REPORT ON EXAMINATION

OF

CAPITOL PREFERRED INSURANCE COMPANY, INC.

TALLAHASSEE, FLORIDA

AS OF

DECEMBER 31, 2009

BY THE

OFFICE OF INSURANCE REGULATION

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TALLAHASSEE, FLORIDA

December 22, 2010

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, 2009, of the financial condition and corporate affairs of:

CAPITOL PREFERRED INSURANCE COMPANY, INC.
2255 KILLEARN CENTER BLVD, SUITE 101
TALLAHASEE, FLORIDA 32309

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

SCOPE OF EXAMINATION

This examination covered the period of January 1, 2005, through December 31, 2009. The Company was last examined by representatives of the Florida Office of Insurance Regulation (Office) as of December 31, 2004. This examination commenced with planning at the Office on May 12 , 2010, to May 14, 2010. The fieldwork commenced on May 17, 2010, and concluded as of December 22, 2010.

This financial examination was a statutory 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.

The Financial Condition Examiners Handbook requires that the examination be planned and performed 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. 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 Company were considered in accordance with the risk-focused examination process.

This report of examination is confined to significant adverse findings, a material change in the financial statements or other information of regulatory significance or requiring regulatory action. The report comments on matters that involved departures from laws, regulations or rules, or which were deemed to require special explanation or description.

SUMMARY OF SIGNIFICANT FINDINGS

Current Exam Findings

The following is a summary of material adverse findings, significant non-compliance findings, or material changes in the financial statements noted during this examination.

General

The Company had not written insurance coverage in the surety or bail bonds lines of business. If the Company does not write any premiums in a line of business within a calendar year, the Company shall have that line removed from its Certificate of Authority in accordance with Section 624.430, Florida Statutes.

Prior Exam Findings

The following is a summary of significant adverse findings contained in the Office's prior examination report as of December 31, 2004, along with resulting action taken by the Company.

General

The Company had not written insurance coverage in the allied lines and farm owners lines of business in the period covered by this examination. The Company stated that it had every intention of marketing these lines of business in the near future and will concentrate on the small risk in Georgia rather than Florida. **Resolution: The Company wrote insurance coverage in the allied lines and removed farm owners lines of business from its Certificate of Authority.**

Fidelity Bond

The Company maintained fidelity bond coverage up to $350,000 with a deductible of $10,000, which did not reach the suggested minimum coverage as recommended by the NAIC. **Resolution: The Company purchased the minimum amount of fidelity bond coverage as recommended by the NAIC.**

HISTORY

General

The Company was incorporated in Florida on April 9, 1998, and commenced business on May 24, 1998, as Capitol Preferred Insurance Company.

Pursuant to Consent Order 107226-09-CO, filed October 23, 2009, the Company was approved to take up to 25,0000 multiple peril polices from Citizens Property Insurance Corporation (Citizens) pursuant to Citizens' depopulation plan. On December 15, 2009, the Company removed 15,000 policies form Citizens. Of the polices assumed in December 2009, plus the 5,000 policies assumed in February 2010, 76% of the renewals offered were retained through August 31, 2010.

The Company continued to use independent agents to market its products throughout Florida. As of December 31, 2009, the Company was in compliance with the provisions of this Consent Order.

The Company was authorized to transact the following insurance coverage in Florida on December 31, 2009:

Fire	Bail Bonds	Private Passenger Auto Liability*
Homeowners Multi Peril	Surety	PPA Physical Damage*
Mobile Home Multi Peril	Allied Lines	
Mobile Home Physical Damage	Inland Marine*	

The Company had not written insurance coverage in the surety or bail bonds lines of business. The Company was not in compliance with Section 624.430 (1), Florida Statutes, which requires that Company write premiums in a line of business within a calendar year or shall have that line removed from its Certificate of Authority.

Note: *These lines were approved on June 8, 2009, with understanding that the Company anticipated marketing them starting in July, 2010.

The Articles of Incorporation and the Bylaws were not amended during the period covered by this examination.

Dividends to Stockholders

There were no dividends declared or paid to its stockholders during the period covered by the examination.

Capital Stock and Capital Contributions

As of December 31, 2009, the Company's capitalization was as follows:

Common Capital Stock:

Number of authorized common capital shares	20,000
Number of shares issued and outstanding	18,750
Total common capital stock	$1,875,000
Par value per share	$ 100.00

Preferred Capital Stock:

Number of authorized preferred capital shares	100,000
Number of shares issued and outstanding	0
Total preferred capital stock	0.00
Par value per share	$ 100.00

Control of the Company was maintained by its parent, Preferred Holding Company, Inc. (PHC), a Kentucky corporation, who owned 80 percent of the stock issued by the Company, who in turn was 72 percent owned by J.A. PATTCO, Inc. (PATTCO), f/k/a PATTCO, LLC, a privately held corporation, and 20 percent owned by James A. Graganella, an individual.

Surplus Debentures

On January 1, 2009, the Company consolidated and exchanged several surplus notes and debentures issued in 2004 and 2005 with certain of the Company's investors. As of December 2009, there were $17,350,000 surplus notes issued to PHC ($7,240,000), PATTCO, ($6,000,000), Van Fishback ($3,235,000), Robert Fishback ($625,000) and Alan Baker ($250,000). The Company received cash funds for the issuance of these Surplus Notes. The interest rates were amended to the long term applicable federal rates in effect which was more favorable to the Company than the original interest rate. The maturity of all the notes was set to October 31, 2029. Each of the subordinated surplus debentures were amended to set an interest rate of 3.57 percent. The Office approved these actions.

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

There were no acquisitions, mergers, disposals, dissolutions, or purchases or sales through Reinsurance during the period covered by this examination.

CORPORATE RECORDS

The recorded minutes of the shareholder, Board of Directors, (Board), 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.

Conflict of Interest

The Company adopted a policy statement requiring annual disclosure of conflicts of interest in accordance with the NAIC Financial Condition Examiners Handbook adopted by Rule 69O-138.001, Florida Administrative Code.

MANAGEMENT AND CONTROL

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, 2009, were:

Directors

Name and Location	Principal Occupation
James A. Patterson II Louisville, Kentucky	President PATTCO, LLC
Thomas A. Dieruf Louisville, Kentucky	Vice President PATTCO, LLC
Donald D. Buchanan Louisville, Kentucky	Vice President PATTCO, LLC & PATTCO Mgmt. LLC
James A. Graganella Tallahassee, Florida	President/CEO Capitol Preferred Insurance Company
Keith E. Martin Tallahassee, Florida	Vice President/Secretary/Treasurer Capitol Preferred Insurance Company
Alan Baker Brookings, South Dakota	CFO/Director FishBack Financial Corp Brookings

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

Senior Officers

Name	Title
James A. Graganella	President & CEO
Keith E. Martin	Vice President, Secretary & Treasurer

The Company's Board appointed an audit committee in accordance with Section 607.0825, Florida Statutes. Following were the members of the audit committee as of December 31, 2009:

Audit Committee

Thomas A. Dieruf[1]
Donald D. Buchanan
James A. Patterson

Chairman [1]

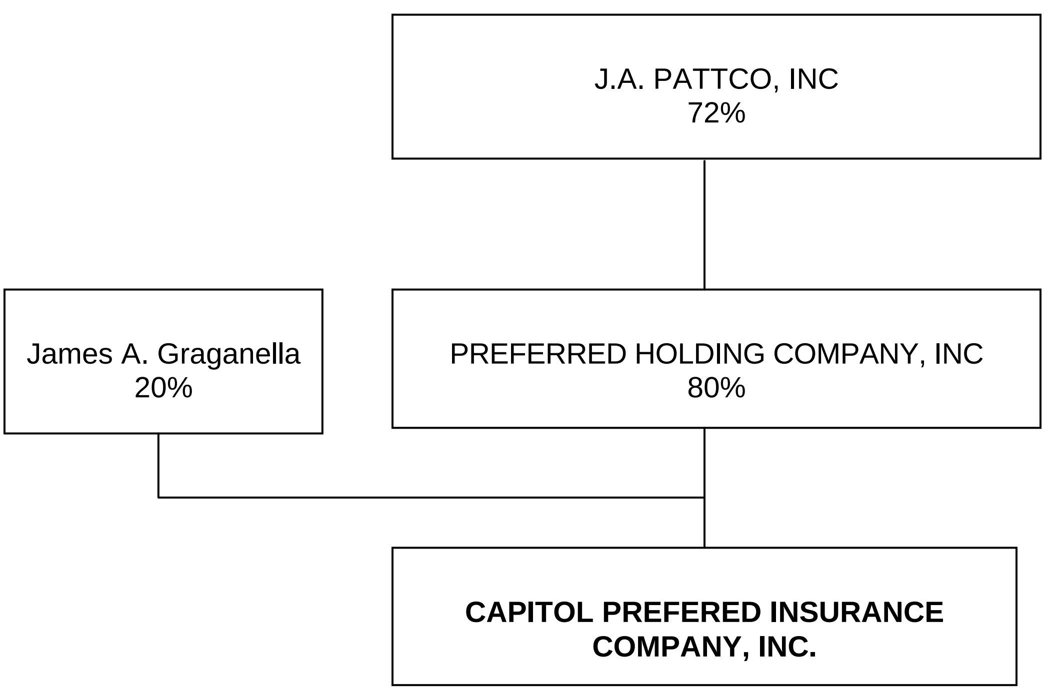
Affiliated Companies

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 10, 2010, as required by Section 628.801, Florida Statutes, and Rule 69O-143.046, Florida Administrative Code.

A simplified organizational chart as of December 31, 2009, reflecting the holding company system, is shown below. Schedule Y of the Company's 2009 annual statement provided a list of all related companies of the holding company group.

CAPITOL PREFEREED INSURANCE COMPANY, INC.
ORGANIZATIONAL CHART

DECEMBER 31, 2009



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

Tax Allocation Agreement

The Company, along with its parent, filed a consolidated federal income tax return. On December 31, 2009, the method of allocation between the Company and its parent was based upon separate return calculations with current credit for net losses.

Managing General Agent Agreement

The Company entered into a Managing General Agent (MGA) Agreement with its affiliate, Preferred Managing Agency, Inc. (PMA) for the insurance policies covering homeowners and fire. PMA provided underwriting and claims handling services and charged a $25 policy fee. PMA had the authority to assist with negotiation of reinsurance; however, PMA did not bind reinsurance.

The Company was authorized to pay to PMA thirty one percent of the earned premiums for the services rendered. Also, the Company, at the sole discretion of the Board, was authorized to pay an additional four percent of the earned premiums when the Company reached appropriate loss ratio and expense levels. There were several addendums to the MGA agreement since the prior examination. The commissions were reduced in the subsequent years (below thirty one percent of the earned premiums) for fire and homeowners lines of business. The forgiveness of commission was provided by PMA to allow the Company the opportunity to increase surplus following the adverse effects of the four hurricanes during 2004. In addition, PMA also absorbed the cost of the loss adjustment expenses associated with those hurricanes.

FIDELITY BOND AND OTHER INSURANCE

The Company along with its parent and PMA maintained fidelity bond coverage up to $1,000,000 with a deductible of $25,000, which reached the suggested minimum as recommended by the NAIC.

The Company also maintained business owners, commercial inland marine, commercial auto, employment practice liability and directors and officers (D&O) liability insurance coverage during the period covered by this examination.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The Company's employees were eligible to participate in a 401 K plan sponsored by PATTCO, the ultimate parent company. Employees were authorized to contribute up to $16,500 per year with the Company matching up to 4% of the participants' compensation.

TERRITORY AND PLAN OF OPERATIONS

The Company was authorized to transact insurance in the following states:

Florida	Georgia	South Carolina

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.

COMPANY GROWTH

The Company experienced a significant net underwriting loss of $8,997,120 in 2005. The damages were caused by four hurricanes that struck Florida during 2004. The balance of all reinsurance protection was exhausted leaving the Company to absorb the difference which impacted earnings by approximately $9.4 million. During 2005, the Company continued to experience loss activities from the 2004 storms. However, the reinsurance in place for the 2005 season provided more than adequate claims protection to the Company. The Company re-capitalized following the 2004 hurricanes by issuing $8,800,000 million in surplus notes to affiliates. The Company re-capitalized again, in 2005, by issuing $8,550,000 in surplus notes to affiliates. The Company was taking out polices from Citizens pursuant to a depopulation plan. The Company continued to utilize independent agents to solicit business and to purchase the usual aggregate reinsurance protection to provide catastrophe loss coverage for a probable 100 year event together with reinstatement premium and third event covers.

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.

	2009	2008	2007	2006	2005
Premiums Earned	12,030,002	11,413,704	15,978,995	10,293,213	11,470,295
Net Underwriting Gain/(Loss)	11,490	(179,522)	1,998,647	(30,605)	(8,997,120)
Net Income	690,071	656,489	3,115,034	781,713	(8,481,954)
Total Assets	35,039,202	30,105,079	31,041,909	29,895,220	19,049,890
Total Liabilities	23,517,406	19,790,629	21,291,199	23,237,021	13,395,000
Surplus As Regards Policyholders	11,521,796	10,314,450	9,750,710	6,658,199	5,654,890

LOSS EXPERIENCE

During 2005, the Company continued to experience loss activities from the 2004 storms. Underwriting Losses decreased significantly in 2006 to $30,605 as the Company settled more claims. In 2008, those Losses were $179,522 and were associated with the assumed book of business from Florida Select related to severe weather losses. The increase in losses, incurred during 2009, was the result of the downturn in the national economy, which fueled additional claims counts and more aggressive fraudulent attention from specific outside entities associated with sinkhole claims, and increased adjustment costs associated with the growth in claims from public adjusters. During 2009, the Company sustained a loss of $2 million net of catastrophe reinsurance recoveries from the wild fires in South Carolina.

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 risk on an excess of loss basis from Citizens Property Insurance Corporation.

Ceded

The Company ceded risk on a quota share, per risk excess of loss, and catastrophe excess of loss to both authorized and non-authorized reinsurers as well as to the authorized mandatory pools. The five largest primary reinsurers were the mandatory pools (Federal Emergency Management Agency (FEMA) and Florida Hurricane Catastrophe Fund); Aspen Insurance Limited; Endurance Specialty Insurance LTD; and Hiscox Insurance Company. Letters of Credit in the amount of $18,343,000 were properly established for Aspen Insurance Limited.

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 Tallahassee, Florida, where this examination was conducted.

An independent CPA audited the Company's statutory basis financial statements annually for the years 2005, 2006 and 2007, 2008 and 2009 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 and non-affiliates had the following agreements:

Custodial Agreement

The Company utilized the investment and custodial services of SunTrust Bank. The custodial agreement was amended on February 1, 2010. The amended custodial agreement met all of the requirements of Rule 69O-143.042, Florida Administrative Code.

Independent Auditor Agreement

The Company maintained an agreement with Chilton & Medley of Louisville, Kentucky to perform audits of the financial statements in accordance with Section 624.424 (8) (a), Florida Statues.

Information Technology Report

Mike Park of Computer Aid, Inc., performed an evaluation of the information technology and computer systems of the Company. Results of the evaluation were noted in the Information Technology Report provided to the Company.

STATUTORY DEPOSITS

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

STATE	Description	Par Value	Market Value
FL	CD, 3.21%, 08/06/05	$ 300,000	$ 300,000
TOTAL FLORIDA DEPOSITS			
GA	USTBDS, 11.5%, 08/15/09	$ 100,010	$ 100,010
SC	USTBDS, 6.25%, 08/15/09	255,596	255,737
TOTAL OTHER DEPOSITS		$ 355,606	$ 355,747
TOTAL SPECIAL DEPOSITS		$655,606	$655,747

FINANCIAL STATEMENTS PER EXAMINATION

The following pages contain financial statements showing the Company's financial position as of December 31, 2009, 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."

CAPITOL PREFERRED INSURANCE COMPANY, INC.
Assets

DECEMBER 31, 2009

	Per Company	Examination Adjustments	Per Examination
Bonds	$12,305,596		$12,305,596
Cash	16,698,744		16,698,744
Investment income due & accrued	135,030		135,030
Uncollected premium	162,367		162,367
Deferred premium	1,587,007		1,587,007
Amounts recoverable from reinsurers	58,223		58,223
Net deferred tax asset	1,043,196		1,043,196
Aggregate write-in for other than invested assets	3,049,039		3,049,039
Totals	$35,039,202	$0	$35,039,202

CAPITOL PREFERRED INSURANCE COMPANY, INC.
Liabilities, Surplus and Other Funds

DECEMBER 31, 2009

	Per Company	Examination Adjustments	Per Examination
Losses	$6,271,691		$6,271,691
Loss adjustment expenses	809,375		809,375
Commimssions Payable	102,051		102,051
Other expenses	49,500		49,500
Taxes, licenses and fees	251,786		251,786
Currnt federal & foreign income taxes	14,000		14,000
Unearned premiums	7,067,041		7,067,041
Advance premium	1,645,907		1,645,907
Ceded reinsurance premiums payable	6,980,270		6,980,270
Funds held by company under reins treaties	159,287		159,287
Amounts withheld by company	20,110		20,110
Provision for reinsurance	2,000		2,000
Aggregate write-ins for liabilities	144,388		144,388
Total Liabilities	$23,517,406	$0	$23,517,406
Common capital stock	$1,875,000		$1,875,000
Surplus Notes	17,350,000		17,350,000
Gross paid in and contributes surplus	3,629,988		3,629,988
Unassigned funds (surplus)	(11,333,192)		(11,333,192)
Surplus as regards policyholders	$11,521,796	$0	$11,521,796
Total liabilities, surplus and other funds	$35,039,202	$0	$35,039,202

CAPITOL PREFERRED INSURANCE COMPANY, INC.
Statement of Income

DECEMBER 31, 2009

Underwriting Income	
Premiums earned	$12,030,002
Deductions:	
Losses incurred	12,106,717
Loss expenses incurred	2,053,077
Other underwriting expenses incurred	(2,141,282)
Aggregate write-ins for underwriting deductions	0
Total underwriting deductions	$12,018,512
Net underwriting gain or (loss)	$11,490
Investment Income	
Net investment income earned	$632,315
Net realized capital gains or (losses)	0
Net investment gain or (loss)	$632,315
Other Income	
Net gain or (loss) from agents' or premium balances charged off	($18,713)
Finance and service charges not included in premiums	78,979
Aggregate write-ins for miscellaneous income	0
Total other income	$60,266
Net income before dividends to policyholders and before federal & foreign income taxes	$704,071
Dividends to policyholders	0
Net Income, after dividends to policyholders, but before federal & foreign income taxes	$704,071
Federal & foreign income taxes	14,000
Net Income	$690,071
Capital and Surplus Account	
Surplus as regards policyholders, December 31 prior year	$10,314,450
Net Income	$690,071
Change in net deferred income tax	513,570
Change in non-admitted assets	5,705
Change in provision for reinsurance	(2,000)
Change in excess statutory over statement reserves	0
Surplus adjustments: Paid in	0
Aggregate write-ins for gains and losses in surplus	0
Examination Adjustment	0
Change in surplus as regards policyholders for the year	$1,207,346
Surplus as regards policyholders, December 31 current year	$11,521,796

A comparative analysis of changes in surplus is shown below.

CAPITOL PREFERRED INSURANCE COMPANY, INC.
Comparative Analysis of Changes In Surplus

DECEMBER 31, 2009

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, 2009, per Annual Statement				$11,521,796
	PER COMPANY	PER EXAM	INCREASE (DECREASE) IN SURPLUS	
ASSETS:	No adjustments			
LIABILITIES:	No adjustments			
Net Change in Surplus:				0
Surplus as Regards Policyholders December 31, 2009, Per Examination				$11,521,796

COMMENTS ON FINANCIAL STATEMENTS

Liabilities

Losses and Loss Adjustment Expenses $7,081,066

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, 2009, made a reasonable provision for all unpaid loss and loss expense obligations of the Company under the terms of its policies and agreements.

The Office engaged Mary Frances Miller, FCAS, MAAA of Select Actuarial Services to review the unpaid loss and loss adjustment expense reserves carried in the Company's balance sheet as of December 31, 2009, and was in concurrence with this opinion.

Capital and Surplus

The amount reported by the Company of $11,521,796, exceeded the minimum of $4,000,000 required by Section 624.408, Florida Statutes.

SUMMARY OF RECOMMENDATIONS

General

We recommend that the Company comply with Section 624.430, Florida Statutes, and write insurance coverage in the surety lines or request that they be removed from its Certificate of Authority.

CONCLUSION

The insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Capitol Preferred Insurance Company, Inc.** as of December 31, 2009, consistent with the insurance laws of the State of Florida.

Per examination findings, the Company's Surplus as regards policyholders was $11,521,796, which exceeded the minimum of $4,000,000 required by Section 624.408, Florida Statutes.

In addition to the undersigned, Mike Young, Financial Examiner/Analyst II, AFE, and Kethessa Carpenter, CPA, Financial Examiner/Analyst Supervisor of the Office and Mike Park, IT Examiner of Computer Aid, Inc., participated in the examination. We also recognize Mary Frances Miller, FCAS, MAAA of Select Actuarial Services participation in the examination.

Respectfully submitted,

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