

**VERLAN FIRE INSURANCE COMPANY**

**EXAMINATION: DECEMBER 31, 2005**

**NUMBER 10815**

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Baltimore, Maryland  
April 10, 2007

Honorable Alfred W. Gross  
Chairman, NAIC Financial Condition (E) Committee  
Insurance Commissioner  
Virginia SCC Bureau of Insurance  
1300 East Main Street  
Richmond, Virginia 23219

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Secretary, Midwestern Zone, NAIC  
Director of Insurance  
South Dakota Division of Insurance  
Department of Revenue and Regulation  
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Pierre, South Dakota 57501

Honorable Thomas E. Hampton  
Secretary, Northeastern Zone, NAIC  
Insurance Commissioner  
District of Columbia  
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Washington, D.C 20002

Honorable Julie Mix McPeak  
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Kentucky Office of Insurance  
215 West Main Street  
Frankfort, Kentucky 40601

Honorable D. Kent Michie  
Secretary, Western Zone, NAIC  
Insurance Commissioner  
Utah Department of Insurance  
State Office Building, Room 3110  
Salt Lake City, Utah 84114

Honorable R. Steven Orr  
Insurance Commissioner  
Maryland Insurance Administration  
525 St. Paul Place  
Baltimore, Maryland 21202-2272

Dear Madam and Sirs:

In accordance with Section 2-205 of the Insurance Article of the Annotated Code of Maryland, an association examination has been conducted of the financial condition and activities of the

**VERLAN FIRE INSURANCE COMPANY**

(hereinafter called the Company), at its home offices located at 8403 Colesville Road, Suite 300, Silver Spring, Maryland 20910-3352, and the following Report on Examination is submitted.

**SCOPE OF EXAMINATION**

This examination, covering the period from January 1, 2001 to December 31, 2005, including any material transactions and/or events noted occurring subsequent to December 31, 2005, was conducted under the Association Plan of the National Association of Insurance Commissioners (NAIC) by examiners of the Maryland Insurance Administration representing the Northeastern Zone of the NAIC. The Southeastern Zone, Western Zone, and Midwestern Zone of the NAIC were invited to participate but did not respond to the examination call.

Our examination was conducted in accordance with examination policies and standards established by the Maryland Insurance Administration and procedures recommended by the NAIC and, accordingly, included such tests of the accounting records and such other examination procedures as we considered necessary in the circumstances.

Our examination included a review of the Company's business policies and practices, management and corporate matters, a verification and evaluation of assets and a determination of the existence of liabilities. In addition, our examination included tests to provide reasonable assurance that the Company was in compliance with applicable laws, rules and regulations. In planning and conducting our examination, we gave consideration to the concepts of materiality and risk, and our examination efforts were directed accordingly.

The Company was audited annually by an independent public accounting firm. The firm expressed unqualified opinions on the Company's financial statements for calendar years 2001 through 2005. We placed substantial reliance on the audited financial statements for calendar years 2001 through 2004 and, consequently, performed only minimal testing for those periods. We concentrated our examination efforts on the year ended December 31, 2005. We reviewed the working papers prepared by the independent public accounting firm related to the audit for the year ended December 31, 2005, and directed our efforts to the extent practical to those areas not covered by the firm's audit.

## **STATUS OF PRIOR EXAMINATION FINDINGS**

There were no exception conditions reported upon in our preceding Report on Examination, dated August 30, 2001, which covered the period from January 1, 1996 to December 31, 2000.

### **HISTORY**

#### **General:**

The Company was originally incorporated on February 24, 1970 as Verlan Limited (Bermuda), which commenced operations in Bermuda in 1970. In this regard, pursuant to an act of the Bermuda Legislature entitled, "The Verlan Company Act 1969," the National Paint and Coatings Association (the Association) created Verlan Limited (Bermuda) in 1969 as a captive insurer to serve the insurance needs of the Association's members.

In order to provide a United States presence and to comply with Federal requirements that certain insurance policies be issued by insurers located in the United States, in 1982, Verlan Limited (Bermuda) created a subsidiary, Verlan Limited (a Vermont corporation).

In 1985, Verlan Limited (Bermuda) was purchased from the Association by a group of approximately 50 policyholders of Verlan Limited (Bermuda). The acquiring policyholders were manufacturers of paint and coatings products. Subsequent sales and transfers of stock were made to various individuals. The individual owners were employees of the Company or its wholly-owned subsidiary, Coatings Industry Services, Inc., or were individuals who were involved in the paint and coatings business.

In 1992, Verlan Limited (Bermuda) established Verlan Limited (U.S. Branch) and on January 29, 1993, the Maryland Insurance Administration granted a Certificate of Authority to Verlan Limited (U.S. Branch).

The purpose of establishing Verlan Limited (U.S. Branch) was to allow for the redomestication of Verlan Limited (Bermuda) to Maryland. On May 26, 1993, the Commissioner approved the Articles of Redomestication and Restated Articles of Incorporation of Verlan Limited (Bermuda). On the same date, the Commissioner approved the Restated Articles of Incorporation, which changed the name of Verlan Limited (Bermuda) to Verlan Fire Insurance Company. On June 1, 1993, the Maryland State Department of Assessments and Taxation received for the record and approved the Articles of Incorporation. The Bermuda Office of the Registrar of Companies issued a Certificate of Discontinuance to the Company on August 2, 1993.

The Company's former Vermont subsidiary, Verlan Limited, wrote insurance from 1983 through May, 1993, all of which was ceded to the Company. On May 17, 1994, the Vermont subsidiary entered into an Assignment and Assumption Agreement with the Company under which the Company assumed all of the Vermont subsidiary's rights, duties, obligations and liabilities under the insurance policies issued by the Vermont subsidiary. By

action of the Company's Board of Directors on May 23, 1994, the Vermont subsidiary was dissolved. Effective the same date, the Vermont subsidiary was granted a Certificate of Dissolution from the Vermont Secretary of State.

The Company was notified by the Maryland Insurance Administration on September 9, 1994 that it was deemed to be a part of an insurance holding company system and became subject to registration pursuant to Article 48A of the Annotated Code of Maryland (currently codified as Section 7-603 of the Insurance Article of the Annotated Code of Maryland), effective upon its redomestication from Bermuda to Maryland on June 1, 1993.

As a result of a share exchange between the Company and Verlan Holdings, Inc. (VHI, the Company's parent), all of the Company's outstanding voting securities were acquired by VHI. The articles of share exchange were approved by the Commissioner on August 25, 1997 and the share exchange became effective September 10, 1997 upon the approval of the Maryland Department of Assessments and Taxation.

Under the Company's Restated Articles of Incorporation, it was primarily organized to write all the kinds of insurance and reinsurance authorized by the Maryland insurance laws, except life insurance and annuities.

#### Capital Stock:

The Company's Restated Articles of Incorporation authorized the Company to issue 5,000,000 shares of common stock with a par value of \$.60 per share and 5,000,000 shares of cumulative redeemable preferred stock with a par value of \$.10 per share. As of December 31, 2005, the Company had issued 4,341,334 shares of common stock with an aggregate par value of \$2,604,800, and 3,952,000 shares of cumulative redeemable preferred stock with an aggregate par value of \$395,200, all to its parent, Verlan Holdings, Inc.

#### Dividends to Stockholder:

The Company declared and paid the following dividends to its sole stockholder during the examination period:

<u>Year</u>	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Total</u>
2001	\$ 23,712	\$ 76,288	\$ 100,000
2002	-	-	-
2003	47,424	-	47,424
2004	-	1,307,800	1,307,800
2005	-	586,080	586,080

There were no declared but unpaid dividends as of December 31, 2005. The dividends declared and paid in 2004 and 2005 were extraordinary dividends. All dividends were submitted to and approved by the Maryland Insurance Administration.

Management:

The following persons were serving as the Company's directors as of December 31, 2005:

<u>Name and Address</u>	<u>Principal Occupation</u>
Joseph S. W. Parker, Sr. Marblehead, Massachusetts	President, Sterling-Clark-Lurton Corporation
Richard A. Flowers Huntington, West Virginia	President, Columbia Paint Corporation
T. Patrick Foy Cincinnati, Ohio	President, Cintech Industrial Coatings, Inc.
John W. Johnson Silver Spring, Maryland	President, Verlan Fire Insurance Company
Denise M. Kaczmarczyk Silver Spring, Maryland	Executive Vice President, Verlan Fire Insurance Company
Hisham R. Kanaan N. Brattleboro, Vermont	Chief Executive Officer, C.E. Bradley Laboratories, Inc.
Clifford W. Kozemchak Philadelphia, Pennsylvania	Vice President, General Reinsurance Corporation
Robert A. Lefelar Wayne, New Jersey	President, Clifton Adhesive, Inc
Patricia A. Novak Silver Spring, Maryland	Treasurer, Verlan Fire Insurance Company
P. Bruce Wright New York, New York	Partner, LeBoeuf, Lamb, Greene & MacRae

The following persons were serving as the Company's officers as of December 31, 2005:

Joseph S.W. Parker, Sr.	Chairman of the Board
John W. Johnson	President
Denise M. Kaczmarczyk	Executive Vice President and Secretary
George A. Seuss, Jr.	Vice President- Engineering
Allen B. Swartz	Vice President - Underwriting
Patricia A. Novak	Treasurer

Committees:

As of December 31, 2005, the Company's Board of Directors had established the following committees:

Finance, Investment and Compensation

John W. Johnson (Chairman)  
Hisham R. Kanaan  
Clifford W. Kozemchak  
Joseph S. W. Parker, Sr.

Nominating

Hisham R. Kanaan (Chairman)  
T. Patrick Foy  
Richard A. Flowers

Bylaws

Denise M. Kaczmarczyk (Chairman)  
Richard A. Flowers  
Patricia A. Novak

Conflicts of Interest:

Directors, officers and responsible employees regularly respond to conflict of interest questionnaires. If possible conflicts were disclosed, they would be scrutinized further by Company officials. Our review of the conflict of interest questionnaires completed for the period under examination disclosed no reported conflicts. Furthermore, our examination did not disclose any conflicts of interest that would adversely affect the Company.

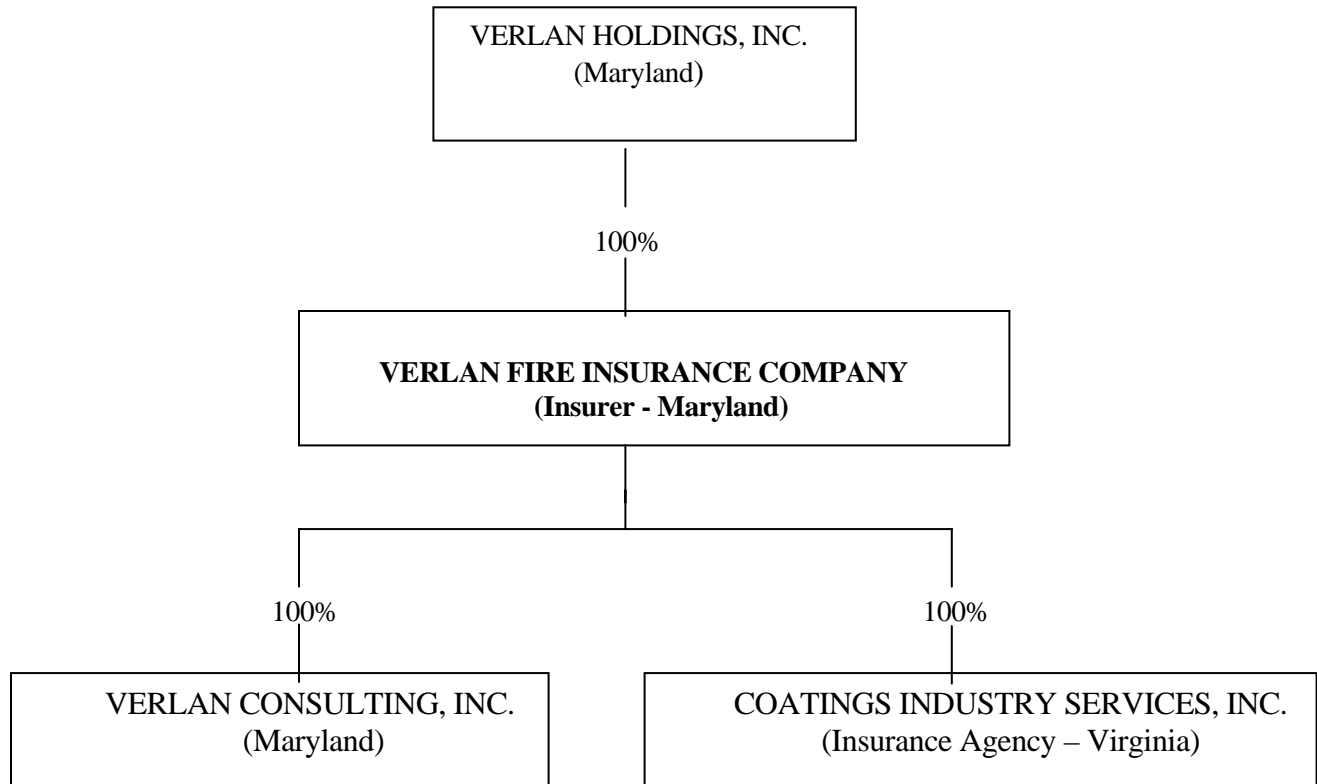
Corporate Records:

We reviewed the minutes of the meetings of the Board of Directors and committees, for the period under examination. Based on our review, it appeared that the minutes documented the Company's significant transactions and events and that the directors approved those transactions and events.

## **AFFILIATED COMPANIES**

The Company is wholly owned by Verlan Holdings, Inc., a Maryland domiciled holding company. The holding company structure as of December 31, 2005 was as follows:

## **ORGANIZATIONAL CHART**



Subsidiaries owned 100% by the Company were Coatings Industry Services, Inc. (CIS) and Verlan Consulting, Inc. (VCI). CIS is an insurance agency that was incorporated in Virginia in 1979. The Company created CIS to augment the insurance products offered by the Company. CIS offers comprehensive general liability, product liability, umbrella liability, commercial automobile coverage and workers' compensation for other insurance companies, to paint, coatings, ink and adhesives manufacturers, as well as to chemical distributors. VCI was incorporated in Maryland in 1999 as a non-insurance entity to provide consulting engineering services to manufacturers. It is currently inactive.

## **INTERCOMPANY AGREEMENTS**

### **Federal Income Tax Allocation Agreement:**

Effective October 5, 1999, the Company along with its subsidiaries, Coating Industry Services, Inc. and Verlan Consulting, Inc., entered into a Federal Income Tax Allocation Agreement with its parent, Verlan Holdings, Inc. Under the consolidation arrangement, the parties allocated the consolidated tax liability among the members of the group in the ratio that each member's separate return tax liability bore to the sum of the separate return tax liabilities of the members.

### **Management Services Agreement:**

Effective January 1, 1985, the Company entered into a management agreement with its wholly-owned subsidiary, Coating Industry Services, Inc. Pursuant to this agreement, the Company provides management support services. In addition, the agreement provides that, to the extent that the Company performs such services for Coating Industry Services, Inc., an appropriate fee is paid to the Company. This fee was based upon the actual costs incurred by the Company under this agreement. Management fees paid to the Company during 2005 totaled \$130,370. This agreement was submitted to the Maryland Insurance Administration at the time of the Company's original licensing in Maryland in 1993.

## **FIDELITY BOND AND OTHER INSURANCE**

The Company and its subsidiaries were named insureds under a fidelity bond issued to its parent, Verlan Holdings, Inc. in the amount of \$350,000, with a single loss deductible of \$3,500. The coverage exceeded the minimum amount of fidelity bond coverage recommended by the NAIC for the companies on a consolidated basis. In addition, the Company has procured other business and liability coverage. Based on our review, the Company's insurance coverage for these risks appeared to be adequate.

## **PENSION, STOCK OWNERSHIP AND INSURANCE PLANS**

The Company participated in two benefit plans available to all eligible employees: a noncontributory defined benefit retirement income plan (Plan I) and a defined contribution plan (Plan II). The total 2005 pension expense for the Company was \$249,588.

Plan I's benefits were based upon the employees' years of service and compensation for the highest three of the last ten years of employment. The Company's funding policy was to contribute annually to Plan I sufficient funds to meet the minimum funding requirements established by the Employee Retirement Income Security Act of 1974, plus such additional amounts as may be deemed appropriate from time to time up to the maximum contribution allowed under the Internal Revenue Code.

As of December 31, 2005, Plan I's accumulated benefit obligation was \$1,822,994 of which \$1,805,241 was vested. The fair value of the Plan I assets, valued as of December 31, 2005, was \$1,811,204.

Under Plan II, employees could voluntarily contribute a portion of their yearly compensation. An employee could contribute up to 6% of his/her yearly compensation not to exceed the maximum elective deferral allowable under the Internal Revenue Code. The contribution is matched by the Company on a 50% basis. The Company's contribution to the defined contribution plan was \$35,324 in 2005.

The accrued pension liability was \$401,539 as of December 31, 2005.

The Company paid the majority of the cost of comprehensive medical care insurance for all of its employees and their spouses and dependent children, as well as the full cost of disability insurance and life insurance for its employees.

### **STATUTORY DEPOSITS**

In compliance with Section 4-106 of the Insurance Article of the Annotated Code of Maryland, the Company had deposited in trust with the Maryland State Treasurer United States Treasury Notes, with a total par value of \$1,500,000 and a market value of \$1,533,559, as of December 31, 2005. These funds were held for the protection of all policyholders and creditors.

In addition, the Company had statutory deposits consisting of other bond issues with the following jurisdictions. These deposits were held for the protection of the policyholders in those jurisdictions. These deposits and the above mentioned bonds deposited with the Maryland State Treasurer, are included in the Company's balance sheet under the Caption, "Bonds."

<u>Jurisdiction</u>	<u>Par Value</u>	<u>Market Value</u>
Massachusetts	\$ 510,000	\$ 516,722
Nevada	225,000	234,774
New Hampshire	500,000	530,990
North Carolina	300,000	325,152
Virginia	<u>300,000</u>	<u>320,079</u>
Total	<u>\$ 1,835,000</u>	<u>\$ 1,927,717</u>

### **TERRITORY AND PLAN OF OPERATION**

As of December 31, 2005, the Company was licensed to issue property insurance in twenty one (21) states, namely: California, Connecticut, Illinois, Indiana, Kentucky,

Maryland, Massachusetts, Michigan, Missouri, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Virginia, Washington and West Virginia. (See additional states, in which the Company was licensed in 2006 in the “Subsequent Events” section of this report). The Company writes the highest concentration of its business within the State of New Jersey (15%) followed by California (9%). The Company offers, on a national basis, fire insurance policies that may include allied lines, boiler and machinery, inland marine and earthquake coverage.

As of December 31, 2005, the Company insured approximately 530 accounts, comprising over 1,200 locations in total, throughout the United States. In some jurisdictions where it was not licensed, the Company wrote insurance under laws related to the direct placement of insurance with unauthorized insurers or under industrial insured exemption laws. The direct placement laws permitted the procurement of certain types of insurance by an insured with unauthorized insurance companies. The industrial insured exemption laws generally permitted certain larger, more sophisticated insurance purchasers to directly procure insurance with unauthorized insurers. In jurisdictions where the Company was not licensed that did not have such laws, or where a prospective insured did not meet the criteria of those laws, the business was written by the Universal International Reinsurance Company, Ltd. (Bermuda) and ceded to the Company. See additional comments regarding this arrangement in the “Reinsurance” section of this report under the caption “Assumed Reinsurance.”

The Company’s primary business was insuring industrial property risks for higher risk companies, such as: manufacturers of paint and coatings, pesticides, plastics, ink, resin and fragrances.

The Company assesses risks through its staff of trained fire protection and mechanical engineers, who conducted thorough physical examinations of insured and prospective risk sites. These examinations focused on the methods used by the current and prospective insureds to prevent losses from occurring and on evaluations of the fire protection systems in place. The adequacy of base rates and the underwriting assessment of property risks are based on occupancy, construction and loss control evaluations. New accounts are either pre-inspected by the Company, or they submit (via telephone or interview) an in-depth, technical questionnaire developed by the Company to provide the needed loss control-related information which is subsequently inspected, depending on total insured values. The Company solicits business primarily through the use of independent brokers in states where it is licensed.

### **INSURANCE PRODUCTS AND RELATED PRACTICES**

The Maryland Insurance Administration’s Property and Casualty Section’s Market Conduct Unit has not scheduled an examination of the market conduct affairs of the Company. A market conduct examination would include a review of the Company’s sales and advertising, agent licensing, underwriting, rating, claims processing and complaint handling practices and procedures.

During this examination, we did not review the following market conduct-related areas:

- Policy Forms
- Fair Underwriting Practices
- Advertising and Sales Materials
- Treatment of Policyholders:
  - Claims Processing (Timeliness)
  - Complaints

## **REINSURANCE**

### **Assumed Reinsurance:**

During the examination period, the Company assumed business through a reinsurance treaty. As previously noted, in jurisdictions where the Company was not licensed that did not have direct placement statutes or industrial insured exemption laws, business was written by the Universal International Reinsurance Company Ltd. (Bermuda) (UIRC) and ceded to the Company under a quota share reinsurance treaty effective June 1, 1993. Under this treaty, the Company assumed 100 percent of the losses per occurrence, plus a proportionate share of the related loss adjustment expenses.

As of December 31, 2005, the Company was no longer assuming business from UIRC because the Company was licensed in enough states that the arrangement was no longer necessary. However, there were still some renewals in 2005 and, under this quota share treaty, the Company assumed premiums totaling \$36,000 in 2005. As of December 31, 2005, the Company had no loss and loss adjustment expense reserves for assumed business. In connection with this treaty, the Company had placed in trust investments with a par value of \$250,000 as collateral in the event of its failure to pay losses as required under the reinsurance contract. These investments were reported by the Company under “Bonds” in its Annual Statement.

### **Ceded Reinsurance:**

The Company ceded business through various contracts (e.g., excess of loss, automatic facultative excess of loss, property catastrophe treaties and terrorism treaties) with a number of reinsurance companies. During 2005, the Company paid reinsurance premiums totaling \$9,418,190 and recovered \$2,445,582 for losses covered under the reinsurance contracts. The Company’s estimated liability for losses, loss adjustment expenses and unearned premiums were reduced by \$2,409,000, \$488,000 and \$4,750,000 respectively, due to its ceded reinsurance as of December 31, 2005.

To the extent that reinsurance companies are unable to meet their obligations relating to the reinsured business, the Company remains liable for these amounts.

Our review of the reinsurance treaties did not disclose any unusual provisions.

## **ACCOUNTS AND RECORDS**

The Company's general accounting records consisted of an automated general ledger system and various subsidiary ledgers (e.g., cash receipts, cash disbursements). Our review did not disclose any significant deficiencies in these records.

## FINANCIAL STATEMENTS

The following financial statements reflect the financial condition of the Company as of December 31, 2005, as determined by this examination:

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The accompanying Notes to Financial Statements are an integral part of these Financial Statements.

**BALANCE SHEET**

**ASSETS**

	<b>Assets</b>	<b>Nonadmitted Assets</b>	<b>Net Admitted Assets</b>
Bonds	\$ 18,056,749	\$	\$ 18,056,749
Common stocks	3,333,398		3,333,398
Cash ((\$256,585)) and short term investments (\$1,898,713) and Cash equivalents (\$324,814)	1,966,942		1,966,942
Investment income due and accrued	210,938		210,938
Uncollected premiums and agents' balances in the course of collection	1,507,051	2,011	1,505,040
Deferred premiums, agents' balances and installments booked but deferred and not yet due (including \$ 0 earned but unbilled premiums)	395,102		395,102
Amounts recoverable from reinsurers	108,383		108,383
Other amounts receivable under reinsurance contracts	47,983		47,983
Current federal and foreign income tax recoverable and interest thereon	4,439		4,439
Net deferred tax asset	413,110	72,577	340,533
Guaranty funds receivable or on deposit	40,145	40,145	
Electronic data processing equipment and software	8,164	8,164	
Furniture and equipment, including health care delivery assets	25,045	25,045	
Receivables from parent, subsidiaries and affiliates	792		792
Aggregate write-ins for other than invested assets	100,718	100,718	
Total	\$ 26,218,959	\$ 248,660	\$ 25,970,299

## LIABILITIES, SURPLUS AND OTHER FUNDS

Losses (NOTES 1 and 2)	\$ 1,615,290
Loss adjustment expenses (NOTES 1 and 2)	812,852
Commissions payable, contingent commissions and similar charges	26,144
Other expenses (excluding taxes, licenses and fees)	1,020,096
Taxes, licenses and fees (excluding federal & foreign tax)	146,689
Unearned premiums (after deducting ceded reinsurance unearned premiums of \$4,750,241)	4,945,500
Ceded reinsurance premiums payable (net of ceding commissions)	1,781,485
Amounts withheld or retained by company for account of others	27,836
Provision for reinsurance	120,000
Payable to parent, subsidiaries and affiliates	<u>1,000</u>
Total liabilities	<u>\$ 10,496,892</u>
Common capital stock	\$ 2,604,800
Preferred capital stock	395,200
Gross paid in and contributed surplus	1,003,000
Unassigned funds	<u>11,470,407</u>
Surplus as regards policyholders	<u>\$ 15,473,407</u>
Total liabilities and surplus	<u><u>\$ 25,970,299</u></u>

## STATEMENT OF INCOME

### Underwriting Income

Premiums earned		\$ 9,429,424
Underwriting deductions:		
Losses incurred	\$ 2,654,528	
Loss expenses incurred	249,346	
Other underwriting expenses incurred	<u>5,293,225</u>	
Total underwriting deductions		<u>8,197,099</u>
Net underwriting gain		\$ 1,232,325

### Investment Income

Net investment income earned	\$ 1,163,871	
Net realized capital gains	<u>2,348</u>	
Net investment gain		1,166,219

### Other Income

Net (loss) from agents' or premium balances charged off	(4,124)	
Aggregate write-ins for miscellaneous income	<u>18</u>	
Total other income net (loss)		<u>(4,106)</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$ 2,394,438
Federal and foreign income taxes incurred		<u>571,404</u>
Net income		<u><u>\$ 1,823,034</u></u>

## CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders, per examination December 31, 2000		\$ 7,673,575
	Gains and (Losses) in Surplus	
Net income, 2001	\$ 899,841	
Net unrealized capital gain	25,398	
Change in non-admitted assets	1,392	
Change in provision for reinsurance	4,364	
Cumulative effect of changes in accounting principles	99,903	
Dividends to stockholders	<u>(100,000)</u>	
Change in capital and surplus for the year		<u>930,898</u>
Surplus as regards policyholders, December 31, 2001		\$ 8,604,473
	Gains and (Losses) in Surplus	
Net income, 2002	\$ 1,034,476	
Net unrealized capital (loss)	(50,729)	
Change in net deferred income tax	113,485	
Change in non-admitted assets	(121,855)	
Change in provision for reinsurance	(133,775)	
Aggregate write-ins for gains (loss) in surplus	<u>247,022</u>	
Change in capital and surplus for the year		<u>1,088,624</u>
Surplus as regards policyholders, December 31, 2002		\$ 9,693,097
	Gains and (Losses) in Surplus	
Net income, 2003	\$ 2,039,453	
Change in Net unrealized capital gain	281,623	
Change in Net deferred income tax	48,649	
Change in non-admitted assets	54,132	
Change in provision for reinsurance	(4,000)	
Dividends to stockholders	<u>(47,424)</u>	
Change in capital and surplus for the year		<u>2,372,433</u>
Surplus as regards policyholders, December 31, 2003		\$ 12,065,530
	Gains and (Losses) in Surplus	
Net income, 2004	\$ 2,060,462	
Change in Net unrealized capital gain	140,211	
Change in Net deferred income tax	(28,700)	
Change in non-admitted assets	(1,568)	
Change in provision for reinsurance	30,000	
Change in paid in capital	804,800	
Paid in surplus adjustments	503,000	
Dividends to stockholders	<u>(1,307,800)</u>	
Change in capital and surplus for the year		<u>2,200,405</u>
Surplus as regards policyholders, December 31, 2004		\$ 14,265,935

(continued from previous page)

	Gains and (Losses) in Surplus	
Net income, 2005		\$ 1,823,034
Change in Net unrealized capital gain		62,269
Change in Net deferred income tax		(20,907)
Change in non-admitted assets		71,277
Change in provision for reinsurance		(5,000)
Dividends to stockholders		(586,080)
Aggregate write-ins for gain (loss) in surplus		<u>(137,121)</u>
Change in capital and surplus for the year		<u>1,207,472</u>
Surplus as regards policyholders, December 31, 2005		<u>\$ 15,473,407</u>

## **ANALYSIS OF EXAMINATION CHANGES TO SURPLUS**

There were no adjustments to surplus as a result of our examination.

## COMPARATIVE FINANCIAL POSITION OF THE COMPANY

The comparative financial position of the Company for the five year period ended December 31, 2005, was as follows:

	<u>2005</u>		<u>2004</u>		<u>2003</u>		<u>2002</u>		<u>2001</u>
Assets	\$ 25,970,299	\$	23,904,543	\$	22,278,748	\$	19,486,544	\$	15,002,067
Liabilities	10,496,892		9,638,608		10,213,218		9,793,447		6,397,594
Capital and surplus	15,473,407		14,265,935		12,065,530		9,693,097		8,604,473
Premiums earned	9,429,424		9,588,739		8,121,860		5,622,101		3,492,225
Net underwriting gain	1,232,325		1,687,549		1,755,644		542,652		748,576
Net investment gain	1,166,219		1,083,689		1,120,317		947,375		679,974
Net income	1,823,034		2,060,462		2,039,453		1,034,476		899,841

Note: Amounts presented in the preceding financial statements for the years ended December 31, 2001 through December 31, 2004 were taken from the Company's Annual Statements as filed with the Administration. Amounts for the years ended December 31, 2000 and December 31, 2005 are amounts per examination.

## **NOTES TO FINANCIAL STATEMENTS**

1. The Company reported reserves for “Losses” and “Loss adjustment expenses” totaling \$1,615,290 and \$812,852, respectively. These amounts represent management’s best estimate of all claims that had been incurred but still unpaid as of December 31, 2005. The methodologies utilized by the Company to compute reserves, and the adequacy of the loss reserves and loss adjustment expense reserves as of December 31, 2005, were reviewed. As part of our review, we relied on the actuarial work performed by the Company’s independent actuary, who concluded that these reserves appeared to be sufficient. The reserves for “Losses” and “Loss adjustment expenses” were shown net of estimated amounts recoverable from reinsurance companies under the Company’s reinsurance agreements. If the reinsurers were not able to meet their obligations under these agreements, the Company would be liable for any defaulted amounts. Estimated amounts recoverable from reinsurers as of December 31, 2005, totaled \$2,409,000 for losses and \$488,000 for loss adjustment expenses.
2. As further described under the “History” section of this Report, the Company was originally incorporated as Verlan Limited (Bermuda), which commenced operations in Bermuda in 1970. From 1978 to 1983, Verlan Limited (Bermuda) wrote comprehensive general liability insurance. This business was either written directly by Verlan Limited (Bermuda) or was written by its subsidiary, Verlan Limited (a Vermont corporation), and assumed by Verlan Limited (Bermuda) through reinsurance treaties. Several claims have been filed under these policies, predominantly related to the remediation of hazardous waste sites that were used by certain insureds to dispose of manufacturing by-products. The Company’s “Losses and Loss adjustment expense reserves” as of December 31, 2005, included amounts for open product liability claims as well as for incurred but not reported reserves (IBNR) for emerging product liability and environmental claims. It must be noted however that because of the inherent uncertainty in estimating the ultimate liability for these risks, more substantial losses on these policies could emerge.

## **COMMENTS AND RECOMMENDATIONS**

During our examination we made a number of suggestions and recommendations to the Company with regard to annual statement preparation and other procedures relating to its operations and the Company initiated or indicated to comply with our recommendations.

## **SUBSEQUENT EVENTS**

The Company was licensed to issue property insurance in Arizona, Delaware, Rhode Island, Texas and Wisconsin during 2006, bringing to 26 the number of states in which it is licensed to do business. The Company was licensed in Minnesota during 2007.

## CONCLUSION

Our examination disclosed that as of December 31, 2005, the Company had:

Admitted Assets	<u>\$ 25,970,299</u>
Liabilities and Reserves	<u>\$ 10,496,892</u>
Common Capital Stock	\$ 2,604,800
Preferred Capital Stock	395,200
Gross Paid in and Contributed Surplus	1,003,000
Unassigned Funds (Surplus)	<u>11,470,407</u>
Surplus as Regards Policyholders	<u>\$ 15,473,407</u>
Total Liabilities and Surplus	<u>\$ 25,970,299</u>

Based on our examination, the accompanying balance sheet properly presents the statutory financial position of the Company as of December 31, 2005, and the accompanying statement of income properly presents the statutory results of operations for the period then ended. The supporting financial statements properly present the information prescribed by the Annotated Code of Maryland, the Code of Maryland Regulations and the National Association of Insurance Commissioners.

Title 4 of the Insurance Article of the Annotated Code of Maryland specifies the level of capital and surplus required for the Company. We concluded that the Company's capital and surplus funds exceeded the minimum requirements during the period under examination.

## **SIGNATURES**

In addition to the undersigned, the following examiners representing the Maryland Insurance Administration participated in this examination:

Ernest Mangae, CFE, Maryland Insurance Administration  
Fatima Mohamed, Maryland Insurance Administration  
Purushotam Shrestha, Maryland Insurance Administration

Respectfully submitted,

***Original Signature on File***

---

Evelyn E. Grim, CFE  
Examiner-In-Charge  
Maryland Insurance Administration

Under the supervision of,

***Original Signature on File***

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Antonio S. Sadorra, CFE, CIE  
Assistant Chief Examiner  
Maryland Insurance Administration

MARTIN O'MALLEY  
Governor

ANTHONY G. BROWN  
Lt. Governor

R. STEVEN ORR  
Commissioner

JAMES V. MCMAHAN, III  
Deputy Commissioner

LESTER C. SCHOTT  
Associate Commissioner  
Examination and Auditing

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1-800-492-6116 TTY: 1-800-735-2258  
[www.mdinsurance.state.md.us](http://www.mdinsurance.state.md.us)

May 1, 2007

John W. Johnson  
President  
Verlan Fire Insurance Company  
8403 Colesville Road, Suite 300  
Silver Spring, Maryland 20910

Dear Mr. Johnson:

Enclosed is a draft copy of the Report on Examination of the affairs and financial condition of **Verlan Fire Insurance Company**, as of December 31, 2005, dated December 21, 2006. Please call our attention to any errors or omissions.

Unless a written request for a Hearing with respect to the Report (in accordance with the provisions of Sections 2-209 and 2-210, Insurance Article of the Annotated Code of Maryland) is received on or before **May 30, 2007**, the Report will become final, and will be filed as a public document within this Administration.

If this Report on Examination contains a section entitled "Comments and Recommendations" that discloses certain areas requiring action, the Company shall submit a statement covering the corrective measures which will be taken.

If the Company's position on any of these points is contrary to the Examiner's findings, an explanation should be submitted covering each contested comment and/or recommendation.

All of your comments concerning these matters must be in writing and shall be furnished to this Administration **within thirty (30) days** from the date of this letter (**May 30, 2007**). **In addition to the hard copy mailed to the Administration, also please send our response electronically in Microsoft Word format to [pgiles@mdinsurance.state.md.us](mailto:pgiles@mdinsurance.state.md.us).**

The Report on Examination should be called to the attention of your Board of Directors at its next meeting. Each Director should review the Report and acknowledge such review over his signature. Documentation of such review should be maintained for future verification.

If you have any questions or if you would like to discuss these recommendations, please do not hesitate to call me at 410-468-2120.

Sincerely,

*Original Signature on File*

Jeffrey Lieman, CPA, CFE  
Chief Examiner

**VERLAN** FIRE INSURANCE COMPANY

8403 COLESVILLE ROAD  
SUITE 300  
SILVER SPRING, MARYLAND 20910  
TEL 301.495.7722  
FAX 301.495.9425  
<http://www.verlan.com>

May 10, 2007

Mr. Jeffrey Lieman, CPA, CFE  
Chief Examiner  
Maryland Insurance Administration  
525 St. Paul Place  
Baltimore, MD 21202-2272

Dear Mr. Lieman:

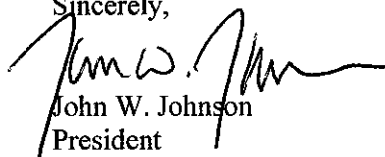
Verlan Fire Insurance Company ("the Company") hereby acknowledges receipt of your May 1, 2007 letter forwarding the **Report on Examination** of the affairs and financial condition of Verlan Fire Insurance Company as of December 31, 2005.

The Company finds no errors or omissions in the Report.

We will see that the Company's Board of Directors reviews the Report at their next regularly-scheduled meeting, and each Director will be asked to sign an acknowledgment of such review.

Thank you again for the courtesies extended to our staff during the audit review process.

Sincerely,

  
John W. Johnson  
President

MARTIN O'MALLEY  
Governor

ANTHONY G. BROWN  
Lt. Governor

R. STEVEN ORR  
Commissioner

JAMES V. MCMAHAN, III  
Deputy Commissioner

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[www.mdinsurance.state.md.us](http://www.mdinsurance.state.md.us)

May 15, 2007

John W. Johnson  
President  
Verlan Fire Insurance Company  
8403 Colesville Road, Suite 300  
Silver Spring, Maryland 20910

Dear Mr. Johnson:

We are in receipt of your letter, dated May 10, 2007, which addresses the corrective action taken by Verlan Fire Insurance Company, to comply with the recommendations made in the Report on Examination as of December 31, 2005, dated December 21, 2006. Your response adequately addresses the recommendations made in the Report.

During our next examination of the Company, we will review the implementation of the corrective actions taken.

As the May 10, 2006 letter did not request a hearing, pursuant to § 2-209 of the Insurance Article, Annotated Code of Maryland, the Report is Final and is attached for your records. The Report will be forwarded electronically, along with a copy of this letter, to each Commissioner whose name is set forth on Page 1 of the Report, as well as to each of the participating zone examiners, to the National Association of Insurance Commissioners, and to each state in which the Company is licensed, according to your Annual Statement.

Sincerely,

***Original Signature on File***

Jeffrey Lieman, CPA, CFE  
Chief Examiner