

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA

REPORT OF
EXAMINATION

OF

Agent Alliance Insurance Company

MOBILE, ALABAMA

AS OF

DECEMBER 31, 2010

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EXAMINER'S AFFIDAVIT

STATE OF ALABAMA
COUNTY OF Mobile

Toni L. Bean, CFE, being duly sworn, states as follows:

1. I have authority to represent Alabama in the examination of Agent Alliance Insurance Company.
2. The Alabama Department of Insurance is accredited under the National Association of Insurance Commissioners Financial Regulation Standards and Accreditation.
3. I have reviewed the examination workpapers and examination report, and the examination of Agent Alliance Insurance Company was performed in a manner consistent with the standards and procedures required by the State of Alabama.

The affiant says nothing further.

Toni Bean
Examiner-in-Charge

Subscribed and sworn before me by Toni Bean on this
23 day of Sept.

(SEAL)

Ashley N. Blacker

(Signature of Notary Public)



ROBERT BENTLEY
Governor

JIM L. RIDLING
Commissioner

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CHARLES M. ANGELL (acting)

Chief of Staff
RAGAN INGRAM

Chief Examiner
RICHARD L. FORD

State Fire Marshal
EDWARD S. PAULK

General Counsel
REYN NORMAN

September 23, 2011

Honorable Jim L. Ridling, Commissioner
Alabama Department of Insurance
201 Monroe Street, Suite 502
Montgomery, Alabama 36104

Dear Commissioner:

Pursuant to your authorization and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, an examination has been made of the affairs and financial condition of

Agent Alliance Insurance Company

at its home office located at 3800 Sollie Road, Mobile, Alabama 36619, as of December 31, 2010. The Report of Examination is submitted herewith. Where the description "Company" appears herein without qualification, it will be understood to indicate Agent Alliance Insurance Company.

SCOPE OF EXAMINATION

A full scope examination was performed at December 31, 2007, by the North Carolina Department of Insurance. On December 31, 2009, the Company was re-domesticated and reincorporated as an Alabama Corporation. The current examination covers the intervening period from the date of the last examination through December 31, 2010, and was conducted by examiners representing the State of Alabama. Where deemed appropriate, transactions, activities, and similar items subsequent to 2010 were reviewed.

The examination was conducted in accordance with applicable statutory requirements of the Alabama Insurance Code, the Alabama Insurance Department regulations, bulletins and directives and in accordance with the procedures and guidelines promulgated by the NAIC, as deemed appropriate, and in accordance with generally accepted examination standards and practices.

The examination was conducted in accordance with the NAIC Financial Condition Examiners Handbook. The examination was planned and performed to evaluate the financial condition of the Company as of December 31, 2010, and to identify the Company's prospective risks by obtaining information about the Company including corporate governance. In addition, the examination was planned and performed to identify and assess the inherent risks within the Company and to evaluate system controls and procedures used to mitigate those risks. The examination also included 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.

An examination of the Company's information systems (IS) was conducted concurrently with the financial examination. The IS examination included a review of management and organizational controls, logical and physical security controls, changes in applications controls, system and program development controls, contingency planning controls, service provider controls, operations controls, processing controls, e-commerce controls, and network and internet controls.

The market conduct examination was performed concurrently with the financial examination. The examination included a review of the Company's territory and plan of operation. See "MARKET CONDUCT ACTIVITIES" on page 14 for further discussion of the market conduct examination.

The Company's Annual Statements for each year under examination (2008 through 2010) were compared with or reconciled to the corresponding general ledger account balances.

Carr, Riggs & Ingram, LLC was the Company's certified public accountants (CPAs) for the three years under examination. The examiners reviewed and utilized the CPAs' workpapers for the years under examination.

A signed certificate of representation was obtained during the course of the examination. In this certificate, management attested to having valid title to all assets and to the nonexistence of unrecorded liabilities as of December 31, 2010.

ORGANIZATION AND HISTORY

Berkley Insurance Company of the Carolinas (hereinafter referred to as Berkley), Inc. was organized on December 8, 1995 under the laws of the State of North Carolina for the purpose of providing multiple lines of property and casualty insurance. On July 10, 2006, Emerald Investments, LLC acquired 100% of Berkley's stock, and changed the name of the company to: Agent Alliance Insurance Company. On December 31, 2009, the Company re-domesticated and reincorporated under the laws of the State of Alabama. Article Two, of the Articles of Redomestication and Incorporation lists the purpose or purposes for which the organization was formed as:

To conduct and transact generally the business of an insurance corporation under Title 27, Chapter 5, Code of Alabama 1975, and to do all things and exercise all powers and perform all functions that an insurance corporation is authorized or empowered to do, exercise or to perform under and by virtue of the laws of Alabama, or that it may be by law hereafter authorized to do, exercise, or perform; and do all the above things as an Alabama corporation and insofar as is consistent with the laws of Alabama.

Article V of the Articles of Redomestication and Incorporation authorized 10,000,000 shares of common stock with a par value of \$1 per share.

MANAGEMENT AND CONTROL

Stockholders

At December 31, 2010, Emerald Investments, LLC owned 100% of the Company's common capital stock.

Article III, Section 2 of the Company's Bylaws states, "The annual meeting of the shareholders for the election of directors and the transaction of other business shall be held annually in any month on any day (except Saturday, Sunday, or a legal holiday) as fixed by the board of directors." The Company's shareholders met annually for the period under examination.

Board of Directors

The Company's Bylaws provide that the business and affairs of the Company be managed by the Board of Directors. Article IV, Section 2, states: "The number constituting the board of directors shall be not less than one (1) nor more than fifteen (15)." The Company's Bylaws were not in accordance with ALA. CODE § 27-27-23 (a) (1975) which states: "The affairs of every domestic insurer shall be managed by not less than three directors, and at least one-third of the directors shall be bona fide residents of this state."

Director/Residence

Michael Gregory Myles
Mobile, Alabama

Morgan Barry Myles
Grand Bay, Alabama

Phillip Russel Myles
Mobile, Alabama

Occupation

President, Agent Alliance
Insurance Company

President, Core Industries

Partner, McDowell, Knight,
Roedder & Sledge

Committees

The Board had no committees during the examination period.

Officers

At December 31, 2010, the following officers were serving:

<u>Name</u>	<u>Title</u>
Michael Gregory Myles	President
Suzanne Northam Trovinger	Secretary
Brian Scott Perry	Treasurer

Conflict Of Interest

The Company policy requires that any interests of its officers and directors that might conflict with any interests of the Company be disclosed. The Company required its officers and directors to sign and file conflict of interest disclosure statements annually. Conflict of interest statements were signed and filed by all of the Company's officers and directors for each year under examination.

CORPORATE RECORDS

The Company's Articles of Redomestication and Incorporation, as filed with the Mobile County Court of Probate, and the Bylaws, were inspected during the course of this examination.

Minutes of the meetings of the shareholders and the Board of Directors were reviewed for the period under examination. The minutes did not reflect approval of the investment transactions made during the examination period. ALA. CODE § 27-41-5 (1975) states:

An insurer shall not make any investments or loans, other than loans on policies or annuity contracts, unless the same be authorized, approved or ratified by the board of directors of the insurer or by such committee or person as the board of directors shall expressly authorize. The action of the board of directors, the committee, or other persons so authorized shall be recorded and regular reports thereof shall be submitted to the board of directors.

Management indicated that the Board of Directors was provided with financial reports; however, there was no indication in the meeting minutes that the directors:

- Considered risk assessment activities and corporate governance issues.

- Reviewed activities critical to the financial solvency of the Company.
- Discussed the Company's budgets, audit reports or the letter to the audit committee provided by the external auditors.

HOLDING COMPANY AND AFFILIATE MATTERS

Holding Company

The Company is subject to the Alabama Insurance Holding Company Regulatory Act as defined in ALA. CODE § 27-29-1 (1975), as amended. Appropriate filings required under the Holding Company Act were made from time to time by the Company. A review of the filings during the period under review indicated that appropriate disclosures were included regarding the Company, except as noted otherwise in the Report of Examination.

Dividends to Stockholders

There were no dividends paid to the stockholders during the examination period.

Management and Service Agreements

The Company re-domesticated to Alabama on December 31, 2009. All of the agreements referenced below were grandfathered in with the exception of the Related Party Agreement – 2010.

Management and Claims Service Agreement

On July 5, 2006, the Company (*f/k/a* Berkley Insurance Company of the Carolinas) and InsTrust Insurance Group, LLC (hereinafter referred to as InsTrust) entered into an administrative service agreement. Per the agreement InsTrust provided the following services to the Company:

- Staff (Officers and Employees)
- Data Processing Equipment
- Business Property
- Communications Equipment
- Underwriting
 - Policy Application Review

- Assignment of Policy Numbers
- Issuance of Policies
- Policy Endorsement and Cancellations
- Accounting
 - Maintenance of Financial Records
 - Financial Statement Preparation
 - Commission, Expense and Claims Statements
 - Tax and Auditing Services
- Claims Administration and Payments
 - Provide staff to execute claims handling procedures established by the Company
- Producers
 - Compute and Pay Commission
 - Training
 - Management
 - Guidance and Oversight
 - Develop Commissions or Allowances

Within thirty days of the end of each calendar year, InsTrust would provide a detailed written statement of the amount owed. For management services provided, the amount owed to InsTrust was a specified percentage of written premiums. The amount owed for claims services consisted of: (1) a specified percentage of written premiums paid for all third party liability claims and net subrogation recoveries arising from first party property damage; and (2) a specified fee for first party property damage, collision and comprehensive claims, and each incident report/record on potential first party property damage, collision or comprehensive losses.

The Company submitted multiple estimated commission payments to InsTrust each month during 2010. According to the monthly billing statements submitted by InsTrust, the fees due totaled \$6.7 million; however, the Company remitted \$8.3 million in payments. As a result of these over payments, the Company received refunds of \$397,000 and \$790,000, on September 30, 2010 and December 31, 2010, respectively. These over payments were considered to be interest free loans which were not deemed fair and reasonable. ALA. CODE § 27-29-5 (1975) states:

- (a) Transactions with Affiliates. Material transactions by registered insurers with their affiliates shall be subject to the following standards:
 - (1) The terms shall be fair and reasonable;

(b) The following transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into such transaction at least 30 days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period.

(1) Sales, purchases, exchanges, loans or extensions of credit, guarantees, or investments provided the transactions are equal to or exceed: a. With respect to nonlife insurers, the lesser of three percent of the insurer's admitted assets or 25 percent of surplus as regards policyholders as of the 31st day of December next preceding.

The Company did not comply with ALA. ADMIN. CODE 482-1-055-.18 (1994) which states: "An insurer required to give notice of a proposed transaction pursuant to Section 27-29-5 shall furnish the required information on Form D, hereby made a part of this chapter."

A similar situation was noted in the North Carolina Department of Insurance Report of Examination as of December 31, 2007, whereby the Company submitted estimated commission payments to InsTrust each month during 2007 and 2008, resulting in significant over payment balances. These transactions violated the settlement provision included in the Management and Claims Service Agreement and were considered interest free loans which were not deemed fair and reasonable. The Company was directed to immediately discontinue its practice of advancing funds to InsTrust prior to the timely settlement of refundable balances.

InsTrust was managing the Company's insurance business, adjudicating claims, underwriting policies, and indirectly producing business for the Company. InsTrust was managing general agent (MGA) in accordance with ALA. CODE §27-6A-2 (1975). However, this current examination determined that InsTrust was not licensed as a MGA. This was not in accordance with ALA. CODE § 27-6A-3 (1975) which states:

No person, firm, association, or corporation shall act in the capacity of a managing general agent representing an insurer domiciled in this state with respect to risks located outside this state unless then licensed in this state as a managing general agent of the insurer. Where applicable, the license may be a nonresident license pursuant to this chapter.

On August 15, 2006, the agreement was amended changing the name of the Company from Berkley Insurance Company of the Carolinas to Agent Alliance Insurance Company. On January 1, 2008, the agreement was amended to assign the rights under the agreement to Specialty Insurance Services, LLC; whose name would be changed to InsTrust Insurance Group.

Factoring Agreement

On May 15, 2007, the Company and its parent, Emerald Investments LLC (hereinafter referred to as Emerald), entered into a factoring agreement whereby Emerald purchased the Company's premium receivable for a commission equal to 2% of the gross amount of receivables purchased annually. Emerald, at its sole discretion could:

1. Make advance payments in an amount of up to 75% of the net amount of the premium receivable.
2. Make over-advances (purchase amounts in excess of the amount calculated using the formula prescribed) at a rate of 1% per annum in excess of the contract rate of interest as calculated pursuant to the formula prescribed in the agreement.

If the Company breached any of the representations and warranties in the agreement, Emerald had the right to chargeback the full amount of the receivable with interest; however, Emerald would retain a security interest in the receivable until the receivable was fully paid, settled or discharged and all of the Company's obligations to Emerald were fully satisfied.

The agreement contained the standard provisions regarding termination and default; solvency; and assignment. However, the agreement did not have a settlement provision or provisions regarding the frequency of the purchase. The precise nature and details of the purchase was not clearly stated in the agreement. Company management indicated that the premium receivable was sold on an as needed basis and the determination to sell the premium receivable was made by the Company Treasurer based on current and projected cash flow needs. This was not in accordance with ALA. CODE § 27-29-5 (1975) which states:

Material transactions by registered insurers with their affiliates shall be subject to the following standards: The books, accounts, and records of each party will

be so maintained as to clearly and accurately disclose the precise nature and details of the transactions.

Also, this was not in accordance with SSAP No. 96, paragraph six, which states: “Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date...”

Related Party Agreement – 2009

On November 15, 2009, the Company and its affiliate and Managing General Agent, InsTrust Insurance Group LLC (hereinafter referred to as InsTrust), entered into an agreement for the repayment of commissions on cancelled policies that were not promptly deleted from the premium processing system due to an error within the system. See **Note 1** under the heading “Notes To Financial Statements” for further discussion of the premium processing system. InsTrust would repay the commission amounts due to the Company in 36 installments of principal and interest, on a monthly basis. This agreement and any rights pursuant to the agreement; were not assignable and the agreement would remain in effect until all amounts due the Company were repaid by InsTrust. The amount of the refund was \$232,928.

Related Party Agreement - 2010

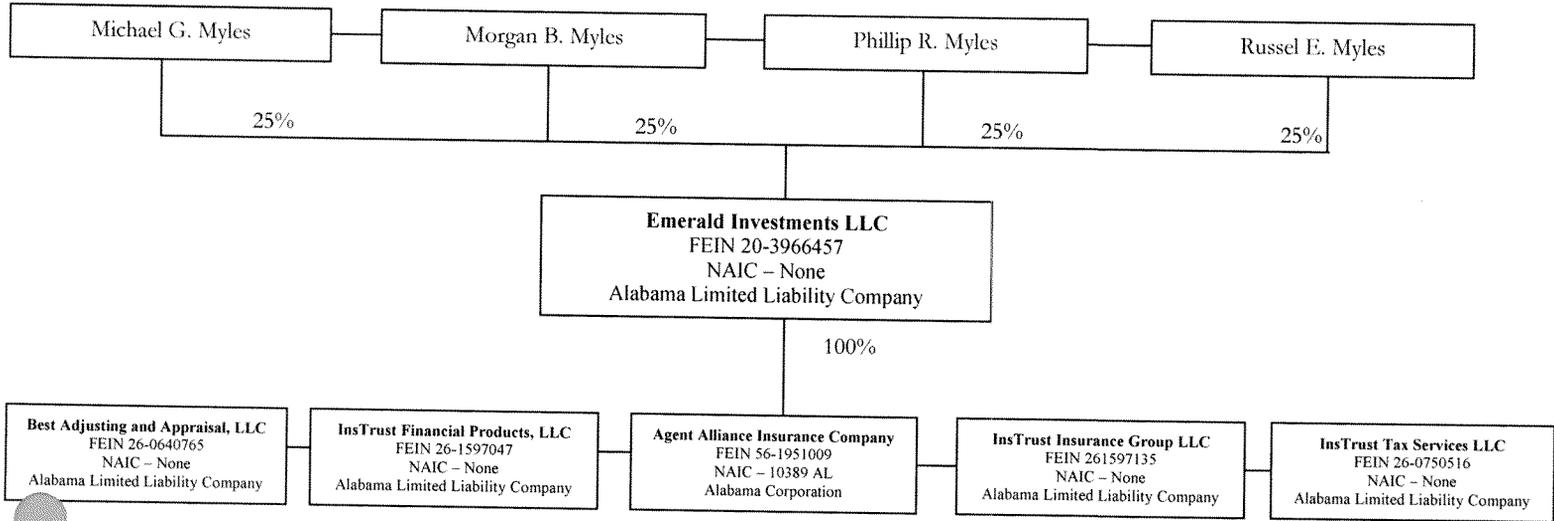
On December 31, 2010, the Company and its affiliate and Managing General Agent, InsTrust Insurance Group LLC, entered into an agreement whereby InsTrust would refund the Company for over payment of commissions in December 2010. A refund was due because the premium estimates used to calculate the commissions were greater than the actual commission recorded. The amount of the over payment was \$89,617.

The amount due the Company including interest was paid on March 30, 2011, in accordance with the agreement which states: “InsTrust will repay the commission amount due to AAIC on or before March 31, 2011.”

Organizational Chart

The following details the identities of and interrelationships among all affiliated persons within the Holding Company System at December 31, 2010:

ORGANIZATIONAL CHART



All entities listed below the natural persons on the organizational chart are 100% owned by Emerald Investments, LLC.

DIVIDENDS TO POLICYHOLDERS

There were no dividends paid to policyholders during the examination period.

FIDELITY BOND AND OTHER INSURANCE

The Company provided a fidelity bond issued by Chubb Group of Insurance Companies of New Jersey. The fidelity bond was inspected and the Company was not listed as a named insured. Management indicated that because the Company had no employees, and all of its transactions were being handled by its Managing General Agent, InsTrust Insurance Group, LLC (hereinafter referred to as InsTrust) an affiliate and due to common ownership between the two entities, it would be more benefitting to obtain fidelity coverage for InsTrust only.

While the Company had no employees, a fidelity bond whereby the Company was a named insured was necessary to protect it against potentially fraudulent acts that could be perpetuated by employees of InsTrust.

Because the Company utilized a Managing General Agent, a copy of the fidelity bond protecting the insurer should have been filed with the Department of Insurance in accordance with ALA. ADMIN. CODE 482-1-106-.04 (2002) which states:

Any insurer who is required under Rule 482-1-106-.03 to file for appointment of a managing general agent (MGA) must complete and file all of the following within thirty (30) days of that appointment...A copy of a fidelity bond for the protection of the insurer in the minimum amount of one hundred thousand (\$100,000) with no deductible.

There were other insurance coverages held by InsTrust for Workers Compensation and Employer Liability and Agents and Brokers Liability Insurance, to which the Company was not a named insured.

EMPLOYEE WELFARE

The Company had no employees and no employee benefit plans were in effect during the examination period. All administrative and employee services were provided by employees of InsTrust Insurance Group LLC (an affiliate and Managing General Agent) via the Management and Claims Service agreement discussed on page 6 under

the heading “**Management and Services Agreements.**” The Company reimbursed InsTrust a specified percentage of written premiums and a fee for services provided. Persons employed by InsTrust were offered the following benefits:

- 401(K) Plan
- Health Insurance
- Life Insurance
- Company Holidays
- Employee Vacation and Wellness Time

SCHEDULE OF SPECIAL DEPOSITS

At December 31, 2010, as required or permitted by law, the Company maintained deposits with the respective statutory authorities as follows:

<u>State and Territory</u>	<u>Book Value</u>	<u>Fair Value</u>
Alabama	\$ 205,226	\$ 205,215
North Carolina	\$1,865,289	\$1,867,714
South Carolina	\$ 160,804	\$ 160,630
Total	\$2,231,319	\$2,233,559

FINANCIAL CONDITION/GROWTH OF COMPANY

The following schedule presents financial data, which reflects the growth of the Company for the years indicated:

	<u>2010*</u>	<u>2009</u>	<u>2008</u>
Admitted assets	\$6,779,016	\$ 7,916,620	\$7,140,039
Liabilities	4,323,428	4,748,028	3,951,542
Gross Written Premium	21,950,241	22,395,121	21,462,094
Net Losses Incurred	3,995,139	2,345,583	2,202,383
Net Loss Adjustment Expenses Incurred	531,944	(111,004)	1,796,462
Common Capital Stock	1,800,000	1,800,000	1,800,000
Surplus Notes	350,000	350,000	350,000
Gross Paid in and Contributed Surplus	1,800,000	1,800,000	1,800,000
Unassigned Funds (Surplus)	(1,494,413)	(781,408)	(761,504)

*Per examination

MARKET CONDUCT ACTIVITIES

Plan of Operation

The Company writes non-standard automobile insurance. Their lines of business included private passenger automobile liability and private passenger automobile physical damage coverage.

The Company marketed its product to two groups of potential buyers: those ineligible for standard coverage and those who preferred dealing with an independent agent.

All business was written in the state of North Carolina during the examination period.

Territory

At December 31, 2010, the Company was licensed to transact business in the following states: Alabama, Maryland, North Carolina, Pennsylvania, South Carolina and Tennessee. The Certificates of Authority were reviewed and no exceptions were noted.

Underwriting and Rating

At December 31, 2010, all policies in-force were in the state of North Carolina. The North Carolina Private Passenger Automobile Underwriting Guidelines used during the examination period were inspected.

During the examination period, no underwriting guidelines were developed for Alabama.

Marketing and Advertising

The Company does not advertise in Alabama since they do not solicit business in the state of Alabama. InsTrust, an affiliated company and Managing General Agent, maintained an internet site for use by producers and consumers alike.

Claim Handling

The Company has a comprehensive Management and Claim Service Agreement with InsTrust Insurance Group LLC, an affiliated Managing General Agent. InsTrust processed claims and provided claim information to the Company.

The Company had no business in-force in the state of Alabama and there were no payments for claim services in Alabama during the examination period.

Producer Licensing

The Company had no producers licensed, appointed or terminated in Alabama during the examination period.

Policyholder Complaints

The Company maintained a complaint database for documenting complaint information. No complaints were filed by Alabama residents during the examination period, since there was no policies in-force in Alabama.

COMPLIANCE WITH ALA. ADMIN. CODE 482-1-146 (2009)

ALA. ADMIN. CODE 482-1-146-.11 (1) (2009) states:

A Section 1033 insurer subject to the Commissioner's examination authority shall have and apply the following:

(a) An internal procedure for determining, by means of background checks or investigations or otherwise, whether applicants for employment or individuals with whom the insurer intends to contract for activities in the business of insurance, whether or not in a capacity requiring a license, have a felony conviction for a Section 1033 offense.

(b) An internal procedure after initial employment or contracting, applied on a periodic basis, to ascertain the existence of a felony conviction for a Section 1033 offense.

The Company did not comply with these requirements as it did not have internal procedures in place for determining if applicants for employment had been convicted of a Section 1033 offense and there were no internal procedures in place to

periodically ascertain if existing employees had been convicted of a Section 1033 offense since the date of hire. As of January 2011, the Company established procedures to comply with ALA. ADMIN. CODE 482-1-146 (2009).

REINSURANCE

Reinsurance Assumed

At December 31, 2010, the Company reported assumed premiums of (\$1,325) related to the ceded reinsurance agreement with Berkley Regional Insurance Company. For further discussion of this agreement see the heading immediately below, entitled "*Berkley Regional Insurance Company.*"

Reinsurance Ceded

Berkley Regional Insurance Company

Effective January 1, 1997, Berkley Insurance Company of the Carolinas (BICC) and Berkley Regional Insurance Company (BRIC) entered into a 100% quota share agreement whereby BICC ceded 100% of its net liability for policies issued or renewed on January 1, 2000 to BRIC. In addition, to substandard automobile insurance, BICC wrote other lines of insurance, namely, workers compensation, in other states.

On July 10, 2006, Emerald Investment, LLC purchased BICC changing the name of the company to Agent Alliance Insurance Company. Effective June 30, 2006, the agreement between the Company and BRIC was terminated; however, BRIC was to remain liable for all losses for policies written prior to July 10, 2006.

At December 31, 2010, the Company reported assumed and ceded premiums of (\$1,325) to and from BRIC, and reported no premiums receivable or unearned premiums.

North Carolina Motor Vehicle Reinsurance Facility

The Company is a member of the North Carolina Motor Vehicle Reinsurance Facility (NCRF) in accordance with North Carolina Code § 58-37-5 (1983) which states:

There is created a nonprofit unincorporated legal entity to be known as the North Carolina Motor Vehicle Reinsurance Facility consisting of all insurers

licensed to write and engaged in writing within this State motor vehicle insurance or any component thereof. Every such insurer, as a prerequisite to further engaging in writing such insurance in this State, shall be a member of the Facility and shall be bound by the rules of operation thereof as provided for in this Article and as promulgated by the Board of Governors. No company may withdraw from membership in the Facility unless it ceases to write motor vehicle insurance in this State or ceases to be licensed to write such insurance.

Sub-standard risks accepted by all participating insurers were ceded to the NCRF and all insurers equitably shared the results of the business ceded. The NCRF reinsured 100% of each risk ceded to the facility.

The Company ceded 100% of its automobile liability premium and losses to the NCRF during the examination period. The Company ceded premiums of approximately \$13.0 million; \$13.7 million; and \$13.1 million to the NCRF in 2008, 2009, and 2010, respectively. At December 31, 2010, the reinsurance recoverable on paid losses was approximately \$12.0 million.

Imagine International Reinsurance

Effective April 1, 2007, the Company entered into a 60/40 quota share reinsurance agreement with Imagine International Reinsurance (hereinafter referred to as Imagine Re). This agreement covered all policies classified as private passenger automobile physical damage insurance. There was a sliding scale commission provision based on the loss ratio and a loss ratio cap as well. Imagine Re's maximum limit of liability for any one agreement year was not to exceed 142% of the ceded net earned premium for that year and 129% of the ceded net earned premium for all of the agreement years in the aggregate. The consulting actuaries for the Alabama Department of Insurance reviewed the agreement and determined that it properly transferred risk.

This agreement was terminated on March 31, 2010. The Company ceded premiums of approximately \$5.0 million; \$5.0 million; and \$1.4 million in 2008, 2009, and 2010, respectively. At December 31, 2010, the reinsurance recoverable on paid losses was \$131,000.

ACCOUNTS AND RECORDS

The Company's internal controls and information systems infrastructure was evaluated by interviewing Company personnel and reviewing the Company's responses to Exhibit B – Examination Planning Questionnaire and Exhibit C – Evaluation of Controls in Information Technology (IT) found in the NAIC Financial Condition Examiners Handbook. The Company's accounts and records were maintained electronically. For further discussion on the IT systems used, see the heading below entitled "Information Systems."

Internal Controls

At December 31, 2010, the Company did not have any employees. All administrative services for the Company were performed by InsTrust Insurance Group, LLC (an affiliate and Managing General Agent) in accordance with the "Management and Claims Service Agreement" previously discussed in the HOLDING COMPANY AND AFFILIATE MATTERS section of this report under the caption "**Management and Service Agreements.**" InsTrust staff was responsible for the day to day operations of the Company. The Company did not have an internal audit division, and those serving on the Board of Directors were all related in some capacity to the President of the Company. The Board of Directors meeting minutes for the examination period did not reflect that the BOD scrutinized or performed an in-depth review of those activities that were significant to the financial condition of the Company, such as a thorough review of the Company's reserving methodologies and policies or approval of investment transactions. The Company did not have strong internal controls, as such; controls were not relied on for any phase of the examination.

Information Systems

The Company used informal control processes for its business processes and financial reporting. For the most part, there were no IT written policies to support business or IT procedures. The size of the Company limited the segregation of duty controls and IT staff. Overall, the IT controls used to support the Company's business and financial data were not strong.

There were three IT systems used during the examination period: one for policy management and administration, one for general ledger functions, and one for investment activities. During the examination of these systems and all IT related functions the following was noted:

1. The Company did not have a written record retention policy and procedures in place to retain data. The lack of a written record retention policy increased the risk that the Company would not retain data in accordance with ALA.

ADMIN. CODE 482-1-118-.03 (1999) which states:

Every insurer, which term shall include every domestic insurer, foreign insurer, health care services corporation, health maintenance organization, prepaid dental plan, managing general agent or any other legal entity regulated by the Insurance Code and licensed to do business in this state shall maintain its books, records, documents and other business records in order that the insurer's financial condition may be readily ascertained by the Department of Insurance, taking into consideration other record retention requirements. All records must be maintained for not less than five (5) years.

2. IT employees were storing system backups at their homes. Storing backups at home increased the risk that the data would be lost, damaged, or tampered with. Keeping Company data at employee residences was not in compliance with ALA. ADMIN. CODE 482-1-126-.04 (2003) which states:

Each licensee shall implement a comprehensive written information security program that includes administrative, technical and physical safeguards for the protection of customer information. The administrative, technical and physical safeguards included in the information security program shall be appropriate to the size and complexity of the licensee and the nature and scope of its activities.

3. The hardware used to create daily backups had been removed and replaced with a small commercial network attached storage device (NAS). Conversations with IT personnel confirmed data backups were not being performed and the NAS was being used as an ad-hoc device to capture business activity and associated data files. This was not in compliance with ALA. ADMIN. CODE 482-1-126-.04 (2003) which states:

Each licensee shall implement a comprehensive written information security program that includes administrative, technical and physical safeguards for the protection of customer information. The administrative, technical and physical safeguards included in the

information security program shall be appropriate to the size and complexity of the licensee and the nature and scope of its activities.

FINANCIAL STATEMENTS INDEX

The Financial Statements included in this report were prepared in conformity with those accounting practices prescribed or permitted by the Commissioner of Insurance for the State of Alabama utilizing Company records and is intended to depict the statutory financial condition of the Company as of December 31, 2010. The information reported therein has been verified by the examiner to the extent deemed necessary. Amounts shown in the comparative statements for the years 2008 and 2009 were compiled from the Company's copies of filed Annual Statements. The statements are presented in the following order:

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THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

Agent Alliance Insurance Company
Statement of Assets, Liabilities, Capital and Surplus
For the Year Ended December 31, 2010

	<u>Assets</u>	<u>Non- admitted Assets</u>	<u>Net Admitted Assets</u>
Bonds	\$ 762,943	\$ -	\$ 762,943
Cash, cash equivalents and short term investments	<u>2,232,206</u>	-	<u>2,232,206</u>
Subtotals, cash and invested assets	\$2,995,149		\$ 2,995,149
Investment income due and accrued	3,651	-	3,651
Premiums and Considerations:			
Uncollected premiums and agents' balances in course of collection (Note 1)	1,225,215	1,149,665	75,549
Deferred premiums, agents' balances and installments booked but deferred and not yet due	2,567,303	-	2,567,303
Amounts recoverable from reinsurers	487,426	-	487,426
Net deferred tax asset	540,081	144,061	396,021
Receivables from parent, subsidiaries, and affiliates	<u>253,917</u>	<u>-</u>	<u>253,917</u>
Total Assets	<u>\$8,072,742</u>	<u>\$ 1,293,726</u>	<u>\$ 6,779,016</u>

LIABILITIES, SURPLUS AND OTHER FUNDS

Losses (Note 2)	\$ 426,567
Loss adjustment expenses (Note 2)	334,000
Other expenses (excluding taxes, license and fees)	128,612
Taxes, license and fees (excluding federal and foreign income taxes) (Note 3)	364,111
Unearned premiums	2,042,247
Advance premium	65,668
Ceded reinsurance premiums payable	887,611
Payable to parent, subsidiaries and affiliates	<u>74,612</u>
Total Liabilities	\$ 4,323,428
Common capital stock	1,800,000
Surplus notes	350,000
Gross paid in and contributed surplus	1,800,000
Unassigned Funds (surplus) (Note 4)	<u>(1,494,413)</u>
Surplus as regards policyholders	<u>\$ 2,455,587</u>
Totals	<u>\$ 6,779,015</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

Agent Alliance Insurance Company
Statement of Income
For the Years Ended December 31, 2010, 2009 and 2008

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Underwriting Income			
Premiums earned	\$ 6,124,322	\$ 3,707,300	\$ 3,406,898
Deductions			
Losses incurred (Note 2)	\$ 3,995,139	\$ 2,345,583	\$ 2,202,383
Loss adjustment expenses incurred (Note 2)	531,944	(111,004)	1,796,462
Other underwriting expenses incurred (Note 3)	3,154,227	2,081,489	(59,754)
Aggregate write-ins for underwriting deductions	<u>89,483</u>	<u>69,754</u>	<u>42,445</u>
Total underwriting deductions	7,770,793	4,385,822	3,981,536
Net underwriting gain (loss)	<u>\$ (1,646,471)</u>	<u>\$ (678,522)</u>	<u>\$ (574,638)</u>
Investment Income			
	\$ 41,273	\$ 95,944	\$ 117,770
Net investment income earned	<u>69,280</u>	<u>-</u>	<u>-</u>
Net realized capital gains (losses) less capital tax gain	<u>\$ 110,553</u>	<u>\$ 95,944</u>	<u>\$ 117,770</u>
Net investment gain (loss)			
Other Income			
Net gain (loss) from agents' or premium balances charged off	\$ -	\$ -	\$ -
Finance and service charges not included in premium	842,356	467,975	435,775
Aggregate write-ins for miscellaneous income	<u>136,057</u>	<u>124,444</u>	<u>117,215</u>
Total other income	<u>\$ 978,413</u>	<u>\$ 592,419</u>	<u>\$ 552,990</u>
Net income before dividends to policyholders, after capital gain tax and before all other federal and foreign income taxes	(557,505)	9,841	96,124
Dividend to Policyholders	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Net income, after dividends to policyholders, after capital gain tax and before all other federal and foreign income taxes incurred	\$ (557,505)	\$ 9,841	\$ 96,124
Federal and foreign income taxes incurred	<u>(35,690)</u>	<u>-</u>	<u>-</u>
Net income	<u>\$ (521,815)</u>	<u>\$ 9,841</u>	<u>\$ 96,124</u>
Capital and Surplus Account			
Surplus as regards policyholders, December 31 prior year	<u>\$ 3,168,591</u>	<u>\$ 3,188,495</u>	<u>\$ 3,323,215</u>
Net income	\$ (521,815)	\$ 9,841	\$ 96,124
Change in net deferred income tax	144,176	32,304	75,268
Change in nonadmitted assets	<u>(335,365)</u>	<u>(62,049)</u>	<u>(306,111)</u>
Change in surplus as regards policyholders for the year	<u>\$ (713,004)</u>	<u>\$ (19,904)</u>	<u>\$ (134,719)</u>
Surplus as regards policyholders, December 31 current year	<u>\$ 2,455,587</u>	<u>\$ 3,168,591</u>	<u>\$ 3,188,496</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

NOTES TO FINANCIAL STATEMENTS

Note 1 – Uncollected premiums and agents' balance in course of collection

\$75,549

The captioned amount is the same as the amount reported by the Company in its 2010 Annual Statement.

The report of examination issued at December 31, 2007, by the North Carolina Department of Insurance, indicated that cancelled policies were not deleted from the system due to limitations within the Company's current software package. More specifically, the premium processing software system used by the Company did not properly reverse premiums receivable against premium income upon policy cancellation. Instead of the policies being cancelled on the payment due date, the policies were cancelled a certain number of days after the cancellation notice was issued. As a result, the amount of the premium receivable that should have been reversed was overstated. This examination confirmed that the system glitch or limitation dated back to year-end 2006.

Management determined based on the volume of policies affected, the time needed to correct this problem, and in the interest of practicality and efficiency; it would be best if the software vendor created a software patch to correct this error. By doing so, any potential adjustments would be processed electronically and this would prove more efficient in the long-term. Because the correct amount of the uncollectible premiums receivable could not be reasonably estimated, the entire amount as determined by the system was non-admitted. This resulted in a reduction to the Company's capital and surplus. However, the reduction to the capital and surplus was overstated due to the system glitch. Conversely, premiums ceded and commissions paid pursuant to the reinsurance agreements in place were incorrect as the premium receivable was not being reversed upon policy cancellation.

A correction in the form of a system patch was implemented in November 2010. Management decided to implement the patch on an incremental or installment basis. Increments or installments would be processed because it provided the Company with the ability to review the corrections on a policy by policy basis.

SSAP No. 5, paragraph seven states:

The impairment of an asset shall be recorded by a charge to operations if both of the following conditions are met:

Information available prior to the issuance of the statutory financial statements indicates that it is probable that an asset has been impaired, and

The amount of the loss can be reasonably estimated.

The amount or exposure to the loss could not be reasonably estimated, as such, a disclosure was made in Note 20 and Note 21 of the Notes To Financial Statement, for the years under examination in accordance with SSAP No. 5, paragraph 14 which states:

If a loss contingency or impairment of an asset is not recorded because only one of the conditions 7 a. or 7 b. is met, or if exposure to a loss exists in excess of the amount accrued pursuant to the provisions described above, disclosure of the loss contingency or impairment of the asset shall be made in the financial statements when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

The amount reported in the financial statements contained in this report of examination remains unchanged because the uncollectible premium receivable associated with the policies that were not deleted properly will be written off entirely by December 31, 2011.

**Note 2 – Losses and
Loss adjustment expenses**

\$426,567
\$334,000

The captioned amounts are \$32,000 less than and \$139,000 more than the \$458,567 and \$195,000, respectively, reported by the Company in its 2010 Annual Statement.

The Company's appointed actuary relied on Schedule P data when selecting A Priori loss ratios and industry data when selecting loss development patterns. The A Priori loss ratios relies on actual loss experience for prior accident years as well as the Company's carried Schedule P ultimate losses and defense and cost containment expense (DCCE) reserves. However, the A Priori loss ratio assumptions were weakened due to: (1) an accounting change; (2) a problem with the premium processing system not reversing premium receivable against premium income upon policy cancellation; and (3) problems with losses being entered in the Company's data

system which resulted in an adjustment for payments made in accident years 2008 and prior. Per the Company's appointed actuary, industry data was relied on exclusively for loss development because of credibility considerations. However, industry data for automobile liability includes losses and DCCE combined, while the Company's net automobile liability consisted of DCCE only, because the Company ceded all of its liability losses to the North Carolina Reinsurance Facility. The consulting actuaries for the Alabama Department of Insurance determined that the Company's net automobile experience had sufficient credibility for some consideration in selecting loss development patterns.

The consulting actuaries for the Alabama Department of Insurance performed an analysis on the net automobile liability loss and DCCE reserves using alternative assumptions for A Priori ratios and loss development patterns. Per the analysis performed, an adjustment of \$189,000 for net automobile liability loss and DCCE liabilities was necessary. When comparing the Automobile Physical Damage (APD) losses, DCCE reserves, and the carried net Adjustments and Other (A & O) reserves for APD as determined by the consulting actuaries to the Company's appointed actuaries estimates, redundancies were noted.

Because of the redundancies noted in the appointed actuary's estimates, the net carried loss reserves were decreased by \$32,000 and the net LAE reserves were increased by \$139,000 based on the adjustment outlined above pertaining to the net LAE, reduced by \$50,000 for redundancy in the A & O reserves. As a result, an overall adjustment of \$107,000 to the total net loss and LAE reserves was recorded.

Note 3 - Taxes, licenses and
fees (excluding federal and foreign income taxes) **\$364,111**

The captioned amount is \$184,741 more than the \$179,370 reported by the Company in its 2010 Annual Statement.

The Company took reductions to the 3.6% gross premium tax rate based on the number of employees and investments in real property as specified in accordance with ALA. CODE § 27-4A-3 (a) (3) d. 1 and 2 (1975) which states:

Alabama Insurance Offices Facilities Credit. For each office owned or leased by an insurer in the State of Alabama and used for insurance operations, an insurer shall be entitled to a credit against the tax imposed by paragraph a. of this subdivision (3) according to the following: Number of Full-Time

Employees in Office 11-50 employees at 0.0075%... For each \$1,000,000 in value of real property investments in the State of Alabama, an insurer shall be entitled to a credit of 0.10 percent of its Alabama premiums taxable at the rate specified in paragraph a. of this subdivision (3).

The Company calculated their 2010 retaliatory taxes using a reduced tax rate of 2.65%. The retaliatory tax rate should have been 3.4925%. As a result, the Company under accrued their taxes, licenses and fees by \$184,741.

Note 4 – Unassigned funds (surplus) (\$1,494,413)

The above captioned amount is \$291,741 less than the (\$1,202,672) reported by the Company in its 2010 Annual Statement. The following is a reconciliation of unassigned funds per the examination.

Unassigned funds per Company		(\$1,202,672)
Examination increase/ (decrease) to assets:	0	
Total increase/ (decrease) to assets		0
Examination (increase)/decrease to liabilities:		
Note 2 - Losses and LAE:	(\$107,000)	
Note 3 - Taxes, license, and fees:	(\$184,741)	
Total (increase)/decrease to liabilities		(291,741)
Unassigned funds (surplus) per Examination		<u>(\$1,494,413)</u>

COMMITMENTS AND CONTINGENT LIABILITIES

Examination of these items included: reviewing the Company’s Annual Statement disclosures, generally reviewing the Company’s records and files for unrecorded items, and obtaining letters of representation from management.

As of December 31, 2010, there was no pending litigation against the Company and no material contingent liabilities were identified.

COMPLIANCE WITH PREVIOUS RECOMMENDATIONS

The Company was last examined by the North Carolina Department of Insurance as of December 31, 2007. On December 31, 2009, the Company re-domesticated to Alabama. This examination covers the intervening period from the date of the last examination through December 31, 2010. Being that this was the first examination conducted by the Alabama Department of Insurance, there were no prior recommendations to comply with.

COMMENTS AND RECOMMENDATIONS

Board of Directors – Page 4

It is recommended that the Company update its Articles of Incorporation to change the minimum number of directors to three to comply with ALA. CODE § 27-27-23 (a) (1975), which states: “The affairs of every domestic insurer shall be managed by not less than three directors, and at least one-third of the directors shall be bona fide residents of this state.”

Corporate Records – Page 5

It is recommended that the Board of Directors (or a committee expressly authorized), approve or ratify all investment transactions of the Company in accordance with ALA. CODE § 27-41-5 (1975) which states:

An insurer shall not make any investment or loan, other than loans on policies or annuity contracts, unless the same be authorized, approved or ratified by the board of directors of the insurer or by such committee or person as the board of directors shall expressly authorize.

It is recommended that the Company answer No to General Interrogatory 15 of the General Interrogatories of the Annual Statements in those years in which the investment transactions of the Company are not authorized, approved, or ratified by the Board of Directors of the Company, or a subordinate committee thereof.

It is recommended that the minutes of the Board of Directors meetings contain a complete and thorough account of the monitoring and discussions of the financial solvency and risk management issues of the Company, including review of the

Company's budgets, audit reports, and the letters by the external auditors to the audit committee.

Holding Company and Affiliate Matters – Page 6

It is recommended that the Company stop making interest free loans to its affiliate in accordance with ALA. CODE § 27-29-5 (1975) which states:

Material transactions by registered insurers with their affiliates shall be subject to the following standards:

- (1) The terms shall be fair and reasonable;
- (b) The following transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into such transaction at least 30 days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period.
- (1) Sales, purchases, exchanges, loans or extensions of credit, guarantees, or investments provided the transactions are equal to or exceed: a. With respect to nonlife insurers, the lesser of three percent of the insurer's admitted assets or 25 percent of surplus as regards policyholders as of the 31st day of December next preceding.

It is recommended that all proposed transactions with related parties are filed with the Commissioner of Insurance in accordance with ALA. ADMIN. CODE 482-1-055-.18 (1994) which states: "An insurer required to give notice of a proposed transaction pursuant to Section 27-29-5 shall furnish the required information on Form D, hereby made a part of this chapter."

It is recommended that the Company's managing general agent, InsTrust, become licensed as a managing general agent in accordance with ALA. CODE § 27-6A-3 (1975) which states:

- (b) No person, firm, association, or corporation shall act in the capacity of a managing general agent representing an insurer domiciled in this state with respect to risks located outside this state unless then licensed in this state as a

managing general agent of the insurer. Where applicable, the license may be a nonresident license pursuant to this chapter.

It is recommended that the factoring agreement be amended to clearly and concisely reflect the nature and detail of the transactions (sale of premium receivable) in accordance with ALA. CODE § 27-29-5 (1975) which states:

Material transactions by registered insurers with their affiliates shall be subject to the following standards: (4) The books, accounts, and records of each party will be so maintained as to clearly and accurately disclose the precise nature and details of the transactions; and.

It is recommended that the factoring agreement be amended to include a settlement provision in accordance with SSAP No. 96, paragraph six which states: “Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owned, with a specific due date.”

Fidelity Bond and Other Insurance – Page 12

It is recommended that the Company obtain a fidelity bond or become a named insured on a fidelity bond in at least the suggested minimum amount found in the NAIC Financial Condition Examiners Handbook.

It is recommended that the Company file a copy of its fidelity bond with the Alabama Department of Insurance in accordance with ALA. ADMIN. CODE 482-1-106.-04 (2002) which states:

Any insurer who is required under Rule 482-1-106-.03 to file for appointment of a managing general agent (MGA) must complete and file all of the following within thirty (30) days of that appointment...A copy of a fidelity bond for the protection of the insurer in the minimum amount of one hundred thousand (\$100,000) with no deductible.

Compliance with ALA. ADMIN. CODE 482-1-146 (2009) – Page 15

It is recommended that the Company establish internal procedures for background checks or investigations, or otherwise for applicants for employment and employees in accordance with ALA. ADMIN. CODE 482-1-146 (2009) which states:

A Section 1033 insurer subject to the Commissioner’s examination authority shall have and apply the following:

- (a) An internal procedure for determining, by means of background checks or investigations or otherwise, whether applicants for employment or individuals with whom the insurer intends to contract for activities in the business of insurance, whether or not in a capacity requiring a license, have a felony conviction for a Section 1033 offense.
- (b) An internal procedure after initial employment or contracting, applied on a periodic basis, to ascertain the existence of a felony conviction for a Section 1033 offense.

Accounts and Records – Page 18

It is recommended the Company implement a formal data retention policy that complies with ALA. ADMIN. CODE 482-1-118-.03 (1999) which states:

Every insurer, which term shall include every domestic insurer, foreign insurer, health care services corporation, health maintenance organization, prepaid dental plan, managing general agent or any other legal entity regulated by the Insurance Code and licensed to do business in this state shall maintain its books, records, documents and other business records in order that the insurer’s financial condition may be readily ascertained by the Department of Insurance, taking into consideration other record retention requirements. All records must be maintained for not less than five (5) years.

It is recommended that the company implement a comprehensive written security program in accordance with ALA. ADMIN. CODE 482-1-126-.04 (2003) which states:

Each licensee shall implement a comprehensive written information security program that includes administrative, technical and physical safeguards for the protection of customer information. The administrative, technical and physical

safeguards included in the information security program shall be appropriate to the size and complexity of the licensee and the nature and scope of its activities.

Uncollected premiums and agents balances in the course of collection – Page 24

It is recommended that the Company implement system controls for its premium processing software to insure that its premium receivable is properly reversed against its premium income when policy are cancelled. The implementation of system controls would reduce the amount of premium receivables that are non-admitted thus reducing the amount charged to capital and surplus and it would also ensure that the amount of premiums ceded are not overstated.

Taxes, Licenses, and fees (excluding federal and foreign income taxes) – Page 26

It is recommended that when computing premium tax rate reductions, the Company comply with ALA. CODE § 27-4A-3 (a) (3) d. 1 and 2 (1975) which states:

Alabama Insurance Offices Facilities Credit. For each office owned or leased by an insurer in the State of Alabama and used for insurance operations, an insurer shall be entitled to a credit against the tax imposed by paragraph a. of this subdivision (3) according to the following: 11-50 employees at 0.0075... For each \$1,000,000 in value of real property investments in the State of Alabama, an insurer shall be entitled to a credit of 0.10 percent of its Alabama premiums taxable at the rate specified in paragraph a. of this subdivision (3).

SUBSEQUENT EVENTS

The general ledger and cash transactions occurring subsequent to the balance sheet date were reviewed and no significant subsequent events were identified. However, on June 28, 2011, the Alabama Department of Insurance approved the acquisition of the Company by Integon National Insurance Company.

CONCLUSION

Acknowledgement is hereby made of the courteous cooperation extended by the officers of Agent Alliance Insurance Company during the course of this examination.

The customary insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed to the extent deemed appropriate in connection with the verification and valuation of assets and determination of liabilities set forth in this report.

In addition to the undersigned, Blase Abreo, CFE, Financial Examiner; Charles Turner, CISA, IS Examiner; Jerry Hyche, AIE, MCM, FLMI, Market Conduct Examiner; Robert Thompson, Financial Examiner; and Michael Solomon, FCAS, MAAA; Sue Buehler, FCAS, MAAA and Meghan Brown, of Merlinos & Associates, Inc., Consulting Actuaries; all representing the Alabama Department of Insurance, participated in this examination of Agent Alliance Insurance Company.

Respectfully submitted,



Toni L. Bean, CFE
Examiner-in-Charge
State of Alabama
Department of Insurance