

MARKET CONDUCT EXAMINATION
OF
AMERICAN HEALTHCARE INDEMNITY COMPANY
AS OF
DECEMBER 31, 2006

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SALUTATION

April 15, 2008

Honorable Matthew Denn
Insurance Commissioner
State of Delaware
841 Silver Lake Boulevard
Dover, Delaware 19904

Dear Commissioner Denn:

In compliance with the instructions contained in Certificate of Examination Authority Number 06-719, and pursuant to statutory provisions including 18 Del. C. §§318-322, a Market Conduct Examination has been conducted of the affairs and practices of:

(39152) American HealthCare Indemnity Company.

The examination was performed as of December 31, 2006. American HealthCare Indemnity Company, hereinafter referred to as the "Company" or as "AHIC," is incorporated under the laws of the State of Delaware. The examination consists of two phases, an onsite phase and an offsite phase. The onsite phase of the examination was conducted at the following Company locations:

1888 Century Park East, Suite 800, Los Angeles, CA 90067-1708
12020 Sunrise Valley Drive, Suite 100, Reston, VA 20191.

The offsite examination phase was performed at the offices of the Delaware Department of Insurance, hereinafter referred to as the "Department" or as the "DDOI," and other appropriate locations.

The report of examination thereon is respectfully submitted.

EXECUTIVE SUMMARY

The Company provides Medical Malpractice insurance in California and Delaware. As of 2005, the lines reported on Schedule T of the Annual Statement include Physicians, Hospitals and Other Health Care Professionals. In 2004, coverage for Other Health Care Facilities was also provided. Marketing material created in 2006 indicates that the Southern California Physicians Insurance Exchange Companies (SCPIE Companies), the parent company of American Healthcare Indemnity Company, underwrite Healthcare Billing Errors and Omissions, Managed Care Organization Liability Risks, Liability coverage for Directors and Officers of Healthcare Corporations, Medical Malpractice Insurance for Physicians with special Professional Liability needs (non-standard), Liability Coverage for Physicians and Healthcare Providers and Professional Liability Coverage for Surgery Centers.

In 2004, the Company's Schedule T showed that eighty-seven percent (87%) of the direct written premium was in California and nine percent (9%) in Delaware. In 2005, the proportions were eighty-nine percent (89%) and nine percent (9%). In 2006, the proportions remained the same.

This is a Delaware Baseline Examination in which the processes, procedures and controls utilized by the Company are reviewed and evaluated.

There are ten (10) areas of concern noted during the examination. These issues are discussed in each of the following sections of the report:

- Procedure 01 – Internal and External Audit
- Procedure 05 – Anti-Fraud
- Procedure 08 – Vendor Oversight and Control
- Procedure 09 – Customer and Consumer Privacy Protection
- Procedure 10 – Production of Business
- Procedure 13 – Advertising, Sales and Marketing
- Procedure 14 – Agent Produced Advertising
- Procedure 15 – Producer Training
- Procedure 20 – Producer Selection, Appointment and Termination
- Procedure 22 – Prevention of Use of Persons with Felony Conviction

SCOPE OF EXAMINATION

The basic business areas that are subject to a Delaware Market Conduct Examination vary depending on the type of insurer. For all insurers these areas include, Company Operations/Management, Complaint Handling, Marketing and Sales, Producer Licensing, Policyholder Service, Underwriting & Rating and Claims.

This examination is comprised of two components. The first is a review of the Company's countrywide complaint patterns. This review is not a pass/fail test, rather, it determines whether or not there is a detectable pattern to the complaints the Company has received from all sources.

The second component is an analysis of the management of the various business areas subject to a Market Conduct Examination through a review of the written procedures and operating processes of the Company. This component also includes an analysis of how the Company communicates its instructions and intentions to its operational echelons, how it measures and monitors the results of those communications, and how it reacts to and modifies its communications based on the resulting findings of the measurement and monitoring activities. The examiners also determine whether or not this process is dynamic and results in enhanced compliance activities. Because of the predictive value of this form of analysis, focus can be directed on those areas where review indicators suggest that the process used by management does not appear to be achieving the appropriate levels of statutory and regulatory compliance.

All business areas noted above are addressed, to some extent, by one or more of the Procedures reviewed, thus providing a comprehensive view of the Company and its component operations.

This examination report is a report by exception rather than a report by test. This means that only those areas where a Recommendation for corrective action is made are detailed.

HISTORY and PROFILE

The Company was originally incorporated as General Electric Mortgage Insurance Corporation of Florida on October 3, 1980 and then issued a Certificate of Authority from the State of Florida on November 24, 1980. Its Articles of Incorporation were amended September 3, 1985 changing its name to General Electric Mortgage Reinsurance Corporation. On February 7, 1986, the Company was sold to General Electric Mortgage Capital Company, chartered in Delaware. On July 1, 1989, the Company was re-domesticated to the State of North Carolina. On July 10, 1991, the Company again changed its name to FG Insurance Corporation. The Company was re-domesticated to Delaware on March 23, 1992 as a result of its purchase by CitiBank Delaware. The Company ceased the direct writing of business on June 1, 1995.

All of the Company's outstanding and issued stock was purchased by SCPIE Holdings, Inc. on March 29, 1996 in accordance with a stock purchase agreement created January 26, 1996. SCPIE Holdings, Inc. is a Delaware Corporation. All liabilities existing at the time, and those created as a result of executing the agreement, were assumed by Citicorp Assurance Company.

The Company assumed its present name on July 16, 1996.

On January 29, 1997, the Southern California Physicians Insurance Exchange merged with SCPIE Indemnity Company in accordance with the Amended and Restated Plan and Agreement of Merger of August 8, 1996. Amendment Number 1 was dated December 19, 1996. SCPIE Holdings, Inc. became the parent of SCPIE Indemnity and, concurrently, SCPIE Management Company became wholly owned by SCPIE Indemnity. Permission to withdraw from the State of California had been submitted to the California Department of Insurance on May 24, 1996. On January 29, 1997, Southern California Physicians Insurance Exchange surrendered its Certificate of Authority and withdrew from California.

SCPIE Holdings started trading publicly on the New York Stock Exchange on January 30, 1997. The Form S-1 became effective January 29, 1997. SCPIE Holdings sold 2,300,000 common shares in the initial trading.

On August 5, 1997, the Directors of SCPIE Indemnity approved a dividend of all the stock of SCPIE Management, payable to the sole stockholder, SCPIE Holdings, Inc. as of September 30, 1997. This made SCPIE Holdings, Inc. the sole owner of SCPIE Management Services, Inc. and SCPIE Insurance Services, Inc.

SCPIE Insurance Services, Inc. is a broker-agent, licensed in California. SCPIE Management Services, Inc. manages unaffiliated businesses and provides claims services.

SCPIE Holdings, Inc. transferred all of the Company's issued and outstanding stock to its wholly owned subsidiary, SCPIE Indemnity Company.

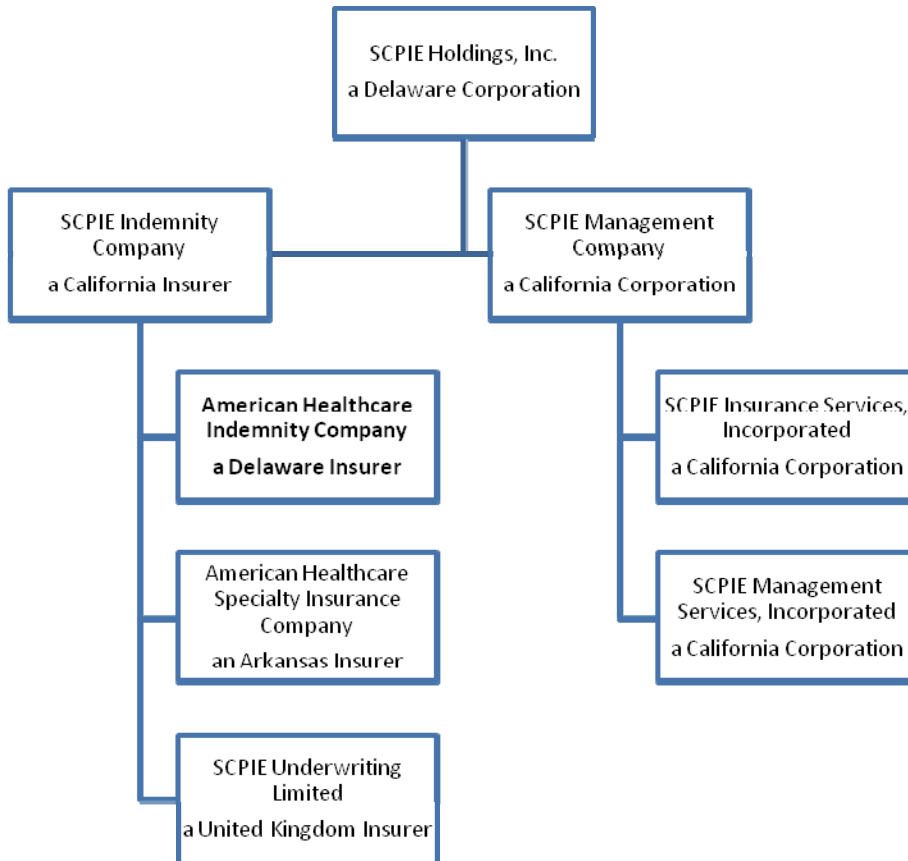
The Company's Certificate of Authority authorizes it to transact the business of Health, Property, Surety, Casualty, including: Vehicle, Liability, Burglary & Theft, Personal Property Floater,

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Glass, Boiler & Machinery, Credit, Workers' Compensation and Employers' Liability, Leakage and Fire Extinguisher Equipment, Malpractice, Elevator, Livestock, Miscellaneous, Marine and Transportation.

ORGANIZATIONAL CHART

The organizational chart of SCPIE Holdings, Inc., as of August 2005, follows:



METHODOLOGY

This examination is based on the Standards and Tests for a Market Conduct Examination of a Property & Casualty Insurer found in Chapter VIII of the Delaware Market Conduct Examiners' Handbook. This chapter is derived from applicable Delaware Statutes, Rules and Regulations as referenced herein and the NAIC's *Market Conduct Examiners' Handbook* (2004 edition).

The types of reviews used in this examination fall into three general categories: generic, sample, and electronic.

A "generic" review is conducted through an analysis of general data gathered by the examiner or provided by the examinee in response to queries by the examiner.

A "sample" review is conducted through direct review of a random sample of files using a sampling methodology described in the Delaware Market Conduct Examiners' Handbook and the NAIC's *Market Conduct Examiners' Handbook*. Samples of complaint files, underwriting files and claim files were reviewed to determine that the processes described by the Company are actually used by the Company.

An "electronic" review is conducted through the use of a computer program or routine applied to a download of computer records of the examinee. This type of review typically reviews one hundred percent (100%) of the records of a particular type.

In this examination only two Standards were directly tested. The Procedures were tested through a combination of "generic" review and direct observation of the processes used. Each Standard contains a brief description of the purpose or reason for the Standard. The Procedure review does not include this description. In some cases a "Recommendation" for corrective action is made.

A. COMPANY OPERATIONS/MANAGEMENT

This examination report is not designed to be a pass/fail report with the exception of the following two Standards dealing with appropriate licensure and cooperation with the examination process.

Standard A 08

<p>NAIC's <i>Market Conduct Examiners' Handbook</i> - Chapter VIII, §A, Standard 8 The Company is licensed for the lines of business that are being written. 18 Del. C. §318(a), §505(b), §508(b)</p>
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The review methodology for this Standard is "generic." This Standard has a direct insurance statutory requirement. This Standard determines whether the Company's operations are in conformance with the Company's Certificate of Authority.

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Result: Pass

Observation: The Company is licensed for the lines of business being written based upon a review of premium schedules and the Company's Delaware Certificate of Authority. The Company performs their business operations as an admitted writer.

Recommendation: None

Standard A 09

<p>NAIC's <i>Market Conduct Examiners' Handbook - Chapter VIII, §A, Standard 9</i> The Company cooperates on a timely basis with the examiners performing the examination. 18 Del. C. §318(a), §320(c), §508(b), §520(b)3</p>
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The review methodology for this Standard is "generic." This Standard has a direct insurance statutory requirement. This Standard determines whether the Company is cooperating with the examiners in the completion of an open and cogent review of the Company's operations. Cooperation with the examiners in the conduct of an examination is not only required by statute, it is conducive to completing the examination in a timely manner thereby minimizing cost.

Result: Pass

Observation: The Company cooperated with the examiners in the conduct of the examination. Access to persons pertinent to the completion of the examination was provided and persons interviewed were open and informative. The majority of the information requested was received in a timely manner and the Company's personnel made frequent visits to confirm information and receive status updates.

Recommendation: None

B. COMPLAINTS

The evaluation of the Standards in this business area is based on the Company's response to various information requests (IRs) and their handling of complaint files at the Company. Delaware statute 18 Del. C. §2304(17) requires the Company to "...maintain a complete record of all complaints received." This statute also requires that "this record shall indicate the total number of complaints, their classification by line of insurance, the nature of each complaint, the disposition of these complaints and the time it took to process each complaint." Delaware's definition of a complaint is: "... any written communication primarily expressing a grievance."

Observation: The Company provided a database with no logged Delaware complaints for the period of examination. The database format and the information contained within the database complies with 18 Del. C. §2304(17). A search of the NAIC database revealed no Delaware complaints filed against the Company from January 2004 through May, 2007.

Recommendation: None

C. REVIEW OF PROCEDURES

The management of well-run companies generally has some processes that are similar in structure. These processes usually take the form of written procedures. While these procedures vary in effectiveness from company to company, the absence of these procedures or the ineffective application of them is often reflected in the failure of various examination Standards. The processes usually include:

- a planning function where direction, policy, objectives and goals are formulated
- an execution or implementation of the planning function elements
- a measurement function that considers the results of the planning and execution and
- a reaction function utilizing review of metrics directing resulting corrective action or to modify the process to develop more efficient and effective management.

The absence of written procedures that provide direction for company staff in its various operational areas often results in inconsistent application of the intended process. The same is generally true of the absence of a means to measure the results of the application of procedures and a means to determine that the process is performing as intended.

The reviews in this section are not pass/fail measurements. Rather, they are intended to reflect those management strengths and weaknesses that have a bearing on regulatory compliance issues.

Note that this examination did not test all possible Procedures therefore the numbering of the Procedures is not in sequential order. The Procedures for which no Recommendation is made are listed below, followed by a detailed discussion of each Procedure that resulted in a Recommendation.

C.1. Procedures Reviewed but with No Recommendations or Concerns

Procedure 02 – Assertion of Privilege
Procedure 07 – Managing General Agent Oversight
Procedure 11 – Complaint Handling
Procedure 21 – Producer Defalcation
Procedure 24 – Premium Billing
Procedure 25 – Correspondence Routing
Procedure 26 – Policy Issuance
Procedure 27 – Reinstatement
Procedure 30 – Premium Determination and Quotation
Procedure 31 – Policyholder Disclosures
Procedure 32 – Underwriting and Selection
Procedure 33 – Rate and Form Filing
Procedure 34 – Terminations
Procedure 35 – Underwriting File Documentation
Procedure 36 – Underwriting Training

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Procedure 40 – Staff Training
Procedure 42 – Adjustors and Claims Personnel Training
Procedure 43 – Claim Handling
Procedure 44 – Internal Claim Audit
Procedure 45 – Claim File Documentation
Procedure 46 – Subrogation and Deductible Reimbursement
Procedure 48 – Catastrophe Claim Handling

C.2. Procedures Reviewed with Recommendations

Procedure 01 – Internal and External Audit

The Company has no written procedure for Internal Audit. The Internal Audit Procedure is maintained and implemented by a vendor, DLC Inc., a CPA firm. This service is provided to the Company's parent, SCPIE Holdings, Inc. All subsidiaries, including AHIC, are included in the vendor's internal audit work. DLC Inc. maintains two employees at the Company's office in Los Angeles. DLC Inc. began providing an internal audit service in February 2006. Until that time the Company relied on its Sarbanes-Oxley audits as substitutes for internal audits. Ernst and Young, LLP attests to the effectiveness of the Company's internal control over financial reporting.

The vendor uses criteria established in the Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Internal audit findings are reported to the executive in charge of the area, the Chief Accounting Officer, and either the parent SCPIE Holdings Inc.'s Board of Directors or the Board of the relevant subsidiary.

Two deficiencies are noted with the Company's approach. First, Company management maintains the right of approval for any internal audit recommendations. If the Company's management does not approve of a particular recommendation, the recommendation is ignored. Second, the Chief Accounting Officer acts as the reviewer of his own work in Financial Closing & Reporting, Investments, Payroll, Cash Disbursements and Income Taxes.

The scope of the Internal Audits is controlled by the senior DLC Inc. employee in the Los Angeles office. During an interview with this auditor he explained that internal audit scope is determined by risk assessment studies that he personally conducts. Market Conduct compliance is not specifically addressed in this Internal Audit Procedure. If Market Conduct compliance issues happen to be included in the scope of an audit, it is only as part of the financial procedures selected during his risk assessment. Producing brokers are not considered when evaluating risk, and therefore, not considered for internal audit.

DLC Inc. relies on internal control frameworks found in COSO and COBIT (Control Objectives for Information and Related Technology). Both are normally related solely to information systems audit. However, their internal control disciplines are applicable in this case.

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Recommendation: It is recommended that the Company cease negotiating on the recommendations prepared by independent auditors. It is recommended that the Company's Board of Directors require compliance with Audit Report Recommendations. It is recommended that the work performed by the Chief Accounting Officer in Financial Closing & Reporting, Investments, Payroll, Cash Disbursements and Income Taxes be reviewed by someone other than the Chief Accounting Officer. It is recommended that the Company require the inclusion of producing brokers in its risk assessment and, if necessary, in its audit scope. For additional information refer to Procedure 20.

Procedure 05 – Anti-Fraud

The Company responded that it does not have a Claims Anti-Fraud Procedure or processes in place. The Company also maintains that such procedures are not necessary.

The examiners informed the Company of the requirements of 18 Del. C. §24, the Delaware Insurance Fraud Prevention Act. This statute is applicable to applicants, policyholders, agents, brokers and Company personnel.

Recommendation: It is recommended that the Company immediately implement Anti-Fraud Procedures so as to be compliant with 18 Del. C. §24, the Delaware Insurance Fraud Prevention Act.

Procedure 08 – Vendor Oversight and Control

The Company has no written procedure for Vendor Oversight. The Company contracts with affiliates that are wholly owned by its parent SCPIE Holdings, Inc. for administrative services such as personnel, claims and underwriting. Additionally, the Company uses two vendors for internal and external audit services, DLC Inc. and Ernst & Young, LLP.

Information reports are used to monitor vendor operations. Management's periodic reviews of these reports on claims activity provides information such as reviews on open and closed claims for adequacy of claim reserves, claim documentation (including notification of reinsurers), consistency of claim information between the claims file and computer system, and adherence to company policies.

Additional monthly reports are generated that detail claim activity such as Physicians Monthly Status Report – by all states each month, Claims Management Report – all lines each month, Open Claim Assignment Reports – all lines each month, Mandatory Settlement Calendar (MSC) and Trial Calendar – each month, and Claims with Combined Reserves of \$1M – each quarter. In addition, the Actuarial/Operations department performs an in-depth analysis of claims trends on a quarterly basis and the Senior Bookkeeper prepares a monthly reconciliation for each of the bank accounts established for Claims-Indemnity and Claims-Expenses.

Company personnel and operations are provided by the owner's subsidiaries and business is conducted according to the owner's requirements. Because administrative services are provided

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by co-located affiliates, vendor oversight is accomplished in the course of normal business operations.

When asked to provide the oversight structure for each vendor used by the Company in its underwriting, claims, sales/marketing, producer licensing or policyholder services processes, other than those for an MGA, GA or TPA, the Company addressed only the claims processing in its response. Observations made during the onsite visit indicate that the underwriting processes are adequately monitored.

While reviewing the claims manual, the examiners noted that claims personnel have the ability to edit and delete diaries. As such, supporting evidence of the Company's actions could be destroyed or changed. Delaware statute 18 Del. C. §320(c) requires that the accounts, records, documents, files, information, assets and matters relating to the subject of the examination shall be made freely available to the Commissioner. If these diaries are edited or deleted the examiners cannot accurately reconstruct the handling of the claim or complaint.

Procedure 09 – Customer and Consumer Privacy Protection

The Company provided excerpts from its Employee Handbook and The Code of Business Conduct and Ethics in support of Customer and Consumer Privacy Protection Procedures. The Company's Senior Vice President & General Counsel is responsible for this procedure. The examiners' review showed that access to sensitive information in the Company's information system network is limited by an employee's role, based on the user profile and subgroup profiles. Editing of personally identifiable information is limited to certain employees per system restrictions. Periodic audits verify profile membership.

The Company responded that vendors do not have access to privacy sensitive data. Company affiliates provide vendor services such as administrative services, employees and claims processing. These affiliates/vendors have access to confidential privacy sensitive data, however, due to the tight integration of the vendors into the Company's business and their common ownership and goals, no conflicts or extended risks were noted.

The Company addresses Customer and Consumer Privacy Procedures during training. Access to electronically maintained data is limited. The Company also relies on the absence of complaints to verify the procedure is working, however, this is not an effective control.

Recommendation: It is recommended that the Company design and implement reasonable methods to monitor or verify the security of the handling of personally identifiable information on a continual basis.

Recommendation: It is recommended that the Company perform background checks on all applicants to verify the lack of any criminal conviction. It is recommended that the Company

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implement an annual review process to verify and ensure that all employees and all producers writing business for the Company are not in conflict with 18 U.S.C.A. §1033.

Procedure 10 – Production of Business

The Company has no written procedure for Production of Business and instead relies upon its Marketing Plan. The Production of Business is monitored by the distribution and subsequent review of a monthly sales report.

The Company's Senior Vice President of Underwriting, Marketing and Sales is responsible for this procedure. Interviews during the onsite visit revealed that the majority of business is created through the Company's broker network. This fact was stated without consideration of Delaware business, referring to California business only.

All Delaware business is produced by a single brokerage firm, KTD Inc. The Company identifies KTD Inc. as a broker but it has not issued an appointment. This is a violation of 18 Del. C. §1715. Refer to Procedure 20 for additional information.

Recommendation: It is recommended that the Company develop and maintain a written procedure for Business Production.

Procedure 13 – Advertising, Sales and Marketing

The Company has no written procedure for Advertising, Sales and Marketing. The Company's response to the examiners shows little oversight and management of this subject.

The examiners requested clarification of the methods used to measure the operation and effectiveness of the procedure. The Company provided a folder labeled IR013 Advertising, Sales and Marketing, however, one of the sub-folders labeled "Marketing Plans" was listed but was not provided for review. None of the other sub-folders contained documentation pertaining to measuring effectiveness. Regarding a description of the Company's marketing plan and objectives statement, neither the response nor the provided references addressed a marketing plan. The Company failed to adequately respond to the examiners' requests.

The Company's Senior Vice President of Underwriting & Marketing and the Company's Vice President of Marketing hold joint responsibility for this procedure. Given the potential for errors if oversight is not practiced on a continual basis it seems prudent that the Company Manager responsible for Compliance should have equal or greater responsibility for the operation of this procedure rather than the Marketing Department.

Communications with producers are conducted primarily by telephone conversations and personal visits. Although internal audits are frequently conducted, onsite interviews revealed that advertising is not audited for compliance issues.

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Of the nineteen (19) advertising specimens reviewed, six (6) were specifically for California and five (5) had no unique ID to allow specific identification. Broker Kits containing specimens of Broker Kits for various lines of business were also provided for review. Of the seven (7) specimens, six (6) did not contain a unique ID to allow specific identification. One specimen contained neither a date nor unique ID.

The Company has producer training manuals and related documentation, however, all of these materials are specific to California business. Nothing specific to Delaware business was provided to the examiners. There are no controls in place to monitor compliance with Delaware's Insurance Statutes and Regulations.

Training is provided for selected brokers only and training participation is optional.

The materials provided did not address unfair methods of competition or unfair or deceptive acts or practices, as defined in 18 Del. C. §§2304(1), (2) and (3).

Recommendation: It is recommended that the Company develop, enforce and monitor compliance with written Advertising policies and procedures, training manuals and related documentation, specific to Delaware's statutory and regulatory requirements, including 18 Del. C. §§2304(1), (2) and (3). It is recommended that the Company make training attendance mandatory for all producers. It is recommended that the Company assign unique IDs and date of creation for each advertising piece to aid in compliance verification. It is recommended that the Company include Advertising and Marketing Procedures in its internal audit scope. It is recommended that the Company comply with 18 Del. C. §320(c) which requires that the Company make freely available to the examiners the accounts, records, documents, files, information, assets and matters of the Company, relating to the subject of the examination, and that the Company shall facilitate the examination.

Procedure 14 – Agent Produced Advertising

The Company has no written procedure for Agent Produced Advertising. The Company's Vice President of Marketing, and not the Company's Compliance Officer, has responsibility for Agent Produced Advertising.

The Company stated that it offers brokers assistance with advertising needs through its Communications Department. It also stated that brokers cannot use the Company's name in any type of advertising without its permission and prior approval. The Company stated, "This is standard with all companies so brokers are aware of the need for prior approval." As such, the Company expects its brokers to inform them of instances of non-compliance with the Company's policy and procedure. No indications that the Company searches for non-compliance were noted.

When asked to describe the Company's limitations on Agent Produced Advertising the sole response from the Company was, "Prior company approval is required." The Company relies upon this requirement to prevent the unauthorized use of its name by brokers. The Company

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does not inquire about or focus resources on identifying brokers in violation of the Company's policy.

No controls exist to indicate non-compliance with the Company's expectation to review and approve the use of its name in advertising prior to use, nor to indicate non-compliance with 18 Del. C. §2304(1), (2) and (3), Delaware's Unfair Trade Practices Act.

No training is provided addressing the requirements of 18 Del. C. §2304(1), (2) and (3). Training is not offered to all brokers and is not mandatory in any case.

There is no evidence that Management Personnel responsible for Company Compliance or Statutory and Regulatory Compliance are responsible for broker produced advertising.

The Company does not use a broker contract. Agent produced advertising is not internally audited.

Recommendation: The Company should develop and exercise a written procedure for Broker Produced Advertising and the procedure should address the requirements of 18 Del. C. §2304(1), (2) and (3). It is recommended that the Company develop and exercise a training program for all of its brokers, addressing 18 Del. C. §2304(1), (2) and (3) and the Company's own requirements. It is recommended that the Company develop and exercise a standard contract with its brokers.

Procedure 15 – Producer Training

The Company has no written policy or procedure for Producer Training. The Company's Vice President of Marketing is responsible for producer training.

When asked to identify the methods used to measure the operation and effectiveness of the procedure, the Company referred to broker production reports as a metric of producer training. The Company determines its training adequacy by measuring increased sales and not by compliance with Company requirements and compliance with the States' statutes and regulations. No controls exist that measure the effectiveness of the procedure or the degree of compliance.

When asked to describe the specialized product training provided to producers and the frequency of the training, the Company responded with a broker training program presentation outline, a list of training materials and the Table of Contents from a training program reference notebook. All three supplements are prepared for California only and do not address Delaware's requirements. Producer training, as presented in the Company's response, addresses only California business, is only offered for inexperienced brokers and attendance is not required.

In describing its efforts to prevent producer misrepresentation, the Company stated "AHI issues written quotes showing the terms and conditions of the offer of insurance. Brokers are provided with product fliers that outline the major coverage provisions." However, the provision of written quotes with terms and conditions, or printer fliers, does not prevent brokers from

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misrepresenting the product and/or the Company. There was no evidence of comprehensive training, written policies and constant monitoring of consumer complaints.

Recommendation: It is recommended that the Company develop and maintain a comprehensive written Producer Training Procedure and Policy that addresses Delaware business. It is recommended that the Company develop and use controls that monitor its training effectiveness.

Procedure 20 – Producer Selection, Appointment and Termination

The procedure for Producer Selection, Appointment and Termination is the responsibility of the Company's Vice President of Marketing. All documentation and forms provided to the examiners refer only to California business. The Company has no forms or documentation specific to Delaware. The effectiveness of the broker selection process is only measured by broker sales revenue. The Company has no other metrics in use for measuring effectiveness.

The Company does not use contracts with producers. The Company pays all brokers a commission of ten percent (10%). The Company's written procedure states that it does not appoint agents and uses only brokers, which is a violation of 18 Del. C. §1714(f). This statute reads as follows:

(f) An insurer or insurance producer shall not pay a commission, service fee, brokerage or other valuable consideration to a person for selling, soliciting or negotiating insurance in this State if that person is required to be licensed under this chapter and is not so licensed. Nothing in this section allows an insurer to pay commissions to a nonappointed insurance producer when an appointment is otherwise required.

The Company stresses that it appoints no agents, all business not produced by direct writing is submitted by independent brokers. All Delaware business is submitted by the principal of KTD, Inc., a Delaware based and Delaware licensed insurance producer. Since the inception of the Delaware business, the total written premium listed in Schedule T of the Annual Statements is \$13,966,810. At the examiner's request, the Company provided a summary of the commissions paid by the Company to KTD, Inc. The summary listed a total of \$1,166,334.38 commissions paid. A broker, by definition, represents the policyholder/applicant. The act of paying the producer a commission makes the producer an agent of the insurer, and as such, agents must be appointed in Delaware.

The Company has paid and currently pays commissions to this broker for every policy underwritten. This is a violation of 18 Del. C. §1714(f). As of June 7, 2007, the Company has paid \$1,166,334.38 in commissions to its sole "broker" KTD, Inc. for each policy underwritten in Delaware.

Delaware statute 18 Del. C. §1702(i) defines a producer as "... a person required to be licensed under the laws of this State to sell, solicit or negotiate contracts of insurance or annuity or the lines of authority authorized within the scope of such license. For the purposes of this title the

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terms "insurance agent," "insurance broker," and "insurance consultant" shall be used interchangeably with the term "insurance producer."

Upon specific inquiry by the examiners, management stated that the Company does not notify the Commissioner of producer terminations. Delaware statute 18 Del. C. §1716(a) requires "An insurer or authorized representative of the insurer that terminates the appointment, employment, contract or other insurance business relationship with a producer" to notify the Commissioner if the termination is for one of the causes defined in §1712. Also, 18 Del. C. §1716(b) requires that the Commissioner be notified of termination without cause, using language similar to that described above for §1716(a).

The Company did not provide the requested initial adoption date of the procedure, a violation of 18 Del. C. §320(c).

Recommendation: It is recommended that the Company comply with 18 Del. C. 17, pertaining to licensure requirements. It is recommended that the Company cease identifying its insurance producer as a broker and appoint the agent, as required by 18 Del. C. §1702(b) and 18 Del. C. §1715(a). It is recommended that the Company develop and use documentation and forms specifically designed for Delaware. It is recommended that the Company develop and maintain controls that monitor Producer Selection. These controls should include a review of consumer complaints about a producer. It is recommended that the Company notify the Commissioner of Insurance of any producer terminations, as required by 18 Del. C. §1716(a) and (b).

Procedure 22 – Prevention of Use of Persons with Felony Conviction

The Company does not have a written procedure regarding the Prevention of Use of Persons with a Felony Conviction. The Company only asks applicants if they have a history of felony conviction. Verification of the answers is sought only for those applying for a financial department position.

Recommendation: It is recommended that the Company perform background checks on all applicants to verify the lack of any criminal conviction. It is recommended that the Company implement an annual review process to verify and ensure that all employees and all producers writing business for the Company are not in conflict with 18 U.S.C.A. §1033.

SUMMARY of RECCOMENDATIONS

Procedure 01 – Internal and External Audit

Recommendation: It is recommended that the Company cease negotiating on the recommendations prepared by independent auditors. It is recommended that the Company's Board of Directors require compliance with Audit Report Recommendations. It is recommended that the work performed by the Chief Accounting Officer in Financial Closing & Reporting, Investments, Payroll, Cash Disbursements and Income Taxes be reviewed by someone other than

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the Chief Accounting Officer. It is recommended that the Company require the inclusion of producing brokers in its risk assessment and, if necessary, in its audit scope. For additional information refer to Procedure 20.

Procedure 05 – Anti-Fraud

Recommendation: It is recommended that the Company immediately implement Anti-Fraud Procedures so as to be compliant with 18 Del. C. §24, the Delaware Insurance Fraud Prevention Act.

Procedure 08 – Vendor Oversight and Control

Recommendation: It is recommended that the Company remove the ability to edit or delete an entry in all of its various systems' diaries.

Procedure 09 – Customer and Consumer Privacy Protection

Recommendation: It is recommended that the Company design and implement reasonable methods to monitor or verify the security of the handling of personally identifiable information on a continual basis

Recommendation: It is recommended that the Company perform background checks on all applicants to verify the lack of any criminal conviction. It is recommended that the Company implement an annual review process to verify and ensure that all employees and all producers writing business for the Company are not in conflict with 18 U.S.C.A. §1033.

Procedure 10 – Production of Business

Recommendation: It is recommended that the Company develop and maintain a written procedure for Business Production

Procedure 13 – Advertising, Sales and Marketing

Recommendation: It is recommended that the Company develop, enforce and monitor compliance with written Advertising policies and procedures, training manuals and related documentation, specific to Delaware's statutory and regulatory requirements, including 18 Del. C. §§2304(1), (2) and (3). It is recommended that the Company make training attendance mandatory for all producers. It is recommended that the Company assign unique IDs and date of creation for each advertising piece to aid in compliance verification. It is recommended that the Company include Advertising and Marketing Procedures in its internal audit scope. It is recommended that the Company comply with 18 Del. C. §320(c) which requires that the Company make freely available to the examiners the accounts, records, documents, files, information, assets and matters of the Company, relating to the subject of the examination, and that the Company shall facilitate the examination.

Procedure 14 – Agent Produced Advertising

Recommendation: The Company should develop and exercise a written procedure for Broker Produced Advertising and the procedure should address the requirements of 18 Del. C. §2304(1), (2) and (3). It is recommended that the Company develop and exercise a training program for all of its brokers, addressing 18 Del. C. §2304(1), (2) and (3) and the Company’s own requirements. It is recommended that the Company develop and exercise a standard contract with its brokers.

Procedure 15 – Producer Training

Recommendation: It is recommended that the Company develop and maintain a comprehensive written Producer Training Procedure and Policy that addresses Delaware business. It is recommended that the Company develop and use controls that monitor its training effectiveness.

Procedure 20 – Producer Selection, Appointment and Termination

Recommendation: It is recommended that the Company comply with 18 Del. C. 17, pertaining to licensure requirements. It is recommended that the Company cease identifying its insurance producer as a broker and appoint the agent, as required by 18 Del. C. §1702(b) and 18 Del. C. §1715(a). It is recommended that the Company develop and use documentation and forms specifically designed for Delaware. It is recommended that the Company develop and maintain controls that monitor Producer Selection. These controls should include a review of consumer complaints about a producer. It is recommended that the Company notify the Commissioner of Insurance of any producer terminations, as required by 18 Del. C. §1716(a) and (b).

Procedure 22 – Prevention of Use of Persons with Felony Conviction

Recommendation: It is recommended that the Company perform background checks on all applicants to verify the lack of any criminal conviction. It is recommended that the Company implement an annual review process to verify and ensure that all employees and all producers writing business for the Company are not in conflict with 18 U.S.C.A. §1033.

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CONCLUSION

The examination was conducted by Keith Perry, AES, CISA, AFE & CIE, Candace Reese, Susanna Stevens and Cynthia M. Amann, MCM and is respectfully submitted.

A handwritten signature in black ink that reads "Keith A. Perry". The signature is written in a cursive style with a large, sweeping initial "K".

Keith Perry, CIE, AES, CISA and AFE
Market Conduct Examiner-in-Charge
State of Delaware
Department of Insurance