurance company on their respective systems of internal control;

i. To the extent that certain information maintained by the custodian is relied upon by the insurance company in preparation of its annual statement and supporting schedules, the custodian agrees to maintain records sufficient to determine and verify such information.

j. That the custodian shall provide, upon written request from a regulator or an authorized officer of the insurance company, the appropriate affidavits, with respect to the insurance company's securities held by the custodian;

k. That the custodian shall secure and maintain insurance protection in an adequate amount;

l. That the foreign bank acting as a custodian, or a U.S. custodian's foreign agent, or a foreign clearing corporation is only holding foreign securities or securities required by the foreign country in order for the insurer to do business in that country. A US custodian must hold all other securities.

The examination review indicated that the Company's custodial agreement was lacking certain protective covenants set forth in Section IV.H of the NAIC Financial Condition Examiners Handbook.

It is recommended that the Company procure an agreement that complies with the NAIC guidelines stated above.

6. AUTHORIZED POWERS AND MINIMUM CAPITAL REQUIRED

The Company is 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	Worker's compensation and employer's liability
16	Fidelity and surety
19	Motor vehicle and aircraft physical damage
20	Marine and inland marine
21	Marine protection and indemnity
26(A)(B)(C)(D)	Gap

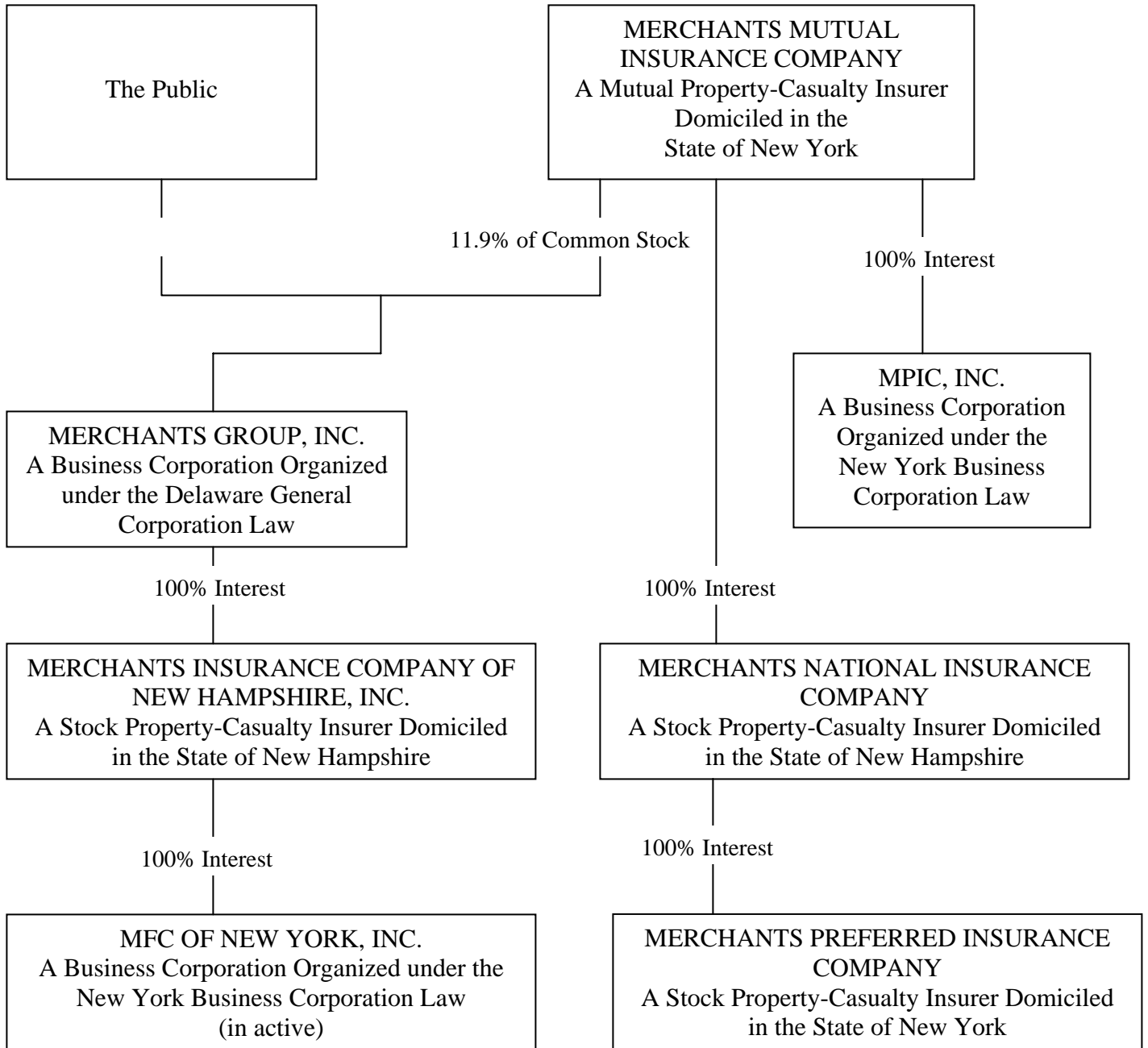
Based on the lines of business for which the Company is licensed and the Company's current capital structure, and pursuant to the requirements of Articles 13 and 41 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of \$6,000,000.

7. HOLDING COMPANY SYSTEM

The Company is a member of a holding company that is ultimately controlled by Merchants Mutual Insurance Company.

The following is a chart of the holding company system at January 10, 2007:

ORGANIZATIONAL CHART



At January 10, 2007, the Company was party to the following agreements with other members of its holding company system:

Management Agreement

Effective October 18, 2006, the Company and its affiliates Merchants Mutual Insurance Company (“Mutual”) and Merchants National Insurance Company (“National”), entered into a management agreement. Pursuant to the terms of the agreement, Mutual will provide the Company and National with the administrative and clerical personnel, data processing equipment and services, office supplies, equipment and furniture and other facilities necessary or desirable for conduct and administration of their businesses.

Pooling Agreement

Effective January 1, 2007, the Company and its affiliates Mutual and National entered into a pooling agreement. Pursuant to the terms of the agreement, the Company and National will cede to Mutual all of their respective insurance business as defined in the agreement and each will assume from Mutual an amount of the combined insurance business of the companies equal to its pooling percentage of 20% and 10% for National and the Company, respectively.

Tax Allocation Agreement

Effective October 18, 2006, the Company and its affiliates Mutual, National and MPIC Inc. (“MPIC”), a New York business corporation entered into a tax allocation agreement. Pursuant to the terms of the agreement, the parties will file consolidated federal income tax returns. The agreement stipulates that the Company’s tax liability on a consolidated basis would not exceed the liability had the Company filed its tax return on a stand alone basis.

The Department Circular Letter No. 33 (1979) stated:

“To help assure the domestic insurer's enforceable right to recoup federal income taxes in the event of future net losses an escrow account consisting of assets eligible as an investment for the domestic insurer shall be established and maintained by the parent in an amount equal to the excess of the amount paid by the domestic insurer to the parent for federal income taxes over the actual payment made by the parent to the Internal Revenue Service. Escrow assets may be released to the parent from the escrow account at such time as the permissible period for loss carry backs has elapsed.”

The examination review shows that the Company's tax allocation agreement is missing the escrow account clause as specified above.

It is recommended that the Company amend its agreement to comply with Department Circular Letter No. 33 (1979).

8. CONCLUSION

Based on the foregoing examination, it is concluded that the Company sold 100,000 shares of common stock with a par value of \$10 per share. These shares represented half of the 200,000 authorized and issued stock for which the Company received a consideration of \$15,000,000, of which \$1,000,000 represents capital and \$14,000,000 represents gross paid in and contributed surplus.

9. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>		<u>PAGE NO.</u>
A	<u>Custodial Agreement</u>	
	It is recommended that the Company procure a custodial agreement that complies with the guidelines set forth in the NAIC Examiners Handbook.	7
B	<u>Tax Allocation Agreement</u>	
	It is recommended that the Company amend its agreement to comply with Department Circular letter No 33 (1979).	11

STATE OF NEW YORK,)
) SS.:
COUNTY OF ERIE)

The undersigned each an executive officer of Merchants Preferred Insurance Company (the "Company") duly sworn, depose and say under oath that, on the date of January 10, 2007:

- (1) Each of the undersigned is an officer of the Company.
- (2) The Company's capital and surplus equals Fifteen Million Dollars (\$15,000,000), consisting of paid in capital of One Million Dollars (\$1,000,000) and contributed surplus of Fourteen Million Dollars (\$14,000,000) (the Capital and Surplus"). The capital and surplus is on deposit with the UBS Financial Services Inc.
- (3) No part of the Capital and Surplus has been withdrawn, pledged, or in any way impaired.
- (4) No part of the Capital and Surplus is to be invested or otherwise legitimately used or appropriated except for the sole and exclusive use and benefit of the Company.
- (5) There is no agreement or understanding, express or implied, made or existing between the Company and its officers, or any or either of them, or any person or persons, to the effect or import that the money paid in by any stockholder shall be loaned or returned to it.
- (6) Neither the Company nor any of its officers is in any way, manner or form pledged or committed to make any investment, loan or disposition of the Capital and Surplus, or any part or portion thereof, which is not in strict conformity in all respects with the provisions of the Insurance Law of the State of New York.
- (7) The Capital and Surplus is the property of the Company and is possessed by the Company in its corporate name and capacity for the benefit of its policyholders.

Robert M. Zak 1/10/07
Robert M. Zak
President

Kenneth J. Wilson 1/10/07
Kenneth J. Wilson
Treasurer

Subscribed and sworn to before me
this 10th day of January, 2007

Janice M. Wojtanik
Notary Public.

JANICE M. WOJTANIK
Notary Public, State of New York
Qualified in Erie County
My Commission Expires 7/24/2011

Appointment No. 22584

**STATE OF NEW YORK
INSURANCE DEPARTMENT**

I, Louis W. Pietroluongo, Acting Superintendent of Insurance of the State of New York, pursuant to the provisions of the Insurance Law, do hereby appoint:

Adebola Awofeso

as proper person to examine into the affairs of the

MERCHANTS PREFERRED INSURANCE COMPANY

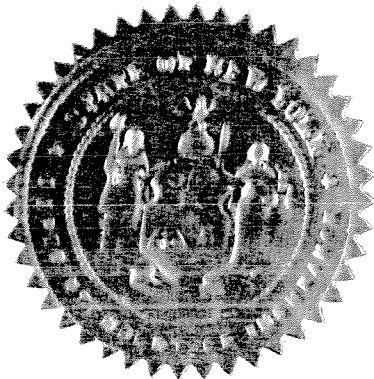
and to make a report to me in writing of the condition of the said

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 3rd day of January, 2007



A handwritten signature in black ink, appearing to read "Louis W. Pietroluongo", written over a horizontal line.

LOUIS W. PIETROLUONGO
Acting Superintendent of Insurance