REPORT OF EXAMINATION

OF THE

HERITAGE INDEMNITY COMPANY

AS OF

DECEMBER 31, 2014

Dave Jones

Insurance Commissioner

FILED 3-17-16

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Los Angeles, California
February 12, 2016

Honorable Dave Jones
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

HERITAGE INDEMNITY COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 7125 West Jefferson Avenue, Suite 200, Lakewood, Colorado 80235. The Company's statutory home office is located at 23 Pasteur, Irvine, California 92618.

## SCOPE OF EXAMINATION

We have performed our multi-state examination of the Company. The previous examination of the Company was made as of December 31, 2010. This examination covers the period from January 1, 2011 through December 31, 2014. The examination was conducted in accordance with the National Association of Insurance Commissioners *Financial Condition Examiners' Handbook* (*Handbook*). The Handbook requires the planning and performance of the examination to evaluate the Company's financial condition, assess corporate governance, identify current and prospective risks, and evaluate system controls and procedures used to mitigate those risks. The examination also includes identifying and evaluating significant risks that could cause an insurer's surplus to be materially misstated both currently and prospectively.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process. This may include assessing significant estimates made by management and evaluating management's compliance with Statutory Accounting Principles. The examination does not attest to the fair presentation of the financial statements included herein. If an adjustment was identified during the course of the examination, the impact of such adjustment will be documented separately following the Company's financial statements.

This examination report includes significant 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

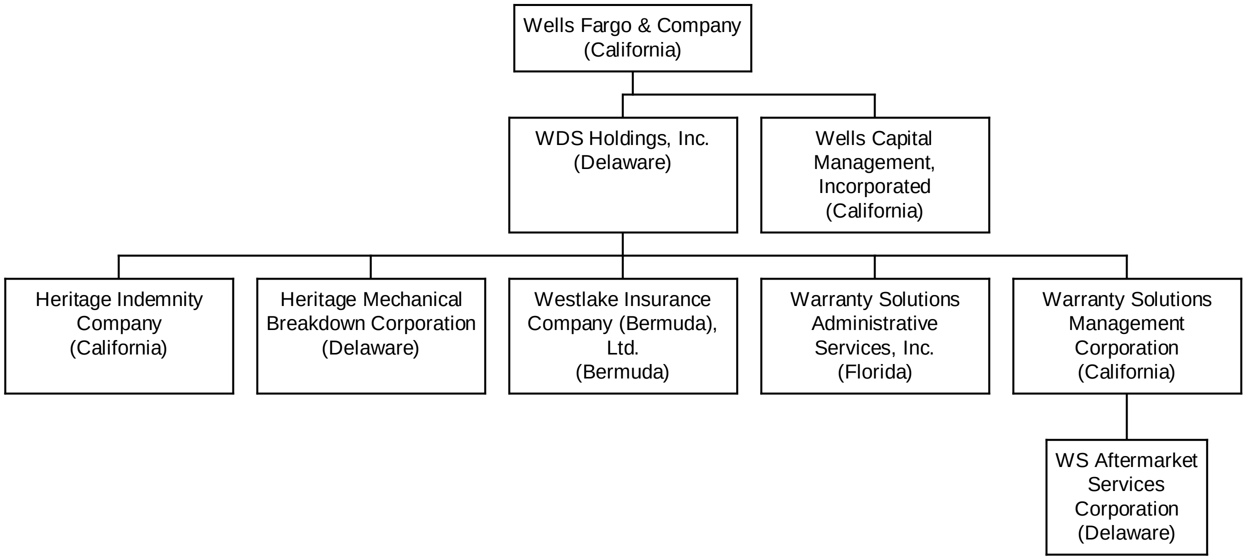
On May 1, 2012, the Company's former parent WDSI, LLC, was merged into WDS Holdings Inc., a Delaware company.

### Dividends Paid to Parent

On September 30, 2014, the Company paid an extraordinary cash dividend of $60 million to its parent, WDS Holdings, Inc., which was approved by the California Department of Insurance (CDI) on September 18, 2014. The Company accounted for the dividend by charging $40,035,817 to unassigned funds, and $19,964,183 to paid in capital as a return on investment.

## MANAGEMENT AND CONTROL

The following abridged organizational chart depicts the Company's relationship within the holding company system (all ownership is 100%):




The six members of the 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, 2014:

## Directors

| Name and Location | Principal Business Affiliation |
|---|---|
| Jeffrey R. Fleischer[a]<br>Littleton, Colorado | Chief Actuary<br>Warranty Solutions and Heritage Indemnity Company |
| Dawn Marie Martin Harp[a]<br>Dana Point, California | Head of Dealer Services and Executive Vice President<br>Wells Fargo Bank, N.A. |
| William J. Katifias[a]<br>Ladera Ranch, California | Dealer Services National Production Manager and Executive Vice President<br>Wells Fargo Bank, N.A. |
| John K. Palmer[a]<br>Trabuco Canyon, California | Dealer Services Financial Manager and Senior Vice President<br>Wells Fargo Bank, N.A. |

| Name and Location | Principal Business Affiliation |
|---|---|
| Adam S. Pope<br>Littleton, Colorado | President<br>Warranty Solutions and Heritage Indemnity Company |
| Jonathan J. Wilmot[(a)]<br>Littleton, Colorado | Operations Leader<br>Warranty Solutions and Heritage Indemnity Company |

The Company's by-law states that the board members shall be no less than seven and no more than fifteen. It was noted and brought to the Company's attention, that the Company did not have the proper number of board members during the years under review. Subsequently, in 2015, the Company added Chief Financial Officer, Shawn J. O'Keefe, to the board.

## Principal Officers

| Name | Title |
|---|---|
| Adam S. Pope | President |
| Shawn J. O'Keefe[(c)] | Chief Financial Officer |
| Jay H. Berman[(b)] | Secretary and Vice President |
| Guy S. DuBose[(c)] | Assistant Secretary |
| Jeffrey R. Fleischer[(c)] | Assistant Secretary and Chief Actuary |
| Thomas J. Lari[(c)] | Senior Vice President |
| John K. Palmer[(c)] | Senior Vice President |
| David E. Haggard[(c)] | Tax Manager and Vice President |
| Sean P. Hauptman[(c)] | Treasurer |
| Jonathan J. Wilmot[(c)] | Vice President |

The following changes in management occurred on September 25, 2015, subsequent to the examination date:

(a) Jeffrey R. Fleischer, William J. Katafias, Dawn Marie Martin Harp, John K. Palmer, and Jonathan J. Wilmot have been replaced as Board members with Stuart D. Hollander, Adam Z. Karkowsky, Barry W. Moses, Harry C. Schlachter, and Stephen B. Ungar.

(b) Jay H. Berman is no longer Company Secretary and Vice President, but serves as Assistant Secretary

(c) Guy S. DuBose, Jeffrey R. Fleischer, David E. Haggard, Sean P. Hauptman, Thomas J. Lari, Shawn J. O'Keefe, John K. Palmer, and Jonathan J. Wilmot have been replaced as Officers of the Company by: Harry C. Schlachter, Treasurer; Stephen B. Ungar, Secretary; Stuart D. Hollander, Vice President; Barry W. Moses, Vice President, Regulatory Compliance and Assistant Secretary; Stephen Brandt, Vice President; and Jeffrey Mayer, Chief Actuary.

Management Agreements

Tax Sharing Agreement: Effective November 1, 2012, the Company amended its Tax Sharing Agreement to include its ultimate parent, Wells Fargo and Company (WFC), and to update various other affiliate legal entity names. This agreement is for the purpose of filing federal income tax returns on a consolidated basis. Under this Agreement, the tax liability of the Company and its affiliates will be computed as if each member filed a separate stand-alone return. WFC is the party primarily responsible for filing and making all tax payments on behalf of the Company and its subsidiaries. The amendment was approved by the California Department of Insurance (CDI) on October 11, 2012.

Investment Agreements: Effective April 1, 2012, the Company entered into an Investment Management and Services Agreement with Wells Capital Management, Inc. (WCM), an affiliated company. This agreement is for the purpose of managing the Company's investment portfolio by WCM. Fees paid by the Company were $230,624, $310,620, and $288,828 for 2012, 2013, and 2014 respectively. The agreement was approved by the CDI on December 16, 2011.

WCM utilizes Clearwater Analytics, LLC (Clearwater), a third party vendor, to perform the accounting recordkeeping on investments. As such, the Company entered into a Master Agreement with Clearwater, effective December 31, 2011, for ensuring consistent statutory accounting information for reporting purposes. Fees paid by the Company were $21,640, $20,804, and $18,737 for 2012, 2013, and 2014 respectively.

The Company amended its Clearwater Master Agreement, effective September 3, 2014, to allow a daily File Transfer Protocol be processed by an affiliate company to perform credit risk service on the Company's portfolio.

Services and Shared Expense Allocation Agreement: Effective January 1, 2013, the Company entered into Services and Shared Expense Allocation Agreement with WFC, its ultimate parent, and its affiliates: Warranty Solutions Administrative Services, Inc., WS Aftermarket Services Corporation, Heritage Mechanical Breakdown Corporation, Westlake Group, Ltd., Westlake Insurance Company (Bermuda), Ltd., WDS Holdings, Inc., and Wells Fargo Bank, NA.

Services provided include: data processing and related services, services pertaining to communications, marketing, public relations, advertising and sales promotion services, human resources and personnel services, accounting and tax services, legal services, purchasing services, administration of agent and agency services, actuarial services, underwriting services, and claim services. Compensation for providing the services shall be based on actual cost without a profit factor being built into that cost. The indirect and shared expenses shall be allocated in accordance with a method of cost allocation in conformity with Statement of Statutory Accounting Principles (SSAP) No. 70 paragraph 6. SSAP No. 70, paragraph 6 states that expense allocation should be based on a method that yields the most accurate results. Where specific identification is not feasible, allocation of expenses should be based upon pertinent factors or ratios such as studies of employee activities, salary ratios or similar analyses.

Charges are presented at least annually and are due within 30 days following the end of the month of receipt of notice. The fees paid by the Company were $9,520,145 and $9,208,903 for 2013 and 2014, respectively. The agreement was approved by the CDI on July 6, 2012.

## TERRITORY AND PLAN OF OPERATION

The Company primarily insures vehicle service contracts administered and marketed by affiliated companies through automobile dealers and original equipment manufacturers throughout the United States. As of December 31, 2014, the Company was licensed in all 50 states and the District of Columbia.

In 2014 the Company wrote $75.1 million of direct premiums. The top five states by premiums are listed below:

| State | Amount | Percentage |
|---|---|---|
| California | $11 million | 14.7% |
| Georgia | $5.6 million | 7.5% |
| New York | $4.5 million | 6.0% |
| Texas | $4.4 million | 5.8% |
| Virginia | $3.8 million | 5.1% |
| All other States | $45.8 million | 60.9% |

## REINSURANCE

### Assumed

The Company assumes an insignificant amount of business, only $2,000, as compared to its direct writings of $75.1 million. The assumed business is from Aria (Sac), Ltd., a Bermuda based insurance company.

### Ceded

The Company entered into a 100% quota-share agreement, effective March 1, 1984, and amended on October 25, 2004, with its affiliate, Westlake Insurance Company (Bermuda), Ltd. (Westlake), whereby the ceding commission was amended from 10% to 0% for service contract liability insurance policies written on or after January 1, 2004 as specified in the agreement. During 2014, the Company ceded $28.2 million in premiums to Westlake or approximately 37.6% of the Company's direct business of

$75.1 million.  The agreement was approved by the California Department of Insurance on June 18, 1996, in accordance with California Insurance Code Section 1215.5(c).

## ACCOUNTS AND RECORDS

During the course of the examination, a review was made of the Company's general controls over its information systems.  As a result of this review, some findings were noted and were presented to the Company along with recommendations to strengthen its controls.  The Company should evaluate the recommendations and make appropriate changes to strengthen its information systems controls.

## 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, 2014. No adjustments were made to the statutory financial statements filed by the Company.

Statement of Financial Condition as of December 31, 2014

Underwriting and Investment Exhibit for the Year Ended December 31, 2014

Reconciliation of Surplus as Regards Policyholders from December 31, 2010 through December 31, 2014

<u>Statement of Financial Condition</u>
<u>as of December 31, 2014</u>

| Assets | Ledger and Nonledger Assets | Assets Not Admitted | Net Admitted Assets | Notes |
|---|---|---|---|---|
| Bonds | $ 132,925,889 | $ | $ 132,925,889 | |
| Cash and short-term investments | 5,591,395 | | 5,591,395 | |
| Receivable for securities | 340,040 | | 340,040 | |
| Investment income due and accrued | 1,366,444 | | 1,366,444 | |
| Net deferred tax asset | 7,156,163 | 503,309 | 6,652,854 | |
| Receivables from parent, subsidiaries and affiliates | 4,635,669 | | 4,635,669 | |
| Aggregate write-ins for other than invested assets | 139,467 | 139,467 | | |
| Total assets | $ 152,155,067 | $ 642,776 | $ 151,512,292 | |
| <u>Liabilities, Surplus and Other Funds</u> | | | | |
| Losses and loss adjustment expenses | | | $ 1,205,977 | (1) |
| Other expenses | | | 16,360 | |
| Taxes, licenses and fees | | | 701,651 | |
| Current federal and foreign income taxes | | | 6,994 | |
| Unearned premiums | | | 95,984,169 | (1) (2) |
| Payable to parent, subsidiaries and affiliates | | | 1,961,738 | |
| Total liabilities | | | 99,876,889 | |
| Common capital stock | | $ 3,000,000 | | |
| Gross paid-in and contributed surplus | | 40,784,907 | | |
| Unassigned funds (surplus) | | 7,850,495 | | |
| Surplus as regards policyholders | | | 51,635,402 | |
| Total liabilities, surplus and other funds | | | $ 51,512,292 | |

## Underwriting and Investment Exhibit
## for the Year Ended December 31, 2014

### Statement of Income

| | | |
|---|---|---|
| **Underwriting Income** | | |
| Premiums earned | | $ 47,730,030 |
| Deductions: | | |
| Losses and loss expenses incurred | $ 35,281,722 | |
| Other underwriting expenses incurred | 11,455,740 | |
| Total underwriting deductions | | 47,037,462 |
| Net underwriting loss | | 692,568 |
| **Investment Income** | | |
| Net investment income earned | $ 5,085,172 | |
| Net realized capital gain | 673,906 | |
| Net investment gain | | 5,759,078 |
| **Other Income** | | |
| Net income before dividends to policyholders, after capital gains tax and before federal and foreign income taxes | | 6,451,646 |
| Federal and foreign income taxes incurred | | 1,211,665 |
| Net income | | $ 5,239,981 |

### Capital and Surplus Account

| | | |
|---|---|---|
| Surplus as regards policyholders, December 31, 2013 | | $ 112,599,765 |
| Net income | $ 5,239,981 | |
| Change in net deferred income tax | 308,592 | |
| Change in nonadmitted assets | 957,733 | |
| Surplus adjustments: | | |
| Paid-in | (19,964,183) | |
| Dividends to stockholders | (40,035,817) | |
| Aggregate write-ins for losses in surplus | (7,470,668) | |
| Change in surplus as regards policyholders for the year | | (60,964,363) |
| Surplus as regards policyholders, December 31, 2014 | | $ 51,635,402 |

## Reconciliation of Surplus as Regards Policyholders from December 31, 2010 through December 31, 2014

| | Gain in Surplus | Loss in Surplus | |
|---|---|---|---|
| Surplus as regards policyholders, December 31, 2010 per Examination | | | $ 84,666,450 |
| Net income | $ 30,461,192 | $ | |
| Net unrealized capital gains | 2,167 | | |
| Change in net deferred income tax | | 1,353,646 | |
| Change in non-admitted assets | 4,946,973 | | |
| Change in provision for reinsurance | 5,000 | | |
| Surplus adjustments: Paid-in | | 19,964,183 | |
| Dividends to stockholders | | 40,035,817 | |
| Aggregate write-ins for gains and losses in surplus | | 7,092,703 | |
| Total gains and losses | $ 35,415,302 | $ 68,446,349 | |
| Net decrease in surplus as regards policyholders | | | (33,031,047) |
| Surplus as regards policyholders, December 31, 2014 | | | $ 51,635,403 |

## COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses
Unearned Premiums

Based on the analysis by a Casualty Actuary from the California Department of Insurance, the Company's Losses and Loss Adjustment Expense and Unearned Premiums reserves as of December 31, 2014 were found to be reasonably stated and have been accepted for purposes of this examination.

(2) Unearned Premiums

The Company changed its method of accounting for ceded unearned premiums from the pro rata/reverse rule basis to the loss incidence basis, which is the method used for direct unearned premiums. On January 1, 2014, the Company recorded the effects of the change in method of accounting by increasing unearned premiums and decreasing statutory surplus by $7,814,502.

## SUBSEQUENT EVENTS

On June 4, 2015, AmTrust Financial Services, Inc. (AFSI) submitted a Form A filing to California Department of Insurance (CDI) regarding the proposed acquisition of the Company. The CDI approved the Form A filing on September 18, 2015. On September 25, 2015, AmTrust Financial Services, Inc. acquired the Company, a Wells Fargo business, for $54 million in cash.

On March 3, 2016, the Company filed with the National Association of Insurance Commissioners Uniform Certificate of Authority Application Corporate Amendments Application to move its statutory home office to 17771 Cowan, Suite 100, Irvine, California 92614.

On June 30, 2015, the Company paid an extraordinary cash dividend of $15 million to its parent, WDS Holdings, Inc., which was approved by the CDI on June 19, 2015. The Company accounted for the dividend by charging $15 million to gross paid in and contributed surplus.

On September 25, 2015, the Company filed the following agreements with the CDI which are pending approval: (a) Intercompany Reinsurance Agreement between the Company and AmTrust International Insurance, Ltd., and (b) Intercompany Management Agreement between the Company and AFSI.

On December 29, 2015, the CDI approved a Tax Allocation Agreement between the Company and AFSI with an effective date of September 25, 2015.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Accounts and Records – (Page 8): As a result of the review of the Company's information systems controls, recommendations for improving these controls were presented to the Company. The Company should evaluate these recommendations and make appropriate changes to strengthen its controls over its information systems.

### Previous Report of Examination

Management and Control – Management Agreements – Tax-Sharing Agreement (Page 5): It was recommended that the Company amend its Tax-Sharing Agreement to reflect its current ultimate parent, Wells Fargo and Company. The Company has complied with this recommendation.

## ACKNOWLEDGMENT

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

Respectfully submitted,

Thomas Podsiadlo, CFE,
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California

Grace Asuncion, CFE
Senior Insurance Examiner, Supervisor
Department of Insurance
State of California