

REPORT ON EXAMINATION

of the

PREFERRED AUTO INSURANCE COMPANY, INC.

MEMPHIS, TN

RECEIVED

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Dept. of Commerce & Insurance
Company Examinations

as of

DECEMBER 31, 2007

DEPARTMENT OF COMMERCE AND INSURANCE

STATE OF TENNESSEE

NASHVILLE, TENNESSEE

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Memphis, Tennessee
June 5, 2009

Honorable Leslie A. Newman
Commissioner
State of Tennessee
Department of Commerce and Insurance
Nashville, Tennessee 37243

Dear Commissioner:

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

**PREFERRED AUTO INSURANCE COMPANY, INC.
MEMPHIS, TENNESSEE**

hereinafter and generally referred to as the Company, and a report thereon is submitted as follows:

INTRODUCTION

This examination was called by the Commissioner of Commerce and Insurance of the State of Tennessee and commenced on January 16, 2009. The examination was conducted under the association plan of the NAIC by duly authorized representatives of "The Department of Commerce and Insurance", State of Tennessee ("TDCI").

SCOPE OF EXAMINATION

This examination report covers the period from December 31, 2002, the date of the last previous examination, to the close of business on December 31, 2007, and includes any material transactions and/or events occurring subsequent to the examination date and noted during the course of the examination.

The examination of the financial condition was conducted in accordance with guidelines and procedures contained in the National Association of Insurance Commissioners (NAIC) Examiners Handbook. During the course of examination, assets were verified and valued and liabilities were determined and estimated as of December 31, 2007. The financial condition of the Company and its amount of solvency were thereby established. Test checks were made of income and disbursement items for selected periods, and a general review was made of the

Company's operations, practices, and compliance with applicable statutes and regulations. All asset and liability items contained in the financial statement of this report were examined and verified with relative emphasis according to their amount and potential impact on capital and surplus.

In addition, the following topics were reviewed:

- Company History
- Charter and Bylaws
- Management and Control
- Corporate Records
- Fidelity Bonds and Other Insurance
- Territory (includes inforce/premium by state)
- Plan of Operation
- Market Conduct Activities
- Reinsurance
- Retirement Plan and Other Employee Benefits
- Loss Experience
- Accounts and Records
- Statutory Deposits
- Agreements with Parent, Subsidiaries and Affiliates
- Pecuniary Interest
- Commission Equity
- Dividends or Distributions
- Litigation
- Subsequent Events
- Financial Statement

The previous examination was conducted as of December 31, 2002 by authorized representatives of the TDCI, State of Tennessee. The previous examination made several comments. These comments are outlined under the caption "COMMENTS – PREVIOUS EXAMINATION".

COMMENTS – PREVIOUS EXAMINATION

- The Company negotiated with its commercial bank, Trustmark, to have the excess funds on deposit swept to a Federated Treasury Sweep Account which qualifies as a cash equivalent asset as valued by the Securities Valuation Office of the NAIC in order that all funds on deposit with Trustmark will be classified as cash on future financial statements filed with the TDCI. This change was effective as of December 23, 2003.
- The Company should allocate recoverable income tax to the asset, "Federal and foreign income tax recoverable" rather than an aggregate write in line on future filings with the TDCI. This will better comply with

Statement of Statutory Accounting Principles No. 10 and annual statement instructions.

- Tenn. Code Ann. § 56-11-206(a)(2) requires that the Commissioner be notified in writing of the intent to enter into transactions such as management agreements and service contracts thirty (30) days prior thereto. The Company had filed its general agency agreements and claims service contract with the TDCI as Form D filings on October 19, 2001; however, filing did not fall into the above referenced time window. The Company was made aware of the requirement during the examination and stated that it will comply with future filings. The said agreements are outlined under the caption "AGREEMENTS WITH PARENT, SUBSIDIARIES AND AFFILIATES" on page 14 of this report.
- The Company was made aware that Tenn. Code Ann. § 56-3-103 prohibits pecuniary interest of directors and officers in the investment or disposition of Company funds. It was suggested that the Company develop a conflict of interest policy and have the affected persons complete conflict of interest statements to attest compliance. The relationship of directors and officers of the Company to other companies in the holding company system is outlined under the captions "AGREEMENTS WITH PARENT, SUBSIDIARIES AND AFFILIATES" on page 14 of this report and "PECUNIARY INTEREST TENN. CODE ANN. § 56-3-103" on page 15 of this report.
- At December 31, 2002, the Company had surplus funds in the amount of \$860,036 after the establishment per examination of a liability for the "commission equity" in ceded unearned premium. This liability should be exhibited as an "aggregate write-in liability" on statements filed with the TDCI and is discussed under the captions "COMMISSION EQUITY" on page 16 of this report and "COMMENTS RESULTING FROM EXAMINATION" on page 24 of this report. The Company therefore does not exhibit "bona fide surplus funds" in the amount of \$1,000,000 required pursuant to Tenn. Code Ann. § 56-2-115. The Company does continue to comply with Tenn. Code Ann. § 56-46-101, *et seq.* (Risk-Based Capital for Insurers), and exceeds the minimum capital and surplus which would require "Company Action" pursuant to Tenn. Code Ann. § 56-46-104.

Review during the present examination indicated that the Company has addressed all findings made during the previous examination.

COMPANY HISTORY

The Company was incorporated on April 27, 2000 under the Tennessee Business Corporation Act as a for-profit corporation authorized to transact

business in the State of Tennessee. The Company's Charter authorizes it to engage in and conduct insurance business of all types, except life and annuity. The first meeting of the incorporators was held on March 7, 2000. At that meeting, the Charter and the Corporate Bylaws were approved and the Board of Directors was elected. A resolution was issued which stated that: "the Board of Directors be and they are hereby authorized to issue the capital stock of the corporation to the full amount or the number of shares authorized by the Articles of Incorporation, in such amounts and proportions as from time to time shall be determined by the Board, and to accept in full or in part payment thereof such property as the Board may determine shall be good and sufficient consideration and necessary for the business of the corporation." At this same meeting, it was resolved that the Commissioner and Deputy Commissioner of the TDCI shall be considered and held to have continuing power of attorney for said company, for the purpose of service of process in any action against it. The first meeting of the Board of Directors was held on March 8, 2000 at which time, officers were elected.

On April 28, 2000, Stock Certificate One for 550,000 shares of capital stock was issued to Jeffrey L. Kelley, Stock Certificate Two for 200,000 shares was issued to Clinton B. Haley, Stock Certificate Three for 200,000 shares was issued to Vincent G. Kelly, and Stock Certificate Four for 50,000 shares was issued to Danny W. Lazenby.

The Company was issued a certificate of authority dated January 16, 2001 from the TDCI of the State of Tennessee to transact the business of property, casualty and vehicle insurance. The Company's principal place of business is 216 South Cooper, Memphis, Tennessee.

On April 18, 2001, the Board of Directors approved an option for Charles L. Kelley, Sr. and/or Lennie F. Kelley to purchase all of the original stock issued to Vincent G. Kelley. Additionally, Charles L. Kelley, Sr. and/or Lennie Kelley were granted an option to purchase 30% of the original stock issued to Jeffrey L. Kelley which was approved by the Board at the same meeting.

On April 24, 2002, Charles L. Kelley, Sr. exercised the option to purchase all 200,000 shares of the capital stock owned by Vincent G. Kelley. Mr. Charles L. Kelley, Sr. subsequently filed a "Disclaimer of Control" dated May 1, 2003 with the TDCI. The Disclaimer was received by the TDCI on May 21, 2003. No formal acceptance letter was issued to either Mr. Kelley or the Company.

Ownership percentage of the Company has varied during the examination period. As of December 31, 2007 owners' shares and percentages were: Jeffrey L. Kelley, 357,142.86 shares (35.71%); Vincent G. Kelley, 285,714.29 shares (28.57%); Clinton B. Haley, 285,714.29 shares (28.57%); and Danny W. Lazenby, 71,428.571 shares (7.14%).

As of December 31, 2007, the Company was licensed in one state, Tennessee.

The following exhibit depicts certain aspects of the growth and financial history of the Company since the previous examination, according to annual statements filed with the TDCI.

<u>Date</u>	<u>Earned Premiums</u>	<u>Incurred Losses & LAE</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Capital and Surplus</u>
12/31/2003	\$1,422,750	\$1,474,134	\$7,253,977	\$4,670,707	\$2,583,270
12/31/2004	1,175,309	1,123,296	7,335,190	4,723,237	2,611,953
12/31/2005	1,155,380	1,089,750	6,957,188	4,302,240	2,654,948
12/31/2006	1,745,650	1,427,488	6,747,044	3,958,660	2,788,384
12/31/2007	2,226,565	1,747,517	7,106,914	4,242,288	2,864,626

Dividends or Distributions:

No dividends or distributions have been paid to stockholders as of December 31, 2007. A dividend was declared subsequent to the examination period and is addressed under the caption "SUBSEQUENT EVENTS".

CHARTER AND BYLAWS

Charter:

The Charter was filed and recorded with the Tennessee Secretary of State on April 27, 2000, and recorded with the Shelby County Register on December 4, 2000. The Charter had been approved by the TDCI on April 27, 2000. The principal purposes of the Company are:

- (i) "To engage in any lawful business for which corporations may be incorporated pursuant to the laws of Tennessee;"
- (ii) "To engage in and conduct insurance business of all types, except life and annuity, including without limitation all activities under Tennessee insurance laws and regulations, to issue insurance policies, to make contracts of insurance; and to establish and hold reserves;"
- (iii) "The Corporation shall have all the powers incident to conducting its business as a corporation organized under Tennessee laws."

The Charter authorizes a maximum number of ten million (10,000,000) shares of

capital common stock with a par value of one dollar (\$1) per share.

Bylaws:

The Bylaws of the Company in effect as of December 31, 2007 were adopted by the unanimous consent of the Board on March 7, 2000 at the meeting of the Incorporators, have not been amended or changed during the period covered by this examination, and include the following provisions:

An annual meeting of the shareholders of the Company shall be held at such time and place, either within or without this State, as may be designated from time to time by the directors. Unless the time is otherwise specified, said meetings shall be held in June of each year, or as close thereto as practicable. Special meetings of the shareholders may be called by the president, a majority of the board of directors, or by the holders of at least thirty percent (30%) of the stock of the Corporation entitled to vote at such meeting. The place of special meetings shall be designated by the directors or stockholders calling said meeting. A majority of shares entitled to vote shall constitute a quorum for the transaction of business.

The business and affairs of the Corporation shall be managed under the direction of a board of directors. The number of directors shall be not less than two nor more than seven members. The annual meeting of the board of directors shall be held immediately after adjournment of the annual meeting of shareholders, at which time the officers of the corporation shall be elected. The board may also designate more frequent intervals for regular meetings. A majority of the directors shall constitute a quorum.

The officers for the corporation shall be a president and a secretary, and such other officers as the board of directors shall from time to time deem necessary. Any two or more offices may be held by the same person, except the offices of president and secretary.

The bylaws contain a restriction on transfer of shares of capital stock as follows: "The shares of stock may not be sold, transferred or assigned except as provided in the Corporation's Certificate of Incorporation, its bylaws, or agreement among shareholders or any amendments thereto."

MANAGEMENT AND CONTROL

Management:

The Company's bylaws state that the business and affairs of the Company shall be under the direction and control of a Board of Directors consisting of not less than two (2) or more than seven (7) directors. As of December 31, 2007, the

Board of Directors of the Company was composed of the following:

<u>Name</u>	<u>Director Affiliation</u>
Jeffrey Laine Kelley	Part owner of Preferred Auto Insurance Company, Inc.
Vincent Gregory Kelley	Part owner of Preferred Auto Insurance Company, Inc.
Clinton Boyce Haley	Part owner of Preferred Auto Insurance Company, Inc.
Danny Wayne Lazenby	Part owner of Preferred Auto Insurance Company, Inc.
Charles Larry Kelley, Sr.	Senior Agent of Preferred Auto Insurance Company, Inc.

As of December 31, 2007, the following persons held office in the Company:

Jeffrey Laine Kelley, President
Vincent Gregory Kelley, Secretary/Treasurer
Clinton Boyce Haley, Vice President
Danny Wayne Lazenby, Vice President

The administrative and executive functions of the Company are performed by the home office staff. Marketing and other general agency services are performed by Granite, LLC which is an affiliated company. Claims adjustment activities are performed by Corporate Insurance Services, Inc. which is an affiliated company. Relationships with the mentioned firms are discussed under the heading "Agreements with Parent, Subsidiaries and Affiliates". Certain services are purchased from outside contractors if needed and are not available from in house personnel. Such services include actuarial analysis and independent audit.

Actuarial Services: John Booher, ACAS, MAAA
Actuarial / Insurance Consultants Ltd.
381 Highway 20
Loganville, GA 30052

Auditing Services: Lee R. Watson, CPA
P. O. Box 100512
Nashville, TN 37205

Control:

The primary control of the Company is vested in its four (4) shareholders. The

shareholders and their percentage of ownership are as follows:

Jeffrey L. Kelley	35.72%
Vincent G. Kelley	28.57%
Clinton B. Haley	28.57%
Danny W. Lazenby	7.14%

A holding company organizational chart is included at the last page of this examination report.

CORPORATE RECORDS

Minutes of meetings of the shareholders and Board of Directors of the Company were reviewed for the period under examination. The Company did not produce minutes for 2003 and 2004 as required by Tenn. Code Ann. § 48-26-101(a). Minutes for 2005 – 2007 were reviewed. Minutes did not reflect an annual meeting as stated in the by-laws and as required by Tenn. Code Ann. § 48-17-101(a). All meetings were recorded as regular meetings. The minutes did not reflect annual election of directors and officers as required by Tenn. Code Ann. § 48-18-103(d), and as stated in the Company's by-laws. The minutes did not have consistent approval of professionals (auditor, actuary) retained by the Company. Inaction of not declaring or holding annual meetings does not affect the validity of corporate actions. Upon expiration of a director's term, the director continues to serve until a successor is elected and qualified or until there is a decrease in the number of directors.

FIDELITY BOND AND OTHER INSURANCE

The following is a schedule of insurance maintained by the Company at December 31, 2007.

<u>Type of Coverage</u>	<u>Coverage Limits</u>
1. Precision America Office Program	
A) Primary Property Coverages	
Scheduled Buildings	Amount per schedule
Automatic Building Increase	2.5% of limits
Scheduled personal property	Amount per schedule
Peak Season Personal Property Increase	50% of limit
Primary properties are Agency Offices owned by AutoPlan USA, Inc.	
B) Additional Coverages	

Accounts Receivable	\$25,000
BI & EE – Dependent Properties – 30 days	Actual Loss
BI & EE – Newly Acquired Properties – 180 days	\$250,000
Loss of Business Income (BI) and Extra Expense (EE) – 12 months	Actual Loss
Property In Transit	\$2,500
Employee Dishonesty	\$10,000
Forgery And Alteration	\$10,000
Property Temporarily Off Premises	\$15,000
Various Additional Coverages	Amounts Vary

Coverage is underwritten by Maryland Casualty Company which is licensed in Tennessee as a “Foreign Property and Casualty Insurer”.

2. Workers’ Compensation and Employers Liability

A) Workers Compensation	Tennessee Limit
B) Employers Liability	
Bodily Injury by Accident (each accident)	\$100,000
Bodily Injury by Disease (policy limit)	\$500,000
Bodily Injury by Disease (each employee)	\$100,000

Coverage is underwritten by Hartford Casualty Insurance Company which is licensed in Tennessee as a “Foreign Property and Casualty Insurer”.

Minimum fidelity bond coverage of \$125,000 to \$150,000 is suggested by guidelines published in the NAIC Financial Condition Examiners Handbook. Presently, the Company has \$10,000 employee dishonesty coverage and no directors and officers liability coverage.

TERRITORY

As of December 31, 2007, and as of the date of this examination report, the Company was licensed to transact business in the State of Tennessee. The Certificate of Authority for that jurisdiction was reviewed.

During 2007, the Company wrote direct premium in one (1) state:

<u>State</u>	<u>Amount</u>
Tennessee	<u>\$5,103,945</u>
Total	\$5,103,945

PLAN OF OPERATION

The Company writes personal automobile liability and physical damage coverage for the non standard market in Tennessee. Policies may be written for a period of six or twelve months. Premiums are payable in monthly installments of 1/12 (8.33%) of annual premium plus a billing fee of ten dollars (\$10) per month. If premiums are paid before the monthly bill has been produced, the ten dollar (\$10) fee does not apply. The vast majority of the business is produced by a captive agency, AutoPlan U.S.A., Inc. One independent agency also writes policies on behalf of the Company. Additionally, the Company is approved to issue a Tenant Fire policy, on a six or twelve month term, with a maximum coverage of \$15,000.

The automobile policy is basic limit coverage as follows:

Basic Limit Policies:

Private Passenger Automobile Liability:

\$25,000 Bodily Injury, each person
\$50,000 Bodily Injury, each accident
\$25,000 Property Damage, each accident

Private Passenger Automobile Physical Damage

\$50,000 each vehicle

Uninsured Motorists:

\$25,000 Bodily Injury, each person
\$50,000 Bodily Injury, each accident
\$25,000 Property Damage, each accident

Medical Payments:

\$500 each person, per occurrence

Automobile Rental Reimbursement

\$450

The largest net amount insured by the Company in any one risk is \$45,000.

During the period under review and through the date of this report, all policy preparation was performed in the home office and was subject to the underwriting rules adopted by the Company and promulgated in accordance with approved rates. The most significant premiums for new policies, policy endorsements and renewal amounts are collected by Granite, LLC in a fiduciary capacity and remitted to the Company. Further overview is contained under the caption "Agreements with Parent, Subsidiaries and Affiliates".

The adjustment of claims is handled by Corporate Insurance Services, Inc. (CIS,

Inc.) an affiliated claims adjustment service company. The Company and CIS, Inc. entered into a contract for services which provides for CIS, Inc. to be paid a flat fee per claim and is further discussed under the caption, "Agreements with Parent, Subsidiaries and Affiliates".

MARKET CONDUCT ACTIVITIES

In accordance with the policy of the TDCI, a market conduct review was made of the Company as of December 31, 2007 in conjunction with this examination. The following items were addressed:

Policy Forms, Rating and Underwriting:

Under Tenn. Code Ann. § 56-5-305, rates, supplementary rate information, policy forms and endorsements will be filed with the Commissioner at least thirty 30 days before the proposed effective date. The Company applied for rate increases during the examination period with all being approved by the TDCI. The most recent submission for a rate increase was May 1, 2006 with approval being granted on May 16, 2006.

The Company uses casualty rates developed by a combination of Company experience and industry data. Application files and underwriting standards of written policies were reviewed. The Company maintains a written underwriting procedures and rating guide.

Advertising:

The advertising program consists of a Company website (www.paicinsurance.com) and advertising carried out by AutoPlan U.S.A., Inc. (captive agency). AutoPlan advertises on television and radio as well as in the Yellow Pages. The advertising file was reviewed and appears to be in compliance with applicable statutes and regulations.

Claims Review:

A sample of open and closed claim files reviewed during the examination indicated that claims were being paid in accordance with policy provisions and settlements were made promptly upon receipt of proper evidence of the Company's liability.

Policyholder Complaints:

Inquiries made to the various policyholders' service offices indicated no regulatory concerns with the Company during the period under examination. No unusual practices or items warranting criticism of the Company were noted.

Privacy Policy:

The Company has a written privacy statement that includes all affiliated companies and agents. It is supplied to its policyholders annually in compliance with Tenn. Comp. R. & Regs., ch. 0780-1-72-.06

REINSURANCE

The Company's reinsurance agreement was reviewed and found to contain standard provisions. The following is a summary of the reinsurance agreements in effect as of December 31, 2007:

Ceded:

(1)

<u>Type:</u>	Quota Share
<u>Reinsurer:</u>	Transatlantic Reinsurance Company
<u>Term:</u>	January 1, 2006 until terminated
<u>Premium:</u>	Proportional share of the Gross Written Premium Income less a provisional ceding commission of 30%
<u>Commission:</u>	A minimum ceding commission equal to 25.75% of the ceded earned premium at a loss ratio of 67.0% or higher with a 1% increase for each decrease of 1% in loss ratio until a ceding commission equal to 42.75% of the ceded earned premium is reached at a loss ratio of 50.0% or lower. Carry forwards will be calculated for loss ratios greater than 67% or less than 50% by multiplying the difference of said loss ratio and actual loss ratio by the ceded earned premium for the contract year. The results will be subtracted from incurred loss in the succeeding year.
<u>Coverage:</u>	55% Quota Share participation of up to \$500,000 each policy, each loss occurrence, for such amounts to include loss adjustment expenses, extra contractual obligations and loss in excess of policy limits.

For purposes of this Agreement:

- (a) Reinsurer shall not be liable for more than \$1,000,000 for all losses incurred during a contract year resulting from an Act(s) of Terrorism.
- (b) Extra contractual obligations and loss in excess of policy limits shall be subject to a maximum limit of liability to the Reinsurer of \$1,500,000 for all losses occurring during each contract year.

Intermediary: John B. Collins Associates, Inc.

Transatlantic Reinsurance Company is a property and casualty reinsurer and

qualifies as an authorized reinsurer in Tennessee.

RETIREMENT PLAN AND OTHER EMPLOYEE BENEFITS

At December 31, 2007, the following benefits were available to the Company's employees:

401 (K) Plan

The Company offers a "Salary Reduction" plan to all employees. The Company matches dollar for dollar the first 3% and 50¢ on the dollar for the next 2%. The plan is administered through Salomon Smith Barney.

Medical Coverage

Medical coverage is provided through optional participation in UnitedHealthcare Choice Plus plan. The Company pays \$115 per month towards each employee's cost of healthcare.

Long Term Disability, Etc.

Employees have Company paid disability insurance which pays an employee until age 65. Additional workplace insurance is offered, on the basis of voluntary participation, to each employee through the AFLAC/Assurant group of companies.

Education

The Company provides reimbursement to employees who take certain business and job related courses.

Other benefits available for employees include holidays, sick leave, and vacation leave.

LOSS EXPERIENCE

<u>Year</u>	<u>Losses Incurred</u>	<u>LAE Incurred</u>	<u>Premiums Earned</u>	<u>Loss Ratio</u>
2003	\$778,518	\$695,616	\$1,422,755	103.6%
2004	634,456	488,840	1,175,309	95.6%
2005	644,628	445,122	1,155,380	94.3%
2006	795,181	632,307	1,745,650	81.8%
2007	<u>1,143,941</u>	<u>603,576</u>	<u>2,226,565</u>	78.5%
Total	\$3,996,724	\$2,865,461	\$7,725,659	88.8%

ACCOUNTS AND RECORDS

During the course of examination, such tests and audit procedures were made as were considered necessary, including substantial verification of postings, extensions and footings and reconciliation of subsidiary ledgers to control accounts where necessary. General ledger trial balances were reconciled with copies of annual statements for the years 2003, 2004, 2005, 2006, and 2007.

Accounting records conform to generally accepted insurance accounting practices and appear to properly reflect the operations during the period under examination and the status of the Company at the date of examination.

The Company's Risk Based Capital Report was reviewed. The Company was in compliance with Tenn. Code Ann. § 56-46-101, *et seq.* (Risk Based Capital for Insurers).

An annual audit of the Company is performed by an independent accounting firm, Lee R. Watson, CPA.

Books and records of the Company are kept at the home office location:

216 South Cooper
Memphis, TN 38104

COMMITMENTS

The Company entered into a ten (10) year employment contract with a former shareholder for management services that will expire in 2017.

STATUTORY DEPOSITS

In compliance with statutory requirements, the Company maintained the following deposits as of December 31, 2007.

<u>Where Deposited and Description</u>	<u>Par Value</u>	<u>Book/Adjusted Carrying Value</u>	<u>Fair Value</u>
Tennessee			
Rutherford County Gen. Obligation 3.75%	\$150,000	\$152,881	\$152,192
Dickson County Gen. Obligation 3.35%	\$100,000	\$100,628	\$99,941
Total general deposits held for the			

benefit of all policyholders of the Company	<u>250,000</u>	<u>253,509</u>	<u>252,133</u>
Total	<u>\$250,000</u>	<u>\$253,509</u>	<u>\$252,133</u>

The above deposit was confirmed with the custodian at the Division of Insurance.

AGREEMENTS WITH PARENT, SUBSIDIARIES AND AFFILIATES

The Company is a member of an insurance holding company system as defined by § 56-11-201 and is subject to Tenn. Code Ann. § 56-11-201, *et seq.* "Insurance Holding Company System Act of 1986". The Company files a Holding Company Registration Statement annually as required by Tenn. Code Ann. § 56-11-205. The required Forms B and C were filed April 18, 2007.

The Company is owned by 4 shareholders with the percentage of ownership as follows:

Jeffrey L. Kelley	35.72%
Vincent G. Kelley	28.57%
Clinton B. Haley	28.57%
Danny W. Lazenby	7.14%

These same individuals own the same percentage of Granite, LLC, Foremost Partnership, and Corporate Insurance Services, Inc. which have agreements with the Company as follows:

- (A) Granite, LLC has a general agency agreement with the Company with an effective date of October 1, 2003. This agreement allows the Agency to collect, receive and receipt for premiums on insurance contracts placed with the Insurer by the Agency. The Agency is granted authority to receive and submit applications and proposals for automobile policies in any jurisdiction where Agency is properly licensed and where Insurer has confirmed with the state insurance department that Agency is Insurer's Agent.
- (B) Foremost Partnership rents to the Company's home office location under a lease agreement for \$4,500 a month beginning July 1, 2007. The prior rental amount was \$3,500 a month. The monthly rate is contracted to increase each July 1 of the subsequent year by \$500 per month. The Company has exercised its option to continue the lease agreement for 5 one year periods, subsequent to the expiration of the initial lease.
- (C) Corporate Insurance Services, Inc. operates under an agreement with the Company to provide claims administration services which include the

following:

Basic claim service	Appraisals outside of Tennessee
Police reports	Independent Adjuster Services
History of vehicle registration/clear title guarantee	Claims research software and subscription
NADA Appraisal Information	Special Investigative Unit
Car tag registration	ISO Claims Search

The fee paid to Corporate Insurance Services, Inc. is \$250.00 per claim plus \$45.00 per hour for SIU work over 10 hours each claim.

During 2007, Granite, LLC, Foremost Partnership, and Corporate Insurance Services, Inc. were paid \$3,236,024, \$45,000 and \$233,500 respectively by the Company.

All agreements were properly filed and approved in accordance with Tenn. Code Ann. § 56-11-206 "Insurance Holding Company System Act of 1986".

PECUNIARY INTEREST TENN. CODE ANN. § 56-3-103

During 2007, the four (4) stockholders drew a salary from the Company. They received no salary from any of the other affiliated companies.

The Company's directors file annual conflict of interest statements. The statements were reviewed and found to be in compliance with Tenn. Code Ann. § 56-3-103.

LITIGATION

As of December 31, 2007, the Company had no pending litigation, other than that arising out of the normal course of business, which would adversely affect the financial condition of the Company.

SUBSEQUENT EVENTS

As required by Tenn. Comp. R & Regs. 0780-01-65-.07(3), the Company retained the services of Gene Riley, CPA of Brentwood, TN for the Company's audit at December 31, 2008. Previously, the Company had used Lee R. Watson, CPA of Nashville, TN for seven (7) consecutive years.

The Company continued its current policy for matching employee 401(K) plans through 2008. In 2009, this policy the match was suspended due to the economy.

Effective January 1, 2009, the Company modified its quota share participation to retain 30% and cede 70% of its net liability up to \$500,000 each policy, each loss occurrence, such amounts to include loss adjustment expenses, extra contractual obligations and loss in excess of policy limits.

On December 18, 2008, the Company requested approval of a dividend in the amount of \$280,000. The amount qualified as an ordinary dividend, and did not need prior approval pursuant to § 56-11-206(b). The TN Insurance Division accepted the filing and notified the Company on January 5, 2009.

FINANCIAL STATEMENT

The following is a statement of assets, liabilities and statement of income as of December 31, 2007, together with a reconciliation of capital and surplus for the period under review, as established by this examination:

ASSETS

	<u>Ledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>
Bonds	\$2,853,509		\$2,853,509
Cash and short-term investments	1,554,769		1,554,769
Investment Income due and accrued	10,058		10,058
Premiums, agent balances, and installments booked but deferred and not yet due	2,336,990		2,336,990
Reinsurance amounts recoverable from Reinsurers	250,898		250,898
Current federal and foreign income tax recoverable and interest thereon	26,690		26,690
Net deferred tax asset	74,000		74,000
Aggregate write-ins for other than invested Assets	<u>0</u>	<u>0</u>	<u>0</u>
Totals	<u>\$7,106,914</u>	<u>\$0</u>	<u>\$7,106,914</u>

LIABILITIES, SURPLUS, AND OTHER FUNDS

Losses	\$711,491
Reinsurance payable on paid loss and loss adjustment expenses	0
Loss adjustment expenses	529,806
Commissions payable, contingent commissions and other similar charges	0
Other expenses (excluding taxes, licenses and fees)	0
Taxes, licenses and fees (excluding federal and foreign income tax)	6,675
Federal and foreign income taxes	0
Unearned premiums	1,160,427
Ceded reinsurance premiums payable (net of ceding commissions)	1,623,590
Payable to parent, subsidiaries, and affiliates	210,277
Aggregate write-ins for liabilities (commission equity in ceded unearned premium)	<u>22</u>
Total Liabilities	4,242,288
Common capital stock	1,000,000
Gross paid in and contributed surplus	1,381,583
Unassigned funds (surplus)	<u>483,043</u>
Surplus as regards policyholders	2,864,626
Total liabilities and surplus	<u>\$7,106,914</u>

STATEMENT OF INCOME

UNDERWRITING INCOME

Premiums earned		\$2,226,565
Deductions: Losses incurred	\$1,143,941	
Loss expenses incurred	603,576	
Other underwriting expenses incurred	<u>894,009</u>	
Total underwriting deductions		<u>2,641,526</u>
Net underwriting gain (loss)		(414,961)

INVESTMENT INCOME

Net investment income earned	213,282	
Net realized capital gains (losses)	<u>0</u>	
Net investment gain		213,282

OTHER INCOME

Aggregate write-ins installment billing fees and miscellaneous income		<u>257,660</u>
Net income before dividends to policyholders and before federal income taxes		55,981
Dividends to policyholders		0
Federal income taxes incurred		<u>13,310</u>
Net income		<u>\$42,671</u>

CAPITAL AND SURPLUS

Surplus as regards policyholders, December 31 prior year		\$2,788,384
Net income	\$42,671	
Net unrealized capital gains (losses)	0	
Change in net deferred income tax	8,000	
Change in non-admitted assets	0	
Cumulative effect of changes in accounting principles	0	
Surplus adjustments: Paid in	0	
Aggregate write-in for gains and losses in surplus	25,571	
Change in surplus as regards policyholders for the year		76,242
Surplus as regards policyholders, December 31 current year		<u>\$2,864,626</u>

**RECONCILIATION OF CAPITAL AND SURPLUS
FOR THE PERIOD UNDER EXAMINATION**

Surplus as regards policyholders December 31	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Previous Year	<u>\$2,436,300</u>	<u>\$2,583,270</u>	<u>\$2,611,953</u>	<u>\$2,654,948</u>	<u>\$2,788,384</u>
Net Income	3,810	44,683	48,995	111,436	42,671
Net unrealized capital gains or (losses)	0	0	0	0	0
Change in net deferred Income tax	18,000	(16,000)	(6,000)	22,000	8,000
Change in non-admitted Assets	0	0	0	38,688	0
Change in provision for Reinsurance	0	0	0	0	0
Cumulative effect of changes In accounting principles	0	0	0	0	0
Capital changes: Paid in	0	0	0	0	0
Surplus adjustments: Paid in	0	0	0	0	0
Aggregate write-ins for gains and losses in surplus	<u>0</u>	<u>0</u>	<u>0</u>	<u>(38,688)</u>	<u>25,571</u>
Surplus as regards to policyholders December 31					
Current Year	<u>\$2,583,270</u>	<u>\$2,611,953</u>	<u>\$2,654,948</u>	<u>\$2,788,384</u>	<u>\$2,864,626</u>

**ANALYSIS OF CHANGES IN FINANCIAL STATEMENT AND COMMENTS
RESULTING FROM EXAMINATION**

Bonds

\$2,853,509

The above amount reflects an increase of \$2,600,000 to the amount stated in the annual statement. On December 31, 2007, the Company had three certificates of deposit with the Bank of Fayette County in the amount of \$2,600,000. The three certificates of deposit have a fixed schedule of payments and maturity dates in excess of one year from the date of acquisition. This classifies the certificates of deposit as bonds according to Statement of Statutory Accounting Principles No. 26 and annual statement instructions.

Cash and short-term investments

\$1,554,769

The above amount reflects a reduction of \$2,600,000 from the amount stated in the annual statement. This is the amount of three certificates of deposit with the Bank of Fayette County. Since certificates of deposit with a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition being classified as a bond, this amount was reclassified to line A-1, "Bonds" for purposes of this examination to better comply with Statement of Statutory Accounting Principles No. 26 and annual statement instructions.

**SUMMARY SCHEDULE FOR “ANALYSIS OF CHANGES
IN FINANCIAL STATEMENT AND COMMENTS RESULTING FROM
EXAMINATION” AS THEY AFFECT SURPLUS**

The following depicts the change in surplus as outlined in the previous section of this report:

<u>Item</u>	<u>Surplus</u>	
	<u>Increase</u>	<u>Decrease</u>
Bonds	\$2,600,000	
Cash and short-term investments		\$2,600,000
	-----	-----
Totals	<u>\$2,600,000</u>	<u>\$2,600,000</u>
 Net change in surplus		 <u>\$ 0</u>

COMMENTS AND RECOMMENDATIONS

Comments:

- As of December 31, 2007, the supporting documentation of the Account Receivable balance (premium deferred installments) provided by the Company did not reconcile to the SIS system program recognition of the account balance. As of the examination date, the difference was not material. The Company will examine the system for programming changes to alleviate the discrepancy.

Recommendations:

- The Company improperly reported, in its 2007 Annual Statement, three certificates of deposit on Schedule E, Part 1. The three certificates of deposit have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition. This classifies as a bond under Statement of Statutory Accounting Principles No. 26.

It is recommended that the Company properly reflect the certificates of deposit in Schedule D and as Bonds on the Annual Statement Asset page 2 to better comply with SSAP No. 26 and Tenn. Code Ann. § 56-1-501(g) when completing the Annual Statement.

- The following inaccuracies were reported on the Company's 2007 Annual Statement:
 - 1) The Company's Jurat page does not include Charles L. Kelley as a director. Mr. Kelley is a member of the board of directors.
 - 2) On the Company's Schedule D, Part 1, the bonds are being reported on the settlement date instead of the trade date. In accordance with SSAP No. 26, paragraph 4, the Company should report bond transactions on the trade date and not the settlement date.
 - 3) On the Company's Schedule D, Part 1, the bonds are being shown having an accretion. These amounts are amortizations. The Company should properly reflect these amounts in the Annual Statement.
 - 4) On the Company's Schedule D, Part 1, the bonds are being reported with NAIC designations of 1. The designation should be reported as 1FE.
 - 5) The due and accrued interest on Schedule E – Part 1 is misreported. The Company should report the amounts accurately. The amount was deemed immaterial, resulting in no change to the financial statements.

Based on the above inaccuracies, it is recommended that the Company comply with Tenn. Code Ann. § 56-1-501(g) by preparing annual statements in accordance with the NAIC Accounting Practices and Procedures Manual.

- The Company did not produce minutes for 2003 and 2004. Minutes for 2005 – 2007 were reviewed. Minutes did not reflect an annual meeting as stated in the by-laws. All meetings were recorded as regular meetings. The minutes did not reflect election of directors and officers as stated in the Company's by-laws. The minutes did not have consistent approval of professionals (auditor, actuary) retained by the Company.

It is recommended that the Company comply with Tenn. Code Ann. § 56-2-103(a)(2) by holding annual meetings as required by Tenn. Code Ann. § 48-17-101(a), electing officers as required by Tenn. Code Ann. § 48-18-103(d), and maintaining corporate records as required by Tenn. Code Ann. § 48-26-101(a).

CONCLUSION

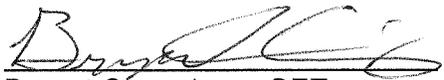
Insurance examination practices and procedures, as promulgated by the National Association of Insurance Commissioners, have been followed in connection with the verification and valuation of assets and the determination of liabilities of Preferred Auto Insurance Company, Inc. of Memphis, Tennessee.

In such manner, it was determined that, as of December 31, 2007, the Company had admitted assets of \$7,106,914 and liabilities, exclusive of unassigned funds, of \$4,242,288. Thus, there existed for the additional protection of the policyholders, the amount of \$2,864,626 in the form of capital, gross paid in and contributed surplus and unassigned funds (surplus).

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

In addition to the undersigned, Mr. Donnie R. Nicholson, Insurance Examiner, State of Tennessee, Mr. Glenn A. Tobleman, FCAS, FSA, MAAA and Mr. Gregory S. Wilson, FCAS, MAAA of the contracting actuarial firm Lewis and Ellis, Inc. of Richardson, Texas participated in the work of this examination.

Respectfully submitted,



Bryant Cummings, CFE
Insurance Examiner
State of Tennessee
Southeastern Zone, N.A.I.C.

AFFIDAVIT

The undersigned deposes and says that he has duly executed the attached examination report of Preferred Auto Insurance Company, Inc. dated June 5, 2009, and made as of December 31, 2007, on behalf of the TDCI, State of Tennessee. Deponent further says he is familiar with such instrument and the contents thereof, and that the facts therein set forth are true to the best of his knowledge, information and belief.


Bryant Cummings, CFE
Insurance Examiner
State of Tennessee
Southeastern Zone, N.A.I.C.

Subscribed and sworn to before me

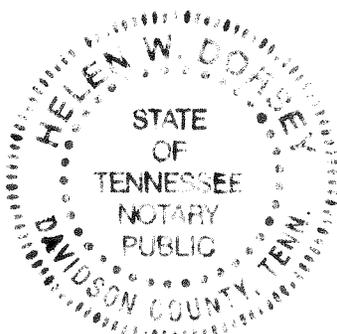
this 5th day of
June, 2009

Notary Helen W. Dorsey

County Davidson

State Tennessee

Commission Expires 05/22/2010



My Commission Expires MAY 22, 2010

ORGANIZATIONAL CHART

