

REPORT OF EXAMINATION
OF THE
SUTTER INSURANCE COMPANY
AS OF
DECEMBER 31, 2007

Participating State
and Zone:

California

Filed June 1, 2009

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San Francisco, California
May 27, 2009

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Morris Chavez
Secretary, Zone IV - Western
Superintendent of Insurance
New Mexico Department of Insurance
Santa Fe, New Mexico

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

SUTTER INSURANCE COMPANY

(hereinafter also referred to as the Company) at its statutory home office and main administrative office located at 1301 Redwood Way, Suite 120, Petaluma, California, 94954.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2007. The examination was made pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2007, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

COMPANY HISTORY

The Company paid ordinary cash dividends to its stockholders of \$6.7 million in 2007 and \$2.2 million in 2006.

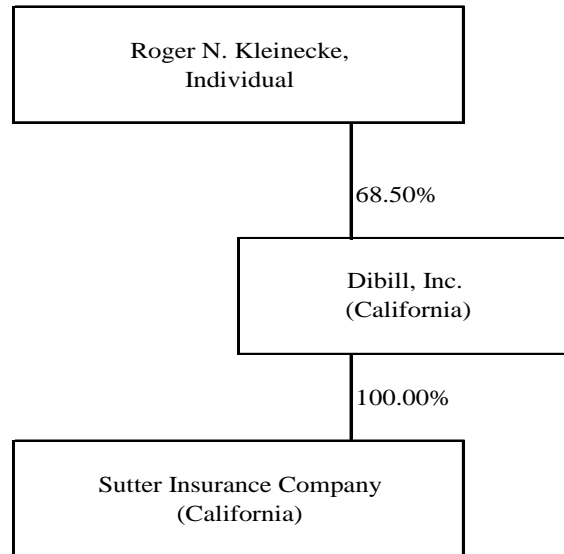
MANAGEMENT AND CONTROL

The Company is wholly-owned by DiBill, Inc., which in turn is owned by members of the Kleinecke family. The ultimate controlling person is Roger N. Kleinecke.

Prior to November 2007, Roger N. Kleinecke, as trustee for the Kleinecke Marital Trust (the Marital Trust) dated July 14, 1993, directly owned 9,328 shares, or 16%, of the common stock of the Company. On November 30, 2007, Roger N. Kleinecke sold the 9,328 shares owned by the Marital Trust to DiBill, Inc. for \$3.8 million, thereby making DiBill, Inc. the sole shareholder of the Company. Roger N. Kleinecke received \$1.2 million in cash and a note for the balance at 6% interest, payable in installments and due in full by November 2008. The note was paid in full on December 29, 2007.

The Company completed this transaction without the proper consent or exemption from the California Department of Insurance (CDI) as required by CIC Section 1215.2. In addition, it did not provide timely notice of the transaction to the CDI as required by CIC Section 1215.4(e). The Company was made aware of the violations.

The following organizational chart depicts the Company's relationship within the holding company system at December 31, 2007:



Management of the Company is vested in an annually elected, three-member board of directors. A listing of the members of the board and principal officers serving on December 31, 2007 follows:

Directors

Name and Residence

Principal Business Affiliation

Diane E. Kleinecke
Santa Rosa, California

Vice President, Secretary and Treasurer
Sutter Insurance Company

Roger N. Kleinecke
Kentfield, California

President
Sutter Insurance Company

William B. Kleinecke
Novato, California

Vice President
Sutter Insurance Company

Principal Officers

<u>Name</u>	<u>Title</u>
Roger N. Kleinecke	President
William B. Kleinecke	Vice President, Underwriting
Diane E. Kleinecke	Vice President, Secretary, Treasurer
Harry L. Boatright	Vice President, Claims

Tax Allocation Agreement

The Company is party to a tax allocation agreement with its parent company, DiBill, Inc. The agreement provides that any tax benefits from consolidation be paid to the Company when realized by the parent. The agreement was approved by the California Department of Insurance on March 25, 1999.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2007, the Company was licensed to transact property and casualty insurance in the states of California, Nevada, Oregon, and Washington. Direct written premiums for 2007 by state were as follows: California \$17.9 million (78%); Nevada \$0.7 million (3%); Oregon \$1.8 million (8%); and Washington \$2.6 million (11%). The Company primarily writes commercial auto liability, auto physical damage, vehicle service contracts, and homeowners. Of the \$23,011,937 in direct written premiums in 2007, the Company wrote \$11,298,277 in vehicle service contracts, \$5,888,804 in commercial auto, \$2,564,125 in auto physical damage and \$1,215,691 in homeowners. The Company's commercial auto business includes a regional (11 western states) long-haul trucking program. The trucking program is written on a preferred basis. Other commercial auto the Company insures is Social Service Vehicles (vehicles used by non-profit organizations) and light trucks. Maximum limit of liability on commercial auto is \$1 million combined single limit. Business is written through approximately 30 policy-issuing agents and 230 independent brokers. The auto warranty business is written and managed through one unaffiliated managing general agent, PRco, Inc. of Walnut Creek, California.

REINSURANCE

Assumed

The Company assumes minor amounts of reinsurance through mandatory pools in California.

Ceded

The Company had the following reinsurance contracts in force at December 31, 2007:

<u>Reinsurer</u>	<u>Business Covered</u>	<u>Company Retention</u>	<u>Reinsurer's Maximum Limits</u>
<u>Effective 7/1/2003:</u> Motors Insurance Corporation (Authorized)	Homeowners Property and Casualty	\$150,000 per loss occurrence	1 st Excess - \$450,000 excess of \$150,000 2 nd Excess - \$400,000 excess of \$600,000 Casualty Excess - \$1,000,000 excess of \$1,000,000
<u>Effective 10/1/2007:</u> QBE Reinsurance Corporation (50%) Partner Reinsurance Company of the U.S. (50%) (Both authorized)	Auto Liability	\$350,000 per loss occurrence	\$650,000 excess of \$350,000
<u>Effective 7/1/2007:</u> QBE Reinsurance Corporation (12.5%) Odyssey America Reinsurance Corporation (12.5%) (Both authorized) Flagstone Reinsurance Ltd. (75%) (unauthorized)	Property Catastrophe	\$1,500,000	95% of \$1,500,000 per occurrence excess of \$1,500,000, subject to a maximum liability of \$2,850,000

It was noted the auto liability contract effective November 1, 2007 did not contain an entire agreement provision as required by California Code of Regulations (CCR), Title 10, Section

2303.13(b). It was also noted that the homeowners agreement effective July 1, 2003 was not in compliance with the early termination provision of CCR, Title 10, Section 2303.14(b)(1)(B) in that it did not provide for 60 days notice to the ceding insurer. It is recommended that the Company revise these reinsurance agreements to comply with California regulations.

ACCOUNTS AND RECORDS

A review was made of the Company's general controls over its information systems. As a result, weaknesses were noted in the areas of disaster recovery and business continuity planning. The weaknesses were presented to the Company along with recommendations to strengthen the controls. It is recommended that the Company evaluate the recommendations and make appropriate changes to strengthen its information systems controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2007

Underwriting and Investment Exhibit for the Year Ended December 31, 2007

Reconciliation of Surplus as Regards Policyholders from December 31, 2003
through December 31, 2007

Statement of Financial Condition
as of December 31, 2007

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Nonadmitted Assets</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 49,057,405	\$	\$ 49,057,405	
Cash and short-term investments	2,489,544		2,489,544	
Investment income due and accrued	615,294		615,294	
Premiums and considerations:				
Uncollected premiums and agents' balances in the course of collection	373,011	13,965	359,046	
Reinsurance:				
Amounts recoverable from reinsurers	3,900		3,900	
Other amounts receivable under reinsurance contracts	260,005		260,005	
Current federal and foreign income tax recoverable	793,343		793,343	
Net deferred tax asset	1,637,821	360,258	1,277,563	
Aggregate write-ins for other than invested assets	<u>164,478</u>	<u> </u>	<u>164,478</u>	
Total assets	<u>\$ 55,394,801</u>	<u>\$ 374,223</u>	<u>\$ 55,020,578</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 10,126,018	(1)
Loss adjustment expenses			2,313,571	(1)
Commissions payable, contingent commissions and other similar charges			727,145	
Other expenses (excluding taxes, licenses and fees)			576,762	
Unearned premiums			17,003,378	
Drafts outstanding			<u>34,365</u>	
Total liabilities			30,781,239	
Common capital stock		\$ 3,000,000		
Gross paid-in and contributed surplus		2,800,000		
Unassigned funds (surplus)		<u>18,439,339</u>		
Surplus as regards policyholders			<u>24,239,339</u>	
Total liabilities, surplus and other funds			<u>\$ 55,020,578</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2007

Statement of Income

Underwriting Income

Premiums earned		\$ 23,488,559
Deductions:		
Losses incurred	\$ 11,675,470	
Loss expenses incurred	1,505,413	
Other underwriting expenses incurred	<u>7,000,527</u>	
Total underwriting deductions		<u>20,181,410</u>
Net underwriting gain		3,307,149

Investment Income

Net investment income earned	\$ 2,524,705	
Net realized capital gains	<u>22,508</u>	
Net investment gain		<u>2,547,213</u>

Other Income

Net loss from agents' or premium balances charged off	\$ (427,998)	
Finance and service charges not included in premiums	<u>101,268</u>	
Total other income		<u>(326,730)</u>
Net income before federal income taxes		5,527,632
Federal income taxes incurred		<u>1,207,415</u>
Net income		<u>\$ 4,320,217</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2006		\$ 29,976,489
Net income	\$ 4,320,217	
Change in net deferred income tax	(315,981)	
Change in nonadmitted assets	(41,386)	
Dividends to stockholders	<u>(6,700,000)</u>	
Change in surplus as regards policyholders for the year		<u>(2,737,150)</u>
Surplus as regards policyholders, December 31, 2007		<u>\$ 24,239,339</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2007

Surplus as regards policyholders, December 31, 2003, per Examination			\$ 21,445,811
	<u>Gain in</u> <u>Surplus</u>	<u>Loss in</u> <u>Surplus</u>	
Net income	\$ 12,722,864	\$	
Change in net unrealized capital gains		269,805	
Change in net deferred income tax		603,746	
Change in nonadmitted assets		155,785	
Dividends to stockholders (cash)	<u> </u>	<u>8,900,000</u>	
Total gains and losses	<u>\$ 12,722,864</u>	<u>\$ 9,929,336</u>	
Increase in surplus as regards policyholders			<u>2,793,528</u>
Surplus as regards policyholders, December 31, 2007, per Examination			<u>\$ 24,239,339</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Based on an analysis by a Casualty Actuary for the California Department of Insurance, the Company's loss and loss adjustment expense reserves as of December 31, 2007 were found to be reasonably stated.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Reinsurance (Page 5): It is recommended that the Company revise its reinsurance agreements to comply with California regulations.

Accounts and Records (Page 6): It is recommended that the Company review the recommendations from the review and make appropriate changes to strengthen its information systems controls.

Previous Report of Examination

Reinsurance (Page 7): It was recommended that the Company revise its reinsurance agreements to comply with California laws. The Company's offset and insolvency clauses were found to be in compliance with CIC 922.2(a)(2).

Unearned Premium (Page 8): It was recommended that the Company take appropriate measures to address the understatement of unearned premium due to this methodology error. The Company has complied with this recommendation.

Accounts and Records (Page 8): It was recommended that the Company continue to work towards improving the weaknesses noted in its information systems controls. It was recommended that the

Company amend its data processing agreement with Fiserv, Inc. to require a Type II SAS 70 review on an annual basis. It was recommended that the Company amend the Limitation of Liability Clause in the data processing agreement. The Company no longer uses Fiserv to process data.

Comments on Financial Statement Items – Taxes, Licenses and Fees (Page 13): It was recommended that the Company employ methods to calculate the number of vehicles insured based on actual quarterly in-force counts using the procedures required by regulations. It was also recommended the Company work with the California Department of Insurance (CDI) to address the underreporting issue. The Company has complied with these recommendations and has agreed to pay an additional auto fraud assessment fee of \$23,198 to the CDI.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/s/

Sandra Bailey, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California