



STATE OF NEW YORK
INSURANCE DEPARTMENT
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David A. Paterson
Governor

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In the Matter of the Conversion
of the
Commercial Mutual Insurance Company
from an Advance Premium Cooperative
Property/Casualty Insurance Company
into a
Stock Property/Casualty Insurance Company

Opinion and Decision

The Commercial Mutual Insurance Company ("Company" or "CMIC"), a domestic advance premium cooperative property/casualty insurance company, has made an application to the Superintendent of Insurance ("Superintendent") to convert into a domestic stock property/casualty insurance company pursuant to New York Insurance Law ("Insurance Law") § 7307. This Opinion and Decision reviews the history of the Company and the requirements of Insurance Law § 7307, discusses the potential advantages and disadvantages of conversion, and sets forth the Superintendent's reasons for concluding that the Plan of Conversion should be approved.

History of the Company

The Company was incorporated under the laws of New York on April 12, 1886 as The Co-operative Fire Insurance Company of Greene, Schoharie and Delaware Counties. The Company was organized for the purpose of transacting business as a co-operative fire insurance company in these counties.

In November 1922, the Insurance Department issued a certificate authorizing the Company to change its name to The Co-operative Fire Insurance Company of Catskill, New York. Subsequently, the Company amended its charter to permit the Company to extend its territory to include the entire State of New York and, wherever authorized by law, any other state of the United States of America and the District of Columbia.

On June 1, 1935, the Company assumed all of the assets and liabilities of the Commercial Mutual Fire Insurance Company of Greene County pursuant to a reinsurance agreement approved by the Insurance Department.

In or around 1976, the Company filed with the Superintendent a Certificate of Amendment of Charter, as amended, in compliance with Insurance Law § 1206. Such certificate amended the Company's charter and license to reflect a change in the Company's name from The Co-operative Fire Insurance Company of Catskill, New York to Commercial Mutual Insurance Company. The Insurance Department approved the amendment on April 20, 1976.

For most of its history, the Company wrote homeowners, dwelling fire, and small business policies throughout New York State. In the 1990s, CMIC increased its concentration of business in downstate New York. In 1997, the Company began to experience financial difficulty.

On April 1, 1998, Eagle Insurance Company ("Eagle"), a Robert Plan company, infused \$3 million into the Company by purchasing a surplus note issued in accordance with Insurance Law § 1307. On March 12, 1999, Eagle purchased another surplus note in the amount of \$750,000 with a similar interest rate and terms, bringing its total investment in the Company to \$3,750,000.

Since 2002, CMIC has added private passenger auto physical damage only, for-hire vehicle physical damage only, 3-4 family homeowners and dwelling fire, full private passenger auto, and personal umbrella to its product lines.

On January 31, 2006, Eagle sold all of its \$3,750,000 in surplus notes to DCAP Group, Inc. ("DCAP").

Provisions of New York Insurance Law § 7307

Insurance Law § 7307 provides that a domestic mutual or advance premium cooperative property/casualty insurer¹ may apply to the Superintendent for permission to convert into a domestic stock property/casualty insurer. Insurance Law § 7307(b) requires that the application be pursuant to a resolution, adopted by no less than a majority of the applicant's board of directors, specifying the reasons for the proposed conversion and the manner in which the conversion is expected to benefit policyholders and the public.

If the Superintendent finds the application to be acceptable, Insurance Law § 7307(b)(3) requires the Superintendent to order an examination of the mutual insurer pursuant to Insurance Law § 310, as of the last day of the period covered in its latest filed statement. The Superintendent shall also appoint a person to appraise and report to the Superintendent the fair market value of the mutual insurer and, to the extent necessary, its affiliates, on the basis of its latest filed annual or quarterly statement, and of any significant subsequent developments. See Ins. Law § 7307(c).

Under Insurance Law § 7307(d), after receiving the examination report and the appraisal report, the Superintendent may grant or deny permission to the board of directors to submit a plan of conversion. If permission is granted, Insurance Law § 7307(e) provides that the plan of conversion shall include the following: (1) the proposed charter and by-laws of the insurer as a stock corporation; (2) the manner of treating a holder of an Insurance Law § 1307 agreement (i.e., a surplus notes holder), if any; (3) the manner and basis of exchanging the equitable share of each eligible mutual policyholder for securities or other consideration, or both, of the stock corporation into which the mutual insurer is to be converted and the disposition of any unclaimed shares; (4) the number of voting common shares proposed to be authorized for the stock corporation, their par value, and the price at which they are to be offered; and (5) any other features requested by the Superintendent.

¹ While CMIC is an advance premium cooperative company, Insurance Law § 7307 uses the term "mutual insurer" as a shorthand term for both mutual and advance premium companies. See Insurance Law § 7307(a)(3). Therefore, the statutory discussion in this section uses the term "mutual insurer" for the sake of consistency.

Insurance Law § 7307(g) further requires the Superintendent to hold a public hearing, after which the Superintendent shall approve the plan as submitted, refuse to approve the plan, or request modification of the plan before granting approval. Ins. Law § 7307(h)(1). If the plan is not inconsistent with the Insurance Law, is fair and equitable, and is in the best interests of the policyholders and the public, the Superintendent shall approve such plan. Id. If the Superintendent finds that the plan does not meet the foregoing standards for approval, he shall either refuse to approve the plan and the plan shall become null and void, or else return the plan to the mutual insurer for modification to meet the objections. Id.

After approval by the Superintendent, the plan shall be submitted to a vote of the persons who were policyholders of the mutual insurer on the day preceding the date of adoption of the resolution of the board of directors regarding the proposed conversion. See Ins. Law § 7307(i). The votes of two-thirds of all of the votes cast by the policyholders represented at the meeting in person or by proxy are necessary for the adoption of the plan. See Ins. Law § 7307(j).

The Company's Conversion Application

CMIC's application to convert to a domestic stock property/casualty insurance company arose from a resolution adopted by the Company's Board of Directors at a special meeting held on March 1, 2007. That resolution requests the Superintendent's permission for CMIC to convert from an advance premium cooperative into a stock form of organization, and advances the following arguments in favor of conversion:

1. As an advance premium cooperative property/casualty insurance company, the Company cannot issue equity securities. As a result, in order to raise capital, the Company is limited to borrowing funds, assessing its members, or merging with other advance premium corporations or mutual insurers.

2. The Company needs to increase capital in order to maintain or expand its market position and to successfully compete in the future.

3. Conversion to a stock insurer should enhance the Company's ability to obtain an acceptable rating from A.M. Best or other rating agencies.

4. To the extent that equity capital enables increased underwriting capacity, the Company in stock form should be more competitive in the marketplace (in both its current service area and other geographic areas).

5. The Company will be able to provide more and different kinds of insurance to its constituencies at competitive rates.

6. The Company will be able to make its own stock available for future acquisitions or mergers and other lawful investments, and for issuance and sale to raise additional equity capital.

7. As a stock entity, the Company could establish stock options and other stock related compensation plans for its employees as performance incentives and as a means of attracting, retaining and compensating management and other personnel.

8. Conversion will allow the Company to discharge its Insurance Law § 1307 surplus notes obligations.

9. The Company's policyholders could benefit from being insured by an insurer with a more secure capital base and with better ratings from the rating agencies. With a larger capital base, the Company may be able to write its business with less dependence on reinsurance, which could ultimately decrease premium rates for policyholders.

Upon receipt of the application, the Superintendent:

(a) Ordered an examination of the Company as of December 31, 2006, the date of the Company's last filed statement as of receipt of the application, pursuant to Insurance Law § 7307(b). The Report on Examination, dated January 28, 2008, indicates a policyholder surplus of \$4,284,069 as of December 31, 2006. The report was filed on February 27, 2008.

(b) Appointed the public accounting firm of Weiser LLP ("Weiser") as an independent appraiser to assess the fair market value of the Company as of December 31, 2006. Weiser, having considered the assets and liabilities of the Company and other factors bearing on its value, made its Appraisal Report to the Superintendent on December 5, 2007. The Appraisal Report states that the fair market value of the Company as of December 31, 2006 was \$5,493,000.

The Appraisal Report and the Report on Examination were made available to the Company on January 2, 2008 and February 13, 2008, respectively.

On March 13, 2008, the Superintendent granted permission, pursuant to Insurance Law § 7307(b), to the Company's Board of Directors to submit to the Superintendent a Plan of Conversion. The Board of Directors adopted the Plan of Conversion on April 24, 2008, and then subsequently amended it. Specifically, the Plan of Conversion as originally submitted provided for the policyholders to receive premium credits, rather than a cash distribution. After discussion with the Department, the Plan of Conversion was amended to provide for a cash distribution to policyholders.

The Plan of Conversion notes that individuals who held policies with the Company at any time during the three years prior to March 1, 2007 ("Eligible Policyholders") - the date that the Company's Board of Directors adopted the resolution to apply to the Superintendent for permission to convert into a domestic stock property/casualty insurer - have a right under Insurance Law § 7307(e)(3) to "securities or other consideration." However, Insurance Law § 7307(e)(2) states that the Plan of Conversion must include, among other things, the manner of treating an Insurance Law § 1307 surplus notes holder, and permits such surplus notes holder, if qualified, to exchange the surplus notes for an equitable share of the securities or other consideration, or both, of the new stock company. Therefore, prior to determining the amount of surplus available to be distributed to the policyholders, the surplus notes holder, DCAP, has to be satisfied in the conversion.

To this end, the Plan of Conversion proposes that 100% of the shares of the stock company be allocated to the surplus notes holder, DCAP. In exchange, DCAP will waive its claim to all accrued and unpaid interest on the notes.

As of December 31, 2006, the surplus of the Company as determined by Department examination was \$4,284,069. As of December 31, 2006, the face amount of the surplus notes was \$3,750,000 with accrued unpaid interest of \$1,821,250. Therefore, the proposed Plan of Conversion provides that a distribution to the Eligible Policyholders in the form of cash will be

made for the difference between the determined surplus of \$4,284,069 and the face amount of the notes \$3,750,000, yielding a total distribution amount to the policyholders of \$534,069.

In accordance with Insurance Law § 7307(e)(3), the Plan of Conversion provides that each Eligible Policyholder will be entitled to receive a cash distribution based upon his or her equitable share in the Company. The equitable share of each Eligible Policyholder will be determined by the ratio that the net premiums (i.e., gross premiums less return premiums and dividends paid) such Eligible Policyholder has properly and timely paid to the Company on insurance policies in effect during the three years immediately preceding March 1, 2007 ("Credited Premiums") bears to the total Credited Premiums received by the Company from all Eligible Policyholders. As such, the Eligible Policyholders will be those persons who had a policy of insurance in effect at any time from March 1, 2004 through February 28, 2007.

Pursuant to the Plan of Conversion, Credited Premiums will be determined from the records maintained by the Company. Premiums will be deemed paid ratably over the term of each policy (i.e., the premium will be deemed to have been paid and earned pro-rata over the term of the policy). In computing each Eligible Policyholder's Credited Premiums, no credit will be given for any net premiums that result from an endorsement that is effective on or after March 1, 2007.

Insurance Law § 7307(i) provides that after the Superintendent approves the plan, the plan must be submitted to a vote of the persons who were policyholders of the mutual insurer on the day preceding the date of the adoption of the board resolution. Accordingly, the proposed Plan of Conversion states that if the Superintendent approves the plan, those persons who were policyholders of the Company on February 28, 2007, the day preceding the date of adoption of the Application Resolutions, will vote on approving or disapproving the Plan of Conversion.

The Department's Consideration of the Conversion Application

Insurance Law § 7307(g) requires the Superintendent to hold a public hearing regarding each plan of conversion and sets forth the requirements for providing notice of the hearing to current and former policyholders and the public. Accordingly, the Superintendent held a public hearing regarding the Plan of Conversion on October 20, 2008. Notice of the hearing was mailed to each policyholder on September 15, 2008. Notice of the hearing and a summary of the Plan of Conversion were also published in newspapers of general circulation in the county in which the Company has its principal office (Ulster County), and in the two largest cities (New York, New York and Buffalo, New York) in which the Company has underwritten insurance during the five years prior to March 1, 2007. Notice of the hearing was also published in the September 3, 2008 issue of the New York State Register.

The Superintendent reviewed the following during his analysis of the conversion application:

1. The financial condition of CMIC;
2. The financial condition of DCAP;
3. Information and comments presented at the public hearing held on October 20, 2008; and
4. Biographical information regarding the owners of DCAP.

The Superintendent's Concerns Regarding the Application

The Superintendent identified the following areas of concern during his analysis of the conversion application:

(i) A review of DCAP's Form 10-Q filings for the quarterly periods ended June 30, 2008 and September 30, 2008 and DCAP's draft consolidated financial statements for the year ended December 31, 2008 revealed that DCAP's stockholders' equity is minimal, which raises concerns regarding, among other things, DCAP's overall financial strength and whether it will be in a position to provide CMIC with a capital infusion if necessary in the future.

(ii) DCAP has extended the maturity dates of its term loan and subordinated notes, has extended the mandatory redemption date for certain preferred shares, and plans to sell and/or close certain stores that are not operating profitably. These actions raise concerns that DCAP may be experiencing cash flow difficulties and might seek to access the assets of CMIC post-conversion to address its cash flow needs.

(iii) The Department found certain agreements and transactions between the parties to be a cause for concern, including an employment agreement between CMIC and an individual who serves as an officer/director for both CMIC and DCAP, which raised the specter that the individual's dual roles may create potential conflicts of interest. CMIC also reimbursed DCAP for expenses associated with the hiring of a consultant to raise capital for CMIC post-conversion. This caused the Department to question whether the terms of the arrangement between CMIC and DCAP were fair and equitable; whether the charges to CMIC were reasonable; and whether the expenses incurred were allocated to CMIC on an equitable basis.

(iv) As a result of the conversion, the stock company would become a producer-controlled insurer and, without the proper safeguards, there is the potential that the relationship between the insurer and the producer could create conflicts of interest that might harm policyholders or injure the insurer. For example, DCAP and CMIC might enter into commission arrangements in excess of those paid to other producers for comparable business, or might enter into unfair or inequitable expense sharing arrangements.

Reasons for Approving the Application

Despite these concerns, there are a number of factors that weigh in favor of approving the application for CMIC to convert into a domestic stock property/casualty insurance company.

First, CMIC's policyholder surplus includes \$3,750,000 in surplus notes held by DCAP. Upon conversion, the surplus notes will be converted into common stock and DCAP will forgive all accrued and unpaid interest on the surplus notes as of the date of conversion. The elimination of the surplus notes and the accrued interest should enhance CMIC's ability to obtain an acceptable rating from A.M. Best, because pursuant to the Plan of Conversion, DCAP will discharge CMIC's obligation to repay these notes.

Second, while CMIC has been able to grow without an A.M. Best rating, its future growth may be impeded by the lack of a rating. Insurance producers may be unable or reluctant to place business with an insurer that is not adequately rated, because their errors and omissions policies will not cover financial losses that result from business placed with such an insurer.

Having an acceptable rating may alleviate these producer-related concerns. Insurers may similarly refuse to write umbrella coverage over policies issued by CMIC, which may force current CMIC insureds to seek coverage from insurers with adequate ratings. CMIC's obtaining an adequate rating would enhance the ability of CMIC insureds to obtain umbrella coverage over their CMIC insurance policies. Furthermore, in the reinsurance marketplace, reinsurers may refuse to reinsure business with a non-rated insurer. However, with an adequate rating, the Company may be able to obtain more reinsurance bids, which could ultimately enable it to offer better rates to its policyholders.

Third, the conversion to a stock company should enhance CMIC's ability to increase its capital base by accessing the financial markets. Currently, CMIC's ability to increase its capital is limited. The payment of interest and principal on surplus notes requires the Superintendent's prior approval. This requirement hampers the ability of small and medium-sized insurers to raise additional capital via the issuance of surplus notes. As a stock insurer, CMIC may be able to raise capital in the equity markets through the issuance of stock. With additional capital, CMIC may expand its premium writings, offer higher limits to its insureds, and reduce its dependence on reinsurance, thereby enabling CMIC to be more competitive in the marketplace.

Furthermore, in conjunction with DCAP's pending application pursuant to Insurance Law § 1506 to acquire control of CMIC (to be known as Kingstone Insurance Company upon conversion), the Department has obtained the following commitments in writing from DCAP:

1. DCAP will inform the Department if it plans to make any significant deviations (including entering into new products or lines of business) to the plan of operations and financial projections, that DCAP submitted with its application to acquire control of CMIC upon conversion;
2. The newly acquired stock insurer will not pay any dividends to shareholders for the first two years of operations following acquisition without the prior approval of the Insurance Department; and
3. DCAP will remove any officer or director of the insurer or parent company who the Insurance Department finds to be untrustworthy upon conclusion of its investigation.

In addition, in order to further protect the policyholders of the Company, the Department has obtained a commitment from DCAP that "any direct or indirect transaction involving the Company and DCAP or any member(s) of DCAP's holding company system must be filed and reported to the Superintendent pursuant to Section 1505 of the New York Insurance Law regardless of any percentage of admitted assets threshold set forth in Section 1505(d)(1) of the New York Insurance Law." Therefore, the Department must be notified prior to the implementation of any transaction contemplated between the parties.

The Superintendent continues to have reservations with regard to DCAP's minimal stockholders' equity as indicated in its Form 10-Q filings as of June 30, 2008 and September 30, 2008, and DCAP's draft consolidated financial statements for the year ended December 31, 2008. However, while it would be preferable for the acquiring party to have a larger capital base, the Insurance Law does not impose any minimum requirements on an acquiring party with respect to stockholders' equity.

DCAP's commitment that the newly acquired stock company will not pay dividends to shareholders (i.e., DCAP) for the first two years of operations following the acquisition without

the prior approval of the Superintendent, as well as its commitment to file Insurance Law § 1505 transactions with and report such transactions to the Superintendent, mitigates the Superintendent's concerns regarding DCAP's potential cash flow difficulties. Adherence to these commitments should preclude DCAP from accessing CMIC's assets to address its cash flow needs.

DCAP's Insurance Law § 1505 commitment also mitigates the Superintendent's concerns that the relationship between CMIC and DCAP could create conflicts of interest that might harm policyholders or injure the insurer. Pursuant to that commitment, regardless of the threshold set forth in Insurance Law § 1505(d)(1), the controlled insurer may not enter into any transactions with any person in its holding company system unless the insurer notifies the Superintendent in writing of its intention to enter into such transaction at least thirty days prior thereto, and the Superintendent does not disapprove it within such time period. Such reporting will enable the Department to review proposed transactions to ensure that the terms are fair and equitable, the charges or fees for services performed are reasonable, and that the expenses incurred are allocated to CMIC on an equitable basis and in conformity with customary insurance accounting practices consistently applied.

In sum, the Superintendent believes that the conversion will benefit CMIC, its policyholders and the public to the extent that it will, among other things, eliminate CMIC's surplus note obligations, enhance CMIC's ability to obtain a favorable rating, provide CMIC with the opportunity to raise additional capital in the financial markets, and potentially become more competitive in the insurance and reinsurance marketplace. Thus, while the Superintendent harbors some concerns, upon careful review and consideration, he nevertheless believes that on balance, the potential benefits to CMIC, its policyholders and the public, in conjunction with the aforementioned commitments, tip the scales in favor of the Plan's approval.

Conclusion

Accordingly, it is the considered opinion of the Superintendent that the proposed Plan of Conversion of Commercial Mutual Insurance Company complies with Insurance Law § 7307(h)(1) in that it does not violate the Insurance Law, is fair and equitable, and is in the best interests of the policyholders and the public. Therefore, pursuant to the provisions of Insurance Law § 7307, such Plan of Conversion is hereby approved.

Prior to the Plan of Conversion's implementation, the plan must be approved by two-thirds of all votes cast by eligible members represented at the Special Meeting of Policyholders to be held pursuant to the notification requirements set forth in Insurance Law § 7307(i).

Dated: April 15, 2009
New York, NY

Eric R. Dinallo
Superintendent of Insurance

By:

Martha A. Lees

Martha A. Lees
Deputy General Counsel