

Report on Examination
of
Avalon Healthcare, Inc.

Tampa, Florida

as of

December 31, 2006

By The
State of Florida
Office of Insurance Regulation

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Tallahassee, Florida

October 1, 2007

Kevin M. McCarty, Commissioner
Florida Office of Insurance Regulation
200 East Gaines Street
Tallahassee, Florida 32399-0326

Julie McPeak, Executive Director
Kentucky Office of Insurance
Secretary, NAIC Southeastern Zone
P.O. Box 517
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Alfred W. Gross, Commissioner
Virginia Bureau of Insurance
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Commissioners McCarty and Gross and Executive Director McPeak:

Pursuant to your instructions, in compliance with Section 624.316, Florida Statutes (F.S.), 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:

Avalon Healthcare, Inc.
3030 N. Rocky Point Dr., Suite 800
Tampa, Florida 33607

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

SCOPE OF EXAMINATION

This examination covered the period of September 22, 2005 through December 31, 2006. This was the first financial condition examination of the Company by the Florida Office of Insurance Regulation (the "Office").

Planning for the current examination began on April 2, 2007. The fieldwork commenced on April 9, 2007 and concluded on July 11, 2007. The examination included any material transactions and/or events occurring subsequent to the examination date and noted during the course of this examination.

This was a statutory financial condition examination conducted in accordance with the *NAIC Financial Condition Examiners Handbook, Accounting Practices and Procedures Manual, and Annual Statement Instructions* as adopted by Rules 69O-137.001(4) and 69O-138.001, Florida Administrative Code (F.A.C.), with due regard to the 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 they affect the Company's solvency.

The examination included a review of corporate and other selected records deemed pertinent to the Company's operations and practices. In addition, the NAIC Insurance Regulatory Information System (IRIS) ratio results were reviewed and utilized where applicable within the scope of this examination.

We valued and/or verified the Company's assets and liabilities as reported by the Company in its 2006 annual statement. Transactions subsequent to December 31, 2006 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 require special explanation or description.

HISTORY

GENERAL

The Company was incorporated in Florida on July 8, 2005, and commenced business on September 22, 2005.

As of the date of this examination, the Company was authorized to transact accident and health insurance coverage in Florida, in accordance with Section 624.401, F.S.

Neither the Company's articles of incorporation nor its bylaws were amended during the period covered by this examination.

CAPITAL STOCK

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

	<u>As Reported</u>	<u>Per Examination</u>
Number of authorized common capital shares	10,000	10,000
Number of shares issued and outstanding	10,000	100
Total common capital stock	\$10,000	\$100
Par value per share	\$1.00	\$1.00

In its 2006 annual statement, as originally filed, the Company incorrectly reported that 10,000 of its common shares were issued and outstanding in the total amount of \$10,000, rather than 100 shares in the total amount of \$100. On July 9, 2007, the Company filed an amended annual statement and corrected the error.

At December 31, 2006, the Company was wholly-owned and controlled by Avalon Healthcare Holdings, Inc. An abbreviated organizational chart appears on page 6.

PROFITABILITY

For the period of this examination, the Company reported the following:

	<u>2006</u>	<u>2005</u>
Net premiums	\$659,906	\$0
Total revenues	\$667,615	\$0
Net loss	\$2,549,663	\$564,661
Total capital and surplus	\$1,655,702	\$4,234,173

DIVIDENDS

The Company did not pay any shareholder dividends during the period of this examination.

MANAGEMENT

The annual shareholder meeting for the election of directors was held in accordance with Section 607.0701, F.S. Directors serving as of December 31, 2006 were:

Directors	
Name and Location	Principal Occupation
Brett G. Baris New York, New York	General Partner Inter-Atlantic Group
Andrew B. Cassidy Tampa, Florida	Chief Financial Officer and Treasurer Avalon Healthcare, Inc.
Frederick S. Hammer New York, New York	General Partner Inter-Atlantic Group
Henry H. Neely Tampa, Florida	Secretary Avalon Healthcare, Inc.
Charles T. O'Neill Tampa, Florida	President and Chief Executive Officer Avalon Healthcare, Inc.

At December 31, 2006, members of the principal committee of the Board were:

**Executive
Committee**

Andrew B. Cassidy
Charles T. O'Neill

**Audit
Committee**

Brett G. Baris
Andrew B. Cassidy
Charles T. O'Neill

The following were the Company's senior officers as of December 31, 2006, as appointed by its board of directors in accordance with the Company's bylaws:

Senior Officers		
Name		Title
Charles T. O'Neill		President and Chief Executive Officer
Andrew B. Cassidy		Chief Financial Officer and Treasurer
Henry H. Neely		Secretary

CONFLICT OF INTEREST PROCEDURE

The Company adopted a policy statement requiring annual disclosure of conflicts of interest in accordance with Section 607.0832, F.S. No exceptions were noted during this examination.

CORPORATE RECORDS

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

AFFILIATED COMPANIES

The Company was a member of an insurance holding company system as defined by Rule 69O-143.045(3), F.A.C. Its latest holding company registration statement was filed with the State of Florida, as required by Section 628.801, F.S., and Rule 69O-143.046, F.A.C., on February 25, 2005.

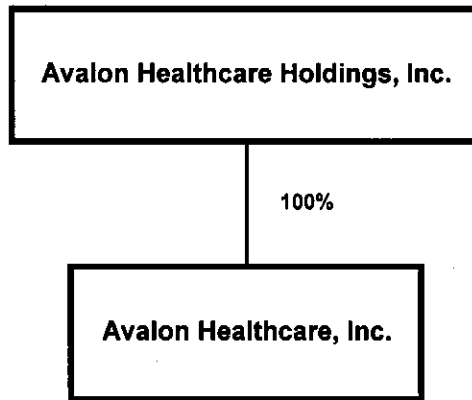
The following agreement was in force between the Company and its affiliates on December 31, 2006:

MANAGEMENT AGREEMENT

Avalon Healthcare Holdings, Inc. provided management services to the Company pursuant to an April 1, 2006 agreement in return for fees which amounted to \$0.6 million and \$2.6 million in years 2005 and 2006, respectively. Services provided included executive management and administration, marketing, accounting and financial support, claims processing and administration, claims analysis and statistical reporting, and utilization management services.

An abbreviated 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 the names of all related companies in the holding company group.

**Avalon Healthcare, Inc.
Organizational Chart
December 31, 2006**



FIDELITY BOND AND OTHER INSURANCE

The Company maintained fidelity bond coverage of up to \$250,000 with a deductible of \$5,000 which adequately covered the suggested minimum amount of coverage for the Company as recommended by the NAIC of \$50,000.

PENSION, STOCK OWNERSHIP, AND INSURANCE PLANS

The Company offered to eligible employees participation in a 401(k) retirement plan.

STATUTORY DEPOSITS

The Company maintained a cash deposit of \$100,000 with the State of Florida as required by Section 624.411, F.S.

INSURANCE PRODUCTS AND RELATED PRACTICES

The Company marketed individual and group accident and health insurance products through licensed agents and brokers.

TERRITORY AND PLAN OF OPERATION

At December 31, 2006, the Company was authorized to transact insurance solely in the State of Florida.

TREATMENT OF POLICYHOLDERS

The Company established procedures for handling written complaints in accordance with Section 626.9541(1)(j), F.S., and maintained a claims procedure manual that included detailed procedures for handling each type of claim.

REINSURANCE

ASSUMED

The Company did not assume insurance during the examination period.

CEDED

The Company maintained reinsurance coverage with General Re Life Corporation on a loss occurring basis of up to \$5 million in losses on covered policies in excess of the first \$100,000 of medical expenses.

ACCOUNTS AND RECORDS

Pursuant to Section 624.424(8)(b), F.S., the Company was exempt from the general requirement to have conducted an annual audit by an independent certified public accountant.

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

The Company's main administrative office was located in Tampa, Florida, where this examination was conducted.

RISK-BASED CAPITAL

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

The following agreement was in effect between the Company and a non-affiliate:

TPA AGREEMENT

Health Network America, Inc. provided third party administrator services to the Company pursuant to a January 1, 2006 agreement. Fees related to this agreement were \$315,041 and \$426,696 in years 2005 and 2006, respectively.

FINANCIAL STATEMENTS PER EXAMINATION

The following four pages contain statements of the Company's financial position at December 31, 2006, as determined by this examination, and the results of its operations for the year then ended as reported by the Company. Adjustments resulting from this examination are summarized on page 16.

Avalon Healthcare, Inc.
Assets
December 31, 2006

	Per Company	Examination Adjustments	Per Examination
Cash, cash equivalents, & short-term investments	\$2,122,744	\$0	\$2,122,744
Investment income due and accrued	<u>5,547</u>	<u>0</u>	<u>5,547</u>
Totals	<u><u>\$2,128,291</u></u>	<u><u>\$0</u></u>	<u><u>\$2,128,291</u></u>

Avalon Healthcare, Inc.
Liabilities, Capital and Surplus
December 31, 2006

Liabilities	Per Company	Examination Adjustments	Per Examination
Claims unpaid	\$6,102	\$0	\$6,102
Unpaid claims adjustment expenses	15,000	0	15,000
Aggregate health claim reserves	201,627	0	201,627
Premiums received in advance	116,504	0	116,504
Amounts due to parent, subsidiaries and affiliates	17,353	0	17,353
Amounts due to parent, subsidiaries and affiliates	<u>116,003</u>	<u>0</u>	<u>116,003</u>
Total liabilities	<u>472,589</u>	<u>0</u>	<u>472,589</u>
Capital and Surplus			
Common capital stock	10,000	(9,900)	100
Gross paid in and contributed surplus	4,790,000	9,900	4,799,900
Unassigned funds	<u>(3,144,298)</u>	<u>0</u>	<u>(3,144,298)</u>
Total capital and surplus	<u>1,655,702</u>	<u>0</u>	<u>1,655,702</u>
Total liabilities, capital and surplus	<u>\$2,128,291</u>	<u>\$0</u>	<u>\$2,128,291</u>

Avalon Healthcare, Inc.
Statement of Revenue and Expenses
For The Year Ended December 31, 2006

Net premium income		\$659,906
Aggregate write-ins for other non-health revenues		<u>7,709</u>
Total revenues		667,615
Hospital/medical benefits	\$341,999	
Outside referrals	3,967	
Emergency room and out-of-area	8,578	
Prescription drugs	<u>25,881</u>	
Claims adjustment expenses	380,425	
Claims adjustment expenses	15,000	
General administrative expenses	<u>2,932,351</u>	<u>3,327,776</u>
Net underwriting gain (loss)		(2,660,161)
Net investment income earned		<u>110,498</u>
Net income (loss)		<u><u>(\$2,549,663)</u></u>

Avalon Healthcare, Inc.
Capital and Surplus Account
For The Year Ended December 31, 2006

Capital and surplus - December 31, 2005		\$4,234,173
Net loss	(\$2,549,663)	
Change in nonadmitted assets	(28,808)	
Examination adjustments	<u>0</u>	<u>(2,578,471)</u>
Capital and surplus - December 31, 2006		<u><u>\$1,655,702</u></u>

COMMENTS ON FINANCIAL STATEMENTS

Common capital stock	\$100
Gross paid in and contributed surplus	\$4,799,900

The amount of common capital stock reported by the Company of \$10,000 has been decreased by \$9,900, and the amount of "gross paid in and contributed surplus" reported by the Company of \$4,790,000 has been increased by the same amount. In its 2006 annual statement, the Company incorrectly reported 10,000 shares of \$1 par value common capital stock as being authorized, issued, and outstanding. While 10,000 shares were authorized, only 100 shares were issued and outstanding. Accordingly, \$9,900 has been reclassified from common capital stock to "gross paid in and contributed surplus." On July 9, 2007, the Company filed an amended annual statement and corrected the error.

Claims unpaid	\$6,102
Aggregate health claim reserves	\$201,627

The Company's appointed actuary rendered an opinion that the amounts carried in the Company's balance sheet as of December 31, 2006 reasonably provided for all unpaid loss and loss expense obligations of the Company under the terms of its policies and agreements. The Office actuary reviewed work papers provided by the Company and concurred with this opinion. Based on the results of the Office actuary's review and analysis of work papers and data provided by the Company, we concluded that the aggregate liability was not materially misstated.

Avalon Healthcare, Inc.
Comparative Analysis of Changes in Capital and Surplus
December 31, 2006

The following is a reconciliation of capital and surplus between that reported by the Company and as determined by the examination.

Capital and surplus, December 31, 2006 - per annual statement				\$1,655,702
	<u>Per Company</u>	<u>Per Exam</u>	<u>Increase (Decrease) In Surplus</u>	
Common capital stock	\$10,000	\$100	(\$9,900)	
Gross paid in and contributed surplus	\$4,790,000	\$4,799,900	<u>\$9,900</u>	
Net change in capital and surplus				<u>0</u>
Capital and surplus, December 31, 2006 - per examination				<u><u>\$1,655,702</u></u>

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, 2006.

Capital and Surplus

As reported on pages 2 and 15, the Company incorrectly reported in its 2006 annual statement, as originally filed, that 10,000 of its common shares were issued and outstanding in the total amount of \$10,000, rather than 100 shares in the total amount of \$100. **We recommend that the Company correctly report the components of its equity in accordance with the *NAIC Annual Statement Instructions*.**

CONCLUSION

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

Per examination findings, the Company's total capital and surplus was \$1,655,702, which was in compliance with Section 624.408, F.S. Its required minimum capital and surplus at December 31, 2006 was \$1.5 million.

In addition to the undersigned, the following participated in this examination: Kerry A. Krantz, Actuary; and David C. Schleit, CPA, CFE, Financial Examiner/Analyst Supervisor.

Respectfully submitted,

Russell Judge, Financial Examiner/Analyst
Florida Office of Insurance Regulation