

REPORT ON EXAMINATION
OF THE
NOVA CASUALTY COMPANY
AS OF
DECEMBER 31, 2002

DATE OF REPORT

AUGUST 10, 2005

EXAMINER

RALPH BASIT

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STATE OF NEW YORK
INSURANCE DEPARTMENT
25 BEAVER STREET
NEW YORK, NEW YORK 10004

August 10, 2005

Honorable Howard Mills
Superintendent of Insurance
Albany, NY 12257

Sir:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 22056, dated June 6, 2003, attached hereto, I have made an examination into the condition and affairs of the Nova Casualty Company as of December 31, 2002, and submit the following report thereon.

Whenever the designations "Company", "NCC" or "NOVA" appear herein without qualification, they should be understood to indicate the Nova Casualty Company. "NAGI" refers to Nova American Group, Inc., Nova Casualty Company's parent.

The examination was conducted at the Company's home office located at 180 Oak Street, Buffalo, New York 14203.

Wherever the term "Department" appears herein without qualification it should be understood to indicate the New York Insurance Department.

1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 1998. This examination covered the four-year period from January 1, 1999 through December 31, 2002. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

The examination comprised a complete verification of assets and liabilities as of December 31, 2002, a review of income as deemed necessary to accomplish such verification and utilized, to the extent considered appropriate, work performed by the Company's independent certified public accountants. A review or audit was also made of the following items as called for in the Examiners Handbook of the National Association of Insurance Commissioners:

- History of Company
- Management and control
- Corporate records
- Fidelity bonds and other insurance
- Territory and plan of operation
- Growth of Company
- Reinsurance
- Accounts and records
- Financial statements
- Market conduct activities

A review was also made to ascertain what action was taken by the Company with regard to comments and recommendations in the prior report on examination. This report on examination is confined to financial statements and comments on those matters which involve departures from laws, regulations or rules, or which are deemed to require explanation or description.

2. DESCRIPTION OF COMPANY

The Company was incorporated under the laws of the State of New York on September 13, 1979, as the First Security Insurance Corporation and became licensed to transact insurance business effective July 18, 1980. On December 30, 1988, the present name, Nova Casualty Company, was adopted.

Capital paid up at December 31, 2002 was \$2,500,500, which consisted of 8,335 shares of common stock at \$300 par value per share issued and outstanding. Gross paid in and contributed surplus amounted to \$10,870,945 at December 31, 2002. In 1995, the Company issued surplus notes to its immediate parent, Nova American Group, Inc. ("NAGI") in the amount of \$2,000,000, pursuant to the provisions of Section 1307 of the New York Insurance Law. During 2000, the surplus note was converted to paid in and contributed surplus with the approval of the Department. In addition, NAGI contributed \$750,000 and \$3,500,000 of additional paid in surplus to the Company in 2001 and 2002, respectively.

A. Management

Pursuant to the Company's charter and by-laws, management of the Company is vested in a board of directors consisting of fourteen members. The board met at least five times during each calendar year of the examination period.

The Company's directors as of December 31, 2002, were as follows:

| <u>Name and Residence</u> | <u>Principal Business Affiliation</u> |
|---|---------------------------------------|
| Harsha Acharya East Amherst, NY | President, NOVA Casualty Company |
| Frank C. Ernst Williamsville, NY | President, United Import Motors |
| Helen M. Ernst Williamsville, NY | None |
| Jacqueline A. Ernst Orchard Park, NY | None |

| <u>Name and Residence</u> | <u>Principal Business Affiliation</u> |
|--|--|
| Norman F. Ernst, Jr. Orchard Park, NY | Chairman, NOVA Casualty Company |
| Gordon R. Gross Amherst, NY P.C. | Senior Partner, Gross, Shuman, Brizdle & Gilfillan, |
| Paul J. Harder Lakeview, NY | Chairman, Devon Publishing Group |
| Jeffrey B. Harvey Snyder, NY | Vice President, Janney, Montgomery, Scott, LLC |
| Herbert J. Heimerl, Jr. Williamsville, NY | Partner, Harris, Beach, Attorneys at Law |
| William N. Hudson, Jr. Williamsville, NY | President, Hudson Advisor Services, Inc. |
| Arnold C. Keller Amherst, NY | Self-employed |
| Donald F. Newman Clarence, NY | Retired Chairman, NOCO Energy Corp. |
| Reginald B. Newman, II Amherst, NY | Retired Chairman and CEO, NOCO Energy Corp. |
| Thomas J. Scanlon East Amherst, NY | Senior Vice President, M & T Capital Corp. |

The minutes of all the meetings of the board of directors and committees thereof held during the examination period were reviewed.

The Company's by-laws state that the secretary of the Company shall attend all meetings of the board and all meetings of the shareholders. However, the secretary of the Company did not attend any meetings of the board or of the shareholders during the examination period.

It is recommended that the Company comply with its by-laws by having the Company's secretary attend all board and shareholder meetings.

At December 31, 2002, the principal officers of the Company were:

| <u>Name</u> | <u>Title</u> |
|-----------------------|---------------------------------------|
| Norman F. Ernst, Jr. | Chairman and Chief Executive Officer |
| Harsha Acharya | President and Chief Operating Officer |
| Eugene Wahlstrom | Vice President |
| Christopher C. Hoover | Vice President & Treasurer |
| William D. Sheldon | Vice President |
| Rosemary Bravetti | Vice President & Assistant Secretary |
| Robert L. Frailey | Vice President |
| Joseph P. Beitz | Vice President |
| Patricia A. Nolan | Assistant Vice President & Secretary |
| Stuart Capers | Assistant Vice President |
| William D. McKenny | Assistant Vice President |
| Victor T. Ehre | Assistant Vice President |

B. Territory and Plan of Operation

As of December 31, 2002, the Company was licensed to do business in the following twenty-three states and the District of Columbia:

| | | | | |
|----------|-------------|--------------|----------------|---------------|
| Arizona | Indiana | Nevada | Oregon | Utah |
| Arkansas | Iowa | New York | Pennsylvania | Virginia |
| Florida | Louisiana | North Dakota | South Carolina | West Virginia |
| Georgia | Maryland | Ohio | Tennessee | |
| Idaho | Mississippi | Oklahoma | Texas | |

Approximately 34% and 27% of the Company's direct writings in 2002 were concentrated in Florida, and New York, respectively.

The following schedule shows direct premiums written in New York State as a percentage of those written countrywide during the period under examination:

DIRECT PREMIUMS WRITTEN

| <u>Calender Year</u> | <u>New York State</u> | <u>Total United States</u> | <u>Percentage of New York Premiums Written in United States</u> |
|----------------------|-----------------------|--------------------------------|---|
| 1999 | \$ 6,746,032 | \$ 30,443,975 | 22.16% |
| 2000 | \$ 7,441,864 | \$ 31,903,588 | 23.33% |
| 2001 | \$ 9,324,913 | \$ 36,935,803 | 25.25% |
| 2002 | \$ 14,359,713 | \$ 52,589,153 | 27.31% |

As of December 31, 2002, the Company was licensed to transact the kinds of insurance as defined in the following numbered paragraphs of Section 1113(a) of the New York Insurance Law:

| <u>Paragraph</u> | <u>Kind of Insurance</u> |
|------------------|--|
| 3 | Accident and health |
| 4 | Fire |
| 5 | Miscellaneous property damage |
| 6 | Water damage |
| 7 | Burglary and theft |
| 8 | Glass |
| 12 | Collision |
| 13 | Personal injury liability |
| 14 | Property damage liability |
| 15 | Workers' compensation and employers' liability |
| 16 | Fidelity and surety |
| 19 | Motor vehicle and aircraft physical damage |
| 20 | Inland marine |

In addition, the Company is licensed to transact such workers' compensation insurance as may be incident to coverages contemplated under paragraph 20 of Section 1113(a) of the New York Insurance Law, including coverages described in the Longshoremen's and Harbor Workers' Compensation Act (Public law no. 803, 69th Congress, as amended; 33 USC Section 901 et.seq. as amended).

Based upon the kinds of insurance for which the Company is licensed, and the Company's current capital structure, and pursuant to the requirements of Articles 13 and 41 of the New York Insurance Law,

Nova Casualty Company is required to maintain a minimum surplus to policyholders in the amount of \$2,500,500.

During the current examination period the Company continued to experience significant growth in the commercial multiple peril line of business. During calendar year 2002, the commercial multiple peril line of business accounted for 67.3% of the Company's direct writings.

Nova American Group, Inc. (d.b.a Brokers' Marketplace) is the Company's managing general agent in New York and servicing agent in all other states other than Arizona, Florida, Georgia, Nevada, Maryland and Pennsylvania. By virtue of its relationship with NAGI, the Company is considered a producer controlled insurer per Department Regulation 52-A. General and independent agents are used in the latter six states.

At December 31, 2002, the Company maintained branch offices for the purpose of marketing and underwriting in Miami, Florida, Tempe, Arizona and Atlanta, Georgia. In 1999, the Company closed its office in Altamonte Springs, Florida. In July 2003, subsequent to the exam period, the Company closed its office in Tempe, Arizona.

C. Reinsurance

The Company did not assume any business during the four-year period of this examination.

The data contained in Schedule F of the Company annual statements filed for the years within the examination period was found to accurately reflect its reinsurance transactions.

All reinsurance contracts effected during the examination period were reviewed. Except as noted below, all contracts were found to contain the necessary clauses required by statute, including the insolvency clause required by Section 1308 of the New York Insurance Law. All contracts were with authorized companies.

The Company had the following reinsurance program in effect at December 31, 2002:

| <u>Type of Contract</u> | <u>Business Covered</u> | <u>Limits</u> |
|--|--|--|
| Property Quota Share | Commercial Multiple Peril Property | 35% of the Company's gross retention up to \$1,000,000 per risk. |
| Multi-line Excess of Loss 2 layers | Property & Casualty: Excluding Surety, Travel, and business written by RBL General Agency | \$1,125,000 excess of \$75,000 per risk for property. \$1,125,000 excess of \$75,000 per policy per occurrence for casualty. Maximum \$675,000 per occurrence for property or casualty (1 st Layer). Maximum \$2,700,000 per occurrence for property or casualty (2 nd Layer). |
| Property Facultative Excess of Loss Binding Agreement | Commercial Property and Inland Marine | Five (5) times the minimum Company retention each risk, each occurrence subject to a maximum limit for ultimate net loss of \$5,000,000 each risk, each occurrence. As respects Inland Marine and Automobile Physical Damage coverage, five (5) times the minimum Company retention each risk, each occurrence subject to a maximum limit for ultimate net loss of \$250,000 each risk, each occurrence. As respects risks located on Long Island, New York, five (5) times the minimum Company retention each risk, each occurrence subject to a maximum limit for ultimate net loss of \$100,000 each risk, each occurrence. |

| <u>Type of Contract</u> | <u>Business Covered</u> | <u>Limits</u> |
|---|---|---|
| Multi-line Excess of Loss | Property & Casualty business underwritten by RBL General Agency | \$850,000 excess of \$150,000 ultimate net loss per risk for property or per policy per occurrence for casualty. Maximum recovery \$2,550,000 per occurrence. |
| Commercial Umbrella Liability Quota Share | Commercial Umbrella Liability & Excess Liability policies | 95% of the Company's net loss as respects the first \$1,000,000 for each occurrence. 100% of the Company's net loss for amounts in excess of \$1,000,000 from each occurrence up to but not exceeding \$5,000,000 each policy. |
| Surety Excess of Loss | Surety | 90% of \$1,125,000 ultimate net loss in excess of \$125,000 each principal. Annual aggregate limit of 90% of \$2,250,000 ultimate net loss with respect to all losses discovered for any one agreement year, regardless of the number of principals. |
| Equipment Breakdown | Equipment breakdown liability | 100% cession. Reinsurer's liability not to exceed \$25,000,000 for any one accident. |
| Quota Share Reinsurance Fronting Arrangements | Travel accident and sickness and trip cancellation business | 100% quota share of original limits up to \$150,000 any one insured person and \$1,500,000 any one accident in the aggregate. |

Effective January 1, 1998, the Company entered into a multi-year aggregate stop loss reinsurance agreement with American Re-Insurance Company, an authorized reinsurer, covering all lines of business written by the Company. This reinsurance coverage provides protection when the Company's

aggregate accident year loss ratio exceeds 70%, for each accident year covered by this contract. Recoveries under this contract were limited to \$2,000,000 per accident year with a \$4,000,000 aggregate limit for all accident years covered. On January 1, 2001, the Company commuted the portion of the agreement for accident years 1998 and 1999. As a result of the commutation, the Company received \$900,000 for re-assuming \$1,156,000 in outstanding losses. The accident year 2000 stop loss reinsurance agreement is still effective as of the examination date. However, recoveries were limited to \$500,000 per accident year, and in the aggregate.

In 2001, the Company changed its primary property and casualty reinsurer, and its multi-line excess of loss reinsurer from American Re-Insurance Company to Motors Insurance Corporation.

The following are the net retention and limit of the Company's primary reinsurance contract and the multi-line excess of loss changes during the examination period:

| | <u>Retention</u> | <u>Limit</u> |
|-----------|------------------|--------------|
| 1999-2000 | \$150,000 | \$1,000,000 |
| 2000-2001 | \$75,000 | \$1,200,000 |
| 2001-2002 | \$75,000 | \$1,200,000 |

In 2002, the Company terminated its property surplus & quota share treaty and first and second multi-line excess of loss treaties with Motors Insurance Corporation on a runoff basis and replaced them with a quota share treaty and first and second multi-line excess treaties with slight term changes. The reinsurer remained unchanged.

Subsequently, the Company terminated its 2002 first and second multi-line excess of loss treaties and quota share treaty on a cutoff basis and replaced them with new treaties which changed terms and increased the net retention of its multi-line excess of loss treaty to \$150,000.

The following deficiencies were noted with regards to the reinsurance contracts effective in 2002:

- The arbitration clause contained in the property facultative excess of loss binding agreement with American Re-Insurance Company and the equipment breakdown reinsurance agreement with Hartford Steam Boiler did not specifically mention that the arbitration will be governed by the laws of the State of New York as required by the Department. Subsequent to the completion of this examination, the agreements were amended to state that the arbitration will be governed by the laws of the State of New York.
- The offset clauses included in the quota share reinsurance agreement with Motors Insurance Corp. regarding the travel program, the property facultative excess of loss binding agreement with American Re-Insurance Company, the commercial umbrella liability quota share reinsurance agreement with American Re-Insurance Company and the surety excess of loss reinsurance agreement with American Re-Insurance Company allowed for broad rights to offset. In reinsurance agreements containing such broad rights of offset, this Department requires that the following language be included:

“In the event of the insolvency of either party to this agreement then offsets shall only be allowed to the extent permitted by the Provisions of Section 7427 of the New York Insurance Law.”

- It is recommended that the Company ensure that the offset clauses included in all reinsurance contracts to which it is a party, which allow for broad rights of offset include the following language:

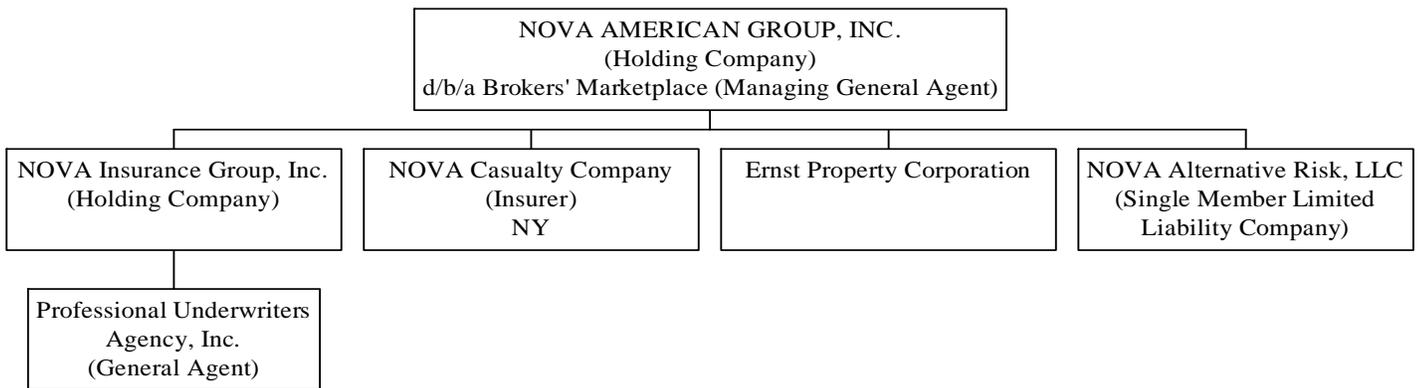
“In the event of the insolvency of either party to this agreement then offsets shall only be allowed to the extent permitted by the provisions of Section 7427 of the New York Insurance Law.”

- The commercial umbrella liability quota share reinsurance agreement with American Re-Insurance Company did not contain an errors and omission provision. Subsequent to the completion of the examination, the agreement was amended to include an errors and omission provision.

D. Holding Company System

The Company is a wholly-owned subsidiary of Nova American Group, Inc. (“NAGI”) d/b/a/ Brokers’ Marketplace, an insurance broker licensed pursuant to Section 2104 of the New York Insurance Law. NAGI acts as the managing general agent of the Company. During the examination period, annual holding company filings were made pursuant to Department Regulation 52.

The following chart depicts the Company in relationship to its affiliates within the holding company system as of December 31, 2002:



American Reinsurance Company, M & T Capital Corporation, NOCO Unlimited and Reginald B. Newman, each of whom own more than ten percent of NAGI have applied for and received designations of non-control pursuant to Section 1501 of the New York Insurance Law.

Control of NAGI is held by Norman Ernst and Frank Ernst, by ownership of 13.98% and 13.04% of NAGI shares, respectively.

The following changes have occurred within the holding company system during the examination period:

Nova (Bermuda) Holding Company, Ltd. (“Nova Bermuda”)

Nova (Bermuda) Holding Company, Ltd. Hamilton, Bermuda was formed under the laws of incorporation of Bermuda by Nova American Group, Inc. as a wholly-owned subsidiary on January 4, 1994. Nova Bermuda was formed as a holding company for NOV American Reinsurance Company, Ltd. On January 18, 1999, Nova Bermuda entered into voluntary liquidation. As a result, NOV American Reinsurance Company, Ltd, which was a wholly-owned subsidiary of Nova Bermuda, became a wholly owned subsidiary of NAGI.

NOV American Reinsurance Company, Ltd. (“NOV American”)

NOV American Reinsurance Company, Ltd. Hamilton, Bermuda was formed under the laws of incorporation of Bermuda as a wholly-owned subsidiary of Nova (Bermuda) Holding Company, Ltd. on January 4, 1994. On January 6, 1994, NOV American Reinsurance Company, Ltd. was registered in Bermuda as an insurer pursuant to Section 13(1) of the Bermuda Insurance Act of 1978. In 2001, NOV American entered into voluntary liquidation.

NOVA Alternative Risk, LLC (“NOVA Alternative”)

NOVA Alternative Risk was organized on October 4, 2000. The sole member of NOVA Alternative is NAGI. NOVA Alternative designs, arranges, and administers self-insurance programs and risk management programs.

As of the examination date, the Company was a party to the following agreements with other members of its holding company system:

General Agency Agreement

Pursuant to this agreement, effective December 21, 1982, as amended, the Company appointed First Security Corporation (now NAGI) d/b/a Brokers’ Marketplace to act as its general agent for business written in the State of New York. The general agent has the authority to receive and accept proposals for insurance and to collect premiums thereon. NAGI remits all premiums written, net of commissions, to the Company on a monthly basis.

By virtue of its relationship with NAGI, the Company is considered a producer controlled insurer per Department Regulation 52-A. Regulation 52-A requires states the following:

“(c) Reporting requirements. The controlled insurer shall annually, on or before April 1, provide to the superintendent: (1) In addition to the loss reserve opinion required to be filed with the annual statement pursuant to section 307 of the insurance law, an opinion by an independent casualty actuary, who shall be a member of the American Academy of Actuaries and in active practice, or by any other independent loss reserve specialist acceptable to the superintendent. The opinion shall report on the adequacy of loss and loss adjustment expense reserves established by the controlled insurer as of the preceding December 31, for each line of insurance on the annual statement for which any business was placed by a controlling producer; and (2) A report, consisting of the following: (i) (a) the amount of premiums on insurance business placed with the controlled insurer by the controlling producer; (b) the amount of commissions, charges or other fees paid by the controlled insurer to the controlling producer during the previous calendar year; and (c) the amounts owed to the controlling producer on the business by line of insurance on the annual statement; and (ii) the percentage that the amount specified in subparagraph (i) of this paragraph represent of the controlled insurer’s net premiums written for each such line of insurance”.

The Company has never filed the reports required by Regulation 52-A. It is recommended that the Company file the reports required by Regulation 52-A.

General Agency Contingent Commission Agreement

In addition to the regular commission as specified in the general agency agreement, a general agency contingent commission agreement, effective December 21, 1982, allows NAGI additional commissions in the event of a favorable loss ratio development. The maximum contingent commission payable in any year is 10% of premiums earned.

Department Regulation 52-A requires the following language in the contingent commission agreement:

“If the contract provides that the controlling producer, on insurance business placed with the insurer, is to be compensated contingent upon the insurer’s profits on that business, then such compensation shall not be determined and paid until at least five years after the premiums on liability insurance are earned and at least one year after the premiums are earned on any other insurance. In no event shall the commissions be paid until the adequacy of the controlled insurer’s reserves on remaining claims has been independently verified”.

The contingent commission agreement did not include the required language. It is recommended that the general agency contingent commission agreement include required language per Regulation 52-A.

Service Agreement

This agreement, effective January 1, 1989, as amended, appointed NAGI d/b/a Brokers’ Marketplace as its general agent for policies written outside of the New York State. Pursuant to this agreement, NAGI is authorized to collect and receive premiums, order Motor Vehicle Reports (“MVR”)

surveys, and underwriting reports necessary to accept underwriting proposals on behalf of the Company. The servicing agreement was amended to also exclude commission on business written in the states of Arizona, Pennsylvania, Georgia, Maryland and Nevada from the service fee calculation. The agreement was also amended to exclude Brokers' Marketplace from the requirement of performing underwriting of proposals in the aforementioned states. In addition, there was an amendment to exclude commission on business written in Florida by the Company through Professional Underwriters Agency, Inc. The terms and conditions are similar to those of the general agency agreement with the exception of the commission arrangement.

Expense Sharing Agreement

This agreement, effective December 21, 1982, provides that NAGI will pay any expenses incurred by NAGI in connection with the solicitation and procurement of business to be placed with the Company, including but not limited to MVR, surveys and underwriting reports, advertising, travel, postage, telephone, auditing, printing, and data processing. Any reimbursement to NAGI by the Company for such expenses will be in the form of commission.

The agreement further provided this, Nova will pay all other costs and expenses associated with Nova's business and operations including, but not limited to, claims adjustment, commissions and brokerage, boards, bureaus and associations, policy form and rate filing approvals, audit of assureds records, preparation of financial, statistical and other reports, salaries, procurement of personnel employee relations and welfare, insurance, directors' fees, printing and stationary, legal fees, taxes, license fees, investment fees, bank charges, and accounting fees.

Additionally, from time to time the Company may request that the employees of NAGI provide services to the Company under the general agency agreement and vice versa. In either case, the party

receiving the service of the employees or the other shall reimburse the other party for the actual expense of such employees.

Sub-lease Agreement

Nova Casualty Company, sub-leases office space at 180 Oak Street, Buffalo, New York, from NAGI under an agreement dated March 18, 1988, as amended. NAGI leases said space from First Insurance Plaza Associates, a New York limited partnership of which Ernst Property Corporation is general partner. Effective January 1, 1998, the term of the sub-lease was extended to December 31, 2007.

Consolidated Restated Federal Income Tax Agreement

Pursuant to this agreement, effective July 2, 1991, the Company files a consolidated federal income tax return with Nova American Group, Inc. and its subsidiaries.

Assignment and Assumption Agreement

Pursuant to this agreement, effective December 31, 1993, the Company assigned all its rights and interests under a license agreement obtained from Strategic Data System to NAGI.

Sub-license Agreement

Effective December 30, 1993, the Company and Nova American Group, Inc., entered into an agreement whereby Nova American Group, Inc. sub-licensed its rights and interests in a software system to the Company. On December 8, 1997, the agreement was amended to extend its term to December 31, 2000. On December 31, 2000, the agreement terminated and the Company exercised its option to purchase all of NAGI's rights and interest in the system.

Section 1307 of the New York Insurance Law Loan Agreement

On November 9, 1995, the Company issued a surplus note to NAGI in the amount of \$2,000,000 pursuant to Section 1307 of the New York Insurance Law. On December 5, 2000, NAGI contributed all of its rights and interests under the loan agreement to the Company as additional surplus.

A review was made of the aforementioned agreements and addenda thereto. Said review indicated that all agreements and addenda thereto had been submitted to and placed on file by this Department pursuant to the requirements of Section 1505(d) of the New York Insurance Law.

Inter-company Reinsurance Agreements

As mentioned previously herein, as of the examination date, American Re-Insurance Company owned in excess of 10% of the Company's ultimate parent, NAGI. However, this Department has determined that American Re-Insurance Company does not control the Company, notwithstanding its equity interest in NAGI. The disclaimer of control was issued with the condition that all direct or indirect transactions between American Re and NAGI, and NAGI's subsidiaries, including Nova Casualty Company, being reported to the Department as if such transactions were subject to reporting pursuant to Section 1505 of the New York Insurance Law.

During the exam period, the Company entered into several reinsurance treaties with American Re-Insurance Company. The reinsurance agreements were not filed pursuant to Section 1505 of the New York Insurance Law. However, subsequent to the acquisition of NAGI by Sterling American Re-Insurance Company did not have an equity interest in NAGI. This is more thoroughly discussed in item 6 herein, "Subsequent Events".

E. Significant Operating Ratios

Based upon the results of this examination, the following ratios have been computed as of December 31, 2002:

| | |
|--|-----------|
| Net premiums written in 2002 to surplus as regards policyholders | 3.37 to 1 |
| Liabilities to liquid assets (cash and invested assets less investments in affiliates) | 104.11% |
| Premiums in course of collection to surplus as regards policyholders | 22.80% |

The ratio of Net premiums written to surplus as regards policyholders is outside the benchmark range (3 to 1) set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners and was the result of the examination decrease to surplus.

The underwriting ratios presented below are on an earned/incurred basis and encompass the four-year period covered by this examination:

| | <u>Amounts</u> | <u>Ratios</u> |
|--|---------------------|----------------|
| Loss and loss adjustment expenses incurred | \$60,170,991 | 72% |
| Other underwriting expenses incurred | 34,667,181 | 42 |
| Net underwriting loss | <u>(11,517,387)</u> | <u>(14)</u> |
| Premiums earned | <u>\$83,320,784</u> | <u>100.00%</u> |

F. Abandoned Property Law

The Company has filed abandoned property reports with the Office of the Comptroller of the State of New York for each of the four years under examination. As per Section 1316 of the New York Abandoned Property Law, insurance property is deemed abandoned if unclaimed for three years. As of the examination date, the Company had checks that were outstanding for more than three years, which should have been turned over to the Comptroller's Office.

It is recommended that the Company remit all abandoned property in accordance with Section 1316 of the New York Abandoned Property Law.

G. Account and Records

Custodial Agreement

At December 31, 2002, the Company maintained a custodial agreement with JP Morgan Private Bank for the safekeeping of the Company's securities. A review of the Company's custodial agreement revealed that it lacked several of the protective covenants and provisions as per the National Association of Insurance Commissioners Examiners Handbook.

Subsequent to the examination date, the Company executed an amendment to the custodial agreement that included the necessary protective covenants.

Allocation of Expenses

Regulation 30, as promulgated by the Department, sets forth allocation methods to be used in reporting operating expenses to the loss adjustment, other underwriting expenses, and investment expense functions. A review of the Company's allocation methods revealed that the Company based their allocations to the loss adjustment function only on the direct expenses of the claims department. Allocations from other departments were not included in the loss adjustment expense function. This resulted in an overstatement of "other underwriting expenses" and an understatement of "loss adjustment expenses". For 2002, an additional amount of approximately \$27,863 should have been allocated to loss adjustment expenses.

It is recommended that the Company abide by the requirements of Department Regulation 30 in allocating and reporting its operating expenses by functions.

This recommendation was included in the prior report on examination.

Agents Balances

It is noted that the Company offsets commission payable to agents against premium receivables that are ninety (90) days overdue. The balances offset were not from the same underlying policies, as required by Statements of Statutory Accounting Principles (“SSAP”) No. 6.

It is recommended that the Company only offset its agents' commissions payable with ninety (90) days overdue agents' balances from the same underlying policy, in accordance with SSAP No. 6.

3. FINANCIAL STATEMENTS

A. Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as determined by this examination, and as reported by the Company:

| <u>Assets</u> | <u>EXAMINATION</u> | | <u>COMPANY</u> | | <u>Surplus Increase (Decrease)</u> |
|---|---------------------|-------------------------------------|------------------------------------|------------------------------------|--|
| | <u>Assets</u> | <u>Non- admitted Assets</u> | <u>Net Admitted Assets</u> | <u>Net Admitted Assets</u> | |
| Bonds | \$23,822,151 | | \$23,822,151 | \$23,822,151 | |
| Preferred Stocks | 78,150 | | 78,150 | 78,150 | |
| Common Stocks | 1,035,092 | | 1,035,092 | 1,035,092 | |
| Cash and short-term investments | 10,871,313 | | 10,871,313 | 10,871,313 | |
| Premiums and agents' balances in course of collection | 2,477,022 | 369,883 | 2,107,139 | 2,107,139 | |
| Premiums, agents' balances and installments booked but not deferred and not yet due | 6,928,928 | | 6,928,928 | 6,928,928 | |
| Reinsurance recoverables on losses and loss adjustment expense payments | 806,572 | | 806,572 | 806,572 | |
| Federal and foreign income taxes recoverable and interest thereon | 2,383,547 | 739,251 | 1,644,296 | 1,644,296 | |
| Guaranty funds receivable or on deposit | 12,969 | | 12,969 | 12,969 | |
| Electronic data processing equipment and software | 206,686 | | 206,686 | 206,686 | |
| Interest, dividends and real estate income due and accrued | 361,972 | | 361,972 | 361,972 | |
| Receivable from parent, subsidiaries and affiliates | 5,806,933 | | 5,806,933 | 5,806,933 | |
| Other assets non-admitted | 396,913 | 396,913 | - | - | |
| Salvage and subrogation receivable | 100,000 | | 100,000 | 100,000 | |
| Fair Plan receivable | <u>42,113</u> | <u> </u> | <u>42,113</u> | <u>42,113</u> | <u> </u> |
| Total assets | <u>\$55,330,361</u> | <u>\$1,506,047</u> | <u>\$53,824,314</u> | <u>\$53,824,314</u> | <u>\$ 0</u> |

| <u>Liabilities and Surplus and other Funds</u> | <u>Examination</u> | <u>Company</u> | <u>Surplus Increase (Decrease)</u> |
|---|-------------------------|-------------------------|--|
| Losses and loss adjustment expenses | \$25,218,662 | \$19,918,662 | (\$5,300,000) |
| Commissions payable, contingent commissions and other similar charges | (1,949,054) | (1,949,054) | |
| Other expenses (excluding taxes, licenses and fees) | 505,173 | 505,173 | |
| Taxes, licenses and fees (excluding federal and foreign income taxes) | 328,470 | 328,470 | |
| Federal and foreign income taxes | 312,000 | 312,000 | |
| Unearned premiums | 15,678,582 | 15,678,582 | |
| Advance premiums | 206,140 | 206,140 | |
| Ceded reinsurance premiums payable | 4,252,646 | 4,252,646 | |
| Amounts withheld or retained by company for account of others | <u>31,275</u> | <u>31,275</u> | <u> </u> |
| Total liabilities | <u>\$44,583,894</u> | <u>\$39,283,894</u> | <u>(\$5,300,000)</u> |
| <u>Surplus and Other Funds</u> | | | |
| Common capital stock | \$2,500,500 | \$2,500,500 | \$ |
| Gross paid in and contributed surplus | 10,870,945 | 10,870,945 | |
| Unassigned funds | <u>4,131,025</u> | <u>1,168,975</u> | <u>(5,300,000)</u> |
| Surplus as regards policyholders | <u>\$9,240,420</u> | <u>\$14,540,420</u> | <u>(\$5,300,000)</u> |
| Total liabilities and surplus | <u>\$53,824,314</u> | <u>\$53,824,314</u> | |

Note: The Company was last audited by the Internal Revenue Service in 1992. The examiner is unaware of any potential exposure of the Company to any further tax assessment and no liability has been established herein.

B. Underwriting and Investment Exhibit

Surplus as regards policyholders increased \$1,004,865 during the four-year examination period, January 1, 1999 through December 31, 2002, detailed as follows:

Statement of Income

Underwriting Income

| | | |
|-----------------|--|--------------|
| Premiums Earned | | \$83,320,784 |
|-----------------|--|--------------|

Deductions

| | | |
|--|-------------------|-------------------|
| Loss and loss adjustment expenses incurred | \$60,170,991 | |
| Other underwriting expenses incurred | <u>34,667,180</u> | |
| Total underwriting deductions | | <u>94,838,172</u> |
| Net underwriting gain or (loss) | | \$(11,517,388) |

Investment Income

| | | |
|--|---------------|-----------|
| Net investment income earned | \$6,078,680 | |
| Net realized capital gains or (losses) | <u>15,977</u> | |
| Net investment gain or (loss) | | 6,094,657 |

Other Income

| | | |
|---|-------------|-----------------------|
| Net gain or (loss) from agents' or premium balances charged off | \$(484,278) | |
| Finance and service charges not included in premiums | 2,537,880 | |
| Miscellaneous income | <u>18</u> | |
| Total other income | | <u>2,053,620</u> |
| Net income before federal income taxes | | \$ (3,369,111) |
| Federal and foreign income taxes incurred | | <u>902,628</u> |
| Net income | | <u>\$ (4,271,738)</u> |

Capital and Surplus Account

| | | | |
|---|-----------------------------------|------------------------------------|--------------------|
| Surplus as regards policyholders, December 31, 1998, per report on examination | | | \$8,235,555 |
| | <u>Gains in</u> <u>Surplus</u> | <u>Losses in</u> <u>Surplus</u> | |
| Net income | | \$4,271,738 | |
| Net unrealized capital gains or losses | | 458,445 | |
| Change in net deferred tax | \$1,050,954 | | |
| Change in non-admitted assets | | 1,204,585 | |
| Change in non-ledger assets | 341,711 | | |
| Change in excess of statutory reserves over statement reserves | 144,000 | | |
| Change in surplus notes | | 2,000,000 | |
| Cumulative effect of change in acctg principles | 1,129,024 | | |
| Paid in surplus | 6,250,000 | | |
| Participation in NYPIUA | <u>23,944</u> | _____ | |
| Total gains and losses | <u>\$8,939,633</u> | <u>\$7,934,768</u> | |
| Net increase in surplus as regards policyholders | | | <u>1,004,865</u> |
| Surplus as regards policyholders, December 31, 2002, per report on examination | | | <u>\$9,240,420</u> |

4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for losses and loss adjustment expenses combined of \$25,218,662 is \$5,300,000 more than the \$19,918,662 reported by the Company as of December 31, 2002. The examination analysis was conducted in accordance with generally accepted actuarial principles and practices and was based on statistical information contained in the Company's internal records and in its filed annual statements. The Company has recognized \$3,463,000 of this deficiency through December 31, 2004, as reflected in its subsequently files annual statements.

5. MARKET CONDUCT ACTIVITIES

In the course of this examination, a review was made of the manner in which the Company conducts its business practices and fulfills its contractual obligations to policyholders and claimants. The

review was general in nature and is not to be construed to encompass the generally more precise scope of a market conduct examination.

The general review was directed at practices of the Company in the following major areas:

- A. Sales and advertising
- B. Treatment of policyholders and claimants

No problem areas were encountered.

6. SUBSEQUENT EVENTS

On May 3, 2005, subsequent to the examination, Sterling Capital Partners, LLC, Sterling Capital Partners, L.P. and Sterling Capital Partners II, L.P. (herein collectively referred to as “Sterling”) filed with the New York Insurance Department a Section 1506 Application for the Acquisition of Control of Nova Casualty Company. Through a proposed capital transaction, Sterling would acquire control of Nova through N.A. Holdings, Inc. and N.A. Mergersub, Inc. Following the approval by the New York Insurance Department of the Section 1506 Application, N.A. Mergersub, Inc. would merge with and into NAGI. NAGI would then become a wholly-owned subsidiary of N.A. Holdings, Inc. N.A. Holdings, Inc. would thereby become the ultimate parent of Nova, while NAGI would remain the direct parent of Nova. The Department approved the Section 1506 Application on June 28, 2005. The proposed capital transaction closed on June 29, 2005. On the date of closing, \$34.7 million of additional surplus was contributed to the Company from NAGI.

7. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination as of December 31, 1998 contained comments and recommendations as follows (page numbers refer to the prior report):

| <u>ITEM</u> | <u>PAGE NO.</u> |
|--|-----------------|
| A. <u>Allocation of Expenses</u> | |
| It is recommended that the Company abide by the requirements of Regulation 30 in allocating and reporting its operating expenses by functions. | 15 – 16 |
| The Company has not complied with this recommendation and it is reiterated herein. | |

8. SUMMARY OF COMMENTS AND RECOMMENDATION

| <u>ITEM</u> | <u>PAGE NO.</u> |
|--|-----------------|
| A. <u>Management</u> | |
| i It is recommended that the Company comply with its by-laws by having the Company’s secretary attend all board and shareholder meetings. | 5 |
| B. <u>Reinsurance</u> | |
| i. It is recommended that the Company ensure that the offset clauses included in all reinsurance contracts to which it is a party which allow for broad rights of offset include the following language: | 11 |
| “In the event of the insolvency of either party to this agreement then offsets shall only be allowed to the extent permitted by the provisions of Section 7427 of the New York Insurance Law. | 11 |
| C. <u>Holding Company System</u> | |
| i. It is recommended that the Company file the reports required by Regulation 52-A. | 15 |
| ii. It is recommended that the general agency contingent commission agreement include required language per Regulation 52-A. | 15 |
| D. <u>Abandoned Property Law</u> | |
| It is recommended that the Company remit all abandoned property in accordance with Section 1316 of the New York Abandoned Property Law. | 20 |

| <u>ITEM</u> | <u>PAGE NO.</u> |
|---|-----------------|
| E. <u>Account and Records</u> | |
| <u>Allocation of Expenses</u> | |
| It is recommended that the Company abide by the requirements of Regulation 30 in allocating and reporting its operating expenses by functions. | 20 |
| <u>Agents Balances</u> | |
| It is recommended that the Company only offset its agents' commission payable with 90-days overdue agents' balances from the same underlying policy, in accordance with SSAP No. 6. | 21 |

Appointment No. 22056

STATE OF NEW YORK
INSURANCE DEPARTMENT

I, GREGORY V. SERIO, Superintendent of Insurance of the State of New York,
pursuant to the provisions of the Insurance Law, do hereby appoint:

Ralph Basit

as proper person to examine into the affairs of the

NOVA CASUALTY INSURANCE COMPANY

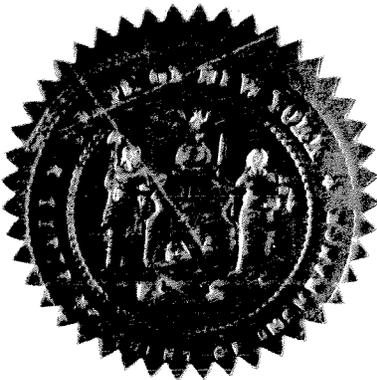
and to make a report to me in writing of the condition of the said

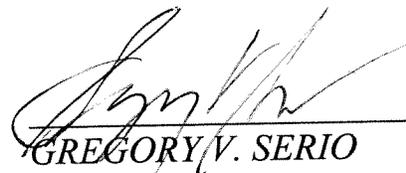
Company

with such other information as he shall deem requisite.

*In Witness Whereof, I have hereunto subscribed by the
name and affixed the official Seal of this Department, at
the City of New York,*

this 6th day of June, 2003





GREGORY V. SERIO
Superintendent of Insurance

Respectfully submitted,

_____/s/_____
Ralph Basit
Associate Insurance Examiner

STATE OF NEW YORK)
)SS.
)
COUNTY OF NEW YORK)

RALPH BASIT, being duly sworn, deposes and says that the foregoing report submitted to by him is true to the best of his knowledge and belief.

_____/s/_____
Ralph Basit

Subscribed and sworn to before me
this _____ day of _____ 2005.