BEFORE THE INSURANCE COMMISSIONER
FOR THE STATE OF ARKANSAS

IN THE MATTER OF
THE REVISED REPORT OF EXAMINATION OF
ULICO INDEMNITY COMPANY

AID NO. 2005 - 060

ADOPTION ORDER

Now on this day the matter of the Revised Report of Examination ("Report" or "Report of Examination") as of December 31, 2004, of, Ulico Indemnity Company ("Ulico"), now "Darwin Select Insurance Company", of Little Rock, Arkansas, NAIC No. 24319, is taken under consideration by Julie Benafield Bowman, Insurance Commissioner for the State of Arkansas ("Commissioner"), as presented by Associate Counsel, Ragenea Thompson Hodge, and the Finance Division of the Arkansas Insurance Department ("Department"). From the facts, matters and other things before her, the Commissioner finds as follows:

FINDINGS OF FACT

1. The Commissioner has jurisdiction over the Company and the subject matter involved herein.

2. The Company is an Arkansas-domiciled property & casualty insurer, authorized to transact the business of property, casualty (including workers' compensation), surety, marine and disability insurance (Certificate of Authority No. 2383).

3. Pursuant to Ark. Code Ann. §§ 23-61-201 *et seq.*, the Commissioner authorized and directed the Department to conduct a regular examination of the affairs, transactions, accounts, records and assets of the Company as of December 31, 2004.

4. Said examination was commenced on March 21, 2005, and was completed on June 29, 2005.

5. The verified Report of Examination was filed with the Department on August 5, 2005; it was then forwarded to the Company via certified mail on August 5, 2005. The Company received the Report on August 11, 2005, according to the certified mail return receipt.

5. The verified Report of Examination contained the following comments on discrepancies or deficiencies concerning the Company's operations that were either noted or found by the Department's Examiners:

(a) Corporate Records: The minutes of the meetings of the stockholders and directors were reviewed to assess whether the minutes adequately approve and support Company transactions and whether the minutes comply with Arkansas Rule & Regulation 9. Investment transactions were not properly approved for the years 2000-2002 by the Board of Directors, and the minutes were not recorded on consecutively pre-numbered pages affixed with the imprinted seal of the Department, as required by Rule & Regulation 9;

(b) Conflict of Interest: While the Company had established a formal policy regarding the disclosure of any possible conflict of interest of its officers and directors, as required by Ark. Code Ann. § 23-66-206(5), in 2000, 2001 and 2002, such forms were not always properly completed by all officers and directors;

(c) Custodial Agreement: The Company had entered into a custodial agreement with Mellon Bank; the agreement does not contain certain NAIC

Financial Condition Examiner's Handbook language, such as "prompt replacement of lost securities," as required by Part 1, Section IV, J (2) (c) of the Handbook; and

(d) Losses: Because of a Loss Portfolio Transfer Reinsurance Agreement executed by the Company in 2004, no net loss or loss adjustment expense reserves were carried by the Company as of December 31, 2004. The Department's Actuary reviewed the data available to evaluate the Company's gross and net reserves and concluded that the reserves established appear reasonable; however, the Actuary noted that significant risk remains that improvements in claims processing and revaluation of exposures will lead to significant increases in the estimated liability. The claims processing and reserving anomalies included the following:

1. Claims may not have been reserved and evaluated properly.
2. Historical claims processing and reserving timeframes may have varied over time.
3. Case reserves may have been suppressed for a period of time under new management because of a concern about revealing litigation strategies.
4. Many claims were initially reserved at one dollar ($1) each.

These anomalies degraded the data available to complete actuarial projections. Consequently, the Company's estimates of gross unpaid losses rose in 2004 from approximately $3.9 million as of March 31, 2004, to ultimately management's best estimate of approximately $8.2 million as of December 31, 2004.

Finally, as part of the sale of the Company to Darwin, ULLICO Inc. will guaranty to Darwin all of Ulico Casualty's obligations under the Stock Purchase Agreement, the 2005 Quota Share Agreement, and the Assumption Agreement. In addition, $12 million will be placed in a trust pursuant to a Trust Agreement with Mellon Trust of Delaware, N.A. to satisfy the liabilities under the 2005 Quota Share Agreement. Darwin's independent actuary estimated the high end of the Company's reserve range to be $12 million for unpaid claim liability as of December 31, 2004; the outstanding liability will be estimated by Darwin's independent actuary at January 1 of each year, and the trust balance will be increased to the midpoint estimate, if necessary.

7. Based on the notations and findings in paragraph 6, *infra*, the Examiners recommended in the Report that the Company do the following:

(a) Corporate Records: comply with the provisions of Rule & Regulation 9;

(b) Conflict of Interest: execute the required officer and director conflict of interest forms on an annual basis;

(c) Custodial Agreement: amend the custodial agreement (to the extent it is still in force) with Mellon Bank to include the recommended language of the NAIC Financial Condition Examiner's Handbook Part 1, Section IV, J (2) (c).

(d) Losses: provide the Department the following ~

1. Quarterly analyses performed by Ulico Casualty regarding the unpaid liabilities under the 2005 Quota Share Agreement; if no ongoing analysis is being performed, the Company should provide data on loss payments, case reserves, allocated and unallocated loss adjustment expenses by accident year and by coverage in order to enable the Department to track the reserve runoff.

2. Actuarial analyses regarding the Ulico Casualty reserves under the 2005 Quota Share Agreement completed by Darwin's consulting actuary for 2005 and 2006 and for periods subsequent at the request of the Department.

3. Milliman's full actuarial report supporting the statement of actuarial opinion for the Ulico Affiliates for 2005 and 2006 and for periods subsequent at the request of the Department to allow review of the union and fiduciary liability triangles for the Ulico Affiliates and to provide an indication of the reserve strength of Ulico Casualty and USA Casualty.

4. Annual and quarterly financial statements for Ulico Casualty and USA Casualty to monitor the reserve development and financial position and to assist in assessing the ability of Ulico Casualty to meet its commitments to the Company.

5. Updates as of June 30, 2005, and quarterly thereafter at the discretion of the Department, on Ulico Casualty's efforts to improve

its claims processing and the quality of the underlying actuarial data for those losses ceded under the 2005 Quota Share Agreement.

6. Updates on efforts by Ulico Casualty to obtain additional staff and resources in the actuarial area in light of the data and other issues faced by the Company in order to complete timely and thorough review of reserves and actuarial data.

7. An analysis completed by Ulico Casualty as of June 30, 2005, and quarterly thereafter at the discretion of the Department, supporting their assessment that SSAP No. 53, Property Casualty Contracts – Premiums, requires no premium deficiency reserves.

8. August 18, 2005, the Company requested, and the Department granted, an extension of time until September 30, 2005, to respond to the Report.

9. Current and former management of the Company responded to the Report on September 28, 2005, which was received by the Finance and Legal Divisions of the Department on September 29 and October 4, 2005, respectively.

10. Current management (Darwin) of the Company responded in the following manner:

(a) <u>Corporate Records</u>: Darwin is aware of the Department's Rule & Regulation 9, which requires the use of consecutively numbered minute pages bearing the seal of the Department. Procedures for obtaining the pages with the requisite seal will be followed going forward;

(b) <u>Conflict of Interest</u>: Since Darwin purchased the Company in May

2005, current management's policy is to execute conflict of interest statements on all employees on an annual basis including directors and officers of the Company; and

(c) <u>Custodial Agreement</u>: Due to the change in ownership and management, the custodial agreement with Mellon Bank is no longer in force; the Company now has a custodial agreement with the Bank of New York, as a subsidiary of the Darwin Group and Alleghany Insurance Holdings. Prior to adding the Company to this custodial agreement, an amendment to the agreement was made to include the required Arkansas custody agreement provisions including the "prompt replacement of lost securities" language.

11. Former Management (Ulico Casualty) responded to the <u>Losses</u> portion of the findings and observations made by the Examiners in the Report as follows:

(a) Concerning the 2005 Quota Share Agreement, Darwin will provide to the Department information that it requested and receives from Ulico Casualty in accordance with the Agreement – quarterly information prepared by Ulico Casualty's internal actuaries regarding unpaid liabilities, and an actuarial opinion issued by a nationally recognized independent actuarial firm;

(b) Darwin will also provide actuarial analysis regarding Ulico Casualty's reserves under the 2005 Quota Share Agreement completed by Darwin's consulting actuaries;

(c) Ulico Casualty will provide to the Department ~

1. The actuarial report supporting the actuarial opinion issued by a nationally recognized independent actuarial firm.

2. Annual and quarterly financial statements for Ulico Casualty and USA Casualty.

3. An update on Ulico Casualty's efforts to improve claims processing and the quality of the underlying actuarial data for those losses ceded under the 2005 Quota Share Agreement (already provided).

4. Analysis for Ulico Casualty that no premium deficiency reserve is required.

(d) Ulico Casualty requested that the Department take note that Darwin manages the credit risk of Ulico Casualty through the existence of a trust account in which Ulico Casualty has placed investments of 1.5 times the estimated liabilities.

(e) Regarding the Department's request that the Company comment on the certain detailed actuarial findings related to Ulico Casualty and USA Casualty, Ulico Casualty management provided comments, but does not consider the detailed actuarial findings relevant to the examination of the Company; rather, Ulico Casualty believes the actuarial findings relevant to other companies. Additionally, Ulico Casualty responded that the Department's exam scope was Ulico Indemnity, and not the Company's affiliates. While Ulico Casualty understands that some level of review of affiliates is necessary, it stated that the scope of the actuarial review in including a comprehensive actuarial review of the affiliates companies appeared excessive. Since it provided the requested comments (below) on the actuarial findings in its response to the

Department, Ulico Casualty requested that the corresponding language of the Exam be removed. Last, the company does not consider the changes noted in the actuarial data below to result in significant changes to the estimated loss liabilities as of December 31, 2004; its comments were as follows ~

1. Regarding the $799,999 negative case reserve on Ulico Casualty, the recovery was not processed before year-end 2004. The reserve was reduced in early 2005 upon acceptance and processing of this settlement.

2. With regard to the negative losses for Ulico Casualty's fiduciary line for accident year 1999, there was one claim, number C99000000566, which had its ceded amounts placed in Annual Statement Line 172 (claims-made) when it should have been in Annual Statement Line 171 (occurrence). The Company has revised the triangles to correct this error.

3. Regarding negative case reserves for commercial multi-peril West for accident year 1997, when the CMP West triangles were split between construction defect and non-construction defect, the ceded reserves were misallocated between the two pieces. Since the Company at this point does not have a good allocation, it will combine the two lines together pending further research to determine a better allocation.

4. With regard to the comment on the net paid ALAE data for the others workers compensation line on Ulico Casualty containing

specific errors, our review of the actuarial data could not locate a problem with the data. If further research of Uiico Casualty's other workers compensation actuarial triangles are needed, the company will need more information as to the problems noted.

5. Regarding the comment that incurred losses are ceded in years 1993 through 2003 for the others workers compensation line, but only premium is ceded in 2003, the company has just finished a study to reconstruct the workers compensation ceded earned premium by the four categories it split them into (Hudson Waterfront, Union Hall, ADR, Other.) The company provided documentation showing the historical ceded earned premium for the "Other" category.

6. Regarding the comment that loss development has been more erratic than expected, fiduciary is a high severity, low frequency line and there will be a lot of variance from one period to another. The company is a small company, and the credibility for its lines it small. Changes in claim management as well as changes in the use of TPAs for workers compensation over the past few years has resulted in changes in reserving philosophies. The presence of these changes is known and considered when using the loss reserve data.

7. With regard to the comment that no losses were ceded for workers compensation ADR in the December 31, 2002 valuation,

the company has enhanced the triangles for workers compensation to report ceded data back to the valuation as of the 4^{th} quarter of 2002. Valuations for each quarter from the 4^{th} quarter of 2002 until the 2^{nd} quarter of 2005 now include both direct and ceded activity.

8. Ulico Casualty and Ulico Indemnity do not have reinsurance in place for its Union Liability line of business beginning October 15, 2003. Limits were lowered to $2 million accordingly. Ulico Indemnity ceased writing all policies effective March 2004.

9. Many claims were reserved at $1. The nature of the fiduciary and union liability business that Ulico Indemnity wrote is such that the majority of claims filed has no merit and are subsequently closed without payment. Additionally, due to the litigious nature of these claims, it takes several months to determine the estimated value of these claims. As such, a $1 reserve was assigned to these claims upon notification of the claim. As part of the change in claims management, an estimated average case reserve is now assigned for new claims.

THEREFORE, pursuant to the provisions of Ark. Code Ann. § 23-61-205, the Commissioner hereby orders:

1. That following receipt and consideration of the Company's former and current management's response(s), the Department revised the Report and removed the language objected to by the Company's former management.

2. That the Revised Examination Report, as filed with the Department, is hereby adopted.

3. That the Department shall forward a copy of this Order and the adopted Revised Examination Report, as filed, to the Company, certified mail. The mailing to the Company shall include specimen affidavit forms for the Company's Directors to use in acknowledgement of receipt of the adopted Revised Report of Examination and this Order.

4. That within twenty (20) days of receipt of this Order and the adopted Revised Examination Report, the Company shall file with the Department affidavits executed by each one of its Directors, stating under oath or affirmation that each has received a copy of this Order and the adopted Revised Examination Report;

5. That the adopted Revised Examination Report shall be open for public inspection upon the expiration of thirty (30) days from the Company's receipt of this Order.

6. That the Department, as a matter of course, reserves the right to consider administrative proceedings against the Company at a later date.

IT IS SO ORDERED this 31st day of October 2005.

Julie Benafield Bowman

JULIE BENAFIELD BOWMAN
INSURANCE COMMISSIONER
STATE OF ARKANSAS