

**REPORT ON EXAMINATION**  
**OF**  
**MERCURY INDEMNITY COMPANY OF**  
**FLORIDA**  
**CLEARWATER, FLORIDA**

**AS OF**  
**DECEMBER 31, 2002**

**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 .....	2
General .....	2
Capital Stock.....	4
Profitability.....	4
Dividends to Stockholders.....	4
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 .....	8
Tax Allocation Agreement .....	8
Cost Sharing Agreement.....	9
Management Agreement.....	9
MGA Agreement .....	9
ORGANIZATIONAL CHART .....	10
FIDELITY BOND AND OTHER INSURANCE .....	11
PENSION, STOCK OWNERSHIP, AND INSURANCE PLANS.....	11
STATUTORY DEPOSITS .....	11
INSURANCE PRODUCTS AND RELATED PRACTICES.....	12
Territory and Plan of Operation.....	12
Treatment of Policyholders .....	12
REINSURANCE .....	13
Assumed .....	13
Ceded .....	13

ACCOUNTS AND RECORDS .....	13
Custodial Agreement.....	14
CPA Agreement .....	14
Risk-Based Capital.....	14
FINANCIAL STATEMENTS PER EXAMINATION.....	15
Assets .....	16
Liabilities, Surplus and Other Funds .....	17
Statement of Income .....	18
COMMENTS ON FINANCIAL STATEMENTS.....	19
Assets.....	19
Liabilities .....	19
Other Expenses .....	19
COMPARATIVE ANALYSIS OF CHANGES IN SURPLUS.....	20
SUMMARY OF FINDINGS .....	21
SUBSEQUENT EVENTS.....	21
CONCLUSION .....	25

Tallahassee, Florida

October 24, 2003

Kevin M. McCarty  
Director  
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 (FS), 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, 2002, of the financial condition and corporate affairs of:

**MERCURY INDEMNITY COMPANY OF FLORIDA  
1901 ULMERTON ROAD, SIXTH FLOOR  
CLEARWATER, FLORIDA 33762-2307**

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

## **SCOPE OF EXAMINATION**

This examination covered the period of August 27, 2001 through December 31, 2002. This is the first examination of the Company. This examination commenced with planning at the Office of Insurance Regulation (Office) on May 15, 2003 through May 16, 2003. The fieldwork commenced on May 19, 2003, and was concluded as of October 24, 2003. The examination included any material transactions and/or events occurring subsequent to the examination date and noted during the course of the examination.

This financial examination was a statutory financial examination conducted in accordance with the Financial Examiners Handbook, Accounting Practices and Procedures Manual and Annual Statement Instructions promulgated by the NAIC as adopted by Rules 4-137.001(4) and 4-138.001, Florida Administrative Code (FAC), 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 assets and the determination of liabilities, as those balances affect the financial solvency of the Company.

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 report, the A.M. Best Report, the Company's independent audit reports and certain work papers prepared by the Company's independent certified public accountant were reviewed and utilized where applicable within the scope of this examination.

We valued and/or verified the amounts of the Company's assets and liabilities as reported by the Company in its annual statement as of December 31, 2002. Transactions subsequent to year-end 2002 were reviewed where relevant and deemed significant to the Company's financial condition.

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.

### **Status of Adverse Findings from Prior Examination**

This was the first examination of the Company, therefore no prior examination findings exist.

## **HISTORY**

### **General**

The Company was incorporated in Florida on August 27, 2001, and commenced business on January 2, 2002, as Mercury Indemnity Company of Florida. In 2003, the Company changed its name to Mercury Indemnity Company of America.

In accordance with Section 624.401(1), FS, the Company was authorized to transact the following insurance coverage in Florida on December 31, 2002:

Private Passenger Auto Physical Damage

Private Passenger Auto Liability

The articles of incorporation were amended during the period covered by this examination.

The Company should amend their by-laws, Section 9.07, which incorrectly refers to Section 628.281, FS, because the Company is not exempt from having their records in the State of Florida. The Company is not in compliance with Section 628.271, FS, or Department of Financial Services (DFS) Consent Order 43810-01-CO (12); both of which require the records be in the State of Florida.

## **Capital Stock**

As of December 31, 2002, the Company's capitalization was as follows:

Number of authorized common capital shares	1,000
Number of shares issued and outstanding	1,000
Total common capital stock	\$1,000
Par value per share	\$1.00

Control of the Company was maintained by its parent, Mercury General Corporation (MGC). MGC owned 100 percent of the stock issued by the Company. MGC was a publicly traded insurance holding company domiciled in the State of California.

The Company amended its Articles of Incorporation in 2003, changing its capital stock from 1000 shares at \$1.00 per share to 1,200,000 shares at \$1.00 per share. The amended Articles of Incorporation were approved by the Office.

The Company was unable to provide the original stock ledger book; therefore, the Company was not in compliance with Section 607.1601(3), FS.

## **Profitability of Company**

The Company reported no direct premiums. The Company reported net income after taxes, of \$50,890.

## **Dividends to Stockholders**

In accordance with Section 628.371, FS, the Company did not declare or pay dividends to its stockholder in 2002.

## Management

The annual shareholder meeting for the election of directors was held in accordance with Section 607.1601 and 628.231, FS. The Company has a Treasurer, but the shareholder meeting did not include the election of a Treasurer. The Company is required to maintain a position of Treasurer as stated in their by-laws and to comply with Section 607.08401(1), FS. Directors serving as of December 31, 2002, were:

### Directors

<b>Name and Location</b>	<b>Principal Occupation</b>
Bruce Bunner Fairfield, CT	Director Retired President, FSL Group
Gabriel Tirador Tustin, CA	Director President/COO, MGC & Subsidiaries
George Joseph Los Angeles, CA	Director/Chairman CEO, MGC & Subsidiaries
Judith Ann Walters Oxnard, CA	Director VP/Corp. Sec., MGC & Subsidiaries
Donald Patrick Newell Rancho Sante Fe, CA	Director Senior VP, The SCPIE Cos.

The Board of Directors in accordance with the Company's bylaws appointed the following senior officers, with the exception of the Treasurer as noted above:

### Senior Officers

<b>Name</b>	<b>Title</b>
Gabriel Tirador	President
George Joseph	Treasurer
Judith Ann Walters	Secretary
Theodore Robert Stalick	Vice President

Jack Dougherty

Vice President

The Company's board appointed one internal committee in accordance with Section 607.0825, FS. Following is the principal internal board committee and its members as of December 31, 2002:

<b>Executive Committee</b>	<b>Audit Committee</b>	<b>Investment Committee</b>
None	None	George Joseph Gabriel Tirador Chris Graves Richard Grayson

The Company did not maintain an audit committee, as required by Section 624.424(8), FS.

#### **Conflict of Interest Procedure**

The Company had adopted a policy statement in their Employee Handbook, but did not maintain a Conflict of Interest Statement, which officers and directors could utilize to disclose information regarding related party conflicts, in violation of Rule 4-138.001(1), FAC.

#### **Corporate Records**

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

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

The Company had no acquisitions, mergers, disposals, dissolutions, purchase or sales through reinsurance.

## **Surplus Debentures**

The Company had no surplus debentures.

## **AFFILIATED COMPANIES**

The Company was a member of an insurance holding company system as defined by Rule 4-143.045(3), FAC. The latest holding company registration statement was filed with the State of Florida on September 8, 2003, as required by Section 628.801, FS, and Rule 4-143.046, FAC.

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

### **Tax Allocation Agreement**

The Company, along with its parent and various affiliated companies, filed a consolidated federal income tax return. On December 31, 2002, the method of allocation between the Company and its parent with respect to the income tax due, required the Company to pay the parent estimated payments on or before the 10<sup>th</sup> day prior to the due date an amount equal to the estimated tax payment that the Company would have had to pay if it had been filing a separate return. Final payment was due on or before the 10<sup>th</sup> day prior to the due date of any such tax payment. The parent and subsidiaries are members of an affiliated group, within the meaning of Section 1504(a) of the Internal Revenue Code. The parties filed the return on a consolidated basis, as required by Section 1502 of the IRS Code.

The Company was not following the repayment due date terms contained in their Tax Allocation Agreement, in violation of Section 607.1601(2), FS and Rule 4-143.047(1)(d), FAC.

The Company was not reporting tax payments to their parent on Schedule Y, Part 2 of the Annual Statement, in violation of Rule 4-137.001(4), FAC.

### **Cost Sharing Agreement**

The Company did not maintain a Cost Sharing Agreement.

### **Management Agreement**

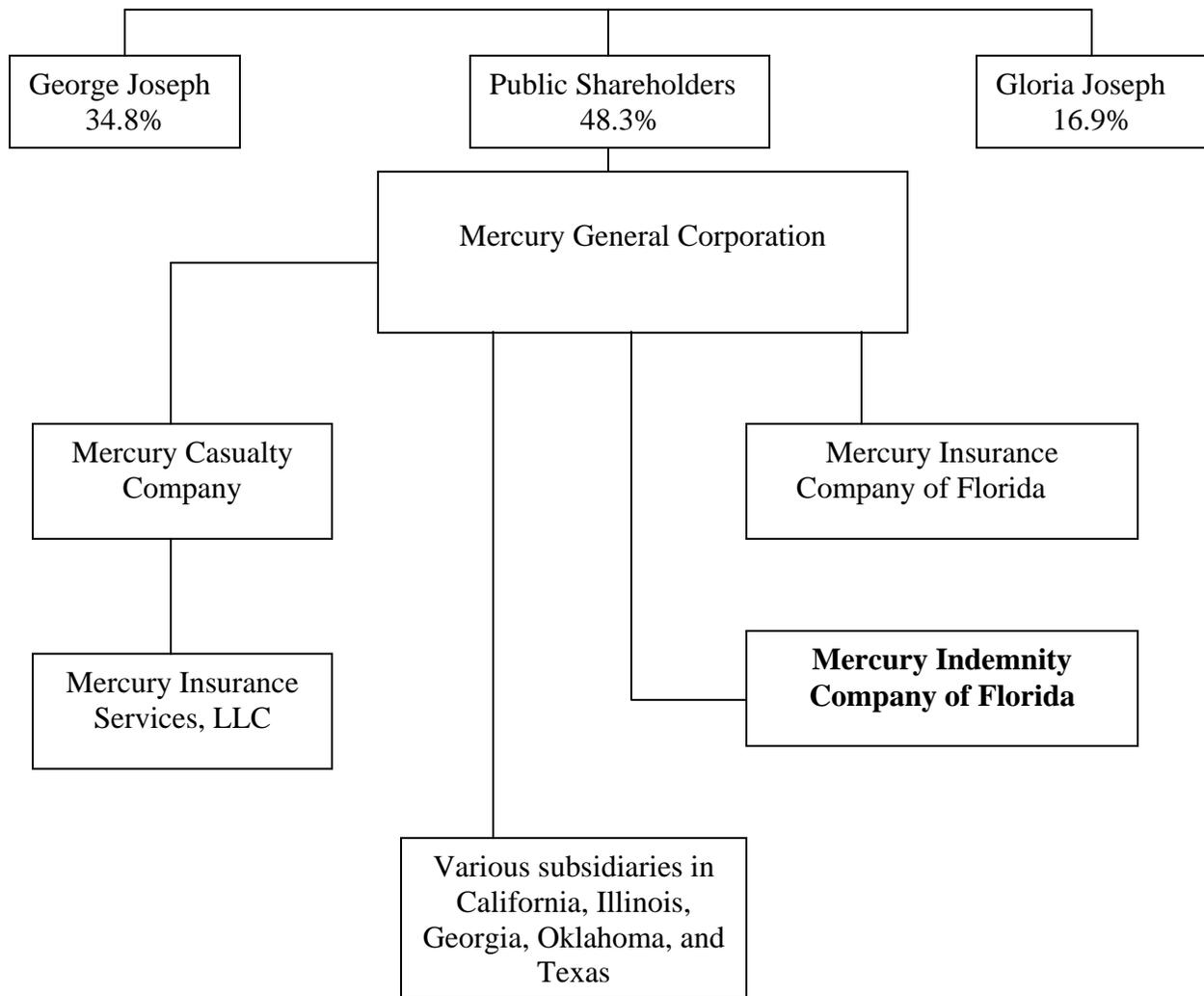
The Company had a Management Agreement with Mercury Insurance Services, LLC (MIS). MIS agreed to manage all of the duties that the Company deemed necessary for the complete operation of the Company. Some of the duties in the Agreement included issue and underwrite insurance, settle and adjust any and all losses and claims, prepare records, perform all operating functions, pay operating expenses, including rent, salaries and phone expense.

### **MGA Agreement**

The Company maintained a Managing General Agency Agreement (MGA) with Mercury Group, Inc. (MGI). The Agreement stated the MGA duties and responsibilities would include, but not be limited to, marketing and sales, underwriting, premium auditing, premium recovery, invoicing and receipts processing, claims administration, safety and loss prevention and policy issuance.

An organizational chart as of December 31, 2002 reflecting the holding company system is shown below. Schedule Y of the Company's 2002 annual statement did not provide a list of all related companies of the holding company group, in violation of Rule 4-137.001(4), FAC.

**MERCURY INDEMNITY COMPANY OF FLORIDA  
ORGANIZATIONAL CHART  
DECEMBER 31, 2002**



## FIDELITY BOND AND OTHER INSURANCE

The Company maintained fidelity bond coverage up to \$2,500,000 with a deductible of \$100,000, which adequately covered the suggested minimum amount of coverage for the Company as recommended by the NAIC.

## PENSION, STOCK OWNERSHIP, AND INSURANCE PLANS

The Company did not have any employees.

## STATUTORY DEPOSITS

The following securities were deposited with the State of Florida as required by Section 624.411, FS., and with various state officials as required or permitted by law:

State	Description	Par Value	Market Value
FL	US TNOTE 5%, 08/15/11	<u>\$ 350,000</u>	<u>\$ 383,796</u>
TOTAL FLORIDA DEPOSITS		<u>\$ 350,000</u>	<u>\$ 383,796</u>

## **INSURANCE PRODUCTS AND RELATED PRACTICES**

There was no current market conduct examination by the Office.

### **Territory and Plan of Operation**

The Company was authorized to transact insurance in Florida only, in accordance with Section 624.401(2), FS.

### **Treatment of Policyholders**

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

## **REINSURANCE**

### **Assumed**

The Company assumed no business.

### **Ceded**

The Company ceded no business.

## **ACCOUNTS AND RECORDS**

An independent CPA audited the Company's statutory basis financial statements annually for the years 2001 and 2002, in accordance with Section 624.424(8), FS. Supporting work papers were prepared by the CPA as required by Rule 4-137.002, FAC.

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, except where noted in this report.

The Company maintained its principal operational offices in Clearwater, Florida, where this examination was conducted. The Company's accounting office was located in Los Angeles, California, in violation of Section 628.271(1), FS.

The Company and non-affiliates had the following agreements:

### **Custodial Agreement**

The Company maintained a Custodial Agreement with the Bank of New York Trust Company. The Agreement was in compliance with Rule 4-143.042(1), FAC.

### **Independent Auditor Agreement**

The Company maintained a contract with an external CPA to perform the annual audit, in compliance with Section 624.424(8), FS.

### **Risk-Based Capital**

The Company reported its risk-based capital at an adequate level.

### **IT Report**

Computer Aid, Inc. performed a computer systems evaluation on the Company. Results of the examination were noted in the Information Technology (IT) Report provided to the Company. A summary of those findings were as follows:

Major initiatives in disaster recovery and the renovations of the data center are scheduled to be implemented over the next few months. When these are in place the system of IT controls at Mercury will be adequate.

The IT examiners had numerous recommendations for the company including, but not limited to:

1. IT department should have a written strategic plan
2. Consideration should be given to consolidating all IT resources under one organization
3. Consideration should be given to formalizing sponsor signoff prior to release and to collect satisfaction feedback after change in controls
4. A User Satisfaction Survey should be sent to appropriate user community
5. Complete planned renovations to the data center as soon as possible

6. Inventory of IT assets should be conducted and asset tags affixed to equipment
7. Sensitive written procedures should be reviewed on a scheduled basis
8. Consider creating a cross-functional Security Incident Response Team
9. Formal penetration tests should be run at least once a year by an independent third party

### **FINANCIAL STATEMENTS PER EXAMINATION**

The following pages contain financial statements showing the Company's financial position as of December 31, 2002, 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."

**MERCURY INDEMNITY COMPANY OF FLORIDA**  
**Analysis of Assets**

**DECEMBER 31, 2002**

Classification	Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	\$358,316		\$358,316
Cash:			
On deposit	54,846		54,846
Short Term Investments	4,665,403		4,665,403
Interest & dividend income due	7,162		7,162
Totals	\$5,085,727	\$0	\$5,085,727

**MERCURY INDEMNITY COMPANY OF FLORIDA**  
**Liabilities, Surplus and Other Funds**

**DECEMBER 31, 2002**

Liabilities	Per Company	Examination Adjustments	Per Examination
Taxes, licenses and fees	\$712		\$712
Federal and foreign income taxes	5,000		5,000
Payable to parent, subsidiaries and affiliates	<u>5,994</u>		<u>5,994</u>
Total Liabilities	\$11,706		\$11,706
Common capital stock	1,000		1,000
Gross paid in and contributed surplus	4,999,000		4,999,000
Unassigned funds (surplus)	<u>74,021</u>		<u>74,021</u>
Surplus as regards policyholders	<u>\$5,074,021</u>		<u>\$5,074,021</u>
Total liabilities, capital and surplus	<u><u>\$5,085,727</u></u>	<u>\$0</u>	<u><u>\$5,085,727</u></u>

MERCURY INDEMNITY COMPANY OF FLORIDA

Statement of Income  
DECEMBER 31, 2002

**Underwriting Income**

Premiums earned	\$0
DEDUCTIONS:	
Losses incurred	0
Loss expenses incurred	0
Other underwriting expenses incurred	10,564
Aggregate write-ins for underwriting deductions	0
Total underwriting deductions	<u>\$10,564</u>
Net underwriting gain or (loss)	(\$10,564)

**Investment Income**

Net investment income earned	\$100,587
Net realized capital gains or (losses)	(8,133)
Net investment gain or (loss)	<u>\$92,454</u>

**Other Income**

Net gain or (loss) from agents' or premium balances charged off	\$0
Finance and service charges not included in premiums	0
Aggregate write-ins for miscellaneous income	0
Total other income	<u>\$0</u>

Net income before dividends to policyholders and before federal & foreign income taxes	\$0
Dividends to policyholders	81,890
Net Income, after dividends to policyholders, but before federal & foreign income taxes	<u>\$81,890</u>
Federal & foreign income taxes	<u>31,000</u>
Net Income	<u><u>\$50,890</u></u>

**Capital and Surplus Account**

Surplus as regards policyholders, December 31, 2001	\$5,023,131
---	-------------

**Gains and (Losses) in Surplus**

Net Income	\$50,890
Net unrealized capital gains or losses	0
Change in net deferred income tax	0
Change in non-admitted assets	0
Capital changes: Paid in	0
Cumulative effect of changes in accounting principles	0
Examination Adjustment	0
Change in surplus as regards policyholders for the year	<u>\$50,890</u>
Surplus as regards policyholders, December 31, 2002	<u><u>\$ 5,074,021</u></u>

## COMMENTS ON FINANCIAL STATEMENTS

### Assets

**Cash** \$54,846

The Company was not maintaining all of its assets in Florida. The Company was maintaining its cash in a California bank, Bank of America, in violation of Section 628.271(2), FS.

### Liabilities

**Other Expenses** \$0

The Company did not accrue Other Expenses on the Annual Statement, in violation of Section 625.041(4), FS. No adjustments were made to Surplus as reported on the Annual Statement due to the immateriality of the dollar amounts of those adjustments.

**MERCURY INDEMNITY COMPANY OF FLORIDA**  
**Comparative Analysis of Changes in Surplus**

**DECEMBER 31, 2002**

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 per December 31, 2002, Annual Statement	\$5,074,021
---	-------------

	<u>PER COMPANY</u>	<u>PER EXAM</u>	<u>INCREASE (DECREASE) IN SURPLUS</u>
ASSETS:			
	\$0	\$0	\$0
LIABILITIES:			
	\$0	\$0	\$0
Net Change in Surplus:			0
Surplus as Regards Policyholders December 31, 2002, Per Examination			\$5,074,021

## SUMMARY OF FINDINGS

### **Current examination comments and corrective action**

The following is a brief summary of items of interest and corrective action to be taken by the Company regarding findings in the examination as of December 31, 2002.

#### **General**

The Company did not disclose all payments to its parent, MGC, under their tax allocation agreement on Schedule Y, Part 2 of the Annual Statement. **The Company is directed to comply with Rule 4-137.001(4)(a), FAC, and report all tax payments on Schedule Y, Part 2, as required by the NAIC's Annual Statement Instructions, adopted by the State of Florida; in all future filings of the quarterly and annual statements.**

The Company's By-laws incorrectly state the Company is exempt from keeping their records in Florida in accordance with Section 628.281, FS. **The Company is directed to comply with DFS Consent Order No. 43811-01-CO, Sections (12) and (2) and also Section 628.271, FS which states that every domestic insurer shall have an office in this state and shall keep therein complete records of its assets, transactions, and affairs, specifically including: (a) Financial records and (d) Access to all accounting transactions and access in this state, upon demand by the Department, to all original accounting documents.**

**The Company is directed to amend their By-laws to correct Section 9.07 and to make sure all records are in the State of Florida. The Company is to provide documentation of compliance to the Office within 90 days after the report is issued.**

The Company was unable to provide the original stock ledger book. **The Company is directed to comply with Section 607.1601(3), FS which states that a corporation or its agent shall maintain a record of its shareholders in a form that permits preparation of a list of names and addresses of all shareholders in alphabetical order by class showing the number and series of shares held by each. The Company is to provide documentation of compliance to the Office within 90 days after the report is issued.**

The Company did not maintain individual officer and director Conflict of Interest Statements. **The Company is directed to comply with Rule 4-138.001(1), FAC wherein the NAIC Financial Handbook is adopted, which states, per Part 1, Section IV, the examiner shall review conflict of interest statements from management and directors. The Company is directed to comply with Section 607.0832, FS and submit their related party contracts or other transactions for review and approval to the Board of Directors. The Company is to provide documentation of compliance to the Office within 90 days after the report is issued.**

The Company had various findings regarding their IT systems. **The Company is directed to present a plan of action to correct the deficiencies in their systems. The Company is to provide documentation of compliance to the Office within 90 days after the report is issued.**

### **Management**

The Company did not maintain an audit committee. **The Company is directed to comply with Section 624.424(8)(c), FS which states that the board shall establish an audit committee of three or more directors of the insurer or an affiliated company. The Company is to provide documentation of compliance to the Office within 90 days after the report is issued.**

The Company did not have a record of election of a Treasurer as required by their By-laws. The By-laws require a Treasurer shall be chosen annually by the Board of Directors. **The Company is directed to comply with its By-laws, and the following Statutes: Section 607.0701(1), FS which states that a corporation shall hold a meeting of shareholders annually, for the election of directors; Section 607.08401(1), FS which states that a corporation shall have the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws; and Section 607.1601(1), FS which requires them to keep a permanent record of minutes of all meetings of its shareholders and board of directors. The Company is to provide documentation of compliance to the Office within 90 days after the report is issued.**

#### **Management Agreements**

The Company was not paying estimated and final tax payments on schedule per the terms of their Tax Allocation Agreement with MGC. **The Company is to provide documentation of compliance to the Office within 90 days after the report is issued.**

The Company did not maintain a Cost Sharing Agreement. **The Company is directed by the Office to enter into a Cost Sharing Agreement with its affiliates sharing costs at their Clearwater regional office, specifying terms of payment and method of allocation. The Company is to provide documentation of compliance to the Office within 90 days after the report is issued.**

## **Cash**

The Company was not maintaining their cash balance in a Florida bank. **The Company is directed to comply with Section 628.271(2), FS, and maintain its assets in the State of Florida. The Company is to provide documentation of compliance to the Office within 90 days after the report is issued.**

## **Other Expenses**

The Company did not accrue any general office expenses for 2002. **The Company is directed to comply with Section 625.041 (4), FS which states that in any determination of the financial condition of an insurer, liabilities to be charged against its assets shall include: Taxes, expenses, and other obligations due or accrued at the date of the statement. The Company is directed to correctly report account balances on all future annual and quarterly statement filings.**

## CONCLUSION

The customary insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Mercury Indemnity Company of Florida** as of December 31, 2002, consistent with the insurance laws of the State of Florida.

Per examination findings, the Company's surplus as regards policyholders was \$5,074,021, which was in compliance with Section 624.408, FS.

In addition to the undersigned, Mary James, CFE, Financial Examiner/Analyst Supervisor, participated in the examination.

Respectfully submitted,

---

Miriam Bleakley  
Financial Examiner/Analyst II  
Florida Office of Insurance Regulation