

**REPORT ON EXAMINATION**

**OF**

**PRIVILEGE UNDERWRITERS**

**RECIPROCAL EXCHANGE**

**WHITE PLAINS, NEW YORK**

**AS OF**

**DECEMBER 31, 2007**

**BY THE**

**OFFICE OF INSURANCE REGULATION**

## TABLE OF CONTENTS

<b>LETTER OF TRANSMITTAL .....</b>	<b>-</b>
<b>SCOPE OF EXAMINATION.....</b>	<b>1</b>
<b>HISTORY .....</b>	<b>2</b>
GENERAL .....	2
CAPITAL STOCK.....	3
PROFITABILITY OF RECIPROCAL.....	3
DIVIDENDS TO STOCKHOLDERS .....	4
MANAGEMENT .....	4
CONFLICT OF INTEREST PROCEDURE.....	5
CORPORATE RECORDS .....	5
ACQUISITIONS, MERGERS, DISPOSALS, DISSOLUTIONS, AND PURCHASE OR SALES THROUGH REINSURANCE.....	5
SURPLUS DEBENTURES .....	6
<b>AFFILIATED COMPANIES .....</b>	<b>6</b>
<b>FIDELITY BOND AND OTHER INSURANCE.....</b>	<b>7</b>
<b>PENSION, STOCK OWNERSHIP AND INSURANCE PLANS .....</b>	<b>7</b>
<b>STATUTORY DEPOSITS.....</b>	<b>8</b>
<b>INSURANCE PRODUCTS AND RELATED PRACTICES.....</b>	<b>8</b>
TERRITORY AND PLAN OF OPERATIONS .....	8
TREATMENT OF POLICYHOLDERS.....	8
<b>REINSURANCE .....</b>	<b>9</b>
ASSUMED.....	9
CEDED .....	9
<b>ACCOUNTS AND RECORDS.....</b>	<b>10</b>
CUSTODIAL AGREEMENT .....	10
ATTORNEY-IN-FACT AGREEMENT .....	11
INFORMATION TECHNOLOGY REPORT.....	12
<b>FINANCIAL STATEMENTS PER EXAMINATION.....</b>	<b>13</b>
ASSETS .....	14
LIABILITIES, SURPLUS AND OTHER FUNDS .....	15
STATEMENT OF INCOME.....	16
<b>COMMENTS ON FINANCIAL STATEMENTS.....</b>	<b>17</b>
LIABILITIES .....	17
SURPLUS .....	17
<b>COMPARATIVE ANALYSIS OF CHANGES IN SURPLUS.....</b>	<b>18</b>

<b>SUMMARY OF FINDINGS .....</b>	<b>19</b>
<b>SUBSEQUENT EVENTS.....</b>	<b>19</b>
<b>CONCLUSION .....</b>	<b>20</b>

Tallahassee, Florida

September 12, 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 Chapter 629, and 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, 2007, of the financial condition and corporate affairs of:

**PRIVILEGE UNDERWRITERS RECIPROCAL EXCHANGE  
ONE NORTH LEXINGTON AVENUE  
WHITE PLAINS, NEW YORK 10601**

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

## **SCOPE OF EXAMINATION**

This examination covered the period of January 23, 2007 through December 31, 2007. This was the Reciprocal's first financial examination. This examination commenced, with planning at the Florida Office of Insurance Regulation (Office), on July 8, 2008 to July 11, 2008. The fieldwork commenced on July 14, 2008 and was concluded as of September 12, 2008.

This financial examination was a statutory financial examination conducted in accordance with the NAIC Financial Condition Examiners Handbook (NAIC 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.

The NAIC Handbook requires that the examination be planned and performed to evaluate the financial condition and identify prospective risks of the Reciprocal by obtaining information about the Reciprocal including corporate governance, identifying and assessing inherent risks within the Reciprocal, and evaluating system controls and procedures used to mitigate those risks. An examination also includes assessing the principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation and management's compliance with Statutory Accounting Principles and annual statement instructions when applicable to domestic state regulations.

All accounts and activities of the Reciprocal were considered in accordance with the risk-focused examination process.

The examination included a review of the corporate records and other selected records deemed pertinent to the Reciprocal's operations and practices. In addition, the NAIC IRIS ratio reports, the Reciprocal's independent audit reports and certain work papers prepared by the Reciprocal's independent certified public accountant (CPA) 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.

## **HISTORY**

### **General**

The Reciprocal was organized in Florida on January 23, 2007 as a reciprocal insurer and commenced business on January 29, 2007 as Privilege Underwriters Reciprocal Exchange. The Reciprocal was a non-assessable unincorporated aggregation of subscribers governed by a Subscribers Advisory Committee (SAC) which is similar to a board of directors.

The Reciprocal was managed by its Attorney-in-Fact (AIF), Pure Risk Management, L.L.C. The AIF managed all of the operations of the Reciprocal and was owned by Privilege Underwriters, Inc.

The Reciprocal was initially capitalized with \$10 Million of surplus notes.

The Reciprocal was party to Consent Order No. 88701-06-CO filed January 16, 2007 with the Office regarding the application for the issuance of a certificate of authority. The Reciprocal was in compliance with that order.

The Reciprocal was authorized to transact the following insurance coverage in Florida on December 31, 2007:

Homeowners multi peril	Inland marine
Other liability	Private passenger auto liability
Private passenger auto physical	

The SAC Charter was not amended during the period covered by this examination.

### **Capital Stock**

The Reciprocal was a non-assessable reciprocal and therefore had no capital stock.

### **Profitability of Reciprocal**

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

	<b>2007</b>
Premiums Earned	1,989,299
Net Underwriting Gain/(Loss)	(2,956,544)
Net Income	(3,410,591)
Total Assets	59,393,434
Total Liabilities	10,269,770
Surplus As Regards Policyholders	49,123,664

## **Dividends to Stockholders**

The Reciprocal was organized as a non-assessable reciprocal insurer and therefore had no stockholders.

## **Management**

The annual SAC meeting was held in accordance with Section 629.201, Florida Statutes. A document titled "Powers of the Subscriber's Advisory Committee" sets forth the terms and conditions upon which the SAC shall operate. Members serving as the SAC as of December 31, 2007 were:

### **Subscriber Advisory Committee Members**

#### **Name and Location**

#### **Principal Occupation**

Ross Buchmueller  
White Plains, New York

President  
Privilege Underwriters Reciprocal Exchange

William W. Wilson  
Key Largo, Florida

President  
RefocuX, Inc.

Javier Holtz  
Miami, Florida

Retired  
Bank Executive

Subsequent to December 31, 2007 the following changes were made to the SAC members:

Javier Holtz resigned effective May 23, 2008

Ross Buchmueller resigned as Chairman on May 23, 2008

Doug Fields, Weston, Florida, was elected to the Committee on May 23, 2008

William W. Wilson was elected Chairman on May 23, 2008

Harold Bitler, Hilton Head, South Carolina, was elected to the Committee on August 23,

2008

The Reciprocal was managed by its AIF, Pure Risk Management, L.L.C. The following were senior officers of the AIF:

#### **Senior Officers**

<b>Name</b>	<b>Title</b>
Ross Buchmueller	President
Martin Hartley	Executive Vice President and COO
Jeffrey Paraschac	Senior Vice President and CFO

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

The Reciprocal did not have a Conflict of Interest Procedure for completing conflict of interest statements annually.

#### **Corporate Records**

The recorded minutes of the SAC were reviewed for the period under examination and to the end of the examination field work. The recorded minutes of the SAC adequately documented its meetings and approval of Reciprocal transactions 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**

The Reciprocal had no acquisitions, mergers, disposals, dissolutions and purchase or sales through reinsurance during the period under examination.

## **Surplus Debentures**

The Reciprocal had the following surplus debentures as of December 31, 2007.

Trident III, L. P. issued \$9,762,600 on January 25, 2007 with an interest rate of 11.89% with no due date.

Trident III Professional Fund L. P. issued \$237,400 on January 25, 2007 with an interest rate of 11.89% with no due date.

Privilege Underwriters, Inc. issued \$24,000,000 on June 4, 2007 with an interest rate of 10.75% with no due date.

State Board of Administration of Florida issued \$17,000,000 on June 13, 2007 with an interest rate of 5.00% due June 13, 2027.

All surplus notes have restrictions which require the approval of the Office before payment of interest or repayment of principal.

## **AFFILIATED COMPANIES**

The Reciprocal was not a member of an insurance holding company system as defined by Rule 69O -143.045(3), Florida Administrative Code.

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

## **Subscribers Agreement and Power of Attorney**

Each new Subscriber signs a Subscriber's Agreement and Power of Attorney which appointed Pure Risk Management, LLC as the AIF which allowed the AIF to conduct the lawful business of the Reciprocal. Each Subscriber agreed to make a surplus contribution for five years. The surplus contribution was a percentage of the policy premium and was 10% for Homeowner and Watercraft policies and 4% for all other policies.

## **FIDELITY BOND AND OTHER INSURANCE**

The AIF managed the affairs of the Reciprocal. The AIF filed with the Office a bond in the sum of \$100,000 in aggregate form in favor of the State of Florida, for the benefit of all persons damaged as a result of a breach by the AIF from the conditions of the bond. This adequately adhered to the suggested minimum amount of coverage as required in Section 629.121, Florida Statutes.

The Reciprocal also maintained Directors and Officers (D&O) liability insurance coverage limits of \$5,000,000 and deductibles ranging from \$25,000 to \$50,000. In addition to the primary Directors and Officers (D&O) coverage, the Reciprocal had D&O Liability Limit excess amount up to \$20,000,000.

## **PENSION, STOCK OWNERSHIP AND INSURANCE PLANS**

The Reciprocal had no employees and therefore had no pension, stock ownership or insurance plans.

## 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
FLORIDA	Cash	\$ 300,000	\$ 300,000
TOTAL FLORIDA DEPOSITS		<u>\$ 300,000</u>	<u>\$ 300,000</u>

## INSURANCE PRODUCTS AND RELATED PRACTICES

### Territory and Plan of Operations

The Reciprocal was authorized to transact insurance only in the State of Florida. The Certificate of Authority was issued to the AIF in accordance with Section 629.091, Florida Statutes.

### Treatment of Policyholders

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

The Reciprocal maintained a claims procedure 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 Reciprocal had no assumed business at December 31, 2007.

### **Ceded**

The reinsurance contracts were reviewed by the Reciprocal's appointed CPA who agreed with the Reciprocal's assessment that there was a transfer of risk with the reinsurance coverage.

All contracts were properly executed, contained the clauses required by Florida Statutes and were signed by the reinsurers within the required time after the effective date of the contract.

As of December 31, 2007, the Reciprocal's reinsurance program consisted of a quota share agreement for each line of business, Florida Hurricane Catastrophe Fund (FHCF) and property excess of loss reinsurance for catastrophic events. The Reciprocal's primary reinsurance contract was the property quota share agreement effective January 1, 2007 to June 1, 2008. The reinsurers were with ACE Tempest Re on behalf of ACE Property and Casualty Insurance Company, Arch Reinsurance Ltd, Everest Reinsurance, Flagstone Reinsurance Ltd, Folksamerica Reinsurance and Lloyd's Syndicate Ltd. The property contract coverage was for 85% of all losses, net of other reinsurance coverage. The limit of liability subject to this contract was \$5 million with respect to each and every risk.

The ceding of net premium stipulated in the contract between the Reciprocal and the reinsurers was a commission of 26.5% on all premiums ceded. The Reciprocal was to allow the reinsurer return commissions at the same rate.

## **ACCOUNTS AND RECORDS**

The Reciprocal maintained its principal operational office in White Plains, New York where this examination was conducted.

An independent CPA audited the Reciprocal's statutory basis financial statements for 2007 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 Reciprocal's accounting records, underwriting and claims were maintained on a computerized system. The Reciprocal's balance sheet accounts were verified with the line items of the annual statement submitted to the Office.

The Reciprocal had the following non - affiliate agreements:

### **Custodial Agreement**

The Reciprocal entered into a custodial agreement with Commerce Bank, National Association dated May 2, 2007. The agreement did not contain all the requirements of Rule 690-143.042 (2), (g), (h), (i) and (l),

(g) The custodian and its agents shall be required to send to the insurance company all reports which they receive from a clearing corporation their respective systems of internal

accounting control and reports prepared by outside auditors on the custodians or its agent's internal accounting control of custodied securities that the insurance company may reasonably request.

(h) The custodian shall maintain records sufficient to determine and verify information relating to custodied securities that may be reported in the insurance company's Annual Statement and supporting Schedules and information required in any audit of the financial statements of the insurance company.

(i) The custodian shall provide, upon written request from the Office or from an appropriate officer of the insurance company, the appropriate affidavits on Forms OIR-A1-341 (A), (B), or (C) (rev. 12-07, or substantially similar forms with respect to custodied securities. Form OIR-A1-341 (A), (B) and (C) (rev. 12-07), entitled "Custodian Affidavit," are hereby incorporated by reference. These forms shall become effective on the effective date of these rules and may be obtained from the Office of Insurance Regulation Larson Building, Tallahassee, Florida.

(l) In the event that there is a loss of custodied securities for which the custodian shall be obligated to indemnify the insurance company as provided in paragraph (k) above, the custodian shall promptly replace the securities or the value thereof and the value of any loss of rights or privileges resulting from said loss of securities.

**Subsequent Event:** On September 12, 2008, the Company provided a custodial agreement that was in compliance.

### **Attorney-in-Fact Agreement**

The Reciprocal, being a non-assessable reciprocal insurer and as prescribed by Chapter 629, Florida Statutes, entered into an Attorney-in-Fact agreement with the AIF, Pure Risk Management, LLC on January 24, 2007. The agreement provided, in general, that the AIF manage the affairs of

the Reciprocal to include premiums and claims administration services and periodic reporting of the Reciprocal's financials to the SAC.

For providing the services, excluding claim handling, AIF was paid a percentage of the total gross written premium and for claim handling services was paid a percentage of gross earned premium. Loss adjustment expenses, in excess of \$2,500 per claim, were paid by the Reciprocal.

The agreement will continue in effect for a 5 year term. Thereafter it will automatically renew for additional one year terms.

### **Information Technology Report**

Jennan Enterprises conducted an onsite limited Information Systems (IS) examination of the Reciprocal. Results of the evaluation were noted in the IS report provided to the Reciprocal.

## **FINANCIAL STATEMENTS PER EXAMINATION**

The following pages contain financial statements showing the Reciprocal's financial position as of December 31, 2007, and the results of its operations for the year then ended as determined by this examination.

**PRIVILEGE UNDERWRITERS RECIPROCAL EXCHANGE**  
**Assets**

**DECEMBER 31, 2007**

<b>Classification</b>	<b>Per Company</b>	<b>Examination Adjustments</b>	<b>Per Examination</b>
Bonds	\$46,183,334		\$46,183,334
Cash and short-term investments	6,380,341		6,380,341
Investment income due and accrued	281,729		281,729
Uncollected premiums	989,970		989,970
Deferred premiums	4,680,242		4,680,242
Amounts recoverable from reinsurers	153,002		153,002
Receivable from Attorney in Fact	724,816		724,816
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Totals	\$59,393,434	\$0	\$59,393,434
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**PRIVILEGE UNDERWRITERS RECIPROCAL EXCHANGE**  
**Liabilities, Surplus and Other Funds**

**DECEMBER 31, 2007**

<b>Liabilities</b>	<b>Per Company</b>	<b>Examination Adjustments</b>	<b>Per Examination</b>
Losses	\$405,024		\$405,024
Loss adjustment expenses	252,836		252,836
Commissions payable	691,747		691,747
Other expenses	212,468		212,468
Taxes, licenses and fees	502,098		502,098
Unearned premium	3,647,796		3,647,796
Advance premium	6,809		6,809
Ceded reinsurance premiums payable	1,395,695		1,395,695
Funds held under reinsurance treaties	2,321,214		2,321,214
Aggregate write-ins for liabilities	<u>834,083</u>		<u>834,083</u>
Total Liabilities	\$10,269,770		\$10,269,770
Surplus notes	\$51,000,000		\$51,000,000
Gross paid in and contributed surplus	1,657,450		1,657,450
Unassigned funds (surplus)	(3,533,786)		(3,533,786)
Surplus as regards policyholders	<u>49,123,664</u>		<u>49,123,664</u>
Total liabilities, capital and surplus	<u>\$59,393,434</u>	\$0	<u>\$59,393,434</u>

**PRIVILEGE UNDERWRITERS RECIPROCAL EXCHANGE**  
**Statement of Income**

**DECEMBER 31, 2007**

**Underwriting Income**

Premiums earned		\$1,989,299
	<b>Deductions</b>	
Losses incurred		\$583,709
Loss expenses incurred		349,615
Other underwriting expenses incurred		4,012,519
Total underwriting deductions		\$4,945,843
Net underwriting gain or (loss)		(\$2,956,544)

**Investment Income**

Net investment income earned		(\$454,242)
Net realized capital gains or (losses)		195
Net investment gain or (loss)		(\$454,047)

Net income before dividends to policyholders and before federal & foreign income taxes		(\$3,410,591)
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**Capital and Surplus Account**

Surplus as regards policyholders, December 31 prior year		\$0
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**Gains and (Losses) in Surplus**

Net Income		(\$3,410,591)
Change in net deferred income tax		1,270,502
Change in non-admitted assets		(1,393,697)
Change in surplus notes		51,000,000
Paid in surplus		1,657,450
Change in surplus as regards policyholders for the year		\$49,123,664
Surplus as regards policyholders, December 31 current year		\$49,123,664

## COMMENTS ON FINANCIAL STATEMENTS

### Liabilities

#### Losses and Loss Adjustment Expenses \$657,860

An outside actuarial firm, appointed by SAC, rendered an opinion that the amounts carried in the balance sheet as of December 31, 2007, make a reasonable provision for all unpaid loss and loss expense obligations of the Reciprocal under the terms of its policies and agreements.

Bartlett Actuarial Group, LTD, an independent actuarial firm, as part of this examination, performed its own analysis and determined the reserves make a reasonable provision for all unpaid loss and loss expense obligations.

### Surplus

#### Surplus as regards policyholders

The amount reported by the Reciprocal of \$49,123,664 exceeded the minimum of \$4,000,000 required by Section 624.408, Florida Statutes.

A comparative analysis of changes in surplus is shown below.

**PRIVILEGE UNDERWRITERS RECIPROCAL EXCHANGE  
COMPARATIVE ANALYSIS OF CHANGES IN SURPLUS**

**DECEMBER 31, 2007**

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, 2007, Annual Statement	\$49,123,664
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	<b>PER COMPANY</b>	<b>PER EXAM</b>	<b>INCREASE (DECREASE) IN SURPLUS</b>
<b>ASSETS:</b>			
No adjustment needed			
<b>LIABILITIES:</b>			
No adjustment needed.			
Net Change in Surplus:			\$0
Surplus as regards policyholders December 31, 2007, Per Examination			\$49,123,664

## **SUMMARY OF FINDINGS**

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

There were no comments or recommendations in the current examination.

## **SUBSEQUENT EVENTS**

Privilege Underwriters, Inc. was granted a Certificate of Authority by the Office effective August 5, 2008, for a new insurance company named Pure Insurance Company (PIC). PIC was capitalized with \$84,000,000 in the form of common stock. The \$84,000,000 was from \$50,000,000 in cash and \$34,000,000 in receivables on Surplus Notes previously issued by the Reciprocal. PIC was formed for the purpose of reinsuring business from the Reciprocal. PIC and the Reciprocal entered into an intercompany reinsurance pooling agreement on a 50/50 basis effective August 5, 2008. A. M. Best assigned PIC and the Reciprocal a rating of A- after these actions were completed.

## CONCLUSION

The customary insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Privilege Underwriters Reciprocal Exchange** as of December 31, 2007, consistent with the insurance laws of the State of Florida.

Per examination findings, the Reciprocal's Surplus as regards policyholders was \$49,123,664, which was in compliance with Section 624.408, Florida Statutes.

In addition to the undersigned, Robert Moore, CFE, Examiner-In-Charge, Kenneth Weine, AIR, MBA of JVP Partners, and Richard Shaffer, Examiner, participated in the examination. We also recognize Jennan Enterprise and Bartlett Actuarial Group, LTD participation in the examination.

Respectfully submitted,

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Kethessa Carpenter, CPA  
Financial Examiner/Analyst Supervisor  
Florida Office of Insurance Regulation