



STATE OF TENNESSEE
DEPARTMENT OF COMMERCE AND INSURANCE

REPORT ON EXAMINATION
OF
PREFERRED AUTO INSURANCE CO., INC.
(NAIC # 10223)
MEMPHIS, TENNESSEE

AS OF
December 31, 2017

TABLE OF CONTENTS

Introduction.....	1
Scope of Examination.....	1
Compliance with Previous Examination Findings	2
Company History	2
Capital Stock.....	3
Management and Control	3
Management	3
Control.....	4
Organizational Chart	4
Corporate Records.....	5
Agreements with Parent, Subsidiaries, and Affiliates	5
Territory and Plan	6
Growth of Company.....	7
Reinsurance	7
Accounts and Records	7
Market Conduct Activities	8
Financial Statements	10
Assets	10
Liabilities, Surplus, and Other Funds	10
Statement of Income	11
Capital and Surplus Account.....	12
Analysis of Changes in Financial Statements.....	13
Comments and Recommendations	13
Conclusion.....	14
Affidavit.....	15

Memphis, Tennessee
January 10, 2019

Honorable Julie Mix McPeak
Commissioner
Tennessee Department of Commerce and Insurance
500 James Robertson Parkway
Nashville, Tennessee 37243

Dear Commissioner:

In accordance with your instructions and pursuant to Tennessee Code Annotated ("Tenn. Code Ann.") § 56-1-408, a full-scope financial examination and a market conduct review, as of December 31, 2017, has been made of the condition and affairs of:

PREFERRED AUTO INSURANCE CO., INC.
NAIC # 10223
216 South Cooper Street
Memphis, Tennessee 38104

hereinafter referred to as the "Company" and a report thereon is submitted as follows:

INTRODUCTION

This examination was arranged by the Tennessee Department of Commerce and Insurance ("Department") and in accordance with procedures established by the Department and practices and procedures promulgated by the National Association of Insurance Commissioners (NAIC) in the *Financial Condition Examiners Handbook* ("Handbook") as deemed appropriate, and was conducted by duly authorized representatives of the Department.

SCOPE OF EXAMINATION

The last examination of the Company was made as of December 31, 2012. This examination covers the period January 1, 2013, through December 31, 2017, and includes any material transactions and/or events occurring subsequent to the examination date which were noted during the course of the examination. There are no other insurers in the holding company group; therefore, no examination coordination with any other states was necessary.

The examination was planned and performed to evaluate the financial condition of the Company as of December 31, 2017. The examination sought to identify prospective risks by obtaining information about the Company, including its corporate governance. Significant inherent risks within the Company were reviewed and assessed. Controls and mitigation for those significant risks were also reviewed. The examination also included assessing the principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation and management's compliance with statutory accounting principles and annual statement instructions.

All significant risks were reviewed to determine which key activities and accounts would be examined. The key activities included: Investments; Underwriting/Premiums; Reserving/Claims; Reinsurance Ceded; and Related Parties.

A limited examination of the Company's information technology software and hardware was conducted. A review was also performed of the Company's disaster recovery plan for data and software.

A separate market conduct review was also performed concurrently with the financial examination. See the "Market Conduct Activities" section of this report.

The independent auditor's workpapers for the 2017 audit were reviewed and copies were incorporated into the examination, as deemed appropriate.

COMPLIANCE WITH PREVIOUS EXAMINATION FINDINGS

There were no recommendations in the prior examination report.

COMPANY HISTORY

The Company was incorporated on April 27, 2000, under the Tennessee Business Corporation Act as a for-profit corporation authorized to transact business in the State of Tennessee. The Company was issued a certificate of authority, dated January 16, 2001, from the Tennessee Department of Commerce and Insurance ("Department") to transact the business of property and casualty insurance.

CAPITAL STOCK

As of December 31, 2017, the Company had authorized capital of ten million (10,000,000) shares of \$1 par value common stock, of which one million (1,000,000) shares were issued and outstanding to the following individuals:

<u>Owners</u>	<u>Number of Shares</u>	<u>Percentage</u>
Jeffrey L. Kelley	357,142.85	35.72
Clinton B. Haley	285,714.29	28.57
Vincent G. Kelley	285,714.29	28.57
Danny W. Lazenby	<u>71,428.57</u>	<u>7.14</u>
Totals	<u>1,000,000.00</u>	<u>100.00</u>

MANAGEMENT AND CONTROL

MANAGEMENT

Directors

As of December 31, 2017, the Board of Directors ("Board") consisted of the four (4) owners of the Company, who were also officers of the Company. There were no independent directors, contrary to Tenn. Code Ann. § 56-11-106(c)(3). However, the Company was granted a waiver from the Department of the requirement to have at least one-third (1/3) of the directors not be officers or employees of the Company. The waiver was dated July 1, 2015.

The following persons were serving as directors, as of December 31, 2017:

<u>Name</u>	<u>Principal Occupation</u>
Jeffrey L. Kelley	Owner, President and Chief Executive Officer
Clinton B. Haley	Owner, Vice-President and Chief Financial Officer
Vincent G. Kelley	Owner, Secretary/Treasurer
Danny W. Lazenby	Owner, Vice-President

Officers

The following were serving as officers, as of December 31, 2017:

<u>Name</u>	<u>Title</u>
Jeffrey L. Kelley	Owner, President and Chief Executive Officer
Clinton B. Haley	Owner, Vice-President and Chief Financial Officer
Vincent G. Kelley	Owner, Secretary/Treasurer
Danny W. Lazenby	Owner, Vice-President

Committees

The Company’s Audit Committee, at December 31, 2017, was as follows:

<u>Name</u>	<u>Title</u>
Jeffrey L. Kelley	Director, President
Clinton B. Haley	Director, Chief Financial Officer
Max L. Jones	Controller

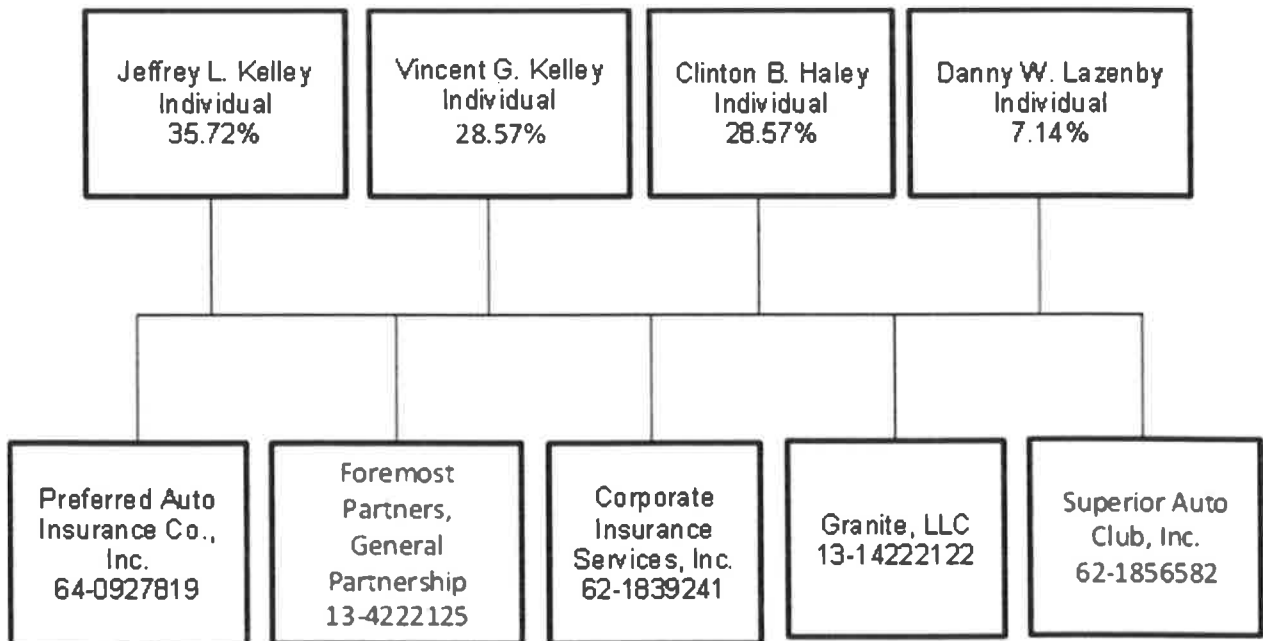
The Company’s Finance Committee, at December 31, 2017, was as follows:

<u>Name</u>	<u>Title</u>
Jeffrey L. Kelley	Director, President
Vincent G. Kelley	Director, Secretary/Treasurer
Clinton B. Haley	Director, Chief Financial Officer

CONTROL

As of December 31, 2017, the ultimate controlling persons were Jeffrey L. Kelley; Clinton B. Haley, and Vincent G. Kelley with their common stock ownership of thirty-five and seventy-two hundredths percent (35.72%), twenty-eight and fifty-seven hundredths percent (28.57%), and twenty-eight and fifty-seven hundredths percent (28.57%), respectively.

ORGANIZATIONAL CHART



Note: Ownership percentage was the same for all affiliated entities.

CORPORATE RECORDS

Minutes of the stockholders' and directors' meetings reflected adequate approval and support of the Company's transactions. The Board gave regular approval for all investment transactions as required by Tenn. Code Ann. § 56-3-408(b)(1). The Company's Charter and Bylaws did not have any amendments during the examination period.

AGREEMENTS WITH PARENT, SUBSIDIARIES, AND AFFILIATES

Agency Agreement

Effective October 1, 2003, the Company entered into an agency agreement with Granite, LLC ("Granite"). The agreement set commission rates for new and renewal business. In addition, Granite collected premiums and related fees for the Company's policies which it wrote. Effective July 1, 2014, the agreement was amended for commission rates on renewal business. This agreement and amendment was approved by the Department on September 9, 2004, and June 19, 2014, respectively.

Software Lease Agreement

Effective October 1, 2007, the Company entered into a software lease agreement with Granite. Granite had rights to web-enabled software through a software agreement. This software enabled the Company to contract with independent agents, provided web-based rating, document imaging, ability to receive applications from policyholders, track policies, and provided current information to independent agents. This agreement was approved by the Department on October 3, 2007.

Claims Administration Service Agreement

Effective February 1, 2012, the Company entered into a service agreement with Corporate Insurance Services ("Corporate Services"). Under the provisions of the agreement, Corporate Services provided the Company claims administration services. The Company paid Corporate Services fees on a per claim basis. The agreement was approved by the Department on January 31, 2012.

Lease Agreement

Effective July 1, 2013, the Company entered into a lease agreement with Foremost Partners, General Partnership ("Foremost") to lease the building at 216 South Cooper Street, Memphis, Tennessee that the Company uses to conduct their business operations. The Company paid Foremost monthly based on the fee schedule in the agreement. The agreement was approved by the Department on May 29, 2013.

Surplus Note

Effective December 31, 2014, the Company executed a \$400,000 surplus note with Granite. The surplus note was for a period of ten (10) years with interest at six percent (6%) per annum and payable on December 31 of each subsequent year. The Department approved the surplus note on December 30, 2014. The Company made interest payments plus installments of \$40,000 each year, which were approved by the Department. As of December 31, 2017, the balance of the surplus note was \$280,000.

Cost Sharing Agreement

Effective January 1, 2015, the Company entered into a cost sharing agreement with Granite for shared management services. Under the terms of the agreement, the Company paid the salaries of officers, related payroll taxes, and 401k employee benefits for both the Company and Granite. Each month, Granite reimbursed the Company forty percent (40%) of the salaries, related payroll taxes, and employee benefits for Granite's share of the expenses. The agreement was approved by the Department on September 14, 2015. The Company did not file the agreement timely as required by Tenn. Code Ann. § 56-11-106(a)(2)(D). See "Comments and Recommendations" section in this report.

TERRITORY AND PLAN

TERRITORY

As of December 31, 2017, and as of the date of this report, the Company was licensed to transact business only in the State of Tennessee.

PLAN OF OPERATION

The Company writes automobile liability and physical damage coverage for the non-standard market. The Company markets its insurance products through both captive and independent agents. As of December 31, 2017, approximately eighty percent (80%) of the company's business was in Shelby County, Tennessee. The Company had not appointed agents as required by Tenn. Code Ann. § 56-6-115 throughout its history. Subsequent to the examination date, the Company appointed all past and current agents. See "Comments and Recommendations" section in this report.

The maximum retention on any one risk was \$22,500.

GROWTH OF COMPANY

The following exhibit depicts certain aspects of the growth and financial history of the Company for the period subject to this examination, as recorded in its annual statements as filed with the Department:

<u>Year</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Total Surplus</u>	<u>Net Earned Premiums</u>	<u>Net Income</u>
2017	\$9,703,818	\$6,423,250	\$3,280,568	\$3,224,065	\$139,306
2016	\$8,650,744	\$5,476,480	\$3,174,264	\$2,732,698	\$69,933
2015	\$7,628,194	\$4,491,863	\$3,136,331	\$2,464,962	\$50,206
2014	\$7,602,157	\$4,481,033	\$3,121,124	\$2,261,413	\$44,502
2013	\$6,097,145	\$3,421,523	\$2,675,622	\$2,018,043	\$27,341

REINSURANCE

Assumed

The Company did not assume risks through reinsurance during the examination period.

Ceded

Effective January 1, 2016, the Company entered into a seventy percent (70%) quota share reinsurance agreement with Transatlantic Reinsurance Company, an authorized reinsurer. The agreement was very similar to the prior agreement which had been effective since 2010. The reinsurance covered all the Company's business except for "non-owner" coverage, which represented approximately three percent (3%) of the Company's premium written. Effective January 1, 2017, the agreement was amended to increase the maximum ceded written premium per contract year.

The agreement transferred risk in accordance with Statements of Statutory Accounting Principles No. 62R.

ACCOUNTS AND RECORDS

Independent audits were performed each year during the examination period with each resulting in an unqualified opinion.

Differences in various items were noted during the examination, however, none were determined to produce a material effect on surplus funds, as regards policyholders, either singularly or in the aggregate. Accounting records conformed to statutory

accounting principles and reflected the operations and status of the Company during the examination period.

The Company's Risk-Based Capital Report was in compliance with Tenn. Code Ann. § 56-46-101, *et seq.*

The Company's primary books and records were located at 216 South Cooper Street, Memphis, Tennessee.

MARKET CONDUCT ACTIVITIES

A market conduct review was made of the Company, as of December 31, 2017, in conjunction with this examination. The following items were addressed:

Underwriting, Rates and Policy Forms

In the examination of underwriting and rating, Company operations were examined for compliance with their own underwriting guidelines, filed rates and forms, and applicable statutes and rules. As a result of the examination, no issues or concerns were identified.

Complaint Handling Practices

The Company's complaint handling procedures and complaint register were examined to ensure that records maintained by the Company were in accordance with applicable statutes, rules and regulations, and the timeframe within which the Company responded was reasonable. It was noted during the examination that the Company did not record all written complaints as required by Tenn. Code Ann. § 56-8-104 (11) on its complaint register. As a result, the Company amended its complaint handling policies and procedures. See "Comments and Recommendations" section in this report.

Advertising

All advertising and sales materials utilized by the Company were examined for compliance with statutory and rule requirements. As a result of the examination, no issues or concerns were identified.

Claims Handling

The Company's efficiency of claims handling, accuracy of payment, adherence to policy provisions, and compliance with applicable statutes and rules were examined. As a result of the examination, no issues or concerns were identified.

Anti-fraud Plan

The Company had an anti-fraud plan which met statutory requirements. Company procedures were reviewed to ensure they included proper guidance for employees. Company operations were examined for implementation of anti-fraud measures and management was questioned about past, present, and future fraud issues and concerns. As a result of the examination, no issues or concerns were identified.

Privacy of Consumer Information

The Company's policies and procedures for the privacy of consumer information were examined to ensure the Company had developed and implemented written policies and procedures for the management of confidential and personal insurance information. As a result of examination, no issues or concerns were identified.

FINANCIAL STATEMENTS

There follows a statement of assets, liabilities, and a statement of income, as of December 31, 2017, together with a reconciliation of capital and surplus for the period under review, as reported by the Company in its 2017 annual statement.

ASSETS

	<u>Assets</u>	<u>Non- admitted Assets</u>	<u>Net Admitted Assets</u>
Bonds	\$247,892		\$247,892
Cash and short-term investments	7,110,225		7,110,225
Investment income due and accrued	1,960		1,960
Deferred premiums; agents' balances and installments deferred and not yet due	1,595,128		1,595,128
Amounts recoverable from reinsurers	689,613		689,613
Net deferred tax asset	59,000		59,000
Total assets	<u>\$9,703,818</u>	<u>\$0</u>	<u>\$9,703,818</u>

LIABILITIES, SURPLUS, AND OTHER FUNDS

Losses		\$1,343,661
<u>Loss adjustment expenses</u>		1,222,216
Commissions payable, contingent commissions and other similar charges		68,606
Taxes, licenses, and fees		15,900
Current federal and foreign income taxes		40,674
Unearned premiums		893,328
Ceded reinsurance premiums payable		2,595,383
Payable to parent, subsidiaries, and affiliates		242,932
Aggregate write-in for liabilities:		
Due to others		<u>550</u>
Total liabilities		6,423,250
Common capital stock	1,000,000	
Surplus notes	280,000	
Gross paid in and contributed surplus	1,381,583	
Unassigned funds (surplus)	<u>618,985</u>	
Surplus as regards policyholders		<u>3,280,568</u>
Totals		<u>\$9,703,818</u>

STATEMENT OF INCOME

UNDERWRITING INCOME

Premiums earned		\$3,224,065
Deductions:		
Losses incurred	\$1,8562,844	
Loss adjustment expenses incurred	1,007,665	
Other underwriting expenses incurred	<u>562,693</u>	
Total underwriting deductions		<u>3,433,202</u>
Net underwriting gain (loss)		(209,137)

INVESTMENT INCOME

Net investment income earned	45,640	
Net realized capital gains (losses)	<u>(173)</u>	
Net investment gain (loss)		45,467

OTHER INCOME

Other Income		
Fee Income	381,050	
Miscellaneous income	<u>1,000</u>	
Total other income		<u>382,050</u>
Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes		218,380
Federal and foreign income taxes incurred		<u>79,074</u>
Net income		<u>\$139,306</u>

CAPITAL AND SURPLUS ACCOUNT

	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>
Surplus as regards policyholders, December 31 prior year	\$3,174,264	\$3,136,331	\$3,121,124	\$2,675,622	\$2,648,280
Net Income	139,306	69,933	50,206	44,502	27,341
Change in net deferred income tax	7,000	8,000	5,000	1,000	
Change in surplus notes	(40,000)	(40,000)	(40,000)	400,000	
Change in surplus as regards policyholders for the year	106,306	37,933	15,206	445,502	27,341
Surplus as regards policyholders, December 31 current year	<u>\$3,280,568</u>	<u>\$3,174,264</u>	<u>\$3,136,329</u>	<u>\$3,121,123</u>	<u>\$2,675,621</u>

ANALYSIS OF CHANGES IN FINANCIAL STATEMENTS

Total Capital and Surplus

\$3,280,568

Total capital and surplus, as established by this examination, is the same as what was reported by the Company in its 2017 Annual Statement. There were no changes made to any asset or liability items as a result of our examination performed as of December 31, 2017.

COMMENTS AND RECOMMENDATIONS

The following list presents a summary of comments and recommendations noted in this report:

Comments

1. As noted in "Agreements with Parent, Subsidiaries, and Affiliates" as of December 31, 2017, the Company did not file its cost sharing agreement timely as required by Tenn. Code Ann. § 56-11-106(a)(2)(D). The Company should have procedures to ensure holding company agreements are approved by the Department timely as required.
2. As noted in "Plan of Operation", the Company had not appointed agents throughout its history, as required by Tenn. Code Ann. § 56-6-115. Subsequent to the examination date, the Company appointed all past and current agents.
3. As noted in "Complaint Handling Practices", the Company did not record all written complaints on its complaint register, as required by Tenn. Code Ann. § 56-8-104(11). As a result, the Company amended its complaint handling policies and procedures.

CONCLUSION

Rules and procedures, as prescribed by the statutes of the State of Tennessee, and the customary insurance examination practices and procedures, as promulgated by the NAIC, have been followed in connection with the verification and valuation of assets and the determination of liabilities of Preferred Auto Insurance Co., Inc.

In such manner, it was found that as of December 31, 2017, the Company had admitted assets of \$9,703,818 and liabilities, exclusive of surplus, of \$6,423,250. Thus, there existed for the additional protection of the policyholders, the amount of \$3,280,568 in the form of common capital stock, surplus notes, gross paid in and contributed surplus, and unassigned funds (surplus). Tenn. Code Ann. §§ 56-2-114 and 56-2-115 require an insurer of this Company's type to maintain a minimum capital of \$1,000,000 and minimum surplus of \$1,000,000. For this examination, as of December 31, 2017, the Company maintains capital and surplus sufficient to satisfy those requirements.

The courteous cooperation of the officers and employees of the Company, extended during the course of the examination, is hereby acknowledged.

In addition to the undersigned, James T. Pearce, Jr. and Jay Uselton, CFE, Insurance Examiners for the State of Tennessee, participated in the work of this examination.

Respectfully submitted,



Don Karnes, CFE
Examiner-in-Charge
State of Tennessee

AFFIDAVIT

The undersigned deposes and says he has duly executed the attached examination report of Preferred Auto Insurance Co., Inc. located in Memphis, Tennessee, dated January 10, 2019, and made as of December 31, 2017, on behalf of the Tennessee Department of Commerce and Insurance. Deponent further says he is familiar with such instrument and the contents thereof, and the facts therein set forth are true to the best of his knowledge, information, and belief.



Don Karnes, CFE
Examiner-in-Charge
State of Tennessee

State Tennessee

County Davidson

Subscribed to and sworn before me

this 28th day of May, 2019

Mindy C. Walker



EXHIBIT B

Preferred Auto Insurance Company, Inc.

June 4, 2019

E. Joy Little
Director of Financial Examinations/Chief Examiner
Tennessee Department of Commerce and Insurance
500 James Robertson Parkway
Nashville, TN 37243-1135

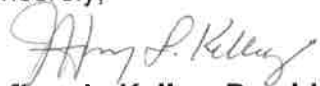
RE: Report of Examination - Preferred Auto Insurance Company, Inc.

Dear Ms. Little:

We hereby acknowledge receipt of the final Report of Examination for **Preferred Auto Insurance Company, Inc.**

By signing below, we indicate acceptance of the report, as transmitted, and without rebuttal.

Sincerely,



Jeffrey L. Kelley, President