

REPORT OF EXAMINATION  
OF THE  
VETERINARY PET INSURANCE COMPANY  
AS OF  
DECEMBER 31, 2007

Filed April 3, 2009

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION.....	1
SUBSEQUENT EVENTS .....	2
COMPANY HISTORY .....	2
MANAGEMENT AND CONTROL: .....	3
Management Agreements .....	4
TERRITORY AND PLAN OF OPERATION .....	6
REINSURANCE: .....	6
Assumed.....	6
Ceded .....	7
FINANCIAL STATEMENTS:.....	7
Statement of Financial Condition as of December 31, 2007 .....	8
Underwriting and Investment Exhibit for the Year Ended December 31, 2007.....	9
Reconciliation of Surplus as Regards Policyholders from December 31, 2004 through December 31, 2007.....	10
COMMENTS ON FINANCIAL STATEMENT ITEMS:.....	11
Receivable from Parent, Subsidiaries and Affiliates .....	11
Reinsurance Payable on Paid Losses and Loss Adjustment Expenses .....	11
Losses and Loss Adjustment Expenses .....	11
SUMMARY OF COMMENTS AND RECOMMENDATIONS:.....	11
Current Report of Examination.....	11
Previous Report of Examination.....	11
ACKNOWLEDGEMENT .....	13

Los Angeles, California  
January 29, 2009

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

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

**VETERINARY PET INSURANCE COMPANY**

(hereinafter also referred to as the Company) at its statutory home office and primary location of its books and records, 3060 Saturn Street, Brea, California 92821.

**SCOPE OF EXAMINATION**

The previous examination of the Company was made as of December 31, 2004. This examination covers the period from January 1, 2005 through December 31, 2007. The examination was made pursuant to the National Association of Insurance Commissioners' 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; accounts and records; and sales and advertising.

## SUBSEQUENT EVENTS

On May 1, 2008, the Company's parent, Scottsdale Insurance Company (SIC) issued a voluntary tender offer for all outstanding shares of the Company's common stock, and thereafter merged the Company with Scottsdale Acquisition Company (SAC), an entity owned by SIC. As a result of the voluntary tender offer, SIC increased its ownership percentage from approximately 64% as of December 31, 2007 to 99% as of July 14, 2008. On October 28, 2008, the California Department of Insurance (CDI) approved the short-form merger of SAC with and into the Company, with the Company being the surviving entity. Effective December 10, 2008, all remaining shareholders were cashed out and the Company became wholly-owned by SIC.

On July 17, 2008, the Company informed the CDI that an embezzlement of \$2.7 million was discovered on June 23, 2008. The embezzlement amount was covered through the Company's fidelity bond coverage and was paid during the fourth quarter of 2008.

## COMPANY HISTORY

On June 8, 2005, Scottsdale Insurance Company (SIC), the Company's parent, advanced the Company \$15 million as a surplus note contribution. This note bears interest at a fixed rate of 5%, with semi-annual payments of interest only. This agreement was approved by the California Department of Insurance on May 11, 2005. The Company has paid interest to SIC totaling approximately \$1.9 million through December 31, 2007.

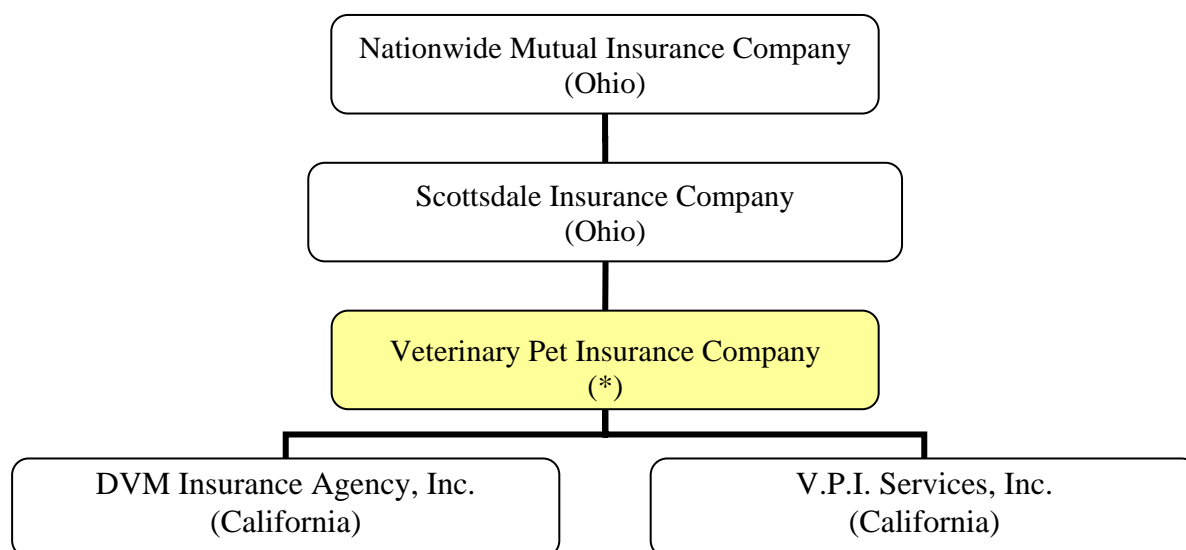
On June 14, 2005, an amendment was made to the Articles of Incorporation to authorize an additional 10,000 shares of common stock of the Company and decrease the par value to \$0.1772611 per share. In addition, effective July 6, 2005, the Company's former parent, Veterinary Pet Services, Inc., merged with and into the Company, with the Company as the surviving entity.

During the exam period various employees and individual investors exercised 172,450 shares of stock options at \$4 per share. As a result, common capital stock increased by \$30,569 and gross paid in and contributed surplus increased by \$659,232.

As of December 31, 2007, the Company had 5,821,480 shares issued and outstanding. Approximately 64% of the shares are owned by SIC, a wholly-owned subsidiary of Nationwide Mutual Insurance Company. The IAMS Company owned approximately 9%, and the remaining shares were owned by individual veterinarians, employees, and various other investors.

### MANAGEMENT AND CONTROL

The following abridged organizational chart, which is limited to the Company's parent along with its subsidiaries, depicts the Company's relationship within the holding company system as of December 31, 2007:



(\* ) As of December 31, 2007, the Company was approximately 64% owned by Scottsdale Insurance Company (SIC). Effective December 10, 2008 the Company became wholly-owned by SIC.

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

## Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Dennis P. Drent Brea, California	President and Chief Executive Officer Veterinary Pet Insurance Company
Terri L. Hill Columbus, Ohio	Executive Vice President and Chief Administrative Officer Nationwide Mutual Insurance Company
David J. Lancer Palm Coast, Florida	Retired Controller Veterinary Pet Insurance Company
Michael D. Miller Scottsdale, Arizona	President and Chief Operating Officer Scottsdale Insurance Company
Gary L. Tiepelman Scottsdale, Arizona	Senior Vice President Scottsdale Insurance Company

## Principal Officers

<u>Name</u>	<u>Title</u>
Dennis P. Drent	President and Chief Executive Officer
Kenneth L. Watkins (*)	Chief Financial Officer
Philippe E. Grevin	General Counsel
Lorin A. Young	Marketing and Sales Officer
Jonathan E. Kass	Operations and Chief Information Officer
Peggy K. Castellano (**)	Human Resources and Administration Officer
Carol McConnell, DVM	Underwriting and Chief Veterinary Medical Officer

(\*) Terminated in September 2008. Current responsibilities are handled by Larry Goodyear.

(\*\*) Resigned in June 2008. Current responsibilities are handled by Howard Cardon.

## Management Agreements

Administrative Services Agreement: During the exam period the Company had an administrative services arrangement with its subsidiary, DVM Insurance Agency, Inc. (DVM). Under the terms of this arrangement, the Company provides the following services; underwriting, marketing, billing,

collection, and all administrative services for DVM. In return, DVM places the Company's insurance policies outside California with National Casualty Company (NCC). The Company receives all commissions provided to DVM by NCC. Fees received by the Company under this arrangement were \$24 million, \$28.2 million and \$32.6 million in 2005, 2006 and 2007, respectively. The arrangement was formalized through a written agreement effective January 1, 2009. The California Department of Insurance (CDI) approved the agreement on January 15, 2009.

**Administrative Services Agreement:** During the exam period the Company had an administrative services arrangement with its subsidiary, V.P.I. Services, Inc. (VPIS). The Company operates a nationwide pet registry service for its policyholders through VPIS that includes a pet identification and pet recovery program for lost pets. Annual fees charged to policyholders for this program are \$12 for new business and \$6 for renewals. The Company provides all administrative services such as marketing, billing, collections and accounting on behalf of VPIS and receives all their income in consideration for these services. Fees received by the Company under this arrangement were \$3 million, \$3.3 million and \$3.6 million in 2005, 2006 and 2007, respectively. The arrangement was formalized through a written agreement effective January 1, 2009. The CDI approved this agreement on January 15, 2009.

**Tax Allocation/Sharing Agreement:** For the tax year ending December 31, 2007, the Company and its subsidiaries, DVM and VPIS were parties to a Tax Allocation Agreement. The Company prepares and files the consolidated federal income tax return and allocates the tax liability for each subsidiary based on separate return calculations with settlements made within 30 days after the filing of the consolidated income tax return. Upon becoming wholly-owned effective December 10, 2008, the Tax Allocation Agreement was replaced by a Tax Sharing Agreement where the Company and its subsidiaries are included in the consolidated federal income tax return of its ultimate parent, Nationwide Mutual Insurance Company (NMIC), and affiliates. The new agreement is effective for the tax year ending December 31, 2008. The agreement is administered by NMIC and allocation of taxes is based upon separate tax return calculations with all settlements of inter-company tax balances made within 90 days after the filing. The Tax Sharing Agreement was approved by the CDI on December 15, 2008.

## TERRITORY AND PLAN OF OPERATION

The Company provides medical coverage for pets, primarily dogs and cats. Although the Company is licensed only in California, business is generated countrywide through a fronting arrangement with National Casualty Company and Scottsdale Insurance Company (SIC), subsidiaries of Nationwide Mutual Insurance Company. The Company's subsidiary, DVM Insurance Agency (DVM), acts as the Company's non-resident agent for policies written outside of California. The Company also operates a nationwide pet registry service for its policyholders that includes a pet identification and pet recovery program for lost pets through VPI Services, Inc., also a subsidiary.

In 2007, the Company had net written premiums of \$125.9 million, of which \$33.6 million were direct premiums and \$92.3 million were assumed from SIC and produced by DVM. Business is primarily marketed and produced through direct and online methods. The Company's main markets are individuals and its fastest growing channel is group sales for companies with at least 100 employees.

## REINSURANCE

### Assumed

DVM Insurance Agency (DVM), a licensed non-resident insurance agency, places all insurance written outside California with National Casualty Company (NCC). NCC, in turn, reinsures 100% of this business with Scottsdale Insurance Company (SIC). The Company assumes this business through a reinsurance agreement with SIC on an 80% quota-share basis. SIC receives a flat ceding commission of 33.5% based on the net written premium ceded. Ceding commissions paid in 2007 totaled \$30.9 million. As of December 31, 2007, reinsurance payables, for assumed reinsurance totaled \$4.1 million or 11.6% of surplus as regards policyholders.

The Company obtained a letter of credit from Union Bank of California, N.A, in the amount of \$14 million to secure the reinsurance credits claimed by SIC.

Ceded

The Company does not cede any reinsurance.

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, 2004 through December 31, 2007

Statement of Financial Condition  
as of December 31, 2007

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 70,123,459	\$	\$ 70,123,459	
Stocks:				
Common stocks	2,000	2,000		
Cash and short-term investments	4,885,600		4,885,600	
Investment income due and accrued	780,743		780,743	
Premiums and considerations:				
Uncollected premiums and agents' balances in course of collection	1,641,511	109,648	1,531,863	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	41,093,120		41,093,120	
Net deferred tax asset	7,320,914	2,306,328	5,014,586	
Electronic data processing equipment and software	3,446,378	3,446,378		
Furniture and equipment, including health care delivery assets	1,290,407	1,290,407		
Receivables from parent, subsidiaries and affiliates	2,935,994		2,935,994	(1)
Aggregate write-ins for other than invested assets	<u>1,757,577</u>	<u>1,752,212</u>	<u>5,365</u>	
Total assets	<u>\$ 135,277,703</u>	<u>\$ 8,906,973</u>	<u>\$ 126,370,730</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 11,305,291	(2)
Reinsurance payable on paid losses and loss adjustment expenses			0	(1)
Loss adjustment expenses			713,388	(2)
Commissions payable, contingent commissions and other similar charges			142,672	
Other expenses			5,895,324	
Taxes, licenses and fees			123,752	
Current federal and foreign income taxes			898,426	
Unearned premiums			65,159,445	
Advance premiums			683,969	
Payable to parent, subsidiaries and affiliates			2,966,360	
Aggregate write-ins for liabilities			<u>2,783,000</u>	
Total liabilities			90,671,627	
Common capital stock		\$ 1,030,569		
Surplus notes		15,000,000		
Gross paid-in and contributed surplus		23,422,755		
Unassigned funds (surplus)		<u>(3,754,221)</u>		
Surplus as regards policyholders			<u>35,699,103</u>	
Total liabilities, surplus and other funds			<u>\$ 126,370,730</u>	

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

Statement of Income

Underwriting Income

Premiums earned		\$ 117,457,747
Deductions:		
Losses incurred	\$ 73,066,409	
Loss expense incurred	5,356,174	
Other underwriting expenses incurred	<u>42,890,684</u>	
Total underwriting deductions		<u>121,313,267</u>
Net underwriting loss		(3,855,520)

Investment Income

Net investment income earned	\$ 2,485,082	
Net realized capital gain	<u>20,095</u>	
Net investment gain		2,505,177

Other Income

Net loss from agents' or premium balances charged off	\$ (6,421)	
Finance and service charges not included in premiums	<u>6,761,712</u>	
Total other income		<u>6,755,291</u>
Net income before federal income taxes		5,404,948
Federal income taxes incurred		<u>1,737,745</u>
Net income		<u>\$ 3,667,203</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2006		\$ 30,823,397
Net income	\$ 3,667,203	
Change in net unrealized capital gains	1,740	
Change in net deferred income tax	279,809	
Change in nonadmitted assets	1,899,567	
Capital changes: Paid in	29,949	
Surplus changes: Paid in	1,010,330	
Aggregate write-ins for losses in surplus	<u>(2,012,892)</u>	
Change in surplus as regards policyholders		<u>4,875,706</u>
Surplus as regards policyholders, December 31, 2007		<u>\$ 35,699,103</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2004 through December 31, 2007

Surplus as regards policyholders, December 31, 2004, per Examination			\$ 7,946,755
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 9,235,606	\$	
Change in net unrealized capital losses		1,715	
Change in net deferred income tax	404,668		
Change in nonadmitted assets	5,033,214		
Change in surplus notes	15,000,000		
Capital changes: Paid in	30,569		
Surplus adjustments: Paid in	659,232		
Aggregate write-ins for losses in surplus	<u>                    </u>	<u>2,609,226</u>	
Totals	<u>\$ 30,363,289</u>	<u>\$ 2,610,941</u>	
Net increase in surplus as regards policyholders for the examination			<u>27,752,348</u>
Surplus as regards policyholders, December 31, 2007, per Examination			<u>\$ 35,699,103</u>

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Receivable from Parent, Subsidiaries and Affiliates

### (1) Reinsurance Payable on Paid Losses and Loss Adjustment Expenses

According to Statement of Statutory Accounting Principles (SSAP) No. 62, paragraph 42, assumed reinsurance payable on paid losses shall be classified as a separate liability item on the balance sheet. The Company nets the reinsurance payable balance of \$2.1 million with other intercompany transactions and includes the balance as a receivable from parent, subsidiaries and affiliates. It is recommended the Company report the balance for reinsurance payable separately in accordance with SSAP 62, paragraph 42.

### (2) Losses and Loss Adjustment Expenses

The Company's reserves were evaluated by a Casualty Actuary from the California Department of Insurance. Based on the analysis, the Company's December 31, 2007 reserves for losses and loss adjustment expenses appear reasonable and have been accepted for purposes of this examination report.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Comments on Financial Statement Items – Receivable from Parent, Subsidiaries and Affiliates and Reinsurance Payable on Paid Losses and Loss Adjustment Expenses (Page 11): It is recommended the Company report the balance for reinsurance payable separately in accordance with Statement of Statutory Accounting Principles No. 62, paragraph 42.

### Previous Report of Examination

Management and Control – Conflict of Interest (Page 5): It was recommended that the Company provide completed conflict of interest questionnaires. The Company has complied.

Management and Control – Management Agreements (Page 6): It was recommended the Company establish an agreement to properly allocate expenses paid on behalf of its affiliates. The Company has complied.

Corporate Records (Page 6): It was recommended that the Company implement procedures in its board meetings to ensure compliance with California Insurance Code (CIC) Section 1201. The Company has complied.

Accounts and Records – Escheat Procedures (Page 8): It was recommended that the Company establish written procedures for escheatable funds and file the required reports in accordance with the California Unclaimed Property Act. The Company has complied.

Accounts and Records – Information System Controls (Page 8): It was recommended that the Company continue to review its information systems and make appropriate changes to strengthen internal controls. The Company has complied.

Comments on Financial Statement Items – Short-term Investments (Page 13): It was recommended that the Company place its securities with a qualified custodian in accordance with CIC Section 1104.9. The Company has complied by transferring its securities to Union Bank of California, N.A., who is an approved custodian.

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/

Deanna Lo, CFE  
Examiner-In-Charge  
Senior Insurance Examiner  
Department of Insurance  
State of California