

REPORT ON EXAMINATION

OF

CAPACITY INSURANCE COMPANY

SUNRISE, FLORIDA

AS OF

DECEMBER 31, 2006

BY THE

OFFICE OF INSURANCE REGULATION

TABLE OF CONTENTS

LETTER OF TRANSMITTAL	-
SCOPE OF EXAMINATION	1
STATUS OF ADVERSE FINDINGS FROM PRIOR EXAMINATION	2
HISTORY	3
GENERAL	3
CAPITAL STOCK	4
PROFITABILITY OF COMPANY	4
DIVIDENDS TO STOCKHOLDERS	5
MANAGEMENT	5
CONFLICT OF INTEREST PROCEDURE.....	6
CORPORATE RECORDS	6
ACQUISITIONS, MERGERS, DISPOSALS, DISSOLUTIONS, AND PURCHASE OR SALES THROUGH REINSURANCE.....	7
SURPLUS DEBENTURES	7
AFFILIATED COMPANIES	7
ORGANIZATIONAL CHART	8
CLAIMS SERVICING AGREEMENT	9
AGENCY AGREEMENT	9
FIDELITY BOND AND OTHER INSURANCE.....	9
PENSION, STOCK OWNERSHIP AND INSURANCE PLANS	10
STATUTORY DEPOSITS.....	10
INSURANCE PRODUCTS AND RELATED PRACTICES.....	11
TERRITORY	11
TREATMENT OF POLICYHOLDERS.....	11
REINSURANCE	11
ASSUMED.....	11
CEDED	11
ACCOUNTS AND RECORDS.....	12
CUSTODIAL AGREEMENT	12
FINANCIAL STATEMENTS PER EXAMINATION.....	13
ASSETS	14
LIABILITIES, SURPLUS AND OTHER FUNDS	15
STATEMENT OF INCOME.....	16
COMMENTS ON FINANCIAL STATEMENTS.....	17
ASSETS	17

LIABILITIES	17
CAPITAL AND SURPLUS	17
COMPARATIVE ANALYSIS OF CHANGES IN SURPLUS.....	18
SUMMARY OF FINDINGS	19
SUBSEQUENT EVENTS.....	20
CONCLUSION	21

Tallahassee, Florida

March 7, 2008

Kevin M. McCarty
Commissioner
Office of Insurance Regulation
State of Florida
Tallahassee, Florida 32399-0326

Dear Sir:

Pursuant to your instructions, in compliance with Section 624.316, Florida Statutes, and in accordance with the practices and procedures promulgated by the National Association of Insurance Commissioners (NAIC), we have conducted an examination as of December 31, 2006, of the financial condition and corporate affairs of:

**CAPACITY INSURANCE COMPANY
1300 SAWGRASS CORPORATE PARKWAY
SUNRISE, FL 33323-2804**

Hereinafter referred to as the "Company". The report of examination is herewith respectfully submitted.

SCOPE OF EXAMINATION

This examination covered the period of January 1, 2006 through December 31, 2006. The Company was last examined by representatives of the Florida Office of Insurance Regulation (Office) as of December 31, 2003. This examination commenced, with planning at the Office, on November 28, 2007, to December 7, 2007. The fieldwork commenced on December 10, 2007, and was concluded as of March 7, 2008.

This financial examination was a financial examination conducted in accordance with the Financial Condition Examiners Handbook, Accounting Practices and Procedures Manual and annual statement instructions promulgated by the NAIC as adopted by Rules 69O-137.001(4) and 69O-138.001, Florida Administrative Code, with due regard to the statutory requirements of the insurance laws and rules of the State of Florida.

In this examination, emphasis was directed to the quality, value and integrity of the statement of assets and the determination of liabilities, as those balances affect the financial solvency of the Company as of December 31, 2006. Transactions subsequent to year-end 2006 were reviewed where relevant and deemed significant to the Company's financial condition.

The examination included a review of the corporate records and other selected records deemed pertinent to the Company's operations and practices. In addition, the NAIC IRIS ratio reports, the Company's independent audit reports and certain work papers prepared by the Company's independent certified public accountant (CPA) and other reports as considered necessary were reviewed and utilized where applicable within the scope of this examination.

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

Based on the review of the Company's control environment and the materiality level set for this examination, reliance was placed on some of the work performed by the Company's CPA, after verifying the statutory requirements for the following accounts:

Current Federal & Foreign income tax recoverable
Net deferred tax asset

Status of Adverse Findings from Prior Examination

The following is a summary of significant adverse findings contained in the Office's prior examination report as of December 31, 2003, along with resulting action taken by the Company in connection therewith.

Reinsurance

The Company did not report reinsurance recoverable on paid losses as an asset. Instead, it netted these amounts against ceded reinsurance premiums payable. The NAIC Accounting Practices and Procedures Manual, SSAP No. 62, paragraph 19, requires that reinsurance recoverable on paid losses be set up separately as an asset. **Resolution: The Company properly reported reinsurance recoverable on paid losses as an asset as of December 31, 2006.**

Taxes

The Company, in presenting its 2003 income taxes, failed in disclosing the proper federal income tax liability and allocation for this expense in their 2003 annual statement. The stated liability in the 2003 annual statement totaled \$194,613 while the actual expense reported in the

Company's 2003 federal income tax return was \$284,033. **Resolution: The Company properly included all federal income tax liability in the 2006 annual statement.**

Information Technology (IT) Audit Report

In reviewing the IT audit report for significant findings, the report indicated that the Company's IT controls were at acceptable standards/levels except for their contingency planning. The report also stated that some key elements of an adequate recovery plan existed and have been tested (the replication server in Tampa, FL). However, a plan should be developed to assign and communicate responsibilities and to identify a comprehensive task list in the case of an emergency. **Resolution: The Company developed a contingency plan that communicated and assigned responsibilities clearly and identified comprehensive task lists in the case of an emergency as of December 31, 2006.**

HISTORY

General

The Company was incorporated in Florida on April 23, 1986 and commenced business on February 16, 1989, under the name Capacity Insurance Company, to operate as a stock property and casualty insurer in accordance with Section 624.4621, Florida Statutes. The Company specialized in commercial multi-peril coverage for various low-hazard classes of business.

The Company was authorized to transact the following insurance coverage in Florida on December 31, 2006:

Fire	Allied lines
Commercial multiple peril	Burglary and Theft
Inland marine	Glass
Other liability	
Commercial automobile liability	

Auto physical damage

The articles of incorporation and the bylaws were not amended during the period covered by this examination.

Capital Stock

As of December 31, 2006, the Company's capitalization was as follows:

Number of authorized common capital shares	750,000
Number of shares issued and outstanding	750,000
Total common capital stock	\$750,000
Par value per share	\$1.00

Control of the Company was maintained by Frances T. Buto, who owned 100% of the stock issued by the Company.

Profitability of Company

The following table shows the profitability trend (in dollars) of the Company for the period of examination, as reported in the filed annual statements.

	2006	2005	2004
Premiums Earned	2,524,244	3,591,309	1,872,975
Net Underwriting Gain/(Loss)	(861,986)	107,351	(2,550,374)
Net Income	(360,343)	328,937	(2,026,219)
Total Assets	13,045,982	14,299,263	11,440,119
Total Liabilities	7,957,644	9,014,401	6,408,671
Surplus As Regards Policyholders	5,088,338	5,284,859	5,031,448

Dividends to Stockholders

The Company did not pay or declare dividends to its stockholder during the period covered by this examination.

Management

The annual shareholder meeting for the election of directors was held in accordance with Sections 607.1601 and 628.231, Florida Statutes. Directors serving as of December 31, 2006, were:

Directors

Name and Location	Principal Occupation
Donna M. Buto Margate, Florida	CEO
Frances T. Buto Parkland, Florida	Chairperson of the Board
Douglas W. Bullington Southwest Ranches, Florida	President MacNeill Group, Inc.
Stephen Buto Coral Springs, Florida	Executive Vice President
Arnold Zisselman Boca Raton, Florida	CFO

The Board of Directors in accordance with the Company's bylaws appointed the following senior officers:

Senior Officers

Name	Title
Donna M. Buto	CEO
Arnold Zisselman	CFO
Stephen Buto	Executive Vice President
Helen K. Bacon	Senior Vice President

The Company's board appointed several internal committees in accordance with Section 607.0825, Florida Statutes. Following are the principal internal committees and their members as of December 31, 2006:

Audit Committee

Steven Buto¹
Donna M. Buto
Arnold Zisselman

Investment Committee

Donna M. Buto¹
Arnold Zisselman

¹ Chairman

The Audit Committee is solely comprised of management which is not considered independent in accordance with Section 624.424(8) (c), Florida Statutes.

Conflict of Interest Procedure

The Company adopted a policy statement requiring annual disclosure of conflicts of interest in accordance with the NAIC Financial Condition Examiners Handbook.

Corporate Records

The recorded minutes of the shareholder, Board of Directors, and certain internal committees were reviewed for the period under examination. The recorded minutes of the Board adequately documented its meetings and approval of Company transactions and events in accordance with Section 607.1601, Florida Statutes, including the authorization of investments as required by Section 625.304, Florida Statutes.

Acquisitions, Mergers, Disposals, Dissolutions, and Purchase or Sales Through Reinsurance

As of December 31, 2006, the Company had no acquisitions, mergers, disposals, dissolutions, and purchases or sales through reinsurance.

Surplus Debentures

On December 22, 2004, the Company issued a surplus note due on December 31, 2004 in favor of Program Underwriters, Inc. (affiliated company) in the amount of \$1,800,000. Also, on September 29, 2006, the Company issued a surplus note due on September 30, 2026 in favor of Program Underwriters, Inc. in the amount of \$500,000. Interest on these surplus notes were payable semi annually with the prior approval of the Office. Interest was calculated at the prime rate plus 2.75%. The surplus notes issuances were approved by the Office.

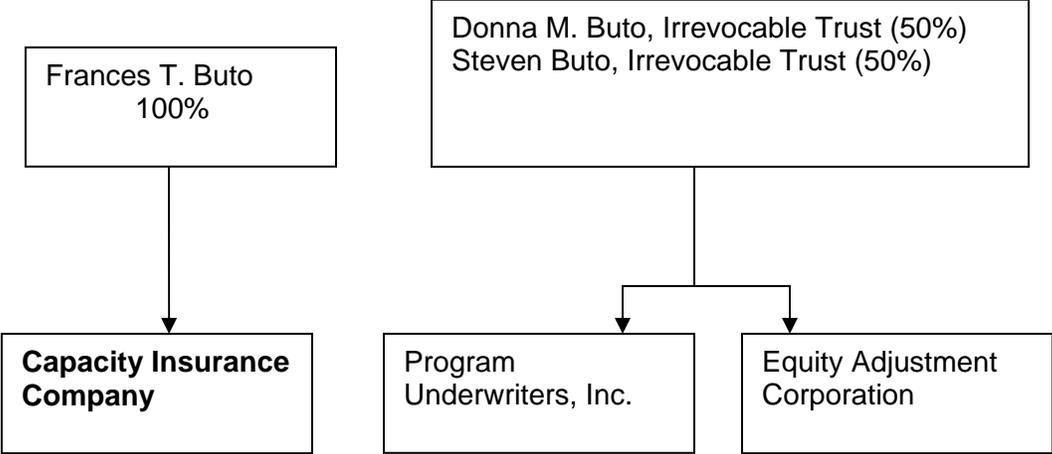
AFFILIATED COMPANIES

The Company was a member of an insurance holding company system as defined by Rule 69O-143.045(3), Florida Administrative Code. The latest holding company registration statement was filed with the State of Florida on February 28, 2007, as required by Section 628.801, Florida Statutes, and Rule 69O-143.046, Florida Administrative Code.

An organizational chart as of December 31, 2006, reflecting the holding company system, is shown below. Schedule Y of the Company's 2006 annual statement provided a list of all related companies of the holding company group.

**CAPACITY INSURANCE COMPANY
ORGANIZATIONAL CHART**

DECEMBER 31, 2006



The following agreements were in effect between the Company and its affiliates:

Claims Servicing Agreement

The Company had an agreement with Equity Adjustment Corporation (EAC) to provide claims handling services. The agreement was entered into on January 1, 1990. The agreement stipulated that EAC provide claims processing services to the policies on behalf of the Company. The original agreement allowed for this service as a fee of 2.5% of gross written premiums. An addendum dated January 1, 1991, changed the agreement to allow for this service on a per claim basis and based on time spent, as payment for claims handling services.

Agency Agreement

The Company had an agreement with Program Underwriters Inc. (PUI) to produce business for which it was paid a commission. The Company agreed to pay PUI 7.5% of the Company's gross written premiums in return for certain administrative services provided by PUI, including but not limited to policy typing and issuance, data processing services, management consulting services and other financial functions.

FIDELITY BOND AND OTHER INSURANCE

The Company along with its affiliates maintained fidelity bond coverage with aggregate limit of \$500,000 with a deductible of \$5,000, which adequately covered the suggested minimum amount of coverage for the Company as recommended by the NAIC.

The Company also maintained workers compensation, commercial property, general liability, commercial crime and business auto coverages as deemed necessary for the operation of an insurance company.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

On May 27, 1996, the Company executed a supplemental participation agreement in which it became a participating employer evidencing the adoption of a 401(K) profit sharing plan and trust, sponsored by Program Underwriters, Inc. for the company employees meeting certain eligibility requirements.

The Company also provided health, dental, life /accidental death and disability coverages for employees meeting eligibility requirements.

STATUTORY DEPOSITS

The following securities were deposited with the State of Florida as required by Section 624.411, Florida Statutes:

State	Description	Par Value	Market Value
FL	US Treasury Notes, 5.5%, 02/15/2008	\$ 401,300	\$ 402,220
TOTAL FLORIDA DEPOSITS		<u>\$ 401,300</u>	<u>\$ 402,220</u>
TOTAL SPECIAL DEPOSITS		<u>\$ 401,300</u>	<u>\$ 402,200</u>

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory

The Company was authorized to transact insurance in the State of Florida only.

Treatment of Policyholders

The Company established procedures for handling written complaints in accordance with Section 626.9541(1) (j), Florida Statutes.

The Company maintained a claims procedure manual that included detailed procedures for handling each type of claim in accordance with Section 626.9541(1) (i) 3a, Florida Statutes.

REINSURANCE

The reinsurance agreements reviewed complied with NAIC standards with respect to the standard insolvency clause, arbitration clause, transfer of risk, reporting and settlement information deadlines.

Assumed

The Company assumed no risk from other companies.

Ceded

The Company ceded risk on a quota share, facultative, and excess of loss basis through Guy Carpenter, a reinsurance intermediary to a majority of authorized and some unauthorized reinsurers. The Company also ceded risk to the Florida Hurricane Catastrophe Fund.

Letters of Credit were properly established for unauthorized reinsurers.

The reinsurance contracts were reviewed by the Company's appointed actuary and were utilized in determining the ultimate loss opinion.

ACCOUNTS AND RECORDS

The Company maintained its principal operational offices in Sunrise, Florida, where this examination was conducted.

An independent CPA audited the Company's statutory basis financial statements annually for the years 2004, 2005 and 2006, in accordance with Section 624.424(8), Florida Statutes. Supporting work papers were prepared by the CPA as required by Rule 69O-137.002, Florida Administrative Code.

The Company's accounting records were maintained on a computerized system. The Company's balance sheet accounts were verified with the line items of the annual statement submitted to the Office.

The Company and non-affiliates had the following agreements:

Custodial Agreement

The Company entered into a custodial agreement with Regions Bank (formerly Union Planters Bank) on April 30, 2002. Regions Bank is a national bank and met the requirements of an Agent or Custodian in the State of Florida. The custodial agreement with Regions Bank was in compliance with Rule 69O-143.042, Florida Administrative Code.

FINANCIAL STATEMENTS PER EXAMINATION

The following pages contain financial statements showing the Company's financial position as of December 31, 2006, and the results of its operations for the year then ended as determined by this examination. Adjustments made as a result of the examination are noted in the section of this report captioned, "Comparative Analysis of Changes in Surplus."

CAPACITY INSURANCE COMPANY
Assets

DECEMBER 31, 2006

	Per Company	Examination Adjustments	Per Examination
Bonds	\$7,014,067		\$7,014,067
Cash	2,335,325		2,335,325
Investment income due & accrued	93,830		93,830
Aggregate write-in for invested assets			
Agents' Balances:			
Uncollected premium	1,190,694		1,190,694
Deferred premium	532,802		532,802
Reinsurance recoverable	753,049		753,049
Current federal & foreign income tax	55,000		55,000
Net deferred tax asset	462,576		462,576
Aggregate write-in for other than invested assets	608,639		608,639
	<hr/>		
Totals	\$13,045,982		\$13,045,982
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CAPACITY INSURANCE COMPANY
Liabilities, Surplus and Other Funds

DECEMBER 31, 2006

	Per Company	Examination Adjustments	Per Examination
Losses	\$2,079,023		\$2,079,023
Loss adjustment expenses	271,742		271,742
Other expenses	3,526		3,526
Taxes, licenses and fees	372,568		372,568
Unearned premium	3,269,940		3,269,940
Ceded reinsurance premiums payable	712,500		712,500
Funds held under reinsurance treaties	23,345		23,345
Provision for reinsurance	225,000		225,000
Payable to parent, subsidiaries and affiliates	<u>1,000,000</u>		<u>1,000,000</u>
 Total Liabilities	 \$7,957,644		 \$7,957,644
 Common capital stock	 \$750,000		 \$750,000
Surplus notes	2,300,000		2,300,000
Gross paid in and contributed surplus	2,063,800		2,063,800
Unassigned funds (surplus)	<u>(25,462)</u>		<u>(25,462)</u>
Surplus as regards policyholders	<u>\$5,088,338</u>		<u>\$5,088,338</u>
Total liabilities, surplus and other funds	<u><u>\$13,045,982</u></u>		<u><u>\$13,045,982</u></u>

CAPACITY INSURANCE COMPANY
Statement of Income

DECEMBER 31, 2006

Underwriting Income		
Premiums earned		\$2,524,244
	Deductions:	
Losses incurred		815,435
Loss expenses incurred		(17,036)
Other underwriting expenses incurred		2,587,831
Aggregate write-ins for underwriting deductions		0
Total underwriting deductions		<u>\$3,386,230</u>
Net underwriting gain or (loss)		(\$861,986)
Investment Income		
Net investment income earned		\$288,200
Net realized capital gains or (losses)		0
Net investment gain or (loss)		<u>\$288,200</u>
Other Income		
Net gain or (loss) from agents' or premium balances charged off		\$3,562
Finance and service charges not included in premiums		23,884
Aggregate write-ins for miscellaneous income		1,115
Total other income		<u>\$28,561</u>
Net income before dividends to policyholders and before federal & foreign income taxes		(\$545,225)
Dividends to policyholders		0
Net Income, after dividends to policyholders, but before federal & foreign income taxes		(\$545,225)
Federal & foreign income taxes		<u>(184,882)</u>
Net Income		(\$360,343)
Capital and Surplus Account		
Surplus as regards policyholders, December 31 prior year		\$5,284,860
Net Income		(\$360,343)
Change in non-admitted assets		(213,886)
Change in provision for reinsurance		(104,000)
Change in deferred income tax		(18,293)
Change in surplus notes		500,000
Examination Adjustment		0
Change in surplus as regards policyholders for the year		<u>(\$196,522)</u>
Surplus as regards policyholders, December 31 current year		<u><u>\$5,088,338</u></u>

COMMENTS ON FINANCIAL STATEMENTS

Liabilities

Losses and Loss Adjustment Expenses

\$2,350,765

An outside actuarial firm appointed by the Board of Directors, rendered an opinion that the amounts carried in the balance sheet as of December 31, 2006, make a reasonable provision for all unpaid loss and loss expense obligations of the Company under the terms of its policies and agreements.

The Office contracted actuary reviewed work papers provided by the Company and was in concurrence with this opinion.

Capital and Surplus

The amount reported by the Company of \$5,088,338, exceeds the minimum of \$4,000,000 required by Section 624.408, Florida Statutes.

A Comparative analysis of changes in surplus is shown below.

**CAPACITY INSURANCE COMPANY
COMPARATIVE ANALYSIS OF CHANGES IN SURPLUS**

DECEMBER 31, 2006

The following is a reconciliation of Surplus as regards policyholders between that reported by the Company and as determined by the examination.

Surplus as Regards Policyholders December 31, 2006, per Annual Statement	\$5,088,338
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	<u>PER COMPANY</u>	<u>PER EXAM</u>	<u>INCREASE (DECREASE) IN SURPLUS</u>
ASSETS:			
No adjustment.			
LIABILITIES:			
No adjustment.			
Net Change in Surplus:			0
Surplus as Regards Policyholders December 31, 2006, Per Examination			\$5,088,338

SUMMARY OF FINDINGS

Compliance with previous directives

The Company has taken the necessary actions to comply with the comments made in the 2003 examination report issued by the Office.

Current examination comments and corrective action

The Company's Audit Committee was comprised of management which is not independent in accordance with Section 624.424 (8) (c), Florida Statutes.

SUBSEQUENT EVENTS

Effective September 1, 2007, The Company entered into an agreement with the MacNeill Group, Inc., to provide general accounting support as needed and as directed by the CFO.

CONCLUSION

The insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Capacity Insurance Company** as of December 31, 2006, consistent with the insurance laws of the State of Florida.

Per examination findings, the Company's Surplus as regards policyholders was \$5,088,338, in compliance with Section 624.408, Florida Statutes.

In addition to the undersigned, Joel Bengo, Financial Examiner II, John Berry, Financial Examiner/Analyst Supervisor, and Bonnie Maxie, FCAS, MAAA, Oliver Wyman Actuarial Consulting, participated in the examination.

Respectfully submitted,

Samita Lamsal
Financial Examiner/Analyst II
Florida Office of Insurance Regulation