

REPORT ON EXAMINATION AS TO THE CONDITION OF

CLARENDON AMERICA INSURANCE COMPANY

TRENTON, NEW JERSEY

AS OF DECEMBER 31, 2008

NAIC GROUP CODE 0517

NAIC COMPANY CODE 43095

**FILED**

**June 22, 2010**

Commissioner  
Department of Banking & Insurance

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**SALUTATION**

Honorable Alfred W. Gross  
Chairman Financial Condition, (E)  
Subcommittee, NAIC  
State Corporation Commission  
Bureau of Insurance  
P.O. Box 1157  
Richmond, Virginia 23218

Mary Jo Hudson  
Secretary, Midwestern Zone  
Director  
Ohio Department of Insurance  
50 West Town Street  
Third Floor, suite 300  
Columbus, OH 43215

James J. Donelon  
Secretary, Southeastern Zone  
Commissioner  
Louisiana Dept. of Insurance  
1702 N. 3rd Street  
P.O. Box 94214  
Baton Rouge, Louisiana 70802-9214

Paulette J. Thabault  
Secretary, Northeastern Zone  
Commissioner  
Vermont Insurance Division  
Dept. of Banking, Insurance, Securities, and  
Health Care Administration  
89 Main Street  
Montpelier, Vermont 05620-3101

Christina Urias  
Secretary, Western Zone  
Director  
Arizona Department of Insurance  
2910 N. 44th Street, suite 210  
Phoenix, Arizona 85018-7269

Honorable Tom Considine  
Commissioner  
New Jersey Department of Banking and  
Insurance  
State of New Jersey  
20 West State Street  
Trenton, NJ 08625-0325

June 2, 2010

Commissioners:

In accordance with the plan adopted by the National Association of Insurance  
Commissioners for association examination of insurance companies, a financial  
condition examination has been made of:

Clarendon America Insurance Company  
Princeton, New Jersey  
NAIC Group Code 0517 NAIC Company Code 43095

Hereinafter referred to as the "Company".

## **SCOPE OF THE EXAMINATION**

This financial condition examination was called by the Commissioner of Banking and Insurance of the State of New Jersey pursuant to the authority granted by N.J.S.A. 17:23-22. The examination covers the period January 1, 2005 through December 31, 2008.

A separate target exam was conducted in 2007 as a follow up on certain issues on the prior examination.

The examination was conducted at the Company's main administrative office located at 466 Lexington Avenue, New York, New York 10017. The examination was conducted in accordance with the Association Plan of Examination guidelines established by the National Association of Insurance Commissioners.

The examination was conducted in accordance with the 2008 NAIC Financial Condition Examiners Handbook. The Handbook requires that we plan and perform the examination to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the Company including corporate governance, identifying and assessing inherent risks within the Company and evaluating system controls and procedures used to mitigate those risks. An examination also includes assessing the principles and significant estimates made by management, as well as evaluating the overall financial statement presentation, management's compliance with Statutory Accounting Principles and annual statement instructions when applicable to domestic state regulations. All accounts and activities of the Company were considered in accordance with the risk-focused examination process as defined in the 2008 NAIC Financial Condition Examiners Handbook.

In addition, a review or audit was also made of the following items:

- Policy on Conflict of Interest
- Corporate Records
- Fidelity Bond and Other Insurance Coverage's
- History and Kind of Business
- Management and Control
- Continuity of Operations
- Territory and Plan of Operation
- Treatment of Policyholders
- Accounts and Records
- Reinsurance
- Parent, Subsidiaries and Affiliates
- Intercompany Agreements
- Information System Review

Surplus as regards policyholders determined by the examination, at the examination date, consisted of the following:

Common Capital Stock	\$ 5,000,000
Gross Paid in and Contributed Surplus	134,128,161
Unassigned Funds	<u>(5,813,739)</u>
<b>Surplus as Regards Policyholders</b>	<b><u>\$ 133,314,422</u></b>

*The change in assets, liabilities and surplus for the period covered by this examination is detailed below:*

	<b>12/31/2008</b>	<b>12/31/2007</b>	<b>12/31/2006</b>	<b>12/31/2005</b>	<b>12/31/2004* (Per Exam)</b>
Assets	\$235,728,590	\$255,893,417	\$518,398,464	\$494,687,472	\$464,135,265
Liabilities	\$102,414,168	\$128,361,848	\$368,721,736	\$311,477,746	\$344,883,387
Surplus	\$133,314,422	\$127,531,569	\$149,676,728	\$183,209,726	\$119,251,878

*\*Amounts differ from the financial statements for the year ended Dec. 31, 2004.*

## **COMPLIANCE WITH PRIOR EXAMINATION REPORT AND 2007 TARGET RECOMMENDATIONS**

### **MANAGEMENT AND CONTROL**

It is recommended that the Company comply with its By-laws regarding the required number of Directors.

*During this examination, the Company complied with this recommendation.*

It is recommended that the appointment of the Director of Internal Audit be documented in the corporate minutes of either the Board of Directors or the Audit Committee thereof. A new Director of Internal Audit was appointed in 2005 was indicated in corporate records provided by the Company.

*The Company has complied with this recommendation.*

### **CONTINUITY OF OPERATIONS**

It is again recommended that the disaster plan be fully tested. Before completion of the 2004 examination the Company provided documentation they had performed disaster recovery plan testing subsequent to the examination date.

*The Company has complied with this recommendation.*

## TREATMENT OF POLICYHOLDERS

It is again recommended that the Company communicate to its agencies the requirement to maintain complaint logs, and that it ensures they are being maintained as required by New Jersey Code, NJSA 17:29B-4 (10).

*The Company has complied with this recommendation.*

## ACCOUNTS AND RECORDS

It is again recommended that the Company implement a comprehensive accounting system, with both physical and electronic controls, to collect and monitor claims, premiums, reinsurance and other related accounting data.

*The Company is in the process of complying with this recommendation. Additional comments are found under Accounts and Records in this report.*

It is again recommended that the Company have consistent claims and premium accounting cut-off dates and limit or eliminate the use of estimates of premium and claims activity.

*The Company has complied with this recommendation regarding claims. The Company is no longer writing new business; therefore this recommendation is no longer applicable regarding premiums.*

## REINSURANCE

It is again recommended that the Company ensure its reinsurance files are maintained with complete signed copies of all reinsurance agreements and such agreements are readily available for review by the examiners.

*The Company has complied with this recommendation.*

## PARENT, SUBSIDIARIES AND AFFILIATES

It is recommended that all affiliated transactions be reported in Schedule Y Part 2 in accordance with NAIC Annual Statement Guidelines.

*The Company has complied with this recommendation.*

## INTER-COMPANY AGREEMENTS

It is recommended that all signatures affixed to any inter-company agreements be accompanied by the date the signature was attached to allow for a determination of when it becomes a binding agreement.

*The Company has complied with this recommendation.*

## BONDS AND STOCKS

It is again recommended that the Company revise their custodial agreement to meet all the requirements and contain the satisfactory safeguards and controls as outlined in the provisions of the NAIC guidelines. Subsequent to the 2004 examination date, the Company complied with this recommendation and currently has custodial agreement in compliance with the NAIC standards.

*The Company has complied with this recommendation.*

## UNCOLLECTED PREMIUMS AND AGENTS' BALANCES IN THE COURSE OF COLLECTION

It is again recommended that the Company properly age all Agents' Balances and non-admit all receivables in excess of 90 days due (aged from inception date of coverage) in compliance with statutory accounting procedures (SSAP#6).

*The Company is no longer writing new business; therefore this recommendation is no longer applicable.*

It is again recommended that the Company ensure that all provisions of their agency agreements are complied with, specifically, required data files.

*The Company is no longer writing new business; therefore this recommendation is no longer applicable.*

## RECEIVABLE FROM PARENT, SUBSIDIARIES AND AFFILIATES

It is recommended that the Company comply with NAIC Accounting and Practices Procedures Manual SSAP 64 when reporting receivables/payables from/to affiliates.

*The Company has complied with this recommendation.*

## LOSSES AND LOSS ADJUSTMENT EXPENSES

It is again recommended that the Company establish and maintain a reserve for loss adjustment expenses to cover the ultimate estimated expenses necessary to adjust all unpaid losses irrespective of any agreements other than a valid contract of reinsurance.

*The Company has complied with this recommendation.*

## CEDED REINSURANCE PREMIUMS PAYABLE

It is recommended that the Company develop and maintain its reinsurance related records to enable it to respond to and promptly respond to requests for information made by the examiners in future examinations.

*The Company has complied with this recommendation.*

It is recommended that the Company maintain proper documentation to support all ceded reinsurance premiums payable reported in future annual statements.

*The Company has complied with this recommendation.*

It is recommended that the Company should make certain that it reports the proper reinsurers with corresponding amounts on Schedule F.

*The Company has complied with this recommendation.*

## 2007 EXAM FINDINGS

It is recommended that the Company comply with Quarterly Statement Instructions and disclose all disputed reinsurance balances in excess of five percent (5%) of surplus.

*The Company has complied with this recommendation.*

It is recommended that the Company review the aging process and result of all manually determined programs for accuracy. It is further recommended that the Company implement automated aging techniques whereby human error is removed from the aging process to the extent possible.

*The Company is no longer writing new business; therefore this recommendation is no longer applicable.*

It is recommended that in determining authorized Lloyds syndicates, the Company utilize the specific Syndicates listed on the then – current NAIC Quarterly List of Alien Reinsurers.

*The Company has complied with this recommendation.*

It is recommended that the Company include a detailed allocation of the blanket LOC in future MOU quarterly reporting, similar to that included in the December, 2007 reporting package.

*The Company has complied with this recommendation.*

## **HISTORY AND KIND OF BUSINESS**

The Company was incorporated under the laws of the State of Delaware on March 11, 1980, and commenced business on March 12, 1980. It redomiciled to the State of New Jersey on June 1, 1995.

During 1996, the Company became a subsidiary of Clarendon National Insurance Company through a corporate restructuring of the Clarendon Insurance Group.

In 1999, the Company was part of the Clarendon Insurance Group which became a wholly owned subsidiary of Hannover Finance Incorporated, a Delaware corporation. The Company's ultimate parent is Hannover Ruckversicherung AG, hereinafter referred to as "Hannover Re".

On March 7, 2006, the Company's ultimate parent, Hannover Ruckversicherung AG (Hannover Re) announced a fundamental restructuring of its U.S. primary insurance business, including the Company's business, by transferring, through an indemnity reinsurance agreement, most of the specialty business of the Hannover Finance Inc. group insurance subsidiaries (HFI) to Praetorian Financial Group (PFG). The agreement was made effective July 1, 2005, and was done on a cutoff basis. Hannover Re also announced its intention to renew all future specialty business of HFI through PFG. The Company and its remaining insurance affiliates will continue to service its inforce book of business through the run-off period, but all active specialty business was renewed with PFG.

During 2005, the Company, along with its Parent, entered into a Memorandum of Understanding with the Department to, among other things, provide additional quarterly reporting related to certain financial information. If the Company fails to materially comply with the agreement, the Department has the right to take additional regulatory action. Made part of that Memorandum, Hannover Re's commitment and general plan to continue to support the Company through the runoff process was described in a letter to the NJDOBI from the Hannover Re Executive Board dated October 19, 2005. As required by the Memorandum, the Company continues to file quarterly supplemental reports with the NJDOBI that provides updated financial data and operational results in relation to its runoff process.

The Company, its Parent and its affiliate focus is to continue to service its in-force book of business and the orderly administration, including prompt claims payment, of its discontinued business. The administration of the in-force book requires the renewal of business in accordance with the state specific forced renewal requirements.

An amended Certificate of Authority dated March 19, 1996 authorized the Company to transact the business of insurance specified in paragraphs "a", "b", "d", "e", "f", "g", "i", "j", "k", "l", "m", "n" and "o-1", "o-2", and "o-3" of N.J.S.A. 17:17-1 et seq. and 17B:17-4 "Health Insurance" as defined in the "Life and Health Insurance Code".

The capital structure of the Company includes 5,000 shares of common stock with a par value of \$1,000 per share totaling \$5,000,000 of common stock. The Company's capital also includes \$134,128,161 of gross paid in and contributed surplus and unassigned funds (surplus) of (5,813,739).

The Company's current statutory home office is located 196 Princeton Hightstown Road, Building 2, Suite 14A, Princeton Jct., NJ 08550. The examination was conducted at the Company's New York, New York offices. The registered agent upon whom process may be served is William F. Megna at the Company's statutory home office.

### **TERRITORY AND PLAN OF OPERATIONS**

The Company ceased writing new business on July 1, 2005. In instances of mandatory renewals the Company has complied with these requirements. The Company entered into fronting arrangements with Praetorian Financial Group on certain programs.

The Company's direct written business currently in runoff is primarily program business which consists of homogeneous books of business dedicated to a well defined market segment. Many of these programs had been recommended to the Company by various reinsurers who desire to participate in the program through quota share treaties.

The Company used reinsurance intermediary brokers to negotiate its reinsurance. These brokers are licensed either in New Jersey or in other accredited states having similar laws to the State of New Jersey.

Prior to starting the run-off process, the Company was actively marketing its insurance products, it primarily employed managing general agents (MGAs), general agents (GAs) and third party administrators (TPAs) to actively manage its various programs. These parties conduct a substantial portion of the administrative work associated with premium and claims processing functions, backup supporting records, and reconciliation to Company bank accounts established for their use.

These firms have contracts with the Company, whereby their responsibilities and authority delineated. Our review determined that the Company was requiring that their MGAs obtain fidelity bond insurance as required under N.J.S.A. 17:22-(2-7).

## REINSURANCE

### Assumed:

The Company's assumed reinsurance, from both affiliates and unaffiliated insurers, at December 31, 2008, was substantially reduced as the Company continues the runoff process. The Company reported 2008 assumed paid losses and LAE of \$9.54 million and known case losses and LAE reserves of \$180.87 million. Approximately 77% of the known assumed case and LAE reserves were related to the Company's Raydon program, which is discussed later in this report.

### Ceded:

The Company makes extensive use of ceded reinsurance in managing its business. During 2008, the Company ceded \$1.5 million of its direct and assumed premiums written.

The Company's ceded reinsurance arrangements are described as follows:

### Program and Global Reinsurance:

The Company ceded program level business on both a pro rata and excess of loss basis to other reinsurers.

While the Company focuses on managing its discontinued business, there remained forced renewal on some of its property business. Effective June 1, 2006, the Company purchased excess reinsurance to protect its exposure for this business, consistent with its exit strategy; which was subsequently extended through May 31, 2008. The contract was not renewed.

Effective July 1, 2005, the Company transferred, through an indemnity reinsurance agreement, most of the insurance business of the Company to Redland Insurance Company and Praetorian Insurance Company and sold the renewal rights for ongoing business of the Company. Cessions under the indemnity agreement were net of underlying reinsurance on the Company's books for the period July 1, 2005 through December 31, 2005. Effective January 1, 2006 the agreement was amended and cessions were made on a gross basis.

### Affiliated Reinsurance:

Effective December 31, 2003, the Company and its affiliates, Clarendon National Insurance Company and Harbor Specialty Insurance Company entered into a Loss Portfolio retroactive ceded reinsurance agreement with affiliate Hannover Re, whereby Hannover Re agrees to assume 100% of the ultimate net liability of certain discontinued programs of business, subject to a loss limitation of \$350 million. The contract further provides to the Company unlimited protection for uncollectible reinsurance, disputed reinsurance and legal expenses associated to the collection of those balances. This agreement was approved by the New Jersey Department of Banking and Insurance. As of December 31, 2004, the inception to date losses and loss adjustment expenses and uncollectible or disputed reinsurance ceded under this contract totaled \$614 million for all three reinsureds.

The Company has filed a Form D with the New Jersey Department of Banking and Insurance seeking approval to commute the Loss Portfolio Agreement (LPT). Under the terms of the commutation Hannover Re will pay to Clarendon approximately \$245,946,678 which represents the sum of (i) the discounted value calculated on the \$252,946,678 in outstanding reserves commuted, and (ii) a risk charge for the reserves that are re-assumed. It is noted that the reserves were determined at December 31, 2009 and will be adjusted to their value as of the March 31, 2010 effective date of the calculation, but the \$7,000,000 differential in the consideration vs. the commuted reserve amount will remain constant.

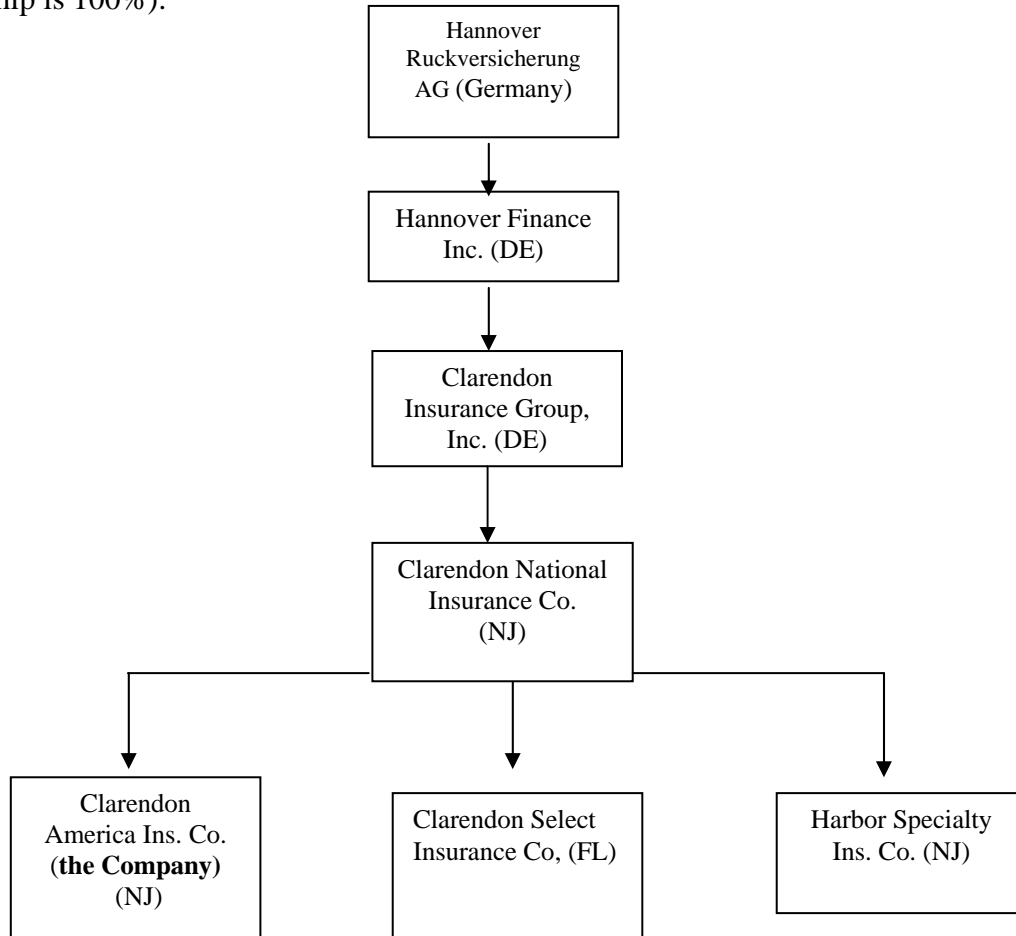
Simultaneously the ADC will be amended to include unlimited protection for failed reinsurance, disputed reinsurance, and any other contingencies for which the uncapped coverage of the LPT would have responded for both the Raydon and Cromwell programs including a payment for the enhanced coverage provided by this amendment. The cost to the Company for this amendment is \$5,000,000.

Effective July 1, 2005, the Company and its affiliates Harbor Specialty Insurance Company and its parent, Clarendon National Insurance Company, entered into an Adverse Development Cover reinsurance agreement with Hannover Re. Under the terms of the agreement, the Companies can recover \$295 million of losses in excess of the ultimate net liability on specific programs, as defined in the agreement.

## PARENT, SUBSIDIARIES AND AFFILIATES

The Company is a member of an insurance company holding system as defined in N.J.S.A. 17:27A-1 et seq. Accordingly, the Company has registered with the State of New Jersey under the registration it filed as required under N.J.S.A. 17:27A-3.

A chart of the holding company system, as it relates to the Company follows (all ownership is 100%):



## **INTER-COMPANY AGREEMENTS**

### **Federal Income Tax Allocation and Settlement Policy Agreement:**

The Company is party to a Federal Income Tax Allocation and Settlement Policy Agreement dated January 1, 2003. This agreement was made between the Company's parent, Hannover Finance Incorporated and its subsidiaries.

The provisions of this agreement call for each subsidiary to calculate the amount of federal income tax it would be required to pay as a stand alone company. All applicable rates of the federal income tax laws are required to be applied by each subsidiary in preparing their individual returns.

A consolidated return consisting of all of the subsidiaries in the Clarendon Insurance Group is prepared by the Company and submitted to Hannover Finance Incorporated for inclusion in its consolidated federal income tax filing as required under this agreement.

The specific settlement terms of this agreement call for each subsidiary to pay the annual settlement of their tax assessment on or before the prescribed due date of the consolidated income tax return. In the event that the Hannover Finance Corporation owes the subsidiary an overpaid amount, that corporation is required to remit that overpayment to the subsidiary on or before the due date of the consolidated federal tax return.

### **Expense Allocation Agreement:**

The Company is party to an expense allocation agreement that provides provisions to allocate certain expenses to and from various affiliated companies. The agreement calls for the Company to receive services as needed including, but not limited to: accounting, underwriting, actuarial, consulting, claims and other administration services.

### **Claims Administration Agreement:**

The Company is a party to a Claims Administration Agreement dated, January 1, 1999 with North American Risk Services, Inc. which remained in effect until NARS was sold in 2008.

### **Investment Agreement:**

The Company is party to an Investment Management Agreement with Ampega Gerling effective January 1, 2004 until December 31, 2008. The agreement covers managing, investing, realizing and reinvesting all or any part of the portfolio under the terms of the agreement and the Company's investment guidelines. A new agreement was submitted to and approved by the NJDOBI prior to the completion of this examination.

## **MANAGEMENT AND CONTROL**

On February 25, 1999, the Company became a wholly owned subsidiary of Hannover Finance Incorporated, due to its acquisition of all of the issued and outstanding stock of Lion Holding Incorporated. The Company's ultimate parent is Hannover Re which owns 100% of Hannover Finance Inc.

### **Shareholders**

The By-laws provide for an annual meeting of the shareholders at a time and place to be designated by the Board of Directors. This meeting shall be for election of Directors and for the completion of any other business concerned with the Corporation.

The By-laws also state that special meetings, of the shareholders, may be called by the Chairman of the Board, the President, the Secretary, the Board of Directors or by the holders of at least one-half of all of the outstanding shares of stock of the Company.

A quorum at all shareholder meetings shall be majority of the outstanding shares of the Corporation represented either in person or by proxy. In the absence of a quorum, a majority of the represented shares may adjourn the meeting without further notice.

### **Directors**

The affairs of the Corporation are managed by its Board of Directors. The number of Directors shall be fixed from time to time by resolution of the Board of Directors or the shareholders. Each Director holds office until the next annual shareholders meeting or until his successor shall have been elected and qualified. Directors may be removed with or without cause as provided by law. A successor Director shall be elected to replace the removed Director by a plurality of the votes cast by a quorum of the Board present at the meeting to remove the Director in question.

The regular meeting of the Board shall be held immediately following and at the same place as the annual shareholders meeting. The Board may provide, by resolution, the time and place for additional meetings without notice other than the resolution. Special meetings of the Board may be called by the Chairman of the Board, the Vice Chairman of the Board, the President or the Secretary at the request of a majority of the Board of Directors.

A majority of the number of Directors shall constitute a quorum at all meetings of the Board providing that, in the absence of a quorum, a majority of the Directors that are present can adjourn the meeting which shall be rescheduled with at least twenty-four hours notice.

A review was made of the Board minutes for the period of the examination. It was determined that Board minutes adequately support all major Company decisions. At December 31, 2008, the Board of Directors was comprised of the following members:

**Name and Address of Director**

**Principal Occupation**

Patrick Fee  
2045 Church Street  
Wauwatosa, WI 53213

President and CEO

Anders Larsson  
6 Marion Road  
Westport, Ct 06880

COO and CFO

Robert Redpath  
166 Georgetown Road  
Weston, CT 06883

General Counsel and SVP

The By-laws state that the Board may, by resolution, designate one or more committees each consisting of one or more of the Directors of the Corporation. As of the examination, the Board had established the following Committees:

**Committee**

**Members**

Audit Committee

Dr. Elke Koenig (Chairwoman)  
William Kelty III  
Patrick Fee

Compensation Committee

Wilhelm Zeller (Chairman)  
William Kelty III  
Patrick Fee

Investment Committee

Dr. Elke Koenig (Chairwoman)  
Patrick Fee  
Anders Larsson  
Matt Mascia

Litigation Committee

William Kelty III  
Elke Koenig  
Patrick Fee  
Dr. Michael Pickel  
Robert Redpath

In 2009, William Zeller was replaced by Dr. Michael Pickel as Chairman of the Board of Directors and Chairman of the Compensation Committee. In 2009, Elke Koenig was replaced by Roland Vogel as a member of the Board of Directors and the Chairman of the Audit Committee and Investment Committee.

The Underwriting Committee and Actuarial Committee were dissolved in 2006. The Litigation Committee was dissolved in 2008.

Though the Company is not in compliance with N.J.S.A. 17:27A-4d (3)(4) whereby at least one third of its directors must be outside members and not associated with the Company, its ultimate parent does meet the requirements of New Jersey Statutes regarding the make-up of its Board of Directors.

Article V of the By-laws dictates the corporate officers, their powers and duties. Under this article, the officers, of the Company shall be the following:

Chairman of the Board  
Vice Chairman of the Board  
President  
Vice Presidents  
Secretary  
Treasurer

The duties of the above listed officers, as stated in the by-laws are as follows:

Chairman of the Board – shall be the Chief Executive Officer of the Company and subject only to the Board of Directors, shall have general authority over the property and business affairs of the Company. The Chairman shall preside at all meetings of stockholders and of the Board of Directors. In the event of the absence or disability of the President, the Chairman of the Board shall discharge all of the duties of the President.

Vice Chairman of the Board – shall exercise all powers of the Chairman of the Board in his absence or disability. At the direction of the Chairman, he shall preside at meetings of the Board of Directors and of the stockholders.

President – shall be the Chief Operating Officer of the Company and subject only to the Chairman of the Board and to the Board of Directors. He shall direct the everyday business of the Company. The President shall have such specific duties as may be assigned by the Chairman of the Board and the Board of Directors. During the absence or disability of the Chairman and the Vice Chairman, he shall exercise all powers of the Chairman. In the event of the absence of the Chairman and the Vice Chairman, the President shall preside at meetings of the Board of Directors and of the Shareholders. In the absence of the Chairman of the Board, the Vice Chairman and the President, the Board of Directors may direct a Vice President or some other person to be the acting Chief Executive Officer and Acting Chief Operating Officer to perform all duties prescribed for the Chairman of the Board and the President.

Vice Presidents – The Board of Directors shall elect one or more Vice Presidents to serve in such capacities as shall be directed by the Chairman, the Vice Chairman, the President or the Directors.

Secretary – shall have custody of the seal of the Company which he or Assistant Secretary may affix to any corporate documents on which it is required. The Secretary shall perform all duties incidental to that office and such other duties as may be assigned to him by the Chairman of the Board, the Vice Chairman of the Board, the President or the Board of Directors. In the absence of the Secretary, any Assistant Secretary may perform the duties of the Secretary.

Treasurer – Shall be the custodian of the funds and securities of the Company. He shall perform all duties incidental to the office of the Treasurer as well as any other duties which may be assigned to him by the Chairman of the Board, the Vice Chairman of the Board, the President or the Board of Directors. In the absence of the Treasurer, the President or any Assistant Treasurer may perform the duties of the Treasurer.

As of December 31, 2008, the officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Patrick Fee	President & CEO
Robert Redpath	Secretary and General Counsel
Anders Folke Larsson	Chief Operating Officer
Matthew Mascia	Treasurer

A review of the minutes of the Board of Directors indicated that the Board approved major company actions.

### **CONTINUITY OF OPERATIONS**

The Company stores its paper files, with Iron Mountain throughout its six locations in NJ and also in a lease warehouse in Orlando, Florida located at 6831 Edgewater Commerce Parkway. Its backup tapes and other important IT information is stored at:

Iron Mountain  
Offsite Data Protection  
203 Moonachie Road  
Moonachie, NJ 07074

Also, at that same location, its computer systems weekly backups are stored. All required systems are real time replicated to a hot site hosted in Equinix in New Jersey.

The Company has in place a disaster recovery plan. This plan includes the appointment of a recovery executive committee, headed by the President and managed by the Chief Administrative Officer, who have overall responsibility for the implementation of the plan.

If the Company were to lose the use of its primary office or its computer facility, the hot site will provide access via internet from any location for key computer systems. From this location, the Company will have key personnel and team leaders from all of its major business areas, work in restoring the Company's ability to operate as a viable entity.

The plan is comprehensive and appears to cover most disasters that might harm the Company's ability to act as a viable operation. A review of the disaster recovery by a consultant contracted by the New Jersey Department of Banking and Insurance indicated areas whereby the Company could improve their disaster recovery program. These comments were communicated to the Company. As of the examination date, the Company tests its hot site location yearly.

The continuity of management is provided for in the Company's By-laws which state, under the section dealing with the duties of officers, the Chairman of the Board shall be the Chief Executive Officer of the Company and shall have general authority over the general management of the corporation. The By-laws also state that the President shall be the Chief Operating Officer of the Company. In the case of the disability or absence of either the Chairman of the Board or of the President, the duties of the unavailable officer shall be assumed by the remaining one. If both the above officers should be unavailable to serve, the Board of Directors may select a Senior Vice President or some other party to act instead.

### **POLICY ON CONFLICTS OF INTEREST**

The Company has adopted a conflict of interest policy. This policy states that all directors, officers and employees should conduct business in the spirit of the law, and to refrain from any illegal, dishonest and unethical conduct. If a situation arises which makes it difficult to determine a proper course of action, the matter should be discussed with immediate supervisors or the Human Resource Department.

Transactions with outside firms must be conducted and controlled by the executive level of the Clarendon Insurance Group. Business dealings with outside firms should not result in unusual gains for those firms. Unusual gains refers to bribes, product bonuses, special fringe benefits, unusual price breaks and other windfalls designed to ultimately benefit either the employee, the employer or both. Promotional plans that could be interpreted to involve unusual gain require specific executive level approval.

This policy is comprehensive and helps the Company to seek out any potential conflicts and decide on a course of action regarding the same.

## **FIDELITY BOND AND OTHER INSURANCE COVERAGES**

The Company's bonding and all other insurance coverage are part of the overall insurance program administered by Hannover Finance, Inc., for itself and its network of subsidiaries. The types of coverage for the Company are summarized as follows:

Fidelity Coverage – a fidelity bond with an aggregate amount of liability of \$15,000,000 was in force at the date of our examination. This fidelity bond included blanket coverage of Hannover Finance, Inc., and its related subsidiaries. Based on the consolidated audited financial statements of the Hannover Finance, the suggested minimum amount of fidelity insurance was calculated using NAIC guidelines. It was determined that the coverage in force was in compliance with the NAIC prescribed amounts.

Other Insurance Coverage's:

### Property and General Liability

(Provided by the Travelers Indemnity Company of America)

#### Limits

Personal Property.....	\$1,040,000
Business income with extra expense waiting period 72 hours.....	\$1,200,000
Electronic data processing.....	\$ 500,000
Valuable Papers.....	\$ 500,000

### Business Automobile:

Provided by the Travelers Property & Casualty Company of America for \$1 million per occurrence.

### Workers Compensation:

Provided by the Travelers Indemnity Company of America for \$1 million each accident, \$1 million policy limit and \$1 million each employee.

### Umbrella Liability:

Provided by the Travelers Property & Casualty Company of America for \$10 million each occurrence, \$10 million aggregate.

### Excess Follow Form Liability:

Provided by The American Insurance Company for \$50 million, \$50 aggregate.

### Fiduciary Liability:

Provided by the St. Paul Mercury Insurance Company for \$5 million each policy period.

### Financial Institution Bond:

Provided by the St. Paul Fire and Marine for \$10 million with a \$250,000 deductible.

Financial Institution Computer Crime:

Provided by the St. Paul Fire and Marine 50/50 Co-Surety with Federal Insurance Company for \$10 million with a \$250,000 deductible.

Cyber Security Crime Policy:

Provide by the Federal Insurance Company for \$1 million, \$ 250,000 deductible.

Cyber Security Liability Policy:

Provided by the Federal Insurance Company for \$1 million, \$150,000 deductible.

Professional Liability:

Provided by the Columbia Casualty Insurance Company for \$10 per loss/ aggregate, retention \$ 1.5 million.

Excess Professional Liability:

Provided by the Illinois Union Insurance Company for \$10m million per loss/ aggregate.

Group Travel Insurance:

Provided by the Federal Insurance Company for \$5 million per accident / aggregate limit.

Employment Practices Liability:

Provided by the Federal Insurance Company for \$ 5 million each loss / aggregate \$ 5 million.

Punitive Damages Insurance Policy:

Provided by the Chubb Atlantic Indemnity Insurance Company for \$5 million each claim, \$5 million aggregate.

Kidnap & Ransom Insurance Policy:

Provided by the Liberty Insurance Underwriters, Inc. for \$ 10 million each loss ,max benefit to any one person of \$100,000.

## **ACCOUNTS AND RECORDS**

Investment transaction data is provided by Ampega-Gerling to the Company in accordance with the terms of an investment services agreement. The company enters the data into the SunGard Investment accounting system. The data from SunGard is transported to the Oracle General Ledger, as well as the Freedom Annual Statement system.

Policy and claims detailed transactions are also primarily administered through contracts executed with third party vendors, as described under the "Territory and Plan of Operation" section of this report. The Company obtains applicable information on a monthly basis through a variety of means such as reports and electronic media. This information is downloaded or entered, as applicable, into excel spreadsheets that in turn flow into other spreadsheets and eventually the data is uploaded, on a quarterly, into Oracle. The Company utilizes an early cut-off of 2 months for the recording of its premium/claim data, primarily due to its reliance on third party administrators/managers and the timing of the receipt of this data, and also due to the timing necessary to be able to report Company data upstream to its parent in Germany. The Company uses estimates of underwriting accounts for two month each quarter which is reversed the following quarter.

During KPMG's review of the Company a significant deficiency was noted relating to the Company's extensive use of spreadsheets. "These spreadsheets are utilized to accumulate or calculate certain gross and ceded revenue, losses, expenses, asset and liability balances. The spreadsheets are utilized to account for transactions entered into by the Company's managing general agents and processed by the program accounting group. Due to the extensive use of spreadsheets the Company is not able to design and implement sufficient controls over access, program development and program changes controls over these spreadsheet."

In response to this concern, the Company is implementing two accounting systems. One system will handle direct data loads, direct calculations, statutory reporting, general ledger posting and management reports. The other system performs cession calculations, reinsurance billings, reinsurance reporting and Schedule F reporting. It was noted that KPMG expressed the same concerns related to spreadsheets during their 2009 audit.

## **TREATMENT OF POLICYHOLDERS**

N.J.S.A. 17:29-4 (10) requires the maintenance of a complete record of all complaints received by the Company since the date of the prior examination. The Company informed the examiners that the complaint logs are maintained at their various agency offices and monitored by Company personnel.

## **STATUTORY DEPOSITS**

The following is a list of deposits as of December 31, 2008 for the states that require the Company to maintain a deposit for the benefit of all policyholders or the policyholders of the particular state.

The securities held are either US Treasury Notes or a specific security and are in the following amounts and for the indicated states:

<b><u>State</u></b>	<b><u>Statement Value</u></b>
Arkansas	\$ 124,531
Delaware	109,587
Louisiana	99,624
Massachusetts	747,183
New Hampshire	502,457
New Jersey	2,604,382
New Mexico	119,962
New York	752,933
Oklahoma	100,391
South Carolina	<u>398,498</u>
Total	<u>\$5,559,549</u>

The New Jersey deposit was held for the protection of all policyholders while the other deposits were held for the protection of the policyholders in the named jurisdictions.

**Comparative Statement of Assets,  
Liabilities, Surplus and Other Funds at  
December 31, 2008**

Exhibit A

	<u>Balance per Examination</u>	<u>Balance per Company</u>	<u>Note</u>
<b><u>Assets:</u></b>			
Bonds	99,942,031	99,942,031	1
Cash, Cash Equivalents & Short term investments	56,996,547	56,996,547	
Investment income due and accrued	1,020,194	1,020,194	
Amounts recoverable from reinsurers	45,291,922	45,291,922	
Receivable from parent, subsidiaries and affiliates	26,123,389	26,123,389	
Aggregate write-ins for other than invested assets-equities & deposits in pools	<u>6,354,507</u>	<u>6,354,507</u>	
<b>Total Assets</b>	<b><u>\$235,728,590</u></b>	<b><u>\$235,728,590</u></b>	
<b><u>Liabilities:</u></b>			
Losses	46,638,570	46,638,570	2
Reinsurance payable on paid loss and LAE	9,537,501	9,537,501	
Loss adjustment expenses	10,116,637	10,116,637	2
Commission payable, contingent commissions & other similar charges	8,982,103	8,982,103	
Other expenses	1,163,957	1,163,957	
Current federal and foreign income taxes	348,011	348,011	
Taxes, licenses and fees	750	750	
Ceded reinsurance premiums payable	18,693,682	18,693,682	
Funds held by company under reinsurance treaties	194,988	194,988	
Amounts withheld or retained by Company for account of others	160,313	160,313	
Provision for reinsurance	<u>3,195,359</u>	<u>3,195,359</u>	
Aggregate write ins for liabilities			
<b>Total Liabilities</b>	<b><u>\$102,414,168</u></b>	<b><u>\$102,414,168</u></b>	
<b><u>Capital and Surplus:</u></b>			
Common capital stock	5,000,000	5,000,000	
Gross paid in and contributed surplus	134,128,161	134,128,161	
Unassigned funds	<u>(5,813,739)</u>	<u>(5,813,739)</u>	
Surplus as regards policyholders	<u>\$133,314,422</u>	<u>\$133,314,422</u>	
<b>Total Liabilities and Surplus and Other Funds</b>	<b><u>\$235,728,590</u></b>	<b><u>\$235,728,590</u></b>	

**Underwriting and Investment Exhibit  
for the period  
December 31, 2005 to December 31, 2008**

**Exhibit B**

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
<b><u>Underwriting Income</u></b>				
Premiums earned	\$21,678,826	\$1,835,656	\$1,146,844	\$(2,696,219)
Deductions:				
Losses incurred	8,118,278	26,725,896	22,975,954	(6,350,978)
Loss adjustment expenses incurred	7,290,010	16,019,322	9,215,456	8,209,889
Other underwriting expenses incurred	6,920,636	8,886,147	28,923,961	12,524,109
Total underwriting deductions	<u>22,328,924</u>	<u>51,631,365</u>	<u>61,115,371</u>	<u>14,383,020</u>
Net underwriting gain or loss	<u>(650,098)</u>	<u>(49,795,709)</u>	<u>(59,968,527)</u>	<u>(17,079,239)</u>
<b><u>Investment income</u></b>				
Net investment income earned	9,829,124	10,153,704	6,484,665	545,708
Net realized capital gains or losses	220,788	(999,018)	(3,254,728)	799,088
Net investment gain or loss	<u>10,049,912</u>	<u>9,154,686</u>	<u>3,229,937</u>	<u>1,344,796</u>
<b><u>Other income</u></b>				
Net gain or loss from agents' or premium balances charged off	(1,153,893)	(1,204,172)	(8,163,322)	11,345,213
Aggregate write-ins for miscellaneous income	4,610,000	12,242,359	40,166,855	(37,500)
Total other income	<u>3,456,107</u>	<u>11,038,187</u>	<u>32,003,533</u>	<u>11,307,713</u>
Net income before dividends to policyholders and before federal and foreign income taxes	12,855,921	(29,602,836)	(24,735,058)	(4,426,730)
Less: Federal & foreign income taxes incurred	<u>(1,627,923)</u>	<u>(5,671,067)</u>	<u>0</u>	<u>0</u>
Net income	<u>\$14,483,844</u>	<u>\$(23,931,769)</u>	<u>\$(24,735,058)</u>	<u>\$(4,426,730)</u>

**CAPITAL AND SURPLUS**  
**For the period December 31, 2005**  
**to December 31, 2008**

**Exhibit C**

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
<b><u>Gains and losses in surplus:</u></b>				
Net income or (loss)	\$14483844	\$(23931769)	\$(24735058)	\$(4426730)
Change in net deferred income tax	(5,824,010)	4,482,760	10,337,160	(18,164)
Change in non-admitted assets	2,857,771	(5,679,832)	(14865254)	2,806,736
Change in provision for reinsurance	(3,035,416)	(8,404,156)	7,117,993	7,073,000
Aggregate write-ins for gains and losses in surplus	0	0	0	348,011
Change in Surplus as regards to Policyholders for the year	8,482,190	(33,532,997)	(2,145,159)	5,782,853
Surplus, December 31 previous year	<u>174,727,563</u>	<u>183,209,726</u>	<u>149,676,728</u>	<u>127,531,539</u>
Surplus, December 31 current year	<u>\$183,209,726</u>	<u>\$14,9676.728</u>	<u>\$127,531,569</u>	<u>\$133,314,422</u>

## NOTES TO FINANCIAL STATEMENTS

### Note 1: BONDS

At December 31, 2008, the Company was in violation of N.J.S.A 17:24-1. At that time, the Company had admitted assets of \$235,728,590 which, under that Section which limits foreign investments to 10% of its preceding period admitted assets, imposes a limit on the Company's holdings in foreign investments to \$23,728,590. The Company reported foreign investments totaling \$85,695,101, or an excess statutory investment in foreign securities of \$65,122,242.

In July of 2009, the Company sold foreign investments totaling \$65,912,907 and was in compliance with the Insurance Statutes. Therefore, no examination adjustment was deemed necessary.

### Note 2: LOSSES AND LOSS ADJUSTMENT EXPENSES

The Company reported a liability for loss and loss adjustment expenses in the amount of \$46,638,570 and \$10,116,637 respectively. These reserve amounts were evaluated by the actuarial firm of Oliver, Wyman. The review indicated that the gross and net reserve amounts excluding the Cromwell program, established by the Company were found to be adequate. Including the Cromwell program gross reserves were found to be deficient. **It is recommended that the Company accurately estimate and report future gross loss and loss adjustment expense reserve liabilities.**

Prior to the completion of this examination, the Company provided the examiners corrective actions it taken to correct future Cromwell program loss and LAE reserve deficiencies on a gross basis. As stated by the Company, the following were the primary corrective actions taken subsequent to the examination date:

- The Company's provision for ultimate loss & LAE increased by \$40 million from January 1, 2009 through March 31, 2010.
- Further reserve strengthening is anticipated during the remainder of 2010, dependent upon claim emergence patterns vs. those expected.
- The third-party claim administrator for this program has accelerated its timing for the provision of realistic loss and expense reserves, which should reduce the degree of adverse loss development on known claims.
- This program's claim emergence has been monitored monthly since June of 2009 rather than quarterly prior to this date.

The report by Oliver Wyman did not provide an opinion of reserves related to the Raydon Program. See below for a detailed discussion of the Raydon program and the issues with accurately estimating the reserves associated with this program.

An agent named Raydon Underwriting Management ("Raydon") produced a book of business for Clarendon National and Clarendon America (together, "Clarendon") during the 1990's that consists of coverage for self insurance funds, retrocessional and primary

workers compensation business, and personal accident business. Clarendon has specific reinsurance for this book of business that attaches at \$10,000 per occurrence. Clarendon also has reinsurance in place for the aggregate coverage Raydon wrote. Four parties who participated in Clarendon's outward reinsurance protection for the Raydon program have previously disputed their obligations to Clarendon. As at December 31, 2008, Clarendon has settled with three of these reinsurers. As at December 31, 2009 Clarendon has settled with all four of these reinsurers.

There are two contingencies with respect to the Raydon business. First, several purported cedents have notified Clarendon in writing of material amounts allegedly due (or to become due) from Clarendon. Clarendon is auditing such cedents and, for a variety of reasons, has disputed the validity of the bills they have presented.

The total gross amount of such disputed inward cessions (paid and case), on their face and ignoring Clarendon's issues with their validity, equaled approximately \$123 million as of December 31, 2008. Clarendon believes that it would eventually recover approximately \$74 million of this amount from the reinsurance protection it has for the Raydon program, leaving a net of approximately \$49 million before the application of other reinsurance. In comparison, the total gross and net amount of such disputed inward cessions equaled approximately \$53.6 million and \$17.8 million, respectively, as of December 31, 2009.

However, the issues that Clarendon has raised are such that it is very difficult for Clarendon to estimate its actual gross or net exposure concerning such bills to a reasonable degree of certainty in accordance with SSAP No. 5 (7). Notwithstanding this problem, Clarendon has, based on information it has obtained through its audits and its experience with similar issues, made a judgment to book a \$25 million net reserve. The company intends that this net reserve, which is \$20 million as of December 31, 2009, also will protect it in respect of the second contingency described below. This additional net reserve may or may not be adequate to cover the loss Clarendon ultimately suffers with respect to these bills or the second contingency.

The second contingency concerns the IBNR for the Raydon program generally. There is great uncertainty about the amount of primary losses that will be ceded into the market and eventually make their way to Clarendon through the Raydon treaties. Clarendon has, subject to routine audit and legal inquiries, recognized amounts that its cedents have reported (other than the cedents described in the second paragraph of this note and IBNR estimates that the company has been unable to verify). However, with limited exceptions described below, the principles of actuarial science cannot surmount the factual and legal problems presented by this retrocessional book of business. This is true because, in addition to other factors, there are significant uncertainties associated with critical assumptions in the estimation process such as the amount of excluded business, whether a company involved in the chain of cessions is a primary writer, the reconciliation of inconsistent information, what block of business a primary writer cedes into the market under which reinsurance treaty, the effect of inuring reinsurance that others may possess, the extent of actual third party retention, the effect of commutations, legal disputes, and

cancellations, and the extent of claims recirculation caused by various parties who, directly or indirectly, reinsure each other on an excess of loss basis.

Accordingly, Clarendon has decided not to include a separate estimate for net incurred but not reported claims, if any, on the Raydon business, other than the bulk reserve cited above. It is therefore possible that Clarendon could incur a material loss on the Raydon business beyond that which is already reflected in its financial statements.

Based on its aggregate reserve for net losses and loss expenses at December 31, 2008, and at December 31, 2009, Clarendon does not expect that the net liabilities associated with the Raydon business will have a materially adverse impact on its future liquidity or financial position. Clarendon contends that this expectation was strengthened during 2009 with further legal, forensic accounting, and actuarial work on several of the Raydon programs as well as settlements and commutations with various cedents in 2009. In addition, the settlement agreements with the reinsurers reduce potential uncertainty of claims flow. However, given the contingencies identified in this note, Clarendon's actual results could differ, possibly materially, from its current estimates.

Detail supporting the paid losses and loss adjustment expenses and case reserves were verified by the Company's external audit firm KPMG without exception. The examiners reviewed the KPMG workpapers, and relied on their findings.

Loss and Loss Adjustment Expense Reserves-Statement by New Jersey Department of Banking and Insurance Actuary

I, Boris Privman, FCAS, MAAA, Managing Property and Casualty Actuary for the New Jersey Department of Banking and Insurance, have reviewed the actuarial analysis performed by Oliver Wyman for reported loss and loss adjustment expense reserves for the Clarendon America Insurance Company. Based upon this review the Company's booked gross reserves were deficient and it is recommended that the Company better estimate future reserve liabilities. The net loss reserves should be accepted without adjustments.

Actuarial findings as stated above and in this examination report are the sole responsibility of the New Jersey Department of Banking and Insurance's Property and Casualty Actuarial Unit of the Office of Solvency Regulation.

\_\_\_\_\_  
/S/  
Boris Privman-Managing Actuary

## **SUBSEQUENT EVENTS**

In its December 31, 2009 annual statement the Company reported prior period adjustments which totaled \$3,512,482. A summary of these adjustments follows:

<b>Description</b>	<b>Statement Effect</b>	<b>Equity</b>	<b>Liabilities</b>	<b>Period Booked</b>
Correction of error on workers' compensation. The balance reported is the balance retained by the Company after cessions to the LPT.	2,579,616	2,579,616	(2,579,616)	4Q09
Correction of under accrual of the Company's severance and retention policy obligations due to calculation allocation from Clarendon National	932,866	932,866	(932,866)	4Q09
Total Adjustments to unassigned funds	<u>3,512,482</u>	<u>3,512,482</u>	<u>(3,512,482)</u>	

**EXAMINATION RECOMMENDATION**

Page            Losses and Loss Adjustment Expenses

23            It is recommended that the Company accurately estimate and report future loss and loss adjustment expense reserve liabilities.

