

REPORT OF EXAMINATION
OF THE
2-10 HBW WARRANTY OF CALIFORNIA, INC.
AS OF
DECEMBER 31, 2021

Insurance Commissioner

A handwritten signature in blue ink, appearing to read "DeLa", is positioned to the right of the "Insurance Commissioner" text.

Filed on July 28, 2023

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Los Angeles, California
May 31, 2023

Honorable Ricardo Lara
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

2-10 HBW WARRANTY OF CALIFORNIA, INC.

(hereinafter also referred to as the Company). The Company's main administrative office and its primary location of its books and records is located at 13900 E Harvard Avenue, Aurora, Colorado 80014.

SCOPE OF EXAMINATION

We have performed our single-state examination of the Company. The previous examination of the Company was conducted as of December 31, 2015. This examination covered the period from January 1, 2016 through December 31, 2021.

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, 2021, as deemed necessary under the circumstances.

The examination report includes findings of fact and general information about the Company and its financial condition. There might be other items identified during the examination that, due to their nature (e.g., subjective conclusions, proprietary information,

etc.), were not included within the examination report but separately communicated to other regulators and/or the Company.

COMPANY HISTORY

The Company was incorporated under the laws of California on November 3, 1988 and licensed as a Home Protection Company the California Department of Insurance on February 7, 1990.

Capitalization

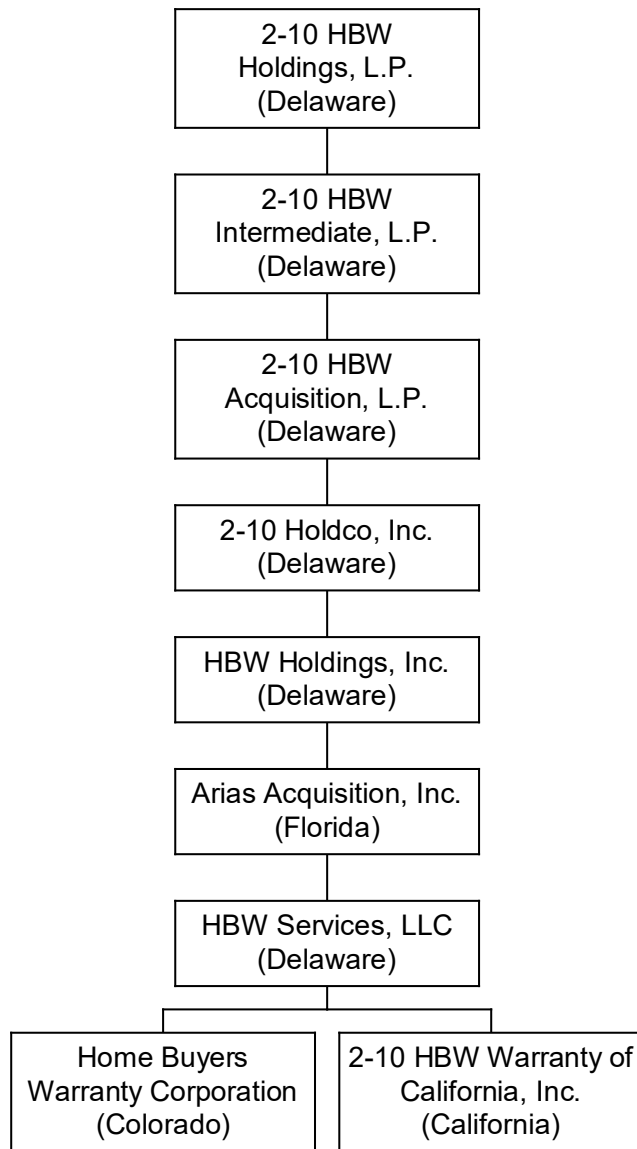
The Company is authorized to issue 100,000 shares of common stock with a par value of \$50 per share. As of December 2021, there were 4,000 shares issued and outstanding. During 2018 and 2020, the Company received a capital contribution of \$70,000 and \$83,500, respectively, from its parent, HBW Services, LLC (HBW Services).

Dividends

The Company paid ordinary cash dividends to its parent, HBW Services, LLC. in the amounts of \$241,865, \$207,000, 931,950, and \$325,750 in 2016, 2017, 2018, and 2019, respectively.

MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of HBW Services, LLC (HBW Services), a Delaware limited liability company. HBW Services is a wholly-owned subsidiary of Arias Acquisitions, Inc., which is 100% owned by HBW Holdings, Inc. The Company's ultimate parent is 2-10 HBW Holdings, L.P. a Delaware limited partnership. The following abridged organization chart shows the Company's relationship within the holding company system as of December 31, 2021. All ownership is 100%.



The four-member board of directors, who are elected annually, manage the business and affairs of the Company. Following are members of the board and principal officers of the Company serving at December 31, 2021:

Directors

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
Scott J. Cromie Greenwood Village, Colorado	President 2-10 HBW Warranty of California, Inc.
Michael C. Fletcher Larkspur, Colorado	Senior Vice President, General Counsel and Secretary 2-10 HBW Warranty of California, Inc.
Mark C. Lewis Centennial, Colorado	Chief Financial Officer 2-10 HBW Warranty of California, Inc.
Cynthia B. Nash Aurora, Colorado	Executive Vice President and Chief Operating Officer 2-10 HBW Warranty of California, Inc.

Principal Officers

<u>Name</u>	<u>Title</u>
Scott J. Cromie	President
Cynthia B. Nash	Executive Vice President and Chief Operating Officer
Scott D. Zinn	Executive Vice President and Chief Revenue Officer
Michael C. Fletcher	Senior Vice President, General Counsel, and Secretary
Todd H. Ehlers	Vice President, Contractor Relations
Kimberly Beckman	Vice President – Homeowner Sales
Richard A. Stanek	Treasurer
Mark C. Lewis	Chief Financial Officer

The following changes in management occurred subsequent to the examination date:

Scott J. Cromie resigned as President of the Company, effective July 11, 2022. Ryan M. O'Hara was elected as President effective July 11, 2022.

Management Agreements

Agreement for Services: Effective January 1, 2013, the Company entered into an Agreement for Services with its affiliate, Home Buyers Warranty Corporation (HBWC), a Colorado corporation. Under the terms of this agreement, HBWC provides certain services including management, payroll processing, office space, telecommunication services, claims administration, accounts payable and receivable, and other ancillary services. HBWC provides these services based on its actual costs with no profit factors built in. The California Department of Insurance (CDI) approved this agreement on January 3, 2013. For 2016, 2017, 2018, 2019, 2020, and 2021, the total fees paid under the agreement were \$291,183, \$281,239, \$275,809, \$283,350, \$333,815, and \$354,768, respectively.

Marketing and Licensing Agreement: Effective January 1, 2013, the Company entered into a Marketing and Licensing Agreement with its affiliate, HBWC. Under the terms of this agreement, HBWC provides certain marketing services, including advertising, development of sales methods, as well as development, production, distribution, issuance and administration of marketing brochures, and home service agreements. All charges by HBWC of Colorado are based on its actual costs with no profit factors built in. The CDI approved this agreement on March 12, 2013. For 2016, 2017, 2018, 2019, 2020, and 2021, the total fees paid under the agreement were \$284,840, \$309,628, \$306,539, \$265,038, \$276,891, and \$328,194, respectively.

Tax Consolidation Agreement: Effective September 20, 2011, a Tax Consolidation Agreement was entered between HBW Holding, Inc., indirect parent, and its subsidiaries. HBWC, is responsible for making federal income tax estimates and final payments on behalf of the group. Under the terms of the agreement, each company computes its separate tax liability as if it had filed a separate federal income tax return. The CDI approved this agreement on September 20, 2011. For 2016, 2017, 2018, and 2021, the total federal income taxes paid by the Company were \$11,021, \$83,253, \$70,000, and \$282,719, respectively.

For the years 2019 and 2020, the Company was included in the consolidated federal income tax return filing. However, the federal income tax liability was not settled among the parties nor reported on the Company's 2019 and 2020 annual statement, and did not comply with the settlement terms of the agreement. The Company acknowledged the non-compliance to the terms of the agreement and corrected the action in 2021.

TERRITORY AND PLAN OF OPERATION

The Company markets its home warranty business to consumers solely in the state of California primarily through real estate agents and brokers. California consumers also have the option of purchasing the products directly from the Company. The products consist of home service agreements for both buyers and sellers, covering breakdown of certain mechanical systems and appliances, such as: built-in appliances, central heating, plumbing and central air conditioning systems, and other optional items, including but not limited to swimming pools and spas, for a period ranging from one to three years with available renewal options. For 2016, 2017, 2018, 2019, 2020, and 2021, the Company's direct premiums were \$1,556,971, \$1,677,978, \$1,621,588, \$1,965,467, \$2,357,441, and \$2,307,256, respectively.

ACCOUNTS AND RECORDS

During the course of the examination, a review was made of the Company's premium tax filings. It was noted that the reported direct premium on the 2020 premium tax return did not match the \$2,357,441 direct premiums written as reported on the 2020 annual statement schedule T. This error resulted in an understatement of taxable premiums by \$436,104. As a result of this discrepancy, the 2020 premium tax liability was understated by \$10,246. It is recommended that the Company amend its 2020 premium tax return with the California Department of Insurance and establish necessary procedures to ensure accuracy of the future premium tax filing.

FINANCIAL STATEMENTS

The following financial statements are based on the statutory financial statements filed by the Company with the California Department of Insurance and present the financial condition of the Company for the period ending December 31, 2021. The accompanying comments on financial statements reflect any examination adjustments to the amounts reported in the annual statements and should be considered an integral part of the financial statements.

Statement of Financial Condition as of December 31, 2021

Underwriting and Investment Exhibit for the Year Ended December 31, 2021

Reconciliation of Surplus as Regards Contract Holders from December 31, 2015
through December 31, 2021

Analysis of Changes to Surplus as of December 31, 2021

Statement of Financial Condition
as of December 31, 2021

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 2,506,292	\$	\$ 2,506,292	
Cash and short-term investments	604,930		604,930	
Home protection contract fees receivable	1,319,034		1,319,034	
Interest, dividends and real estate income due and accrued	12,000		12,000	
Other assets	<u>81,421</u>		<u>81,421</u>	
Total assets	<u>\$ 4,523,677</u>	<u>\$</u>	<u>\$ 4,523,677</u>	
Liabilities, Surplus and Other Funds				
Claims adjusted and unpaid or in process of adjustment			\$ 77,597	(1)
Other expenses			352,481	
Tax, licenses and fees			(443)	
Current federal income taxes			121,103	
Unearned home protection contract fees			<u>1,982,071</u>	(2)
Total liabilities			2,532,809	
Common capital stock		\$ 200,000		
Gross paid-in and contributed surplus		964,912		
Unassigned funds (surplus)		<u>825,956</u>		(3)
Surplus as regards contract holders			<u>1,990,868</u>	(3)
Total liabilities and surplus			<u>\$4,523,677</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2021

Statement of Income

Underwriting Income		
Home protection contract fees earned		\$ 2,187,261
Deductions:		
Claims incurred	\$ 1,053,003	
Claims service expense incurred	199,209	
Other underwriting expenses incurred	<u>603,204</u>	
Total underwriting deductions		<u>1,855,416</u>
Net underwriting loss		331,845
Investment Income		
Net investment income earned	\$ 49,470	
Net realized capital gain	<u>2,359</u>	
Net investment gain		51,829
Other Income		
Total other income		<u>163,375</u>
Net income before federal income taxes		547,049
Federal income taxes incurred		<u>147,744</u>
Net loss		<u>\$ 399,305</u>

Capital and Surplus Account

Surplus as regards contract holders, December 31, 2020		\$ 2,001,817
Net loss	\$ 399,305	
Change in nonadmitted assets	(23,792)	
Other gains or losses in surplus:		
Change in deferred tax assets	6,661	
Correction of prior year error	61,037	
Change in examination adjustments	(453,774)	
Miscellaneous	<u>(386)</u>	
Change in surplus as regards contract holders for the year		<u>(10,949)</u>
Surplus as regards contract holders, December 31, 2021		<u>\$ 1,990,868</u>

Reconciliation of Surplus as Regards Contract Holders
from December 31, 2015 through December 31, 2021

Surplus as regards contract holders, December 31, 2015	\$ 2,371,507
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	Gain in Surplus	Loss in Surplus
Net income	\$ 1,676,059	\$
Change in net deferred income tax	81,421	
Change in nonadmitted assets		21,965
Change in examination adjustments		453,774
Capital changes: paid-in	153,500	
Dividends to stockholders		1,706,565
Change in prior year error		109,315
Total gains and losses	\$ 1,910,980	\$ 1,837,845

Net decrease in surplus as regards contract holders	(380,639)
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Surplus as regards contract holders, December 31, 2021	\$ 1,990,868
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Analysis of Changes to Surplus as of December 31, 2021

As a result of the examination, the following adjustments were made to the Company's reported balance sheet and income statement items. The liability for unearned home protection contract fees was understated because the Company did not comply with California Insurance Code Section 12753 when calculating its unearned home protection contract fees. The sum of the effect was the decrease of the surplus by \$453,774 as shown below:

Surplus as regards policyholders, December 31, 2021, per Annual Statement		\$ 2,444,642
	<u>Increase</u>	<u>Decrease</u>
Unearned home protection contract fees		453,774
Net (decrease)		<u>(453,774)</u>
Surplus as regards policyholders, December 31, 2021, after adjustment		<u>\$ 1,990,868</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Claims Adjusted and Unpaid or in Process of Adjustment

Claims related to home warranty contracts are generally paid within a short period of time after the repairs are made. The Company does not utilize an actuary to determine reserves. The Company estimated the reserves based on the total number of outstanding claim types by system and the estimated severity for that system type by the observed historical amounts and then subtract the paid amounts to get the accrued amount at period end. The examination team reviewed the year-end reserve analysis and deemed the reserving methodology to be adequate.

(2) Unearned Home Protection Contract Fees

California Insurance Code (CIC) Section 12753 requires a home protection company maintain a reserve for unearned premiums in an amount not less than 40 percent of the aggregate premiums charged on its contracts currently in force. Amounts to be reserved shall be on a 12-month basis. Where the contract is for a period of more than 12 months, the reserve for unearned premiums for the period beyond 12 months shall be 100 percent of the pro rata portion of the contract fee attributable to the period of coverage in excess of 12 months.

The Company applied the 40 percent requirement to all contracts in force, including contracts having a term greater than 12-months. As a result, the unearned home protection contract fees were understated by \$453,774. An examination adjustment of \$453,774 was made to the line item. Surplus as Regards Contract Holder decreased by the same amount to reflect the adjustment made. It is recommended that the Company calculate and report its unearned home protection contract fee reserves in accordance with CIC Section 12753.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Accounts and Records – Premium Tax (Page 6): It is recommended that the Company amend its 2020 premium tax return with the California Department of Insurance and establish necessary procedures ensuring accuracy of the future premium tax filing.

Unearned Home Protection Contract Fees (Page 12): It is recommended that the Company calculate and report its unearned home protection contract fee reserves in accordance with California Insurance Code (CIC) Section 12753.

Previous Report of Examination

Accounts and Records – It was recommended that the Company file the agreement in accordance with CIC Section 1215.5(b)(4). The Company has complied with this recommendation.

ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

Ralph Oseguera, CFE
Examiner-In-Charge
Senior Insurance Examiner, Supervisor
Department of Insurance
State of California

Vivien Fan, CFE
Bureau Chief
Department of Insurance
State of California