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Dept. Of Commerce & Insurance
Company Examinations

Report on Examination

of

MERASTAR INSURANCE COMPANY

Chattanooga, Tennessee

as of

December 31, 2004

PARTICIPATION

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DEPARTMENT OF COMMERCE AND INSURANCE
STATE OF TENNESSEE
Nashville, Tennessee

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STATE OF TENNESSEE
DEPARTMENT OF COMMERCE AND INSURANCE
INSURANCE DIVISION
500 JAMES ROBERTSON PARKWAY - 5TH FLOOR
NASHVILLE, TENNESSEE 37243-1135

June 7, 2005

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Commissioner
Tennessee Department of Commerce
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500 James Robertson Parkway
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The Honorable Kevin McCarty
Chair, Southeastern Zone NAIC
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The Honorable Tim Wagner
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The Honorable Mike Kreidler
Chair, Western Zone NAIC
Commissioner
Washington State Office of Insurance
P.O. 40255
Olympia, Washington 98504-0255

Sirs and Madams:

Pursuant to your instructions and in accordance with Tennessee insurance laws and regulations, and resolutions adopted by the National Association of Insurance Commissioners (NAIC), a financial examination and market conduct review has been made of the condition and affairs of

Merastar Insurance Company
5600 Brainerd Road, Suite 1A
Chattanooga, Tennessee 37411

(hereinafter and generally referred to as "the Company") as at December 31, 2004, and the report thereon is hereby respectfully submitted.

SCOPE OF EXAMINATION

The Company was last examined as of December 31, 1999 by the Tennessee Department of Commerce and Insurance (hereafter referred to as the Department). That Report of Examination was adopted by the Department by Order dated April 10, 2002. Exceptions of statutory significance noted in that report and the Company's subsequent actions are summarized as follows:

December 31, 1999 Report Recommendation:	Company Action/Response:
It was recommended that the Company secure the receivables from its parent with competent collateral or non-admit the receivables in accordance with Tenn. Code Ann § 56-1-405.	The Company was sold by its parent, Prudential, in 2004 and reported no receivables from its new parent, Merastar Industries, Ltd., at December 31, 2004.
It was recommended that the Company execute a custodial agreement that complies with Tenn. Reg. 0780-1-46.	Prior to the completion of the December 31, 1999 examination, effective January 1, 2001, the Company executed a custodial agreement that was deemed to be in compliance with Tenn. Reg. 0780-1-46.

This examination, which began August 4, 2004, covers the intervening period from January 1, 2000 through and including December 31, 2004, and was conducted by representatives of the Department. The examination was originally authorized to be performed as of June 30, 2004, but on September 2, 2004, the "as of" date was changed to December 31, 2004. The examination of the financial condition of the Company consisted of a review of corporate minutes and records, verification and valuation of assets and a

determination of liabilities, reserves and the resulting unassigned (surplus) funds, and was conducted in accordance with guidelines and procedures contained in the NAIC Examiners Handbook.

An examination was also made into the following matters:

History of the Company
Management and Control
Pecuniary Interest and Commission Equity
Corporate Records
Statutory Deposits
Fidelity Bond and Other Insurance
Territory and Plan of Operation
Growth of the Company
Loss Experience
Reinsurance
Market Conduct Activities
Employee Welfare and Pension Plans
Accounts and Records
Financial Statement

Such tests and review were conducted as were deemed necessary or appropriate for the purposes of this examination. This report is written by exception, except for certain items of regulatory significance, and those matters examined and found to be substantially in compliance with statutes will not be commented on further. Events subsequent to the December 31, 2004, examination date are included where relevant and appropriate.

The Company is audited annually by an independent accounting firm. The auditors had not completed their 2004 audit of the Company during the course of this examination and no workpapers for the year ended 2004 were available for review.

The annual statements for the years ended December 31, 2000 through 2004 were reviewed and reconciled to the Company's books of account. See further comment under caption "Accounts and Records."

HISTORY OF THE COMPANY

The Company was incorporated pursuant to the provisions of the Tennessee General Corporation Act on August 14, 1974 as Provident General Insurance Company, a for-profit, full line property and casualty insurer, and commenced business on November 1, 1974.

On December 31, 1987 Northwestern National Life Insurance Company (NNLIC) acquired control of the Company through the purchase of all outstanding shares from the Company's sole shareholder, Provident Life and Accident Insurance Company. Through an assumption reinsurance agreement effective December 31, 1989, the Company acquired all inforce policies, assets and liabilities of an affiliate, NWNL General Insurance Company. This assumption agreement had been approved by the Department on October 9, 1989.

Effective August 9, 1990 the Company changed its name to Merastar Insurance Company. A Charter amendment to reflect the name change was approved by the Department on May 21, 1990 and filed with the Secretary of State the next day.

On June 21, 1991 the Company was acquired by GEICO Corporation from NNLIC, and on December 31, 1993 all outstanding stock of the Company was sold to Merastar Corporation, a Maryland corporation, which was owned by a partnership of which the former GEICO Corporation chairman was sole general partner.

On June 1, 1998, 100% of the outstanding common stock of Merastar Corporation was acquired by Prudential Property and Casualty Insurance Company ("PRUPAC") whose ultimate parent was The Prudential Insurance Company of America. Effective January 1, 1999, the Prudential group contributed 100% of Merastar Corporation's outstanding shares to a non-insurance holding company, Prudential P&C Holdings, Inc. (hereinafter "Prudential"), through a transaction that had been approved by the Department November 2, 1998. The

Prudential group underwent demutualization on December 18, 2001 and the ultimate parent of the holding company system changed from Prudential Insurance Company of America (an insurer) to Prudential Financial, Inc. (a non-insurer).

On November 4, 2003 a stock purchase agreement was executed in which Prudential agreed to sell its interests in Merastar Corporation, the Company's parent, to Merastar Industries, Ltd. (hereinafter "Industries"), a Delaware corporation, whose ultimate controlling person is Mark J. Byrne through Haverford (Bermuda) Limited (hereinafter "Haverford"), a licensed Bermuda insurance company owned by three individual entities. On March 4, 2004 final approval was given by the Department for the transaction to be effective March 1, 2004. Following the acquisition, Industries merged with and into Merastar Corporation with Industries as the surviving entity and the Company's parent.

At its incorporation the Company was authorized to issue 20,000 shares of common stock, each share to have a par value of $100.00. By Charter amendment effective June 1, 1981, the Company changed the number of authorized shares to 30,000, all of which are currently held by Industries. A summary of the Company's capitalization since the previous examination is presented as follows:

	Number of Authorized Shares	Par Value	Shares Issued and Outstanding	Common Stock	Paid-In Surplus	Unassigned Funds (Surplus)*
Balance, December 31, 1999	30,000	100	26,000	$2,600,000	$25,754,317	($13,343,205)
Capital paid in, 2003			4,000	400,000		
Surplus contribution from Prudential in 2003					9,600,000	
Surplus contribution from Industries in 2004					7,941,275	
Balance, December 31, 2004	30,000	100	30,000	$3,000,000	$43,295,592	($24,472,188)

* As determined by examination.

MANAGEMENT AND CONTROL

Holding Company System:

The Company is a member of an insurance holding company system as defined by Tenn. Code Ann. § 56-11-201. The Company became a wholly owned subsidiary of Merastar Industries, Ltd., a Delaware holding company, on March 1, 2004. The organization of the Company and its holding company system is presented in a chart attached to this report as Addendum A.

Shareholders:

The Company is wholly owned by its parent, Merastar Industries, Ltd. ("Industries"), which is the sole shareholder of all 30,000 outstanding shares of the Company's common stock.

The Company's Charter is silent as the duties of the shareholders. The Bylaws of the Company, as amended effective March 1, 2004, state that:

> "The annual meeting of the shareholders of the Corporation shall be on such date as may be determined by the Board of Directors,"

and that:

> "The Board of Directors . . . may designate any place, either within or without the State of Tennessee, as the place of the meeting. If no place is fixed, the meeting shall be held at the principal office of the Corporation."

The shareholders held annual meetings in accordance with the Bylaws during the period under examination.

Special meetings may be called by the Board of Directors, the Chairman of the Board, the Vice Chairman of the Board, the President, the Secretary or the holders of at least ten percent (10%) of all the votes entitled to be cast on any issue proposed to be considered at the special meeting."

The Bylaws also provide that "a majority of the shares entitled to be cast on a matter constitutes a quorum for action on that matter" and that "each outstanding share is entitled to one (1) vote on each matter voted." Shareholders may vote "in person or by proxy." An action of the shareholders may be taken without a meeting if the action is evidenced by written consents describing the action taken and such consents are then included in the minutes for filing with the corporate records.

Board of Directors:

The Company's Bylaws state that "All corporate powers shall be exercised by or under the authority of and the business and affairs of the Corporation managed under the direction of the Board of Directors." The number of directors "shall consist of no fewer than seven (7) or more than fifteen (15) members." They "shall be elected at the first annual shareholders' meeting and at each annual meeting thereafter," and their terms shall "expire at the next annual shareholders' meeting following their election." Vacancies on the board may be filled by "either the shareholders or the Board of Directors." A quorum is defined by the Bylaws as a "majority of directors in office immediately before the meeting begins," but "shall in no case consist of less than five (5) directors" and "shall always include either the Chairman or the President."

The following persons had been duly elected by the shareholders and were serving as members of the Board at December 31, 2004:

Name	Home Address	Principal Occupation/Affiliation
David A. Brown	Water's Edge 15 Tucker's Town Rd. St. George HS 02 Bermuda	Chairman of the Board of the Company; 8% shareholder in the Company's ultimate parent, Haverford (Bermuda) Limited.
Timothy D. Bruns	2605 Arbor Creek Way Hixson, TN 37343	President and CEO of the Company,

William P. Roland	4605 Bonnieway Dr. Chattanooga, TN 37411	Vice president, secretary and chief actuary of the Company.
Bradley H. Wright	9919 Cottage Creek Ln. Apison, TN 37302	Vice-president and treasurer of the Company.
Scott D. Harris	2619 Winter Garden Dr. Chattanooga, TN 37421	Vice-president (claims) of the Company.
Kenneth G. Lytle	2808 Nile Rd. Chattanooga, TN 37421	Vice-president (information systems) of the Company.
Richard E. Saltzman	2624 Crescent Club Dr. Hixson, TN 37343	Vice-president (underwriting, customer service and compliance) of the Company.
Don S. Smith	146 Riverwood Dr. Franklin, TN 37064	Vice-president (sales and marketing) of the Company.

Mr. Wright resigned from the Company at year-end 2004 and Mr. Smith resigned in March 2005. Mr. Smith's resignation placed the Company in violation of its Bylaws, which require at least seven directors on the Board, until Mr. Wright was replaced by Stephen Brandt in April 2005 and elected to the Board in May. It is recommended that the Company maintain the number of directors on its Board as stipulated by the Bylaws, or amend the Bylaws to reflect actual practice.

Regular meetings of the Board of Directors "may be held without notice of the date, time, place or purpose of the meeting" and may be held either within or without the State of Tennessee. Special meetings "may be called by the Chairman of the Board, the Vice Chairman of the Board, the President or any two (2) directors."

As with the shareholders, action may be taken by the Board without a meeting if such action is evidenced by written consents as filed with the corporate records. The Board of Directors may also conduct meetings through the use of "any means of communication by which all directors participating may simultaneously hear each other during the meeting. A director participating in a meeting by this means is deemed to be present in person at the meeting."

Officers:

The Bylaws provide that:

> "The officers of the Corporation shall be a Chairman of the Board, a President, one (1) of more Vice Presidents (including an Executive and/or Senior Vice Presidents) as the Board shall determine from time to time, a Secretary, and a Treasurer. There may also be appointed a Vice Chairman of the Board, an Actuary, a Controller, a General Counsel, and Internal Auditor and such other officers as may be from time to time advisable. One person may simultaneously hold more than one office except the President may not simultaneously hold the office of Secretary."

Officers "shall be appointed annually by the Board of Directors at its annual meeting or by a Committee of the Board." Vacancies "may be filled for the unexpired portion of the term by the Board of Directors."

At December 31, 2004, the following persons had been duly elected to and were serving in the positions indicated:

Chairman of the Board	David A. Brown
President and CEO	Timothy D. Bruns
Vice President, Secretary and Chief Actuary	William P. (Paul) Roland
Vice President and Treasurer	Bradley H. Wright
Vice President – Claims	Scott D. Harris
Vice President – Information Systems	Kenneth G. Lytle
Vice President – Underwriting, Customer Service and Compliance	Richard E. Saltzman
Vice President – Sales and Marketing	Don S. Smith

As noted above, Mr. Wright resigned at year-end 2004 and Mr. Smith in March 2005. Mr. Wright was replaced by Stephen Brandt in April 2005.

Committees:

The Company's Bylaws state that "the Board of Directors may create one (1) or more committees . . ., each consisting of one (1) or more members."

At its March 26, 2004 meeting, the board elected an executive committee as follows:

David A. Brown Timothy D. Bruns W. Paul Roland

The executive committee is vested with "all the powers and authority of the Board in the management of the business and affairs of the Company, including the declaration of dividends" as permitted by Tennessee insurance law.

Conflict of Interests:

Prior to the purchase of the Company by Industries, conflict of interests procedures were administered by Prudential's corporate offices which provided no completed statements to the examiners for years prior to the sale in 2004. Following the sale, the Company implemented its own "Conflict of Interest Questionnaire" and "Oath and Conflict of Interest Affidavit" to disclose potential conflicts of interests. These forms were completed by the Company's directors and officers for 2004 without exception.

Investments:

Tenn. Code Ann. § 56-3-408(b)(1) states that "No investment or loan . . . shall be made . . . unless the same shall first have been authorized by the board of directors or by a committee appointed by such board and charged with the duty of supervising such investment or loan." The Company's board of directors has implemented a procedure to approve and ratify the "purchases and sales of assets" at quarterly meetings. This practice appears to fulfill the requirements of Tenn. Code Ann. § 56-3-408(b)(1).

Custodial Agreement: Some of the Company's securities are held as statutory deposits in states where deposits are required for licensure. Custodial agreements are in accordance with statutory requirements in those states. See caption "Statutory Deposits."

For those securities that are not held as statutory deposits, the Company has a safekeeping agreement with the custodian. However, this agreement does not have all of the safeguards recommended by the NAIC or require the "standard of responsibility on the part of the custodian which shall not be less than the responsibility of a bailee for hire or a fiduciary under statutory . . . law of Tennessee" as stipulated by Tennessee Regulation 0780-1-46-.04. During this examination, a Custodial Agreement was executed that now appears to comply with the minimum requirements of the Regulation. It is noted that the Company's securities custodian executed the appropriate Custodian Affidavits as required by Tennessee Regulation 0780-1-46-.04.

Management and Other Agreements:

Investment Management Agreement: Effective March 1, 2004 the Company entered into a Discretionary Investment Management Agreement with West End Capital Management (Bermuda) Limited ("West End"), an affiliated company as defined by Tenn. Code Ann. § 56-11. The agreement provides that West End will "make all investment decisions in respect" of the Company's portfolio including those for purchases and sales, but that the Company will remain "the beneficial owner of Portfolio assets." Investments made by West End "shall comply with Tennessee regulations and NAIC requirements," and as with the Company's Investment Policy, "each security must be rated, or be subject to rating, by NAIC class 1 or 2." West End's fees for services provided vary from 15 to 60 basis points in relation to type of investment and the market value of the assets managed.

The agreement states that fees for West End's services are to be paid "quarterly in arrears." The Company has not been paying this fee timely, although it has been accruing for

the expense, and management states that the fee will be paid in accordance with the agreement for 2005 and forward.

Currently, West End is not registered with the U.S. Securities and Exchange Commission as an investment advisor due to an exemption in the SEC laws. However, this exemption is scheduled to be amended in February 2006 and will no longer be available to excuse West End from registration. West End management states that the firm is in the process of voluntarily registering with the SEC before the exemption amendment takes effect. It is recommended that the Company's investment manager, West End Capital Management (Bermuda) Limited, register as an investment advisor with the SEC so as to be fully compliant with U.S. securities laws as they are to be amended effective February 2006.

The investment management agreement with West End was submitted to the Department in December 2004 and is currently pending approval.

Tax Allocation Agreement: Effective March 1, 2004 the Company entered into a Tax Allocation Agreement with its parent, Merastar Industries, Ltd., under which Industries shall file a consolidated federal income tax return on behalf of itself and the Company. Tax liabilities shall be "apportioned to the insurer based on the tax liabilities of the entities computed on a separate return basis." Settlements between the Company and its parent, including refunds due the Company, shall be made within 30 days. This tax allocation agreement was approved by the Department on April 28, 2005.

Employment Agreements: On March 1, 2004, the Company executed Employment Agreements with the president and vice presidents, all of whom are also directors of the Company. The agreements shall terminate on February 28, 2006 "unless sooner terminated . . . or unless otherwise extended."

The agreements specify the employees' position and title in the Company, salary and conditions of termination. The agreement also include a confidentiality clause whereby employees agree to keep all Company information confidential and "not to disclose or cause to be disclosed such information of the Company or of its customers."

In accordance with Tenn. Code Ann. § 56-11-206(a)(2)(D), the Company filed the Employment Agreements with the Department in January 2005.

Dividends:

The Bylaws of the Company state that the "Board of Directors may, from time to time, declare, and the Corporation may pay, dividends on its outstanding shares of capital stock in the manner and upon the terms and conditions provided for by applicable law."

No dividends were declared or paid by the Company during the years 2000 - 2003. However, in connection with the sale of the Company by Prudential to Merastar Industries, Ltd., a dividend to Prudential of $6 million was approved by the Department on March 3, 2004.

PECUNIARY INTEREST AND COMMISSION EQUITY

No relationships or transactions were noted that would violate the pecuniary interest prohibitions set forth in Tenn. Code Ann. § 56-3-103.

All of the Company's current ceded reinsurance agreements, for which commissions are paid, are transacted on an earned premium basis, and therefore, no commission equity liability is necessary.

On March 1, 2004, the Company entered into a Loss Reserve Reinsurance Agreement (see caption "Reinsurance," below) under which it ceded all business inforce on or prior to

February 29, 2004. A reserve for the commission paid under this agreement was established by the Company to be reduced as this business expires.

CORPORATE RECORDS

The Company's current Certificate of Authority was issued May 22, 1990 and is effective until suspended or revoked.

The Company's Restated Charter is dated March 1, 2004; it was filed with the Insurance Commissioner of the State of Tennessee on October 21, 2004. A Department analyst noted that since the Restated Charter contained no changes from the Charter that had been approved July 9, 1999, so no subsequent approval was required. The Secretary of State's records show that the Company filed a change of registered agent on April 21, 2004.

The Company's Bylaws are not dated, but were approved and adopted by the Board of Directors on March 26, 2004, filed with the Department October 21, 2004, and therefore relied upon for this examination. No subsequent amendments were noted.

The minutes of the annual meetings of the Company's sole shareholder (Industries) were provided to the examiners. The shareholder's primary function is to elect directors to the board annually.

The meeting minutes of the Company's board of directors were provided to the examiners for the period under examination and appear to properly reflect the acts of the Company's board, particularly the election of officers. Attachments and exhibits provided to the directors are maintained with the minutes.

The Company's corporate records are maintained its offices in Chattanooga, Tennessee.

STATUTORY DEPOSITS

In compliance with Tenn. Code Ann. § 56-2-104(a)(4), the Company was maintaining the following deposits for the benefit of all policyholders and creditors at December 31, 2004. Other deposits are held by the custodians of the states listed:

Description of Security	Par Value	Statement Value	Market Value
Tennessee:			
U.S. Treasury Note purchased 5/14/2002, CUSIP #9128276J6, 5.750%, due 8/15/2010	$1,000,000	$1,025,352	$1,100,980
U.S. Treasury Note purchased 5/14/2002, CUSIP #9128277L0, 4.875%, due 2/15/2012	$ 700,000	$ 648,710	$ 702,872
U.S. Treasury Note purchased 5/14/2002, CUSIP #912828AC4, 4.375%, due 5/15/2007	$ 300,000	$ 298,282	$ 308,331
Arkansas:			
U.S. Treasury Note purchased 5/14/2002, CUSIP #912828AC4, 4.375%, due 5/15/2007	$ 70,000	$ 69,599	$ 71,944
Georgia:			
U.S. Treasury Note purchased 5/14/2002, CUSIP #9128277L0, 4.875%, due 2/15/2012	$ 250,000	$ 243,875	$ 264,238

Description of Security	Par Value	Statement Value	Market Value
Louisiana:			
Bank One, Louisiana Certificate of Deposit purchased 4/28/2003, CD #880050236544, 5.200%, matures annually, automatically renews	$ 20,000	$ 20,000	$ 20,000
New Mexico:			
U.S. Treasury Note purchased 5/14/2002, CUSIP #912828AC4, 4.375%, due 5/15/2007	$ 310,000	$ 308,224	$ 318,609
North Carolina:			
U.S. Treasury Bond purchased 11/4/2003, CUSIP #912810EM6, 7.250%, due 8/15/2022	$ 250,000	$ 310,422	$ 322,198
U.S. Treasury Note purchased 5/14/2002, CUSIP #912828AC4, 4.375%, due 5/15/2007	$ 100,000	$ 99,427	$ 102,777
South Carolina:			
U.S. Treasury Note purchased 5/14/2002, CUSIP #912828AC4, 4.375%, due 5/15/2007	$ 150,000	$ 149,141	$ 154,165
Virginia:			
U.S. Treasury Note purchased 5/14/2002, CUSIP #912828AC4, 4.375%, due 5/15/2007	$ 70,000	$ 69,599	$ 71,944
Totals	$3,220,000	$3,242,330	$3,438,058

The above deposits were verified with the custodians of each states' insurance department. In its 2004 Annual Statement, the Company miscalculated the portion of its New Mexico statutory deposit that exceeds the premiums written and unpaid losses which is non-admissible in accordance with Tenn. Code Ann. § 56-1-405. However, the non-admitted portion was calculated incorrectly; the correct calculation results in an additional $44,000 that should have been non-admitted. As this amount is well below the materiality level for the examination, no change has been made to the financial statement of this report.

FIDELITY BOND AND OTHER INSURANCE

As part of its business insurance package, the Company is afforded fiduciary liability coverage that has a policy year occurrence/aggregate limit of $1,000,000 with a deductible of $100,000 for each claim. The minimum range recommended by the NAIC for a company of this size is $700,000 to $800,000 and the Company's coverage is deemed to be in accordance with NAIC recommendations.

The Company's major coverages at December 31, 2004 are summarized as follows:

Type or Class of Coverage	Limits, Retentions and Deductibles
Commercial Property:	
Business Personal Property (contents)	$ 6,755,000
Business Income, incl. ordinary payroll	$ 1,000,000
Accounts Receivable	$ 250,000
Installment or Deferred Sales	$ 50,000
Newly Acquired or Constructed:	
Building	$ 1,000,000
Business Personal Property	$ 500,000
Commercial General Liability:	
General	$ 2,000,000 aggregate
Products/Completed Operations	$ 2,000,000 aggregate
Liability	$ 1,000,000 per occurrence
Fire Legal	$ 1,000,000 per occurrence
Medical Expenses	$ 10,000 any one person

Personal and Advertising Injury	$ 1,000,000 per occurrence
Damage to Rented Premises	$ 300,000 any one premises
Commercial Automobile:	
Liability	$ 1,000,000 combined single limit with $1,000 comprehensive deductible and $1,000 collision deductible
Uninsured Motorists (Tennessee)	$ 1,000,000 each accident
Hired Physical Damage	$ 50,000 each accident
Workers' Compensation	Statutory
Employer's Liability	
Bodily Injury by Accident	$ 500,000 each accident
Bodily Injury by Disease	$ 500,000 each employee
Bodily Injury by Disease	$ 500,000 policy limit
Employment Practices Liability	$ 2,000,000 each policy year
Insurance Company Professional Liability	$ 1,000,000 each policy year
Employee Benefits Liability	$ 1,000,000 per occurrence/aggregate
Umbrella Liability	$ 5,000,000 per occurrence/aggregate with a $10,000 per occurrence retention

All of the Company's policies are underwritten by insurers licensed in Tennessee.

TERRITORY AND PLAN OF OPERATION

The Charter as restated March 1, 2004 states that the purposes of the Company are "To engage as a principal in the business of insurance" and "To engage in any lawful business." The Charter also specifies that the Company is to be operated "for profit."

The Company's Tennessee license allows it to transact the business of property, casualty, vehicle, and surety insurance. At the date of this report the Company was licensed in the District of Columbia and 48 states, excluding Hawaii and Massachusetts, but had no writings in Alaska and New Jersey. Premiums by state in which the Company operated for the year ended December 31, 2004 are presented as follows:

State	Direct Premiums Written	Direct Premiums Earned
Alabama	$ 1,208,930	$ 1,223,532
Alaska	0	0
Arizona	984,598	1,051,386
Arkansas	101,190	98,138
California	6,905,400	6,833,170
Colorado	1,497,457	1,561,843
Connecticut	372,621	356,174
Delaware	500,845	488,135
District of Columbia	34,894	35,066
Florida	6,446,488	6,349,413
Georgia	10,725,778	11,000,290
Idaho	34,579	35,048
Illinois	710,309	722,311
Indiana	417,335	388,349
Iowa	1,703,016	1,745,008
Kansas	99,406	96,682
Kentucky	562,404	521,254
Louisiana	291,233	246,497
Maine	8,846	6,079
Maryland	876,706	886,235
Michigan	1,435,792	1,392,222
Minnesota	3,639,731	3,748,974
Mississippi	442,696	437,680
Missouri	356,277	363,732
Montana	12,292	11,125
Nebraska	130,970	135,343
Nevada	875,228	873,080
New Hampshire	27,202	23,378
New Jersey	0	0
New Mexico	34,125	31,634
New York	2,675,841	2,915,502
North Carolina	1,582,936	1,583,798
North Dakota	12,405	14,331
Ohio	896,200	893,346
Oklahoma	132,877	133,936
Oregon	75,142	69,126
Pennsylvania	1,334,345	1,278,620
Rhode Island	191,477	136,582
South Carolina	3,619,726	3,647,738
South Dakota	32,081	39,174
Tennessee	5,047,285	5,115,396
Texas	2,050,023	2,034,172
Utah	39,987	40,643
Vermont	3,229	2,397

State	Direct Premiums Written	Direct Premiums Earned
Virginia	$ 1,335,142	$ 1,317,372
Washington	517,982	535,904
West Virginia	211,133	219,836
Wisconsin	201,604	205,840
Wyoming	5,156	3,969
Total	$60,400,919	$60,849,460

The Company writes private passenger automobile, homeowners/condo owners, renters, boat and personal liability (umbrella) insurance through employer-sponsored groups of at least 500 members, primarily through payroll deduction. From August 1999 to November, 2003, while a subsidiary of Prudential, the Company also wrote these coverages on a direct basis.

The Company markets its products principally through print material and electronic exchange. A total of 40 sales and service personnel are located in house and are duly licensed for the states they serve. As of August 6, 2004, the company was using 79 brokers. Only one of the brokers, Rewards Plus, provides payroll deduction services for its groups.

REINSURANCE

Assumed Reinsurance:

Effective November 1, 2003, the Company entered into a reinsurance agreement with Consolidated Lloyd's of Dallas, Texas, under which the Company assumes 100% of the fire, homeowners, allied lines and inland marine policies issued or renewed by Consolidated Lloyds and written through the Haskins Agency, Inc., Plano, Texas. Even though the Company is licensed in Texas, a fronting arrangement of this type is necessary to comply with Texas law

regarding the coverages insured. Commissions under the agreement are one percent (1%) of net premiums actually received by the Company, but not less than $1,000 per month.

Ceded Reinsurance:

While a Prudential subsidiary, the Company had reinsurance agreements with an affiliate, PRUPAC. These treaties were commuted and all obligations returned to the Company effective November 1, 2003. The Company currently cedes most of its business through a Quota Share Reinsurance Treaty and a Loss Reserve Reinsurance Agreement, both effective March 1, 2004, and both of which were approved by the Department June 18, 2004. The Company also maintains excess coverage in addition to its primary quota share agreements.

Quota Share Reinsurance Treaty

Type of Contract:	Quota share.
Business Reinsured:	All policies of insurance earned on or after the effective date of the agreement.
Term and Termination:	March 1, 2004 to continue in effect until terminated. Agreement "may be terminated at any time by either party giving 90 days' prior written notice to the other party."
Limits and Retentions:	Cedes 60% of the net reinsurance liability of the losses and loss adjustment expenses incurred on all business reinsured. Company retains the 40% not ceded.
Commissions:	Company shall receive a monthly provisional commission which shall equal 30% of earned premium, subject to review and adjustment 90 days following inception of the agreement. As soon as possible, but no later than 90 days following the last day of each calendar year or the expiration of the contract if terminated, the "final annual commission" shall be calculated and the difference between the provisional and final commissions shall be paid to or by the reinsurer within 30 days of such accounting.
Reinsurer/Participation:	Haverford (Bermuda) Limited – 100%.

Trust Account:	"Premiums less commission due to the Reinsurer will be deposited in a Regulation 114D Trust Account on the date received by the Company. Paid losses and loss adjustment expenses payable by the Reinsurer will be debited to this account as paid by the Company. This account will be invested in accordance with the Company's investment guidelines. All funds in this account will serve as security for the obligation of the Reinsurer to the Company."

Loss Reserve Reinsurance Agreement

Type of Contract:	Quota share.
Business Reinsured:	All business of the Company inforce on or prior to February 29, 2004.
Term and Termination:	The agreement "shall commence at 12:01 A.M. on March 1, 2004 and shall continue and remain in force and effect unless terminated by the Company or by Haverford [the reinsurer] by giving at least 90 days notice in writing."
Limits and Retentions:	Cedes 60% of all loss and loss adjustment expense reserves, net of salvage and subrogation, arising from covered business, "except that loss and loss adjustment expense reserves arising from the Company's PIP exposure in Colorado will be first multiplied by 40%. Company retains the 40% (76% for CO PIP) not ceded.
Commissions:	None.
Reinsurer/Participation:	Haverford (Bermuda) Limited – 100%.
Trust Account:	The Company shall deposit an amount equal to the amount reinsured to a Regulation 114D Trust Account which will serve as security for obligations of the reinsurer. At the end of each calendar month, the sum of all subject losses actually paid during such time in respect of any claim arising out of the reinsured business and incurred prior to March 1, 2004 will be deducted from the Trust Account. Funds in the account are to be invested in accordance with the Company's investment guidelines.

Multiple Lines Excess of Loss Reinsurance Agreement No. S40067-041404

Type of Contract:	Excess of loss.
Business Reinsured:	All private passenger automobile policies, comprehensive personal liability (including watercraft liability) and property policies in force

	as of the effective date of the agreement and for new and renewed policies on or after the effective date of the agreement.
Term and Termination:	March 1, 2004 to "continue in effect until terminated by mutual consent, or by either party's giving to the other party not less than 90 days' notice . . . stating the termination date."
Limits and Retentions:	Private passenger auto liability and comprehensive personal liability – 3 layers: $ 200,000 xs of $300,000 each risk, each occurrence; $ 500,000 xs of $500,000 each risk, each occurrence; $1,000,000 xs of $800,000 each occurrence. Property – 2 layers: $ 200,000 xs of $300,000 each risk, each occurrence, subject to a limit of $900,000 all risks, each occurrence; $ 500,000 xs of $500,000 each risk, each occurrence, subject to a limit of $1.5 M all risks, each occurrence. Basket limit of $200,000 xs of $200,000 for combined liability and property loss sustained as a result of the same occurrence.
Premiums:	Graded with each coverage layer based on net premiums earned by the Company.
Reinsurer/Participation:	Employers Reinsurance Corporation – 100%.

Personal Umbrella Liability Quota Share Reinsurance Agreement No. 040068-041504

Type of Contract:	Quota share.
Business Reinsured:	All personal umbrella policies of insurance earned on or after the effective date of the agreement.
Term and Termination:	March 1, 2004 to "continue in effect until terminated by mutual consent, or by either party's giving to the other party not less than 90 days' notice . . . stating the termination date."
Limits and Retentions:	90% of the net reinsurance liability the first $1,000,000 of each loss occurrence and 100% of the next $1,000,000 in excess of $1,000,000. Excess limits may be reinsured on a facultative basis.
Commissions:	30% of net earned premiums.
Reinsurer/Participation:	Employers Reinsurance Corporation – 100%.

Property Catastrophe Excess Reinsurance Agreement No. 040097-032404

Type of Contract:	Excess of loss.

Business Reinsured:	All fire and allied lines policies, not specifically excluded, and auto comprehensive coverages in force on or issued or renewed to become effective on or after the effective date of the agreement.
Term:	March 1, 2004 to "continue in effect until terminated by mutual consent, or by either party's giving to the other party not less than 90 days' notice . . . stating the termination date."
Limits and Retentions:	Layer 1: 97.5% of $1,000,000 xs of $1,000,000 each occurrence, subject to annual limit of 97.5% of $2,000,000 for all occurrences. Layer 2: 97.5% of 4,000,000 xs of $2,000,000 each occurrence, subject to annual limit of 97.5% of $8,000,000 for all occurrences
Premiums:	Layer 1: 0.92% of net earned premium, Layer 2: 0.63% of net earned premium, subject to an annual minimum premium.
Reinsurer/Participation:	Employers Reinsurance Corporation – 100%.

Property Facultative Binding Agreement No. 160-04

Type of Contract:	Excess of loss.
Business Reinsured:	"Classifiable in the NAIC form of annual statement as homeowners multiple peril (property coverages)."
Term:	March 1, 2004 to continue in effect until terminated by either party's giving to the other party not less than 90 days' notice via certified mail.
Limits and Retentions:	$3,000,000 xs of $1,000,000 per occurrence/aggregate.
Premiums:	As quoted by Reinsurer promptly upon receipt of policy from Company.
Reinsurer/Participation:	General Reinsurance Corporation – 100%.

The above treaties are standard in form and contain acceptable clauses for insolvency, arbitration and termination. The treaties have also been determined to effectuate proper transfer of risk in accordance with NAIC guidelines.

It was noted that during 2004 the Company was not settling reinsurance balances with Haverford (Bermuda) Limited on a timely basis. These balances were settled at year-end and management states that the Company plans to settle reinsurance balances on a quarterly basis in 2005 and forward. See also comments regarding reinsurance accounting under caption "Accounts and Records."

GROWTH OF THE COMPANY

The growth of the Company, as excerpted from annual statements, the financial statement of this report, and the December 31, 1999 Report of Examination, is presented as follows:

Year	Net Admitted Assets*	Liabilities*	Unassigned Funds (Surplus)	Direct Written Premiums
1999	$ 44,868,731	$29,857,619	($13,343,205)	$30,649,882
2000	51,323,214	34,623,667	(11,654,770)	58,504,417
2001	71,510,929	52,213,248	(9,056,636)	96,840,217
2002	64,229,813	43,302,471	(7,426,975)	86,351,894
2003	102,212,525	76,117,866	(12,259,658)	63,383,839
2004	105,090,202	83,266,798	(24,472,188)	60,400,919

* Assets and liabilities for 1999 and 2000 have been adjusted for reinsurance ceding commissions in accordance with a change in accounting practice ordered by the Department for 2001 and forward.

LOSS EXPERIENCE

The loss experience of the Company is presented as follows:

Year	Earned Premiums	Losses Incurred	Loss Ratio	Loss Adj. Expenses	Loss and Exp. Ratio
1999	$28,863,468	$19,467,542	67.45%	$3,902,641	80.97%
2000	2,981,699	2,047,588	68.67	433,547	83.21
2001	3,763,499	3,056,033	81.20	592,823	96.95
2002	4,730,774	3,351,437	70.84	669,223	84.99
2003	14,787,194	13,180,364	89.13	2,426,152	105.54
2004	29,678,172	27,705,361	93.35	7,078,556	117.20

MARKET CONDUCT ACTIVITIES

Underwriting:

The Company primarily writes preferred and standard automobile policies which provide primary coverage limits in Tennessee as follows:

Coverage	Basic Limits	Excess Limits
Bodily injury per person	$25,000	$300,000
Bodily injury per occurrence	$50,000	$500,000
Property damage per occurrence	$10,000	$100,000

The basic limits vary slightly in the other states in which the Company writes in accordance with those states' statutory requirements. The Company writes automobile business on a preferred, standard and non-standard basis with age and experience criteria for each class.

Various endorsements such as for non-owner coverage and custom and special equipment are available. Discounts are given for various situations such as renewals on accident-free policies, multi-car/policy coverage, good student, anti-theft devices and senior citizen safe driver courses. The Company also applies a "Safe and Sound Discount" for policyholders who sign a pledge to adhere to a list of safe driving criteria. Examples of vehicles ineligible for coverage include those with load capacities in excess of ¾ ton, recreational vehicles and motor homes, vehicles driven more than 50,000 miles annually, and antique, restored, custom built or limited production vehicles.

Standard homeowners coverage is written on risks for which replacement cost does not exceed $349,999 with a minimum $250 deductible. High value dwellings may be written for a replacement cost from $350,000 - $999,999 where market value is at least 75% of replacement cost. All risks must be insured at 100% of replacement cost.

Condo owners and renters personal property coverage of $15,000 - $100,000 is written with a minimum $250 deductible. Umbrella coverage requires certain limits of the underlying coverages. Most umbrella policies are written for $1,000,000 of coverage, but limits of up to $5,000,000 are available.

Rates and Policy Forms:

Tenn. Code Ann. § 56-3-305(a) requires that insurers file with the Department "all rates, supplementary rate information, supporting information, policy forms, and endorsements at least thirty (30) days before the proposed effective date."

Tenn. Code Ann. § 56-5-305(a) requires that

> "Every insurer of personal risk insurance shall file with the commissioner all rates, supplementary rate information, supporting information, policy forms and endorsements at least thirty (30) days before the proposed effective date."

The Company primarily utilizes standard forms from the Insurance Services Office (ISO) for its auto and homeowners coverages. The current auto forms, as approved by the Department August 25, 2004, were effective January 1, 2005. Homeowners forms in use were approved by the Department February 4, 2002 for an effective date of July 1, 2002.

On January 10, 2005 the Department approved rates for the Company's auto policies which became effective March 1, 2005. Rates for the Company's homeowners policies were last amended effective July 1, 2004 as previously approved by the Department in March 2004.

The Company's most recent boat owners form was filed on October 10, 2000 and approved by the Department October 23, 2000 for use on or after January 1, 2001. The Company filed revised boat owners rates July 17, 2001 which were approved by the Department August 11, 2001 for new and renewal business effective September 1, 2001.

This filing only added rates for additional amounts of insurance in excess of $30,000. A comprehensive rate filing had previously been approved by the Department on May 26, 1994.

The Company now uses ISO forms for its personal umbrella policies. The current form in effect was filed October 17, 2003 and approved by the Department October 22, 2003 for use on or after February 1, 2004. On February 27, 2004 the Company filed rates and underwriting guidelines for its personal umbrella business to be effective for new and renewal business May 15, 2004. The Department approved these rates March 2, 2004.

A sample of policies was selected to verify that premiums charged were calculated in accordance with filed and approved rates and underwriting guidelines. One boat owners policy was found to have an incorrect premium. The error was immaterial and in favor of the insured.

The Company issues annual homeowners, boat owners and personal umbrella policies. Auto insurance may be written on an annual basis, but most are six-month policies. Most premiums are collected via payroll deduction in accordance with each group's payroll process, usually twice a month. A service charge is assessed for direct bill payments plans "on any installment bill issued or any bill issued as a result of receiving a partial payment of any previously issued installment notice." There is no charge for reinstatements executed within 30 days of the cancellation, and return premiums are calculated pro-rata regardless of the reason for termination.

In accordance with Tenn. Code Ann. § 56-7-1201(a), the Company's auto policy automatically offers uninsured motorists' coverage with limits equal to the policy's bodily injury limits. If lesser limits or no coverage are desired, the applicant must amend the policy by

signing an "Uninsured and Underinsured Motorists Coverage" automobile application policy supplement.

Complaints and Treatment of Policyholders:

The Company maintains a log and files of written complaints that it receives whether from an individual or from a regulatory agency such as the Department. The Company has recently implemented procedures whereby complaints are first recorded in a Microsoft Access database by the compliance department, then forwarded to the appropriate department for handling. Hard copy files are also maintained.

A sample of complaint files was reviewed for completeness of documentation and patterns of deficiencies. Complaints were previously handled by Prudential compliance personnel and the Company was often not provided with proper documentation. Complaints are now handled directly by the Company and files are more complete with the exception of certain disposition and complaint settlement dates.

Claims Handling:

Prior to September 2003, the Company's claims were processed by PRUPAC which processed all property and casualty claims by region. When Prudential sold its property and casualty subsidiaries, with the exception of the Company, to Liberty Mutual Insurance Company, it contracted with Crawford and Company, Atlanta, to handle the Company's claims. By September 2004, following the finalization of the sale of the Company to Merastar Industries, Ltd., the Company was in the process of rebuilding its claims department and had reclaimed all outstanding claims from Crawford.

The Company is now processing all of its own claims. Files are more completely documented than when Crawford was handling claims. However, "closed" dates are often

omitted in the claim files, and although the Company's claims system separates each claim into its respective claimants, payment documentation in the file does not always clearly indicate the claimant for which a particular payment was made. In addition, one claim file, out of approximately 117 requested by the examiners, could not be located by the Company.

Claims for first quarter 2005, including 16 claims that were closed without payment, were reviewed for timeliness of payment. Timeliness was measured as the number of days from the date the claim was reported to the Company to the date that the claim was closed. This data is presented as follows:

Days to Close	Number of Claims	Percentage
<30	2,733	51.80%
31-60	775	14.69%
61-90	380	7.20%
91-120	237	4.49%
121-150	148	2.81%
151-180	106	2.01%
181-210	94	1.78%
211-240	86	1.63%
241-270	80	1.52%
271-300	76	1.44%
301-330	67	1.27%
331-360	53	1.00%
360+	441	8.36%
	5,276	100.00%

Advertising:

The Company's advertising is limited to brochures sent to prospective employers, the brochures provided to employees of groups contracted to the Company and small print ads purchased from a few trade publications. A typical brochure states that the Company provides for auto, homeowners/condo owners, renters, boat, and personal excess (umbrella) insurance. The brochures also provide contact telephone numbers, a website address, payment options and other relevant information.

EMPLOYEE WELFARE AND PENSION PLANS

The Company makes available a comprehensive package of benefits to eligible employees and their family members. An eligible employee is one who works either full-time or at least 20 hours a week part-time. Benefits for which the Company pays the entire premium include:

Term Life Insurance
Accidental Death and Dismemberment Insurance
Short Term Disability
Long Term Disability

Additional term life insurance may be purchased by employees, if desired.

Employees share in the cost of a major medical plan (PPO) that also includes prescription drug coverage. Premiums are deducted from payroll on a pre-tax basis. Employees may also purchase dental and vision coverages, and may participate in a flexible spending account program to pay medical and dependent care expenses on a pre-tax basis.

Employees 21 years of age and older are eligible to participate in the Company's 401(k) plan. The Company contributes 3% of employee base salary annually and will match employee contributions of up to 4% of eligible deferred pay. In addition, the Company may contribute up to another 6% of employee base salary annually, depending on financial results.

The Company provides each employee a "paid time off" (PTO) bank to cover vacation, personal illness, bereavement leave, etc. The number of days accrued annually for PTO depends on whether the employee is full or part-time, the number of years the employee has been with the Company and the employee's status (exempt or non-exempt).

Employees are eligible for all benefits on their date of hire except for participation in the Company's 401(k) plan. Enrollment dates for the 401(k) occur four times a year, and employees can enroll on the next date that occurs after their hire date.

ACCOUNTS AND RECORDS

A review of the Company's accounting system indicates that records appear to conform to generally accepted insurance accounting practices and to accurately reflect the operations of the Company during the period covered by this examination, except as noted below and otherwise commented upon in the section "Analysis of Changes in Financial Statement and Comments Resulting from Examination."

At December 31, 2004, the Company prepared a computer-generated "statutory" trial balance that was reconciled, proved in balance and traced to various exhibits and schedules in the 2004 Annual Statement by the examiners. Similar procedures were performed for each of the four prior years covered by this examination. Minor discrepancies were noted in the reconciliations of years 2000 – 2002, but current periods were reconciled without exception.

The Company has recently converted from a "homegrown" general ledger system to a Fiserv general ledger and accounts payable processing system (Fiserv is the creator and vendor of the Freedom annual statement program). Also, the Company is in the process of installing and implementing new policy and claims systems. The claims system is expected to be operational by late 2005. The policy system will be introduced by state, depending on regulatory requirements, starting in late 2005 through the end of 2006.

The Company's systems are run on an IBM AS/400 minicomputer. The Company has a disaster recovery plan that includes backup data and immediate replacement of its AS/400 computer by IBM if necessary. While a Prudential subsidiary, the Company had a "hot site" to which it could move operations if necessary. On December 31, 2004 the Company entered into a similar agreement with Sungard Recovery Services. All testing and detailed recovery processes will be performed during 2005 using similar standards as were in place under

Prudential. These processes include a Business Impact Analysis, as performed quarterly by Company management, which ensures that all systems are in place.

The Company's statutory financial statements are audited annually by an independent CPA firm which then issues an audit report. Management letters are not issued. Material weaknesses in the internal control structure of the Company under standards established by the American Institute of Certified Public Accountants, if any, would be disclosed in the audit reports. No such weaknesses were noted in the reports issued during the examination period.

The Company obtains actuarial opinions on loss reserves from its chief actuary who is a fellow of the Casualty Actuarial Society and member of the American Academy of Actuaries. The chief actuary and his staff perform reserve analyses to establish loss and loss adjustment expense reserves on an accident quarter basis.

The examiner's review of the Company's risk-based capital (RBC) levels for the examination period disclosed no exceptions. The RBC level at December 31, 2004 is well above any action levels as defined by Tenn. Code Ann. § 56-46-102.

The following exceptions were noted in the examiner's review of the Company's 2004 Annual Statement:

1. The Company reported two bonds as having the same CUSIP number in Schedule D, Part 1. One of the CUSIP's is correct, the other is not. Also, the Company reported a Morgan Stanley bond with the CUSIP number of a PepsiAmericas issue, and reported an incorrect CUSIP number for the PepsiAmericas bond.
2. All of the Company's bonds and one of its U.S. Treasury Bonds are considered "filing exempt" by the NAIC Securities Valuation Office ("SVO"). In accordance with the NAIC *Annual Statement Instructions – Property/Casualty* and the *SVO Purposes and Procedures*, the NAIC designations reported for these securities should be suffixed with "FE."
3. The Company incorrectly reported the maturity dates for its Certificate of Deposit and one of its U.S. Treasury Bonds in Schedules DA and E.
4. The Company deducted cash items in suspense from the asset "Uncollected Premiums and Agents' Balances in the Course of Collection." The NAIC *Annual Statement Instructions – Property/Casualty* and *Accounting Practices and Procedures Manual* SSAP

No. 67 state that suspense items should be reported as a liability in "Remittances and Items Not Allocated."

5. The Company reported an immaterial amount as "Receivable for Securities." NAIC *Accounting Practices and Procedures Manual* SSAP No. 21 states that proceeds from an investment sale are to be reported on this line; however, the amount reported is not investment sale proceeds and should not be reported as "Receivable for Securities."
6. The Company reported fees owed to its investment manager as "Payable for Securities." As the Company's investment manager is an affiliated entity, these fees would normally be reported as "Payable to Parent, Subsidiaries and Affiliates." However, NAIC *Accounting Practices and Procedures Manual* SSAP No. 25 states that cost allocation transactions and "non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity" should not be reported as "Payable to Parent, Subsidiaries and Affiliates." Thus, these fees could appropriately be reported as "Other Expenses" in accordance with the NAIC *Annual Statement Instructions – Property/Casualty* which state that incurred but unpaid investment expenses should be included with this line item.
7. The Company reported certain netted reinsurance transactions and amounts owed to its reinsurer, Haverford (Bermuda) Ltd., for investment income earned on funds held for reinsurance as "Payable to Parent, Subsidiaries and Affiliates." The NAIC *Annual Statement Instructions – Property/Casualty* and SSAP No. 25 state that reinsurance transactions should be excluded from this line item and reported in accordance with SSAP No. 62. Also, SSAP No. 64 lists reinsurance premiums and losses as examples of items that may not be offset.
8. The Company reported the premium taxes and ceding commissions payable for a small book of assumed business as a component of "Other Expenses" in the 2004 Annual Statement. NAIC *Accounting Practices and Procedures Manual* SSAP No. 62 states that "commissions payable on reinsurance assumed business shall be included as an offset to Agents' Balances or Uncollected Premiums." The premium taxes payable would be more appropriately reported as "Taxes, Licenses and Fees."
9. The Company participates in several involuntary state pools from which it receives detailed statements. Premiums and losses from these statements were netted by the Company and reported as "Remittances and Other Items Not Allocated" in the 2004 Annual Statement. However, SSAP No. 63 states that entities participating in pools shall record "participation in the pool as assumed business as in any other reinsurance arrangement." Also, as mentioned above, SSAP No. 64 lists reinsurance premiums and losses as examples of items that may not be offset.
10. The Company reported a liability for "escheat/abandoned property" as "Amounts Withheld or Retained by Company for Account of Others." NAIC *Annual Statement Instructions – Property/Casualty* state that "uncashed drafts and checks that are pending escheatment to a state" should be reported as "Aggregate Write-Ins for Liabilities." Management cites that this has been corrected for the March 2005 Quarterly Statement.

It is recommended that the Company comply with Tenn. Code Ann. § 56-1-501(b) which requires that an annual statement "shall be completed and filed in accordance with

annual statement instructions established by the commissioner." Tenn. Code Ann. § 56-44-102 requires that this same statement be filed with the NAIC.

FINANCIAL STATEMENT

The financial statement of this report consists of the schedules and exhibits listed below and the related commentary which follows the financial statement:

ASSETS

LIABILITIES AND SURPLUS FUNDS

STATEMENT OF REVENUES, EXPENSES AND NET WORTH

ASSETS

	Admitted Amount per Company	Examination Changes	Admitted Amount per Examination
Bonds	$ 76,539,059	$ 0	$ 76,539,059
Common Stocks	2,161,006	0	2,161,006
Cash, cash equivalents and short-term investments	3,604,054	0	3,604,054
Receivable for securities	2,419	0	2,419
Subtotal, Cash and Invested Assets	$ 82,306,538	$ 0	$ 82,306,538
Investment income due and accrued	$ 776,263	$ 0	$ 776,263
Premiums and considerations:			
Uncollected premiums and agents' balances in the course of collection	7,064,660	0	7,064,660
Deferred premiums, agents' balances and installments booked but deferred and not yet due	4,391,443	0	4,391,443
Amounts recoverable from reinsurers	1,346,351	0	1,346,351
Current federal and foreign income tax recoverable and interest thereon	7,018,721	0	7,018,721
Net deferred tax asset	1,506,341	0	1,506,341
Guaranty funds receivable or on deposit	53,835	0	53,835
Electronic data processing equipment and software	597,207	0	597,207
Aggregate write-ins for other than invested assets	28,843	0	28,843
Subtotal	$ 22,783,664	$ 0	$ 22,783,664
TOTAL ASSETS	$ 105,090,202	$ 0	$ 105,090,202

LIABILITIES, SURPLUS AND OTHER FUNDS

Losses	$ 22,015,726	$ 0	$ 22,015,726
Loss adjustment expenses	5,065,869	0	5,065,869
Other expenses	4,080,530	0	4,080,530
Taxes, licenses and fees	250,001	0	250,001
Unearned premiums	6,586,730	0	6,586,730
Ceded reinsurance premiums payable	3,548,975	0	3,548,975
Funds held by company under reinsurance treaties	40,547,608	0	40,547,608
Amounts withheld or retained by company for account of others	479,177	0	479,177
Remittances and items not allocated	251,327	0	251,327
Payable to parent, subsidiaries and affiliates	210,767	0	210,767
Payable for securities	51,750	0	51,750
Aggregate write-ins for liabilities	178,338	0	178,338
Total Liabilities	$ 83,266,798	$ 0	$ 83,266,798
Common capital stock	$ 3,000,000	$ 0	$ 3,000,000
Gross paid in and contributed surplus	43,295,592	0	43,295,592
Unassigned funds (surplus)	(24,472,188)	0	(24,472,188)
Surplus as regards policyholders	$ 21,823,404	$ 0	$ 21,823,404
TOTAL LIABILITIES AND SURPLUS FUNDS	$ 105,090,202	$ 0	$ 105,090,202

UNDERWRITING AND INVESTMENT EXHIBIT

Premiums earned		$ 29,678,172
Losses incurred		(27,705,361)
Loss expenses incurred		(7,078,556)
Other underwriting expenses incurred		(8,933,693)
Aggregate write-ins for underwriting deductions		51,319
Total underwriting deductions		(43,666,291)
Net Underwriting Gain or (Loss)		$ (13,988,119)
Net investment income earned		$ 721,229
Net realized capital gains (losses)		328,259
Net Investment Gain or (Loss)		$ 1,049,488
Net gain or (loss) from agents' or premium balances charged off		$ (494,634)
Finance and service charges not included in premiums		158,675
Aggregate write-ins for miscellaneous income		(56,995)
Total Other Income		$ (392,954)
Net income before dividends and federal and foreign income taxes		$ (13,331,585)
Dividends to policyholders		0
Net income after dividends but before federal and foreign income taxes		(13,331,585)
Federal and foreign income taxes incurred		(8,039,509)
NET INCOME		$ (5,292,076)
Surplus as Regards Policyholders, December 31, Prior Year		$ 26,094,659
Net income	$ (5,292,076)	
Change in net unrealized capital gains or losses	132,130	
Change in net deferred income taxes	(2,213,491)	
Change in non-admitted assets	1,160,907	
Capital changes:		
Paid in	7,941,276	
Dividends to stockholders	(6,000,000)	
Change in Surplus as Regards Policyholders for the Year		(4,271,255)
Surplus as Regards Policyholders, December 31, Current Year		$ 21,823,404

SUMMARY OF EXAMINERS' COMMENTS AND RECOMMENDATIONS

Page	Recommendation
11	The Company's safekeeping agreement with its securities custodian did not have all of the safeguards recommended by the NAIC or require the "standard of responsibility on the part of the custodian which shall not be less than the responsibility of a bailee for hire or a fiduciary under statutory . . . law of Tennessee" as stipulated by Tennessee Regulation 0780-1-46-.04. The agreement was amended during this examination and now appears to comply with the minimum requirements of the Regulation.
12	The Company's investment manager, West End Capital Management (Bermuda) Limited, is not registered with the U.S. Securities and Exchange Commission due to an exemption in the SEC laws. However, this exemption is scheduled to be amended in February 2006 and will no longer be available to excuse West End from registration. West End management states that the firm is in the process of voluntarily registering with the SEC before the exemption amendment takes effect. It is recommended that the Company's investment manager, West End Capital Management (Bermuda) Limited, register with the SEC as an investment advisor so as to be fully compliant with U.S. securities laws as they are to be amended effective February 2006.
33	A number of errors and omissions, involving immaterial amounts, were noted in the Company's 2004 Annual Statement. It is recommended that the Company comply with Tenn. Code Ann. § 56-1-501(b) which requires that an annual statement "be completed and filed in accordance with annual statement instructions established by the commissioner." Tenn. Code Ann. § 56-44-102 requires that this same statement be filed with the NAIC.

Page	Comment
8	From March to May 2005, the Company had only six directors on its Board. Company Bylaws stipulate that the Board "shall consist of no fewer than seven (7) or more than fifteen (15) members." It is recommended that the Company maintain the number of directors on its Board as stipulated by the Bylaws, or amend the Bylaws to reflect actual practice.

Page	Comment
10	Prior to the purchase of the Company by Merastar Industries, Ltd., conflict of interests procedures were administered by Prudential's corporate offices which provided no completed statements to the examiners for years prior to the sale in 2004. Following the sale, the Company implemented its own "Conflict of Interest Questionnaire" and "Oath and Conflict of Interest Affidavit" to disclose potential conflicts of interests. These forms were completed by the Company's directors and officers for 2004 without exception.
17	The Company under-calculated the non-admissible portion of its statutory deposits by approximately $44,000 at December 31, 2004. The calculation has been corrected for future financial reporting. As the amount miscalculated is well below the materiality level for the examination, no change has been made to the financial statement of this report.
25	During 2004 the Company was not settling reinsurance balances with Haverford (Bermuda) Limited on a timely basis. These balances were settled at year-end 2004 and management states that the Company plans to settle reinsurance balances on a quarterly basis in 2005 and forward.
30	Of the approximately 117 claims files requested by the examiners, one could not be located by the Company.

CONCLUSION

Insurance examination practices and procedures, as promulgated by the NAIC, have been followed in connection with the verification and valuation of assets and the determination of liabilities of **Merastar Insurance Company**, Chattanooga, Tennessee.

In such manner it was determined that, as of December 31, 2004, the Company had admitted assets of $105,090,202 and liabilities, exclusive of capital, of $83,266,798. Total surplus as regards policyholders was therefore $21,823,404, which included ($24,472,188) in unassigned funds (surplus).

The timely and courteous cooperation of the officers and employees of the Company extended during the course of the examination is hereby gratefully acknowledged.

Respectfully submitted,

Juli-Kay Baumann

Juli-Kay Baumann, ARM, ARe, AIE, CFE, CPCU
Examiner-in-Charge
Representing the Tennessee Department
of Commerce and Insurance
Southeastern Zone, NAIC

AFFIDAVIT

The undersigned deposes and says that she has duly executed the attached examination report of **Merastar Insurance Company**, dated June 7, 2005, on behalf of the Tennessee Department of Commerce and Insurance. Deponent further says she is familiar with such instrument and the contents thereof, and that the facts therein set forth are true to the best of her knowledge, information and belief.

Juli-Kay Baumann

Juli-Kay Baumann, ARM, ARe, AIE, CFE, CPCU
Examiner-in-Charge
Representing the Tennessee Department
of Commerce and Insurance
Southeastern Zone, NAIC

Subscribed and sworn to before me this
7 day of June, 2005.

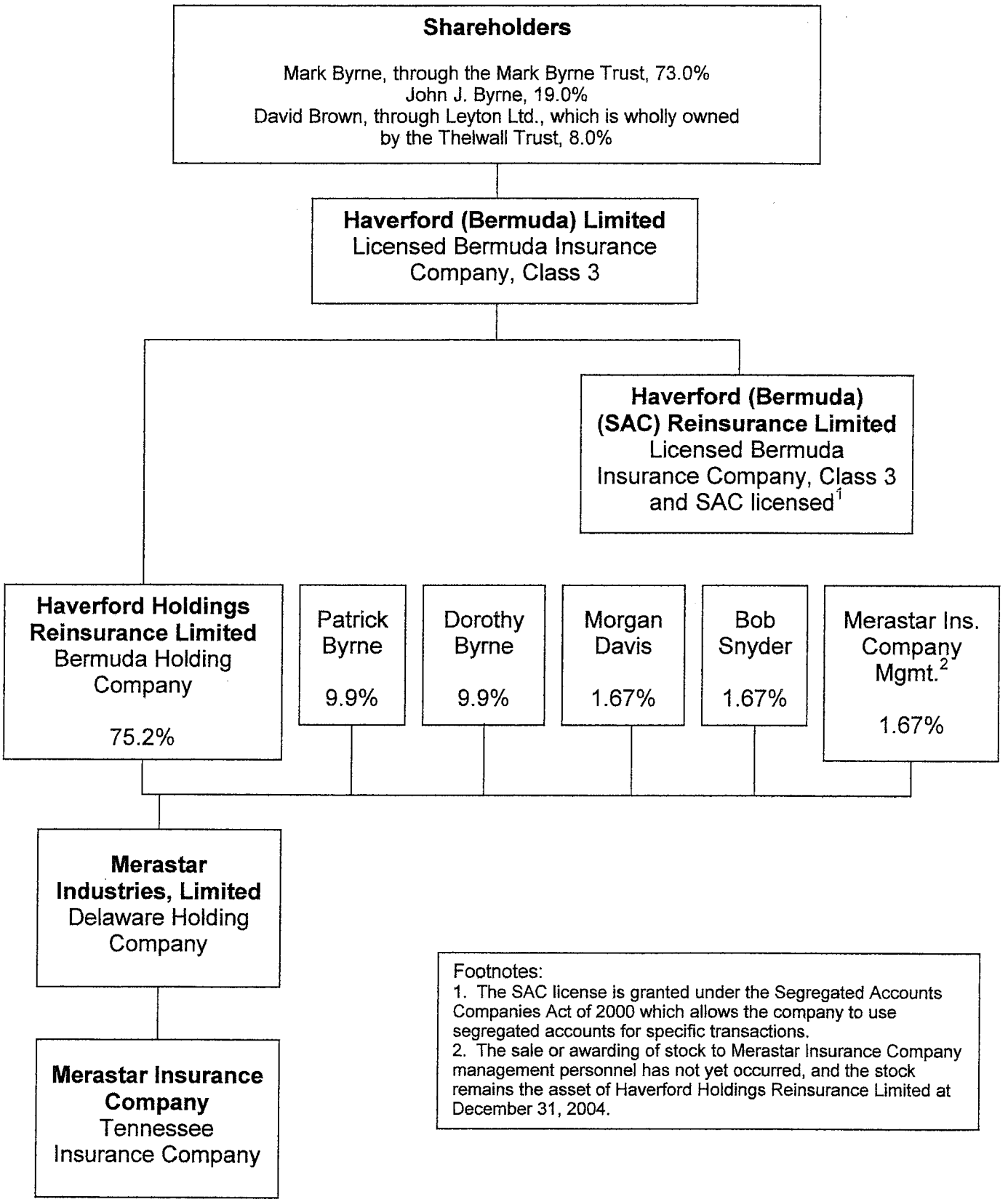
Notary: Meghann Crowe

County: Marathon

State: Wisconsin

My commission expires: 11/23/08

Appendix A



Footnotes:
1. The SAC license is granted under the Segregated Accounts Companies Act of 2000 which allows the company to use segregated accounts for specific transactions.
2. The sale or awarding of stock to Merastar Insurance Company management personnel has not yet occurred, and the stock remains the asset of Haverford Holdings Reinsurance Limited at December 31, 2004.